



German
Economic
Team

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POLICY BRIEFING
ARMENIA

Economic implications of the recent appreciation of the Armenian dram

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Executive Summary

- » Recent significant appreciation of the Armenian dram against the US dollar (end Sep-22 vs 23.02.2022: 15.3%)
- » At the same time: strong real effective appreciation (Sep-22 vs Feb-22: 20.7%)
- **Relevant policy topic, as a significant appreciation took place in a short period**
- » **Reasons**: appreciation to a large extent linked to events in Russia
 - Relocation of IT experts from RUS leads to higher IT exports and personal transfers
 - Strong tourist revenues, especially from Russian tourists
- » **Macroeconomic perspective**: no imminent problem for growth, even helps to keep inflation under control
- » **Sectoral view**: some export-oriented sectors might have problems, but the government should be careful in providing any compensation
- » **Policy implications**: focus should lie on developing the FX forward market in order to prepare for future FX volatility (uncertain developments in Russia)

Contents

1. Introduction
2. Recent exchange rate development
3. Reasons for dram appreciation
4. Macroeconomic implications
5. Policy implications
 - (1) Sectoral policy
 - (2) Opportunities for developing hedging instruments
 - (3) Monetary and fiscal policy
6. Conclusions

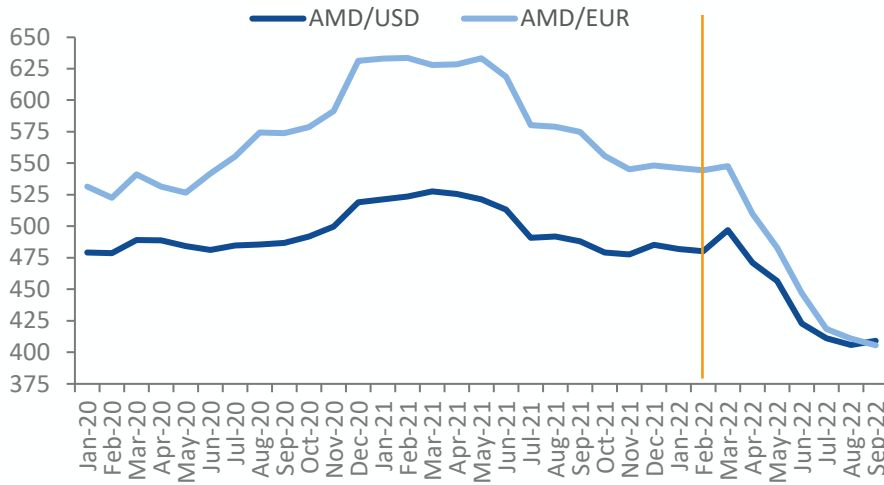
1. Introduction

- » In recent months, there was a strong and rapid appreciation of the Armenian dram against the US dollar
- » What are the reasons for the appreciation and how does it impact the Armenian economy?
- » Moreover: is there a need for the government to react?
- » In this Policy Briefing, we deal with the following issues:
 - Magnitude of the dram appreciation
 - Reasons for the appreciation
 - Macroeconomic implications
 - Policy implications
 - Implications for monetary and fiscal policy
 - Need to support affected sectors?
 - Opportunities for developing hedging instruments

