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# **CONSTRUCTION, SERVICE SPHERE, EXTRACTIVE, MANUFACTURING INDUSTRIES TO BE PRINCIPAL ENGINES OF ECONOMIC GROWTH IN ARMENIA.**

Below is an exclusive interview to the ARKA News Agency by Chairman of the Central Bank of Armenia (CBA) Tigran Sargsyan.

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**ARKA: Mr. Sargsyan, you have closed the year managing all the segments of the country's financial market. What is your assessment of the results of the first year. What has been achieved due to the new functions?**

T. Sargsyan: After we legally assumed the function of universal financial supervision on January 1, 2006, our priority task was integrating all the supervisory bodies placed under the jurisdiction of the Central Bank. They are first of all the Securities Commission, departments supervising the activities of insurance companies and pawnshops, RA Ministry of Finance and Economy.

We elaborated a program of integrating these supervisory functions – from personnel selection and holding of tenders to the adoption of normative documents that regulate both the process of performing supervisory functions by the CBA and financial institutions' activities.

In fact, our priority task was to create universal supervisory instruments, instructions and approaches to the estimation of risks on the financial market irrespective of the type of institution. This naturally requires tremendous work both to prepare normative documents and train personnel supposed to perform the functions. From this viewpoint I can state that the integration process was rather smooth and painless, and we are contented with it.

The second priority of the CBA's activities in 2006 was to clear the financial market of unpromising, noncompetitive and undercapitalized institutions that failed to meet the requirements set by the CBA. Much was done as well. This concerns both commercial banks and insurance companies.

One of the major lines of our activities in 2006 was work in the corporate sector. The matter particularly concerns corporate securities. In 2006, as many as three organizations were licensed to carry out professional activities. Summing up 2006, I can say that this was a year when we created a serious potential for qualitative changes in Armenia's financial sector.

**ARKA: What is your assessment of the generate state of Armenia's financial system. What was the most significant in 2006?**

T. Sargsyan: One of the major events in the banking sector in 2006 was that a new member having a high international rating, Credit Agricole Bank, entered Armenia's financial market. This creates most favorable conditions for competition between two banks with high ratings – ACBA Credit Agricole Bank and HSBC Bank Armenia.

What is also of importance for us is that the banking sector's development be accompanied by the expansion of the branch network. In 2006, 31 branches were opened in the banking system.

Another significant event in 2006 was the signing of an agreement establishing a credit bureau between the CBA and commercial banks. The project can be said to be a success – we have founded a credit bureau which is to launch activities in 2007. The main goal that we hope to achieve in 2007 is the introduction of a scoring system. This will create a new favorable situation for crediting in Armenia.

Seven new credit organizations were licensed in 2006, and 17 companies are working in the sector now. An interesting fact is that they have 12 branches.

Cleaning is still in progress in the insurance sector. I would like to note that 23 companies worked early in 2006, whereas only 15 have remained now. This process will continue especially as stricter capital requirements will be set to insurance companies. Either amalgamation or liquidation of insurance companies is expected. Specifically, at the end of the year we received an application rejecting a license and stating the company's willingness for amalgamation.

As regards pawnshops, the situation is rather stable – as many companies are opened as are closed. They fill a small niche in crediting in Armenia.

**ARKA: What preliminary forecasts concerning financial institutions can be made on the basis of the 2006 results?**

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T.Sargsyan: Armenia's banks show rather high growth rates. Specifically, 26% capital growth was recorded in 2006, which is a very good index. Capital growth is mainly promoted by intensified competition on the market. Credit organizations can be said to be developing rather aggressively in Armenia, which is a happy fact for us. Specifically, the assets of credit organizations have increased by 26% and amounted to AMD 17.8bln, which is about 3.5% of the assets of the banking system. This increase is mainly accounted for by crediting of individuals, which has amounted to AMD 6.5bln. Trade and agricultural credits have increased as well. The credit organization's capital increased by 755 and amounted to AMD 7.7bln against AMD 4.4bln in 2005, with their liabilities amounting to AMD 10bln (a 91% increase).

As regards the activities of insurance companies, I would like to note that insurance compensations amounted to AMD 400mln in 2006 – an 11% increase. A 12% decrease in the ratio between insurance compensations and insurance contributions was recorded compared to the beginning of 2006. Insurance companies' capital increased by 29% and amounted to AMD 5.7bln at the end of the 3rd quarter of 2006.

