

ASSESSING THE CENTRAL BANK OF ARMENIA POLICY UNDER CRISIS

E.M. Sandoyan^{1a}, M.A. Voskanyan^{2a}, A.G. Galstyan^{3a}

^aRussian-Armenian University

ABSTRACT:

The anti-crisis monetary regulation problem has become extremely relevant in the last two decades, both in developed and developing economies. This article is devoted to the anti-crisis monetary policy analysis and assessment regarding the fundamental basis and its practical application in Armenia. The research subject is the monetary policy of the Central Bank of the Republic of Armenia from the point of view of its efficiency in a down economy.

The methodological basis of the research is a review of theoretical and practical models of the monetary policy under crisis, recognized in the scientific literature, as well as its practical application in the developed and developing economies. The main goal of the research is an attempt to identify and assess the monetary policy of the Central Bank of Armenia from the point of view of its practical use over the past two decades. The research finding is the conclusion that under crisis, the monetary policy leads to controversial results, however generally, is the best option for reducing crisis consequences, in particular, in terms of developing economies, which involve the Republic of Armenia.

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KEYWORDS: countercyclical policy, macroeconomic regulation, monetary policy, anticrisis policy.

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Introduction

The modern understanding of countercyclical policy comes from the experience of macroeconomic regulation during the Great Depression. The countercyclical policy aims at smoothing the economic cycles. It means that in conditions of growth, it is necessary to pursue a restraining macroeconomic policy, and during a crisis, the policy has to be stimulating. In contrast to procyclical policy, we should highlight that most research on countercyclical regulation puts monetary regulation at the forefront. In particular, we can trace this emphasis during a crisis, when the policymakers need short-term and flexible instruments, and monetary policy in this sense is more effective for the countercyclical regulation of the economy.

Implementing monetary policy in an open economic environment is a rather tricky task from

the point of view of countercyclical policy. Many economists are wondering whether the monetary policy should be countercyclical at all. Essentially, the answer is what the price of the issue is? What are the economic benefits of a policy that aims to stabilise aggregate output in the face of external shocks?

Among the first authors who addressed the issue under review are Fisher [1] and then Phelps et al. [2], who concluded that the task of monetary policy is to stabilise aggregate output through changes in the money supply, to counteract the effects of external and internal shocks. For example, due to the high dependence on world prices for resources, the countries resort to tight monetary policy to maintain macroeconomic stability in the domestic market, which contradicts the countercyclical policy as such [3]. Despite the extensive literature on optimal monetary policy in an open

¹RSCI AuthorID: 820057

²RSCI AuthorID: 814902

³RSCI AuthorID: 966366

economy, it is difficult to draw causal conclusions from macroeconomic data because both demand shocks and policy responses are often endogenous to underlying economic conditions. In this regard, most of the research is mainly focused on theoretical models and equations [4].

During the global financial crisis that began in 2007, many central banks pursued stimulating monetary policies to ease financial market issues, boost output, and stabilise inflation. Monetary policy has mainly been successful in minimising financial market issues, but output growth and inflation have been weak in many developed economies, slowing recovery growth [5]. These observations have led to a reasonably widespread debate about whether the transmission channels of monetary policy can be considered successful during a crisis, in particular during a financial crisis, and in general, to what extent the monetary policy is successful in the context of financial globalisation and a high degree of volatility in the world economy [6]. Moreover, it is argued that after the global financial crisis the transmission mechanism of monetary policy changed, giving a central role to credit markets and banking system [7].

In this regard, it is crucial to find out whether a countercyclical monetary policy is possible and whether it is necessary to prioritise a stimulating fiscal policy during a crisis. In addition, the issue of undesirable side effects of countercyclical monetary policy, such as the emergence of excessive risks and inflated prices for financial assets, which may result from an extended expansionary policy on the part of the monetary authorities, becomes essential [8, 9, 10, 11]. Moreover, a study argues that an expansionary monetary policy leads to the banks taking higher risks [12]. Evidence shows that the institutional quality has a crucial role in taking cyclical or counter-cyclical measures [13]. And the volatility of output and consumption during crisis can recover with counter-cyclical regulation only if there is a mild response of policy rate to credit spreads [14, 15, 16].