2. Recent exchange rate development

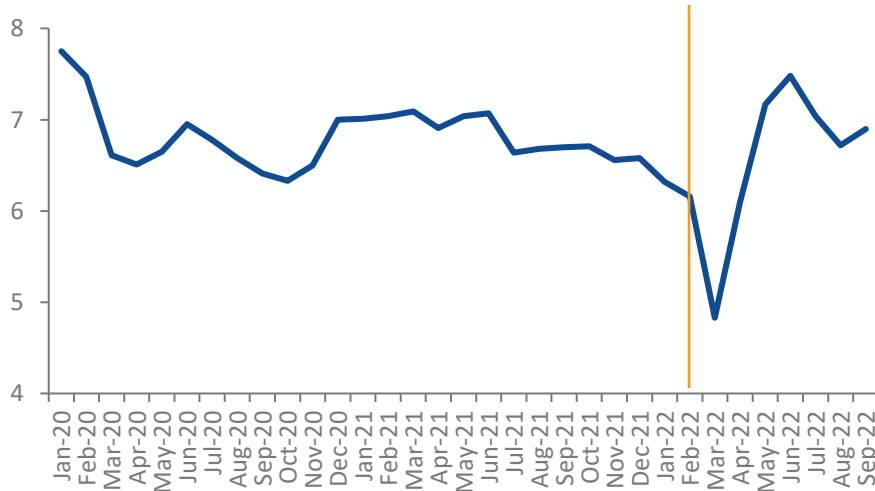
2. Nominal bilateral exchange rate

Exchange rate vs USD and EUR



Source: Central Bank of Armenia

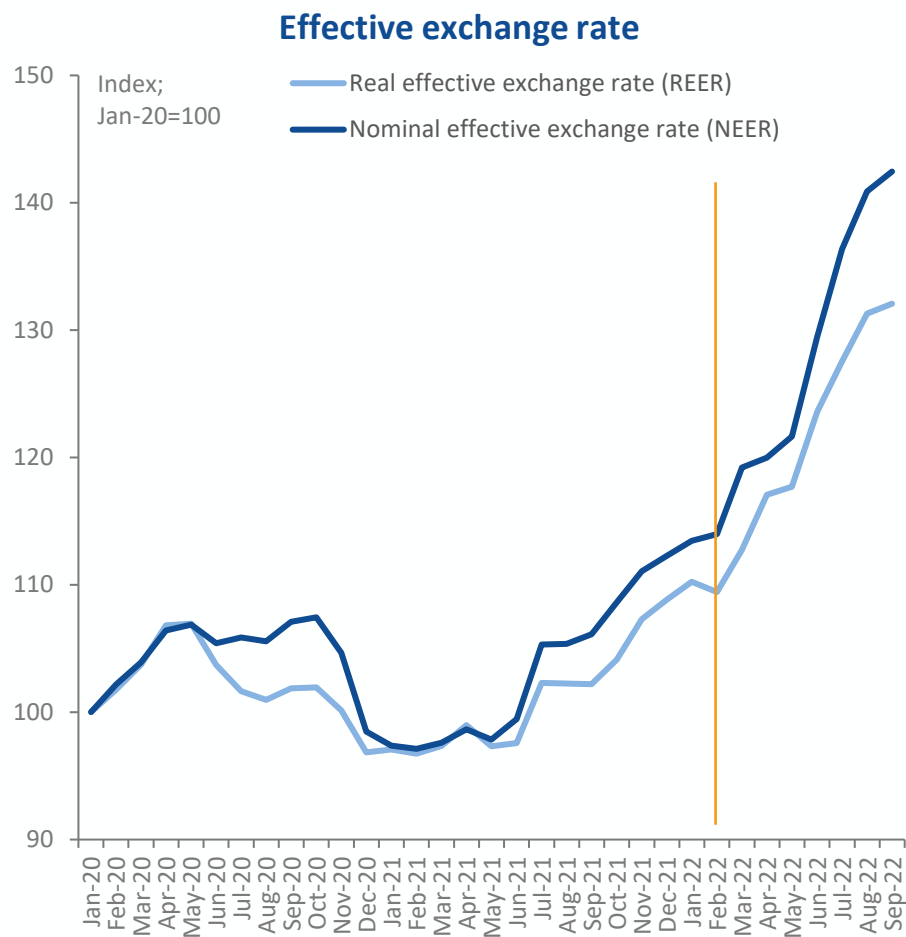
Exchange rate vs RUB



Source: Central Bank of Armenia

- » Straight after the beginning of the war in UKR: pressure on the dram and slight depreciation
- » Later: strong appreciation vs USD
 - End Sep-22: 15.3% since 23.02.2022
- » At the same time: appreciation vs US dollar not due to USD weakness
- » In fact: US dollar currently quite strong
 - End Sep-22: strong appreciation vs EUR of 9.7% since 23.02.2022
 - Thus: dram appreciated even stronger against the EUR (same period: 27.1%)
- » Interesting enough, dram depreciated considerably against the Russian rouble
 - End Sep-22: 25.5% since 23.02.2022
- **Strong appreciation against USD and EUR, but significant depreciation against RUB; quite unique development**

