
Revaluation Of Armenian Dram Lowers Inflationary Expectations, Potential

ARKA News Agency - 4/2/2008

ARKA: Mr. Sargsyan, what preliminary estimates of the country's key macroeconomic indicators for 2007 can you make?

Sargsyan: 13.6% macroeconomic growth was recorded in Armenia in January-November 2007, which growth was mainly facilitated by such sectors as construction, services and agriculture. In January-November, a 2.7% increase was recorded in the industrial sector, and a 9.1% increase without the diamond-cutting industry.

The increase was mainly due to the food industry, particularly due to the confectionary industry, the production of alcoholic beverages, tinned food and natural juices. The increase was also facilitated by the nonferrous industry, namely, the production of aluminum and ferromolybdenum, and that of building materials, particularly cement and lime.

The agricultural sector recorded a 9.6% increase, mainly due to a 10.6% increase in plant cultivation. Bumper fruit and vegetable harvest was gathered thanks to favorable weather conditions in Armenia last year. The cattle-breeding industry recorded an increase as well, mainly due to an increase in the output of meat and eggs.

In January-November 2007, the construction sector recorded a 19% increase, mainly due to capital investments in transport and communication, particularly due to large investments made by mobile operators, as well as due to road construction carried out on the funds allocated by the Lincy Foundation. The increase was also facilitated by intensified energy construction, particularly the construction of small hydro-power plants, as well as the construction of the second section of the Iran-Armenia gas main.

A 13% increase in the service sphere was mainly facilitated by a considerable increase in the amount of transport and communication services, as well as in the volume of trade (primarily wholesale and the trade in cars). The amount of services rendered by all types of transport increased, and the primary reason for the increase in communication services is the increase in mobile communication services.

Moreover, an approximate 20% rise in wages was recorded on the labor market along with reduction of unemployment and higher rates of increase in labor productivity - by about 13% against 12.5% in 2006.

ARKA: How well have the principal provisions of the monetary management program been implemented? What were the major obstacles to the accomplishment of the tasks set?

Sargsyan: The major obstacle we encountered in implementing our monetary management policy involves the world commodity markets, which not only sprang a surprise on us, but also exerted serious influence on all the processes of global economy. First of all, this is a rise in prices for food products, bread, baked goods and butter.

Also, the prices for oil and oil products have risen since the beginning of

the year. This all seriously influenced prices worldwide, with special damaged caused to transitional economies, as the share of the aforementioned products in the basket of goods there is rather large compared with developed countries. So the inflation exceeded the planned level in all the countries in transition. I would like to note that inflation exceeded the planned level by about 4% in all the countries of the Commonwealth of Independent States (CIS). Inflation is to reach about 12% in Russia, and rather high inflation is expected in Georgia. In Azerbaijan inflation may be twice as high as in Armenia.

Armenia is expected to end this year with inflation about 7%. With monetary factors alone considered, inflation would not exceed 3% (about 2.6%), the cause of the rest 4% being the rise in prices on the world markets.

As regards the principal provisions of the monetary management policy of the year, most of them have been implemented. The increase in the monetary base and money supply exceeded the planned level, the primary reason being the fact that the economic growth rates exceeded the planned level, which made the Central Bank serve the real sector by means of emission, which was actually done.

A special feature of the year is also the huge amount of foreign exchange the Central Bank has purchased from the market. By our preliminary estimates, this index will exceed last year's index by about 40% and reach \$350mln.

Despite this, further AMD revaluation against the USD has been observed and is to make about 17%. However, this process facilitated the reduction of inflationary pressures and potential.

By and large, the major obstacles we have encountered this year are: first, the world prices, second low-level price elasticity, which testifies to the need for measures to step up competition on the domestic market for the AMD revaluation to be accompanied by control over import prices.

ARKA: The Central Bank has been managing all the market segments for the second year. What are the results?

Sargsyan: First of all, the Central Bank is trying to smooth away the existing serious differences between individual segments of the country's financial market. It is no secret for anybody that Armenia's banking system has made considerable progress and meets international standards now, which cannot be said about the insurance market, the securities market and the pension system. So it is obvious that more rapid reforms are necessary to smooth away the existing differences.

It should be noted that the largest resources were directed to the nonbank part of the financial sector. First of all, this is the securities sector, for which we drafted a special bill later adopted by the Parliament. Moreover, the Central Bank approved a large number of statutory acts.