We should highlight that current research on the cyclical nature of monetary policy [17, 18, 19] generally suggests that monetary policy is often countercyclical in industrialised countries and pro-cyclical in developing countries.

Modern research in financial system regulation

from the point of view of the countercyclical policy pays great attention to informal factors that are the basis of the rigidity or softness of financial regulation in the modern economy. A relatively large part of research [20, 21] examines financial regulation and its focus due to bargaining for the interests of specific institutions of financial intermediation. Although the informal institutions of pressure and private interests are subject to constant change, Calomiris et al. [21] argue that private benefit underlies many banking regulations in different countries, regardless of time. This point of view finds its confirmation in the extensive literature on this topic. On the other hand, from the point of view of the causes of deregulation or softening of the financial supervision policy, many studies [22, 23, 24, 25, 26, 27] confirm the thesis about the domination of private interests in the process of implementing the policy for the financial system regulation. Thus, in many respects, we can argue that the policy for regulating financial systems is not cyclical due to biased reasons. More precisely, we can say that financial regulation, as a rule, is cyclical due to these biased reasons. On the other hand, some researchers argue that regulatory compliance in the banking system increases the efficiency of banking regulation especially during crisis situations [28]. However, counter-cyclical regulation measures may lead to a decrease in bank profits [29].

In general, there are not many papers devoted to the issues of the cyclical nature of financial regulation. We should note the work of Reinhart and Rogoff [30]. In their work on the recent global financial crisis, they put forward the thesis about the danger of tight regulation, leading to worse economic consequences than deregulation. Blinder [31], in turn, presents the opposite point of view, according to which only tight regulation can be efficient during a crisis. According to Blinder, financial system regulation policies should be more pro-cyclical. An interesting point of view regarding the cyclical nature of the policy for regulating the financial market is present in the work of Aizenman and Glick [32]. They put forward the thesis that the financial system itself and the mechanisms of its regulation underlie the cyclical nature of the economy. Therefore, the optimal policy for regulating financial markets can smooth out the cyclicity of the economy.

Nevertheless, we can argue that regulating the financial system is mostly not cyclical, both in theory and in practice.

Monetary and Currency Regulation of the Central Bank of the Republic of Armenia in Crisis Conditions

Considering the deep economic recession in Armenia in 2009 due to the global financial crisis and the consequent economic stagnation in the last decade, it is necessary to study and evaluate the monetary and financial regulation policy of the monetary authorities of Armenia. The monetary policy regime in Armenia is inflation targeting to ensure the primary goal of prices stability of the Central bank of Armenia (CBA) [33]. The second primary goal of the CBA has been financial stability since 2017. Figure 1 shows the inflation rates and targets in Armenia. Considering the latter, we can conclude that although the target level mostly remains in the three-year interval, we can observe high inflation fluctuations in shorter time periods.

From 2000 until the global financial crisis CBA was conducting expansionary monetary policy accompanied by cheap money policy to stimulate economic growth. The high inflow of capital through remittances and foreign direct investments (FDI) helped implement this policy without depreciating pressures on the Armenian dram. As shown in Figure 2, the reserve requirement gradually decreased from 38 % in January 2000 to 8 % in January 2008.

In 2008, due to the global financial crisis, there was high pressure on prices stability. To stabilise

the situation in financial markets, CBA implemented a strict monetary policy. The refinancing rate increased from 6.25 in 2008 to 7.75 at the beginning of 2009 to restrain the money supply (Figure 3).

On the other hand, to prevent the high depreciation of the Armenian dram due to the reduction in capital inflow in 2008, CBA directly intervened in the currency markets by selling foreign currency until March 2009. The overall direct intervention at the expense of international reserves amounted to about 700 million USD. It is evident that after CBA stopped direct intervention, the exchange rate of Armenian dram overshoot from 305 to 365 during a day (Figure 4). From 2009 to 2014, CBA applied corridor regulation foreign exchange rate policy. By strictly regulating the money supply and exchange rate of the Armenian dram, CBA managed the inflation rate and could stabilise the prices already in 2009 (Figure 3). Application of the described monetary policy instruments indicates the implementation of pro-cyclical monetary policy during the global financial crisis in Armenia. The latter contributed to a deeper economic recession in 2009 (-14.1 %).

