Implications of the World's Financial Crisis for Armenia's Economy

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POLICY FORUM ARMENIA

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Policy Forum Armenia

Mission Statement

Policy Forum Armenia (PFA) is an independent professional non-profit association aimed at strengthening discourse on Armenia's economic development and national security and through that helping to shape public policy in Armenia. PFA has a hybrid mission, operating as a think tank as well as an advocacy group. Its main objective is to offer alternative views and professional analysis containing innovative and practical recommendations for public policy design and implementation. Through its activities, PFA aims to contribute to the creation of an informed public and more effective and accountable government. PFA's main asset is its worldwide network of professionals and leaders in their respective fields, with dedication to Armenia.

Operational Objectives

PFA has a hybrid mission. It primarily operates as a think tank, since its output will comprise of expert assessments and analysis using latest social science research methodologies and will benefit from scholarly exchange. In addition, to the extent that the PFA would advocate for, and have impact on, the social change in Armenia and the Diaspora, it would also function as an advocacy organization.

Vision

We strive to build Armenia as a country and society where:

Government is transparent and fully trusted by its subjects; Its main objective is the current and future well-being of citizens and nationals abroad; Its members are equally accountable before the law in the same manner as any other citizen of the country and have no direct commercial interests.

Judiciary is free, fair, and incorruptible.

Legislature is competent and respectable.

Civil service is the most respected form of employment, because it provides an opportunity to serve the country and people, and is highly professional.

Society has high standards of living; It is well educated, tolerant, and humane.

Economy is at the frontier of progress and innovation, building upon the human capital of the Nation as a whole; It offers equal opportunities for everyone; It does not tolerate unfair competition and redistributes through efficient and fair taxation.

Environment and responsible management of natural resources are essential to the survival of the State, and are key elements of well-being of future generations.

Human rights are the most sacred set of values.

Citizens of Armenia - Armenians, Yezidis, Greeks, Kurds, Russians, and others alike - are the most valuable asset of the State.

Armed Forces are by far the strongest in the region by spirit and dedication of its men and women, by its advanced armament, and by significance of its mission to protect life, history, and culture.

Diaspora and Armenia form a single entity, the Nation. Its stake in Armenia and Armenia's development are recognized and encouraged; Its potential is fully internalized; Its members have dual Armenian citizenship.

History is of essence. **Future** is where we aim.

Table of Contents

IMPLICATIONS OF THE WORLD'S FINANCIAL CRISIS FOR ARMENIA'S ECONOMY

I. Introduction/Motivation

It has become clear by now that the ongoing financial crisis will have a deep and prolonged impact on a wide range of economies. Despite originating in the advanced economies, the crisis is unlikely to let many countries stay on the sidelines and remain unaffected. This is also likely to be true for a peripheral economy like Armenia's, regardless of how isolated its relevant sectors are from the rest of the world. While in-depth research on the causes and consequences of the crisis is still in the pipeline and will become available as more facts are uncovered, economists around the world agree that there is ample evidence of a serious crisis in the making. And perhaps the loudest indicator of the expected slowdown in global economic activity is the drop in the price of crude oil to below $40 per barrel in early-December from its all-time high of $140 in July.

It all started when a broad spectrum of rather difficult-to-price and illiquid assets—mostly asset-backed securities and complex structured instruments—took large losses against the background of falling US housing prices. Given the extent of the leverage in the global financial system, the capital level was not sufficient to cover losses, rising counterparty risks and leading to a flight to quality. A high degree of cross-border financial integration ensured that the shock spread simultaneously across most major economies advanced and emerging economies. World-wide deleveraging and increased risk aversion resulted in large and persistent capital outflows from emerging markets, posing significant external financing difficulties and putting emerging markets' currencies under pressure. Forced and in some countries disorderly external adjustments, sharply falling commodity prices, and the world-wide credit crunch are taking a significant toll on the world economic growth, pushing the world economy into a prolonged and deep recession.

There are strong signs of the crisis spreading and putting strain on countries as well as international financial institutions. In recent weeks alone, seemingly solid and diversified countries/economies such as Hungary, Iceland, Ukraine, Serbia, and Pakistan have turned to the International Monetary Fund (IMF) for support of their worsening external balance-of-payments positions. A few others are presently in the process of negotiating arrangements with the IMF (IMF Survey, 2008) and the number is likely to grow. Interestingly, the IMF itself has secured a deal with the government of Japan whereby it will be given access to additional funds totaling $100 billion to strengthen the IMF's crisis prevention capabilities in these turbulent times (Financial Times web).

