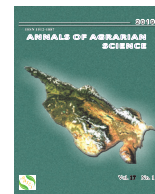




Annals of Agrarian Science

Journal homepage: <http://journals.org.ge/index.php>



Modern attributes of the Republic of Armenia financial system stability

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Received: 15 September 2018; accepted: 11 December 2018

ABSTRACT

The financial and economic crisis in global and regional economies over the past decade has shown that, in parallel with the price stability goal, central banks should focus on financial sustainability in macroeconomic stability assurance process. In order to ensure financial stability, the Central Bank of Armenia implements a macro-prudential policy, which implies the use of appropriate tools. The use of tools is aimed at minimizing systemic risks, or in other words, minimizing risks that hinder the normal functioning of the entire financial system. In the article are discussed the main indicators characterizing the stability of the financial system of RA and based on recent studies and analyzes made in 2005-2017, prove that the Central Bank's financial risks are within the scope of governance, maintaining the stability of the financial system.

Keywords: Financial stability, Central Bank of Armenia, Financial soundness indicators, Macro-Prudential Policy, Financial Stability Report, World Economic Growth.

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Introduction

For the last several decades the central banks of the developed countries have united the price stability problem with financial stability, considering that the last is a preliminary condition of effective monetary policy. Almost all the governments of the world beside the study of the development of separate components of the financial system carried out the study of the country's financial stability as a whole. Ensuring of macroeconomic, monetary and credit stability is a direct comparison to the decrease of risks of the financial system stability. The Central Bank of Armenia is responsible for ensuring financial stability in the Republic of Armenia what is also enshrined in the Law of the Republic of Armenia "On Central Bank"[1]. This is due to the fact that high economic growth, low inflation and unemployment levels ensuring, and effectiveness of monetary policy measures are impossible without stable and developed financial system

intermediation, without development the parts forming the financial system - financial institutions, financial markets and financial infrastructures.

Since 2005 the Central Bank of Armenia regularly implements financial stability vulnerability monitoring including results in the annual report of the Central bank of Armenia and according to the amendments to the Law on the Central Bank of Armenia, the latter has undertaken to publish an Annual Financial Stability Report since 2007. The purpose of the Financial Stability Report is to inform the financial market participants and the public about the risks of the RA financial stability, the reasons for their occurrence or transfer, to assess the elasticity of financial stability in RA, the ability not only to neutralize, but also to absorb the potential risks. The Bank of England [2] is one of the first, which not only adopted financial sustainability as the second main objective, but also since 1996 began to publish Financial Sustainability Report with a semiannual period (Table 1).

Table 1. *Financial Stability Report Publication Guide by States [3]*

State	Publishing Institution	Frequency	Starting Year	Website Address (short)
Great Britain	Bank of England	semi-annual	1996	https://www.bankofengland.co.uk/
Norway	Norges Bank	semi-annual	1997	www.norges-bank.no
Sweden	Sveriges Riksbank	semi-annual	1997	https://www.riksbank.se
Philippines	Bangko Sentral ng Pilipinas	semi-annual	1999	http://www.bsp.gov.ph/
Australia	Reserve Bank of Australia	semi-annual	1999	http://www.rba.gov.au/
Hungary	National Bank of Hungary	semi-annual	2000	http://www.mnb.hu/
Iceland	Central Bank of Iceland	semi-annual	2000	http://www.sedlabanki.is/
Ireland	Central Bank and Financial Services Authority of Ireland	semi-annual	2000	www.centralbank.ie
Austria	Österreichische Nationalbank	semi-annual	2001	www.oenb.at
The Netherlands	National Bank of Poland	semi-annual	2001	www.nbp.pl
Russia	Bank of Russia	annual	2001	www.cbr.ru
Belgium	National Bank of Belgium	annual	2002	www.nbb.be
Canada	BANK OF CANADA	semi-annual, annual	2002	https://www.bankofcanada.ca/
Finland	Bank of Finland	annual	2003	suomenpankki.fi
Switzerland	SWISS NATIONAL BANK	annual	2003	snb.ch
Slovakia	National Bank of Slovakia	annual	2003	nbs.sk
Poland	National Bank of Poland	semi-annual, annual	2003	nbp.pl
Australia	<u>Commonwealth Bank of Australia</u>	semi-annual, annual	2004	commbank.com.au
Czech	<u>Czech National Bank</u>	annual	2004	cnb.cz/en/
Japan	Bank of Japan	semi-annual, annual	2005	boj.or.jp
Korea	Bank of Korea	semi-annual, annual	2005	bok.or.kr
RA[4]	Central Bank of Armenia	annual	2007	www.cba.am