2. Effective exchange rate



Sources: CBA, Bruegel; GET calculations
Note: increasing value means appreciation

- » How does the heterogenous exchange rate development affect the effective exchange rate?
- » Sep-22 vs Feb-22:
 - REER: appreciation of 20.7%
 - NEER: appreciation of 25.0%
 - Significant loss in competitiveness for Armenian exports; imports become relatively cheaper
- » Despite heterogeneous development of bilateral exchange rate: nominal and real effective appreciation of the dram
 - Russia is an important trade partner (2021: 31% of trade turnover)
 - But: outweighed by strong appreciation against EUR (share of 18%) and CYN (share of 13%, appreciation over 55%)
- **Strong real effective exchange rate appreciation; broad economic issue that needs to be considered**

3. Reasons for dram appreciation

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Balance of payments

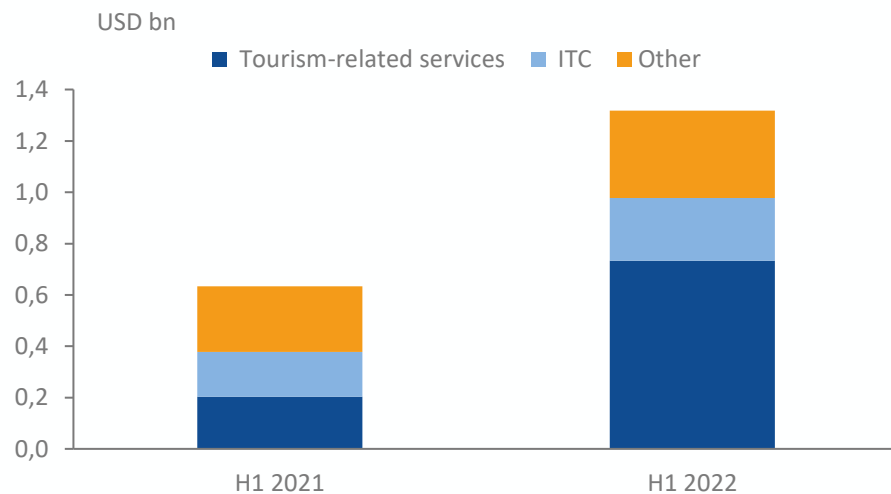
USD m	Q1 2021	Q2 2021	Q1 2022	Q2 2022
Current account	-78.3	28.0	-290.5	-15.2
<i>Goods and services</i>	-173.7	-159.1	-298.5	-131.2
<i>Goods</i>	-232.4	-244.1	-428.7	-455.2
<i>Services</i>	58.7	85.0	130.3	324.0
<i>Tourism-related services</i>	25.4	55.0	106.0	272.9
<i>ICT</i>	77.4	76.5	110.8	111.3
<i>Primary income</i>	-107.4	-80.6	-146.7	-273.0
<i>Secondary income</i>	202.7	267.7	154.6	389.0
<i>Personal transfers</i>	171.8	234.9	101.9	369.6
Capital account	6.6	10.7	9.6	23.2
Financial account	-46.8	-39.6	-223.9	215.0
<i>Direct investment</i>	-77.3	-19.1	-359.4	-204.4
<i>Reserve assets</i>	429.6	99.7	-268.7	555.4
Net errors and omissions	24.9	-78.3	57.0	207.0

Source: Central Bank of Armenia

- » Appreciation/depreciation depends on the demand for a currency; useful to look at the balance of payments
- » Current account:
 - Goods: strong exports, but even stronger imports; not the reason
 - Services: significant tourism-related exports (mostly RUS) and ICT exports
 - Also: strong inflow of personal transfers; also due to influx of RUS migrants
- » Capital account: no significant transfers
- » Financial account: strong inflow of direct investment and build-up of reserve assets
- » Also: significant increase in errors and omissions; in ARM usually related to FX cash movements and remittances
- **Reasons for appreciation seem to lie in the current account: service exports and personal transfers**