In this context, Armenia and all other low income and emerging economies alike are likely to be significantly affected. Moreover, recent developments in emerging markets suggest that the crisis-related deterioration of the economic outlook is likely to occur abruptly with little (if any) signs of early warning. This puts a high premium on the pre-emptive policy response and crisis preparedness efforts. Against this background, this note discusses the main channels through which Armenia's economy is likely to be affected as a result of the adverse global conditions. Along the way, it discusses the peculiarities of Armenia's economy and policies (past and present) that are likely to exacerbate the impact of the crisis and make early prevention efforts more pertinent. To conclude, the note offers some policy recommendations that may help mitigate the impact of the ongoing global crisis on Armenia's economy.

II. Channels of Impact

In the sections that follow, we discuss in detail the potential implication for Armenia's economy from: (1) slowdown in remittances flows, (2) reduction in trade and investment, (3) problems originating from the financial sector, and (4) reduction in official assistance.

A. Decline in Remittance Flows

Households in Armenia receive remittances to the tune of 20 percent of GDP (CBA, 2006). In the past two years this may have amounted to $1.3-1.5 billion annually. Here we discuss the peculiarities of these flows and their potential implications in the Armenian context.

First of all, a non-trivial share of these transfers comes from individuals from outside of the immediate family.[1] This makes the remittances rather sensitive to the financial condition of the sender, compared to the case where the sender is remitting the funds to the members of his/her immediate family.

Second, a very large share of remittances originates from Russia.[2] Furthermore, as shown by Atoyan and Oomes (2006), these transfers are strongly correlated with Russia's GDP growth. This obviously leaves the remittances heavily dependent on the developments in Russia, and in particular, two sectors of the Russian economy, trade and construction. Anecdotal evidence already suggests a slowdown in Russia's construction sector and so the impact of this on Armenia is likely to be felt soon.[3]

Third, a sizable share of total remittances flows is directed toward investment (mainly in construction) and, therefore, is likely to be pro-cyclical. Not only is this portion of remittances likely to be more dependent on the economic conditions in the sender countries (compared to the portion that supports subsistence consumption in Armenia), but it is also likely to be sensitive to the rate of return on those investments in Armenia. Thus, any slowdown of sectors where these transfers are channeled to is likely to result in reduction of the flows themselves, opening a vicious cycle.

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[1] CBA, 2006 report that only 20 percent of remittances senders are distant relatives, with 75 being close relatives. Using the 2004 Integrated Living Standards Measurement Survey conducted by the National Statistical Service of Armenia, Grigorian and Melkonyan (2008) report that in as high as 63 percent of cases remittances come from out-of-household sources.

[2] CBA (2006) reports that 72 percent of total remittances received by households in Armenia come from Russia. In addition, 47 and 68 percent of senders of these transfers work in construction and trade, respectively.

[3] See "Crisis Devastates Businessmen," A1plus.am, November 25, 2008.

Implications of reduced flow of remittances (due to any of the reasons mentioned above) on Armenia's economy could be dramatic.[4] To the extent that they contribute to economic growth either due to boosting consumption or investment (Atoyan and Oomes, 2006) their slowdown will have implications for growth prospects going forward.[5] In addition, since a sizable portion of these transfers are directly financing subsistence-level consumption, a reduction in transfers will have direct implications (i.e., independent of the growth channel) on poverty. Finally, lower remittances flows could have implications on external financial imbalances (i.e., current account) and, other things equal, will lead to pressures on the Central Bank's reserves and/or exchange rate.

B. Trade- and Investment-Related Implications

Reduction in Demand for Exports

The financial crisis, with the attendant slowdown of world economic growth, will reduce demand for Armenia's exports. The concentrated structure of Armenia's exports—six countries account for nearly 70 percent of the country's exports—increases the country's vulnerability to a negative impact arising from a shock to a major trading partner (see Figure 1).[6] Although specific channels of transmission vary for different countries, all of Armenia's major trading partners are likely to be affected by the financial crisis. Indeed, the IMF (see World Economic Outlook, 2008) currently projects a sharp slowdown in 2009 economic growth vis-à-vis average growth rates in 2006-08, ranging from 2 percent in Russia and the USA to over 4 percent in Georgia.[7] Demand for Armenia's exports is also likely to drop notably as a result.[8]

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[4] The discussion on remittances from here on focuses on the component of remittances that finances domestic consumption and investment. Typically, a portion of remittances will also finance imports, in which case a slowdown in remittance flows will also reduce imports with zero net impact on the current account.