Next was the regional crisis that started in December 2014. The transmission mechanism of the crisis was the same as in the case of the global financial crisis. So, the decrease in capital inflow created high depreciation pressure on the national currency in Armenia. To maintain price stability, CBA applied strict monetary policy again. The refinancing rate increased from 6.75 % in the fourth

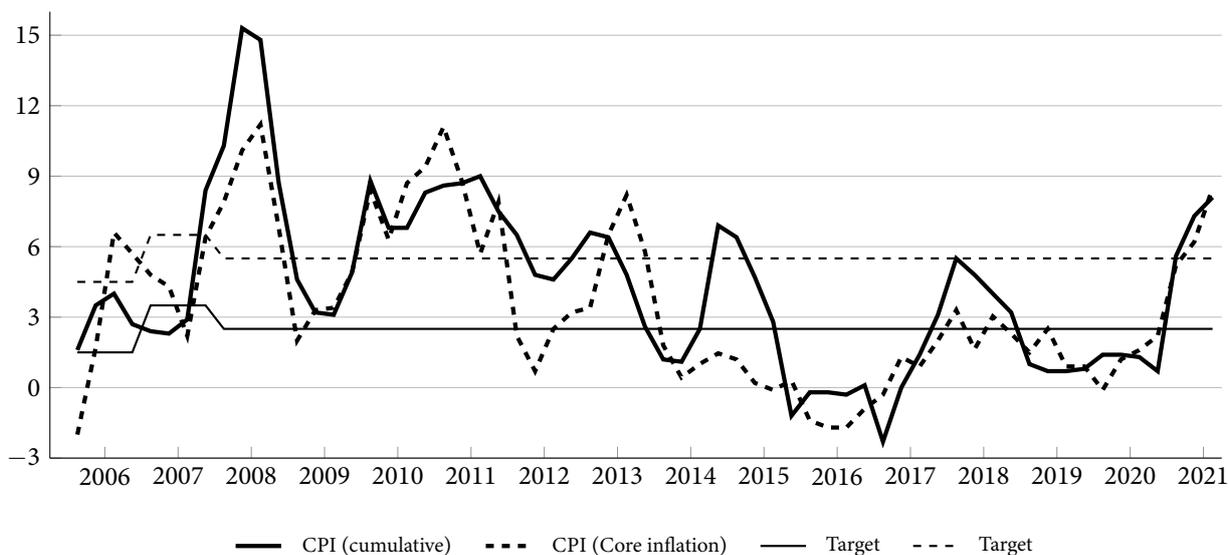


Figure 1 – CPI indicators and inflation targets in Armenia
(Source: Database of the Central bank of Armenia. URL: <http://cba.am/>.)

