ADB

Report and Recommendation of the President to the Board of Directors

Project Number: 51060-002
October 2017

Proposed Programmatic Approach and Policy-Based Loan for Subprogram 1
Armenia: Public Efficiency and Financial Markets Program

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Asian Development Bank

CURRENCY EQUIVALENTS
(as of 7 September 2017)

Currency unit	–	dram (AMD)
AMD1.00	=	$0.0021
$1.00	=	AMD478.31

ABBREVIATIONS

ADB	–	Asian Development Bank
CBA	–	Central Bank of Armenia
EU	–	European Union
GDP	–	gross domestic product
IMF	–	International Monetary Fund
MOF	–	Ministry of Finance
PDMD	–	Public Debt Management Department
PPP	–	public–private partnership
TA	–	technical assistance

GLOSSARY

Asset securitization	–	Process of packaging a pool of illiquid assets and transforming such assets into a marketable security.
Benchmark issue	–	A bond that provides a standard against which the performance of other bonds can be measured. Government bonds are used as benchmark bonds. Benchmark issues are typically used as the basis of yield curves.
Bond switch	–	Two parties agree to respectively switch ownership of two different bonds at an agreed price difference (i.e., for a 5-year–10-year bond switch, party A would buy a 5-year bond from party B who would simultaneously be contractually bound to buy a 10-year bond from party A at agreed prices). Debt managers use switches to build benchmark issues and reduce the liquidity impact of benchmark bonds nearing maturity.
Covered bonds	–	Covered bonds are debt securities issued by a bank or mortgage institution and collateralized against a pool of assets that are subject to specific legislation to protect bond holders. In the case of default, the bondholder can make claims against the issuer.
Financial dollarization	–	Percentage of foreign currency loans in total loans or percentage of foreign currency deposits in total deposits.
Market making	–	Market making is typically required of primary dealers to offer both a buy price and a sell price for the same security.
Money market	–	Market where financial instruments such as treasury bills, corporate notes, and repurchase agreements are used by financial institutions to fund their short-term liquidity requirements, or invest their short-term cash surpluses.

NASDAQ OMX	–	"NASDAQ OMX Armenia" OJSC is the only stock exchange in Armenia, operating for almost 17 years. It provides the Market with a fully automated trading system.
Primary dealers	–	A financial institution that is authorized to deal in new issues of government securities and promote the development of the primary and secondary market activity for such securities.
Regular Treasury Bill Program	–	A program that provides a constant supply of short-term Treasury bills issued by auction on a regular basis (weekly and/or fortnightly) across a range of maturities (one or more of 90, 180, 270, 365 days), and is generally self-funding as the same principal value is issued in each auction.
Repurchase agreement ("repo")	–	A form of short-term borrowing for dealers in government securities. The dealer sells the government securities to investors, usually on an overnight basis, with an agreement to repurchase them at a set term for a set purchase price which includes interest. For the party selling the security (and agreeing to repurchase it in the future), it is a repo; for the party on the other end of the transaction (buying the security and agreeing to sell in the future), it is a reverse repo agreement.
Triparty repo	–	A repo transaction for which post-trade processing—collateral selection, payment and settlement, custody and management during the life of the transaction—is outsourced by the parties to a third-party agent such as custodian banks or a central securities depository.
Yield curve	–	A line that plots the interest rates, at a set point in time, of bonds with equal credit quality but different maturities. A government securities yield curve is used as a benchmark for pricing other debt in the market.

NOTE

In this report, "$" refers to US dollars.

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CONTENTS

PROGRAM AT A GLANCE

1. Basic Data			**Project Number:** 51060-002
Project Name	Public Efficiency and Financial Markets Program, Subprogram 1	**Department /Division**	CWRD/CWPF
Country	Armenia, Republic of	**Executing Agency**	Ministry of Finance (MOF)
Borrower	Republic of Armenia		

2. Sector	**Subsector(s)**	**ADB Financing ($ million)**
✓ **Finance**	Finance sector development	16.67
	Money and capital markets	13.33
Public sector management	Public expenditure and fiscal management	10.00
	Total	**40.00**

3. Strategic Agenda	**Subcomponents**	**Climate Change Information**	
Inclusive economic growth (IEG)	Pillar 1: Economic opportunities, including jobs, created and expanded	Climate Change impact on the Project	Low

4. Drivers of Change	**Components**	**Gender Equity and Mainstreaming**	
Governance and capacity development (GCD)	Institutional development	No gender elements (NGE)	✓
Partnerships (PAR)	Implementation International finance institutions (IFI) Private Sector		
Private sector development (PSD)	Public sector goods and services essential for private sector development		

5. Poverty and SDG Targeting		**Location Impact**	
Geographic Targeting	No	Nation-wide	High
Household Targeting	No		
SDG Targeting	Yes		
SDG Goals	SDG8		

6. Risk Categorization: Low

7. Safeguard Categorization **Environment:** C **Involuntary Resettlement:** C **Indigenous Peoples:** C

8. Financing

Modality and Sources	**Amount ($ million)**
ADB	**40.00**
Sovereign Programmatic Approach Policy-Based Lending (Regular Loan): Ordinary capital resources	40.00
Cofinancing	**0.00**
None	0.00
Counterpart	**0.00**
None	0.00
Total	**40.00**

I. THE PROPOSAL

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

2. The proposed program aims to strengthen fiscal sustainability and support the development of financial markets in Armenia. Sound public debt and fiscal risk management is necessary to ensure that the government's borrowing program is sustainable and that fiscal risks are managed to deliver predictable fiscal outcomes consistent with macroeconomic policies. Well-functioning financial markets are essential to support (i) the expansion of government borrowing in the domestic market and to reduce the government's foreign currency exposure, and (ii) the efficient conduct of monetary policy and to provide suitable mechanisms to address macroeconomic shocks and other financial stability risks. The programmatic approach will support two subprograms for implementation during 2017–2018.[1] A transaction technical assistance (TA) will facilitate program preparation and implementation.[2]

II. THE PROGRAM

A. Rationale

3. **Economic context.** The economic contraction in the Russian Federation continued to be a drag on Armenia's economic performance in 2016, through finance, trade, and remittance channels. Armenia's economic growth slowed substantially to 0.2% in 2016 from 3.2% in 2015. The expansionary fiscal policy to counter the negative pressures stemming from the external environment together with deflationary and weak economic growth, led to widening of the fiscal deficit to 5.5% of gross domestic product (GDP) in 2016 from 4.8% in 2015 and to further debt accumulation to 56.6% of GDP from 48.7% in 2015. This fiscal position and the prevalence of foreign currency public debt pose a significant source of risk exposure of public debt to movements in the exchange rate. Armenia faces the challenge of being fiscally responsible against a backdrop of slowing economic growth and a limited scope of further spending cuts. With the regional slowdown (e.g. Russian Federation) and total public debt exceeding legal limits, the next round of fiscal consolidation will have to be based on domestic revenue mobilization and public spending efficiency.[3]

4. **Development problem.** The current economic slowdown adversely affects the performance of the finance sector and capital market activity. High financial dollarization of both loans and deposits (around 60%), resulting from the aftermath of the global financial crisis in 2009-2010 and exchange rate instability in 2014, limited the mobilization of long-term local currency financing for investment in the economy. The deepening of the domestic financial markets and increased financial intermediation in local currency is, therefore, essential.[4] The core

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[1] The program was initially called Financial Sector Strengthening Program, Subprogram 1, and is included in Asian Development Bank (ADB). 2016. *Country Operations Business Plan: Armenia, 2017–2019.* Manila; and ADB. 2014. *Country Partnership Strategy: Armenia, 2014–2018.* Manila.

[2] ADB provided transaction technical assistance for Support to Public Efficiency and Financial Markets Program (TA 9332-ARM).

[3] When the debt-to-GDP ratio is above 50%, the public debt law stipulates a fiscal rule must be enforced that requires the budget deficit to be reduced as per a specific formula. For 2017, the fiscal rule requires the budget deficit to be reduced by approximately 3% of GDP of its 2016 level.

