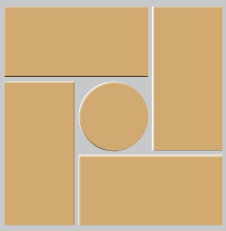
CENTRAL BANK OF ARMENIA



2015

CENTRAL BANK
OF ARMENIA



Annual Report

2015



YEREVAN 2016



Arthur Javadyan

Chairman of the Central Bank of Armenia

Chairman's address

Dear reader,

In 2015 the Central Bank of the Republic of Armenia performed its duties in the face of various challenges coming from the global economy. The Bank managed to reduce inflation expectations, which was also fostered by the lack of inflationary pressures from outside world and fallen prices of agricultural products owing to good weather conditions. The 12-month inflation rate followed a down-sloping path, which was more than expected, resulting in a 0.1% deflation indicator at the end of the year.

During the year the refinancing rate was lowered by 1.75 pp, and monetary conditions eased by 1% at the end of the year made it possible to return to the normal situation that existed before November of 2014.

The external shocks of 2015 were a challenge the domestic financial system, too. Although there was some deterioration in the loan portfolio during the year, developments to threaten the financial stability were not observed. At the same time, financial stability indicators, including those of capital adequacy and liquidity, posted growth. For the first time in Armenia in 2015 we saw asset-backed bonds issued in the framework of the capital development program of the US Agency for International Development.

During the year the Central Bank sustained its multilateral cooperation with partner financial institutions. As part of lending projects in a number of target areas of the economy, the Bank continued liaisons with the World Bank and German KfW Bank, the European Investment Bank, the Asian Development Bank and other international organizations. The SME lending program in agriculture, agriproduct processing and tourism, funded by the

European Investment Bank, started in 2015. Inking the "Bilateral Currency Swap Agreement between the Central Bank of Armenia and People's Bank of China" was an important event, as well.

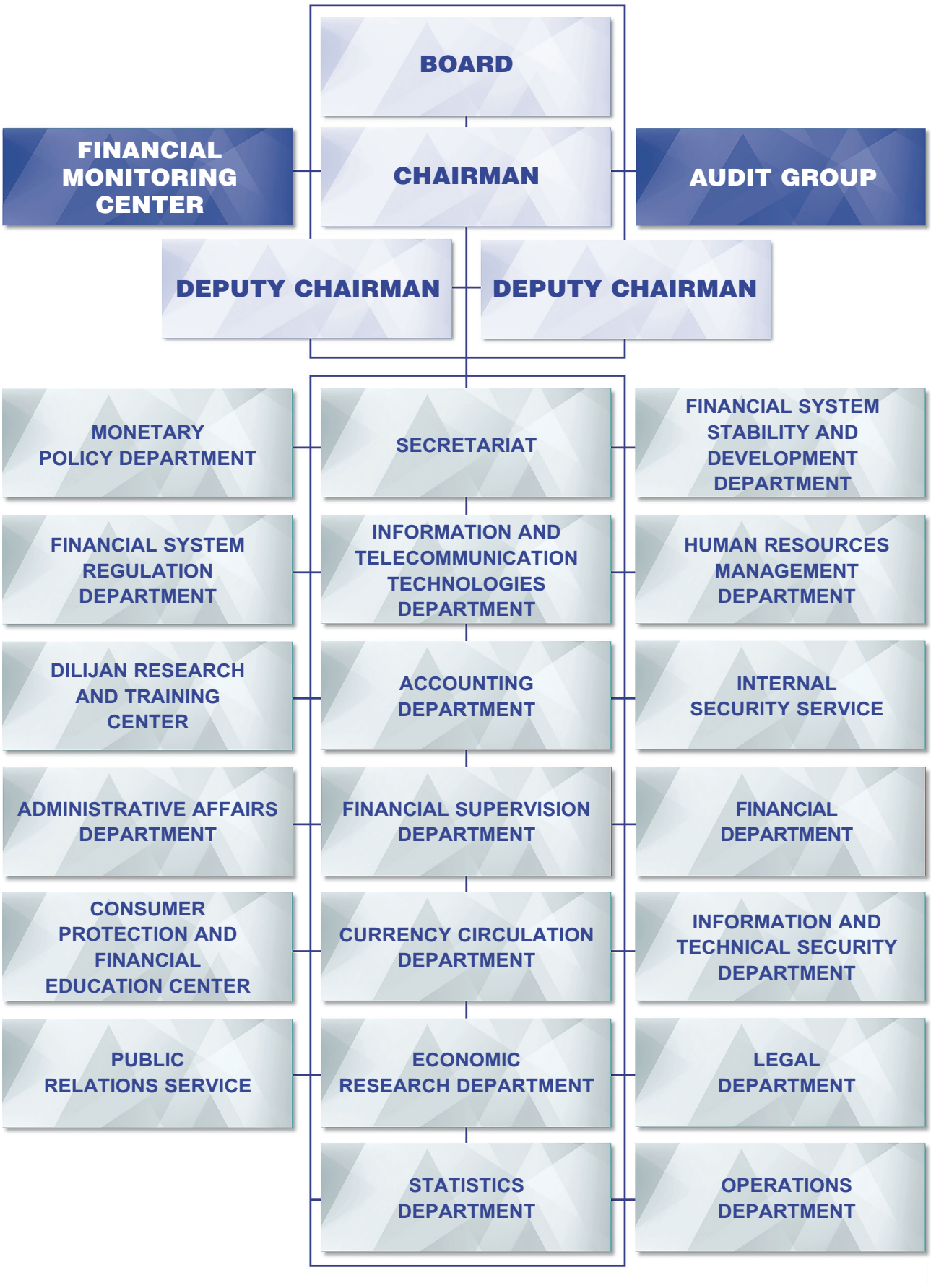
Actively involved in programs for financial education of consumers, the Bank spent further efforts to raise public awareness of financial services and products, placing special focus on the population in rural areas.