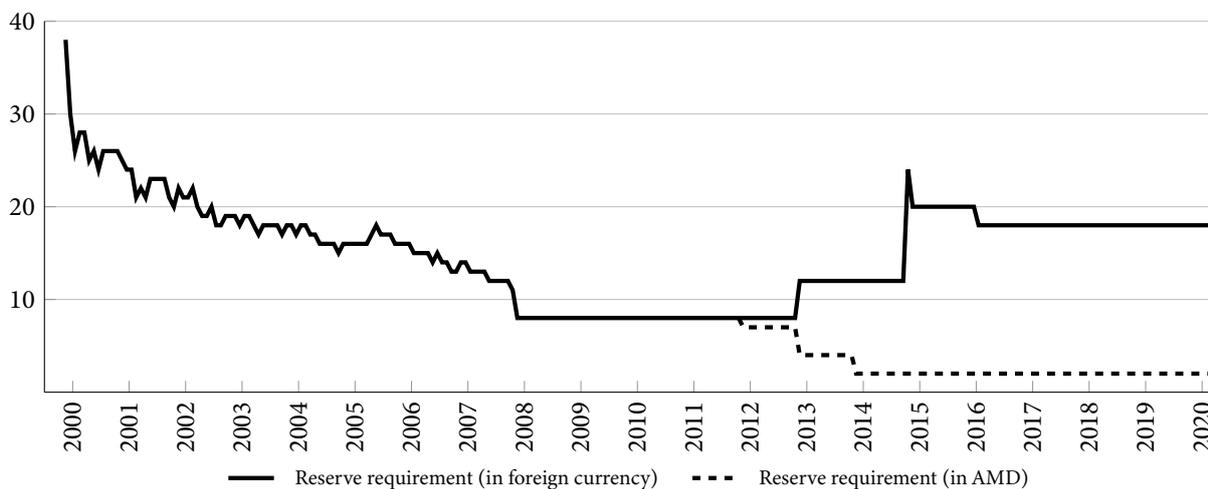


Figure 2 – The reserve requirement of CBA
 (Source: Database of the Central bank of Armenia. URL: <http://cba.am/>.)

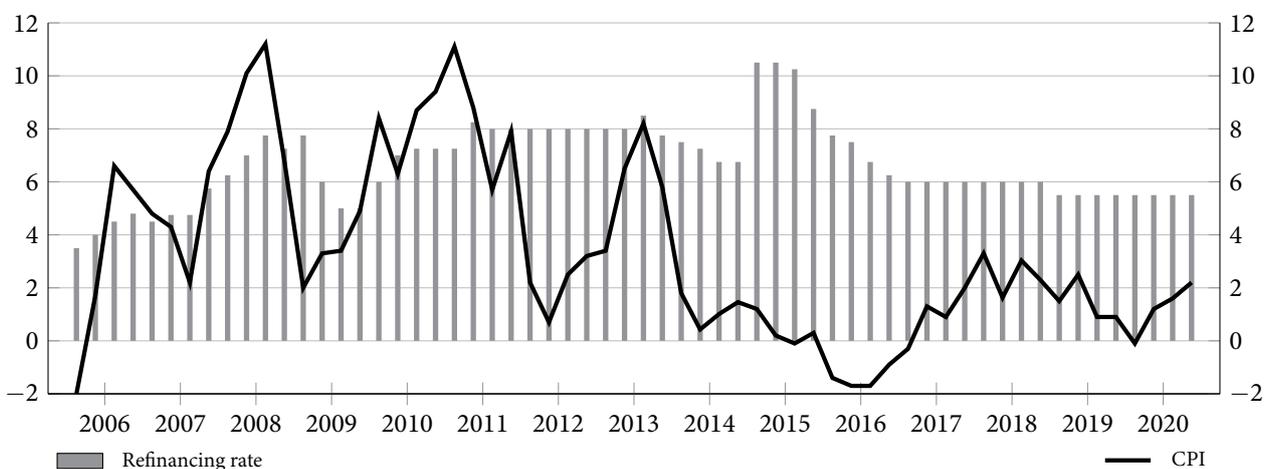


Figure 4 – The refinancing rate and CPI in Armenia
 (Source: Database of the Central bank of Armenia. URL: <http://cba.am/>.)



Figure 4 – The USD/AMD exchange rate, monthly
 (Source: Database of the Central bank of Armenia. URL: <http://cba.am/>.)

quarter of 2014 to 10.5 % in the first quarter of 2015 (Figure 3). At the same time, CBA intervened in the currency market by selling foreign currency for two months. However, in December 2014, the exchange rate of the Armenian dram increased from 420 to 463. During the regional economic crisis, CBA also applied an expensive money policy to restrain the money supply and prevent further depreciation of the Armenian dram without direct interventions. Thus, in December 2014, the reserve requirement for foreign currency deposits doubled (Figure 2). According to our estimations, the change in reserve requirement withdrew from money circulation an additional 310 million USD denominated in Armenian drams. The latter, combined with the 372 million USD direct intervention, eased the pressure on national currency and prices. We can conclude again about a pro-cyclical monetary policy during the regional economic crisis. It contributed to the further economic stagnation in Armenia.