[4] The deepening of the financial markets is supported by (i) stable macroeconomic policies; (ii) a clear debt management strategy and management program to attract investors; (iii) stable fiscal and monetary policies to tackle

development problem that the program aims to address is rooted in three dimensional interconnected constraints: (i) public debt and fiscal risk management that needs to be more credible, transparent, and effective; (ii) challenges and institutional and infrastructure gaps that constrain the development of Armenia's government securities and money markets; and (iii) the lack of instruments and corporate governance practices that impedes the broadening of the investor base in Armenia's corporate debt markets.

5. **Public debt and fiscal sustainability.** As Armenia moves to a middle-income country, it no longer can access concessional financing easily and increasingly will have to rely on mobilizing debt from capital markets, especially from domestic markets. A transition from external, predominantly concessional, sources of finance to local currency-denominated government securities (currently 20%) is required over the medium term. A prudent and effective debt management policy is needed to ensure that, during this transition, the financing needs of the government continue to be met at a minimum cost, but balanced against the need to develop the domestic debt market and reduce foreign exchange risk exposures. In this regard, fundamental upgrades are necessary. For example, the Debt Management Department of the Ministry of Finance (MOF) has functioned without complete documented procedures and controls, or a risk management framework to manage its operational risk exposures. Security of the information system has also been inadequate to protect the integrity of the data, and systems backup and business continuity arrangements are incomplete.

6. In Armenia, the management of fiscal risk-incurring activities is fragmented across ministries. This leads to the inconsistent treatment of risk exposures and costly inefficiencies in terms of vetting. The absence of a centralized approach to fiscal risk management implies that likely operational losses and contingent liabilities of existing and future fiscal expenditure initiatives are not understood or known, and hence, not well vetted, measured, or monitored by the government. For example, credit risk assessments and the monitoring of government onlending to state-owned enterprises, budgetary lending, and guarantees are inconsistent, not well structured, and fail to price the risk that the government is taking on. The government is increasingly promoting the use of public–private partnerships (PPPs) for the provision of public services and infrastructure. However, there are no well-defined methodologies or procedures to effectively solicit, compare, and vet PPP proposals in terms of costs, quality, and risks. Legal risks also must be considered as PPPs imply future fiscal commitments which should be reflected in the PPP contract structure.[5]

7. **Government securities and financial market infrastructure.** High dollarization is a fundamental constraint to private sector borrowers and the government in terms of access to affordable funding at manageable risk levels. The underdeveloped local currency debt markets also contribute to macroeconomic and financial stability risks.[6] The nascent stage of the government securities market and the lack of instruments and institutional mechanisms for

external shocks and ensure financial stability; (iv) financial infrastructure to support efficient, transparent, and low-risk trading settlement and custody of securities, and availability of suitable financial instruments; (v) strong legal and institutional environment to protect borrowers, creditor, and investor rights, and public disclosure practices; and (vi) sequencing in market development. For example, government securities and money markets support development of the private debt and equity markets. International Monetary Fund (IMF). 2014. *The Development of Local Capital Markets: Rationale and Challenges*. Washington, DC.

5 PPP contracts can have direct liabilities (e.g., fixed payments), contingent liabilities (e.g., payments if a risk occurs), and implicit service delivery risks to the government.

6 Dollarization of bank assets and liabilities exposes banks to foreign exchange and refinancing risks. With limited market activity in local currency, both fiscal and monetary policies have little impact on addressing external macroeconomic shocks and to supporting finance sector stability. The role of the exchange rate remains a core macroeconomic and financial stability concern when external shocks occur.

secured interbank trading also impede a more active money market. The stimulation of financial markets requires the public debt issuance program to be transparent, predictable, and strategic in the maturities targeted and gradually build pricing benchmarks in different debt maturities while stimulating trading activity. Such approach would accommodate the government's financing needs while still keeping currency, interest, and refinancing risks at manageable levels. The appropriate structuring of public debt issuances is important for (i) developing the government securities market, so that it can become more liquid at key tenors; (ii) providing low-risk opportunities for retail investors to buy and sell government securities; and (iii) the creation of market-based pricing and reliable pricing benchmarks for private debt and equity markets to use as reference rates.

8. Armenia's money markets are underdeveloped, illiquid, and do not support the development of active secondary debt markets through which efficient cash and liquidity management could be achieved. Secured interbank trading is shallow, while unsecured trading is minimal as the perceived counterparty risks in the banking sector remain high. Promoting less credit-intensive products such as repurchase agreements ("repos"), and an efficient liquid secondary market for treasury bills will mitigate credit risk and be a step forward for stimulating trading activity in the money market. Development of the repo market is hindered by (i) the short supply of marketable securities qualified as collateral; (ii) the absence of standardized contractual terms; and (iii) manual transaction settlements, which involve high transaction and monitoring costs. Stimulating money market activity is vital to deepen the yield curve and promote capital market development. The Armenian authorities recognize the importance of developing financial markets and have established a steering committee for capital market development and a task force for financial market development. However, the mandate of the two bodies needs to be clarified and coordination mechanisms need to be established to support effective sequencing and direction for financial market development.

9. **Investor base and corporate financial transparency.** There are only a few institutional investors in Armenia, such as pension funds and insurance companies, that invest in the domestic capital market. There is a dearth of domestic retail investors who are able to trade small quantities of shares. This is because of a lack of retail access outside Yerevan and the absence of low-cost internet trading facilities that lower the transaction costs for small-volume trading. More generally, the absence of effective consumer and investor protection also undermines retail investments. Due to historically low corporate transparency, there is a general mistrust in the reliability of companies' audited accounts. This reflects deficiencies in the legal framework for sound corporate governance practices such as financial information transparency and the oversight of accounting and audit practitioners. This makes it difficult for investors to assess the incidence and magnitude of Armenian corporate risk. Weak corporate governance and a lack of complete and reliable financial information on domestic companies dissuade investors from actively participating in private financial markets. Strengthening the legal framework to protect consumers and investors, improving corporate governance, and introducing new types of securities will broaden the investor base and facilitate new investment opportunities for local and foreign investors, and make the finance sector more diversified.

10. **Government's reform agenda.** Armenia's long-term development vision, as articulated in the Armenia Development Strategy, 2025, prioritizes modernizing public administration and governance, and the development of money and capital markets.[7] The Central Bank of Armenia (CBA) is promoting money and capital markets and introducing good international practice to

[7] Government of Armenia. 2014. *Armenia Development Strategy for 2014–2025*. Yerevan.

promote diversification away from the dominance of banks.[8] CBA and MOF have initiated legal, regulatory, and institutional reforms in a wide range of areas. The government will implement an issuance program to promote liquid benchmark securities to establish a reliable local currency yield curve. Complementary reforms will strengthen the primary dealer system to increase trading activity and liquidity.

11. **Programmatic approach**. Fiscal and finance sector reforms require a long-term horizon to ensure sustainability. It is critical that the reforms are identified properly and are well sequenced over subsequent subprograms for effective implementation.[9] A programmatic approach provides the necessary flexibility and facilitates chronological sequencing while explicitly stating the objectives and policy actions. The programmatic approach also allows adjustments to policy action objectives in response to changing realities and exogenous shocks. The program can leverage and help coordinate assistance provided by donors. Under subprogram 1, the program initially concentrates on improving systems, strengthening capacity, and providing an enabling environment under subprogram 1. Subprogram 2 implements these initiatives leading to a more stable and reliable yield curve and a better grasp on fiscal risks.