The second segment is the insurance market, where we are cleaning the insurance field. At the initial stage, 23 insurance companies were operating in Armenia, whereas only nine are working now. The process of clearing the segment is accompanied by the improvement of insurance laws. In 2007, the RA Parliament adopted a bill on insurance companies in conformity with European standards. The new law will allow reforms to be implemented at higher rates.

And finally, an important achievement of 2007 is the entry of the OMX operator to Armenia's market, which will promote the development of Armenia's financial market in general and the formation of a real capital market in

particular.

ARKA: What is your general assessment of Armenia's financial system?

What are the financial results of the year?

Sargsyan: In general, Armenia's financial system can be characterized as rather stable. The share of banks and credit institutions that recorded a considerable increase is 97% now.

First of all we are happy over the banking sector, which recorded a 70% increase in crediting of the country's economy. High-rate increase in assets was recorded. As a result, a 3-point increase in the assets/GDP ratio was recorded during one year - up to about 23%, which is a rather serious result. In general, Armenia's banking system can be said to be solidly based. The rates of the banking sector's development are expected to exceed those of economic growth during the next few years. It should also be noted the bank capitalization level is rather high in Armenia in the context of financial stability - 29% against the CBA-set 12%.

Credit institutions have recorded progress as well. The banking sector recorded a 70% increase in crediting, while credit institutions doubled their crediting volume. The interest in credit institutions has increased, and their number has reached 22, as many as commercial banks. In general, credit organizations are developing at higher rates than banks.

Nonresident entities have shown interest in the local insurance market, and we hope that new serious players will come to Armenia next year, and new insurance companies will launch their activities here. First of all, the matter concerns the HSBC Group, which plans to open its insurance company in Armenia. We have been negotiating with it for a long time. Besides, we hope for another European insurance company to come to Armenia. One Russian and one Ukrainian insurance company are expected to launch their activities in Armenia as well.

ARKA: What is your view of 2007 in the context of the entry of new banking brands to Armenia's market?

Sargsyan: The Central Bank is welcoming this process. We are vitally interested in first-rate participants entering Armenia's banking sector, which, on the one hand, promotes competition in the sector, and on the other hand, will contribute to the development of financial intermediation in Armenia.

Thus, we can state that the emergence of the German ProCreditBank will promote competition in the retail sector. The Russian Troyka Dialog Company will introduce new technologies and products on the securities market. The Lebanese Byblos Bank will introduce corporate management culture and private banking, which is well-developed in Lebanon. Finally, the Russian Gasprombank will promote banks' competition for large enterprises.

All this is rather promising for Armenia's financial sector, if we consider the fact that it is due to new players that the Armenian banking system's capital increased by about 40% in 2007.

ARKA: Since the banking system remains the largest player on the financial market, what is your assessment of the current stage of development of Armenia's banks. What are the forecasts for 2007 and 2008?

Sargsyan: First of all, noteworthy is a considerable decrease in net external

assets of the banking system in 2007 - by approximately 82bln AMD. As a result, the system's net external assets for the first time proved to be negative - minus 71.6bln AMD (over \$200mln).

This means that our banks started attracting more funds from nonresidents and investing them in Armenia, primarily in the country's economy. Another important feature is a lower dollarization level in the country. First, AMD credits doubled.

Secondly, a decrease in the share foreign-exchange deposits was accompanied by an increase in the share of AMD deposits - up to 53%.

Assets increased by 41% and amounted to 741bln AMD, the share of AMD assets being 65% - a 7% increase. The share of assets in the GDP increased from 19.8% in 2006 to 23% in 2007.

The banking system's liabilities increased by 43% during one year and amounted to 580bln AMD, and individual deposits increased by 34% and amounted to 191.6bln AMD. The number of banks' clients increased by 150,000 or 20% and reached 913,000, and the number of accounts reached 1,000,000 - a 15% increase.

The capital increased by 34% or by 41bln AMD and reached 161.6bln AMD. Nine banks replenished their authorized capital with 27mln AMD.

The banking system's net profit is to total 23.5bln AMD - a 40% increase compared with 2006.

As regards forecasts for 2008, we hope that the development of the banking system will doubly exceed that of the real sector. The raising of the financial intermediation level requires the development of the banking system at higher rates. Also, we expect the Dutch Postbank in Armenia next year.

ARKA: Early this year you mentioned three "problematic" banks in Armenia, which received low marks by the CAMELS system. Have the problems of the banks been resolved, and are all the banks operating without any problems?