CBA slightly changed its traditional anti-crisis monetary policy in 2020, when the Armenian economy was hardly hit by the crisis due to the covid-19 pandemic and second Artsakh war. Due to massive lockdowns since March 2020, the economic activity slowed down. The war in autumn further halted the economic growth. The pressure on national currency and prices was again high. However, the monetary policy remained somewhat neutral during this crisis.

As a consequence, the exchange rate of the Armenian dram started to increase gradually since October 2020, reaching 527 during five months. It drove up the inflation rate. The latter reached 5.2 %, 6.2 % and 8.5 % during the first three quarters of 2021, respectively. However, since July 2021, the exchange rate has been stabilising. Hence, we expect a stabilisation in prices.

Financial market regulation amid the crisis in Armenia

The unstable state in the financial system can hinder both implementation and efficiency of monetary policy, and provision of long-term and sustainable economic growth. Since January 2008, CBA implemented a regulatory document setting banking standards [34]. The latter was created according to Basel standards.

As we know, the negative impact of the global financial crisis started in the fourth quarter of 2008

and was further deepened in 2009. 2009 was a controversial and difficult period for the financial market. The international financial crisis posed new challenges for financial market participants. However, the Armenian financial market played a vital role in maintaining the stability of the financial system. It was able to effectively redistribute liquidity among the participants of different institutions of the financial system of Armenia. Figure 5 shows how the capital adequacy ratio sharply decreased until the end of 2007 making the banking system more vulnerable to external shocks. However, in regard to this banking standard, Armenian banking system demonstrated good robustness during both global financial and regional economic crises. During both crises we can see a slight decrease in capital adequacy, which recovered during two quarters. The same we can say about the latest covid-19 crises. We should highlight that despite a slight change in capital adequacy minimal requirement in May 2020 (decrease from 10 % to 9 %), the ratio in regard to regulatory capital remained higher than 17 % (minimum requirement – 12 %), and regulatory Tier 1 capital remained higher than 15 %.

After the regional crises, in January 2015, CBA decided to increase the minimum limit of regulatory capital six times – from 5 billion AMD to 30 billion AMD, in force since January 2017 [34]. It was a crucial change in the banking system leading to a significant reduction of the quantity of commercial banks. Such change aimed to increase the sustainability of banking system to external shocks. On the other hand, in two years the total regulatory capital increased by about 40 % reaching 649,3 trillion AMD in the first quarter of 2017 (Figure 5).

In the case of liquidity ratio, the minimum requirement for liquid asset ratio is 15 %, and for liquid assets to short term liabilities – 60 %. We should note that after the implementation of the latter and recovery from the global financial crisis it increased to 140 % creating a reliable liquidity buffer to withstand any future external shocks (Figure 6). In the first quarter of 2009, certain reductions in the level of excess liquidity of the Armenian banking system, as well as current liquidity ratios, were accompanied by an increase in the volume of repo transactions (interbank with the Central Bank of Armenia). In parallel with the re-