The monitoring of the financial risks of the financial system has always been one of the priorities included in the CBA strategy [5]. Financial risks can be external and internal but the Central Bank of Armenia does not exclude the risks of the financial system itself. If the Central Bank develops, approves and implements monetary policy to ensure price

3. Risks derived from developments in RA financial market,
4. Risks derived from financial institutions of RA,
5. Risks derived from financial infrastructures of RA

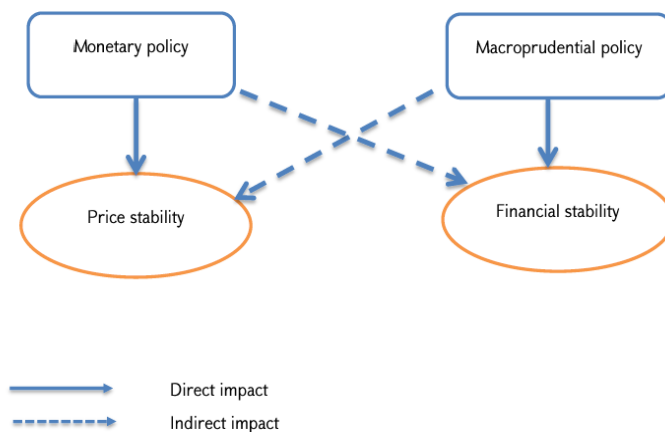


Fig.1. . Interaction of Monetary and Macro-Prudential Policy [7]

stability but for financial stability it implements macro-prudential policy (Fig.1) [6]. Moreover, the impact of monetary policy on financial stability is regarded as an indirect effect.

Based on the above mentioned, the potential risks to the RA financial stability are presented in the report in 5 main directions [8]:

1. Risks deriving from global economic developments,
2. Risks derived from the macroeconomic development of RA,

Getting back to the risks inherent in the global economy, according to the IMF data globally was observed a decline in economic growth. The main reasons for the decline of the latter are conditioned by the slow pace of economic growth in developing and developed countries, with global trade instability, reduction of prices for raw materials and the reduction of capital flows (Table 2).

Table. 2. Developed and Developing States Economic Growth and Inflation in 2005-2017

Indicators	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018 projections	2019 projections
Economic Growth															
World Economic Growth	4,4	5	4,9	3,2	-0,8	5	3,9	3,1	3	3,4	3,2	3,1	3,7	3,9	3,9
Developed States	2,5	3	2,7	0,9	-3,2	3	1,6	1,3	1,4	1,8	2,1	1,7	2,3	2,3	2,2
Developing States	7	7,7	7,8	6,1	2,1	7,1	6,3	5,1	5	4,6	4,1	4,4	4,7	4,9	5
Inflation															
Developed States	2,3	2,3	2,2	1,9	0,7	0,9	1,3	1,2	1,2	1,4	0,3	0,8	2	1,9	2,1
Developing States	5,3	5,1	6,5	9,2	5	5,6	7,1	5,8	5,5	4,7	4,7	4,4	4,7	4,4	4,1

Global economic growth of the International Monetary Fund (IMF) in 2016 was 3.1% [9]. External and internal variations in the first half of 2017 have a favorable impact on the stability of the financial system. RA economic growth in the first half of 2017 was 6.0 % (2016 in the first half of the year was 0.2%) capital outflow leading to fluctuations in the national currency. Revival of activity in the world economy and increase in prices in the stock markets was led to formation of rather high inflationary environment. According to the IMF data in developed countries in 2017, inflation was 2%, and in developing countries - 4.7%. In developing countries notices the tendency of toughening monetary and credit conditions on the international scale due to the yearly decline in economic growth [10]. In the first half of 2017 there has been an increase in prices for commodity markets according to predictions of IMF in 2018 the inflationary pressures will not be significant.

