AMERICAN UNIVERSITY OF ARMENIA

# A STUDY OF CREDIT POLICY AND EXTERNAL DEBT MANAGEMENT IN THE REPUBLIC OF ARMENIA

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ELEN KHACHATRYAN

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Faculty Advisor Date

Dean Date

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**Abstract**

After the collapse of the Soviet Union, Armenia became independent with zero external debt. Still in a very short period of time it started to accumulate external debt in order to be able to cover the budget deficit and promote economic growth. From the very first years of independence the IMF and the World Bank were the main donors of Armenia. The global economic crisis of 2008 could not leave the economy of Armenia unaffected, as a result of the crisis the external debt of Armenia almost doubled in one year reaching from USD 1.5 billion in 2008 to USD 2.9 billion in 2009. Since 2008 the main borrowings of the government of RA were focused on mitigating the effects of the crisis and were directed to the state budget. Nevertheless, according to the reports undertaken by the IMF, despite the level of public debt, which nearly equals USD 4 billion as of December 2011, Armenia is still considered to be a country with medium indebtedness, according to the World Bank's Debtor Reporting System (DRS). Currently RA takes safeguards in order to avoid the possibility of default, including the strategic program of the government aimed at managing the public debt, on-lending external borrowings to private sector, diversification of the sources of borrowing and the promulgation of the Law on Public Debt adopted in 2008. Despite the above mentioned, the paper suggests that an adequate external debt management mechanism is not enough to ease the burden of the external debt; for this reason certain reforms should be undertaken in the economic sphere as well in order for the state to be able to meet it external debt service obligations.

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## Introduction

In the 21st century when there can hardly be found a country without external debt, the management of this debt becomes a burning issue. Currently governments borrow externally for covering budget deficit or boosting their economies. This implies that governments are provided an opportunity to spend more money than otherwise their income level would allow them. While investing in its productive and social infrastructure a government fulfills two goals; on the one hand it aims at developing the economy and on the other hand creating a basis for successfully repaying the debt and on the long run decreasing the level of debt. Still the countries should be careful of not passing the line where the debt might not be served and repaid and consequently bring to default situation. Debt is a two-fold instrument and therefore should be used carefully.

A country unable to service the external debt may turn default, which in it turn will affect negatively not only on the reputation of the country but also cause difficulties in having access to international markets in the future. This might lead to decrease in economic growth of the country, and consequently decrease in the GDP. Therefore the debt management is an essential element for very country.

Starting with the financial crisis in 2008, after which several European countries including Spain, Portugal, Greece, and Ireland faced the possibility of going default, the question whether the debt of Armenia is manageable became a burning topic of discussion. The above mentioned raises a question: what are the reasons for Armenian government to borrow money externally and what safeguards RA takes in order to overcome the risks and avoid default situation? Therefore this Master's paper is focused upon analyzing those issues. This essay aims at presenting the process of the external debt accumulation of Armenia starting from the very first days on independence and with a more strict focus on the years following the global crisis. Moreover, it aims at revealing government's actions on debt management.

The study looks at the following research questions:

1. Who are the main creditors of RA and on what criteria the government of RA decides from which donor to borrow?
2. How the credits that RA has received were spent since 2007?
3. How the external debt is managed and what are the financial and political safeguards against default?

**Methodology**

For the purpose of this study primary and secondary analysis of documents, legal acts and other relevant literature concerning the external debt of Armenia were examined. In order to investigate the above mentioned research questions the study examined the data of the Ministry of Finance of the Republic of Armenia, reports and researches undertaken by IMF and World Bank. Individual interviews were conducted with governmental officials of Armenia and appropriate experts. The list of interviewees includes:

1. Tatoul Manasserian, Doctor of Economics, former member of the National Assembly of 3rd convocation (2003-2007), member of Standing Committee on Financial-Credit Budgetary and Economic Affairs and the founder of "Alternative Research Center";
2. Liana Hunanyan Head of the financial-economic department of the Government of RA
3. Arshaluys Margaryan head of the Department of the Public Debt Management of Ministry of Finance of RA;

4. Artak Kyurumyan free-lance consultant on public financial and public debt management and the Director at the Armenian Deposit Guarantee Fund.

**Literature Review**

During the last decades there can hardly be found a country without any external debt. Sovereign countries might borrow for a wide variety of reasons. In general external borrowings are giving an opportunity to the country to have higher expenditures that otherwise with country's given resources would be impossible, and may be used to cover budget deficits. In this case many sovereign states prefer borrowing externally to decreasing spending or increasing the level of taxation, and therefore avoiding the political consequences that might follow. Need to reduce poverty, increase the level of employment, develop infrastructure is another reason why states might borrow money (Foncerrada, 2005). External borrowings might as well mitigate the impact of shocks or emergencies, like wars.

There has always been different definition of external debt. However in 1988 Bank of International Settlements, International Monetary Fund, Organization for Economic Co-operation and Development and World Bank came up with a joint definition of external debt. According to the Grey Book external debt is defined as;

"Gross external debt is the amount, at any given time, of disbursed and outstanding contractual liabilities of residents of a country to non-residents to repay principal, with or without interest, or to pay interest, with or without principal" (Official website of World Bank, 1988, p19).

For better understanding the definition it needs further explanation. First of all the definition includes only gross debt- all outstanding governmental debt, and secondly "residents" is defined as "The residents of an economy comprise the general government, individuals, private nonprofit bodies serving individuals, and enterprises, all defined in terms of their relationship to the territory of that economy" (Official website of World Bank, 1988, p 68).

Although the above mentioned definition of external debt is widely used, still many other definitions might be found in literature. Namely, World Bank provides the following definition: "Total external debt is debt owed to nonresidents repayable in foreign currency, goods, or services. Total external debt is the sum of public, publicly guaranteed, and private nonguaranteed long-term debt, use of IMF credit, and short-term debt" (World Bank Official Website).

Foreign borrowing and foreign debt management has always been an issue especially in low-income and developing countries including some of the former USSR countries. Many of such countries had no other way out but to borrow from international community so as to cover the deficit between expenditures and available resources or for maintaining and developing the infrastructure. Many studies have been undertaken so as to examine the effect of external debt on the economic growth. Despite the fact that several investigations found no valid data on supporting this relationship, the majority of researchers claim that there is a negative relationship between the level of external debt and economic growth. In general external debt has been viewed as the cause of decrease of the level of investment and growth of performance. Although external borrowings allow having higher current expenditures and investing more, thus fostering economic growth, nevertheless current borrowing means future payments, and therefore might have a negative impact on the economic growth in the future. Consequently before making a decision about the amount of future borrowing, the government should take into consideration the balance of payment in the future and have established credit ceilings (Mehran, 1984).

Warner (1992) analyses heavily indebted countries in the period from 1982-1989 and comes up with the conclusion that economic decline, particularly the decline of investments is not related to the external debt of the countries. He suggests that the decline in the investment might be caused falling export prices and high world real interest rates (Warner 1992, pp 1161-1171).

Unlike Warner, Ayadi analyzing Nigeria in the period from 1980 through 2007 confirmed the negative impact of debt on growth. According to the author the external debt started to limit the participation of the country in the world economy. Moreover the author observed a link between the reduction in investments and external debt; investments are discouraged as investors presume that in the future higher taxes would be put on their income so as to be able to repay the debt, thus this slows economic growth (Folorunso 2008) .

Similarly, the study undertaken in Pakistan covering the period from 1970-2003 reveals negative relationship between external debt and economic growth, particularly a negative effect on the productivity of labor and capital. The result also shows that in the long run debt service effects negatively on the GDP, as a result the country's ability to service its debt is also reduced (Hameed et al. 2008).

Geiger assumes that besides the decrease of the investment external debt might as well effect negatively on other aspects of the economic development. First of all in case the state is not able to cover its debt in time, its creditworthiness will suffer, as a result in the future the state might face difficulties in borrowing money for new projects or will have to pay higher interest rates. Secondly, the increase of debt level decreases the countries efficiency in the sense that it becomes harder for the country "to adjust efficaciously to major shocks and international financial fluctuations" (Geiger 1990, p. 186). Finally, many indebted countries reduce trade and import in order to acquire more foreign exchange and cover the debt (Linwood 1990).

Summing up, overall majority of the empirical studies put an emphasis on the negative relationship between the level of external debt and the economic development of the country.

While analyzing the credit policy and debt management of developing countries a question arises that is of great interest for many authors; why sovereign governments repay their debt. In literature different interpretations can be found on this issue. Eaton and Gersowits argue that although in case of international borrowing there are no explicit penalties for non-payment, the fear of being excluded from future credits and the possibilities of being penalized make the governments repay their debts. Further they develop their idea; once a country loses its reputation as a borrower they either are not able to borrow at all or can borrow with much higher interest rate. They suppose that thereafter saving opportunities of the borrower also decrease (Jonathan et al. 1981).

Bulow and Rogoff disagree with the "the reputation for repayment" as a model that makes government repay their debt. Particularly they focus on small countries for which reputation cannot be an incentive for repaying the debt for simple reason that those small and developing countries do not have high reputation to worry about. Moreover according to authors once the state has other sources of finance, being excluded from a specific credit market will not make them repay their debt. Instead the authors stress the role of direct sanctions (Bulow, Rogoff 1989).

Cole and Kehoe support the reputation model but in wider environment. Namely, according to the authors countries worry about their reputation not solely for borrowing more in the future but because of "reputation spill-over". This imply that once a country is involved in a number of other relations with the creditor besides the debt relationship, then the country will have an incentive to repay its debt. In this case the specific positive debt reputation will expend on country's general reputation and therefore effect positively on the relationship of debtor and creditor in other sectors (Cole, Kehoe 1997).

Rose A. and Spegel M., researchers at National Bureau at Economic Research, analyze the issue of sovereign debt repayment from another angle. They hypothesize that sovereign debts are repaid is the fear that otherwise the default situation might lead to decrease of international trade relations. The hypothesis is supported by analyzing the annual panel data from 1986 up until 1999 which includes the bilateral trade and international banking claims from 20 creditors and 149 debtor countries. The analysis reveals that in fact debtors are tend to borrow from those countries with which they have more international trade links. This being the case, creditors who have strong trade relation with the debtor nation are more secure when lending money (Rose, Spiegel 2002).

Despite the above mentioned there are many cases when the debtors are not able to cover their debt obligations and face a default situation. Scholars have different interpretations about the reasons of default and whether default situations can be avoided. Alesina, Prati and Tabellini argue that long and evenly spread maturity structure may decrease the risk of facing a default situation and bring to equilibrium (Alesina et al. 1989).