In the period under review, the Bank carried out its activities consistent with the values and strategy it adopted, and I would like to note that all that we achieved during the year is the result of teamwork at the Bank.

The complete picture of the activities of the Bank for 2015 is summarized in this annual report which we bring to your attention.

STRUCTURE

OF THE CENTRAL BANK OF THE REPUBLIC OF ARMENIA



The Board
of the Central Bank of Armenia





Arthur
JAVADYAN
Chairman
of the Central Bank



Nerses
YERITSYAN
Deputy Chairman



Vakhtang
ABRAHAMYAN
Deputy Chairman



Oleg
AGHASYAN



Ashot
MKRTCHYAN



Armenak
DARBINYAN



Arthur
STEPANYAN



Arkadi
KHACHATRYAN

CENTRAL BANK OF ARMENIA

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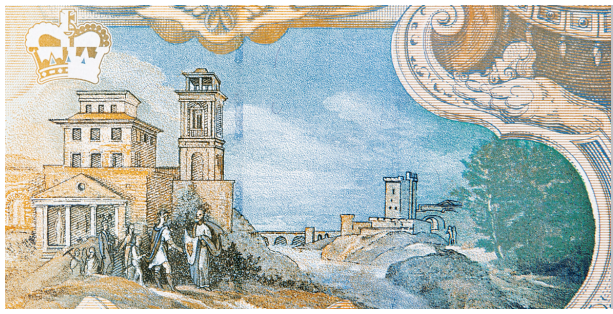
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THE CENTRAL BANK OF ARMENIA





ABOUT THE BANK

The primary goal of the Central Bank (hereinafter the Bank) is to maintain price stability in the Republic of Armenia, according to the Republic of Armenia Law on the Central Bank. To achieve this goal, the Bank has a function of taking measures to attain price stability while formulating, approving and implementing monetary policy programs.

Mission of the Bank:

- be an internationally recognized effective institution that is independent, dynamic, prestigious, transparent and knowledge-based, and be an onlooker of development trends in global financial system,
- maintain institutional capacity to timely respond to the change in economic environment and effectively influence the economic processes,
- support on an ongoing basis the sustainable macroeconomic development of the country, while being an important partner to the Government of Armenia in facing economic challenges.