Sargsyan: All the three banks have improved their financial situation this year. At present we have no banks that would not meet economic requirements and have any supervision-related problems with the Central Bank. In this aspect, all the problems have been resolved. Of course, competition will encourage banks to pay more attention to the management level. It is no secret that it is primarily a bank's management that accounts for its success or failure. So next year we will pay more attention to raising the management level at banks.

ARKA: Early this year you stated the intention to introduce principles of protecting consumers' interests in the banking system.

At what stage is the process, and what progress in the accomplishment of the tasks has been made?

Sargsyan: The Parliament has adopted a number of normative documents.

We have started putting into practice the requirements for banks' activities to become more transparent. Clients must be ware of the services rendered by banks, of the interest rates and of the prices.

The Central Bank's web-site contains full information on the services rendered by all the local banks.

We also plan the introduction of a system of universal interest rates with due regard for clients' other expenses. This will help banks' clients to be aware of the real cost of credits.

New bills have been drafted, which take into account the best international experience and are aimed at the protection of clients.

The laws are supposed to regulate crediting process, ensure the protection of clients' rights and make the services rendered by banks opener. Specifically, we have drafted bills "On financial ombudsman", "On consumer crediting", "On order of attracting deposits".

The Central Bank has also prepared a new concept of financial arbitration. All the aforementioned procedures and concepts will be submitted to the Government and Parliament in 2008.

ARKA: What other new legislative amendments concerning Armenia's financial system, particularly banks, credit institutions, insurance market and stock market , were adopted in 2007?

Sargsyan: In 2007, the Central Bank seriously mitigated the bank management and banking supervision requirements, which allowed banks to manage operational risks using market mechanisms. The bank liquidity requirements were mitigated as well. The first step toward Basel-2 was made. Specifically, a standard approach to credit risk calculation was introduced. For financial services to be more available in Armenia's regions and rural communities, banks were allowed to carry out field crediting.

As I have already noted the newly adopted laws allowed of radical changes in the management of securities and insurance markets. The relevant legislation was brought to conformity with European standards. The new law on insurance prohibits life and nonlife insurance of only one legal entity. New requirements for and standards of corporate and risk management were set for insurance companies.

In conformity with the new law on the regulation of securities, the Armenian Stock Exchange and the Central Depository were transformed to open corporations and later sold to the Swedish OMX stock exchange operator. Minimal requirements to capital were set for professional market participants. The new law allows banks to be immediate securities market participants.

ARKA: What is your assessment of Armenia's insurance market? What is the Central Bank's current policy and forecasts? What are your expectations of the sphere in 2008?

Sargsyan: The first result we achieved is to clear the sector of weak insurance companies that are unable to function in conformity with insurance standards. If we fail to clear the insurance market, we cannot speak of solid foundations for the development of insurance in Armenia.

Our goal is to clear the sector with further introduction of the best standards. We have adopted a law our German colleagues assessed as one of the best laws on insurance. All the changes are supposed to create favorable conditions for the development of insurance business in Armenia.

Our next step is the introduction of compulsory insurance in Armenia.

We hope that the Government will approve the concept of compulsory third-party insurance against traffic accidents, which will promote the development of the insurance sector. The next field is medical insurance. The Government has included measures to develop medical insurance in its program of action. Among the requirements for the development of insurance business is also the development of the institute of actuaries and the creation of a database.

ARKA: How much will the OMX's entry intensify the activities on Armenia's stock market. Can any results be expected this year? In your opinion, how many enterprises will be working on the stock exchange in 2008?

Sargsyan: A priority task for 2008 is the formation of infrastructure. We have quite a long list of measures we must implement in cooperation with the OMX. Specifically, the matter concerns legislative and statutory acts, formation of market institutes, which are necessary for normal operation of the stock exchange and depository. In other words, in 2008 we will direct all our resources to the formation of infrastructure.

In 2007, several entities showed interest in the securities market, and we encourage this process in every possible way, practicing the rating of enterprises. Some of the enterprises have issued their own bonds. In fact, we have entities on the market which will intensify their activities after the OMX enters the market, and, naturally, the interest in the securities market will increase.

ARKA: What inflation level is expected in Armenia in the context of the global economic processes? How well is the bank accomplishing its major task, namely, maintaining stable prices in the country? What is your general opinion of inflation?

