

## IDA AT WORK

# Armenia: Laying the Foundations for Sustainable Development—In Good Times and Bad

Over the past two decades since the collapse of the Soviet Union, Armenia's economic transformation has been profound. The economy today is market-oriented, and highly receptive to trade, capital and technological innovation. From the late 1990s to 2007, GDP expanded by double digits, and Armenia now ranks as a lower middle-income country. As a result of sustained growth, ambitious reforms, and external inflows of capital and remittances, poverty plunged from over 55 percent of the population at the start of the transition to about 25 percent today. While Armenia has benefited from greater openness to global trade and investment, these same channels have also brought the global economic crisis to the country, sharply breaking the decade-long momentum of rapid growth and poverty reduction. The challenge today for Armenia, and its international partners, is to ease the impacts of the immediate crisis on the economy and people, while laying the foundations for recovery and longer-term sustainable development.

Country Indicators	1995	2008
GDP per capita (US\$)	409	3,067
Average inflation (%)	176.7	6.6
Total public debt (% of GDP)	35	16
Fiscal deficit (% of GDP)	-9.0	-1.5
FDI net inflows (US\$ millions)	19	701
Population (millions)	3.1	3.0
Poverty incidence (%)	56 (1998/99)	24.9
Extreme poverty incidence (%)	21 (1998/99)	3.8
Gross primary school enrollment rate (%)	92 (2000)	101(2004)
Under-five child mortality (per 1,000)	24 (1990)	12.3
Maternal mortality (per 100,000 live births)	38.5 (1990)	15

Source: National Statistical Services of Armenia; World Bank staff estimates.

Since the start of transition in 1991, the International Development Association (IDA), the World Bank's fund for the world's poorest countries, has provided about US\$1.2 billion to Armenia to support 51 projects. Armenia consistently ranks among the top performing countries in IDA's portfolio, measured by the IDA Performance-Based Allocation system. In 2008, Armenia also became eligible to begin borrowing from the World Bank's market-rate lending window (IBRD), and in March 2009 arranged an initial loan from IBRD to support small and medium domestic enterprises (SMEs) facing credit constraints due to the global financial crisis.



## **COUNTRY ACHIEVEMENTS**

**Armenia's reform process has been remarkably steady and effective.**

**Armenia suffered a severe economic contraction when it became independent in 1991.**

Dissolution of the former Soviet Union left Armenia with a largely non-functioning command economy. GDP dropped by more than 50 percent during 1990-93. The country was also struggling with the aftermath of a massive 1988 earthquake and a conflict with neighboring Azerbaijan.

The collapsing economy led to hyper inflation, a budget deficit that peaked at 55 percent of GDP in 1993, factory closures, little reliable electricity supply, heavy emigration and mushrooming poverty. Some four-fifths of Armenians survived on humanitarian aid.

**Since the early 1990s, Armenia has pursued a long and successful course of reforms.**

Reforms began with the elimination of wage and price controls, and land reform. Early on, most land was privatized early on, and this stimulated production as farmers began responding to market signals. Most small

enterprises were also privatized. By the mid-1990s the economy was stabilized and, soon after, Armenia was among the first of the former Soviet republics to initiate important reforms in education health and social protection. Progress slowed somewhat in the late 1990s, exacerbated in 1998 by the Russian economic crisis. However, since 2000, reforms have greatly extended the scope of the market economy, improved the environment for private investment and the openness of the economy, and paved the way for Armenia to enter the World Trade Organization in 2003. Regulatory reforms in banking and public utilities have yielded significant efficiency gains and improvements in access and services; the rural economy and environment institutions have improved; public financial management has strengthened; ambitious social service reforms have been initiated and increased investment has helped to improve efficiency and quality.

**The response to these reforms has been positive.**

Armenia's economy today is market-oriented, and highly receptive to trade, capital and technological innovation. From the late 1990s through 2007, GDP expanded by double digits, and Armenia now ranks as a lower middle-income country. Due to sustained growth, ambitious reforms, and external

inflows of capital and remittances, poverty has plunged from over 55 percent in the early 1990s to about 25 percent.

Armenia is on track to achieve most, if not all, of the Millennium Development Goals (MDGs), and has designed a set of even tougher national goals for itself, consistent with its Poverty Reduction Strategy Paper (PRSP). The government hopes to protect these gains from the crisis. Rates of poverty, infant and maternal mortality have fallen, there is virtually full enrollment in basic schools, and the country is in the midst of reforms that are increasing the length of time children are staying in school. Strong efforts are still needed to promote greater gender equality, combat communicable diseases and ensure environmental sustainability.