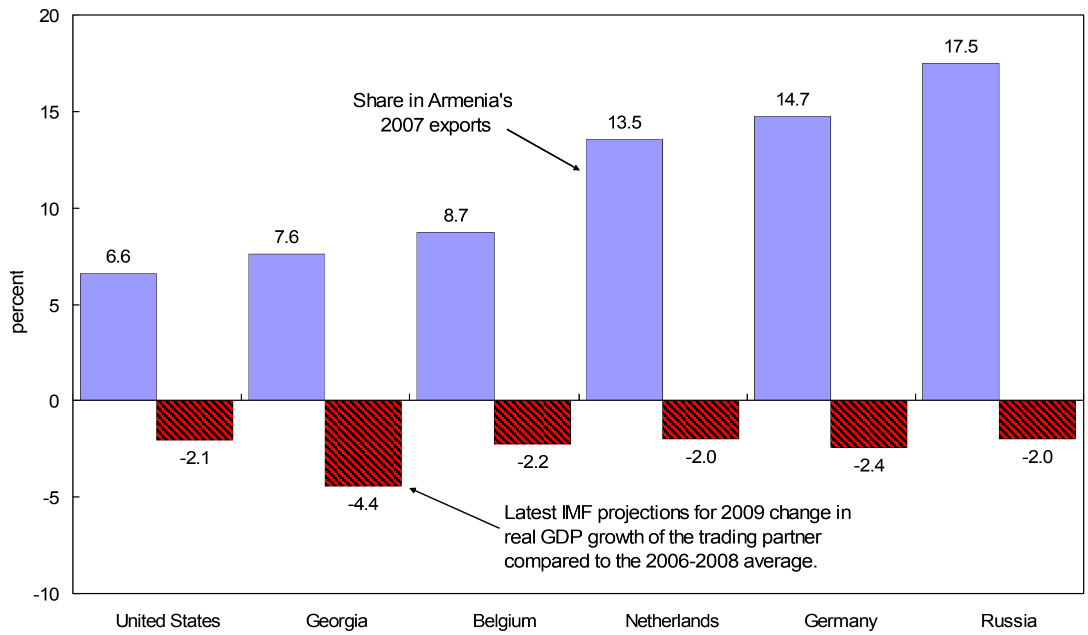
[5] For a report on slowing down consumer demand in Armenia see "Director of STAR Network of Supermarkets: Financial Crisis Has Affected Consumer Demand in Armenia," ArmInfo news agency, November 5, 2008.

[6] It should be noted that Armenia's export sector has already lost some competitiveness due to the appreciation of the national currency in the recent years, and has lost a great deal of steam as a result.

[7] For a report on a critical region for Armenia's trade, see "Eurozone Recession Deepening Rapidly," Financial Times, November 21, 2008.

[8] Slowdown of demand for products of a key sector of Armenia's economy, chemicals, is already becoming visible. See "Global Crisis Results in Suspension of Production at Vanadzor Chemical Complex," Arminfo news agency, November 4, 2008.

Figure 1: Armenia's Exports and Projected Economic Growth of Major Trading Partners



Source: IMF World Economic Outlook database.

Reduction in Prices for Armenia's Key Export Commodities

Decline in demand for Armenia's exports is also likely to coincide with a significant terms-of-trade shock due to falling copper, molybdenum, and gold prices, important categories of the country's exports. Indeed, recent sharp reductions in international prices of most primary commodities suggest that markets expect a significant slowdown in world economic growth, which inversely affects economic prospects for all commodity exporters. While the uncertainty on the exact trajectory of commodity prices in the near term remains significant, the reduction of international metal prices in 2009-10 is expected to be sizable (see Figure 2).[9] And while deterioration of the trade balance is likely to be somewhat compensated by declining prices for Armenia's key imports (food and energy), the pass-through of lower international prices to Armenia's consumers is likely to be incomplete given structural rigidities in the economy and monopoly pricing for key items, such as gasoline and other oil derivatives, sugar, wheat flour, and vegetable oil.