Twenty specialized economic entities licensed as brokerage firms and seven institutions licensed for trust management of securities are currently operating on Armenia's stock market. In 2006, their assets increased by AMD 2.7bln and amounted to AMD 10bln at the end of the 3rd quarter. The professional participants' capital increased by AMD 144mln and amounted to AMD 1.2bln. Liabilities increased by AMD 2.600mln and amounted to AMD 9.300bln. A total of AMD 7bln worth broker transactions, and AMD 100bln dealer transactions were effected. The ratio between the securities market capitalization and the Gross National Product (GNP) increased by 1.5% up to 4%.

**ARKA: Have we any “problematic” banks now?**

T.Sargsyan: At present, Armenia has three problematic banks. According to the CAMELS analysis system they received rather low ratings. This is first of all the result of a low management level at the banks as well as of the application of money-laundering techniques, which is unacceptable for Armenia. The CBA is exercising a strict supervision over the banks now. Negotiations are also being conducted with the banks' owners to resolve the problems. We have a schedule of joint measures to be implemented.

The owners' understanding inspires optimism that we will resolve the problems with the three banks in 2007. The CBA would not like to revoke their licenses. They have a serious potential for resolving their problems so we are against revoking their licenses, but for the implementation of the agreements we have reached. If the owners fail to meet the terms of the agreements, their licenses will be revoked in conformity with the decisions of the CBA Board.

**ARKA: What risks are facing the banks, particularly those related to growing crediting volume?**

T.Sargsyan: A sharp increase in the crediting volume was recorded in 2006, which, of course, caused an increase in the amount of classified assets – their share is currently about 5%. This is a natural process: increasing volume of economic crediting causes increase in the share of classified credits. However, this is not yet an awful index. It is under our control, and banks are capable of working with these classified assets. The banks have sufficient reserves of these credits, loans.

The rates of increase in crediting will be maintained during the next few years, which means that asset classification will be in the center of attention of both the CBA and the banks.

**ARKA: What is your assessment of banks capitalization?**

T.Sargsyan: The CBA has approved a new requirement to the banks' capital – AMD 5bln instead of the previous AMD 2.4bln. All the banks must ensure AMD 5bln capital by the end of 2009. Our estimates show that most of the banks have already ensured AMD 5bln and more capital and, in principle, all the banks will be able to overcome this barrier. That is it is not a problem for them. In fact, we have created equal conditions for both the operating and newly founded banks. As you can remember, we set capital requirements to newly founded banks long ago. We have set this bar to the operating banks as well now. From January 1, 2009, they must meet this requirement. At first we wanted to set stricter requirements – AMD 7bln, but the banks convinced us that AMD 5bln is a sufficient sum for the present.

We are sure that after corporate management rules have been introduced the capital requirement set to banks will not be of principal importance.

**ARKA: What new financial institutions can appear on Armenia's market in 2007? What are your expectations of 2007?**

T. Sargsyan: We hope to have new banks with foreign capital in 2007. First of all this is a Dutch bank with Dutch capital and management, which is expected to enter the market in the first half of 2007. We also expect another bank

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with European capital, which will specialize in crediting small and medium businesses. Thus we expect two new banks with foreign capital in Armenia in 2007.

We also hope to attract the Stockholm Stock Exchange to Armenia not only as an elaborator of projects and programs and projects for the CBA, but also as owner. This will certainly create a most favorable environment for Armenia's enterprises which seek capitalization and entry to the financial markets, issue of securities and attraction of new proprietors. Serious preconditions will be created for this in 2007.

As regards the insurance sector, cleaning and amalgamation is currently in progress here. Credit organizations are a developing segment of the financial market. The promotion of this process is one of the priorities of the CBA's activities in 2007.

**ARKA: What does the CBA plan to do with this end in view in 2007?**

T. Sargsyan: In 2007, we will focus our attention on the elaboration of conceptual documents which would determine the strategy of developing the financial market. We will aim our efforts at creating attractive conditions, attracting first-rate investment companies to Armenia. We do not cherish illusions that we will be able to do it very quickly – this requires the formation of market infrastructures that are currently lacking in the country. Specifically we have elaborated a new concept of developing the insurance market. A new expansive bill on insurance has been drafted to be approved by the Government and submitted to the Parliament. This will create new conditions and advantages for the attraction of private investments.

First, we plan to create infrastructures to keep records of all the insured accidents. Competent record-keeping and calculation of insurance companies' losses and incomes is impossible without such an infrastructure. The second is the establishment of one register office to register all the cases. This requires cooperation between various establishments. Armenia also needs actuaries specializing in making estimations and forecasts, having statistical data at their hand and making calculations for insurance companies. After these structures have been formed, we will be ready to legally stipulate some types of activities liable to mandatory insurance.