**Since 2008, Armenia has been deeply affected by the global economic crisis.**

Armenia has been struck by several simultaneous shocks—a sudden loss of global demand and collapse in international prices for some of its key exports such as non-ferrous metals; an unprecedented drop in remittances from Armenians working overseas, particularly those in Russia; and a sharp decline in private capital flows. Exports and economic growth began to contract in late 2008, and GDP may well further decline by 8 percent or more in 2009 and another 2 percent in 2010. As a result, budget revenues have fallen sharply, and some of Armenia’s earlier gains in improving the population’s well-being are at risk, with poverty and social vulnerability now rising sharply.

Armenia is struggling in the short-term to mitigate the impacts of this crisis on the economy and people, while staying the course with reforms that are essential for recovery

and longer-term sustainable development. The government’s response has been swift, including important actions in the area of exchange rate policy, and re-prioritizing expenditures in favor of those that protect or create jobs and towards social programs, especially a well-targeted safety net. Armenia has also refrained from the temptation of protectionism, and has turned to the international donor community, including IDA, for additional assistance to help it sustain its reform and poverty reduction efforts.

## **IDA CONTRIBUTIONS**

### **IDA’s sustained support to Armenia since 1993 has brought clear results.**

About 40 percent of IDA’s assistance to Armenia since 1993 has been provided through 11 policy operations supporting reform efforts, particularly in the areas of private sector development, customs, taxes, public enterprise reform, the financial sector, and social services. IDA has also funded 40 investment projects focused on rural and community development; renewable energy and heating; health and education; water supply and sewerage; transport; and judicial and public sector modernization. These were complemented by some 60 analytical studies and technical assistance grants, including periodic country economic memoranda, public expenditure and fiduciary reviews, poverty assessments, financial sector assessments, and specific sector studies, that have helped shape Armenia’s institutional and policy reform agenda.

### **Supporting policy reforms**

In 1993, IDA prepared a first Country Economic Memorandum for Armenia that was used by the government and donors as a key strategic document from which to begin reforms.

Since then, IDA has extended a series of 11 policy credits that have helped to stabilize the economy, design basic budget and financial management procedures and systematically strengthen them; develop a social protection strategy and put in place an effective and targeted benefit program for the poor; improve the business and financial sector environments to enable competition; reform public utilities, strengthening their regulation and attracting private investment and management to improve access and services; and supporting improvements in transparency and efficiency of tax and customs administrations. The latest IDA policy credit in 2009 has a special focus on protecting vulnerable populations from impacts of the current global economic crisis.

### Linking sector investments with analytical work and the social and economic policy dialogue

IDA is more than the sum of its parts. For example, investment projects in energy and water utilities have helped these sectors become self-sustaining, an effort that has been re-enforced through IDA's economic policy dialogue with the government. The reduction in public subsidies to utilities in turn provided greater space to increase social spending. Education, health and social protection projects aimed at improving quality, access and efficiency have also been reinforced by IDA's poverty assessment program, public expenditure reviews, policy dialogue and policy-based lending.

### Encouraging a country-led development program

IDA and other donors assisted the government, in consultation with civil society stakehold-

ers, to prepare a Poverty Reduction Strategy Paper (PRSP). Issued in 2003, the PRSP set clear targets, most of which have now been met or exceeded. For the first time, the PRSP placed the country in the driver's seat in formulating strategies and prioritizing investments, thus serving as a welcome framework for donor coordination. In 2008, the government approved the Sustainable Development Program for 2009-2021 (SDP), which also serves as Armenia's second PRSP. It has three key goals: reducing poverty, ensuring human development, and deepening economic growth, with special attention to lagging regions.

### IDA's impact in Armenia is felt across many sectors

**Emergency reconstruction, managing and preventing disasters.** Armenia is vulnerable to natural disasters such as droughts, earthquake, frost, and flooding. IDA has been active in both crisis response and prevention of disasters due to activities such as deforestation, dams etc.

One of the first IDA credits was to help Armenia address the damage caused by the 1988 *earthquake*. As a result, 2,857 housing units were built, rehabilitated or strengthened including eight community centers, schools and hospitals.

Two IDA *dam safety* credits have financed the rehabilitation of 74 of the 87 dams in the country to improve efficiency and reduce the risk of dam failure and flooding for 500,000 people living downstream.

Various IDA agriculture and irrigation projects have financed crisis response and preventive measures for *droughts, flooding, frosts, and deforestation*.

