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INDEPENDENCE OF THE REPUBLIC OF ARMENIA AND LIBERAL REFORMS



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FRIEDRICH NAUMANN
FOUNDATION For Freedom.
Հայաստան Կովկաս

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**FRIEDRICH NAUMANN
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BANKING SYSTEM REFORMS AND BANK DEVELOPMENT IN THE REPUBLIC OF ARMENIA



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1. Laying the foundations of the two-tier banking system

The foundations of the modern banking system of the Republic of Armenia (RA) were laid in the last years of the existence of the Union of Soviet Socialist Republics (USSR). Without going deep into the causes of the collapse of the USSR, it should be noted that in the 1980s, as it transpired, the closed socialist economic system had exhausted its reproductive capacity, particularly with regard to its ability to adapt to the developments of the world economy, or to respond adequately to the current development tendencies; and was surviving, mainly, due to the export of raw materials. For this reason, the political leadership that came to power in the second half of the '80s to save the empire from disastrous collapse introduced a number of transformations, mainly aimed at boosting the economy. In the second half of the '80s, measures were taken to increase economic efficiency, promote liberalization and entrepreneurship, and increase the level of independence of the enterprises. At the beginning of the transformations, certain shifts took place in the banking system. A great number of entities all over the USSR made use of the opportunities provided by the adopted law on cooperation. A great number of non-state banks were instituted in the USSR, as well as in Armenia. The two-tier banking system became a reality, and the state

monopoly was abolished. This stage of reorganization of the economy and the banking system, in particular, was noted for its inconsistency and low efficiency of the implemented reforms. This coincided with the profound national-political, economic, and socio-cultural developments throughout the USSR, which eventually contributed to the fall of the Soviet empire. The developments were firstly triggered by the protest activities over environmental issues in the autumn of 1987 and the Karabagh movement in February 1988. Despite the obstacles and persecutions instigated by the communist authorities along with the Karabagh issue, the movement put forward a demand for the guarantee of democratic freedoms, economic independence and then - political sovereignty. Back in 1988 the movement became more disciplined and issued its program provisions. In the first program adopted in the constituent congress of the Armenian National Movement in November 1989, priority was given to the issues of economic policy. Along with the core issue to independently define the forms of economic activities, the program set a goal to ensure the economic independence of the Republic through economic estimation and self-financing.

Political events, mainly aimed at a rapid dissolution of the USSR, were evolving following a certain logic; however, the USSR unified center seemed unwilling to pay attention to it. On and off, it was trying to prevent the developments by distracting or implementing random violent actions. As for economic transformations, the center was trying to accelerate them while ignoring the reality. This mainly referred to transformations in the banking system, which in terms of their internal logic, became systematic at the end of 1990s, when the Supreme Soviet of the USSR adopted quite progressive laws on the Central Bank, banks and banking activities. According to the above-stated laws, a two-tier banking system was formed, the first level of which was represented by the central banks of the USSR, and the second level - by commercial banks. The Central Bank was given some independence by law, in terms of monetary policy, regulation and control of banking activities, etc. The law defined the terms of licensing for commercial banks, the first set of economic norms, as well as introduced a norm for mandatory reserves. However, in our country things evolved in a unique way. The reforms, viewed as advanced, as far as content is concerned, were only partially implemented in Armenia. The reason was that a number of republics within the USSR, including Armenia, started to openly search for legal and political ways to gain

independence, and were unwilling to accept the existence of the USSR's unified center, which was losing its leverage.