The second conceptual document in 2007 is a new concept of the securities market, which has been approved by the CBA Board and implies close cooperation with the Stockholm Stock Exchange. At present Stockholm Stock Exchange is conducting a survey by the CBA's request to reveal the potential of the country's corporate market. Among the important directions of the CBA's activities in 2007 is preparing the enterprises being rated by the CBA or international rating agencies for issuing their own bonds or securities. We hope that 2007 will be a turning-point, that is, there will appear the first Armenian enterprises that will start issuing their own securities. We will do our best to promote this process. It is important that Armenian enterprises' securities be in circulation on the secondary market equally with government treasury bonds and securities. It will promote the development of the secondary market.

**ARKA: Besides the new banks entering Armenia's market, what else do you expect of the banking system in 2007?**

T. Sargsyan: This is first of all higher rates of economic crediting, emergence of new institutions, attraction of foreign investments. I also regard the preparation of commercial banks for issuing their own shares and for entering international markets as an important direction of developing the banking sector. The whole year 2007 will obviously be a year of preparation for the implementation of these projects, which are most likely to be implemented in 2008-2009, because our banks are not yet ready for this. This is rather long-lasting work which requires the introduction of corporate management rules, increase in capita and transparency of the banks' activities. Such shares and securities must first be put into circulation on the domestic market, for residents. Only after that will we be ready to enter international markets.

In 2007 the banking system's activities will be more transparent than in 2006. Fundamental changes are expected in this direction.

The CBA's activities will be more transparent and predictable as well. As regards supervisory functions, we will assume the commitment to report to the financial community on the preventive measures against particular violations and banks. This will create favorable preconditions for greater confidence in the CBA.

**ARKA: What are the first results of the CBA's inflation targeting policy? What are its strong and weak points? What can you tell about inflation in 2006?**

T. Sargsyan: An important feature of 2006 was the transition to an inflation targeting policy. Armenia was the first CIS country to make this step considering all the strong and weak points of the process.

The average inflation can be said to have remained within the forecast level in 2006. By the end of the year it is expected to be within 5%, which does not exceed the indices set by the Government and the CBA under a 3-year program. In this aspect, I can say that we managed to keep within the bar.

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Our major task in launching the implementing the inflation targeting policy during the three years of transition is that interest rates start performing their function of “signals”. Unfortunately, they are not yet performing this function in Armenia. Therefore, the CBA’s new set of instruments is supposed to promote this process.

By our experts’ estimates, 2006 proved to be a rather effective year - all the market members are closely following the CBA-set refinancing rate, and this rate is a determinant for the market to be guided by. During the three years these rules will be consistently observed. It is important that the correlation between short- and long-term interest rates finally become actuality and allow us to influence money supply and, consequently, the prices in Armenia. Despite all our fears that it is a rather long-term project, I can state that 2006 unexpectedly saw the first positive results. This proves that interest rate correlations and signals can be applied in Armenia, and we are happy about it. Thus, the two major results of the inflation targeting policy is that the signals start operating in Armenia and that we managed to meet the main indices of inflation targets.

**ARKA: What are the peculiarities of Armenia’s monetary policy in 2006?**

T. Sargsyan: An important feature of the CBA’s monetary policy is that the continuing revaluation of the national currency was accompanied by 9% reduction of dollarization. AMD assets constituted over 50% of bank assets for the first time in 2006. That is the psychological barrier has been overcome. I think that early in 2008 we will be able to overcome the psychological barrier in attracting funds, which is currently 46%-47%.

An interesting feature of 2006 is also the fact that Armenian commercial banks’ external assets reduced to zero. This means that all the free dollar funds (about AMD 27bln) our banks put on correspondent accounts abroad were directed to crediting residents. This, in turn, was one of the reasons for the revaluation of the national currency because banks started crediting the country’s economy from these funds. Correspondingly, the USD supply increased on the market.

In general, we can note that the AMD supply increased by 42% during the year, the monetary base by 35% and cash by 37%. These are rather serious indices, and the increase in the money supply and monetary base was directed to serving the economy and slowing down the rates of revaluation of the national currency. The CBA had to issue its AMD70bln securities worth, and AMD 50bln worth securities were redeemed in 2006. AMD 40bln securities have so far been issued, and the Government issued AMD 65bln worth treasury bonds.

**ARKA: What your general estimation of the country’s foreign exchange market in 2006?**

T. Sargsyan: An interesting feature of the foreign exchange market in 2006 was that 70% of all the USD transactions were effected on the Exchange, with only 30% effected on the interbank market.

The CBA’s interventions became much more frequent. In 2005 we purchased \$100mln, and in 2006 about \$250mln, that is 2.5-times as much. In spite of that 11% AMD average annual revaluation was recorded. By the end of the year, 20% AMD revaluation had been recorded.