In early 2006, IDA responded to Armenia's urgent request for help with the *avian flu* threat and is now doing the same for *swine flu*, working with both the agricultural and health ministries on disease surveillance, strengthening veterinary services and contingency planning.

Finally, IDA is supporting analytical work and review of international best practice relevant to Armenia in the areas of *natural disaster risk management* and *climate change adaptation*.

**Rural development and environment.** Several IDA projects have helped convert a badly deteriorated, state-run agricultural system into a more competitive sector capable of supporting growth and reducing rural poverty.

*Land reform* was one of Armenia's first priorities after independence from the Soviet Union. IDA helped establish 47 real estate registration centers, which surveyed and titled almost all 2.5 million parcels transferred to private hands. As a result, agriculture output and producer prices increased substantially.

In *irrigation*, IDA also helped to rehabilitate over 4,000 irrigation canals, increasing productivity of some 140,000 hectares of land, and to introduce local management of tertiary canals by water users' associations.

IDA *rural development* projects have strengthened agricultural research; extended rural finance to over 17,500 under-served rural enterprises and farms; helped community groups implement proposals aimed at improving competitiveness; strengthened veterinary services; and piloted provision of extension services by private providers.

In the field of *environmental protection*, IDA has helped Armenia develop management plans covering 128,000 hectares of forests and strengthen the capacity to monitor and control illegal logging, although enforcement is still a challenge.

**Transportation.** Improving the main transport network was critical to a small landlocked country like Armenia. IDA focused early on rehabilitating over 800 kilometers of *main roads and highways*, 11 *bridges* and the reliability of *rail service* between the capital city of Yerevan and the Georgian border. In view of availability of other donor resources, IDA had phased out of financing transport in the last few years, but has recently re-entered the sector to support rehabilitation of *lifeline roads* that link smaller towns and cities with the main road network, and create much needed jobs in regions hardest hit by the current global economic crisis.

**Energy.** Reliability of *electricity supply* has improved dramatically in Armenia as a result of IDA technical and financial support. The very poor condition of facilities and widespread corruption posed hardships for the population and dampened private sector development. IDA projects restructured the energy sector; rehabilitated eight transmission stations and six generation units; privatized electricity distribution and thereby eliminated the need for costly public subsidies; and created an efficient multi-sector agency to regulate power, telecommunications and water supply.

Given Armenia's heavy reliance on an aging nuclear power plant, IDA has also worked closely with several donors and private groups to establish an innovative fund to support *renewable energy* schemes, and to channel grant support from the Global Environment

Facility to investigate the country's *geothermal* potential. Finally, an *urban heating* project is fostering the use of safe gas supply for households and schools. By providing heating for some 100 schools, IDA has enabled many students in remote areas to attend classes for the first time throughout the winter season.

**Water Supply.** IDA project financing and policy advice have helped Armenia shift from public to private sector management of *Yerevan's water supply system*. In a first stage, the government adopted a management contract and later fully transferred the system to a long-term private lease operator. Metering is nearly universal, collections have quadrupled from a low base of only 20 percent, service has improved and energy consumption been reduced.

IDA is also supporting rehabilitation and private management of water systems outside the capital city, including the cost of the management contract, monitoring of contractor performance commitments, and financing of essential investments. Finally, in areas which are too remote to connect to the grid, IDA has financed freestanding local water systems through the Armenian Social Investment Fund, discussed below under Social Protection.

**Education.** Although Armenia inherited a near universal primary education system from the Soviet period, it was costly to maintain, efficiency was low and quality not up to the needs of a modernizing market economy. IDA has partnered with Armenia since the mid-1990s to introduce a series of innovative reforms, including: per capita financing; establishment of a textbooks fund which became a model for other countries; modernization of the basic and secondary education curricula; massive re-training of principals, school teachers and administrators; and major efficiency measures

that reduced costs and made it possible to raise teacher salaries.

Results have been impressive, with Armenia showing major improvement between 2003 and 2007 in the Trends in International Mathematics and Science Study (TIMSS) tests, widely used by many countries to benchmark education quality. In the sciences, Armenian 8<sup>th</sup> graders' rank rose from 29<sup>th</sup> (out of 45 countries) in the 2003 TIMSS, to 17<sup>th</sup> (of 48) in the 2007 series. In math, Armenian 8<sup>th</sup> graders' rank rose from 22<sup>nd</sup> (out of 44 countries) in 2003 to 8<sup>th</sup> (of 43) in the 2007 tests, placing above a number of more developed countries and clearly demonstrating the impact of sustained efforts to improve curricula, teacher training, school administration and public budget support to the sector.