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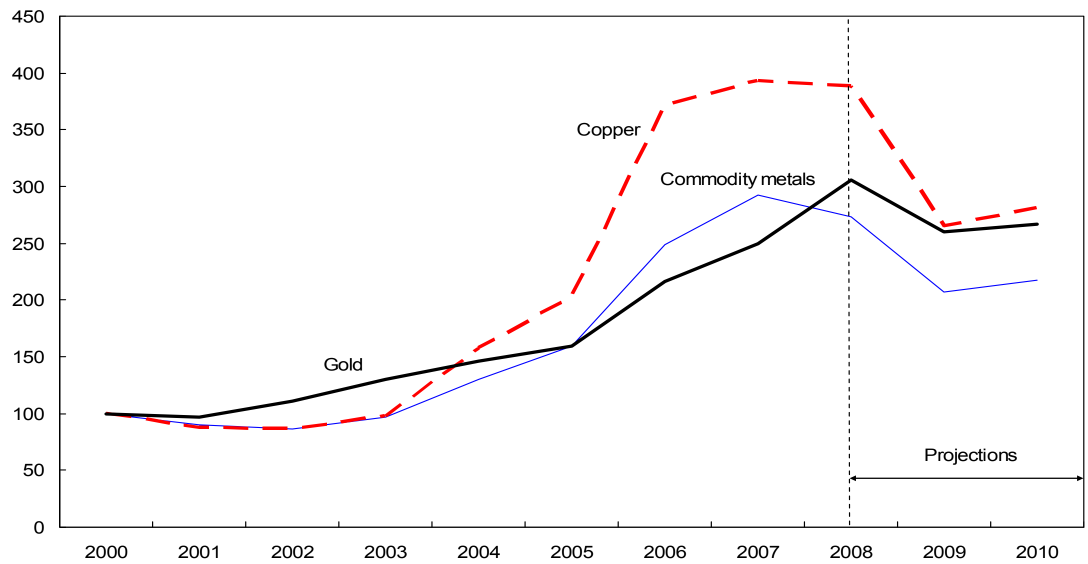
[9] There are already signs of Armenia-based mining companies (e.g., Agarak Copper Molybdenum Factory and Dino Gold Mining Company in Kapan and a gold mining plant in Meghri) experiencing problems and responding to them by announcing major layoffs and/or by pulling out (See "Armenian Ministers Get Acquainted with Situation in Agarak Copper-Molybdenum and Dino Gold Mining Companies in Syunik," Armenpress news agency, November 11, 2008 and "Tamaya Resources Ltd. is Pulling out of Armenia," Hetq.am, November 24, 2008).

Figure 2: World Metal Price Indices (2000=100)



Source: IMF World Economic Outlook database.

The drop in demand for exports and worsening terms-of-trade are likely to have significant negative implications along these dimensions:

- the trade and external current account deficits are likely to deteriorate significantly, rising external financing requirements in the external balance of payments; [10]

