

Financial Stability Report (2008 annual report)

2009-04-29

This Financial Stability Report presents an assessment of potential risks that could threaten the stability of financial system of the Republic of Armenia as well as the capacity of the financial system to absorb such risks. More detailed information on Armenia's macroeconomic environment and financial system analyses is available in the Central Bank's periodicals, such as Annual Report of the Central Bank, Status Report on Monetary Policy Implementation and Armenian Financial System: Development, Regulation, Supervision.

PREFACE

The primary objective of the Central Bank of Armenia (CBA) to ensure price stability in the country is directly related to the issue of financial stability, with an account that serious deteriorations happening in the financial system may affect the implementation and effectiveness of the monetary policy. Meanwhile, macroeconomic and monetary stability helps to reduce the risks undermining the financial stability. The CBA is responsible for ensuring financial stability in Armenia, as provided for by the Republic of Armenia Law on the Central Bank.

Financial stability may be viewed as combination of such conditions under which the financial system, i.e. financial institutions, markets and market infrastructures, is able to be resilient to possible shocks and instabilities in order to reduce likely disruptions of financial intermediation. Ensuring financial stability involves disclosure of exposures to the main financial resources, mismanagement of financial risks and ineffective asset valuations, when savings turn into investments. For assessment of risks and instabilities the financial stability monitoring should be a continuous process that aims at revealing not only origins of risks but also their further advancement. Financial stability report is published mainly to improve the financial institutions and public awareness on issues and measures taken to ensure financial system stability. The purpose of providing information on risk origins and vulnerability of financial stability is to prevent financial instabilities and crises. In this report efforts are made to evaluate Armenia's financial system stability in terms of both the effectiveness of intermediation of the financial system and the capacity of the financial system to mitigate and absorb risks.

The report represents the risks appeared in macro environment and financial system, their

possible impact on the development of all sectors of the economy and financial system. Principal emphasis in the report is placed on the Armenian banking system risks and their trends since assets of domestic commercial banks account for more than 90 percent of assets of all financial institutions. Whereas the other two components of Armenian financial system – financial markets and financial infrastructures – have neither a large share in the financial system, on the one hand, nor are developed enough to have a significant influence on financial stability, on the other.

Massive work was done by the CBA in 2008 to draft anti-crisis measures and ease the adverse impacts of the crisis on the financial system. More frequent and detailed monitoring was carried out to examine financial institutions' risks and the overall financial system development trends, risks and financial stability obstacles in the country. To this end, appropriate stress-scenarios were worked out to identify financial institutions' risks under various critical situations and assess their losses. Results of such stress-scenarios were systematically updated and the possible risk level was monitored on a regular basis.

The CBA developed a package of crisis responding programs where a tool-kit of prudential anticrisis instruments was suggested along with adequate application instructions, priority of actions and tasks and responsibilities. Appropriate legislative amendments envisage lengthening the terms of financial resource injections initiated by the CBA in support of financial stability of commercial banks. In the first half of 2008, when the Armenian economy was experiencing external inflationary pressures, the monetary policy was at that time addressed to the price stabilization; whereas, in the second half of the year, when external inflationary pressures abruptly slowed down and the first signs of impact of international economic crisis appeared on the real sector of the economy and financial system, the CBA policy was additionally addressed to cover the stability of the financial system. The currency depreciation expectations outlined by slowdowns in capital and financial inflows caused additional strains in foreign exchange market and the CBA started a relatively active intervention in the exchange market, prioritizing the importance of financial stability of commercial banks. As the external inflationary pressures weakened, the CBA reduced Repo rates by 0.5 percentage point close to the end of the year, though it had been increasing throughout the year. Smooth shift to such a policy direction enabled the CBA to ensure both the price inflation targets as well as moderation of impacts of external risks spilled over to the Armenian financial sector from the global economy.

In March of 2009 the CBA discontinued sales of foreign currency in exchange market in order to stop further depreciation of the Armenian Dram. As a result, the Dram depreciated 22 percent. This decision was made with an account that in the preceding five

months the Armenian banking system could have adequately prepared itself to respond to the possible shocks expected after dram depreciation, had markedly increased own equity capital and had taken measures to adjust currency composition of assets and liabilities. Such actions helped the banking system to face abrupt challenges of exchange rate with relatively minor losses, rather than expected; in this sector the estimated loss to total capital made 2.0 percent.

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