In recent years, IDA education projects have also helped to continue deepening the reforms mentioned above; add a new 12<sup>th</sup> grade to secondary schools throughout the country; pilot school readiness programs for low-income rural children; modernize and make more transparent university entrance exams; and develop other options for reform of higher education, which IDA will support over the next several years.

**Health.** IDA has been helping Armenia to reform its health program to make it both more accessible and affordable. The old Soviet health system relied on specialized doctors and mainly hospital-based care. Reforms have centered on developing a primary care network at local level, introduction of general family medicine, changes in the basic benefits package, hospital optimization with narrow specialists at that level and general family doctors at primary care centers and regional facilities.

These reforms produced efficiencies, and the allocation of public resources to health also rose from 1.2 percent in 2003 to 1.5 percent in 2007 (with high GDP growth, these increases have actually produced a substantial jump in absolute levels of expenditure). The gap in access of the poor to the basic health system has improved; informal payments have been reduced but are still high. Life expectancy, an indicator of overall health status, rose from 66.4 years in 2000 to 72.4 years in 2008.

**Social Protection.** At the start of transition, Armenia lacked essential instruments to target social assistance to the poor and vulnerable groups (orphans, disabled people, the elderly, etc), nor were there functioning labor market institutions to respond to the phenomenon of unemployment. Local government structures were weak and there was also no tradition of community-led initiatives to tackle local problems, as this had not been encouraged during the Soviet period.

IDA assistance to Armenia has helped to design and strengthen a basic social protection system, comprising:

- a *well targeted family benefit (TSA)* program which has played a major role over the last decade in reducing poverty generally and extreme poverty in particular;
- *improved administration* of pensions and those social assistance programs which have not been folded into the TSA;
- a functioning *network of employment offices supported by up-to-date labor information*;
- a community-driven development program managed by the *Armenian Social Investment Fund (ASIF)*, to engage the poorest populations in tackling local issues; and

- a well-trained, competent National Statistical Service able to use *international best practice in monitoring and analyzing trends in household poverty*, as an input into social protection planning and implementation.

Rapid growth has certainly helped to bring down the overall poverty level in Armenia, but the near eradication of extreme poverty (only 3.8 percent in 2007) is very much the result of the effectiveness of the above social protection system. In the context of the current global economic crisis, Armenia is well positioned to channel additional resources quickly to the poor, with good targeting; to track developments on the employment front in real time and assist the newly unemployed to identify job opportunities; and to generate timely data needed by policy-makers on budgetary needs for social assistance.

Finally, ASIF's more than 730 local community-driven projects (from heating schools to building community centers and providing potable water) empowered and improved living conditions for many communities largely overlooked by economic rapid growth, complementing government's goals and programs in these sectors. Some 380 schools have been rehabilitated or newly constructed, including 145 in the earthquake zone; and over 150 villages now have improved water supply, in areas where connection with regional grids was not possible. Finally, ASIF is playing an important role in mitigating impacts of the current global crisis. IDA is channeling additional financing through ASIF, which in turn is generating much-needed new jobs in some of the hardest hit areas of the country.

## PARTNERSHIPS

IDA's first country economic report for Armenia, prepared in 1993, assisted the government and donors in designing reforms, and in 1994 IDA began chairing regular consultative group meetings that served as fora for dialogue between the international community and Armenia. Over the years, many donors have decentralized greater responsibility to their local country or regional offices. IDA's Regional Director for the South Caucasus is now located in Georgia, and the Country Manager in Armenia participates in or chairs local donor meetings on a wide range of topics.

IDA also joined forces with UNDP and other donors to support the government and local stakeholders as they prepared Armenia's first PRSP and the follow-on Sustainable Development Strategy. These consultative efforts helped promote dialogue and build consensus on medium and longer-term strategic goals. They also produced a framework within which Armenia's partners could support national development priorities.

A number of donors (Japan, the UK, Netherlands, Sweden and the European Union) have channeled grant resources through Trust Funds managed through IDA. These and other multilateral and bilateral donors have also provided direct or parallel co-financing of projects supported by IDA.

Partnership with the International Monetary Fund has been close in the area of economic advice and policy-based lending. IDA and the Asian Development Bank coordinate their transport, water and policy-based lending. The European Bank for Reconstruction and Development has co-financed IDA's renewable

energy project and the two agencies maintain a close relationship in water, financial and private sector development. The European Union and IDA have provided complementary support to Armenia on judicial modernization; Germany in municipal infrastructure and SME development; USAID in the financial sector, tax administration, social protection, and SME development; and the Millennium Challenge Corporation in rural roads and irrigation. The Netherlands has co-financed IDA policy-based lending; and the Russian Federation is providing additional financing to help Armenia to mitigate impacts of the global crisis.