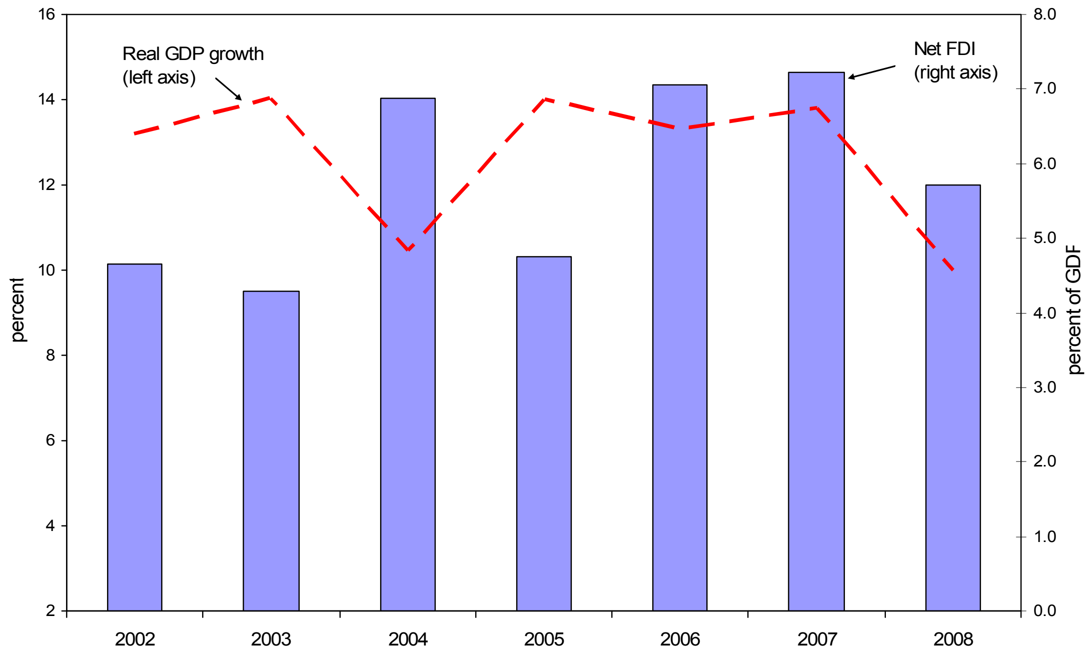
- downward pressures on the exchange rate are likely to emerge adding to building-up inflationary pressures thus straining the loan servicing capacity of the unhedged borrowers with foreign currency mismatches.

Impact on Direct Investment

By the same token, the global slowdown is also likely to reduce foreign direct investment flows to Armenia. Against the background of robust economic growth around the world and abundant liquidity in the international financial markets, Armenia's economy has in the past benefited from significant capital inflows (see Figure 3).

[10] Traditional sources for external financing in Armenia include FDI, external official grants, and external concessional borrowing, all of which are likely to be difficult to secure at historical levels in a difficult external environment.

Figure 3. Economic Growth and Foreign Direct Investment in Armenia



Source: IMF International Financial Statistics database and IMF country report No. 08/176.

With a sharp slowdown in most source countries (most notably Russia, which in addition to a general slowdown is hit by dramatically falling oil prices)[11] and the higher cost of project financing (due to heightened credit conditions in the international capital markets), FDI inflows to Armenia are likely to slow down in the near term with the following potential repercussions:

- economic growth will slow down and, in the absence of a countercyclical (fiscal and monetary) policy response, will result in higher unemployment;
- economic slowdown will in turn undermine the tax collection efforts (relative to the targets) and in an environment of shrinking availability of fiscal financing (both domestic and external), could result in pressures to cut expenditures, at a time when more spending would be advisable;
- a combination of slower growth, higher inflation, and less government spending will likely result in heightened social pressures and more poverty.

[11] There are visible signs already of the crisis putting a strain on Russia's economy. It appears that the Central Bank's reserves declined by almost $150 billion as of mid-November (from $597 billion in August) and wage arrears rose in October by 33.4 percent. (See "Putin Unveils Tax Cuts in $20bn Stimulus Deal," Financial Times, November 20, 2008).

C. Financial Sector Channels

Vulnerability of Armenia's banking sector to the ongoing financial turmoil and global economic slowdown could be fourfold: (1) via direct financial links with banks and financial institutions abroad (i.e., borrowing), (2) via exposure to domestic companies that are either export-oriented or themselves have foreign borrowing exposure, (3) via exchange rate related risks, and (4) other indirect systemic reasons (e.g., lack-of-confidence-induced run on banks). We discuss these risks in turn below.

Direct Financial Links

Due to the relative isolation of Armenia's financial system from the world markets, the banking sector's exposure to foreign loans and obligations is not very large. Only about 4 percent of its total liabilities (including equity) as of September 30, 2008 were liabilities to foreign entities. However, the maturity mix of these obligations is less-than-comfortable with about half of them maturing within months.

Links with Non-Financial Corporate Entities

While Armenia's private sector is not considered highly leveraged, some are export-oriented large companies while others have direct exposure to foreign financial institutions. In the event that these companies' export earnings and/or ability to service their foreign debt drop, this will have an implication on their ability to service their domestic loans, with direct implications for the banking sector. To the extent that some of these corporations have short-term foreign currency-denominated debt, absent roll-over opportunities on the credit market, repaying these debts could put some pressure on the Central Bank's ability to provide foreign exchange in a very volatile environment.