12. **Development partner coordination.** The program helps coordinate the benefits of different sources of TA for fiscal and finance sector reforms in Armenia. Different aspects in the scope of the program have been closely coordinated with the International Monetary Fund (IMF), the World Bank, the European Bank for Reconstruction and Development, and the European Union (EU) delegation in Armenia. This has ensured that proposed program reforms complement related (past or present) TA initiatives by other development partners, and that each partner's work is considered, integrated, and made part of the policy dialogue. IMF has established a fiscal risk division in MOF and the Asian Development Bank (ADB) program builds the fiscal risk management capacity of MOF and operationalizes the division of responsibilities by risk management functions.[10] The program builds on the European Bank for Reconstruction and Development's ongoing support for developing local currency money markets, and expands the scope of that reform effort through key linkages to public debt management and issuance strategies. The program also leverages the EU's ongoing TA aimed at approximating the legal framework for public debt management operations to EU practices and adds to its TA advisory objectives of promoting the deepening of the domestic financial market.

13. **Lessons.** The program incorporates important lessons from the ongoing policy dialogue and from experience in finance sector and public sector reform programs in other countries, as well as from parallel ADB programmatic engagement in Armenia.[11] Policy reforms must be accompanied by significant government ownership, which in this program are demonstrated by the government's clear reform priorities (supported by its development partners). In addition, setting realistic policy actions is critical to ensure that the reform program can be carried out effectively. The reforms of this program also affect the private sector; hence, broad consultations with the private sector were carried out, helping to refine the policy actions. International lessons for the successful development of local currency financial markets emphasize several crucial factors: (i) sound macroeconomic policies and debt management strategies; (ii) a diversified investor base; (iii) a sound legal framework; and (iv) modern, reliable, and efficient infrastructure.[12] The program addresses all these reform areas to varying degrees.

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[8] CBA. 2014. *Strategy of the Central Bank of Armenia, 2015–2017.* Yerevan.

[9] IMF. 2003. *Managing Risks in Financial Market Development, The Role of Sequencing*. Washington, DC.

[10] IMF. 2017. *Armenia: Article IV Consultation and Fifth and Final Review Under the Extended Arrangement Staff Report*. Washington, DC (17 July 2017).

[11] Development Coordination (accessible from the list of linked documents in Appendix 2).

[12] IMF. 2013. *Local Currency Bond Markets, A Diagnostic Framework*. Washington, DC.

14. **ADB's value addition.** ADB is recognized to be able to mobilize strong expertise in financial market development and public sector management to the benefit of its clients. ADB's track record of engagement in Armenia and other developing countries adds significant value to the proposed programmatic intervention, by (i) enhancing the coordination with development partners during the design and execution of the program, (ii) assisting to jointly conceptualize and implement policy measures with the government, and (iii) mitigating risk-aversion by some policy makers regarding the most challenging reform processes required ahead. The interim assessments that the ADB team used to drive the policy dialog forward—technical and guidance notes that were instrumental in contextualizing policy actions, building ownership, and agreeing on the future direction—also benefited from previous work by other finance sector stakeholders (including development partners). The program is focusing on money and government debt market reforms but it also supports the government's finance sector development agenda, by (i) stimulating the local capital markets, enabling companies and households increased access to local-currency borrowing; and (ii) helping to reduce dollarization and related foreign currency risks of public and private borrowers.

B. Impact and Outcome

15. The program is aligned with the following impact: increased fiscal sustainability and resilience in the finance sector of Armenia by 2020. The program will have the following outcome: increased depth of financial markets in Armenia.[13] Subprogram 1 includes 25 actions (expected compliance by end October 2017), and Subprogram 2 includes 26 actions (expected before end-August 2018).

C. Outputs

16. **Output 1: Strengthened public debt and fiscal risk management policies to enhance fiscal discipline and transparency.** This output will improve the government's debt management practices by strengthening the legal framework, improving analytical capacity of the Public Debt Management Department (PDMD), particularly in its middle-office functions, mitigating system risks, introducing more clarity and transparency in PDMD's internal procedures, operations, and debt issuance decisions, being more transparent on the government's debt management objectives over the medium term, and introducing an operational risk management framework. Subprogram 1 has established (i) procedures to formalize PDMD's role in all debt issuance processes of the government and an action plan to add staff, systems, and resources for an effective performance of crucial risk management functions; (ii) flexibility for PDMD to seize market demand opportunities (i.e., reopening of past Treasury bill issuances); and (iii) the requirement for annual public disclosure of its debt sustainability outlook. Subprogram 2 will evaluate options to further a more holistic approach to debt analysis and reporting in the context of the medium-term debt strategy, and establish both a framework to govern the decision-making process regarding external borrowing and issuance of guarantees (ensuring that cost-at-risk analyses are undertaken), and a manual to regulate decisions and the contracting of external loans. Subprogram 1 helped the government develop a PPP policy (approval is expected by end-October, 2017). Subprogram 2 will establish a new PPP law and help build the necessary capacities and decision processes within the government to promote, vet, manage, and execute PPPs. The program will also strengthen and expand the government's management of PPP-related fiscal risks, within a broad effort to develop the fiscal risk management capacity of MOF. Subprogram 1 established a road map to operationalize the division of responsibilities in MOF by sources of risk and risk-management functions. Subprogram 2 will approve a formal, integrated

[13] The design and monitoring framework is in Appendix 1.

framework for fiscal risk management, and initiate its reporting within the medium-term expenditure framework cycle.

17. **Output 2: Improved government securities market and money-market infrastructure to finance the budget and develop financial markets in dram.** This output will increase trading volumes and liquidity in government securities and support the gradual reduction of foreign currency risk exposures by public and corporate borrowers and lenders. These reforms represent key prerequisites to developing reliable risk-free benchmarks for local currency financial contracts. Subprogram 1 established instruments for a more market development-friendly public debt issuance program and started the implementation of key institutional and technological infrastructure for money markets. Under subprogram 1, MOF initiated the consolidation of debt issuances into benchmark-quality issues through higher issuance limits and organizing the reopening of past issuances. MOF has also increased the frequency of debt auctions by initiating a Regular Treasury Bill Program, which enhances liquidity and price discovery. The Regular Treasury Bill Program, with a constant supply of short-term Treasury bills issued in sufficient volume, will increase depth in short tenors and the frequency of pricing points in the risk-free benchmark curve.[14] A streamlined Regular Treasury Bill Program and more effective repos will promote the active and efficient use of Treasury bills and repos for cash and liquidity management. Subprogram 2 will establish a clear policy on its bond buyback and switch operations to increase market's understanding of PDMD's debt management strategy and operational objectives. A more effective primary dealers' system was established in subprogram 1, with market-making responsibilities to promote price discovery and liquidity in the government securities market. Access to public debt issuance for retail investors has been enhanced using mobile technology.

18. This output will also enhance money market infrastructure and secured transactions. Subprogram 1 established the legal framework for secured interbank transactions by passing a number of key legal amendments pertaining to derivatives and repo instruments, insolvency, civil procedures, arbitration, and tax incentives.[15] Further work will be done on secondary regulation and supporting trading systems by introducing standard repo documentation based on the General Masters Repos Agreement as well as put in place an electronic settlement system for repos and a derivatives repository. Subprogram 1 introduced in the policy dialogue the need to gradually reduce foreign currency risk exposures in public debt issuance by focusing on domestic debt issuance in the medium-term public debt strategy. A dedicated working group has been established to investigate options, and subprogram 2 will produce conclusions on how to accelerate this transition.

19. **Output 3: Broadened base of instruments and investors, and enhanced corporate transparency to increase mobilization of private investment.** This output will strengthen the legal and regulatory framework for new instruments and for corporate transparency in Armenia to

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[14] Under the Regular Treasury Bill Program, 91-, 180-, and 365-day Treasury bills are issued in regular fixed volumes, which provide investors with a regular supply of short-term Treasury bills in sufficient volumes to meet demand for a short-term, low-risk liquid instrument and support the secondary market.