Similar viewpoint hold Cole and Kehoe (1996). According to the authors there is a crisis zone and if the debt level is within this zone than crisis might occur. However, according to the authors once the government is able to move the debt level out of the zone by decreasing it or lengthening its maturity, than the crisis will be avoided. Thus, the possibility of crisis depends on several factors: the maturity of the debt, its size and the real cost associated with defaulting on the debt (Cole, Kehoe 1997).

An alternative view of how to reduce the possibility of government default was purposed by Jan Lemmen (1999). He argues that increase of "the sensitivity of government borrowing costs with respect to debt levels, increase [of] the geographical diversification of investor's portfolios with respect to government bonds, and [prevention of] government financing from fuelling private or public sector bailout expectations" will decrease the level of public debt (Lemmen 1999).

The high level accumulated external debt is a burning issue in many CIS countries. After the collapse of the Soviet Union, several low income countries, including Armenia, collected considerable amount of external debt in a relatively short period of time. Different factors brought to debt burden. For instance, Kaiser J., Kowsky H., Schuelle B. (2006) argue that high levels of debt are explained by imperfect political and economic systems of the CIS countries founded after the collapse of the Soviet Union. They state that implementation of those systems was hindered by the former Soviet elites who very often were thinking about holding power (Kaiser, Kowsky et al. 2006).

Working reports of the International Monetary Fund (2004) analysis the issue from a different angle and brings a combination of several factors that had an impact on debt accumulation in 7 low-income CIS countries. According to the report external debt problems can be explained by cut off of subsidies from the Moscow, increase of energy prices, internal armed conflict in several countries, vague fiscal reforms and statistical uncertainty (Helbling, Mody 2004).

In both cases the authors agree that most of the CIA countries started to borrow externally so as to achieve financial stabilization. Moreover both agree that certain reforms should be carried out so as to decrease the level of external debt and not to be dependent on the foreign borrowings to that extent.

Summing up, although high levels of external debt may have a negative impact on the development of the country, in many cases this is the only possible solution for the government to cover its budget deficit.

**History of International Development Aid**

Developing countries have always received aid from rich members of international community for development purposes. Precise definition of what can be called foreign development assistance is given by Development Assistance Committee (DAC) of the Organization for Economic Cooperation and Development (OECD). According to the definition development assistance refers to grants and loans that are provided by bi-lateral and multilateral donors to developing countries with the main aim of "promotion of the economic development and which are concessional in character with a grant element of at least 25 percent" (OECD official website 2003). It is worth mentioning that loans are given to developing countries at much lower rates than commercial rates in capital markets. This is intended to support developing countries especially if taken into consideration that because of their low creditworthiness developing and poor countries generally face higher interest rates than industrialized countries (Dengbol-Martinussen et al. 2005, pp 7-9).

The roots of the international development aid go back to post-Second World War period. Motives of giving aid vary from country to country and are changing in the course of time: first it might be humanitarian motives implying that rich countries have an obligation to support poor countries; secondly it might include political and economic motives, that is by supporting countries financially the donors are might also establish alliances and trade unions with them; finally environmental consideration is important in international development aid policies, namely taking into consideration the variety of environmental issues and the common interests in this aspect rich members of international community should help developing ones to employ environmental policy (Dengbol-Martinussen et al. 2005, pp 10-16).

In 1950s bilateral assistance, particularly by Soviet Union and the US started to emerge. US aid programs, namely Marshal Plan (1948-1951) is one of the major bilateral assistance aimed at helping to rebuild the economy of Europe after the WWII. Later by the decision of the USA president Truman the scope of development aid expanded and started to include countries in the Middle East, Asia and Latin America. The main aim of the assistance was on the one hand to prevent Soviet influence and expansion, and on the other hand to have a free Europe that in the future would have trade relations with the USA (Griffin, Enos, 1970). Similarly Federal Republic of Germany provided aid to those countries that did not recognize the German Democratic Republic. Consequently foreign assistance very often was viewed as a policy tool; therefore the amount that one country lent to another was not that much dependent on the receiving countries need but more on the benefit that the donor would receive in terms of political support (Dengbol-Martinussen et al. 2005, pp 28-29).

During 1960s decolonization process began and with the emergence of newly independent states foreign aid became essential for the economic and political stabilization of new states. The big share of the aid came again form the US, however because of the ex-colonies still having strong ties with their former colonial powers, namely UK and France provided aid (Finn 2006).

During 1960s multilateral developments assistance started to develop. The International Bank for Reconstruction and Development (IBRD) or World Bank and the International Monetary Fund (IMF) founded at the Bretton Woods Conference in 1944 had their impact in the development of the multilateral assistance. The Conference had an aim to comprise certain international rules, achieve international economic stability and prevent the repetition of the Great Depression. For having more or less fixed exchange rate dollar had to preserve a fixed equivalence to gold with little changes and the rates of other currencies were linked to the dollar (in August 1971 gold equivalence to dollar was stopped as US government was no longer able to back dollar with gold). IMF and IBRD had their distinct functions. IMF was to oversee the whole system of fixed exchange rates and at the same time lent money to those countries that were experiencing short-term balance of payment difficulties. IBRD was more focused on providing long-term loans at lower rates to developing countries for strengthening economic growth (Weiss, Daws, 2006, pp 1-5).

Overall the development aid achieved progress in developing countries and especially in 1970s new independent countries borrowed much because of credits being relatively cheap. With the second oil crisis in 1979 changed the situation: increase of interest rates as a result of stabilization policies in rich countries, increase of oil prices and globally slower economic growth brought to international debt crisis which hit severely especially Latin America countries. Even bigger countries like Mexico, Brazil had to look for help of IMF. From the beginning IMF started to provide more loans and include also rural development, but once the interest rates were raised by US Federal Reserve the borrowers were no longer able to fulfill their obligations and as a result the debt of Latin American countries rose (Weiss, Daws, 2006, pp 7-8). This was the time when international financial organizations and bilateral donors were looking for solution of how to support developing countries. Consequently adjustment loans and policy conditionality became rather widespread (Finn 2006).

The level of international aid continued to increase up until 1992, after that a decline was noticed which very often is explained by the end of the Cold War. Since 1990s the criticism of international assistance and international financial institutions became widespread.

**IMF and World Bank: Loans and Conditionality Policy**

The lending policy of both IMF and World Bank have changed significantly since the time those organizations were founded. Membership of IMF has increase from 44 in 1946 to

184 at present. Currently IMF provides loans to countries both industrial and developing for employing policies aimed at increasing the level of economic growth, employment and social investment. Conditions for lending typically depend on the conditions of the country; however the interest rates are generally lower than if the country would have to borrow from private market. Moreover, low income countries can borrow at a concessional interest rate with the help of the Poverty Reduction and Growth Facility (PRGF). In all the other cases loans are provided bases on IMF's market-related interest rate. The level that member countries are allowed to borrow from the IMF depends on their type of loan and number of quota. Loans provided by IMF must be paid back normally within a period from 3 to 5 years, and not later than 10 years (IMF, 2012).

Like IMF, World Bank currently have 184 members. The Bank is providing loans with lower interest rates, interest free credits and grants to developing countries. Countries can repay their loans in 35-40 years and a grace period of 10 years, whereas in case of commercial banks the countries would have to repay the loan within a time frame from 15 to 20 years and with a grace period from 3 to 5 years. Loans are used for certain programs, including "poverty reduction efforts, delivery of social services, protection of the environment, and promotion of economic growth that will improve living standards" (World Bank 2012). In general World Bank is providing two types of loans: investment loans that are supposed to foster economic and social development (such as constructing schools and roads, providing clear water and electricity) and second type of loans are aimed at supporting government policies and programs.

Before providing the loan, both IMF and the World Bank generally require the member country receiving the loan to agree on certain conditionality. Those conditionalities are generally based on "Washington Consensus" points. The Consensus required governments to broaden tax base, stabilize interest rates, have a unified exchange rate, achieve trade liberalization, privatize state enterprises, foster foreign direct investment and competition, and make property rights more secure (World Bank 2010).

For IMF conditionality is an important measure to make sure that the borrowing country will be able to fulfill its obligations and repay its debt. For this purpose all the conditionality of IMF are “macro-critical”, that is they include changes that are either necessary for accomplishing certain macroeconomic goals or are important for fulfilling certain provisions of IMF’s Articles of Agreement (IMF, 2012).

The World Bank conditions are linked to institutional and long-term changes, and agreeing on the conditionality the borrowing government is insuring credibility. World Bank defines conditionality as “the set of conditions that, in line with the Bank’s Operational Policy (OP) […], must be satisfied for the Bank to make disbursement in a development policy operation. These conditions are (a) maintenance of an adequate macroeconomic policy framework, (b) implementation of the overall program in a manner satisfactory to the Bank, and (c) implementation of the policy and institutional actions that are deemed critical for the implementation and expected results of the supported program. These conditions are included in the Bank’s loan agreements” (World Bank, 2005, p4).

In general conditionality policy has to different sides: those for conditionality, especially international financial institutions and countries that are providing loans (United States, France, Japan) claim that conditionality is necessary for the creditors to feel confident that the funds provided will be used properly and the borrower will be able to repay its loan (Langille, 2005). On the other hand critics state that conditionality is very often used by the creditors to enforce certain rules on the borrowers, and thus borrowing state’s autonomy is in danger, as the state’s power of making its own decisions is limited by certain conditions. The problem becomes even more critical when the borrowers are poor countries and are accepting a policy that is not approved by the citizens (Cabello, Sekulova et al. 2008).

## Debt Accumulation of Armenia during the Transition Period

In 1991 after the collapse of the Soviet Union, with the so called “zero option” Russia relieved Armenia from the external debt of the Union, and Armenia had no right to claim the external possessions of the Soviet Union. Consequently, in 1991 Armenia was an independent country with no external debt. Starting from the first years of independence, Armenia had an aim to ensure high economic growth and restore weakened economy with the help of economic liberalization (Թորոսյան 2007, p4). During the beginning of 1990s it was obvious that this aim could not be achieved without external help. There are several factors that should be taken into consideration in this regard. First of all the lack of natural resources and the collapse of the regional trade agreements with former USSR countries and the resulting trade shocks hit the economy severely. Second, the Armenian-Azerbaijan war over Nagorno Karabakh and the resulting blockade by Turkey and Azerbaijan was a serious threat to the economic development. Third, shift from centrally planned economy to liberal market principles turned out to be much harder than it was supposed to be. Combination of all those factors contributed to inflation, which later grew into hyperinflation with about 1,200 percent in 1992, and later in 1993 it became 10,000 percent. The Armenian dram, which came into use in 1993 devalued from 14.3 to 60 US dollar by the end of the year. The Central Bank of Armenia was struggling to protect the initial exchange rate, as a result lost its reserves (IMF, 1998).