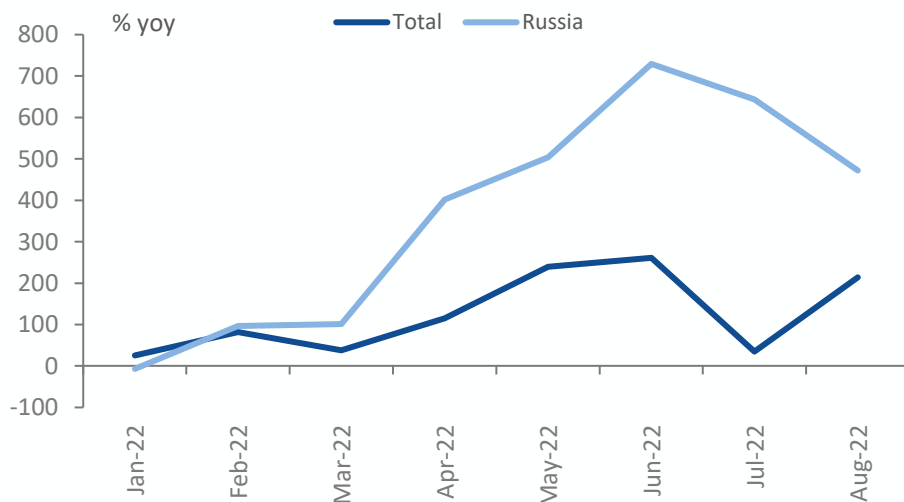
Main drivers of appreciation

Development of exports of services



Source: Central Bank of Armenia

Net inflow of money transfers



Source: Central Bank of Armenia

Exports of services

- » Strong exports of services in H1 2022:
 - High tourist revenues (260% yoy), especially from Russian tourists
 - Strong IT services (40% yoy) due to influx of Russian IT specialists to ARM
 - Traditional services exports are also strong (33% yoy)

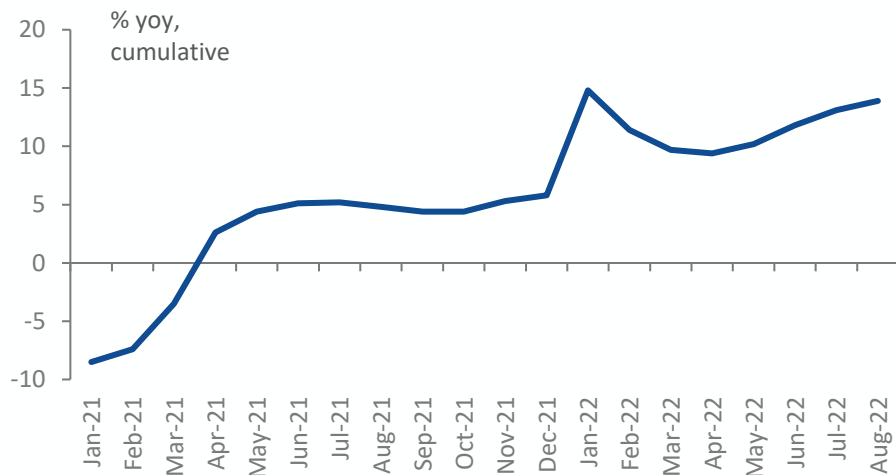
Personal transfers

- » Significant net personal transfers in Q2 2022 (57% yoy)
- » Related to this: strong net inflow of money transfers (8M2022: 144% yoy)
 - Significant net inflow of transfers from Russia (8M2022: 453% yoy)
 - Main reason: very high transfers from relocated Russians after Mar-22
- » Main reasons for appreciation seem to be highly related to the recent influx of people from Russia

