

POPULATION NEEDS TO KNOW THAT MACROECONOMIC STABILITY HAS COME TO STAY



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Interview with the IMF Mission Chief to Armenia, Ratna Sahay

In June 2010, the IMF Board approved a new concessional Extended Fund Facility (EFF)/Extended Credit Facility (ECF) arrangement for Armenia as a replacement for the previous financial assistance under the Stand-By Arrangement. In September, IMF mission to Armenia, led by the Deputy Director of the Middle East and Central Asia Department, Ms. R. Sahay, completed the 2010 Article IV Consultation discussions and reached a staff-level agreement with the authorities on their economic reform program under the First Review of the EFF/ ECF Arrangements. The IMF Executive Board will shortly discuss the completion of the first review, but the national Government has already initiated some structural reforms, and the IMF believes that's not a false start.

Do you think there's going to be an adequate credit demand in the private sector, once the fiscal stimulus is withdrawn?

Armenia's economy suffered a very sharp downturn last year, one of the highest worldwide – with over 14 percent GDP contraction. At that time, demand for credit was very weak. The good news is that this year we see evidence not just of the economy recovering, but the demand for credit going up. If you look at the private sector credit growth, it has actually increased by 23 percent in August 2010, from August of the previous year, so that's quite encouraging. I think this is mainly coming from service and industry sectors. Talking to the Central Bank and bankers in Armenia we felt that they were quite positive on the outlook, in terms of their loan portfolio growing. One issue they are struggling with is lending in drams versus lending in dollars - there is a fairly large dollar portfolio in deposits. Naturally banks would like to match their assets and liabilities, and therefore they would prefer to lend in dollars, but we see some improvement in this area as well, even if today's increase in lending is mainly in dollars.

What tools are most appropriate for the Central Bank to increase credit demand, manage the liquidity and ensure the proximity of interest rates to the policy rate?

There was indeed a difference between the policy rate and the short-term market interest rates for some time. Stepping back, the objective of the Central Bank, which had been well defined even before the crisis, is really price stability, and it continues to be so. And what they are trying to do - with initial success - is to maintain an inflation targeting framework. The CBA has been using its policy levers and monetary instruments quite actively, including open market operations, standing facility, and reserve requirements. We have recently observed that the Central Bank actual REPO rate and

the policy rate are currently very close. When we are talking about money market rates here, we are looking at the shortest spectrum of money market rates, e.g. overnight interbank and 7-day repo rates.

Still the divide between the policy and market rates remains around 10 percent. What do you think could be the main reasons for that? Have you observed competition in the market?

This is a complex question. The policy rate is the basis of the 7-day repo rate which is a very short-term rate transacted among banks and the market rates we are talking about here is banks' retail lending rates which are much longer-term in nature and are transacted between banks and customers. Thus, there is of course a significant difference between them reflecting many factors including the counterparty credit risk premium, term premium, and liquidity premium. That said, you are right that this spread seems relatively high in Armenia. There are many reasons for the spread, and lack of competition could be one of them. Increased competition would enhance efficiency in the banking system and thus reduce cost. But there are other factors that affect the differential in rates my sense is that competition is there, though it can be enhanced. But I think another problem that has become worse during the crisis period, is large deposit dollarization. On the other hand, borrowing is more preferable in the national currency but banks still prefer to lend in dollars. So the mismatch of currencies has been in some sense a bigger factor, and it is evident that Armenian banks are in a difficult position to lend prudently in domestic currency. Banks are faced with both direct foreign currency risk and indirect foreign currency-induced credit risk.

As mentioned above, one of the consequences of the crisis was the re-dollarization of the economy. And the effects are still being felt today. Over time, we think, there is macro-stability coming and as the economy starts to grow people will start having more confidence in the dram. These circumstances are beneficial for dedollarization, which will be very important for monetary policy to be effective. We do see the trend in a positive direction, but we encourage the authorities - both the Central Bank and the Government - to continue following the right policies. Because the most important thing is for the population to believe that macroeconomic stability has come to stay. This will inspire confidence in the dram.

Do you think the currency rate will stay out of any excessive volatilities? What is your advice to the Central Bank?

Our message to the Central Bank is threefold. First, the CBA should intervene when warranted to reduce volatility, so as to avoid worries about excessive exchange rate fluctuations, but not to resist fundamental trends. Secondly, to ensure that there is enough foreign exchange reserves. Thirdly, and in a more long term perspective, we need to make sure that the real exchange rate is in equilibrium and does not weaken the competitiveness of the economy.