[15] A number of key legal amendments were passed to ensure that derivatives and repo instruments (i) are properly defined in law (amendment to Law on Securities Market, e.g., specifying the difference and the requirements for standardized and OTC derivatives); (ii) benefit from indisputable enforceability (amendments to laws on insolvency provided for, e.g., effective operation of close-out netting in insolvency; amendments to the civil code lifted such requirements as notarization, notice, etc.; amendments to the Law on Arbitration facilitated the enforcement of arbitral awards as well as interim measures); (iii) can be under foreign law and arbitration (amendments to Law on Securities Markets provided for local parties to choose the applicable law in the case of standardized derivatives contracts, i.e., International Swaps and Derivatives Association MA and ICMA General Masters Repos Agreement). Also, tax incentives were approved to incentivize filing with the Derivatives Trade Repository (e.g., losses from derivative transactions will only be deductible if the transaction was duly reported to the Derivatives Trade Repository).

encourage more active investors and issuers, and develop the capital markets. Under subprogram 1, the CBA submitted to the Parliament a Residential Mortgage Lending Law draft and amendments to the Covered Bonds Law. Under subprogram 2, the amendments will be approved by the Parliament and the CBA will propose amendments to the Securitization Law to clarify the nature and attributes of new investment instruments. To increase resource mobilization using private equity funds, subprogram 1 supported regulatory changes to enable private equity investment vehicles to have their subscribed capital denominated in US dollars.[16] Under subprogram 2, the government will introduce elements of modern corporate law such as the concept of a shareholder's agreement. Stronger corporate transparency practices and availability of complete and reliable financial information on domestic companies through these policy actions will likely attract investors and channel savings to companies that need capital to grow and generate jobs. To strengthen accounting and auditing practices, under subprogram 1, MOF initiated legal reforms to progressively increase accounting standards and external audit requirements for private companies. Under subprogram 2, these audit reforms will be further advanced by including the establishment of a public oversight board with regulatory and oversight functions on audit.

D. Investment and Financing Plans

20. Low economic growth, deflation, and expansionary fiscal policy put pressure on the government budget in 2016, causing the budget deficit to widen to 5.5% of GDP from 4.8% in 2015. Higher borrowing for infrastructure development and financing the budget deficit raised the ratio of public debt to 56.6% of GDP at the end of 2016 from 48.7% a year earlier. External public debt increased to 45.8% of GDP from 41.4% in 2015, while domestic debt rose to 10.8% from 7.3% in 2016. To reduce debt-related vulnerabilities and contain fiscal risks, the government envisages significant fiscal consolidation in 2017, mainly through cuts in capital spending and measures to contain public wages and pensions. With public debt exceeding the legal limit of 50% of GDP, Armenia's fiscal rule requires the government to reduce the budget deficit from 5.5% in 2016 to 2.8% in 2017. Over the medium term, the budget deficit is expected to narrow to 2.7% of GDP in 2018 and to 2.4% of GDP in 2019.

21. The government has requested a loan of $40 million from ADB's ordinary capital resources (OCR) to help finance subprogram 1. The loan amount reflects the government's financing needs, and the strength and development impact of the proposed policy reforms. The loan will have a 15-year term including a 3-year grace period, (e.g. annuity method based on 10% discount factor, straight line, etc.), an annual interest rate determined in accordance with ADB's London interbank offered rate (LIBOR)-based loan lending facility, a commitment charge of 0.15% per year, and such other terms and conditions as will be set forth in the OCR loan agreement. Based on this, the average loan maturity is 9.25 years and there is no maturity premium payable to ADB. The closing date of the loan is 31 December 2017. The loan will be disbursed in a single tranche.

[16] In December 2016, the CBA adopted an official interpretation that allows nonpublic contractual funds that have registered through a special NASDAQ OMX platform to denominate their fund units in freely convertible currencies. The policy rationale behind this was twofold: (i) even though ultimate corporate investments of these funds are in Armenia and in dram, interested investors still prefer the use of conduits in legal jurisdictions with strong investor protection that can flexibly process dividends and payments on freely convertible currencies; and (ii) nonpublic funds do not attract funds from the general public, so the foreign exchange risks in these contractual funds are more manageable to the type of investors targeted and will have no systemic impact in the Armenian economy. Further, only contractual funds may benefit from this regulation, since all corporate entities, including corporate funds, are prohibited from attracting capital in any currency except dram.

22. The loan size is justified considering the government's development expenditure and financing needs spread over 2017—2019 (Table 1). The government's financing needs in 2017 are projected to be $561.7 million with overall already-secured financing at $367.1 million. The financing gap (i.e., the difference between financing needs, excluding domestic debt and available financing) is expected to be $194.6 or 1.7% of GDP in 2017, which will be financed partly through subprogram 1. The expected amount for Subprogram 2 is $50 million.

Table 1: Armenia State Budget Financing Gap for 2017–2019 (Projected)

Item	**Amount 2017** ($ million)	**Amount 2018** ($ million)	**Amount 2019** ($ million)	**GDP 2017** (%)	**GDP 2018** (%)	**GDP 2019** (%)
1. Revenues and grants[a]	2,545.4	2,847.3	3,133.6	22.4	23.4	23.5
2. Expenditure	2,861.2	3,177.3	3,453.8	25.2	26.1	25.9
3. Overall fiscal balance (=1–2)	(315.8)	(330.0)	(320.2)	(2.8)	(2.7)	(2.4)
4. Debt repayment[b]	586.5	678.2	723.5	5.2	5.6	5.4
5. Financing needs (excluding domestic debt)	561.7	636.1	667.0	4.9	5.2	5.0
6. Financing	367.1	487.6	478.2	3.2	4.0	3.6
7. Financing gap (=5–6)	194.6	148.5	188.9	1.7	1.2	1.4

( ) = negative.
Notes: GDP for 2017 = $11,370.3 million; 2018 = $12,171.0 million; and 2019 = $13,339.6 million. $1 = AMD475.40.
[a] Excluding proposed Asian Development Bank loan.
[b] Includes external and domestic debt repayment of $245.9 million and $340.6 million respectively in 2017; $306.1 million and $372.1 million respectively in 2018; and $346.9 million and $ 376.6 million respectively in 2019.
Sources: The Government of the Republic of Armenia. State Budget. http://www.gov.am/en/budget/; Government of Armenia. 2017. Medium-Term Expenditure Framework 2018–2020. Yerevan.

E. Implementation Arrangements

23. MOF will be the executing agency. CBA and MOF will be implementing agencies in their respective reforms in each output (see policy matrix). MOF has been the executing agency in prior program loans. Both MOF and CBA have a well-established track record of implementing reform programs with ADB, the World Bank, and the IMF. The implementation period for subprogram 1 is from October 2016 to October 2017 and for subprogram 2 from November 2017 to October 2018.

III. DUE DILIGENCE

A. Economic and Financial

24. Empirical research documents that efforts to develop financial systems support long-run economic growth. In addition, the program supports reforms that produce sizable direct financial benefits. These benefits assume continuity in the reforms and are expected to well exceed the program's cost (e.g. benefits from lower funding costs, improved efficiencies in public debt management, and the improved mitigation of fiscal risk exposures and finance sector risks.[17]

[17] Development Coordination (accessible from the list of linked documents in Appendix 2).

B. Governance

25. The government has been reforming its public financial management system through the introduction of program budgeting. The full rollout of program budgeting will improve expenditure priorities, enhance public financial management efficiency, and enhance the assessment of expenditure results against policy objectives. The full rollout is expected to be completed in time for the 2019 budget. Though this will be a significant achievement, the public expenditure and financial accountability assessment identified weaknesses in fiscal discipline, allocation of resources, and cost-effective service delivery.[18] In 2011, procurement was decentralized to line agencies to improve procurement effectiveness by aligning procurement processes to specific needs, increasing transparency, which, in turn, should lead to better procurement outcomes. MOF still has an oversight role, and has introduced additional reforms such as establishing a procurement appeals council, and publishing all information related to procurement, including procurement contracts. The government's Anticorruption Council is responsible for setting anticorruption policies, leading investigations, and imposing remedies. However, the Anticorruption Council appears ineffective as it does not meet regularly and has not produced significant recommendations for reform.