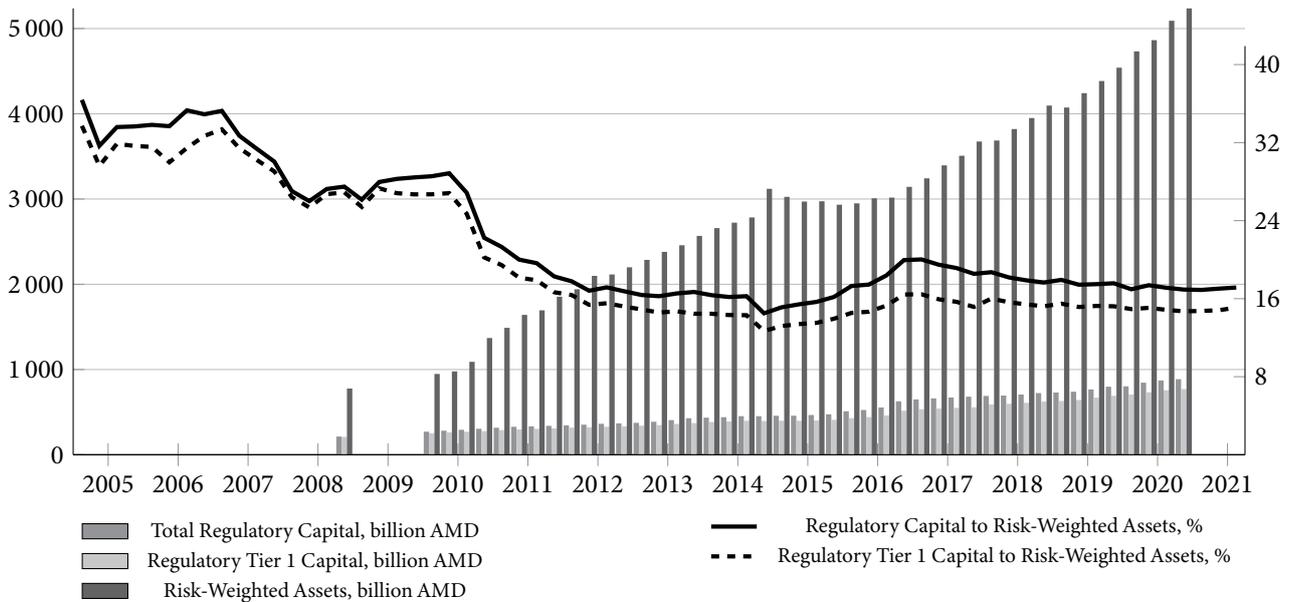


Figure 5 – Regulatory capital and regulatory tier 1 capital to risk-weighted assets ratio (% on right axis)
 (Source: Database of International Monetary Bank. URL: <http://data.imf.org/>)

duction of the refinancing rate by 2.25 percentage points at the beginning of 2009, the Central Bank also intensified its expansionist operations by expanding the resources of commercial banks through active long-term repo instruments and government securities in the secondary market. In the second half of the year, however, financial institutions re-established a stable high level of liquidity, combined with lower central bank participation in the financial market.

The decrease in liquidity ratios during the regional economic crisis wasn't significant. The recovery period accounted for one quarter and al-

ready at the beginning of the second quarter of 2015 the banking system was already stable.

In the first half of 2009, the banking system a rather cautious approach to lending, leading to a lower activity in the credit market. However, activity in the credit market has resumed since the second half of the year, which has been facilitated by the formation of certain expectations towards stability in the income of banks and population, the decrease in the refinancing rate, and various state-sponsored programs. However, the growth rate of loans in 2009, compared to the growth rate of the previous year, sharply decreased to 14 %.

