

Financial Stability Report (2009 annual report)

2010-03-30

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.

INTRODUCTION

Starting 2007 Central Bank of Armenia composes and publishes annual Financial Stability Report. The report presents risks challenging financial system and general assessment of the CBA of the activities aimed at the mitigation of those risks. Ongoing analysis allows early identification of such changes and fluctuations, which can undermine the financial stability or emerge a crisis. Main goal of the Financial Stability Report is to improve awareness of financial institutions, companies, entrepreneurs and general public concerning measures taken by authorities to ensure financial system stability. On the other hand, the purpose of providing information on risk origins and vulnerability of financial stability is to orientate the public for taking decisions in various situations. Main responsible body for financial stability in Armenia is the Central Bank, and this is defined by the law "On Central Bank".

The primary objective of the Central Bank of Armenia is to ensure price stability in the country, which is directly related to the issue of financial stability. Serious deteriorations of the financial system may undermine the implementation of the monetary policy and its effectiveness. At the same time, macroeconomic and monetary stability reduces the probability of the emergence of the risks undermining the financial stability. In Financial Stability Report the financial stability of Armenian financial system is analyzed in two directions. First- assessment of effectiveness of financial system intermediation to macroeconomic processes. Second- assessment of financial system stability and the capacity of the financial system to mitigate and absorb risks. The report presents the risks revealed in macro environment and in financial system, their impact on the development of all sectors of the economy and financial system. The risks affecting financial stability of Armenia can emerge in local economy, foreign economy and in financial system itself. In

this aspect the main preconditions of the financial stability are:

Sustainable development of local and foreign macroeconomic environment, in terms of which the local households and enterprises would be sufficiently creditworthy,

Stable and efficient financial system, risks of which would be prudent and in manageable level,

Efficient financial infrastructure, which would not hinder the functioning of financial system.

On the basis of abovementioned the possible risks affecting financial stability of Armenia are presented in 5 directions:

Risks derived from the developments of world economy,

Risks derived from the developments of Armenian macroeconomic environment,

Risks derived from the developments of financial market of Armenia,

Risks derived from the developments of financial institutions of Armenia,

Risks derived from the developments of financial infrastructures.

The report presents risks revealed in those fields and 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 the financial system. Banking system, being the main component of the financial system, predefines the overall financial stability and financial system development directions. In this report assessment of banking system stability includes credit, market and liquidity risk analysis.

Extensive work was carried out by the CBA in 2009 to draft anti-crisis measures and ease the adverse impacts of the crisis on the financial system. More frequent and detailed monitoring, than standard reporting, was carried out during the year to examine financial institutions' risks and the overall financial system development trends, risks and financial stability obstacles in the country. Financial institutions possible risks under various crisis situations, associated losses and systemic impact were periodically assessed through

appropriate stress-scenarios. In the terms of mitigating impact of the global crisis on Armenian financial system in 2009 CBA monetary policy was aimed at the combination of price stability and financial system stability. As a result of national currency depreciation pressures and conversion of dram denominated deposits to foreign currency, the possibility of the emergence of risks associated with capital adequacy and foreign exchange liquidity rose. For mitigating those risks in the first quarter of 2009 the CBA increased its presence in foreign exchange market trying to temporary stabilize the foreign exchange rate. Such policy allowed the commercial banks to strengthen their financial positions and face challenges rising from global financial crisis. At the beginning of March, when the financial system was sufficiently capitalized and liquid (according to stress-tests), the CBA decided to stop its active intervention in foreign exchange market. As a result, the average annual nominal exchange rate of Armenian dram against US dollar depreciated for 18.8 percent.

In environment of weak internal and foreign inflation pressures the monetary policy of the CBA during the year was also targeted at the support of economic growth and liquidity injection for ensuring financial stability. For this reasons the CBA gradually decreased the Repo (repurchase agreement) interest rate, extended the terms of some monetary instruments and implemented quantitative easing policy. Anti-crisis measures were in the center of attention of the Government of Armenia, which targeted on the assurance of macroeconomic and financial stability, mitigating risks derived from global crisis. Anticrisis action plan of the Government was presented to the Parliament in November 2008 and includes the following steps: improvement of business environment, financial support of businesses, financial resource attraction for SME lending, implementation of infrastructure development and socially oriented programs. Overall, in 2009 the Government initiatives had expansive fiscal impact and were continuously synchronized with the CBA monetary policy.

With the deepening of global economic crisis in 2009 the economic activity declined conditioned by decrease of foreign direct investments, private remittances, mining sector production level and investment programs in construction sector. As a result of reduction of foreign financial inflow and local production export decline, starting the second half of 2008 expectations of Armenian dram depreciation emerged. As a result, depreciation of Armenian dram against currencies of main partner countries was observed. Decline of economic activity, reduction of foreign financing of private sector, sharp depreciation of Armenian dram in their turn had negative impact on Armenian financial system. Armenian commercial banks having excess capital adequacy, liquidity and manageable level of risks, were able to face the problems without significant losses and shocks.