The Armenian National Movement (ANM) did not receive a majority of the votes in the elections of the Supreme Council of the Armenian Soviet Socialist Republic (ASSR) held in Armenia from May-June, 1990. However, due to public support, it undertook the responsibility of restoring the independent national statehood in the existing critical political situation. According to the Declaration of Independence of Armenia adopted by the Supreme Council of the ASSR on August 23, 1990, the beginning of the foundation of an independent state was announced. Among the most important political and strategic issues and freedoms, the Declaration stated: "Only the Constitution and laws of the Republic of Armenia are valid in the territory of the Republic of Armenia." The Declaration played an important role both in the process of formation of Armenia's independence and the development and implementation of the country's economic policy. Thus, Clause 8 of the Declaration stipulates that "On the basis of the multiplicity of property the Republic of Armenia defines the order of its economic entities, establishes its national currency, national bank, financial system, and tax and customs services." The pursuit of independence was most evident in terms of development and implementation of economic programs and implementation of the relevant structural and legislative reforms.

This was revealed in a specific manner in the RA, which with the proclamation of the independence process, started to develop and implement its own economic policy and to draft a relevant legislation. The adoption of the RA law "On Property in the Republic of Armenia" (October 1990) was of key importance for the implementation of the economic reform program. The law aimed to create legal bases for the formation and development of market relations, establishment and development of property pluralism, and protection of property rights. Based on the adoption of a number of laws and programs, the Land Code of the Republic of Armenia and the law on peasant collective farms were accordingly adopted in January and February of 1991. The agrarian reform that started from the beginning of 1991 included privatization of the land, which was the first important step towards economic liberalization. This gave rise to a serious political upheaval in the USSR, which was still intact, and was one of the reasons for the deterioration of relations with the center.

The scope of USSR laws was gradually narrowed down and, eventually, those were abolished in the national republics. However, Russia, which was independence-oriented and was fighting for its rights in all spheres, had a significant influence on the political processes. In parallel with the adoption of the aforementioned banking laws, even a few days earlier, the Supreme Soviet of the Russian Federation passed relevant laws of the Russian Federation, according to which the above-stated initiative of the USSR legislature was rejected and the newly instituted Central Bank was declared the legal successor of the USSR State Bank. In fact, the Soviet-time laws on state banks, banks and banking activities were not legally applicable in Armenia.

In this legally chaotic situation, the Bank of Armenia had an uncertain status, the main powers were regulated by the USSR State Bank. For example, the licensing of banks in Armenia before August 1991 was implemented by the USSR State Bank as requested by an Armenian Bank.

The first legal norm on the RA Bank was adopted only in December 1991, following the Belovezha Accords on dissolution of the USSR, when the USSR State Bank was dissolved and, by the law of legal succession, its official powers were transferred to the Bank of Russia. In accordance with the decree of the RA President, the Armenian Republican Bank of the USSR State Bank was restructured into the Bank of the Republic of Armenia before the adoption of the law on the RA National Bank. The newly established bank was endowed with functions of implementing credit and monetary policy, banking activities, licensing and regulation of foreign currency transactions in the territory of RA. Thus, by the Decree of the Armenian President, the legal basis for the formation of an independent banking system of the newly independent Republic of Armenia was laid.

In fact, the above-specified stage of formation of the modern banking system in Armenia coincided with drastic political and economic transformations, which had an essential impact on all economic developments. After the adoption of the Declaration of Independence, Armenia, still being part of the USSR, started to develop an independent economic policy program in order to establish relations relevant to a market economy, to form a legislative framework, and to implement structural reforms. However, drastic changes in the political situation following the fall of the Soviet Union, the collapse of the traditional

economic system and the breakdown of economic relations resulted in a major economic decline. The problem in Armenia was aggravated by the Nagorno Karabagh conflict growing into a large-scale war, blockades, disruption of supplies, regular bombings of the gas pipeline and the railway line passing through Georgia, as well as the energy crisis. Neither the government, nor the dominant majority of businesses could withstand the resulting situation. The measures taken in the first stage of economic reforms, among them the abolition of the planned system, liberalization of prices and foreign trade significantly affected the quality of the domestic economy. However, the foreign policy and military situation significantly hindered the planned and regulated implementation of economic reforms.