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

C. Poverty and Social

27. The program is expected to contribute indirectly to poverty reduction as policy reforms are expected to have indirect medium- and long-term impacts on poverty, mainly through improved finance sector stability, stronger resilience against external shocks, and higher economic growth and employment opportunities. Program reforms will help (i) strengthen public debt and fiscal risk management and support the government's fiscal consolidation efforts, which will create fiscal space for public spending on priority sectors; (ii) improve financial market infrastructure, which supports the government's objective of generating additional investment opportunities in the economy and, thus, achieving sustainable economic growth; and (iii) enhance the investor base and corporate transparency, laying the foundations of corporate market development and, thus, reorienting the economy toward investment-driven activities. The proposed reforms will also create the necessary preconditions for improving the country's competitiveness and promoting long-term inclusive growth.

D. Safeguards

28. In line with ADB's Safeguard Policy Statement (2009), the program is classified as category C for impacts on the environment, involuntary resettlement, and indigenous peoples.

E. Risks and Mitigating Measures

29. Major risks and mitigating measures in the risk assessment and risk management plan are summarized in Table 2.[19]

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[18] Public Expenditure Financial Accountability Secretariat. 2014. *Public Expenditure and Financial Accountability Assessment Report 2013: Republic of Armenia.* Washington, DC.

[19] Risk Assessment and Risk Management Plan (accessible from the list of linked documents in Appendix 2).

Table 2: Summary of Major Risks and Mitigating Measures

Risk description	Rating	Mitigation Measures	Responsibility
External shocks trigger financial instability and increased demand for dollar assets or liabilities.	High	Economic growth is projected to increase over the life of the program, and external risks are moderating as the Russian economy rebounds. The new government intends to implement reforms to make the economy more resilient, including through this program, by increasing the depth of the government's domestic debt program and reducing foreign exchange borrowing.	Ministry of Finance
Fiscal instability and foreign currency debt servicing affect efforts to stabilize the domestic debt issuance program.	Substantial	The government is reducing expenditure to reduce the fiscal deficit. A new tax code introduced in late 2016 is broadening the tax base and increasing revenues. The new government also wants to transition to issuing more dram debt to reduce foreign currency risks, which can have a fiscal impact.	Ministry of Finance

ADB = Asian Development Bank, PDMD = Public Debt Management Department, TA = technical assistance.
Source: Asian Development Bank.

IV. ASSURANCES

30. The Government of Armenia and MOF have assured ADB that implementation of the program shall conform to all applicable ADB policies including those concerning anticorruption measures, safeguards, gender, procurement, consulting services, and disbursement as described in detail in the draft loan agreement. Policy actions 7 and 8 under Subprogram 1 (both PPP-related) remained outstanding at the date of loan negotiations. These were included as conditions for effectiveness under the loan, as it is not certain they can be achieved before board consideration.

V. RECOMMENDATION

31. I am satisfied that the proposed programmatic approach and policy-based loan would comply with the Articles of Agreement of the Asian Development Bank (ADB) and recommend that the Board approve

(i) the programmatic approach for the Public Efficiency and Financial Markets Program, and

(ii) the loan in an amount of $40,000,000 to Armenia for subprogram 1 of the Public Efficiency and Financial Markets Program, from ADB's ordinary capital resources, in regular terms, with interest to be determined in accordance with ADB's London interbank offered rate (LIBOR)-based lending facility; for a term of 15 years, including a grace period of 3 years; and such other terms and conditions as are substantially in accordance with those set forth in the draft loan agreement presented to the Board.

Takehiko Nakao
President

3 October 2017

DESIGN AND MONITORING FRAMEWORK

Impact the Program is Aligned with
Fiscal sustainability and resilience in the finance sector increased (measured by the Financial Sector Development Index) by 2020[a]

Results Chain	Performance Indicators with Targets and Baselines[b]	Data Sources and Reporting Mechanisms	Risks
Outcome Depth of financial markets increased	By 2020: 1. Percentage of domestic securities in total public debt outstanding increased to 30% (2016 baseline: 20%). 2. Turnover ratio in government bonds increased by 100% (2016 baseline: 4.17%.	CBA, MOF	External shocks trigger financial instability and new dollarization sprees.
Outputs 1. Public debt and fiscal risk management policies strengthened	1a. MOF issuing procedures for (i) issuing Eurobonds, (ii) contracting external loans, and (iii) enacting payments for domestic and external debts by December 2018 (subprogram 2; 2017 baseline: None). 1b. Government approved framework to (i) identify, vet, and prepare PPPs (based on risk profiling, fiscal affordability, and financial viability); (ii) govern unsolicited proposals; and (iii) monitor the operational performance of each PPP on the basis of guidelines developed by December 2018 (subprogram 2; 2017 baseline: 0).	1a. MOF decrees 1b. MEDI decrees	Fiscal instability and foreign currency debt-servicing affect efforts to stabilize the domestic debt issuance program.
2. Government's securities market and money-market infrastructure improved	2a. Number of government securities auctions held by public debt management department increased to 10 per year by December 2017 (2016 baseline: 8 auctions per year). 2b. Legal amendments for secured interbank lending based on standardized repos approved by Parliament by December 2017 (2016 baseline: Not approved).	2a. MOF decree 2b. Revised law on government website	

Results Chain	Performance Indicators with Targets and Baselines[b]	Data Sources and Reporting Mechanisms	Risks
3. Base of instruments and investors broadened, and corporate transparency enhanced	3a. Law for Residential Mortgage Lending and amendments to the Covered Bonds Law submitted to the government for its consideration by December 2017 (2016 baseline: None). 3b. Legislative reforms, which make it mandatory for large firms to be externally audited, submitted to Parliament by December 2018 (subprogram 2; 2017 baseline: None).	3a. CBA decree 3b. Government decree	The new government and Parliament do not prioritize these reforms.

Key Activities with Milestones
Not applicable
Inputs
Asian Development Bank: $40 million loan (ordinary capital resources)
Assumptions for Partner Financing
Not applicable

CBA = Central Bank of Armenia, MOF = Ministry of Finance, MEDI = Ministry of Economic Development and Investments, PPP = public–private partnership.

[a] Government of Armenia. 2014. *Armenia Development Strategy for 2014–2025*. Yerevan.

Source: Asian Development Bank.

LIST OF LINKED DOCUMENTS
http://www.adb.org/Documents/RRPs/?id=51060-002-3

1. Loan Agreement
2. Sector Assessment (Summary): Finance and Public Sector Management
3. Contribution to the ADB Results Framework
4. Development Coordination
5. Economic and Financial Analysis
6. Country Economic Indicators
7. International Monetary Fund Assessment Letter
8. Summary Poverty Reduction and Social Strategy
9. Risk Assessment and Risk Management Plan
10. List of Ineligible Items

DEVELOPMENT POLICY LETTER

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MINISTRY OF FINANCE OF THE
REPUBLIC OF ARMENIA
MINISTER

МИНИСТЕРСТВО ФИНАНСОВ
РЕСПУБЛИКИ АРМЕНИЯ
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№ 5-2/13918-17
«01» 08 2017р.

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

Subject: Public Efficiency and Financial Markets Program – Subprogram 1

Dear President Nakao,

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

This letter outlines Armenia's recent economic developments; highlights the RA Government commitment to reforms needed for reducing macro-financial vulnerabilities and raising economic growth prospects; and provides information on how the proposed Public Efficiency and Financial Markets program contributes towards the strengthening of fiscal sustainability and deepening of financial markets through reforms in the areas of public debt and fiscal risk management, and financial and corporate markets development.

A. Armenia's economic performance

With unfavorable external conditions and subdued domestic demand, economic growth slowed sharply to 0.2% in 2016 from 3.2% in 2015. On the supply side, declines in agriculture and construction were the main causes for the slowdown, while services, manufacturing and mining expanded. On the demand side, growth came mainly from a further narrowing of the deficit in net exports of goods and services. Private consumption decreased by 1.2%, reflecting weak household spending. Public consumption grew by 4.1% due to an expansionary fiscal policy geared toward supporting growth.

Weak aggregate demand and lower commodity prices caused consumer prices to decline by 1.1% month-on-month in December 2016 and further suppressed growth. The Central Bank of Armenia (CBA) pursued expansionary monetary policy by gradually reducing the policy rate from 8.75% in December 2015 to 6.00% in February 2017 to maintain price stability.