The external debt history of newly independent Armenia started in 1992. Starting from 1992 Armenia started to get membership in several International Financial Institutions, including IMF on May 28, 1992 and World Bank on September 1992. The quota of Armenia in IMF as of June 2012 is SDR 92 million. The quota of the members of IMF determines the member’s voting power and admission to the financing. By providing loans IMF fostered the stability of the Armenian currency, encouraged international trade and thus also promoted economic development (IMF, 1996).

The membership to the World Bank and the loans that Armenia received helped to further increase the employment level and improved social conditions. In March 1993 World Bank provided the first loan that was aimed at institutional reforms. This loan strengthened the county's opportunities to implement political reforms and strengthen the economy in the transitional period. Above all large loans were also provided by European Bank for Reconstruction and Development (EBRD), European Union, as well as governments of Germany, France, Russia, Turkmenistan, USA and Japan. During the first years of the independence majority of those loans were provided with certain concessions. What is more important during the first years of independence Armenia received large amounts of official development assistance (ODA), which included humanitarian aid, grants and technical and food assistance. For instance, the US has provided loans in the form of wheat and kerosene, Turkmenistan has provided loans in form of gas. During the upcoming years technical and food assistance started to decrease and foreign aid started to be aimed at financing development projects particularly by providing loans.

Armenian government took foreign credits for the following major objectives:

- To finance the deficit of the state budget
- To correct the negative balance of payment
- To ensure the accomplishment of the economic key policies adopted by the government and to finance the programs aimed at increasing the level of the economic development
- To develop energy, agriculture, health, transportation and education sectors (Թորոսյան 2007, pp 4-6).

By the end of 1994, after the cease-fire agreement with Azerbaijan was reached, Armenian government started to pay even more attention on the macroeconomic conditions of the country. Due to correct fiscal and monetary policies inflation decreased to 32 percent in 1995, and real GDP increased by 5.4 percent in 1994, and 6.9 percent in 1995 (IMF, 1998).

Although during the mid 1990s Armenia mostly relied on the loans received from World Bank and IMF for stabilizing the economy and closing the budget deficit. However, rapid economic growth was not achieved within the short time frame as it was planned. In order to help Armenian government on this hard time, international loans were provided aimed on the one hand on reinforcing the mechanisms and institutions of domestic revenue collection and on the other hand investing in public projects. Despite this economy was developing much slower that was supposed, and fiscal deficit was increasing faster than was anticipated. As a result of continued financing of the budget deficit by foreign borrowings, Armenia’s external debt started to increase particularly after 1996 (IMF, 2001).

During this period Armenia’s total debt in relation to GDP has increased from 31 percent in 1994 up to 47 percent in 1997. From the total debt in 1997 which equaled 682.6 million USD, 58 percent was borrowed from multilateral creditors, including the World Bank (55 percent of the debt owed to multilateral creditors), IMF (nearly 31 percent), EBRD (nearly 13 percent). The other 28 percent was borrowed from national governments, mainly from Russian Federation (44 percent of the total bilateral debt), the EU (nearly 13 percent), US and Turkmenistan (nearly 10 percent each). The remaining 14 percent was borrowed from commercial banks (IMF, 1998).

In general despite the fact that there was some positive shift economic development, the transition period turned out to be rather hard for Armenia. The reason was the fact that the government’s capacity to manage its external debt was overestimated. Moreover international financial institutions as well undervalued the transition process and the challenges that

Armenia faced. As a result the credits that were offered in the beginning of 1990s very often were not concessional enough for Armenia to cover debt costs. There were problems with bilateral creditors as well, namely the credits were provided with higher interest rate and short maturity. However soon enough the loans provided became more concessional. Namely IMF started to provide loans under the Poverty Reduction and Growth Facility (PRGF) terms. This type of loan is aimed at supporting low-income countries, have much lower interest rate of 0.5 percent, and 10 years repayment period. Similarly, EU started to provide loans with better terms. Despite more concessional loans, Armenia's capacity to pay still remained low (IMF, 2001).

The Russian financial crisis in 1998 could not leave Armenia unaffected. In fact as a result of this crisis there was a decrease in export, investment, level of economic growth and depreciation of Armenia's currency against US dollar by 3 percent in the end of 1998, and reached 7 percent in January 1999 which brought increase in debt repayment in expressed in domestic currency. So as to help Armenia overcome this challenge in 1999 International Development Association (IDA), part of the World Bank, increased the level of its aid by nearly 30 percent. Furthermore, a debt restructuring agreement was reached with the EU in 2000 according to which allowed Armenia to delay the repayment of credit until 2001. Energy loan provided by Russia was also renegotiated. Consequently Armenia's total external debt which equaled 50 percent of GDP by the end of 1997 decreased to 44 percent of GDP by the end of 1998 (IMF, 1999).

By the end of 2000 Armenia's external debt reached 862 million USD or 45 percent of GDP, the biggest creditors being World Bank, IMF and Russia that have provided USD 400 million, USD 175 million and USD 115 million credits respectively . Nearly 36 percent of the debt was provided by IDA on concessional terms (Frenikman, 2002, pp28-29).

**Armenia's External Debt in 2007-2011**

By the end of the 2007 Armenia's external debt came reached the equivalent of USD 1,448.9 million, which included foreign liabilities guaranteed by the Armenian government at the amount of USD 1281.9 million or 88.5% of the total debt; and foreign liabilities of the Central Bank of Armenia that equaled USD 167.0 million or 11.5 % of the total debt. In December 2007 the level of external debt has increased by 20.7% or USD 243.3 million compared to the external debt of Armenia by the end of 2006 (Ministry of Finance, 2007 ).

**2007:** In 2007 eleven new loan agreements were signed: with European Bank of Reconstruction and Development, with OPEC Fund for International Development, with Abu Dhabi Fund for Development and with German KfW, 5 loans with International Development Association and 2 loans with Asian Development Bank. In all these cases but the German KfW, the borrower was Republic of Armenia, only in case of German KfW the borrower was the Central Bank of Armenia (Ministry of Finance, 2007). .

International Development Association, which is part of the World Bank and is aimed at helping poorest countries, during the 2007 provided 5 credits with a total cost of 64 million SDR. The first project that was initiated in March 2007 was focused on judicial reforms, particularly it was aimed at modernizing the judicial facilities, improve effectiveness, trustworthiness and transparency of the judicial operations and strengthen dispute resolution mechanisms and judicial administration. Moreover, the "Second Judicial Reform Project" increased public awareness about the judicial system and how to obtain judicial information. For this reason USD 22.5 million credits was provided with grace period of 10 and maturity of 20 years (World Bank, 2007).

The IDA's next loan provided to Armenia for financing "Health System Modernization Project". The USD 22 million credits with grace period of 10, and maturity period of 20 years was a great support to Armenian government in developing the quality of health care service, particularly by providing the vulnerable groups access to better health care and decrease the disparities between the poor and rich income group people in receiving health care. The project aimed at improving hospital system and its performance, detect and prevent threats like AIDS and Tuberculosis (World Bank, 2007).

During 2007 IDA provided two loans total of USD 46.5 million with maturity of 20 years and grace period of 10 tears to support poverty reduction initiated by the government. The aim is to support the government of Armenia in exercising Poverty Reduction Strategy Program (PRSP) which was focused at maintaining economic growth, debt management, develop tax policy administration, and supporting the priority reforms of the government (World Bank 2007).

Finally in 2007 USD 5 million additional financing with grace of 10 and maturity of 20 years was to finance irrigation development, particularly renovate the irrigation system and support Water Users' Associations by providing technical help and trainings. The original agreement of "Irrigation Development Project" was signed in 2001 (Asian Development Bank, 2008).

There were two loans provided by the Asian Development Bank (ADB) in 2007, total amount of which was 43,573 million SDR. Armenia became partners with ADB in 2005 and was categorized as a B country along with Azerbaijan and Georgia; therefore Armenia is financed mostly by ADB's concessional loans.

In October 2007 upon request of the Armenian government ADB provided USD 30.6 million loan and USD 600,000 grant to improve about 260 kilometers of rural roads built back in Soviet Era and develop the transport management in 4 marzes; Gegharkunik, Ararat, Kotayk, and Armavir. The "Rural Road Sector Project" was an important part of the government's Poverty reduction Strategy paper. By developing countryside infrastructure, the project aimed at decreasing rural poverty.  This project is a part of Lifeline Road Network

Program, initiated by Armenian government in 2004. Its aim is to develop the access of countryside neighborhood with national road system and reconstruct about 1 200 km roads. The total project had a total cost of about USD 300 million, and ADB had it own contribution to its implementation. The loan has a grace period of 8 years, and Armenia will have to cover the loan in 32 years. The interest rate is 1 % annually during the grace period and 1.5% after it (Asian Development Bank, 2007). .

The next loan provided by ADB in 2007 with total amount of USD 36 million was aimed to improve water supply and sanitation (WSS) in 9 Marzes, including nearly 125 villages and 16 towns in frames of "Water Supply and Sanitation Project. The project's objective is to develop the infrastructure by renovating and replacing the water and sewerage systems and improve efficiency and management skills of those who are providing WSS service Armenia will repay the interest of the loan at the rate of 1% annually during the grace period of 8 years, and 1.5% after it. Armenia is obliged to repay the loan by 2039 (Asian Development Bank, 2008).

In 2007 Armenia fully repaid all the loans provided in the past by the European bank of Reconstruction and Development (EBRD), and still a new credit agreement was signed. In April 2007 EBRD provided a loan with a total cost of EUR 7 million. In addition the Bank provided also EUR 5 million as a grant. The loan is to finance the "Lake Sevan Environmental project". The project aimed at recovering the wastewater treatment and network system of Gavar, Vardenis, Martuni, Sevan and Jermuk which are located near Lake Sevan. The loan was provided to the Government of Armenia and the Armenian Water and Sewage Company. The main goal of the project is to decrease the level of pollution of Lake Sevan because of wastewater (Asian Development Bank, 2007).

In 2007 OPEC Fund for International Development (OFID) provided USD 10 million loan to the government of Armenia for "Productive Infrastructure Rehabilitation Project".

The objective of the project is to improve irrigation system, roads and bridges, water supply and natural gas system in rural areas (OPEC Fund for International Development, 2010).