Military needs and social problems of the population became priorities to be met. The State, which was getting rid of economic management functions, under the new military-political circumstances and in a state of full blockade, was forced to apply restrictions on consumption, namely, scheduling the electricity supply, obtaining bread and other food by vouchers, etc. New negative phenomena emerged in economics, including a sharp rise in prices and devaluation of the national currency. Payment and settlement relations were disrupted; the banking system had a significant decline. The scale of production fell at an unprecedented rate in 1992. Inflation, the growing level of unemployment, and deplorable social conditions created an atmosphere of despair among society. From 1988-1989, the economic decline which began in the Soviet era had reached unprecedented levels. From 1990-1993, GDP volumes decreased by 79.1%. The industry declined far more severely, the result of which was that a great many enterprises shut down and the socio-economic situation in the country changed drastically. Tendencies of decline typical of all the republics of the USSR had created a crisis situation in a number of spheres of the country's economy. Electricity production volumes in 1993 were reduced by about 2.5 times, when compared with that of the last Soviet years, and the export freight by rail was reduced by about 20 times. In the result of the disrupted economic relations, the industrial enterprises were forced to import the necessary raw material and export the finished products by road, which exceeded Soviet era prices by 20 times.

Tendencies of economic decline were also observed in the neighboring republics of Armenia, Georgia and Azerbaijan. Moreover, in the course of 1991-1996, the GDP decline in Georgia and

Azerbaijan was higher than that in Armenia. The structure of GDP underwent significant changes. In a short period of time, Armenia, a former industrial country, turned into an agrarian country (the share of agriculture increased drastically and reached 48.8% in 1993, while in 1990 it was only 16%; meanwhile the share of industry decreased). The economic decline had a significant impact on the social situation of the population triggering a large-scale emigration. Pessimism, despair and mistrust towards the future prevailed among the population. As a matter of fact, the structural reforms that commenced upon the proclamation of the processes of building the independent state of Armenia, while still within the unified economic system of the USSR and quite active at the beginning of 1992, lost dynamics and consistency in the existing military-political and socio-economic situations. This could be one of the reasons due to which the decline in GDP in 1992 alone was 52.6%.

The way out of the situation was the intensification of the structural reform processes, which started in early 1993. Although the economic downturn continued, the blockade intensified, and large-scale conflicts escalated on and off, the authorities resorted to systematic activities of structural reform, intensive development of market institutions and framework. Among the number of implemented structural reforms were the legislative reforms. In 1993 the tax and customs legislation was significantly developed; laws were adopted, among them on business activities, market institutions formation and activity regulation (securities circulation, currency regulation and control, stock exchanges, etc.), and privatization of housing stock. With the adoption of the RA Law "On Privatization and Denationalization of the State-Owned Enterprises and Unfinished Construction Sites" in March 1992, the large-scale privatization process started. The first stage comprised the partial gratuitous privatization of state-owned enterprises. Privatization of the housing stock had already had a qualitative impact on society. In addition to rural residents, most of the urban residents became private owners. In fact, the majority of people in society became owners. The overall picture of the economy, problems and objectives of the economic policy underwent qualitative changes.

Collaboration of the RA with international financial organizations was important in terms of advancement of the reforms. 1992 Armenia became a member of the International Monetary Fund, the World Bank Group and the European Bank; this provided, firstly, an opportunity to

receive technical assistance from these organizations on a regular basis, secondly, to have the professional conclusion of experts on the developed and implemented activities on reformation, legislative and structural revisions and subsequently, receive financial assistance.

2. Putting national currency into circulation

The situation developed in Armenia since the collapse of the Soviet Union could be described as political independence with some unified economic policies for certain spheres. In fact, the unified military-political system of the USSR had ceased to exist, and the newly developed independent states pursued an independent economic policy; however, the common zone of the former USSR ruble (RUB) continued to be maintained under the auspices of the Russian Federation's joint emission center. In these conditions, the principle of integrity of structural reforms was disrupted, and, for instance, the macroeconomic stability, which was to be central to the reforms, was pushed back.