4. Macroeconomic implications

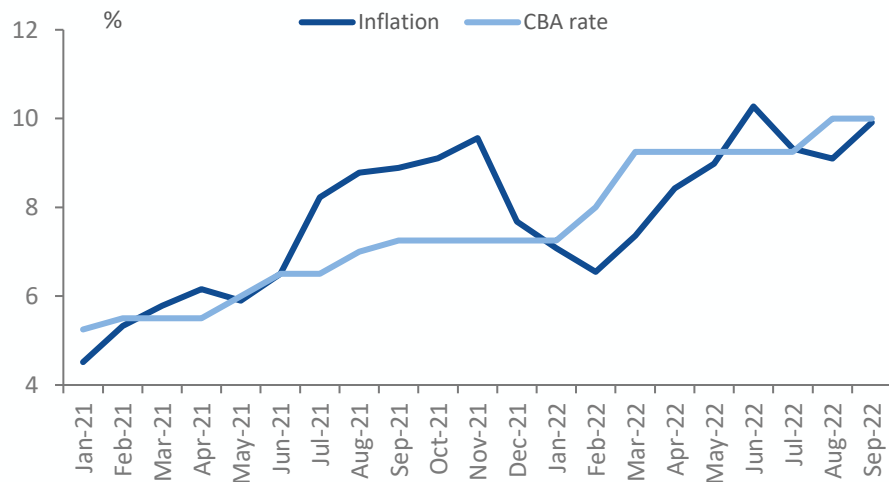
4. Macroeconomic implications

Economic activity



Source: Armstat

Inflation and policy rate



Source: Central Bank of Armenia

Macroeconomic situation

- » High economic growth expected in 2022 (IMF forecast: 7.0%)
 - Indicator of economic activity (proxy for GDP growth) at 13.9% yoy (8M2022)
- » Elevated inflation (Sep-22: 9.9%)

Implications of appreciation

- » In view of high economic growth, appreciation does not pose a risk
- » And: appreciation helps to fight inflation, on top of interest rate policy
- Thus: from a macroeconomic perspective, appreciation currently not a major issue and has even some benefits
- » Having said that: appreciation might hurt exports in specific sectors; need to look at this issue

5. Policy implications

5.1. Sectoral policy (1/2)

- » In general: real effective exchange rate appreciation signifies a loss of competitiveness for export-oriented sectors
- » However, implications of the nominal bilateral exchange rate movements are rather ambiguous in the case of Armenia:
 - **Sectors exporting to the Russian market** (spirits, fish, vegetables, cigarettes, etc.) **benefit from the dram depreciation** against the RUB
 - But: **sectors exporting to the EU or US** (metals, mineral products, etc.) **face a loss in competitiveness** as dram appreciated vs USD and EUR
 - At the same time: imports from US/EU become cheaper; **positive effect on sectors with a high share of input**
- » **Key question**: does the dram appreciation entail a risk for companies in specific sectors going bust and exiting the market?
- » Further research is needed to answer this question; but this cannot be done in the scope of this policy briefing

5.1. Sectoral policy (2/2)

- » At a first glance: appreciation does not appear to be a huge negative shock across all sectors; **no need for broad interventions**
- » Moreover: **government should be careful in supporting specific sectors:**
 - Does the sector in question really need support or was it particularly successful in lobbying?
 - Once the government supports one sector, several other will increase their lobbying activities in order to also receive benefits
- » And: some sectors can adjust to the shock by adjusting wages
 - For example: some companies in the IT sector complain about loss of competitiveness, but employees have seen a clear increase in their wages in USD terms; thus, lowering the AMD wage should be an option
- » On top: companies knew about risk of dram appreciation, but did not hedge
 - **Companies exposed to exchange rate fluctuations should hedge**
 - Not the role of the government to help companies that have no adequate risk management; task for the private, not the public sector
- » At the same time: hedging is only feasible, if such a market exists and works well. Here, important role of authorities in **facilitating the development of such instruments**