Another loan agreement total amount of 37 million Emirati dirham or nearly USD 10 million was signed between Republic of Armenia and Abu Dhabi Fund for Development. The loan was provided for financing “Rehabilitation of Arpa-Sevan Tunnel Project”. The project’s objective is to reconstruct nearly 30 km of the Arpa-Sevan tunnel, develop irrigation system and increase the level of water in Lake Sevan. The loan is given with 3% annual interest rate for 15 years, and Armenia will not pay the first 5 years (Abu Dhabi Fund for Development, 2007).

In 2007 Armenia also increased the amount of loan taken from German KfW by 12 million euro. The loan was provided to Central Bank of Armenia. The money was to develop mortgage program in Armenia.

In general the indexes of external debt of Armenia for 2007 have improved. During 2007 the ratio between GDP and external debt has decreased from 18.9% in 2006 to 15.7% in 2007 compared to previous year. The ratio has decreased not only because of the increase of GDP, but also because of Armenian dram’s appreciation in regards to US dollar. From the above mentioned loans, about 99% have been provided by concessional terms. Only the loans provided by OPEC Fund for International were on commercial terms (Ministry of Finance of RA, 2007).

**2008:** By December 31, 2008 Armenia’s external debt reached USD 1577.1 million, out of which foreign liabilities guaranteed by Armenian government equaled USD 1425.2 million or 90.4% of the total external debt, the remaining USD 151.9 million or 9.6% were guaranteed by the Central Bank of Armenia. If compared to 2007, Armenia’s external debt increased by 8.8% or by USD 128.2 million. In 2008 5 new loan agreements were signed between Armenia and International Development Association, Asian Development Bank, International Fund for Agricultural Development, OPEC Fund for International Development and with the Republic of France 24.4 million EUR. In all those cases the borrower was the Republic of Armenia (Ministry of Finance of RA, 2008)

IDA provided USD 20 million loan with maturity of 20 and grace period of 10 years. The loan was to provide additional financing to the continuous "Municipal Water and Wastewater Project" of the Armenian government aimed at upgrading of the water system (World Bank 2008).

In November 2008 Asian Development Bank approved a supplementary loan USD 17.32 million to finance the existing "Rural Roads Rehabilitation Project". The main loan of USD 30.6 million for "Rural Roads Sector Project" was signed in 2007. The aim of this supplementary loan was to cover the increased price of the project as a result of increase of construction material price, domestic inflation and appreciation of dram. According to the supplementary loan agreement of "Rural Road Sector Project" Armenia is obliged to pay an interest rate of 1% per year during the grace period and after it 1.5 %. The grace period is 8 years, and the loan will have to be covered by 2039 (Asian Development Bank, 2008).

International Fund for Agriculture Development (IFAD)[1], whose main objective is struggle against rural poverty, signed a loan agreement with Armenia in January 2008. For financing the "Farmer Market Access Program" IFAD provided USD 11.9 million as a loan and USD 500,000 in grants. The project's objective is to support poor rural and peri-urban people in developing microenterprises. The project provides loans to those microenterprises that have potential for growth but do not meet the necessary criteria for receiving loans from banks. The program also includes reconstruction of rural roads and gas supplies (International Fund for Agricultural Development, 2008).

[1] International Fund for Agricultural Development (IFAD), a specialized agency of the United Nations, was established as an international financial institution in 1977 as one of the major outcomes of the 1974 World Food Conference.

The above mentioned project was also co financed by OPEC Fund for International Development (OFID) which provided loan of USD 14 million. The loan was mostly used for investing in social infrastructure, renovation of water supply and sanitation services and providing financial assistance to rural farmers (OPEC Fund for International Development, 2012).

On April 27, 2008 the Republic of Armenia and the Republic of France signed an agreement according to which France provides 24.4 EUR million loan and 500,000 EUR grant for renovating the water supply and drainage system of Yerevan. The project's objective is to reduce energy consumption in water supply process, to reduce the water losses, and to improve the quality of drinking water. For this objective pipelines are to be changed, as well as new hydraulic equipments are to be introduced. The loan is provided on concessional terms: loan is provided for 20 years, with a grace period of 5 years during which only the interest rate is to be paid. The annual interest rate is 1.75 % (National Assembly of RA, 2008).

In general in 2008, as well as in 2007, external debt's ratio to GDP has decreased as a result of the increase of GDP and appreciation of Armenian dram in comparison to US dollar (indicate the range of appreciation). By the end of 2008 concessional loans comprised 99.1%. Only the loan provided by OPEC Fund for International Development was provided on commercial terms (Ministry of Finance of RA, 2008).

Up until 2008 economic growth was recorded in Armenia. Moderate economic growth started since 1994 and in the period from 2000-2008 12% average annual rate of growth was recorded. As a result of economic growth the ratio of external debt to GDP decreased significantly from 47.2% in 1999 to 13.5% in 2008. Moreover in 2008 concessional loans comprised majority part of all the loans borrowed. However the situation changed significantly with the financial crisis (Ministry of Finance of RA, 2008).

Macroeconomic conditions and consequently the economic growth of Armenia got worse not only because of the financial crisis, but also because of Russia-Georgia war in 2008 as a result of which a sharp decline was noticed in investment, foreign trade and depreciation of Armenian dram. On the one hand the need to restrain economic decline and on the other hand the necessity to finance the budget deficit increased the volume of external borrowing. For instance, external borrowings financed the budget deficit by AMD 389.3 billion, which is more by AMD 364.7 billion from the amount planned by the 2009 budget (IMF, 2011).

The pre crisis forecast of public debt exceeded the real numbers by about 2.5 times, this mostly resulted from not being able to properly predict the strength of the crisis and because there was decrease in concessional loans provided to RA (IMF, 2011).

Table 1: RA public debt in 2009-2011 (% of GDP) [2]

| | 2009 | | 2010 | | 2011 | |
|---|---|---|---|---|---|---|
| | SDP plan | actual | SDP plan | actual | SDP plan | actual |
| Public debt, including | 15.9 | 40.4 | 16.4 | 39.4 | 17.0 | 41.3 |
| External Debt | 13.2 | 35.7 | 13.2 | 34.2 | 13.3 | 35.9 |
| Domestic Debt | 2.7 | 4.8 | 3.2 | 5.1 | 3.7 | 5.4 |

During the crisis and post-crisis years not only the nominal external debt almost doubled, reaching from USD 1,577.1 million in 2008 to USD 2,966.7 million in 2009, but also the ratio of external debt to GDP dramatically increased, reaching 34.7%, 35.6% and 36.1% in 2009, 2010 and 2011 respectively (Ministry of Finance of RA, 2008) .

**2009:** In 2009 14 new loan agreements were signed; 5 agreements with IDA, 3 agreements with IBRD, 3 agreements with ADB, 1 agreement with IMF, German KfW and Russian federation.

[2] The table shows the public debt of RA in 2009-2011 (% of GDP), SDP stands for Sustainable Development Program. Source: IMF (2011, p. 20)

The loan agreements signed with IDA were mostly focused on lessening the effects of the global economic crisis, and 4 of 5 loans were provided with maturity of 20 and grace period of 10 years. The borrower in all 5 cases was RA. Two of the 5 loans were additional loan agreements, as because of exchange rate fluctuations additional financing was required for the implementation of the project. In February IDA provided USD 8 million loan for the additional financing of "Social Investment Fund III Project". The original agreement was signed in 2006. The project initiated by the Armenian government aims at increasing the standards of living of poor people by developing infrastructure, advance institutional capacity building and increase accountability. An additional objective was added in the frames of this additional loan agreement, namely creation of employment (World Bank, 2009).

Another additional loan was provided by IDA at amount of USD 2 million. This is an additional financing to the loan signed in 2005 under the framework of "Rural Enterprise and Small-Scale Commercial Agriculture Development Project". This additional loan, like the original one, has an objective of expanding small and medium rural business in Armenia, particularly providing opportunities for the farmers to have easier access to markets. Moreover, the project aims at motivating investment in rural areas be it either public or private. The additional loan is to be used so as to widen the number of beneficiaries of the project than was under the original one (World Bank, 2009). During the grace period of 10 years annual commitment fee of 0.5% and annual service fee of 0.75% will be paid. Starting with 2019 April 1 until 2028 October 1 Armenia is obliged to pay the principal amount of the loan at the interest rate of 5 % (National Assembly of RA, 2009).

For supporting Armenia in post-crisis recovery, "First Development Policy Operation" loan agreement of USD 60 million was signed between IDA and RA. The loan supported better investment opportunities and was focused at protecting the poor and fostering competitiveness (World Bank, 2009).

Another loan that was signed in 2009 between IDA and RA is planned to finance "Second Education Quality and Relevance Project". IDA provided adaptable policy loan of USD 25 million so as to improve and assist learning process in general education, to strengthen the preschool children's readiness for entering school, as well as to improve higher education so that it would be on equal foot with European standards. RA is obliged to pay semi-annual payments for commitment fee at 0.5% interest rate annually and service fee at three-fourths percent rate. Loan repayment begins in 2019 May 15 and ends in November 15 2028 (ARLIS, 2009).

As a result of global crisis decline in economic growth, investment, employment was noticed in Armenia and especially in rural parts. So as to overcome those challenges Armenia signed another loan agreement with IDA at amount of USD 25 million. The financing are to be used for "Lifeline Roads Improvement Project", and therefore on the one hand improve certain parts of the lifeline roads with total length of about 100 km, and on the other hand create temporary employment while building the roads. The roads pass through 7 Marzes and thus provide a road connection for 39 communities with total about 71 thousand population (Ministry of Transport and Communication of RA, 2010).

RA shall regularly service the debt with annual 0.5% interest rate and service fee with annual 0.75% interest rate. The loan will have to be repaid with semi-annual payments, starting from June 15, 2019 until January 15, 2029 (ARLIS, 2009).

For implementing the second part of the above mentioned "Lifeline Roads Improvement Project" in 2009 RA signed another loan agreement with International Bank of Reconstruction and Development (IBRD). IBRD provided USD 36.6 million loan for renovating 140km roads which are located in 7 Marzes and provide a road connection for about 176 thousand people. The loan has a maturity of 25 and grace period of 10 years. The loan's principal amount must be repaid with semiannual payments starting from 2019 up until

2034. Moreover from 2019 until 2033 share of the partial payment comprises 3.33% and in 2034 comprises 3.43% (ARLIS, 2009).

In 2009 IBRD provided another loan at the amount of US $ 50 million for “Access to Finance Small and Medium Enterprises Project” aimed at supporting to overcome the challenges of global crisis. Particularly the objective of the project is to develop market linkages and commercial ties in rural areas. The borrower is the Central Bank of Armenia. The maturity of the loan is 26.5 years with a grace period of 5 years (World Bank, 2009).