Risks derived from macroeconomic developments in RA

RA trade partner countries' low economic growth rates, geopolitical tensions and maintaining of low levels of raw materials prices have negative impact on RA economic stability.

As a result of the monetary policy pursued by the RA CB and the stimulating fiscal policy developed by the RA Government partially neutralized the risks that threaten financial stability. In the first half of 2017, in RA was recorded high economic growth (higher than expected) largely due to industry (value-added increase 7.6%) and services (value-added increase 8.4%) sectors [11]. In the first half of 2017 to the recovery in the gross demand also contributed continuous recovery of external demand in particular 8.7% of private consumption and 6.8% increase in investment. 1.6% increase in lending is remarkable. It has been accompanied by 0.4 percentage point decrease in non-performing loans and account receivable specific weight, making it 5.8%.

Risks derived from developments in RA financial market

In the first half of 2017 weakening of monetary conditions had a significant impact on the rates of interest of financial market. The Central Bank,

implementing an expansive monetary policy, reduced the refinancing rate to 6.0 percentage points (a decrease of 4% compared to the end of the previous year).

Reduction of the mandatory reserve rate by the Central Bank to 10% as well as the surplus cash generated by the replenishment of the commercial banks' capital, has resulted in a decrease in the amount of contraction in the financial market at the same time raising the economic activity in the country which indicates a significant increase in the level of financial intermediation.

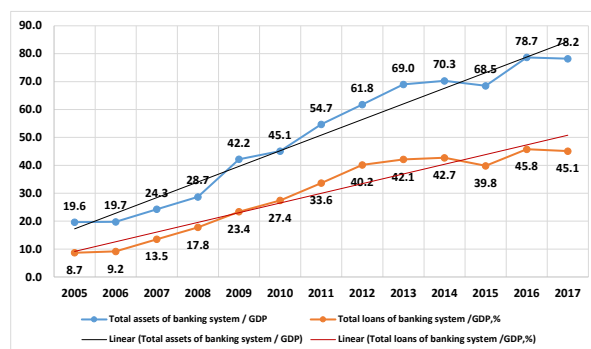


Fig.2. Dynamics and trends of indicators Total assets of banking system/GDP and Total loans of banking system/GDP

In particular, the assets / GDP and credits / GDP indicators decreased by 0.5 and 0.7 percentage points and made respectively 78.2% and 45.1%. According to the trends presented in Figure 2, although assets / GDP and credits / GDP indicators have declined in the last year, nevertheless, their stable growth is predicted in subsequent years. The volatile trends in the RA currency market have also been preserved in 2017 (Fig. 2).

In the first half of 2017 the exchange rate of AMD against the USD valued by 0.72%, against the RUR devalued by 2.72% and against the euro devalued by 6.55% (in 2016, the exchange rate of the Armenian dram almost did not change against the USD, registering 0.04% devaluation in comparison with the same period of the previous year, AMD against RUR devalued by 15.99%, and against EUR valued by 3.22%).

Risks derived from financial institutions in RA

In 2016 financial intermediation has increased due to the growth of economy lending volumes by the commercial banks, which was accompanied by the

increase of the quality of the loan portfolio. Capital adequacy and cash liquidity ratio of the banking system have been improved due to the inflow of financial resources as a result of replenishment of the statutory capital by banks contributing to the strengthening of financial stability.

Risks derived from financial infrastructures of RA

The risks of this section include the risks associated with the RA CB Electronic Payment System (EPS) interbank and valuable security of settlements system.