Another channel that could hurt Armenian companies that are trying to sell products abroad is availability of credit. As credit conditions around the world tighten, importers in partner countries will have a harder time securing credit (e.g., through Letters of Credit) to pay for Armenian goods. Difficulties of securing credit could mean higher interest charges and delays in loan processing due to perceived counterparty risks. The problem becomes even more severe if Armenian exporters also rely on imported goods for their production, which is typically the case in manufacturing.

Finally, Armenia's financial system may be affected by the deterioration of the credit portfolio extended to both corporate and household sectors due to abrupt slowdown in economic growth caused by any of the factors outlined in earlier sections.

Exchange Rate Exposures

As mentioned earlier, slowing down remittances flows and worsening export performance will—other things equal—lead to depreciation of dram vis-à-vis the dollar, the main currency of transfers and export receipts to Armenia. This may have implications for the balance sheets of banks with short foreign exchange (dollar) positions.

Furthermore, the dollar is likely to continue appreciating vis-à-vis other major currencies given that US securities are viewed as a safe haven, largely due to the coordinated efforts by the Federal Reserve and the Department of the Treasury in assembling large scale rescue packages to crisis-stricken banks and corporations. Indeed, throughout the difficult months of August and November, the dollar appreciated against Euro by 25 percent. This alone could put downward pressure on the dram, with similar implications on the balance sheets of banks.

Systemic Risks

In an environment of global financial distress briefly discussed in Chapter I, the main risk to Armenia's banking sector, however, remains its ability to withstand crises of confidence. It is a fact of life that even the most liquid and well-capitalized financial systems may not withstand the blow of a large-scale crisis of confidence and subsequent run on the banks. Yet some systems are better prepared to weather shocks than others. In the case of Armenia, given the untested capacity as well as the still fragile credibility of the Central Bank and the Ministry of Finance to offer any tangible support lines to reduce the downside, a large scale run on the banks is more problematic. This is so because absent adequate anti-crisis capabilities, depositors will be less sure about the value of their deposits (in expected value terms) should they opt to keep the deposits in the bank instead of trying to withdraw them before everyone else does. So far, the authorities' strategy has been to communicate to the market that Armenia is immune because it is disconnected from the financial markets. More recently, announcements were made by top policymakers that there exists a line of defense against crisis but that there is no need to employ it yet. These kinds of signals are unlikely to be sufficient, and so significant improvement in communication strategy would be necessary to give the depositors peace of mind and thus prevent a run on the banks (even those ones with no direct financial linkages with abroad and strong capital positions).

One of the typical lines of defense against a run on the banks is deposit insurance. The Armenian Deposit Guarantee Fund (ADGF) provides insurance for up to AMD 2 million (about $6,600) for dram-denominated deposits and up to AMD 1 million for foreign currency-denominated deposits. Owing to the small size of the average deposit, these limits *de facto* cover in excess of 80 percent of bank accounts in Armenia. Yet, given its relatively young age (it effectively went into operation in 2005) and untested nature, the ADGF itself may come under strain in the event of a large-scale run on the banks. In any case, better communication to the public regarding the general principle of deposit insurance as well as the specifics of what the ADGF has to offer would be helpful to increase confidence.

In sum, indeed the banking sector's links with the rest of the world as well as its size (relative to the size of the economy) may suggest little systemic repercussions on the overall level of economic activity during a full-blown crisis. However, the confidence-related implications of these repercussions could be major and are likely to go beyond those suggested by the first order effects proxied by the size of the sector and intensity of links with the rest of the world.

D. Reduction in Official Assistance Flows

As the global financial crisis puts a significant strain on the budgets of advanced countries, there is a growing concern among development experts that low income countries may also be affected through a reduction in aid flows. Notwithstanding recent strong economic growth, Armenia still relies notably on the external official grant and concessional financing for much of its economic development. There is likely to be a significant economic impact should the aid flows decrease. While there is a broad-based call from international financial institutions—and the international community more broadly—for advanced economies to make good on their aid pledges, it remains to be seen how the aid budgets around the world would be affected. Nevertheless, Armenia is likely to face a tougher competition for the scarce aid funds as most of developing countries are going to feel the squeeze of the tighter aid budget. The recent controversial presidential election and subsequent events (see, PFA, 2008) may pose a risk for Armenia's ability to attract developmental assistance from countries and aid agencies, whose support is tied to improvements in democratic standards and governance.