IBRD in 2009 approved “Irrigation Rehabilitation Emergency Project” and provided USD 30 million loan with 27 maturity year and 5 year grace period. The project is to decrease the amount of water used for irrigation and make the use more efficient. Two irrigation systems of Armavir and Talin will be renovated. Moreover, the project is also aimed at supporting the Armenian government to overcome the challenges of global crisis by creating temporary workplaces (World Bank, 2009).

During the year of 2009 three main loan agreements were also signed between the RA and Asian Development Bank (ADB). Here again, like in case of the abovementioned loan agreements the main focus is on mitigating the impact of global crisis. In 2009 ADB provided USD 60 million loan for financing “Framework Agreement of North-South Road Corridor Investment Program-Project 1”. The project aimed at renovating sub regional and national road system, decrease transport costs, improve governance. In total about 18.4 km of road sections were renovated and road safety improvements were implemented between Yerevan and Ashtarak. Armenia is obliged to pay interest rate of 1% annually during the grace period of 8 years, and 1.5% annually after it. The loan is to be totally covered by 2041 (Ministry of Transport and Communication of RA, 2009).

On request of the RA, ADB provides another two program loans, total amount being USD 80million for “Crisis Recovery Support Program” in 2009. The loans were transferred to the budget of RA. The division between two different loans is explained by the lack of ADF finances for Armenia. The first loan, at the amount of US46.3 million was provided for 24 years including a grace period of 8 years. During the grace period the interest rate comprised 1% and 1.5 % after it. The second loan of USD 33.7 million has an annual interest rate of 1.6% during the whole term of 24 years, including the grace period of 8 years. The aim of the program is to protect the vulnerable part of the population from effects of the crisis. The loan supports the government to provide jobs and increase social protection expenditures so as to tackle crisis. Under the program government was able to give guarantees for the construction companies to continue their suspended job. As a result working places were restored. Due to the loan wages, social benefits and pensions programs were implemented with slight deviations from the planned (Asian Development Bank, 2010).

International Monetary Fund (IMF) also had its contribution on supporting Armenia to overcome the consequences of the global crisis. Namely in 2009 March IMF provided USD 540 million (368 million SDR or 400% of Armenia's quota) stand-by credit aimed at countering the impact of crisis. The loan was provided for 5 years, including 3 years on concessional terms. However after revising the performance of Armenia's economy in the context of stand-by credit, IMF added its financial support, the total amount of loan provided reached USD 822.7 million (544.6 SDR or 580% of Armenia's quota). The reason for additional finance was decline of economic performance, decrease in GDP, in private transfers to Armenia and in tax revenues. The loan has the following objectives: to mitigate the effects of global crisis, restore the confidence in Armenian currency and financial system and protect the vulnerable groups. Monetary and fiscal policies were relieved to some extent due to the loan. Namely Central Bank's possibility to provide longer term dram liquidity to banks was widened. Moreover, despite the decrease in revenues, the government did not decrease the expenditures dramatically at the same time protecting the social spending and continuing financing infrastructure projects financed by donors (IMF, 2009).

The loans were provided for 5 years, with grace period of 3 years and 3 months. Nearly USD 150 million will be covered at SDR rate (SDR rate being 1, 5%), another USD 150 million at the rate 1%+SDR rate and the rest at the 2%+SDR rate. From the total USD 822.7 million, USD 295 million was borrowed by Central Bank, and the rest by RA. The funds were used by the Central Bank to refill the reserves (ARCA news agency, 2009).

German KfW allocated EUR 14.6 million loan to RA for financing the small and medium size agricultural enterprises. The loan was provided for buying agricultural machinery, land consolidation and building greenhouses. In addition to the loan German government provided grant at amount of USD 5 million (ArmBanks, 2012).

Another large loan at amount of USD 500 million was borrowed from the Russian Federation in frames of supporting the Armenian economy to overcome the global crisis. RA is obliged to cover the loan in 15 years, with 5 year grace period where only the interest rate will be paid. The agreement is signed on 3% LIBOR plus interest rate (LIBOR is the average rate that used by London banks when providing credit to other banks). The borrowing is to be used to developing infrastructure, as well as small and medium business (ARCA news agency, 2009).

In general from USD 1064.7 million received through external borrowings, USD 298.7 million were directly sent to the state budget, including USD 500 million received from Russian Federation, USD 158.1 million received from IMF, USD 64.4 million received from IDA and USD 81.4 ADB (Ministry of Finance of RA, 2009)

The total increase of the level of external debt is explained not only in terms of the global crisis, but also as a result of increase of SDR exchange rate in comparison to US dollar. SDR value is defined by weighted rates of four major currencies: USD, EUR, GBP and JPY, and consequently is more stable than each of those currencies taken separately. However, the USD 500 million loan of the Russian Federation decreased density of SDR credits.

Moreover taken into consideration that on the one hand Armenia's GDP was steadily increasing and on the other hand the level of poverty was decreasing up until the global crisis, the amount of concessional loans provided to Armenia decreased, and in 2009 they reached 75% of all the loans received.

**2010:** In 2010 Armenian economy started to gradually recover mainly due to recovery of global economy and anti-crisis actions implemented by Armenian government. An increase was recorded in export of goods and services, and inflowing services. In 2010 the external debt reached USD 3 299.0 which is USD 332.3 more than the previous year. In total 15 new loan agreements were signed so as to mobilize official credits (Ministry of Finance of RA, 2010).

During 2010 6 loan (Dear Doctor Drampian, According to Ministry of Finance 4 loans were signed with IBRD, however the official website of World Bank states that there were 6 loan agreements) agreements were signed between the RA and IBRD total amount being USD 104 million. All the loans were provided with 25 years of maturity period and 10 years of grace period. In February IBRD provided additional financing for "Social Protection Administration Project" at amount of USD 5 million, the original project being signed in 2004. The aim of the project is to enlarge the activities under the original project and develop social protection and employment services. Particularly the project is to cope with unemployment in rural areas, support the youth, poor and disabled people who are looking for a job. RA is obliged to pay interest rate semi-annually at LIBOR rate plus variable spread (World Bank, 2010).

Another additional financing loan agreement was signed between RA and IBRD. IBRD agreed to provide USD 7 million loan for financing “Social Investment Fund III Project”. The original project was signed in 2006, and since then this is the second additional financing. The financing’s objective is to support RA in developing living conditions of the poor and vulnerable groups, particularly by focusing at infrastructure reconstruction. Schools, kindergartens, water pipelines, health clinics will be reconstructed throughout Armenia and especially in the earthquake zone (World Bank, 2010).

IBRD supported Armenian government in “Second Public Sector Modernization Project” by providing USD 9 million loan. The project focuses at boosting the public sector performance by reinforcing policy development methods, and increasing accountability; improving effectiveness of human resources (World Bank, 2010). The loan is provided for 25 years, with 10 year of grace period. The interest rate of the loan is USD LIBOR.

“Lifeline Roads Improvement Project” signed in 2009 between IBRD and RA, in 2010 received additional financing from IBRD at amount of USD 40 million. The objective is to continue the reconstruction of selected road sectors under the original project (World Bank, 2010).

IBRD provided another USD 24 million loan for supporting Armenian government and financing “the E-Society and Innovation for Competitiveness Project”. The project’s main aim is to overcome the obstacles for creating competitive e-Society by innovating the infrastructure, increasing access to telecommunication services for citizens, as well as businesses and providing more possibilities to citizens to have access to computers and Internet (World Bank, 2010).

“The Health System Modernization Project” of Armenia which was signed between IBRD and RA in 2004 received additional financing in 2010 at amount of USD 19 million for completing the second phase of the project. The loan was provided for developing primary health care service and improving hospital net in the region. Moreover, the project aims at supporting vulnerable groups and providing them access to much better health care system (World Bank, 2010).

The consequences of the global crisis were still felt in Armenia, therefore for reinstating fiscal and financial sustainability, and maintaining economic growth and poverty reduction, on request of RA IMF provided SDR 266.8 million (USD 394.8 million) loan. About USD 100 million was provided to the government of RA, and the remaining USD 294.8 million to Central Bank. The loan was provided under two three-year arrangements: the Extended Fund Facility (SDR 133.4 million or USD 197.4 million) and Extended Credit Facility (SDR 133.4 million or USD 197.4 million). The Extended Fund Facility loan was provided based on interest rate under Stand-by agreement; 10 year for repayment, and 4.5 years of grace period. The Extended Credit Facility loan was provided with 0% interest rate, 10 year for repayment, and 5.5 years of grace period (Ministry of Economy of RA, 2010).

One of the urgent issues that RA needed to address in 2010 was the renovation of Yerevan Metro. "Yerevan Metro Rehabilitation" project consists of two phases, the first one being approved in 2010 and the second phase planned to take place in 2012. The project was financed by EBRD and European Investment Bank, each of which provided EUR 5 million loan. In addition EBRD and EU Neighborhood Investment Facility provided EUR 1 million and EUR 5 million grants respectively. The borrower in both cases was RA. The project aimed at modernizing the Yerevan metro system, including reconstruction of rolling stocks, tracks, power supply and pump replacement. Moreover, the project has also to address the issue of water ingress in passageways (Panarmenian net, 2010).

International Fund for Agricultural Development (IFAD) provided RA SDR 8.9 million (USD 12.95 million) loan and SDR 0.33 million (USD 500.000) to support "Rural Asset Creation Programme". The project objective is to support poor and vulnerable people of rural areas. For achieving the objective the project is: launching modernized fruits and nuts sector that will work on enterprise led approach; establishing modern production technology; promoting usage of pesticides that are reliable in the EU market, as well as in many CIS countries, and thus promote export; investing in renovation of public utilities of rural areas, especially with focus on poor mountainous areas, where the level of unemployment and poverty are high. The loan was provided for 10 years, with grace period of 3 years during which no interest or principal payments will be made. For the remaining 7 years loan will be repaid with interest rate of 1.5% (International Fund for Agricultural Development, 2010).

As for 2010 German KfW provided 5 loans. In first loan of EUR 20 million (equal USD 27 million) was provided to the Central Bank for financing “Stable Development of Mortgage Market”. The loan was provided for 10 years with grace period of 3 year and interest rate 3% annually. The loan is to be used for developing local mortgage market: as a result of global crisis of 2008 Armenian banks had to cut mortgage lending; however with the help of this loan mortgage lending was restored as a part of encouraging economic activity. The loan is divided among several commercial banks and mortgage firms chosen by Central Bank. Later the loan is to be on-lent at interest rate of 12-16% with minimum period of 10 years to those Armenian citizens who want to buy new apartments of houses or renovate the old ones (Banks.am, 2010).