5.2. Opportunities for developing hedging instruments (1/2)

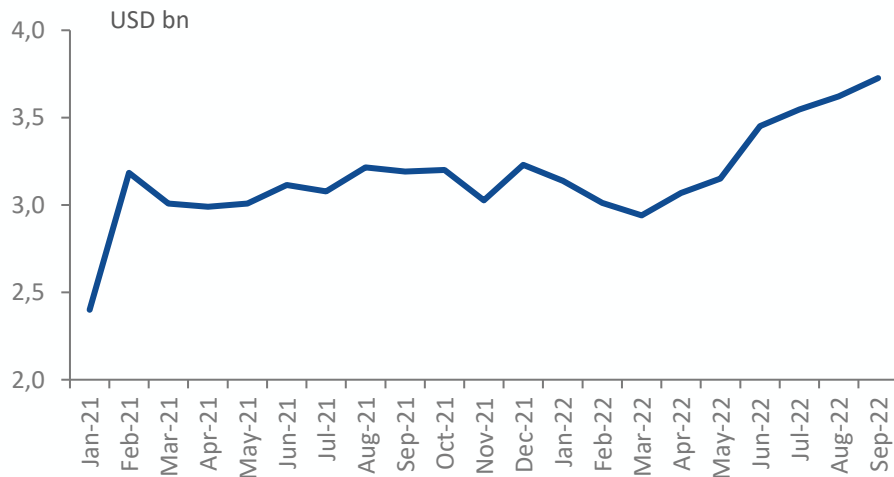
- » Till now, **hedging instruments rather underdeveloped** in Armenia:
 - Interest in hedging (against dram depreciation) mostly from the side of importers
 - Little to no interest in hedging (against dram appreciation) from the side of exporters
 - Thus: asymmetry, only one side of market strong; under such conditions, **difficult for banks to offer low-cost hedging instruments**
- » Now: exporters experienced a strong dram appreciation and might wish in the future to hedge against this risk (provided government does not compensate for losses due to dram appreciation)
- » Moreover: overall high global geopolitical uncertainty; FX markets are likely to remain volatile in the short- to medium-term
 - Also: risk of dram appreciation against the RUB, should the Russian economy face more negative shocks
- **Thus: unique opportunity for establishing a functional FX forward market; important to prepare for future FX volatility**

5.2. Opportunities for developing hedging instruments (2/2)

- » Possible approach to deal with the private sector
 - If companies approach the government, government should insist:
 - We see no reason to support you financially
 - You should hedge against such risks in the future; this is a standard practice worldwide
 - FX risk management involves some costs, but this is part of the cost for companies engaged in foreign trade
- » At the same time: CBA should approach commercial banks in order for them to offer competitive FX forward contracts
 - Monitoring of spreads and comparison to spread in other markets would help; high spreads could inhibit the development of this market
 - **This is also important for the CBA, as it reduces the pressure to do exchange rate management; facilitates more efficient inflation targeting**

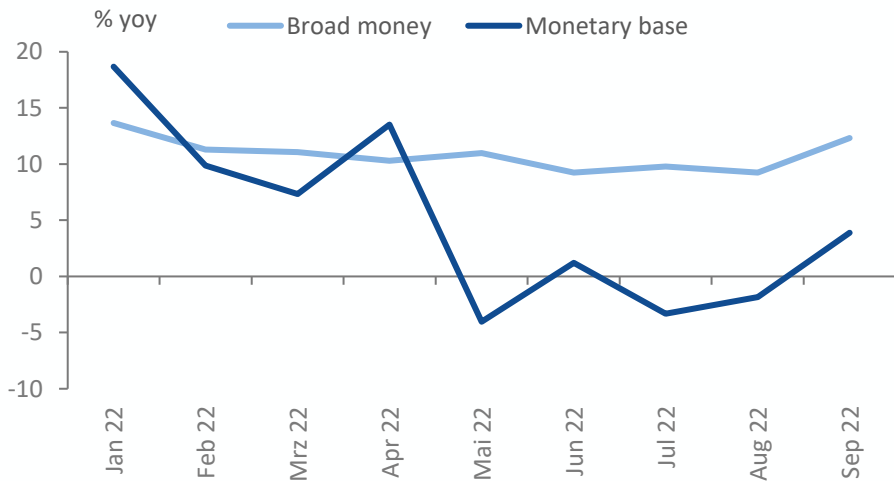
5.3. Monetary and fiscal policy (1/2)