Objectives of the Bank:

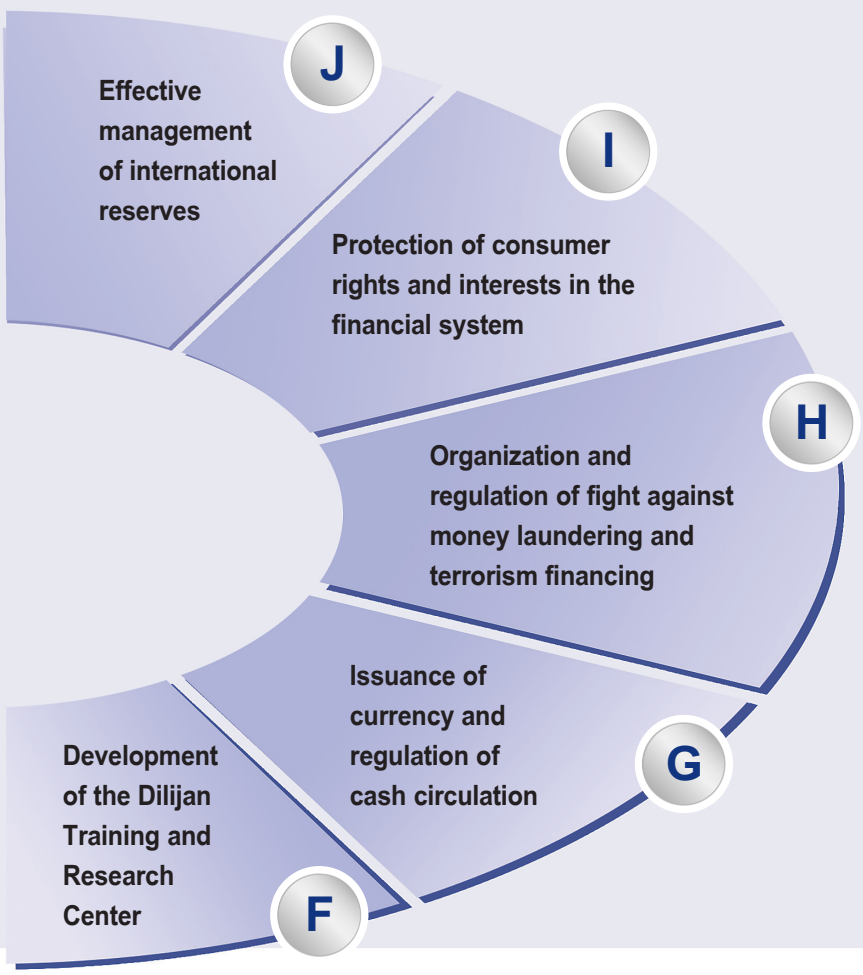
- ensure a stable and normal-functioning financial system, including create conditions for a stable, liquid, solvent and normal-functioning banking sector in Armenia,
- create and develop an efficient payment and settlement system,
- issue the currency of the Republic of Armenia and organize and regulate the currency circulation,
- organize and regulate a framework for combating legalization of criminal proceeds and financing of terrorism,
- create conditions for protecting interest of investors in securities, providing a framework for fair pricing of securities in the market and making sure a regulated, sound, open and trusted securities market is in place for normal operation and development, and
- providing essential conditions for protection of rights and lawful interests of consumers of financial services.

Strategic Directions



To achieve its objectives, the Bank:

- takes up function to manage interest rates in dram markets and handle dram liquidity; acts as a lender of last resort,
- provides banking services to the Government and acts as financial agent and consultant to the Government,
- licenses banks, payment and settlement organizations and other financial system participants, and regulates and oversees their activities for a unified supervision,
- manages international reserves of the Republic of Armenia,
- collects, compiles and publishes monetary and financial system statistics,
- collects, surveys and analyzes information regarding legalization of criminal proceeds and terrorism financing; exchanges information and delivers it to local authorities and international organizations and, where provided for by international treaties of the Republic of Armenia, to competent authorities of other countries,
- regulates and administers activities aimed at improving market conduct and financial literacy of households.



Review of strategic directions



In 2015 the Bank moved to the 2015-2017 strategy which incorporates the vision of the Bank. It establishes that as an independent institution as well as guarantor of price and financial stability in the medium and long run, the Bank will fulfill its primary objective by further looking to maintain sustainable economic development, integrate to international markets and play an important role in providing financial services at the regional level.

For effective handling of the tasks, the Bank spent further efforts in 2015 to introduce and apply best international experience to the financial sector while pursuing diversity and sustainable development in the sector.

In 2015 the Bank prioritized the following objectives:

Maintaining price stability

The monetary policy implemented in 2015 was steered to maintaining price stability and anchoring public expectations under the inflation targeting strategy, while creating important preconditions for sustainable growth in the long run. The inflation environment was relatively high and inflation expectations heightened in early 2015 driven by tightness in the domestic financial and commodity markets under the influence of external factors. The monetary policy conducted under a floating exchange rate policy and increased transparency has contributed to both easing of the aforementioned tightness and gradual moderation of inflation expectations. At the end of the year, driven by the deflationary environment in external sector and positive developments in the domestic agriculture, the inflation rate declined more rapidly. This prompted the Bank to abruptly loosen the monetary conditions in pursuit of taking further steps to facilitate the expanding of the inflation environment and fulfilling the inflation target in a projected 3-year horizon.