It should be noted that from the point of view of financial stability more important are the banking system risks and sector development trends because of the fact that the banking system's assets in the financial system of RA by the end of 2017 make up around 88.1% of the entire financial system's assets (see Fig. 3).

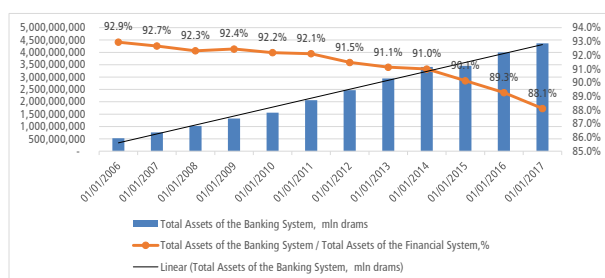


Fig.3. Dynamics and composition of total assets of the banking system in total assets of the financial system

Financial stability in the country is largely conditioned by the level of stability and development of the banking system, and the identification and evaluation of the banking system's risks is an important object of analysis. The following indicators of financial stability are highlighted for RA banking system [12] (see Tabel 3).

1. Total regulatory capital/risk weighted assets

- for enhancing the financial intermediation and strengthening financial sustainability, from January 1, 2010 the minimum amount of the normative total capital for commercial banks has been set at 30 billion drams. The growth of normative total capital, of course, contributes to improving the ability and flexibility of the banking system to withstand shocks in various economic situations at the same time raising the efficiency of the banking system. The minimal correlation of this standard since 2005 has

been declining, which is largely conditioned by an immense increase in the normative total capital.

2. Normative sunk capital (Tier1)/risk weighted assets - As for ability to absorb risks, the general normative capital is characterized by high quality structure: the share of normative sunk capital in the total capital over the past years exceeds 80%, while the correlation between normative sunk capital and risk-weighted assets was continuously decreasing by 2015, and since 2016 has a tendency to grow.

3. Non-performing Loans / Total Loans - In terms of financial stability, for ensuring solvency of banking system management of credit risk is considered important. The loans extended to the economy by the banking system in comparison with the previous year increased by 13.2% (growth in 2016 - 15.4%). In recent years, there has also been a tendency towards gradual improvement of non-performing loans and receivables. The share of non-performing loans and receivables (supervised, non-standard and doubtful risk classes) in total loans and receivables decreased by 1.2 percentage points and amounted to 5.5%.

4. Profitability by assets - According to the RA CB presented audited statements net profit of the banking system in 2017 has made 38.2 billion AMD (for 2016 31,7 billion AMD) [13], moreover 15 banks worked with profits and with loss 2. Profitability of assets in 2017 was 1.2% (In 2016 1.1%).

5. Profitability by capital - By capital in 2017 profitability increased by 0.7 percentage points compared to the previous year. It should be noted that in the structure of income and expenses decreased the share of interest and non-interest income, interest expenses of the banking system and the share of returns from the reserve for potential losses of assets has increased. The specified amendment is explained mainly by improvement of quality of the loan portfolio (Fig. 4).

6. Liquidated assets / total assets - During the year the liquidity level of the banking system has increased mainly due to the total capital replenishment of banks. The overall liquidity ratio has dropped by 0.4% making 32.1%, whereas the minimum limit set by the Central Bank is 15% [14].

7. Liquid assets / demand liabilities - The current liquidity level has also decreased in RA banking system, during 2016 the index grew by 28.4% reaching up to 170.8%, and in 2017 decreased by 29.1% and recorded at 141.7%, with a minimum limit of 60% [15].