KfW provided another EUR 18 million and EUR 1.5 million grant to the Central Bank in the frames of “Renewable Energy Aid Program” second phase. The first phase was signed in 2004. The aim of the project is to finance infrastructural projects, including construction and renovation of hydropower stations by re lending loan to small functioning hydropower stations via selected commercial banks. The program will lead to improved electricity production and supply, and consequently to economic development. The loan is provided for 12 years, with grace period of 3 years.  The annual interest rate is variable; still it is lower than commercial interest rates, which allows not having an increase of prices of electro energy (Azg, 2010).

Vorotan hydropower plant received EUR 51 million financing from KfW for reconstruction, and increase of its efficiency and productivity. The loan is provided for 40 year, with 10 year of grace period. The annual interest rate is about 2%. The role of Vorotan hydropower plant is important not only as pure supplier of energy, but also in case of increase of gas price, it will mitigate the increase of electricity price. KfW provided EUR 30 million for modernizing the water supply of Gyumri and Vanadzor. Thank to the renovations and update of internal plumbing systems, the cities will have 24 hour water supply (Banker.am, 2010).

The last agreement signed in 2010 was with Belgian KBC Bank NV. The Belgian Bank provided EUR 5.08 million loan to RA for buying cyclotron radionuclide accelerator so as to diagnose much easier and efficiently. The loan will finance creating oncology center in Armenia. The loan is with 0 interest rate and is to be repaid in 11 years (ARCA, 2010).

**2011:** In December 2011 Armenia's external debt increased by 8 % in comparison to previous year reaching USD 3568.2 million as of December 2011 or 34.8% of GDP. From the total amount of external debt 82.7% is the debt owed by the government of RA, and the remaining owed by the Central bank. / Like the previous years, the main lenders were international organizations (Ministry of Finance of RA, 2011).

In 2011 OPEC's Fund for International Development provided Armenian government USD 20 million loan to finance "Rural Activities Program". The project aims at strengthening economic capacity in rural areas and innovate the infrastructure. The project will mainly focus at supporting small-scale retail producers who produce nuts and fruits. RA is obliged to repay the loan in 15 years with a grace period of 5 years. The loan has 3.5% interest rate (A1plus, 2011)

In 2011 Armenia received loans from International Development Association (IDA). "The Community Agricultural Resource Management and Competitiveness Project" received USD 16 million loan as financial assistance to develop efficiency of livestock production system and to improve the health conditions of livestock the in selected areas. Moreover the project aims at introducing new technologies and increasing the level of sales. The loan's terms include 20 years of maturity and 10 years of grace period (World Bank, 2011).

For financing the "Second Development Policy Operation" IDA provided USD 21 million loan. The project aimed at protecting the poor and vulnerable groups, strengthening competitiveness, making reforms in education and health sector, and safeguarding social spending. The loan was provided with 20 years of maturity and 10 years of grace period

The "Second Development Policy Operation" was co financed with IBRD which provided USD 4 million loan with grace period of 10 years and maturity of 25 years (World Bank, 2011).

IBRD provided another USD 39 million loan with 30 years maturity and 18 years grace period to finance "Electricity Supply Reliability Project". The project's objective is to improve the capacity of transmission network, for this reason 230 km section of transmission line from Hrazdan thermal power plant to Shinuhayr will be replaced (World Bank, 2011).

The loan agreement on "Irrigation Rehabilitation Emergency Project" signed between Armenia and IBRD in 2009, received US$18 Million additional financing in 2011. Like the original project, additional financing as well aimed at developing water usage in several areas and thus also supports rural employment (World Bank, 2011)

In order to support RA overcome effects of economic crisis, cover the balance of payment and reach stable medium term growth European Commission as representative of European Union provided EUR 65 million loan and EUR 35 million grant as macro financial assistance. The loan is conditional and based on agreement between the RA and the EU; RA has to take reforms in public debt, pension system, external audit, tax policy and administration (Europa, 2011).

European Bank for Reconstruction and Development provided EUR 6.5 million loan to RA to finance "Small Municipalities Water Project", which is later to be re lent to American Water and Sewerage. The loan is to improve water supply in municipalities of Tavush, Lori, Shirak, Gegharkunik, Kotayk, Syunik, and restore the water treatment plants and sewerage collectors in Tavush (Town of Dilijan) and Vayots Dzor (Town of Jermuk) provinces (European Bank of Reconstruction and Development, 2011)

In 2011 Asian Development Bank provided sovereign loan at amount of USD 170 million so as to finance "North-South Road Corridor Investment Program-Project 2". The project aims at developing and constructing efficient and safe road sector of about 41 km that is connecting Ashtarak and Talin, and . This road sector is important as it is connecting Armenia both domestically and internationally. The loan has a grace period of 5 years, and RA has to repay the loan in 20 years.

ADB provided another USD 47 million loan to RA to finance "Sustainable Urban Development Project". The loan is provided with grace period of 8 years with annual 1% interest rate, and is to be repaid in 32 years with 1.5% interest rate. The project is to develop the access to public and social services of urban areas, as well as the transport infrastructure of Yerevan (Asian Development Bank, 2011).

**Georgia's External Debt**

Georgia's first years of independence were rather hard, similar to Armenia; the collapse of the trade relations among the former USSR states, limited natural resources, particularly its dependence upon imported energy, caused economic recession. Later the conflicts in Abkhazia and South Osettia that lasted until 1996 and mass inflow of refugees further worsened economic conditions in Georgia bringing to high level of poverty all over the country. The above mentioned factors brought to the collapse of the financial and monetary system and macroeconomic destabilization. This kind of development after the collapse of the USSR had its negative consequences; Georgia, like Armenia started to rapidly accumulate external debt. By 1994 nominal public debt reached USD 1 billion or 81% of GDP. The major part of the external debt, nearly 65% was accumulated due to the Georgia's dependence on the gas imported from Turkmenistan (IMF, 2003).

The conflicts in Abkhazia and South Ossetia in 1990s brought not only to economic but also to political instability and insecurity. Georgian government under President Shevardnadze tried to conduct several reforms in order to rebuild the economy, however, with little success as a result of weak power and limited government capacity. In addition the level of corruption in police, courts and other public institutions was rather high and the officials took the bribes openly and regularly (Auty, Sosya, 2006, pp 96-99).

Overall starting from 1994 all the Georgian economic programs were focused at achieving stabilization and structural reforms. Those reforms included liberalization of prices and trade, reduction of inflation, establishment of a more competitive and developed energy sector. The credits provided by international organizations and bilateral donors including IMF, World Bank, European Union on concessional terms played their significant role in the implementation of those reforms (IMF, 1999).

As a result of economic reforms and resulting economic growth Georgia's debt to GDP ratio in 1999 decreased to 60%. Overall on the one hand a decline was noticed in the level of external borrowings from bilateral donors, and on the other hand an increase in the share of IMF and World Bank loans. Particularly, the level of borrowings from IMF and the World Bank increased from the 37% in 1998 and 45% in 2002 (IMF, 2003).

Although starting from 2001 there was a rapid economic growth, reaching 7%, the fiscal condition of Georgia up until 2003 was poor as a result of poor taxation mechanisms, high level of shadow economy and accumulation of government domestic expenditure debt as the pensions and wages were not paid on time. Since the Rose Revolution led by Saakashvilli in 2003 the administration was able to implement a fiscal turnover; government initiated privatization program in order to reinforce private sector-led growth, it decreased the level of corruption, increased the state budget, improved the infrastructure by solving the problem of regular water, electricity and fuel in provinces. Economic reforms were still implemented with the help of IMF and the World Bank. As a result of economic growth Georgia was able to repay the energy debt to Turkmenistan rather fast. GDP also started to increase on an annual basis (IMF, 2006).

GDP also started to increase at an annual base since 2003, suggesting that the Rose Revolution and the following reforms had a positive impact on economy. The high GDP growth rate continued up until the 2008 financial crisis and the August war with Russia.

Table 2: Percentage change of GDP

| Country | 1999 | 2000 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Georgia | 3.5 | 1.9 | 4 | 5.5 | 9.5 | 9.3 | 8 | 12 | 2.1 | -3.9 | 6.4 |

Source: Index Mundi, 2011

The global crisis brought to decline the governmental revenues in Georgia followed by increasing budget deficits and foreign credits. Decrease in exports and foreign investments further worsened the situation. Nevertheless this decline was temporary, as it was followed with 6.4% growth in the following year (Index Mundi, 2011).

Despite the economic reforms and economic growth, Georgia still has a significant level of external debt reaching USD 4 billion by 2011 (De Waal, 2011, pp10-15). In order to reduce the level of external debt Georgia, like Armenia, needs to attract foreign investors and increase exports. Unlike those two countries, Azerbaijan with its high oil revenues does not face the problem of balancing the budget. Nevertheless, Azerbaijan's oil revenues are much dependent on the international market and oil prices; therefore it needs to diversify the economy for preserving the sustainability in the future as well. The major step forward for Georgia was the radical change in the tax code since 2005 resulting in better tax collection. As a result of those reforms the taxes paid by the individuals were reduced, the social security tax was repealed and small businesses obtained tax holidays being exempt from taxes if their income was less than 30,000 GEL. In addition the reforms reduced the number of taxes from 21 to 6 at the same time making easier the tax administration. On average the tax revenues in Georgia grew by about 19% over 2004-2010 and total revenues (excluding grants) grew by more than 14% over the same period. This can be explained by the fact that the new tax code attracted investments and developed favorable environment for conducting business (Rahmanov, Valiyev, 2011, pp53-55).

Another important element that brought to increase in economic growth is the significant decrease in the level of corruption in Georgia since 2003. Corruption raises the cost for business and reduces efficiency. Particularly businessmen who wanted to start their business needed either to pay bribes to the state officials or have close relations with them. Thus, corruption hindered economic growth (Rahmanov, Valiyev, 2011, pp5-6). In 2010 Transparency International published Corruption Perception Index (CPI). CPI ranks the countries according to the levels of corruption as perceived by opinion surveys by business people and analysts. According to CPI Georgia is the 4th among the former Soviet Union countries (Armenia ranking the 7th) and 64th out of 178 countries (Armenia ranking 129th). This is a step forward in comparison to 2006 when Georgia ranked 100 (Guardian, 2010).

The reforms made the external debt more manageable, and currently Georgia's external debt is mostly composed of long term loans on concessional terms. It is worth mentioning that foreign aid comprises a big share in finance of Georgia. Much of the Georgian foreign credits go to improving the infrastructure, including construction of new roads and repairing of the old ones.