The weaker-than-expected economic growth, deflation, and expansionary fiscal policy caused the deficit to widen further to 5.5% of gross domestic product (GDP) from 4.8% in 2015 and 1.9% in 2014. The higher budget deficit pushed public debt to 56.6% of GDP at the end of 2016 from 48.7% a year earlier. External public debt increased to 45.8% of GDP from 41.4% in 2015, while domestic debt rose to 10.8%, up by 3.5%. According to the Debt Sustainability Assessment, while public debt remains sustainable, risks are elevated.

With the debt-to-GDP ratio has edged up, fiscal consolidation as required by the RA Law "On Public Debt" is a key objective. We remain committed to meeting the budget deficit target of 2.8% of GDP in 2017 to ensure debt sustainability, rebuild fiscal buffers and put public finances on a sustainable footing.

Growth-friendly fiscal consolidation is necessary to put the public debt ratio on downward trajectory. To ensure long-term fiscal sustainability and foster sustained and inclusive growth, we have initiated wide-ranging macroeconomic and structural reforms, aimed at increasing the efficiency of public spending, improving governance and transparency, enhancing revenue mobilization and supporting private sector development.

Economic activity is picking up and the outlook is more positive for 2017. We expect economic growth of at least 3.3% on the back of continued recovery in domestic and external demand. The economy grew by 6.5% in the first quarter of 2017 compared to 4.7% in the same period in 2016 mainly due to the growth of services (including trade) and industry. Growth in services accelerated to 5.3% in the first quarter of 2017 (versus 3.4% a year earlier) mainly due to the growth of financial and insurance activities, trade, culture, entertainment and recreation. Industry grew by 12.4% (versus 8.9% in the first quarter of 2016), due to strong expansion in manufacturing and electricity. While growth in industry and services accelerated, construction and agriculture declined by 9.6% and 3.8% correspondingly.

Fiscal consolidation remains on track. Higher than expected revenues in the first quarter, allowed the RA Government to increase the capital expenditure in the 2017 state budget by 50 billion drams ($103 million).

B. Development Strategy

In 2014, we approved a new Armenia Development Strategy 2025 to guide our efforts to ensure sustainable growth. The main goal of the Armenia Development Strategy is to create more high-productivity jobs through reforms to: (i) further improve the business environment, (ii) deepen the financial sector; (iii) further develop industry and export-promotion institutions; (iv) improve labor market conditions; (v) upgrade and develop infrastructure in water, irrigation, transport, and electricity; (vii) promote human capital development through better education and healthcare; (viii) strengthen social protection through a new pension system and other forms of assistance; and (ix) modernize public administration and governance, including by improving efficiency and transparency of decision-making and civil society participation.

The main directions and strategic priorities of our reform, with diagnostic analysis and detailed measures and actions, are reflected in the RA Government program for 2017-2022.

The strategic directions developed by the CBA are to develop money and capital markets, and to introduce international practices to promote economic diversification and growth. The CBA and the RA Ministry of Finance are initiating several reforms in the financial sector covering legal, regulatory, and institutional development in what constitutes a wide reform program.

C. Public Finance

Substantial progress has been made by the RA Government in improving its public finance management systems and practices over the past years, as evidenced by various reviews, including the 2014 PEFA assessment.

We continue to be fully committed to improving public financial management practices, including reducing systemic risks, strengthening public debt and fiscal risk management practices, and improving sustainability, transparency and predictability in our public finances.

In the coming years, our fiscal policy will boost economic growth and gradually increase the growth potential in the economy. In the medium-term, fiscal policy will focus on reducing debt which is the most important precondition to assure a sustainable macroeconomic environment to support economic growth.

To achieve the above-mentioned objectives the RA Government program for 2017-2022, envisages the following public finance actions:

a) *To boost economic growth potential and ensure macroeconomic stability, the RA Government plans to:*
   i) Improve public debt management and assure public debt sustainability by:
      - introducing in 2017 a viable system of assessing the behavior of primary market participants in government treasury bonds;
      - introducing new fiscal rules in 2018 that will stabilize debt and not hinder economic growth.
   ii) Introduce a new toolkit in 2019 to comprehensively assess the impact of fiscal policy on the economy;
   iii) Design a budgetary framework in 2022 for the medium-term perspective, which plans to gradualy increase capital expenditures, possibly moderating current expenditures and increasing the efficiency of public expenditure to ensure social needs are met.

b) *To improve regulation of private sector accounting and external audit, the RA Government plans to develop a legislative package in 2018, and a sub-legislation in 2019 to implement the new accounting and auditing legal framework.*

c) *To raise the efficiency of public finance management system the RA Government plans:*

i) To expand the scope of clients using e-procurement system to increase the level of efficiency and transparency in public procurement as well as to increase competitiveness. Specifically:

- by the end of 2017 introduce the e-auction system for procurement;
- by the end of 2018 harmonize the e-procurement system with modern standards for e-management systems.
- by the end of 2018, transfer to e-procurement system the SNCOs, which have organized competitive bidding with a budget exceeding AMD 200 mln;
- by the end of 2019, transfer to e-procurement system the communities, which have organized competitive bidding with a budget exceeding AMD 200 mln;
- by the end of 2020, transfer to e-procurement system community non-commercial organizations and organizations with more than 50% of community shares, which have organized competitive bidding with a budget exceeding AMD 200 mln.

ii) To strengthen the "value for money" principle and introduce an efficient toolkit for public accountability, shift to quantitative and qualitative result based indicators for programs, financed from the state budget. Specifically:
- complete the formulation of methodological base for program budgeting in 2017;
- prepare the 2019 and out-years budgets and submit to the RA Parliament in the program budgeting format.

d) *To develop the financial markets and introduce a long-term pension savings, the RA Government will jointly undertake steps with the CBA to streamline the accumulated funds into the real sector of the economy. This will stimulate the economy and increase investment. The RA Government will do this by:*

i) developing a capital market development program that will promote issuance of shares and bonds by local companies in conjunction with the CBA in 2018;
ii) increase the accessibility of financial services by implementing necessary legal regulations in conjunction with the CBA in 2019;
iii) expand the pension system and develop a medium-term development program for the insurance market that will aim at introducing new insurance toolkits and life insurance system, in conjunction with the CBA in 2020.

D. Financial and Capital Markets

We believe that well-functioning financial and capital markets are essential for economic growth and job creation. The RA Ministry of Finance and the CBA recognize the macroeconomic and financial risks associated with high levels of financial dollarization and the underdevelopment of local currency money and capital markets. The RA Ministry of Finance and the CBA, with support from European Bank for Reconstruction and Development (EBRD) are implementing reforms that would reduce dollarization and increase the capacity of local capital markets to engage in intermediate finance and to reduce systemic risks. The activities include, but are not limited to, the following:

(i) Developing the secured and unsecured interbank markets;
(ii) Adjusting the legal framework as required and otherwise supporting development of the derivatives market (including an interbank foreign exchange swaps, forwards, options, etc.);
(iii) Developing appropriate interest rate benchmarks and interest rate risk management tools;
(iv) Establishing a link between the Central Depository of Armenia and one of the European depositories to facilitate foreign investors' access to the Armenian capital market, and exploring the consolidation of trading and settlement infrastructure within Armenia;
(v) Addressing any barriers to local banks' issuing bonds in Armenian dram, and assisting the banks to develop corporate bond market strategies;
(vi) Supporting practitioner-based educational campaigns for local companies and underwriters on the issuance of financial instruments;
(vii) Supporting the improvement of financial legal and regulatory environment; and
(viii) Supporting the formation of, and participating in, a capital markets development steering committee and/or working group.

E. Donor assistance

We have been working closely with all partners, including ADB, to mobilize resources enabling us to implement our reform agenda. The proposed new program – the Public Efficiency and Capital Market Program complements and builds on efforts by other donors in the areas of i) public debt and fiscal risk management; ii) government securities market and money market infrastructure; and iii) corporate governance.