Table. 2. *Developed and Developing States Economic Growth and Inflation in 2005-2017*

Basic Financial Stability Indicators for the Banking System (in percentage terms)	Dec - 2005	Dec - 2006	Dec - 2007	Dec - 2008	Dec - 2009	Dec - 2010	Dec - 2011	Dec - 2012	Dec - 2013	Dec - 2014	Dec- 2015	Dec - 2016	Dec- 2017
Regulatory capital to risk-weighted assets	33,7	34,9	30,1	27,5	28,4	22,2	18,3	16,8	16,7	14,5	16,2	20,0	18,6
Regulatory Tier 1 capital to risk-weighted assets	31,7	32,7	29,0	26,9	26,7	20,2	16,7	15,2	14,5	12,7	14,0	16,4	15,2
Nonperforming loans to total gross loans	2,0	2,4	2,4	4,3	4,9	3,0	3,4	3,7	4,5	7,0	8,0	6,7	5,5
Return on assets	2,9	3,9	3,5	3,5	1,0	2,8	2,4	2,5	1,9	1,0	-0,5	1,1	1,2
Return on equity	13,7	17,2	16,0	15,2	4,8	12,3	12,7	14,7	12,0	6,4	-3,5	7,0	7,7
Liquid assets to total assets	41,8	41,2	33,7	23,8	34,4	29,5	27,9	25,6	29,1	25,1	28,0	32,5	32,1
Liquid assets to demand deposits	110,5	106,1	98,2	103,1	140,8	131,5	120,8	126,1	142,3	129,4	142,4	170,8	141,7

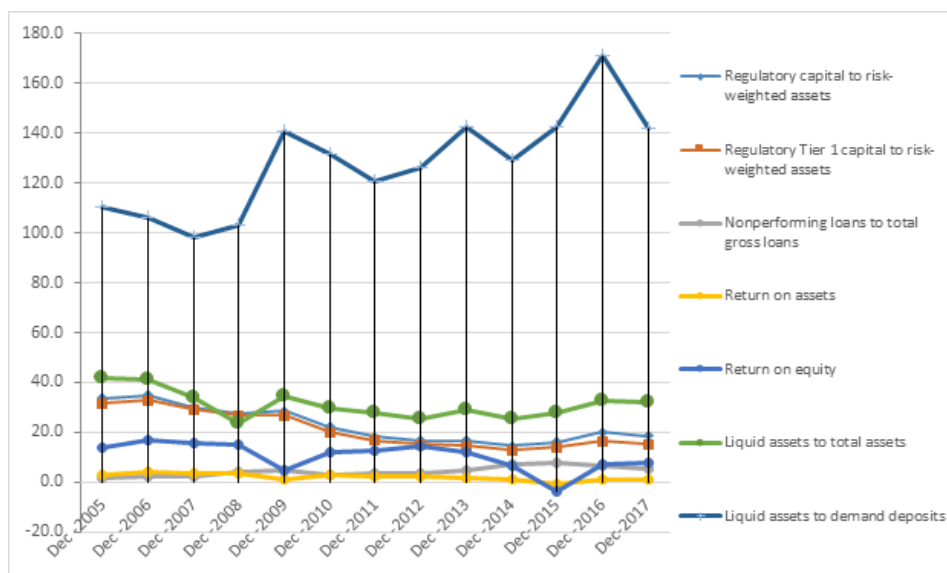


Fig.4. *Dynamics of main indicators of financial stability of the banking system*

Conclusion

It should be noted that, parallel to the main goal of price stability starting from April 9, 2018, financial stability also becomes the main goal of the Central Bank of Armenia caused by various financial crises and their consequences at the global level in recent years [16]. Nevertheless, the policy aimed at ensuring financial stability in the Republic of Armenia still does not have a regulated and complex character compared to countries with developed financial system. There is no single financial sustainability index that will identify the level of financial stability in

the country. Taking into account the large share of assets of the banking system in the financial assets of Armenia, the Central Bank of Armenia (CBA) emphasize the stability of the banking system in terms of ensuring financial stability. In the work were discussed main indicators of financial stability established for bank system of RA.

It should be noted that, according to the observations there was noted the tendency to decrease financial system risks, the established norms are considered to be manageable, without risks for the maintenance of financial stability.

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