Maintaining financial stability

In 2015 the Bank continued its efforts to strengthen financial stability and further improved regulatory and supervisory frameworks as part of the financial stability strategy. The requirement to raising a minimum total capital threshold has prompted banks to take action to stock up their equity. This new minimum total capital requirement of the Bank is aimed at making sure the financial system stability is maintained in the long run, which would enable banks to absorb higher risk levels in stress situations.

Issuing of assets-backed securities, a new tool in the domestic capital market, was an important event in terms of stock market development in Armenia.



Other objectives of the Bank

Issuing currency of the Republic of Armenia, and organizing the currency cycling: in 2015, as part of offering more effective and streamlined cash circulation, the Hrazdan regional cash center terminated its activities.

In 2015 the Bank issued a commemorative coin and commemorative medals dedicated to the centenary of the Genocide of Armenians.

At an international competition "Coin Constellation 2015" held in Moscow, Russia, the set of silver commemorative coins of four titled "The World's Oldest Trees" earned the Bank a prestigious prize in the nomination "Collection of the Year".

Organizing and regulating a framework to combat money laundering and terrorism financing: year 2015 was prominent in that Armenia as Member State of the Council of Europe was the first country whose framework on anti-money laundering, combating the financing of terrorism and proliferation of weapons of mass destruction had been assessed according to FATF 40 Recommendations that were revised in 2012. A three-year action plan offering solution to the problems and weaknesses identified in the "Assessment of Risks to Money Laundering and Terrorism Financing in Armenia", a national initiative, was approved in 2015 in view of increased effectiveness in confronting the ML/TF threats.

Protection of consumer rights and lawful interests in the financial system: in 2015 the Bank took on a variety of measures for protecting the rights and lawful interests of consumers in the financial system. The measures were intended for different target groups in capital Yerevan and regions of Armenia.

Management of international reserves: in 2015 the level of international reserves of the Republic of Armenia further complied with all international criteria to foreign currency reserves, and managing of the international reserves was consistent with international, financial, economic and political developments.



Institutional development

To improve the governance within the Bank, an amendment made to the Republic of Armenia Law on the Central Bank in 2015 has established two seats of deputies to chairman.

Highlighting the importance of information security, the Bank continued improving its Information Security Management System. In the first quarter of 2015 the Bank passed re-certification for an international standard ISO/IEC 27001:2013 (new edition). In addition, many

banks passed certification for a standard ISO/IEC 27001 "Information Security Management System". Other organizations in the financial system have also begun introducing this standard.

The Bank enhanced its bilateral and multilateral cooperation with partner institutions, as well as international financial organizations.

The Dilijan Training and Research Center (hereinafter Dilijan TRC) continued developing. In 2015 the Dilijan TRC arranged in-depth courses and a variety of workshops aimed at developing managerial skills of the staff of the Bank, which were conducted by reputable specialists from the best universities in the world. At the Center, the Economic Research Department continued conducting macroeconomic and microeconomic studies aimed at effective implementation of monetary and financial policies. Topics of research were offered for the employees of ERD, and they plan to publish their articles in best journals, magazines of the world. A number of Harvard University students had their summer work internship at the Center.

As of the end of the year, about 20% of the Bank's staff (144 employees) worked at the Center.

MAINTAINING PRICE STABILITY





Monetary policy

Primary goal of the Bank



According to Article 4 of the Republic of Armenia Law on the Central Bank, the primary goal of the Bank is maintaining price stability, whereby the Bank contributes to the implementation of economic policy for a long-term sustainable economic growth. Price stability means a certain level of inflation which the Bank accepts as a target level of inflation or inflation target. In Armenia, the inflation target is set in the monetary policy programs of the Bank, medium-term expenditures frameworks of the Armenian Government, the Republic of Armenia laws on state budget as well as sustainable development projects (now, a Three-Year Extended Funding Strategy Program). The Bank is independent in deciding on a strategy for conducting monetary policy and intermediate and operational targets as well as monetary instruments.

