

Financial System of Armenia. Development, Regulation, Supervision 2004

2005-05-30

Introduction

Developments in the banking system of Armenia in 2004 come to prove that the potential of Armenia's banking system is high for further expansion and enlargement, given the upward adjustments of macroeconomic environment. The banking system has acted in a sound competitive environment and, through upgrading the confidence and broadening the range of services, attracted a wider circle of bank clients.

The growth of the financial intermediation level became one of the significant progresses recorded in 2004, and measures carried out over the recent years in this respect were fundamental. Due to such undertakings, financial inflows into the banking system were encouraged, on one hand, and owing to effective lending mechanisms and sustained economic activity, lending volumes increased, from the other hand. Regarding these achievements, total deposits attracted by the banking system grew by 24% and loans to the economy increased by 37%, as opposed to respective 3% and 16% in 2003. Compared to a nominal GDP 16.7% growth, the banking system assets have grown by 29 %, which brought to the increase of banking system assets to GDP ratio by 1.8 percentage points to 19.2%, against 17.4% reported in the previous year. Nevertheless, the level of financial intermediation in Armenia remains outstandingly low, for the banking system assets to GDP ratio in some European countries and the former Soviet Union Republics is 60% - 100%.

One of the basic actions fostering the financial intermediation was the banking system "recovery" program implemented by the Central Bank still started in 1999-2000, under which problem banks were tended to be brought out of the market. Along with economic improvements, and by ensuring high competitiveness in the financial market, problem banks became insolvent and their further activity in market might have had its adverse impact on and jeopardized further development of banking system. To this regard, a series of legal actions were taken by the Central Bank, including the adoption of the Republic of Armenia Law on Bankruptcy of Banks and Credit Organizations, and the strengthening of the supervisory role of the Central Bank. These actions enabled the Central Bank to expand its surveillance over the problem banks. Present achievements in the banking system come to prove the rationale of this strategic program, thanks to which

it was enabled to prevent the potential crisis on time, as well as promote further development of the banking system, and strengthen a competitive environment in market.

International loan programs acting in Armenia were crucial for upgrading the financial intermediation level. For few years, Armenian banks were involved in small and medium size business development programs, as a result, these banks were provided with eligible funds. Moreover, particular lending mechanisms were launched, and loan agents were trained and prepared for the banks.

The existence of financial infrastructures and their sound and effective functioning are essential for financial intermediaries. A credit registry and a deposit guarantee scheme were successfully established in 2003, which helped substantially to minimize the risks and enhance consumer confidence toward financial system. At the same time, credit organizations began their activities by providing financial services to wider range of population. In 2004, as it was in 2003, plastic cards continued to highly increase which encouraged an inflow of additional cheap funds to banks, as well as card-related new services (overdraft, consumer loans) were launched in the banking system.

As an outstanding achievement, it is noteworthy to mention the robust growth of gross loan investments (including receivables) in 2004. To this end, investments grew by 38.5% or 36.8 billion drams (AMD) throughout the year. Along with increasing volume of loans, number of loans and receivables grew by 36.9% and made up to 200 000, close to the end of the year. With such a lending surge, the loan investments quality, was not however worsened. It is also important that the lending seasonalities of the previous year addressed to different sectors of economy remained the same.

In 2004, Armenia experienced an outstanding upswing in profit level reflected largely by the increased amounts and sustained quality of loans. Competitiveness between banks became notably stronger. Commercial banks tried to fortify their positions in some sectors of financial market and in some areas of financial instruments and services. 2004 was also critical, because the growth of lending of the banking system, as it had been in the prior period, was attained on account of consumer and trade loans. Consumer loans namely 16.1 billion drams or 69.4% growth was most likely the consequence of new consumer lending mechanisms introduced, and household net disposable income growth. Compared to 2003, the private transfers grew by 63% in 2004, which in their turn caused rise in private sector net disposable income, and 10.6% growth of expenditures. Trade loans grew by 10 billion drams or 47.3%.

In 2004, the nominal GDP growth was 16.7% due largely to contributions of agricultural and construction sectors of economy. Lending to agriculture grew by 11.7% within the year, and the nominal output growth of this branch reached to 22.9%. In construction area, the nominal output growth made up to 18.7%, and along with this the construction lending by the banking system grew by 10.0% or 481 million drams. In this respect, the construction growth in 2004 was supported by private sector funds rather than by banking system lending. Banking loans to industry increased in 2004 by 19.6% (5.8 billion drams) with nominal output growing to 25.1%. As compared to proceeding years, mining industry showed an upswing in its nominal output to 202.1% (mainly associated with high customer prices on raw materials), the lending of which by banks had been increased by 2.7 billion drams and totaled 3.1 billion drams.

The relatively high interest spread in 2004, as a financial intermediation indicator, represents the dissatisfactory level of financial intermediation in Armenian financial market. Nonetheless, the interest spread has been lowered in 2004 by virtually 1 percentage point, it still remains double higher than 5 percentage point spread reported by the Baltic and Central European countries.

The reason of higher spread in Armenian banks is that in case of small Armenian banking system and individual banks, deposit and loan base is also small, which in conjunction with high operational expenses outlines the low effectiveness of bank activities and concludes that the “ scale effect ” in Armenian banking system is still absent. Larger banks, with other things being equal, might introduce a rather comprehensive and effective system in respect to risk management as to minimize possible losses and foster further increase in profitability. High spread is conditioned also by high credit risk, on one hand, and the absence of long-term savings in economy, on the other hand. As a result, investment attraction/allocation inconsistencies may cause additional compensation covering losses expected from other risks (liquidity, interest rates).

[Financial System of Armenia. Development, Regulation, Supervision 2004](#)