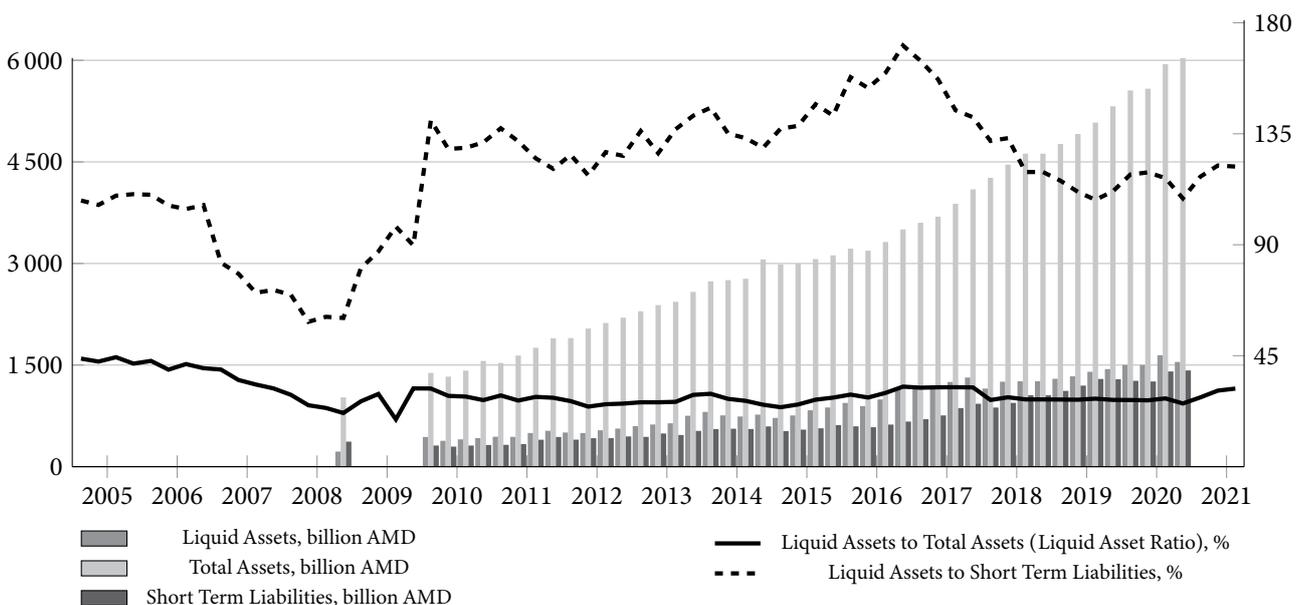


Figure 6 – Liquid asset ratio and liquid assets to short term liabilities (% on right axis)
 (Source: Database of International Monetary Bank. URL: <http://data.imf.org/>)

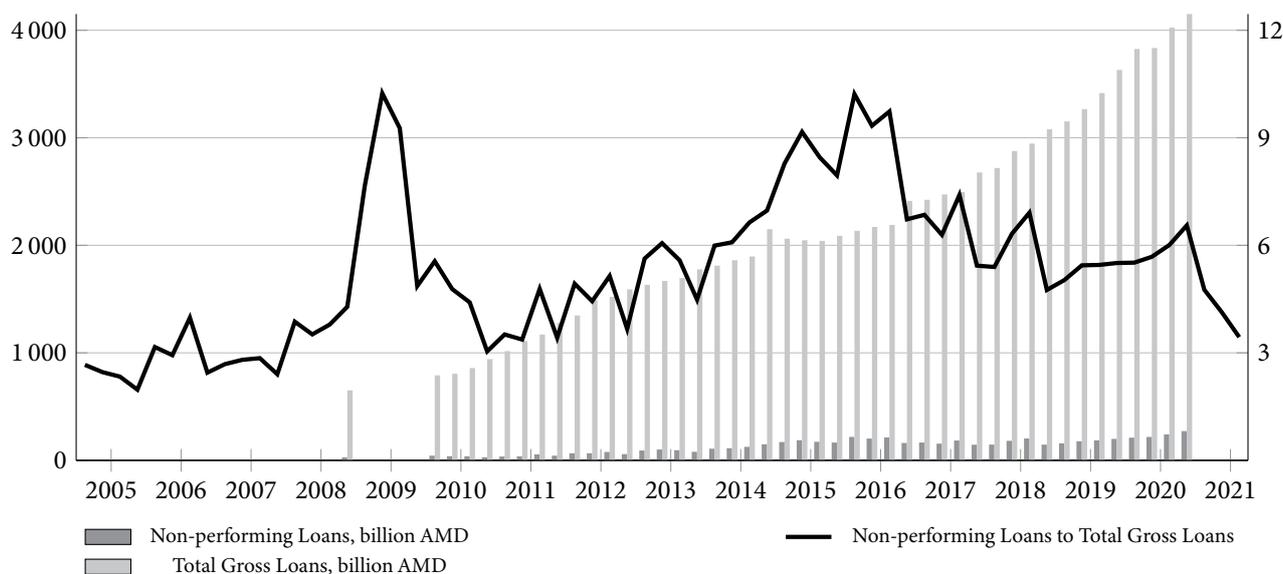


Figure 7 – Non-performing loans to total gross loans ratio
(Source: Database of International Monetary Bank. URL: <http://data.imf.org/>.)