In the context of inflation targeting strategy of the Bank, a projected level of inflation serves an intermediate target and short-term interest rate serves an operational target. Interest rate (refinancing rate) of repurchase operations is the main instrument of monetary policy in the Republic of Armenia. The Board of the Bank sets the refinancing rate according to a pre-announced annual timetable. Interest rates of the monetary policy instruments take effect on the day following the setting.

One of the main ways the Bank communicates to the public is through publication of inflation reports on a quarterly basis[1]. The first part of the inflation report contains the next quarter's monetary policy program and the second part presents the status implementation of the previous quarter's monetary policy program steered to attain the inflation target.

Fulfilling the primary goal

According to the Q1, 2015 monetary policy program, in which the influences of global and regional developments in the previous yearend were considered, the 12-month inflation rate was to increase slightly at the start of the year. Then, the inflation environment was to decline gradually driven by considerable tightening of monetary conditions by the Bank in the previous yearend amid reducing tension in Armenia's financial and product markets, on the one hand, and expected sluggishness of demand in external and domestic economies, on the other.

In the first quarter of 2015 high inflation expectations were somewhat mitigated thanks to the Bank's contractionary monetary policy in late 2014, so the tightness in domestic financial and product markets had phased out generally. This prompted the Bank to loosen monetary conditions considerably in the first quarter of 2015 by cutting the Lombard Repo Facility Rate from 20% early in the year to 12%. In the meanwhile, the Bank raised the Refinancing Rate to 10.5% with the aim to retain the monetary position of the Republic of Armenia over a longer run, reflecting upward trends of investment risk and interest rates in developing countries. These actions not only allowed the Bank to secure the Lombard Repo Facility Rate an accepted 1.5 pp spread from the Refinancing Rate but also pushed short-term market rates down at the end of the first quarter of 2015. Other macro-prudential measures in the first quarter in addition to the interest rate adjustment included the introducing of a zero or weak mechanism of reserve requirement, mitigating the requirements to resident non-financial corporations and reducing risk weights ascribed to foreign currency loans to borrowers active in export businesses, if they have external credit rating.

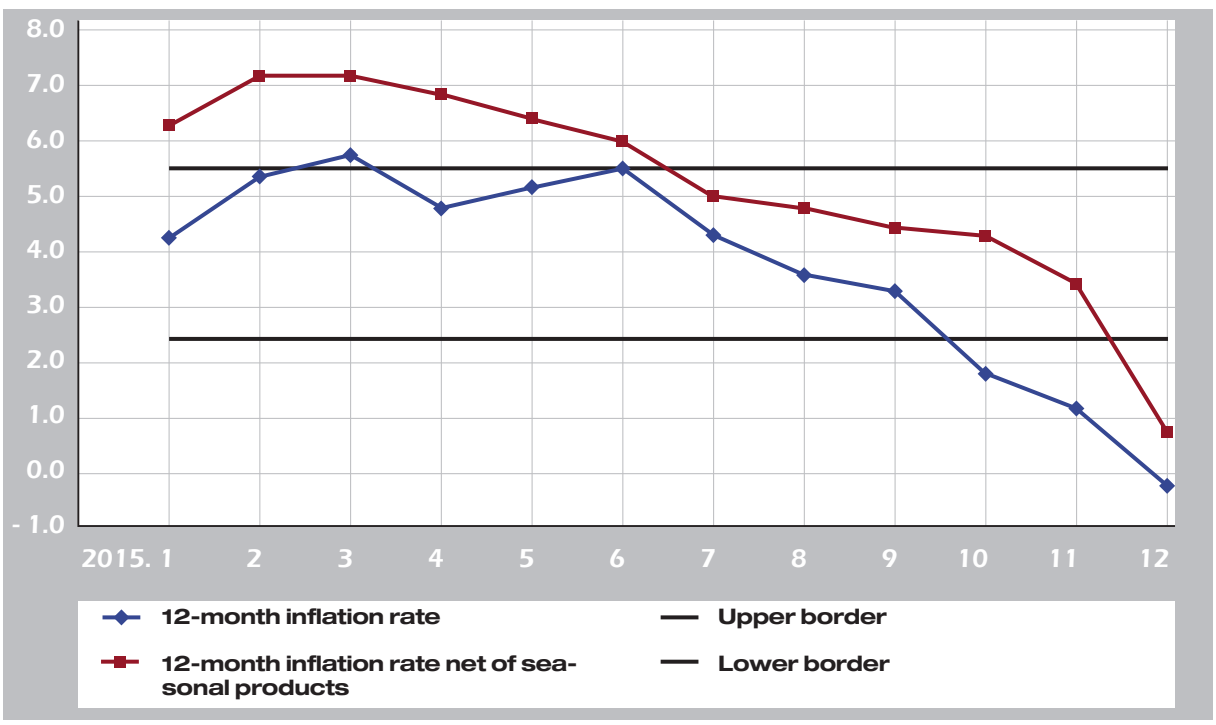
In the meantime, with inflationary expectations still high, the 12-month inflation rate has increased from 4.6% late in the year to 5.8% at the end of March.