## CHALLENGES AHEAD

### Armenia needs to manage the fall-out from today's global crisis, while sustaining critical reforms

Armenia has been hit very hard by the global economic crisis—after over a decade of rapid progress, growth is now falling sharply, and unemployment and poverty are on the rise. The central challenge today for the government is to mitigate the economic and social impacts of this crisis, which are likely to persist for some time, while persevering with the policy and institutional reforms that will be essential for recovery and long-term development.

### Addressing vulnerability

The government is *employing counter-cyclical macroeconomic policies within prudent limits*. These included actions on both the monetary and fiscal fronts, namely exchange rate depreciation, scaling back and re-directing public expenditure towards social protection and rapid infrastructure operations aimed

at safeguarding or creating employment. It has also been easing credit constraints on SMEs by providing credit lines through banks. Armenia has avoided the temptation to adopt a protectionist stance, as this would undermine economic recovery and growth in the post-crisis period.

*Bolstering financial stability* is also key. Due to major reforms over the past decade, the liquidity and solvency of Armenia's banking system were strong at the start of the crisis. This strength needs to be maintained through flexible monetary and exchange rate policy, facilitating bank restructuring if needed, enhancing banking supervision, and broadening the reach of financial intermediation.

### **Strengthening competitiveness**

This agenda includes critical reforms, some of which are underway and need to be maintained, while others require new policy and institutional initiatives.

*Improving public governance* will be key. Over the past decade, Armenia has passed legislation to strengthen public sector management, address political and public accountability, and increase civil society voice and participation. The record is one of mixed progress: greater in capacity building in some institutions, but slower in enforcement. Future efforts will need to concentrate on reducing corruption and modernizing tax and customs administration, public expenditure management, civil service reform and the judiciary.

This needs to be accompanied by measures to *reduce conflict of interest* and *improve the business environment*, especially corporate governance, the regulatory and competition regimes, and access to finance.

Armenia needs to *invest more resources in key infrastructure sectors*, including both *transport*, where the road network is especially important for a landlocked country; and *energy*, where an aging nuclear power plant needs to be replaced by a mix of new sources of power generation and greater attention to energy efficiency.

Achieving Armenia's economic potential will also require *conflict resolution and opening presently closed borders*. While the precise effect is difficult to quantify, removal of artificial trade barriers would increase trade significantly. This highlights the importance of resolving outstanding conflicts and disagreements with Azerbaijan and Turkey.

Finally, *skills development* will be central to Armenia's vision of a knowledge economy. This will involve sustaining and deepening ongoing modernization efforts in basic and secondary schooling, and integration of Armenian tertiary education into the European Higher Education Area in line with the Bologna Process.

### **IDA's future role in Armenia**

The World Bank's Armenia *Country Partnership Strategy (CPS) for 2009-2012* was prepared in close consultation with the government, private sector and civil society, and international partners. Design of the CPS took place in the context of the global economic crisis and its impact on the country. It focuses on the near term needs of mitigating the adverse effects of the crisis on poverty reduction and employment, as well as laying the foundation for longer-term competitiveness and growth.

In 2008, Armenia became a *"blend" country*, eligible to borrow both from IDA and from

the World Bank's non-concessional window (IBRD). The government began IBRD borrowing in early 2009, for a project supporting the credit needs of SMEs during the crisis.

IBRD eligibility is a sign of Armenia's development success. IDA support will continue for a few more years so that the transition to non-concessional borrowing is prudent, taking account of the country's still limited access to international capital markets, the fact that the current global crisis has caused major setbacks for Armenia's growth and poverty reduction efforts, and the importance of preserving a sound public debt structure.

*IDA will finance mainly policy-based lending, human development and public sector reform*, with IBRD supporting mainly sector specific investments. This will be accompanied by a strong program of *analytical sup-*

*port and technical assistance* to help design and implement crisis response measures, strengthen governance, and provide advice on design of the next generation of reforms.

*Portfolio performance has been highly satisfactory* in Armenia. The rate of disbursement—a key indicator of overall performance—is well above the average for IDA countries and all projects have been rated in the satisfactory range for progress in implementation and achieving results. This is likely to continue given the quality and commitment of Armenian authorities to the CPS program, which is based on the country's own SDP, and the quality of technical staff engaged in implementing it.

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