International reserves



Source: Central Bank of Armenia

Development on money aggregates



Source: Central Bank of Armenia; note: in AMD terms

Monetary policy

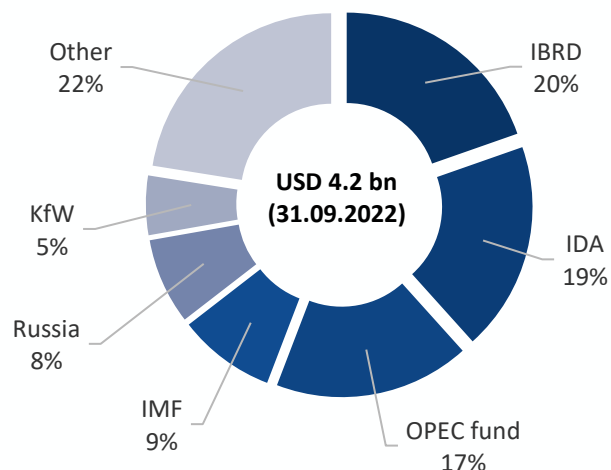
- » Significant purchases of FX by CBA in recent months
 - CBA absorbed roughly USD 590 m since Mar-22
 - Contributed to limiting appreciation
- » Sep-22: monetary base (in AMD) grew by 4% yoy; broad money: 12.3% yoy
 - Net international reserves: +1% yoy
 - Net domestic assets: + 10% yoy

Policy questions

- » Should the CBA try to decrease the magnitude or at least the speed of the appreciation?
- » If so, should the CBA increase its purchases of FX?

5.3. Monetary and fiscal policy (2/2)

Structure of creditors



Source: Ministry of Finance of Armenia

Armenian Eurobonds

	Armenia 2025	Armenia 2029	Armenia 2031
Issue size	USD 500 m	USD 500 m	USD 750 m
Coupon	7.15% (USD 17.9 m)	3.95% (USD 9.9 m)	3.95% (USD 13.5 m)
Coupon frequency	Semi-annual, 26 Mar / 26 Sep	Semi-annual, 26 Mar / 26 Sep	Semi-annual, 26 Mar / 26 Sep

Source: Ministry of Finance of Armenia

Fiscal policy

- » External government debt of USD 4.2 bn
 - 45% of Armenian external government debt is held in USD; SDR: 35%, EUR: 16%
- » As such: dram appreciation convenient from fiscal a policy perspective
 - 2022: reduction of external government debt to 23% from 30% of GDP in 2021

Policy questions

- » Buy-back of Eurobonds on the secondary market?
- » Should the MoF absorb FX by issuing FX bonds, in order to limit the size of the appreciation?
- » In any case: close coordination with monetary policy needed

Conclusions

- » Volatility of dram is to a large extent linked to events in Russia
 - Appreciation vs. USD due to relocation of Russian citizens (exports of services, personal transfers) and tourists from RUS
 - Depreciation vs. RUB due to exchange rate policy in RUS (capital restrictions, etc.)
- » Given that the mid-term situation in Russia remains very unclear, Armenia should expect further exchange rate volatility
- » Dealing with exchange rate volatility is not simple for the CBA and the government due to the divergent development of dram against RUB and USD
 - Concrete: reducing appreciation vs. USD would imply an even stronger depreciation against RUB
 - More fundamental: CBA should focus on inflation, not the exchange rate
- » This makes clear: private sector needs to learn how to live with exchange rate volatility
- » The development of a competitive FX forward market would be a great step for this; a key focus of gov policy in the short term

About the German Economic Team

Financed by the Federal Ministry for Economic Affairs and Climate Action, the German Economic Team (GET) advises the governments of Ukraine, Belarus*, Moldova, Kosovo, Armenia, Georgia and Uzbekistan on economic policy matters. Berlin Economics has been commissioned with the implementation of the consultancy.

**Advisory activities in Belarus are currently suspended.*

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