The single ruble zone that lasted until the summer of 1993, and the policy pursued by the Russian Government and the Central Bank predetermined the monetary and, partially, the fiscal policies in Armenia. Structural reforms in the financial sector in Armenia were also connected to the measures taken in Russia, or at least were following them. The situation was more complicated in the fiscal sphere, also in the conditions of the newly formed tax field, insufficient attraction of budget revenues; this meant Armenia had to take care of the livelihood and military issues. The dire state of public funds, unpredictable inflation due to various external and internal factors, and the low level of fiscal and monetary policy programming significantly affected the efficiency of economic policy and structural reforms. The status of the RA Central Bank was uncertain, the so-called monetary policy was not developed and, at best, the bank provided monetary services to the government or was supplying the economy with cash banknotes. The CB powers in the areas of licensing, control and regulation of banking activities and the opportunities for their implementation were extremely inadequate and inefficient. The above-specified stage of banking activity can be described as a stage of extensive development. From 1991-1993, the number of licensed commercial banks in Armenia increased about five fold, although in the conditions of a high level of inflation, a decline in the volume of

indicators of the banking system activity was observed. The volume of non-cash financial flows began to decrease sharply; cash turnover in the economy increased, basic commodity exchange, barter trading and other phenomena, not typical of the market system, emerged. These, certainly, hampered the development of the banking system.

Until July 26, 1993, when the RA Central Bank first set the exchange rate against the US dollar independently, the RA, in fact, was unalterably applying the estimated exchange rate (settlement) of the Bank of Russia, which was being applied partially, and only for official transactions. However, the exchange rate in the market was about 20% different from the official exchange rate, and it contributed to the out-of-bank conversion and money circulation, increase of cash turnover. Due to Russia's unilateral withdrawal in the summer of 1993 from the common ruble zone, inflation in Armenia increased sharply and the devaluation of local currency rate accelerated. Thus, in the eight months from January 1, 1993 to July 26, 1993, the local currency devalued by about 2.4 times its value, then in the following four months (until November 22, 1993 when the national currency was put into circulation), it was depreciated by about 3.5 times its value. As of the end of September that year, the Russian ruble was quoted in Armenia (this, by the way, can be considered as an introduction of national currency). There was a sharp increase of volume of cash-in-circulation, also due to the Soviet ruble inflow secured from exchange with countries leaving the USSR united zone. While inflation and devaluation rates went up, there was an "escape" from the market of goods, disruption of regular economic ties, and, finally, a decline in the degree of governance over the financial system.

In the current situation - and in view of the fact that the law on the Central Bank adopted months ago was not yet in force - the Supreme Council formed a State Commission for Regulation of Money Circulation represented by the Supreme Council, the Government and the Central Bank, with one representative from each. The Commission was given the authority to regulate the money circulation, put the national currency into circulation, and regulate the activities of the banking system - authorities that the Central Bank was endowed with. At the end of October, it became clear that the Armenian-Russian agreement signed on September 16 of the same year to unite the monetary system of the RA with that of the Russian Federation on "Practical Measures to Create a New Type of Ruble Zone" would not work. By the decision signed on

October 25, 1993, it was established that the former USSR State Bank sample banknotes of 1961-1962, and that of the Russian Federation are temporarily considered the currency of the RA. In a short period of time, organizational measures were taken, relevant regulatory norms were adopted, and on November 22-26, the currency exchange was carried out, during which the banknotes in circulation in Armenia were replaced with the new Armenian Dram (AMD) at an exchange rate of 1 ruble to 200 drams.

With the national currency put into circulation, a fixed exchange rate of the dram against the US dollar was set, which at that time was 14.5 drams against 1 US dollar. Such quotation of the exchange rate was based on the average exchange rate formed in Armenia in November 1993 with all the possible consequences of the exchange taken into consideration. However, the results of the exchange deviated considerably from the expected figures. As early as July, when Russia withdrew from the common ruble zone, measures were taken to prevent the inflow of banknotes into the country; however, the volume of the former convertible rubles exceeded the official estimates by about 30%. In all the years preceding the exchange, about 93 billion former Soviet and Russian rubles were put into circulation in Armenia. Nonetheless, after summarizing the results of the exchange, it became apparent that 117.3 billion rubles had been exchanged, which was 24.3 billion rubles more than had been envisaged. The exchange process ended only in February 1994, when the 1 to 500-ruble banknotes, previously used as coins, were withdrawn from circulation.