In the second and third quarters of 2015 the inflation environment was relatively steady, following even a down-sloping path. In this timespan there was 4.2% deflation, mainly owing to positive developments in agriculture sector, in which case the 12-month inflation rate had subdued to 3.3% in late September. Taking into account still high inflation expectations, underpinned by a relatively high 12-month inflation rate net of seasonal products (4.4% in late September), as well as possible increase of electricity tariff, the Bank reduced the Refinancing Rate by merely 0.25 pp to 10.25%.

1 See the Inflation Report of the Central Bank, which is available at the Bank's website: www.cba.am

Despite expansionary impact of the fiscal policy implemented during the year, the domestic demand remained sluggish in the fourth quarter. This, coupled with influence of deflationary patterns in the external environment, increased supply in agriculture sector and indefinitely postponed rising of electricity tariffs, pushed the 12-month inflation rate to decline faster than expected. Based on the fourth quarter results, there was 1.9% inflation compared to 5.4% recorded in the same reference period last year, in which case the 12-month inflation rate reached a negative value, -0.1%, in late December *(see Figure 1)*. In this situation, the Bank kept on easing monetary conditions in November-December by reducing the refinancing rate by 1.5 pp to 8.75% at the end of December *(see Figure 2)*. It was estimated that inflationary risks arisen from the previous year-end had been largely overcome, and an abrupt easing of monetary conditions made it possible to return to the normal situation that existed before November of 2014. Considerable loosening of monetary conditions late in the year will lead to the expanding of the inflation environment and fulfillment of the inflation target in the forecast horizon.

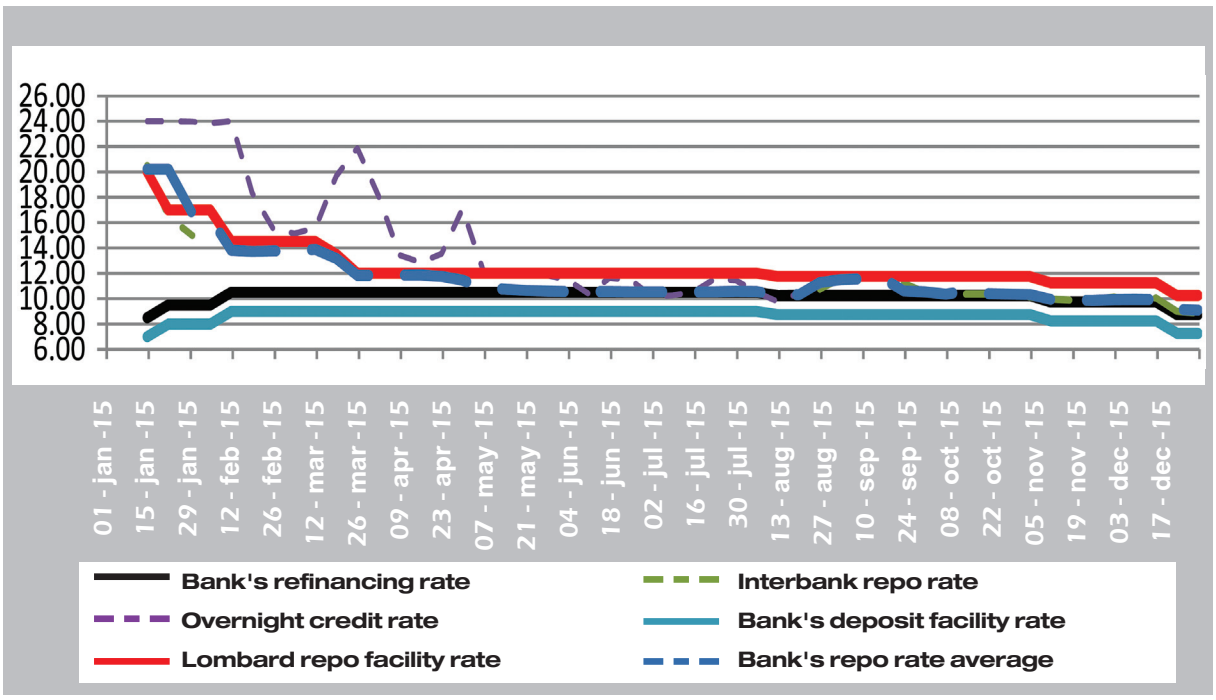
Figure 1 **In 2015 the 12-month inflation rate followed increasingly a down-sloping trajectory, so the year ended with a 0.1% deflation indicator**