## Findings and Analysis

### Safeguards Taken by Government so as to Manage External Debt

Debt management is the key element of public financial management. While speaking about small-size and open economy with limited resources the importance of debt management becomes even urgent. In this situation the government should be sure that the policies it had adopted will not lead to unstable position for the country and the debt will not reach to an extremely high level. This implies that RA should have a working mechanism to manage the debt efficiently. The RA Government's Strategic Program 2012-2014 serves for this aim. The program stresses the need to increase the level of internal borrowings as an important element of increasing the efficiency of debt management and decreasing the possibility of default (Government of RA, 2011). Moreover, while financing the budget deficit through domestic borrowings instead of external ones, in the future the debt service will not be implemented through the state budget. Thus, the program of state bond issuing in RA on the one hand increases the level of domestic borrowings, and on the other hand creates more efficient mechanism for debt control and management. Tatoul Manasserian Doctor of Economics, in the interview also urged the state to take use of its internal resources as well, as unlike the external borrowing, internal ones are providing an opportunity to avoid the conditionalities imposed by the external lenders, and have lower interest rate.

Artak Kyurumyan, freelancing consultant on public financial and public debt management, has a different view on this approach. Particularly, he stated that the potential for developing the internal debt is still low because of the shallow internal capital market. A vivid example can be the introduction of mandatory car insurances, as a result of which 20-30% of the money received from transactions goes to purchasing treasury bonds. This implies that the possibility of internal borrowing will be higher in case of much more developed capital market.

Tatoul Manasserian and Liana Hunanyan, who is the head of the financial-economic department, stressed another important mechanism used by RA to manage the external debt. Namely strategy adopted by the government since 2010-2011 according to which the external loans are on-lent to private sector directly, instead of on-lending them to commercial banks as it was mostly done previously. This new policy first of all creates much favorable conditions for developing local economy, secondly it increases the competitiveness among the private companies as loans are on-lent to companies based on the quality of programs they submit, thirdly the policy might as well increase the export level, and finally the external debt will be repaid by the private sector and not by the state budget.

The essential element in the RA strategy of debt management is the "Law on Public Debt Management" adopted May 2008. The law aims to control relations concerning public debt and to make those relations subject to law regulation. It is natural that even before the adoption of this law there were certain criteria and restrictions related to the regulations of the public debt, however with the introduction of this law all the criteria are going to be defined by law. In this regard articles 5.6 and 5.7 of the law are of great importance. Namely the articles state that as of the December 31 of the current fiscal year public debt should not exceed 60% of the GDP of the previous year. Once the public debt exceeds the ceiling of 50% certain restrictions start to work. Particularly once public debt exceeds 50% of GDP, than the budget deficit of the coming year should not exceed 3% of the average GDP of the previous 3 years.

Can this ceiling be a safeguard against accumulation of extra debt that later might be a burden for the country in term of its service? The debt history of the developed state like US gives the negative answer. Congress which is the only body that can borrow money is also the one who can increase or decrease the level of the debt ceiling. The debt ceiling is a restriction applied by Congress to the level of debt that can be legally borrowed by the national government (Government Accountability Office of US, 2003, p12). Although debt ceiling is used so as to be able to control spending and the amount of money borrowed, in fact is hardly serves its goal. The debt ceiling was introduced in 1917 and was set at USD 11.5 billion. Since that time the debt ceiling has been raised more than 70 times, and as for January 2012 the ceiling is set at USD 16.394 trillion (New York Times, 2012).

This means every time US government needed additional money to borrow for financing operations or covering budget deficit or paying creditors, the ceiling was raised.

What are the alternatives to increasing the level of the ceiling?  There are three ways out: decrease the spending, increase the taxes or admit that the county is not able to repay its debt and is facing default situation. The outcomes might cause another range of economic as well as political issues to solve. Of course by raising the ceiling, the debt problem is not resolved, still situation might not get worse and the government might have enough time to find better solutions. Why the above mentioned solutions are not the best alternatives? Increasing the taxes or making cuts in spending, the government might face the protest of the public, as it was the case in France in 2010. The approval of the bill of increasing the retirement age from 60 to 62 years so as to somehow cut the spending system brought to massive protests and decreased of France President Sarkozy's popularity (Washington Times, 2010). The society is already used to certain standards of living, and negative changes, including the increase of taxes, usually cause discontent and resistance. In the worse scenario, that is default situation, not only the country under default will lose its reputation but also it might have difficulties in having access to international financial markets in the future. As a result of the default the economy of the country, and consequently the GDP will suffer, and in case of great economic powers like US the negative consequences of the US default will be felt in the whole world.

Still if for the US with is one of the most developed economies in the world the high levels of external debt might not be that much problematic in term of its debt service, for Armenia it might turn to a real disaster especially in cases when the debt will have to be repaid from the state budget. In the interview Liana Hunanyan stated that in the near future the 60% ratio of public debt and GDP allowed by law may be bypassed. One of the reasons might be the borrowing of even larger loans from Asian Development Bank in frames of "North-South Road Corridor" project. Still Mrs. Hunanyan stressed that despite the above mentioned overshoot the 60% is not that problematic as the major part of the loan taken by the government was later on-lent to private sector. In this case, according to her words, the level of risk is low, because loans to private companies are guaranteed by collateral and in addition companies are in stable financial condition and thus will be able to repay the debt on time.

Doctor Tatoul Manasserian has another viewpoint concerning GDP public debt ratio. In the interview he stated that although Armenia is still far from reaching the limit allowed by the law, nevertheless he urged that by no means the debt should be allowed to reach that level. Further he clarified his point by saying that as result of low level of internal debt (which in 2011 December comprised 13.6% of the total public debt), the GDP public debt ratio therefore is used for managing the external debt and thus overcoming the 60% will have a negative effect on the economy.

Artak Kyurumyan in his interview stated that problems might arise even before reaching the 50% of GDP. This was the case in 2002 when Armenia had total debt of 47% of GDP (below the 50% threshold stipulated by the Law on Public Debt). However, it was not able to repay its obligations to Russia and had to restructure them (debt-to-equity swap). As a result the debt to GDP declined to 41% in 2003.

Still it is important to mention that despite the above mentioned no country can be fully safeguarded against default. Armenia was able to overcome the recent financial crisis without having the fear of facing default, like the other European countries, including Italy, Portugal, Spain, and this, as Arshaluys Margaryan head of the Department of the Public Debt Management of Ministry of Finance of RA stated is due to the fact that the GDP external debt ratio of Armenia in 2008 was 13.5%, which is rather low index.

It is time for officials to stop walking on the same path with European countries and comparing the level of external debt or the ratio of GDP and external debt to those of European countries. This by no mean can be a justification. The European countries might have higher debts, but still be creditworthy, as a result of their strong economy. Still the same cannot be said about Armenian economy.

Although IMF in its report in 2011 put Armenia in the list of countries with light debt (IMF, 2011) and state officials claim that Armenia's external debt which comprises nearly 35% of GDP is still manageable and there is no need to worry, Artak Kyurumyan mentioned that the problem of Armenia is not its external debt's structure, but rather the structure of its economy. For strengthening his point, Mr. Kyurumyan brought the examples of Belgium, Germany, United Kingdom and Japan. As for 2011 the ratio of debt to GDP in those countries reached 98%, 81%, 86% and 200% respectively, still no one is speaking about the possibility of default in those countries. The reason is that they have very diversified and competitive economies and solid tax base.

Our economy has many risks which might make the debt service problematic. One of such risks is the high level of shadow economy. Due to the level of shadow economy, the amount of revenue that the state budget should have received through taxes is lower that it could have been if those economies were brought into the legal field of taxation. This implies that starting from 2014 when the RA will have to service the debt borrowed since 2007, including the largest USD 500 million loan provided by Russia, in case of lower economic growth, Armenia might have to borrow new loans for covering the older ones. Therefore as Liana Hunanyan mentioned, currently RA should restrain from borrowing new loans. In case of borrowing the government should take into consideration the duration of the grace period, availability of grants, and lower interest rates.

The oligo-monopolistic structure of our economy might become another reason never letting Armenia go down of the path of borrowing money externally. The economic structure of RA where several individuals based on their political power are in charge of economic decision-making, gives them possibility to make those decisions based on their own interest. So as to strengthen the economy it is essential to foster private sector and especially small and medium business, thus promoting economic development, competition, decrease in prices and reduction of unemployment. In this regard a strong political will is needed, as many of the politicians are connected in some way with the oligopoly. Taking into consideration that in 2013 presidential elections will be held in Armenia and the resources and attention of the politicians will be focused on this direction it is hardly possible that government will take measures so as to limit the role of oligopolies, thus also preserving some kind of stability.

The structure of the external borrowings is also risky: the loans are provided in foreign currencies therefore in case of depreciation of dram, debt service costs will increase. This implies that for repaying the debt, foreign currency is needed, which can be achieved through increasing the level of exports. Currently the level of imports of RA is almost three times much than the level of exports (Ministry of Finance, 2011). Moreover almost 40% of the exports is raw materials, including copper and molybdenum, despite the fact that this might be risky as the prices of raw materials depend on international market prices (News.am, 2010). Therefore diversification of export might be another step forward for having stabile economy.

Armenian economy is much dependent on money transfers especially from Russia, and any change in the Russian economy will be immediately felt on Armenia, like it was in case of 1998 crisis in Russia. As a result of 1998 crisis there was a decrease in export, investment and level of economic growth (IMF, 1999).

Above all the loans that were borrowed should be focused on fostering the economic development by improving the infrastructure and supporting the private sector. However as the official report of 2011 of the Ministry of Finance states USD 118.28 million of the borrowed money from the foreign sources was used for financing infrastructural projects, whereas USD 120.20 million was budgetary support. Prime Minister of RA Tigran Sargsyan stated in his interview with Azatutyun radio station in 2012 that Armenian budget has mostly social direction (azatutyun.an, 2011). This implies that government tries to improve the social conditions with the help of foreign debt. Using the foreign borrowings in this way might have the negative outcomes, as loans should be directed in capital investments and developing the economy and as a result start to reduce indebtedness. Otherwise RA might have no other way but to borrow and refinance the old debt with the new ones.

High level of corruption in Armenia brings to inefficient usage of loans even when the loan is aimed at developing the infrastructure. Namely the borrowings finance such sectors that in the long run are not sustainable; this may include the construction of roads that return to their original condition one year after the reconstruction. Moreover, despite the actions undertaken by the government to reduce the level of poverty by increasing the pensions and subsidies, in fact poverty has increased dramatically from 27.6% in 2008 up to 35.8% in 2010 (Armstat, 2011).