E. Our Request to ADB

Dear President Nakao,

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

The program will help us (i) strengthen public debt and fiscal risk management and support our fiscal consolidation efforts, by reducing fiscal and financial risks in the economy (ii) increase money market liquidity and financial market transparency, by deepening the government securities market and improving the money market infrastructure (iii) foster the development of a vibrant private sector, by enhancing corporate transparency and developing and strengthening legislative and regulatory framework. To help financing the program, we request that ADB provide a loan from its Ordinary Capital Resources in the amount of $90 million equivalent. Of this amount, we would request that $40 million equivalent be disbursed upon effectiveness of the appropriate Loan Agreement and after completion of the Subprogram 1 Policy actions with the balance of $50 million equivalent to be disbursed after completion of the Subprogram 2 Policy actions.

The proposed technical assistance grant of $500,000 to support the program will help the government ensure effective and timely implementation of the subprogram 1 policy actions.

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

Sincerely Yours,

Vardan Aramyan

POLICY MATRIX

Policy Objectives	Policy Actions Subprogram 1 (by October 2017)	Compliance Documents	Policy Actions Subprogram 2 Indicative (by August 2018)
Improve management of public debt	1. Ministry of Finance (MOF) strengthens the Public Debt Management Department (PDMD) by: (i) introducing procedures on (a) issuance of Eurobonds; (b) payment procedures for the external and domestic debt, and (c) mapping links between PDMD's databases, the analytical tools used, and the reporting requirements; (ii) engaging PDMD front office in the end to end external borrowing process and negotiations.	MOF decree which includes PDMD procedures flow charts. MOF Letter which describes PDMD's engagement in the borrowing process and negotiations.	1. MOF: (i) studies the costs and benefits of expanding PDMD's role within MOF; (ii) centralizes analysis and reporting of existing government debt within PDMD to ensure a holistic and consistent approach within the context of the medium-term debt strategy (MTDS).
			2. MOF approves a manual for contracting and negotiating external loans, and a framework for evaluating the cost-effectiveness of alternative forms of external borrowing and guarantees, i.e. the cost-at-risk analysis to enhance the MTDS process.
	2. Government approves revisions to the regulatory framework for government securities to allow reopening of T-bill issuance and improve the settlement system.	Government decree detailing revisions to regulatory framework on government securities.	3. Government submits legislative amendments to the Parliament on the Law on Public Debt and, if required, on the Laws on International

Policy Objectives	Policy Actions Subprogram 1 (by October 2017)	Compliance Documents	Policy Actions Subprogram 2 Indicative (by August 2018)
			Treaties, Treasury Systems, and Budget Systems with any necessary implementing regulations to strengthen the role of MOF in the external lending process.
	3. MOF issues a decree that a Debt Sustainability Analysis will be undertaken each year and be published annually.	MOF Decree	4. MOF publishes the 2017 annual Debt Sustainability Analysis on its website.
	4. MOF issues a Decree approving an action plan to: (i) enhance PDMD's risk management capacity by considering the staff, systems and financial resources that would be required to identify and quantify risks associated with public debt management; and (ii) provide monitoring and regular reporting on PDMD risks.	MOF decree which includes approved action plan providing details of the matters specified in items (i) and (ii) of the policy action.	5. MOF adopts a formal Operational Risk Management framework for PDMD which includes a risk matrix that (i) identifies risks and the impact of those risks on outputs and assesses financial loss and the budget impact, and (ii) provide monitoring and regular reporting on PDMD risks.
	5. MOF increases security and backup of all debt records to prevent unauthorized changes to debt records by appointing a systems administrator for DMFAS and approving rules and procedures for: (i) access to DMFAS system; (ii) monitoring system security; and (iii) regular backup arrangements.	MOF decree which includes the appointment of the systems administrator for DMFAS and approved rules and procedures covering items (i) to (iii) related to security arrangements for DMFAS.	6. MOF approves a Business Continuity Plan (BCP) which includes establishing a secure offsite premise, and backup of records on the debt management and financial analysis system and spreadsheets with a capacity building plan.
Increase monitoring of fiscal risks including from PPP projects	6. MOF submits to ADB a roadmap for the division of fiscal risk management responsibilities to	MOF Order which includes the roadmap for the division of fiscal risk management	7. MOF approves and publishes a framework for vetting, monitoring and evaluating

Policy Objectives	Policy Actions Subprogram 1 (by October 2017)	Compliance Documents	Policy Actions Subprogram 2 Indicative (by August 2018)
	cover—budgetary lending, concessions, PPPs including contingent liabilities, guarantees and other; as well as the different functions of risk management (e.g. vetting, risk monitoring and reporting) to be implemented during subprogram 2.	responsibilities covering the items specified in the policy action.	budgetary lending operations and guarantees *(ADB TA)*.
			8. MOF presents in the 2019-2021 MTEF a summary of budgetary lending operations under the recently approved budgetary lending framework.
	7. Government approves a PPP policy (paper) that defines the policy approaches to legislative, regulatory and institutional frameworks to: (i) govern the identification, vetting, and preparation of public-private partnerships (PPPs) based on risk profiling, fiscal affordability, and financial viability; (ii) govern unsolicited proposals; (iii) monitor the performance of each PPP.	Government decree approving the PPP policy and a copy of the approved PPP policy	9. Government submits to the Parliament the draft PPP law for approval, based on the PPP Policy (paper).
	8. The PPP Policy or a subsequent government decision to determine the resources that are required for the functions based on PPP policy (irrespective of where it will be located) to be adequately	Government decree approving the PPP policy and a copy of the approved PPP policy	10. Government's designated agency implements standard methodologies including guidelines and/or manuals to cover (i) the identification, vetting, and preparation of PPPs based on risk profiling,

Policy Objectives	Policy Actions Subprogram 1 (by October 2017)	Compliance Documents	Policy Actions Subprogram 2 Indicative (by August 2018)
	operated under the prospective framework.		fiscal affordability, and financial viability; (ii) unsolicited proposals and procurement with sole bidders; and (iii) monitoring performance of each PPP; This includes implementing value for money tests in the vetting process based on the public sector comparator, and with or without viability gap financing; and (iv) sector specific public sector comparator benchmarks.
	9. Ministry of Economy and Investment publish, in its website, standard information about all past PPPs including concessions transactions.	Letter from MOEI informing of details on the MOEI website containing the information.	
Develop a medium-term capital market development strategy	10. MOF and CBA by MOU establish a working plan for the Steering Committee for Capital Markets and the recently-established Task Force for Financial Markets Development to develop a time-bound roadmap for Capital/ Financial Markets Development	MOU between MOF and CBA which includes working plan.	11. MOF and CBA approve the time bound road map for the medium-term development of capital and financial markets in the country.
Improve public access to government retail debt	11. MOF establishes an electronic sales system for retail debt via the internet in line with international good practices.	Letter from MOF providing details of the establishment of the electronic sales system for retail debt including a link to website.	12. A reporting framework of retail debt issuance and redemption is implemented and available on the MOF website.
Expansion in the domestic debt	12. PDMD establish a Working Group with terms of reference to: (i)	MOF decree which includes composition of working group	13. Working Group Report is approved and adopted by MOF

Policy Objectives	Policy Actions Subprogram 1 (by October 2017)	Compliance Documents	Policy Actions Subprogram 2 Indicative (by August 2018)
program to reduce foreign currency risk exposure.	investigate the costs and benefits of accelerating the transition from external debt issuance to domestic debt issuance; (ii) identify a framework for this analysis to be undertaken regularly within the MTDS framework; and (iii) investigate how the transition to domestic debt may be structured to minimize foreign exchange volatility.	with terms of reference covering the matters specified in items (i) to (iii) of the policy action.	with an action plan which includes: (i) how the analysis should be undertaken within the MTDS framework; (ii) how the findings will be reported and published.; and (iii) PDMD, in consultation with CBA, publish an internal paper on the potential exchange rate impact and mitigation strategy when external debt is repaid and funded domestically.
Developing government securities market	13. MOF approves a revised framework for Primary dealers (PDs) that includes; (i) market making responsibilities with a maximum ceiling on bid-ask spreads; (ii) evaluation criteria orientated around an appointment process that reflects a PD's contribution to developing the government secondary market and (iii) recognition of the need to rotate PDs with other market participants.	MOF decree showing the revised framework.	14. MOF implements the new governing framework for PDs.
	14. MOF: (i) increase the bond issuance ceiling to AMD200 billion; and (ii) consult investors on increasing the domestic bond auctions from 8 times a year to monthly to provide more price discovery around the yield curve and increased access to the	MOF Letter and copy of relevant public announcement.	