The EFF/ECF agreement has set several quantitative targets for the country. Per currency, there is a floor on net international reserves, and a ceiling on domestic assets. If the first is a cushion against over much interventions in foreign currency, then what's the second target for?

The ceiling on domestic assets is an integral part of many IMF backed programs. It is designed to ensure that money supply doesn't increase too rapidly, so as to avoid inflationary pressures. The ceiling guarantees that macroeconomic policy is consistent with the goals of the authorities, both with regards to inflation and growth, because if you have too much inflation it will harm the economy and impose additional burden on the population.

Who do you think could be more contributing to the state budget - start-up businesses, or existing large taxpayers? Do you think that tightening of tax administration will be beneficial for small and medium businesses?

If you go to Armenia and ask the people, they will undoubtedly tell you that there is a certain level of corruption in the tax system. That's a problem both on the business side, and on the tax collectors side. Our view is that the tightening of the tax administration should be focused on the large taxpayers, which are largely the source of the country's shortfall in tax performance. So from the small businesses' perspective tightening is also beneficial, and I think for larger businesses it will also be beneficial in the longer term, because they will not waste resources on tax evasion and bribes. But I would like to add that tax rates in Armenia are comparable to other countries. That is why we support the government policy of focusing first on the administration and collection side and not as much on the tax policy.

Another issue which needs attention is the area of preferential taxation regimes. There are a couple of sectors which have a preferential tax regime, like tobacco and fuel, and that is an area where we had comprehensive discussions with the authorities. The authorities agreed upon transferring tobacco and fuels from today's presumptive taxation to the regular VAT regime and fuel will be moved from the beginning of the next year. It will however, take some time for the tobacco regime to change, because domestic producers have more preferential treatment over importers and there are domestic farmers who grow tobacco, and the government – understandably – wants to protect them from unemployment. We have agreed and support the idea of bringing it gradually under the regular regime, so that the reasons for delays in enforcement should be clear for everybody but it is also clear that there is a law which specifies this change. We expect the law to be passed before the IMF's Board meeting in early November to consider the first review under the IMF-supported program.

Do you think tax authorities are prepared to assume the task of taxing tobacco and fuels with VAT, which is more difficult to administer than the flat tax rate under presumptive taxation, effective today?

This is true, therefore an important consideration is also to strengthen the tax administration, because if you immediately impose VAT, without sufficient capacity to administer it, revenues may be at risk. Some time is needed to set up the system and arrange the channels to get more precise information on the activities of the business.

The government has several times expressed intention to eradicate barriers for domestic competition. Do you think this time the vision will be turned into action?

This, in my view, is a priority area of reform. Ultimately, the goal of any government and of any country is very much to raise economic growth rates, and to ensure that this growth is spread evenly among the population. For this we need to have a competitive economic environment. We've had discussions with the Prime minister of Armenia Tigran Sarkisyan, head of the Central Bank Arthur Javadyan, and Minister of Finance Tigran Davtyan. We do see efforts in that direction, but much more needs to be done. It is not just to simplify the tax regime and make it more transparent but also to streamline the reporting and licensing system.

The Finance Minister informed us that the government has reduced the number of licensing requirement by nearly 40 percent. That's fantastic news! Another very good news is that they are reducing the interface between the people who apply for licenses and officials who release them, by introducing electronic application processes. The business climate, if you compare it to other countries in the region, still has room for improvement. This will be very important going forward, because Armenia is facing a very different world after the crisis. Growth rates amongst the main trading partners of Armenia - Russia and the EU - have not only fallen, but are expected to stay at a lower rate. That is why Armenia needs to be more competitive and find ways to diversify its economy.

Armenia has a huge potential for tourism, which has been very thinly exploited so far. An illustration of the lack of importance given to this sector is that Armenia does not even have a tourism minister. I think that Armenia has not focused enough on a potentially very important source of government revenue, income for the population, employment, and foreign exchange. And tourism is also a gate

for development of a wide range of other supporting industries. Additionally, Armenia has a huge Diaspora, which would surely be happy to invest in tourism in Armenia, so the Government wouldn't have to secure all the investments on its own.

Finally, what are the approximate time boundaries in which the first review of Armenia's performance under the EFF/ECF will be completed, and the agreement will be sent to approval?

This is the first review, and the good news is that the country has met all the targets for the review. There also some targets which had been set for September and we think that the Government will have accomplished them as well. So there is already a staff level agreement with the authorities, then it will be up to the IMF Executive Board to approve it. Upon that approval, the funds will be released. The Board is scheduled to review the agreement in early November.