Sargsyan: Serious inflationary potential was accumulated in 2007, which is a rather serious problem for global economy creating serious turbulence on all the financial markets. Of course, the behavior of China and India exerts serious influence on prices, world markets. In this context, we have fears that the inflationary pressure from the world markets will be rather strong in 2008.

Our goal is 5.5% highest inflation. We hope that this goal will be attainable by the end of 2008. As regards the year 2007, I have already noted that 7% inflation is expected in Armenia.

ARKA: Will anything be changed in your inflation targeting policy in 2008? Are our exporters now able to oppose inflation?

Sargsyan: In 2008, the Central Bank will continue implementing all the necessary measures to switch over to full inflation targeting in the medium-term prospect. Among the measures are the enhancement of confidence in the Central Bank's policy, further development of the financial system, improvement of the macroeconomic forecast system, instruments of monetary policy, etc..

As regards the second part of the question, it is important that the financial market participants are already offering new services to their clients, particularly derivatives, which will allow them to have forecast exchange rates at their disposal for a small price. Of course, it is primarily transparent enterprises able to sign relevant contracts with commercial banks that will be allowed to use these services. On its part, the Central Bank will encourage the introduction of a new culture of financial market, and the market participants must learn to manage their currency risks.

ARKA: Do Armenian citizens trust the Armenian dram now, and how much did the dollarization level reduce?

Sargsyan: Our citizens obviously give their preference to the Armenian dram. Specifically, last year (2006) we reached 50% level in assets, and this year (2007) we reached this level in liabilities.

Over 50% are funds attracted in terms of drams, and this trend will be continued. This process is facilitated by the revaluation of the Armenian national currency on the one hand, and by the reduction of shadow economy on the other hand, which, in turn, stimulates reduction of the dollarization level.

I think that approximate 10% reduction of dollarization level can be expected in 2007 if it is estimated in the context of the share of drams assets in our banks' gross assets as well as that of USD deposits in the total amount of deposits.

ARKA: Does the sovereign rating assigned to Armenia produce any results?

Sargsyan: There is increasing interest in Armenia, especially in the context of the forecasts on the ratings being made. In their turn, our commercial banks started paying more attention to their ratings, which facilitates the establishment of contacts with foreign partners and attraction of new financial resources. The ratings assigned to Armenia are of paramount importance for the country's further economic development, especially in the context of the region.

ARKA: What is Armenia's real and specific potential to become a regional financial center in the context of present-day geopolitical situation?

Sargsyan: First, our banking system is more advanced from the viewpoint of management, organization, knowledge and skills compared with the other countries of the Commonwealth of Independent States (CIS). International experts point out a rather high level of management and supervision in Armenia. The experience and knowledge of employees of Armenia's banking sector play an important role as well. Besides, we plan to direct considerable resources to sharply increase the potential necessary for the country's financial market to be able to render world-class services.

ARKA: At what stage is the KfW Bank's mortgage crediting program in Armenia?

Sargsyan: At present, nine commercial banks and two credit institutions are involved in the program. It is being implemented according to the schedule agreed on with the German side. By mid-2007, under the program financial institutes had issued 286 credits amounting 1.6bln AMD. By our estimates, during the first quarter of 2008 the first tranche of the program, ~@6mln, will have been utilized. The second ~@6mln tranche is expected in April-May 2008.

In 2008, more attention will be paid to the development of the secondary mortgage market, which is most important for us. In total, mortgage crediting doubled in Armenia in 2007 and amounted to 55bln AMD - a 110% increase.

ARKA: What is the expected amount of private transfers in 2007? What are the expected trends for 2008?

Sargsyan: I would like to note that the amount of transfers is increasing. This is reality accounted for by our nation's peculiarities. Two thirds of Armenians are residing abroad, and when their economic and financial

situation gets better, they are more active in investing in Armenia. Naturally, this is a generally positive trend for our nation.

It is no secret for anybody that Armenia is a center of economic interests of not only our country's citizens, but also all Armenians, and the creation of a favorable investment environment in Armenia promotes inflow of capital, development of tourism and use of services. This is reality which shows a long-term trend, and, if no cataclysms occur in the world, particularly in Russia and in the USA, the countries that are principal providers of transfers and have the largest Armenian communities, this trend will continue.

This year our forecasts of private transfers have been exceeded. They were expected to increase by 20-25 per cent, while the actual increase was 40%. That is the volume of private transfers is to exceed \$1bln.