**ARKA: What will be the AMD exchange rate in 2007?**

T. Sargsyan: First, some provisions on setting the AMD exchange rate will be amended. The market will set the AMD exchange rate, and such term as the CBA-set official exchange rate will be put an end to.

All the market members must be guided by the market exchange rate, and the CBA is only one of the market members. The CBA-set exchange rate must not cause market confusions because the CBA forms this exchange rate formed at the Stock Exchange as well as for performing operations with its clients. This means that society must chiefly be guided by the market exchange rate, but not by the exchange rate the CBA uses in settlement operations with the Government because the Government is the CBA’s principal client. This is the first amendment.

If you have noticed the mass media do not any more publish the CBA-set exchange rate, but that formed on the market. However, these are mostly operations performed by commercial banks on the foreign exchange market, which constitute 70% of the foreign exchange market.

The second conceptual amendment is that the calculations of the exchange rate for the budget will be based not on the estimates of the real effective exchange rate of the CBA. The exchange rate will be fixed for a particular date - for example, 15 or 30 days before the approval of the state budget by the Government for society not to be guided by this exchange rate. The exchange rate for next year is impossible to forecast.

On the other hand, for budget problems to be prevented, all the major budget transactions effected through the CBA - USD incomes and expenditures - will be effected at special exchange rates set for transactions with the Government. By and large, the Government will neither sustain losses nor gain profits from the operations, because the CBA and the Ministry of Finance will effect transactions that will smooth budget risks.

**ARKA: What is your personal estimation of the quality of economic growth in Armenia as an economist? Preliminary expectations of 2006 and forecasts for 2007? Which economic fields and segments must be more**

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**actively developed, and what needs to be done for that? What are the specific tasks of the Government's economic policy in particular fields?**

T. Sargsyan: The principal engines of economic growth in Armenia will be construction, the service sphere, extractive and manufacturing industries, which have accumulated a very serious potential for export-oriented economic growth.

The fourth important direction is the chemical industry, where the Government is implementing very serious projects involving the "Nairit" plant and the Vanadzor-based chemical complex. If the two giants are re-operated, they will stimulate the operation of over 200 small and medium enterprises serving the giants. In general, it will ensure a rather high economic growth.

These are the major industries that have accumulated potential, have real development projects that are supposed to determine the economic structure.

Of course, I cannot but mention agriculture and manufacturing industry. Unfortunately, the country's agricultural sector did not record high economic growth in 2006. But we hope that the investment projects being implemented in the sector will soon produce their results, and agriculture, along with the processing industry, will be another engine during the next few years.

As regards high technologies, we must first of all keep an eye on Armenia's intellectual potential, education level - how many specialists and of what level come out of our higher schools. Only after that can we make any judgements on the potential we have in this sphere. Of course, rather serious investments are made in the sphere, but the share of these technologies in the GDP still remains insignificant, and the development is first of all accounted for by investments in education.

I think that economic growth will be within 10% in Armenia because the previously launched projects must be completed. This growth is obvious for the implementation of these projects alone, other things being equal.

**ARKA: Has the sovereign rating assigned to Armenia produced any results? Have foreign investors changed their attitude to Armenia? What is your general assessment of the country's investment attractiveness?**

T. Sargsyan: I think that the assignment of rating to Armenia was one of the most important events of last year. Armenia finally appeared on the world's financial map. All investors are not just speculating on the country's credit worthiness, risk. They are really aware of our world rank, of the interests rates supposed to be in such conditions, of the specific estimates for investors to implement their projects in Armenia. This was certainly a most important event in 2006, and the history of ratings is of high importance.

It is also very important for us that in 2006 the country's rating underwent positive changes in some parameters. Specifically, our commercial companies, banks can receive higher ratings of their currency position that Armenia's country rating due to positive changes in the macroeconomic situation.

Our main goal is to make efforts to improve the situation in the country for all the ratings to be gradually raised, and for Armenia to be more attractive for investors. This is the first step.

The second step is the assignment of ratings to commercial enterprises. Last year the VTB Bank Armenia received a rating, and a number of Armenian banks are expected to receive international ratings in 2007 and prepare for initial public offering (IPO).

The CBA-assigned ratings are of high importance as well. In this aspect we have made rather serious progress as well - the number of rating-seekers has doubled. This means that the number of enterprises wishing to operate is open and that of the ones wishing to use market instruments is increasing.

If, in 2007, companies manage to issue bonds acceptable for the CBA in performing REPO-operations, it will contribute to the market attractiveness, and the CBA will get new instruments for an effective monetary policy.

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