

Financial System of Armenia. Development, Regulation, Supervision 2003

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Introduction

Armenian Banking System – Development, Regulation and Supervision describes the development trends and reforms in the Armenian banking system throughout 2003. The Central Bank of the Republic of Armenia (the Central Bank) published similar papers in 1999 and 2000, which described institutionalization and development of the banking system, and the macroeconomic environment since 1994.

External financial inflows and domestic economic activity determined higher than programmed economic growth, which has been incidental to the countries' success in achieving a completed transition period. The economic growth was 13.9% compared with the program 6%. The inflation later in the year was 2.9%, without considering changes in bread and cereals prices, while the actual indicator of inflation was 8.6%, when considering changes in wheat prices. In fact, the aggregate supply has echoed the growth of the aggregate demand, otherwise the year 2003 would have seen much lower economic growth and higher prices. The growth of assets of the banking system during the year was 16.0%. The highest real growth, 44.4%, was in the Construction area. Even though Construction was carried out mostly on account of external funds, the banking system's loans to the area grew by 46.7%.

A large growth, 52.5%, was recorded in the Consumer Loans area, most likely owing to increased household income. Over 2003, the household income grew in real terms by 9.9%, while the expenditures grew by 12.2%. The purchase of goods and services represented 76.0% of income. Access to Consumer Loans on the one hand, and growing income on the other, have been a major drive to obtaining consumer goods.

Because of adverse weather, the real Agricultural Output in 2003 was 4.3%. The loans to the Agriculture area reduced by 1%. The avoidance of further loan losses seemed to be the motivation for decreased lending. With the rapid growth in GDP, the share of private consumption in GDP decreased in 2003 to 84.5% from 89.6% the previous year. Under growing aggregate demand, the shrinking share of consumption implies growth in savings. The growth of time deposits by 10.3% and demand deposits by 63.0% are

evidences of this trend.

For development of the country's financial system, the strategy of the Central Bank was focused on having a structured, institutionalized banking system, by creating a banking system that would be well prepared to function as financial intermediaries. In this context, achievements in the system for 2003 were weighty enough. Particularly, credit institutions began operating, the Credit Registry launched its activity so as to minimize the credit risk, and the Deposit Guarantee Scheme was created in order to defend the depositor's interest. The number of plastic cards doubled to broaden the spectrum of banking services thus enabling the origination of demand and cheap resources at banks.

In spite of the system's lower financial intermediation, the trends in growing volumes of the banking system, risk management and rising profitability were positive. The current level of development of the Armenian banking system may be considered as satisfactory if compared with that of the former USSR countries, with the exception of the Baltic countries. The indicators describing financial intermediation underscore this fact. Thus, the country's total bank assets to GDP ratio is 17.4%. In 2002, the average ratio in 7 CIS countries (CIS-7) was 18.3%; in the Baltic and Central European countries (BCE countries) – 74.4%. The ratio of deposits attracted from the economy (save for other financial organizations) to GDP is 11.3%. This indicator exceeds the CIS-7's 10.7% but stands well below the BCE countries' 47.9% (for 2002).

Two important factors determine the low level of financial intermediation: i) weak depositor confidence in the banking system, and ii) large credit risk. In practice, these factors find reflection in the relatively high interest rate spread. In particular, Armenia's bank interest rate spread is two times wider than the 5.3 percentage point interest rate spread in the BCE countries.

Weak mechanisms to defend creditor and borrower rights, deficient legal framework, inadequate audit and bookkeeping standards in the real sector all cause credit risk to increase irrespective of the macroeconomic developments. Under such conditions, banks restrain the growth rates of lending. Thus, Armenia's loan investments to GDP ratio is 8.0% whereas it is 9.7% in the CIS-7 and 31.4% in the BCE countries. Notwithstanding these developments, banks have been seeing their net foreign assets climb significantly in the recent two years, owing to the assets allocated in overseas banks. Armenian banks find it meaningful to keep the attracted resources in low-yield but reliable assets.