Government should take into consideration that currently, when the consequences of the global crisis are still felt and the possibility of the second wave of crisis is high, the path for achieving economic growth is not going to be an easy one. The state can no longer rely on external borrowings as a mean of stabilizing and developing economy; it should be done through economic reforms, by increasing the competitiveness, decreasing the level of shadow economy, fostering domestic production and export. Armenian economy is still overcoming the consequences of the global crisis. In 2009 the economic growth of RA decreased by 14.4% as a result of the crisis, whereas in 2010 and 2011 the economic growth has comprised 2.1% and 4.6% respectively (Ministry of Finance, 2011). This implies that the economy has not fully recovered from the crisis and in case of second wave of crisis Armenia might face different consequences and even harder economic conditions, as a result external borrowings will no longer serve as a solution.

Below are the analyses of the research questions:

*1. Who are the main creditors of RA and on what criteria the government of RA decides from which donor to borrow?*

Despite the fact that after the collapse of the Soviet Union Armenia became independent with no external debt, nevertheless within relatively short period of time it started to accumulate external debt. In 1992 Armenia became member of International

Monetary Fund and in 1993 of the World Bank and since then those two organizations became the main creditors of Armenia. By the end of 2000 Armenia's external debt reached 862 million USD or 45 percent of GDP, the biggest creditors still remaining the World Bank, IMF and Government of Russia that have provided USD 400 million, USD 175 million and USD 115 million credits respectively. Moreover taking into consideration the level of poverty in the country, and the economic growth most of the loans provided by the World Bank were given to Armenia through International Development Association on concessional terms.

With the global crisis hitting Armenia as well, Armenia's external debt almost doubled reaching from USD 1,577.1 million in 2008 to USD 2,966.7 million in 2009. Even after the 2008 crisis, RA had to borrow externally so as to cushion the effects of crisis, as a result of which by the end of 2011 Armenia's external debt reached USD 3,568 mln with the main creditors still remaining World Bank, IMF and Russia with 37.5%, 23.2% and 11.1% of the total external debt respectively.

As it was mentioned in the interview with Mrs. Lianna Hunanyan while borrowing externally, the government of RA takes into consideration the level of interest rate, the length of the grace period and maturity years.

*2. How the credits that RA has received were spent since 2007?*

Since the independence in 1991 Armenia had to borrow externally in order to achieve economic growth and stability. With the lack of natural resources, collapse of the regional trade agreements with former USSR countries, and the Armenian-Azerbaijan war over the Nagorno Karabakh following by the blockade by Turkey and Azerbaijan external borrowing remained the optimal way out for stabilizing economy.

In general the money borrowed externally is used to finance the budget deficit, invest in programs aimed at developing the social well being and infrastructure. Starting from 2007 until 2011 Armenia mostly borrowed for several key projects one of the being the upgrading of the water supply both in Yerevan and Marzes. Particularly, there were 10 new loan agreements for total amount of nearly USD 204 million signed in 2007 and 2011 for renovating and replacing the water and sewage systems, thus reducing energy consumption in water supply process, as well as water losses and improving the quality of drinking water.

The next project that was financed during those 5 years was the rehabilitation of the road sector. Total nearly USD 390 million was borrowed for developing the access of countryside to national road system and as well as constructing the North-South highway.

Essential amount of credits was used in order to reduce the level of poverty and develop social assistance. The programs focused at increasing the standards of living of poor people by developing infrastructure (schools, kindergartens, health clinics), advancing institutional capacity building and increasing the social protection. For this aim nearly USD 116.5 million was borrowed externally in the period between 2007 and 2011.

During the same years nearly USD 140 million was borrowed for supporting the poor rural and peri-urban people as well as developing the agricultural sector. Particularly the government on-lent loans to those micro-enterprises that have potential for growth but do not meet the necessary criteria for receiving loans from banks, thus aiming at developing small and medium rural business in Armenia. The borrowings were also used in order to buy agricultural machinery, land consolidation and modernize fruits and nuts sector, promoting export and reducing the unemployment.

Nevertheless the major part of the debt was accumulated as a result of financial crisis and the need to mitigate its consequences. As a result starting from 2009 funds borrowed by Armenia were directed at protecting the vulnerable parts of population by providing jobs and increasing social protection expenditures in order to overcome the crisis. Moreover, credits were used in order to restore fiscal and financial sustainability and maintain economic growth. For those reasons nearly USD 1.878 million was borrowed, including the biggest USD 500 million loan borrowed from Russia on commercial terms. The debt accumulated for decreasing the negative effects of global crisis might raise troubles in term of its service, as far as they were mostly used for covering the budget deficit, and therefore in the future they will be repaid through the budget.

Whether all the credits received were spent efficiently is still debatable. The credits should first of all have a target in enhancing the economic performance of the country rather than developing the social well being. Moreover the capital borrowed should be invested in increasing the productivity, renewing production and fostering export. Only in this case the debt will not become a burden for the state in terms of its service, as by developing economy, creating new workplaces government will in the future be able to allocate money for covering the debt. This implies that only after having a developed and stable economy the government will have an opportunity to service its debt in appropriate manner and in the future decrease the level of external borrowings.

Below the research questions asked in the beginning of this essay are answered in the same order as they were asked.

*3. How the external debt is managed and what are the financial and political safeguards against default?*

There are several mechanisms used in order to manage the external debt, one of them being the "The Law on Public Debt" adopted in 2008, according to which the ration of public debt to DGP cannot exceed 60%. This mechanism aims at putting limits on the amount of money that can be borrowed externally. The second mechanism is the strategic program of the government aimed at managing the public debt. The program is written for 3 years (currently the 2012-2014 program is in force and the new 2013-2015 program is under consideration) and explicitly explains the functions of the government for managing the debt.

Our government continues it cooperation with international financial institutions including the World Bank and IMF, however in order to decrease the debt burden our government gives its preference to loans on concessional terms, with longer grace periods and maturity rate and with fixed interest rate, in order to avoid fluctuations in the future.

Major part of the external borrowings was later on-lent to private sector for enhancing infrastructure; therefore the debt service is shifted to private sector, and will not be paid directly from the state budget. Those private companies have stabile financial standing, and thus low possibility of not being able to repay their debt.

Another important mechanism that would provide a possibility to avoid default is diversifying the sources of borrowing and increase the level of internal borrowings. Unlike the external borrowing, internal ones are providing an opportunity to avoid the conditionalities imposed by the external lenders, and have lower interest rate. The issue of internal borrowing is beyond the topic of this paper, therefore will not be extensively discussed hereinafter.

**Conclusions and Recommendations**

Debt accumulation of Armenia started from the very first years of independence. In order to foster economic growth, develop infrastructure and cover budget deficit Armenia started to borrow externally, the main donors being IMF, World Bank, and Russia. In the period of 2000 up until 2008 an average 12% annual economic growth was recorded in Armenia, as a result of which external debt to GDP ratio decreased significantly from 47.2% in 1999 to 13.5% in 2008. Financial crisis on 2008 and the August war of Russia and Georgia dramatically changed the situation. On the one hand the need to restrain economic decline and on the other hand the necessity to finance the budget deficit increased the volume of external borrowing almost twice.

One can never judge of the burden of the external debt or the possibility of default based on one or two factors. State officials claim that there is nothing to worry about of and that the external debt of Armenia is still manageable and is within the limits allowed by the law (34.8% of GDP as of 2011 December). To prove this point they compare the indicators of the external debt, including the GDP to debt ratio to those of the other European countries, and strengthen the fact that if Armenia was able to overcome the global crisis that the current external debt of USD 3,568.2 (as of December 2011) does not give any floor to worry. Still it is important to mention that what shall be worrisome about Armenia is not the structure of the external debt itself but rather the overall structure of economy. Our economy has many risks which might make the debt service problematic. Those risks include the high level of shadow economy, corruption, oligopoly and weak private sector.

Government should take into consideration that currently, when the consequences of the global crisis are still felt and the possibility of the second wave of crisis is high according to the predictions of Doctor Manasserian, the path for achieving economic growth is not going to be an easy one. The state can no longer rely on external borrowings as a means of stabilizing and developing economy; it should be done through economic reforms, by increasing the competitiveness, decreasing the level of shadow economy, fostering domestic production and export. Armenian economy is still overcoming the consequences of the global crisis. In 2009 the economic growth of RA decreased by 14.4% as a result of the crisis, whereas in 2010 and 2011 the economic growth has comprised 2.1% and 4.6% respectively (Ministry of Finance of RA, 2011). This implies that the economy has not fully recovered from the crisis and in case of second wave of crisis Armenia might face different consequences and even harder economic conditions, as a result external borrowing may no longer serve as a solution.

Taking into consideration all the issues discussed in the paper as well as the interviews, this paper developed the following policy recommendations for Ministry of Finance and the Government of RA:

- The external borrowings should be focused at financing capital expenditures rather than current social programs. In this case the loans used for public investment will in the future generate profit and possibility to repay the debt.
- The loans should be used in order to diversify economy and increase the level of export.
- Armenian government should create appropriate conditions for improving the internal capital market and increasing the level of internal borrowing.
- For decreasing the GDP to external debt ratio, it is important to increase the revenues generated by taxation by bringing the oligopolies and the shadow economy into the taxation field.
- Taking into consideration that the level of external debt is related to every member of society, all the information about the external borrowings should be transparent. In this regard, it is essential that the Ministry of Finance includes in its annual reports on state budget not only the donors and the amount of credits but also on what the funds was spent on.
- For solving social and economic issues in the bordering areas, establishment of free economic zones can be a good solution. On the one hand these zones will attract investors and increase the level of income, and on the other hand will solve the problem of uneven economic distribution.
- The role of the National Assembly should be increased in external debt management. Although the article 77 of the Constitution of RA states that “The National Assembly

shall oversee the implementation of the state budget, as well as the use of loans and credits received from foreign governments and international organizations", nevertheless government should be accountable to Parliament and substantiate whether it is appropriate to borrow the given amount of money from the given source and under the given conditions. Government should also be accountable for the efficient use if the resources and the results.

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## Appendix A: Questionnaire

Below is the questionnaire used during the interviews with state officials and independent experts:

1. In your opinion what are the effective mechanisms exercised by the government in order to manage the country's external debt?
2. What kind of financial and political steps are needed to take in order to avoid the possibility of default?
3. Taking into consideration the percentage growth of the ratio of the external debt to GDP since 2008, how high is the possibility that in near future this ratio will bypass the limit permitted by the law?
4. What sanctions will Armenia face in case it will not be able to service the debt or repay it in time?
5. What alternative administrative and economic mechanisms would you suggest in order to reduce the ratio of the external debt to GDP?