III. Policy Recommendations

Most risks outlined above warrant serious attention from policymakers. To the extent that the economy could be subject to more than one risk/shock at a time, their impact could be more severe. This requires ability to recognize early warning signs, prepare adequate policy response, and develop contingency plans. These would critically depend on good understanding of the specifics of Armenia's economy but also, and in some cases more importantly, understanding of related developments in key trading partner countries as well as in the main global players and international financial institutions.

Addressing Capacity Issues

Unfortunately, while led by a capable Prime Minister, the relevant agencies—the Central Bank and line ministries—have limited capacity and experience to address the potential risks.[12] In addition, coordination between these agencies—between each other and with the cabinet—should be improved dramatically in order for the top policymakers to receive comprehensive and in-depth picture across the key economic sectors.

The following recommendation addresses these problems and will send a strong signal of preparedness and ability to analyze and act.

Recommendation:

- A Crisis Prevention Team (CPT) should be established as a high-level policy advisory body to the government. Reporting directly to the Prime Minister, the CPT should consist of economists and financial sector professionals with strong reputation and experience in dealing with crisis countries. To be seen as credible it should include Diaspora and also possibly non-Armenian professionals and should be non-partisan. In addition to analyzing daily developments in Armenia and around the

[12] This is largely due to lack of trained economists with knowledge of macro-financial linkages as well as first-hand expertise/knowledge of other crisis episodes.

world, the CPT will liaise with international agencies, Diaspora, and key investors and stakeholders, as necessary. Given the importance of public buy-in for the anti-crisis measures, the CPT will be tasked with coordinating the public relations campaign aimed at adequately portraying the costs and benefits of the proposed austerity measures.

We discuss the potential range of these measures below.

Fiscal Policy Response

Typically, the fiscal stimulus would be directed at the sources of the economic slowdown to reduce their intensity and minimize their consequences. In the Armenian context, however, a sizable portion of growth in recent years came from the construction sector, which is expected to be hit hard due to the slowdown of external demand. This concentration and external nature of the source of the slowdown make designing a meaningful fiscal stimulus package quite challenging in Armenia.

Unfortunately, the room for fiscal countercyclical stimulus *in general* in Armenia at present remains limited. While deficit/debt levels are low, as discussed above, it would be difficult to secure financing for expenditure expansion beyond the currently budgeted levels. Already the tax collection targets could be too ambitious and allocation for social spending could be too optimistic/low considering the potential for economic slowdown. Assisting companies or financial institutions that are perceived as systemic (by injections of either debt or capital in them) is, therefore, unrealistic. On the other hand, a fiscal stimulus in the form of subsidies and transfers is likely to boost imports and further deepen the current account deficit.

The following recommendations take these factors into account.

Recommendations:

- As signs of the crisis become more pronounced, some expenditure reallocation within the budget envelope will be required. Specifically, expenditures on line items of secondary importance (excluding social spending) and waste during public procurement should be reduced to free up room for a more targeted fiscal response aimed at exporter support and social assistance. The response should be designed carefully as to minimize the impact on trade balance and, as a result, on the exchange rate.

- This might be a good time to broaden Armenia's notoriously narrow tax base ensuring that nobody remains outside of the tax authorities' radar screens. Given already worsening social conditions in the country, this may also help reduce the potential for social and political tensions down the road.

- In collaboration with international partners, design and launch a guarantee facility to ensure uninterrupted trade financing (particularly for critical commodities) for Armenia. Creation of this facility does not have to be expensive (with a potential downside of acquiring contingent liabilities for the government), but could be an effective way of signaling intentions and ability to handle shocks.

With a limited score for maneuvering on the fiscal side, we turn to monetary and exchange policy as well as structural measures.

Monetary and Exchange Rate Policy Response

In principle, the monetary policy could be called upon to ensure better credit availability and, therefore, fewer disruptions on the production side. Yet, monetary expansion (if not coincided with reduction in price of imported goods) will be inflationary, with the utmost impact on socially vulnerable strata of population. In addition, monetary expansion beyond that in trading partner countries is likely to lead to real exchange rate appreciation with similar implications on the current account as in the case of fiscal expansion. Lowering the policy interest rate may be a double-edge sword, because in addition to making credit cheaper it may also encourage capital flight. In sum, an expansionary monetary policy may have serious downsides in the present context.

