

How the exchange rate of the Armenian currency is set, why is it so strong and how long it will last?

ARVAK Center comment, 20.03.2024

For almost two years, the adjective “strong” has been systematically applied to describe the dynamics of the exchange rate of the Armenian national currency – dram (AMD).

Over the three spring months of 2022, the exchange rate of the Armenian dram against the US dollar increased by about 20%, and since then it has been fluctuating weakly around the same rigid level – 400 AMD per 1 USD. There were periods of strengthening to almost 380 AMD per 1 USD by early fall of 2023, there was also a one-time shock weakening to almost 420 AMD per 1 USD against the backdrop of the exodus of Armenians from Artsakh, but all these movements were only weak fluctuations on a new plateau.

The last time the Armenian currency reached such heights was in 2014. It is even more surprising that this is happening against the background of the dollar’s growth against the currencies of dozens of other countries in the world, including the currencies of almost all of Armenia’s significant trading partners. This means that the exchange rate of AMD, expressed in the currencies of these countries, has strengthened even more.

Why has AMD strengthened?

The Armenian Central Bank operates a floating exchange rate policy. This means that there are no official restrictions on the movement of the dram's exchange rate, such as a "currency corridor" or a rigid peg to the currency of another country. The capital market is liberalized – money can freely come into Armenia from abroad and freely go out (if the banks follow all the necessary AML procedures), if the owners of capital see such a need. Thus, in simple terms, the exchange rate of the dram is defined as the price of any commodity on the market: if the demand for the Armenian currency is higher than its supply, the dram strengthens, if the opposite is true – more bidders want to sell drams to buy another currency – the Armenian currency weakens.

In March 2022, a strong wave of demand for the dram, and thus an impetus to its strengthening, was generated by the demand for Armenian currency from Russians who decided to move their businesses, and sometimes their families, to Armenia. The cash in rubles, dollars, or euros that they brought with them is nothing compared to the volume of the transfers that went from banks in Russia to Armenian banks. In addition, the companies opened in Armenia by the relocated Russians began to receive income from third countries. They could no longer receive this money in their former Russian accounts due to the economic sanctions imposed on Russia and other, often voluntary, self-restrictions of foreign companies to cooperate with Russian legal entities and individuals.

The second major factor in the dram's strengthening came into play in May of the same year. At the initiative of the Russian side, Armenia began to pay for gas contracts with Russia in rubles, although payments had previously been made in US dollars. According to various

estimates, Yerevan was transferring about \$40 million a month to Moscow for gas. As a result of the transition to rubles, the demand for American currency in the Armenian banking system decreased significantly and overnight. This can explain the acceleration of the dollar's decline that began in the second half of May.

How does the strengthening of the dram affect the Armenian economy?

The growth of the national currency rate is profitable for importers who buy goods abroad in foreign currency and sell them in the country for drams. Their incomes grow – for every dram they earn; they can get more dollars or euros to pay for a new batch of imported goods tomorrow. The strong dram has contributed to the reduction of domestic prices for imported goods, which has led to tangible deflation: since the second half of 2023, *Armstat* has regularly recorded negative values of the country's consumer price index. At the same time, the Central Bank of Armenia is very slowly reducing the refinancing rate, which helps to maintain a strong exchange rate of the dram.

The situation is much less comfortable for exporters. Their foreign currency income in dram terms is decreasing. But their costs, at best, do not change or even increase. For example, because of the need to raise staff salaries. The strengthening of the dram worries the Armenian business community, whose revenues depend on the export of goods and services to foreign markets. Moreover, a strong dram is a significant obstacle to foreign direct investment in Armenia: a project that cost, say, \$100 million at the beginning of the year is now estimated at \$120 million at the new exchange rate. If the project is promising and the investor invests his own funds, it is at least unpleasant. What if the investor has borrowed the money? Then the project may be canceled altogether.

There is another beneficiary of the strengthening of AMD – the government. Armenia's foreign debt as of the end of 2023 was estimated at 6.5 billion USD. The servicing of these foreign currency-denominated loans has become significantly cheaper due to the appreciation of the Armenian currency.

What will happen next with the exchange rate of AMD?

In the history of the Armenian dram, there has already been a period of prolonged strengthening against the US dollar, which occurred in 2003–2008. It began simultaneously with the strengthening of the RUB against the USD, and just like the ruble, the AMD began to weaken against USD after the financial crisis began in the fall of 2008. The dependence of the Armenian economy on the macroeconomic situation in the RF has decreased noticeably since then, but the connection still remains. The likely further weakening of the Russian ruble against world currencies will have a negative impact on the inflow of revenues from the export of goods and services, primarily tourism services to Armenia.

After the weakening of the ruble, we can expect a similar trend in the dram's exchange rate. However, the decrease will definitely not be mirror-like – in the current sanctions' environment, the dram is in a much less dramatic situation compared to the Russian ruble. The Republic of Armenia is a member of the EAEU (Eurasian Economic Union/EEU) and

despite the current political tensions between Yerevan and Moscow, in purely economic terms it should continue to benefit from providing alternative trade and financial flows between Russia and third countries, while complying with all necessary sanctions' restrictions.

How is the process of determining the exchange rate of the Armenian currency organized?

In conclusion, it is worth mentioning another point that is not obvious but has a significant impact on the way changes in the national currency exchange rate are perceived by Armenian citizens and businesses. It concerns the system of access to foreign exchange trading in Armenia and the special role of national banks in it.

In countries with an open capital account and no restrictions on the purchase and sale of foreign currency (and the Republic of Armenia considers itself in the list of such countries), the currency trade is most often the basis for determining the exchange rate of the national currency. The actual exchange rates are determined based on them, and the Central Bank simply sets a certain official value of the exchange rate for each day on the basis of these open currency transactions. This is necessary mainly for accounting and legal purposes: when concluding contracts in foreign currency, companies could indicate the official exchange rate of the Central Bank, which is the same for all counterparties.

There is a stock exchange in the RA that has existed for a quarter of a century, but currency transactions are no longer conducted there. The last and very rare transactions on the dollar/dram pair in the trading database on the exchange's website date back to 2018. The Moscow Exchange has been trading in drams since the end of June 2022, but so far, the volumes traded there are too small to serve as an acceptable benchmark. There is also the international currency market *Forex*, where the treasuries of the world's largest banks, corporations and even entire countries exchange currency. But even this market does not generate the volume of trading in drams so that would make it possible to set the official rate on its basis.

How the rate of the national currency is determined, which we see on the website of the Central Bank of Armenia and on the display boards in banks and exchange offices? These rates are a derivative result of currency trading in the interbank market. All Armenian banks can freely trade with each other in foreign currency, and all these operations are transparent for the Central Bank. Based on the results of these trades, the official exchange rate for each day is determined, which serves as a benchmark for setting the rates at which citizens and businesses exchange currency.

Such a system has developed historically in Armenia, and it is reasonable for the banks – in the absence of exchange trading in the national currency, to which everyone has access, and with a minimum lot size of, say, 10.000 drams, the banks get the exclusive right to buy and sell currency in the retail market. And this can only bring them additional commission income.

This system also appropriates the RA Central Bank – it allows it to control the risk of exchange rate manipulation by any of the bidders. It is easy to control if only commercial banks under the control of the Central Bank participate in trading. In the case of open exchange trading in AMD, it will be much more difficult to control the situation: the current volume of the interbank currency market is quite modest by international standards, which means that it will not be difficult for a large investor to move the exchange rate in the desirable direction. Such a case is the matter of reaction of the Central Bank, one of whose constitutional functions is the maintenance of the country's financial stability.