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Strong and rapid dram appreciation: economic policy implications

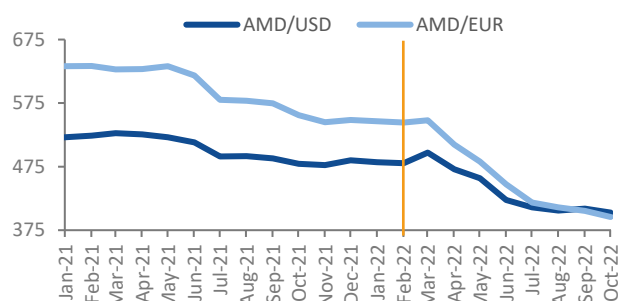
Armenian dram experienced a strong and rapid appreciation against the US dollar and Euro in recent months. The reasons for this are largely related to events in Russia. In particular, the influx of Russian IT specialists, as well as traditional tourists, significantly boost service exports from and personal transfers to Armenia – the two main drivers of the appreciation.

So far, economic implications of the appreciation remain limited. From a macroeconomic perspective, appreciation helps to contain inflation in a booming economy. Having said that, some export-oriented sectors could face problems due to the rapid onset of the shock and the resulting loss of competitiveness. While monetary policy is rightly focused on containing inflation, fiscal policy may have room to support affected business with loans. But as FX volatility is likely to remain high, the main focus should be on further developing the financial market and, in particular, hedging instruments for the private sector.

Strong and rapid appreciation of the Armenian dram

Despite some initial pressure immediately after the start of the war in Ukraine, the Armenian dram has strongly appreciated in recent months. By the end of Oct-22, appreciation against the US dollar amounted to 18.3% compared to the pre-war period. Against the Euro, appreciation was even stronger with 27.4%. In real effective terms, the Armenian dram has appreciated by a total of 18.8% so far (Sep-22 vs Feb-22).

Exchange rate vs USD and EUR



Sources: CBA

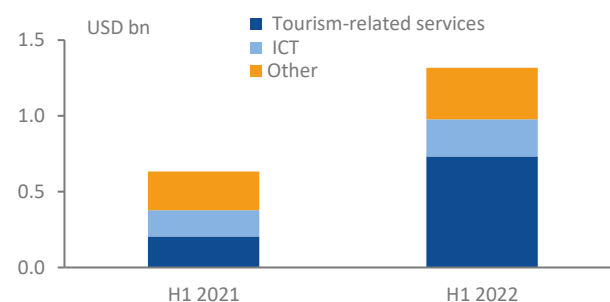
Moreover, the strong increase in value occurred within a relatively short period of time, thus leaving little time for the economy to adjust. As such, some macroeconomic and sectoral problems might arise that would justify economic policy action.

Appreciation linked to events in Russia

The reasons for the appreciation of the Armenian dram are largely linked to events in Russia. After the start of the war, Armenia experienced a significant influx of young specialists from Russia – mostly from the IT sector. The implications of this relocation are clearly visible in the balance of payments and especially in the current account.

The strong growth of service exports (H1 2022: 108% yoy) is one of the reasons for the appreciation. High revenues from tourism-related services (260%) and significant exports of ICT services (40%) – the two main drivers – are both closely linked to conditions in Russia.

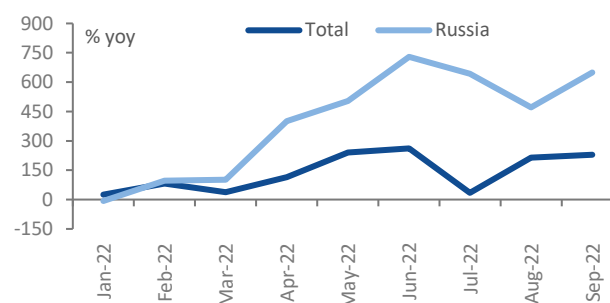
Development of exports of services



Source: CBA

Additionally, significant personal transfers from Russians who relocated to Armenia are further fuelling appreciation. Total net inflows of money transfers increased by 156% yoy (9M2022), while net inflows from Russia grew by 482%.

Net inflow of money transfers



Sources: CBA

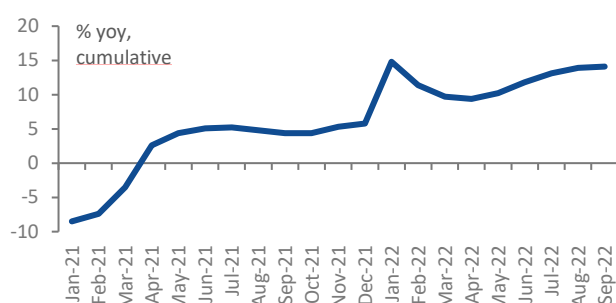
It should be noted that transfers between non-residents and especially cash transfers are oftentimes not fully recorded in the current account and are likely to be even higher. This is also indicated by the rather large net errors and omissions component in the balance of payments of Armenia.

Macroeconomic implications

One of the key questions is whether the strong and rapid appreciation of the dram poses a risk to the Armenian economy. From a macroeconomic perspective, the appreciation does not appear to be an issue so far.

The index of economic activity, a good proxy for growth, currently points toward GDP growth of 14.1% (9M2022). This is well above the potential output growth of 4-5% (according to IMF) and could be a sign of an overheating economy. However, the dram appreciation is rather a side-effect than the cause here. Moreover, appreciation (on top of interest rate policy) even helps to fight the elevated inflation (Oct-22: 9.5%).

Economic activity



Sources: Armstat

While the macroeconomic situation looks quite good overall, there might still be export-oriented sectors that are negatively affected by the loss of competitiveness due to the (real effective) appreciation of the dram.

Should the government support specific sectors?

In general, policymakers should be careful when supporting specific sectors and consider questions such as: does the sector in question really need support or was it just particularly successful in lobbying? Once the government supports one sector, several others will step up their lobbying efforts to gain benefits as well. Moreover, companies exposed to exchange rate fluctuations can be expected to hedge. Here, the government has an important role in facilitating the development of such instruments and the financial market in general. This, in turn, would also reduce the pressure on the Central Bank to monitor the exchange rate and thus allow to maintain the focus on inflation targeting.

That said, there might be room to financially support sound companies that were not able to adjust their business model due to the rapid onset of the shock. Here, subsidised loans with strict criteria could be an instrument to give businesses enough time to get used to the new environment.

Conclusions

The appreciation of the dram is largely linked to the events in Russia: the strong influx of migrants from Russia, as well as traditional tourists, brings FX into the country and boosts the exports of services. Given that the mid-term prospects for Russia remain very unclear, one should expect the dram to be volatile for quite some time.

In the short term, the government should make sure that hedging instruments are well developed and financial literacy of companies is high enough to understand the benefits of hedging. At the same time, the Central Bank should continue to focus their efforts on controlling inflation in the overheating Armenian economy. For fiscal policy, there might be room to support the macroeconomic adjustment by offering subsidised loans. This would give companies, which were financially stable and competitive before, enough time to adjust their business models to the new reality.

This newsletter is partially based on the Policy Briefing [“Economic implications of the recent appreciation of the Armenian dram”](#).

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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