

STATEMENT OF THE POLICY FORUM ARMENIA ON THE DRAM DEVALUATION

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The decision of the Central Bank of Armenia (CBA) to return to a de facto free floating exchange rate regime, announced on March 3, 2009, has led to a swift reaction from economic agents. Within minutes of the announcement, some stores in Yerevan were closed, prices across a wide range of products were adjusted, and the buy-sell margins for dollar trading by banks ballooned. Following the initial reaction, at present the risk of escalation appears to have been contained.

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In its December 2008 Report, [Policy Forum Armenia](#) (PFA) warned about the serious build-up of external economic/financial pressures and proposed a gradual depreciation of the Dram as a key element of government's response strategy. While adopting measures along the lines of some recommendations, this and other key elements contained in the proposal were not followed or countered by alternative measures. What may have been a judgment call regarding the depth and the duration of the global crisis (and by extension also of the factors influencing Armenia's economy), should have been weighed carefully against the potential impact of the delayed response and should have been reversed early on.

Further attempts to use administrative measures to control either exchange rate or prices (or both) amid continued external pressures will prove ineffective and should be avoided given the potential for overshooting of the uncontrolled variable. Expectations of further devaluation (and/or inflation) could reduce the demand for real money balances beyond the decline in the real supply of money being observed at the moment. Depending on the stance of the CBA, this may either result in further loss of reserves or in further devaluation of the Dram. This could have devastating consequences for the domestic economy but also for Armenia's already embattled current account.

Under these circumstances, re-gaining policy credibility and properly managing public's expectations should be the cornerstones of the strategy going forward. To this end, CBA should be candid about the policy trade-off it was facing since the Fall of 2008 and about any errors of judgment that may have made the current outcome inevitable. It may not be easy to build trust now, but to continue to lose it at this juncture may prove dangerous. It is in every sensible citizen's interest to stabilize the situation in Armenia and the authorities should capitalize on this premise and come off as transparent and forward-looking as possible. This will help rebuild confidence and trust in policy management. Only with mutual trust, and if united in their effort, will the government and society overcome this and future turbulence and move toward stability.

Included in these confidence-building measures are some structural policy initiatives outlined in

PFA's December 2008 Report. Chief among them were: (1) the establishment of a crisis management team consisting of experienced economists and finance experts independent of their political affiliations and views; (2) undertaking credible measures to reduce the monopoly price-setting powers of key import companies; and (3) taking swift measures to reduce some well-known barriers to doing business.

Statement on the Dram Devaluation

Without credibility, the traditional policy instruments will have a limited impact on the situation and some are likely to come at higher-than-expected costs. A monetary tightening could reduce the pressure on reserves and help dampen inflationary expectations. However, if not accompanied with sufficient public buy-in, this will not have the desired effect on the public's willingness to hold local currency, and in the meantime will suppress economic activity. Credibility will also be important for the effectiveness of the fiscal policy response, where targeted social spending will be critical for reducing the negative consequences of the devaluation on low income families and of the level of discontent and potential for political instability.

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