Policy Objectives	Policy Actions Subprogram 1 (by October 2017)	Compliance Documents	Policy Actions Subprogram 2 Indicative (by August 2018)
	supply of bonds and distribute the interest rate risk evenly over 12 months.		
Improve liquidity in the Money Market	15. MOF supports further development of the short-term money market by (i) initiating amendments in the regulations to organize reopening for T-bills to consolidate the issuance to enhance liquidity: and (ii) develop and start a Regular Treasury Bill Program (RTBP). (Under a RTBP 91, 182, 273 and 365 bills are issued in regular fixed volumes which provide investors with a certain supply of short term T-Bills in sufficient volumes to meet demand for a short term low risk liquid instrument and support the secondary market.)	MOF decree with regulations and details of the RTBP plan.	15. MOF reviews the implementation of the RTBP with maturities and volumes consistent with the feedback from the. market and aligned to monetary and debt management policies and the need to develop a liquid money market.
Enhance transparency and predictability			16. MOF publishes: (i) the Treasury Securities annual borrowing plan and updates on its website; and (ii) a clear policy on its bond buyback and switch operation to add predictability to its debt management for investors.
Enhance money market infrastructure and secured transactions	16. Parliament approves a new legal framework and necessary amendments to existing laws to enable the use of derivatives (ISDA agreement) and secured	Copy of the approved laws on Securities Market, Insolvency and the Civil Code.	17. CBA: (i) introduces implementing regulations and systems to establish a GMRA and operationalize triparty repos, to enhance money

Policy Objectives	Policy Actions Subprogram 1 (by October 2017)	Compliance Documents	Policy Actions Subprogram 2 Indicative (by August 2018)
	interbank lending based on standardized repos (using the GMRA; triparty repos).		market liquidity; and (ii) uses a triparty GMRA master agreement for its operations which can be varied as a template for interbank and other commercial lending within the financial markets.
	17. CBA: (i) implement regulations and IT framework for unified repository of derivatives (repos) and (ii) facilitate establishment of Clearstream Link for issuance of local currency bonds.	CBA resolutions with regulations describing the IT framework and clearstream link.	18. NASDAQ OMX offers bond switch auctions to facilitate consolidation of outstanding issues based on the CBA and MOF agreement and MOF issued terms of reference.
	18. CBA develops a Repo project management plan to select and implement a Triparty Repo system in Armenia covering; (i) consulting the stakeholders; defining the requirements; (ii) issue an RFI to identify the software provider options and costs; (iii) ascertain market support and conduct a cost benefit analysis of the options; and (iv) an assessment of the resources to support the project.	Letter from CBA attaching a copy of repo project management plan approved by CBA management.	19. CBA implements the Repo project plan and the design and resources for a new IT system solution for triparty repos with NASDAQ OMX that is cost effective and affordable.
	19. MOF transfer auctions to the new NASDAQ OMX platform for primary auctions of government securities.	Agreement dated 25 April 2017 between MOF and NASDAQ OMX Armenia OJSC showing transfer has been affected.	
Cash/Liquidity management.			20. MOF; (i) reviews the source and analysis of government

Policy Objectives	Policy Actions Subprogram 1 (by October 2017)	Compliance Documents	Policy Actions Subprogram 2 Indicative (by August 2018)
			cash flows to improve the accuracy of its forecast projections; and (ii) develops a cash management framework using T-bills, buybacks, switches and other instruments which is coordinated with the CBA's liquidity management function.
Develop legal framework for new types of securities to broaden the investor base	20. To strengthen the legal basis of the mortgage bonds market, the CBA submits to Government: (i) a new law for Residential Mortgage Lending, to strengthen consumer protection, and (ii) amendments to the Covered Bonds Law to enable multi issuer facilities.	Copy of the letter from CBA submitting the following to the Government: (i) the new law for Residential Mortgage Lending, and (ii) amendments to the Covered Bonds Law	21. Parliament approves: (i) a new law for Residential Mortgage Lending (consumer protection); and (ii) amendments to the Covered Bonds Law.
			22. To strengthen the legal basis for asset securitization and asset-backed securities, CBA submits to the government a set of proposed amendments to the Securitization Law, to clarify the fund nature of special purpose vehicles, enable synthetic securitization, and enable the issuance of securities before a loan-book purchase.
Develop legal framework for private equity to increase the	21. CBA makes regulatory changes to enable private equity and other investment fund vehicles to have	Copy of the CBA regulations and/or official interpretations.	23. Government introduces modern elements of corporate law, such as the concept of shareholder's agreement (e.g.

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volume of resource mobilization	their subscribed capital denominated in USD.		as an amendment to the JSC Law).
Strengthen corporate transparency requirements and the financial information practices by encouraging the participation of institutional investors in private debt and equity markets	22. MOF submits to the Government a private sector accounting and External Audit Development Strategy Concept that establishes actions to progressively mainstream external audit requirements in the Armenian private sector.	Copy of the letter from MOF submitting to the Government, the Private Sector accounting and External Audit Development Strategy Concept.	24. Government approves amendments to the Laws on Accounting and Audit and a new proposed Law on Regulation and Public Oversight of Audit and Accounting to delegate some regulatory functions to a Public Oversight Board (POB) and the prospective Chamber of Accountants and Auditors of Armenia.
	23. MOF submits to the Government legislation regulating private sector accounting and setting requirements for companies that are subject to statutory audit based on the amount of annual turnover, the amount of assets and the average number of employees.	Copy of the Letter from MOF submitting to the Government, a copy of the MOF draft legislation regulating private sector accounting for companies that are subject to statutory audit.	25. Parliament approves legislation including mandatory audits and MOF establishes the POB (with a functional secretariat), and initiates public outreach discussions on (i) delegation of oversight role on audit to the POB and (ii) mandatory audits and drafts sub legislations and relevant regulations to implement the new accounting and auditing legal framework.
	24. MOF submits to the Government amendments to the law on accounting and the law on auditing, and introduce a new Law on the Regulation and Public Oversight of Audit and Accounting	Copy of the Letter from MOF to the Government submitting: (i) a copy of the amendments to the	26. MOF implements a statement of objections to ensure that all relevant regulations for the implementation of the new accounting and auditing legal framework are developed in

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	to enhance the quality of corporate financial reporting factoring in the recommendations of the Private Sector Accounting and External Audit Development Strategy Concept.	law on accounting and law on auditing. (ii) a copy of the new Law on Regulation and Public Oversight of Audit and Accounting. (iii) Copy of the Private Sector Accounting and External Audit Development Strategy Concept	accordance with the respective law and the MOU.
	25. MOF signs a MOU with the Association of Accountants and Auditors of Armenia (AAAA) on the way forward for a new division of responsibilities in the regulation of Audit in line with international good practices.	Copy of MOU and the documents submitted for policy action 24 above.	

ADB = Asian Development Bank, AMD = Armenian Dram, CBA = Central Bank of Armenia, DMFAS = Debt Management and Financial Analysis System, GMRA = General Master Repo Agreement, ISDA = International Swaps and Derivatives Association, MOEI = Ministry of Economy and Investments, MOF = Ministry of Finance, MOU = memorandum of understanding, MTDS = medium-term debt strategy, MTEF = medium-term expenditure framework, PDMD = public debt management department, PPP = public–private partnership, TA = technical assistance.