The national currency – the Armenian Dram – has been the only legal means of payment in the territory of the RA and Nagorno Karabagh since November 27, 1993. As a matter of fact, Armenia restored its national currency, as one of the most important features of its independence having been deprived of the opportunity to have a national currency for centuries (the first Republic never managed to put the Armenian ruble into official circulation).

Introducing the national currency was crucial for the development and implementation of independent economic policy; it created new qualitative opportunities for increasing the level of coordination of economic reforms, in particular the reconstruction of the financial, and banking sectors. Shortly after the Armenian dram was introduced, the government and the CB abandoned the policy of steadily regulating the exchange rate

and introduced a policy of “managed floating” exchange rate, as a result of which the dram was devalued by five times during the first month following its introduction. The 1993 results – the continuing economic decline (about 14% during the year), upsurging inflation, budget deficit, large-scale lending of government expenditures and, hence, high levels of inflation rates, ongoing economic blockade, energy crisis, disrupted foreign trade relations, and an actual absence of foreign exchange reserves all led to the devaluation of the Armenian dram. Armenia, in fact, was one of the few countries, which did not have foreign exchange reserves when putting the national currency into circulation.

3. Banking system reforms

The introduction of the national currency, the progress of economic reforms and the stabilization of the economic situation made it necessary to implement reforms in the banking system. In 1994, the law “On the Central Bank of the RA” was put into force, the governing bodies of the CB were formed, which were to act within the framework of certain powers and responsibilities stipulated by the law. Reorganization of CB and formation of a relevant structure became a priority. One of the first steps taken was the dissolution of the CB staff and the recruitment of a new staff; often composed of inexperienced, but young people who were full of aspirations. Measures were taken to prevent hyperinflation and to keep the money supply manageable. Due to the lack of market tools, the CB was forced to resort to mostly administrative leverages. A minimum transaction rate of 360% per annum was set for commercial banks. This somewhat unusual action at first glance, turned out to be most efficient in establishing a positive interest rate in the market in the conditions of current relations and the state of the banking system. Measures were taken by the CB to regulate government lending, strengthen the credit market, and to make the money supply manageable in its broadest sense.

In compliance with the law in force, for the first time in the history of our country, a monetary policy program was developed. In addition to the most important economic and strategic goals (among them curbing the inflation, regulating the money supply and limiting the government lending) this program prioritized activities, such as banking reforms, establishment of an effective system of control and regulation of commercial banks by CB. Regulation of banking activities is of key importance in transition

economies, which lack banking activity experience and traditions; hence legal regulation of bank activities played an exceptional role in the formation and development of the banking system. Since the adoption and implementation of the first basic laws of banking legislation, the Central Bank of Armenia undertook the responsibility to develop and implement an adequate regulatory framework in line with international standards and aimed at banking activity regulation, while taking into account the economic realities in Armenia at that stage of reforms. The introduction of the national currency, the dram, into circulation, the adoption and application of laws on CB, banks and banking activities became the basis for the third stage of the banking system transformation, which played a crucial role in the development of the modern banking system of RA.

In the previous stages of the banking system; development that can be called a “free” stage in expectation of high profitability, meant banks were set up both by state bodies (by involving their subordinate enterprises) and individuals and enterprises representing the newly created private sector of the economy. Among the latter there were entities with non-transparent and unstable financial histories. The majority of the entities formed amid the conditions of poor regulation and control of banking activity, due to imperfect legislation, could only conditionally be named banks.