Instead, there is more room for the use of the exchange rate policy. Depreciation of the exchange rate may not necessarily have the inflationary impact of monetary loosening, and will be a more direct and effective way of supporting the export sector (than other measures with a similar objective). Considering the pressures from the current account, it is expected that downward pressures will build up on the dram or the CBA reserves. Allowing the exchange rate to adjust, instead of trying to keep the predetermined path will allow the exchange rate to work its way to a new equilibrium and minimize painful adjustment down the road. The opposite (i.e., the CBA refusing to devalue and instead attempting to maintain the current level of exchange rate) may be more costly: if agents perceive the CBA's exchange rate stance as non-credible, they will switch to holding foreign exchange (instead of the dram) making it likely for the economy to re-dollarize. It should also be noted that high degrees of perceived misalignment are known to have encouraged attacks on the central bank reserves—*a la* Krugman (1979)—in some countries during the Asian crisis of 1997.

The following recommendations, therefore, put more emphasis on the exchange rate channel.

Recommendations:

- Allow for much greater flexibility of the exchange rate by reducing to a minimum the CBA's interventions (i.e., sales of foreign exchange) on the foreign currency market. While the CBA's holdings of foreign reserves (of 5 months of imports) appear to be adequate for tranquil times, it should use any opportunity to boost its reserves position during adverse market conditions, such as the current one.

- Gradually reduce the policy interest rate and reserve requirements, and ease access to the Central Bank's credit and liquidity facilities, while carefully monitoring inflation developments. Prepare to adopt higher rates of credit expansion specifically targeting producers, especially exporters.

Structural Policy Response

Certain structural policy measures are likely to be effective in better preparing producers and reducing the social impact of the crisis. Given the severity of what is expected, and to adequately gauge the problems and devise remedies facing each sector of the economy, the required approaches would have to be sector-specific.

In the financial sector, prior to committing scarce public funds to support the sector, and as signs of the crisis become stronger, the CBA should encourage the banks to make every effort to raise additional capital from their shareholders (some of whom include prominent international development agencies, banks, and investors). While allowing banks to fail may send a poor signal to the market participants (including international investors), it should be noted that the banking sector in Armenia remains relatively unimportant, in terms of its contribution to GDP and employment, but also in terms of their ties with the households through borrowing and lending.[13]

Armenia's largest corporations too should not receive public funding since their sizable profit margins from previous years are likely to be sufficient to help weather shocks on their own and with the help of their (concentrated) shareholders. In addition, assisting some of these large companies—monopolies and near-monopolies in their respective fields—will be a poor choice politically, given the issue's propensity to create public resentment.

Instead, the focus should be on small and medium sized enterprises (SMEs), especially those engaged in export, and on the social sector.

The following recommendations take these considerations into account.

Recommendations:

- Create a lending facility for SMEs to provide targeted and easy-to-access loans to viable SMEs in need of emergency financing.[14] The loans should be channeled by a specialized financial institution, as opposed to a government agency, to minimize the scope for abuse.

- Take measures to reduce the monopoly price-setting powers of key import companies. In addition to ensuring that the ongoing reduction of prices for fuel and energy as well as food commodities pass fully through to consumers, lower prices for

[13] Once the dust settles, it may be a good time to revise plans for financial sector's strategy going forward. One thing is clear already, however: a banking sector whose main anti-crisis shield is its isolation from the rest of the world, should be more realistic in setting objectives of becoming a regional financial sector in the near term.

[14] This is related to the second monetary policy recommendation (regarding higher credit growth) and could be a joint effort between the monetary authorities and international financial institutions (e.g., The World Bank or its private lending arm, the International Finance Corporation).

importables will counter the potential inflationary impact of dram depreciation, as discussed above.

- Undertake a review (perhaps with the help of the World Bank's Doing Business team) of barriers for business operations and make credible steps to eliminate some of those barriers in the near term.

- Enhance/expand the social safety net by (1) undertaking a review of the poverty guidelines, (2) targeting the next layer (i.e., currently on the margin) of socially vulnerable strata of population, and (3) making credible steps toward eliminating corruption from the existing system.

- Review and enhance existing unemployment insurance and provide assistance to employees that have lost jobs due to crisis-related closures and downsizings.

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