We should note that the share of non-performing loans in the first half of the year increased from 4.4 % in 2008 to 10.2 % at the end of the first half of 2009, and decreased in the second half. At the end of the year, it accounted to 4.9 % of the total loans (Figure 7). During the regional crisis the share of non-performing loans sharply increased to 9.2 % in the second quarter of 2015. The recovery period took up to 6 months. At the end of 2016 this indicator decreased to 6.7 %. During the covid-19 crisis and second Artsakh war there was no significant change in the indicator of non-performing loans. From the second quarter to the fourth quarter of 2020 the change amounted to 1 %, with a consequent decrease of 3.3 % until mid-2021.

Conclusions

Overall, the monetary policy during crisis situations in Armenia has a procyclical nature. The

latter presumes a strict monetary policy during the decreasing period of economic cycle. Such a policy usually leads to a deeper economic recession. However, being loyal to the procyclical policy, the recovery period usually is accompanied with a relatable softer and expansionary monetary policy.

As for the financial regulation policy, here we should note that the Central bank of Armenia mostly followed Basel I, II and III banking standards since January 2008. The most significant change was the requirement for regulatory capital of 30 billion AMD instead of 5 billion in January 2017. The existence of relatively bigger banks with higher capital adequacy ratio improved the robustness of the commercial banks to external shocks during all the crises. Moreover, usually the banking system needs 2-3 quarters for recovery. The other banking standards mostly remained stable during the whole period under consideration.

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AUTHORS' INFORMATION:

Edvard M. Sandoyan – Advanced Doctor in Economic Sciences, Full Professor; Russian-Armenian University (123, O. Emin St., Erevan, 0051, Armenia); edward.sandoyan@rau.am.

Mariam A. Voskanyan – Advanced Doctor in Economic Sciences, Associate Professor; Russian-Armenian University (123, O. Emin St., Erevan, 0051, Armenia); voskanyanm@gmail.com.

Ani G. Galstyan – Ph.D. of Economic Sciences; Russian-Armenian University (123, O. Emin St., Erevan, 0051, Armenia); ani.galstyan@rau.am.

ОЦЕНКА ПОЛИТИКИ ЦЕНТРАЛЬНОГО БАНКА АРМЕНИИ В УСЛОВИЯХ КРИЗИСА

Э.М. Сандоян^{4а}, М.А. Восканян^{5а}, А.Г. Галстян^{6а}

^аРоссийско-Армянский университет

АННОТАЦИЯ:

Проблема антикризисного монетарного регулирования в последние два десятилетия стала очень актуальной, как в развитых, так и в развивающихся странах. Данная статья посвящена анализу и оценке антикризисной монетарной политики с точки зрения фундаментальной базы, а также ее практического применения в Армении. Предметом исследования является монетарная политика ЦБ Республики Армения с точки зрения ее результативности в условиях экономического кризиса.

Методологической базой исследования стал обзор теоретических и практических моделей монетарной политики в условиях кризиса, известных в научной литературе, а также ее практическое применение в развитых и развивающихся странах. Ключевой целью исследования стала попытка выявить и дать оценку монетарной политики Центрального Банка Армении с точки зрения практики применения в течение последних двух десятилетий. Результатом исследования стал вывод о том, что в условиях кризиса монетарная политика приводит к неоднозначным результатам, однако в целом наиболее оптимальная для нивелирования последствий кризиса, в частности в условиях развивающихся экономик, в котором относится Республика Армения.

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КЛЮЧЕВЫЕ СЛОВА: контрциклическая политика государства, макроэкономическое регулирование, монетарная политика, антикризисная политика.

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⁴AuthorID РИНЦ: 820057

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ИНФОРМАЦИЯ ОБ АВТОРАХ:

Сандоян Эдвард Мартинович – доктор экономических наук, профессор; Российско-Армянский университет (0051, Армения, Ереван, ул. О. Эмина, 123); edward.sandoyan@rau.am.

Восканян Мариам Амбарцумовна – доктор экономических наук, доцент; Российско-Армянский университет (0051, Армения, Ереван, ул. О. Эмина, 123); voskanyanm@gmail.com.

Галстян Ани Гамлетовна – кандидат экономических наук; Российско-Армянский университет (0051, Армения, Ереван, ул. О. Эмина, 123); ani.galstyan@rau.am.