Interest rates in the financial market were mainly consistent with changing patterns of the Bank's refinancing rate. The market rates fell at a faster pace in the first half of the year but then they stabilized and drifted around the refinancing rate *(see Figure 2)*.

Figure 2

In 2015 short-term interest rates were mainly consistent with changing patterns of the main policy rate of the Bank



Improvement and advancement

The Bank further worked on advancing its Forecast and Policy Analysis System (FPAS) to reach improved quantitative and qualitative components. These enable the Board of the Bank to have a clearer understanding of the macroeconomic situation and make more informed decisions about directions of the monetary policy. In 2015 the Bank reformulated the paper that incorporated FPAS, which describes how forecasts and decisions are made within the Bank and provides a complete set of models and their practical relevance.

In 2015 the Bank continued working on designing and improving short-term forecasting, support and satellite models for various sectors of the economy. In particular, the short-term inflation forecasting model on the basis of much broader commodity groups in the consumer basket was expanded for an improved quality of inflation forecasting. The model distinguishes commodity groups by origination (import and domestic produce), seasonality and price administration mechanisms (regulated and non-regulated services).

In 2015 the Bank improved the model framework for world economy forecasting. The improvement included reviewing forecast segments for the Russian economy and world commodity markets, introducing detailed satellite models for food product and raw material markets and building a single storage system for forecasts and input and output data.

During the year the Bank designed and applied the Dynamic Stochastic General Equilibrium model for the labor market. This DSGE model was used to study work migration from Armenia to Russia. The model enables to have a clearer understanding of the developments in the labor market, taking into account how the labor supply changes for migration, and to review and predict the behavior of private remittances from Russia to Armenia, considering how such factors as the ruble/dram exchange rate, economic growth in Russia and migration to Russia influence.

In 2015 designing a new version of database for the FPAS model framework was underway. This will enable to aggregate data of an entire process in a single base thus increasing the effectiveness of its management.

Statistics

The Bank collects, compiles and publishes the monetary and financial sector statistics and external accounts statistics, in pursuit of the objectives laid down in the Republic of Armenia Law on the Central Bank. The Bank uses the statistics internally in implementation of its mandate for formulating a monetary policy, maintaining price stability, developing payment and settlement system, financial supervision and such other functions and publishes it for external users such as government departments, financial market participants, international institutions, mass media and general public.

In 2015 the Bank carried on delivering timely and accurate statistical data to the public. Further work was done to broaden the scope of and accessibility to statistical data, improve the methodology for data collection and alignment with international criteria[2].

New data collecting and calculation

Starting from 2015, the Bank publishes financial information about the compulsory pension system and makes it publicly available through the "Central Bank Bulletin", a monthly periodical, and its website, on a quarterly basis. The information incorporates data on the main indicators of compulsory pension funds, namely net asset value and its components, pension fund participants, fund units issued and redeemed.

For improved statistics in the financial account of balance of payments and Armenia's international investment position, the Bank reached a preliminary agreement with the National Statistical Service

2 The Bank publishes the statistical data in the "Central Bank Bulletin" (a monthly periodical), the "Statistical Bulletin of the Central Bank" (an annual periodical) and the Bank's website, at the following links:
www.cba.am/am/SitePages/statspmonthlybulletin.aspx
www.cba.am/am/SitePages/statspannualbulletin.aspx
www.cba.am/am/SitePages/statdatabank1.aspx

of Armenia on obtaining more data on foreign investment by non-financial institutions.

Further work was done to encompass new data on the Armenian economy through improved methodology of sample research and surveys. Specifically, a series of thematic and target surveys provided outcome which was used primarily within the Bank for monetary policy implementation.