In conditions of negative economic trends and high-level inflation, the minimum requirements for establishment of a bank were essentially devalued. In particular, at the beginning of 1994, the minimum amount of the bank's statutory fund was about USD 3000. Under the above-mentioned conditions, at the beginning of 1994, the number of branches of banks operating in Armenia and the foreign banks reached 64. In terms of the ratio of established banks per one million population (more than 20), Armenia exceeded developed European and other countries by a considerable margin; for instance, the ratios of interest were 1.2 in Japan, 4.1 in Germany, 5.5 in Italy, 8.5 in England, however it was quite close to Russia's 17.6.

The next stage of the banking system reform or formation of the modern banking system that was based on the laws regulating these spheres was different from previous ones, as far as quality is concerned. Prerequisites formed due to the economic reforms of the previous period, activation of economic-structural reforms, introduction of the national currency along with the structural-organizational measures carried

out in the banking system, shaped qualitatively new conditions for the development of the banking system.

Formation of a two-tier banking system documented by the law during the mentioned period, legal guarantees of the CB's sovereignty, clarification of issues and functions, and the formation of the CB governing bodies, laid the foundation for the CB transformation. The adopted laws were considerably advanced and reflected developments in the specified sphere. In particular, Article 2 of the Law On the Central Bank stipulates the following issues:

- Provision of internal and external stability of the *dram*;
- Creation of monetary, credit and financial settings boosting the functioning of a well-balanced and stable economic system;
- Protection of interests of banks and other financial institutions, creditors and depositors by regulation and control established over the activities of banks and other financial institutions;
- Establishment of an interbank settlement system.

In compliance with Article 3 of the same law, the CB was empowered to perform the following functions aimed at implementation of the above-mentioned tasks:

- Implementation and regulation of issuing the dram in accordance with the law, organization of money circulation;
- Implementation of monetary policy;
- Organization of interbank settlements;
- Servicing the state debt of the Republic,
- Implementation of the monetary and credit policy of the Republic, management of the RA reserves of currencies, precious metals and stones;
- Licensing banking activities and foreign exchange operations in the territory of the Republic of Armenia,
- Supervision of the activities of banks, other financial and credit organizations, charitable, insurance, pension funds, investment and other similar companies and organizations operating in the territory of the Republic of Armenia;
- Organization of banking statistics;
- Organization of banking services of the RA Government and other state bodies;
- Defining the required reserves' norm;
- Implementation of open market policy.

Solutions to the problems stipulated by the law and the performance of the functions, certainly, required time. However, the enforcement of the law, reorganization of CB and clarification of its powers regulated the process of the banking system reforms. It is noteworthy that among the problems of the CB there are issues, the solution of which in due time would annul all previously taken measures and efforts. Restoration and development of the paralyzed payment and settlement system of the RA required special consideration.

Until 1991, the payment and settlement relations in Armenia were part of the payment and settlement relations of the Soviet Union. Under Soviet rule, payment and settlement relations were based on the requirements of the administrative-planned system and were characterized by their considerably high level of regulation. However, the collapse of the USSR, followed by a breakdown in the banking payment and settlement system triggered a number of problems, among them large non-payments of mutual settlements of enterprises and organizations, lack of legal framework regulating interbank settlements, and the technical inadequacy of the banking system. The situation deteriorated even further in 1992-1993, due to the energy crisis; when even telephone connections were out of operation, and the postal service was destroyed. As the implemented administrative measures were mainly sporadic and incomplete; businesses were forced to seek solutions on their own, which deepened the crisis.

A priority among the key tasks of the emerging banking system was the formation and development of a stable, reliable, efficient payment and settlement system, which was implemented in several stages. A priority, of course, was the revival of the demolished system within the powers of CB, the implementation of which, in terms of expenses and the outcome, was one of the most effective measures. A very simple and inexpensive solution was found in the CB at that time. A clearing system was introduced, which ensured the calculation of payments in the same city (carried out in the same region) through the clearing sessions organized at the CB. Actually, the introduced system enabled payments between different businesses in the same city within one to two days, which in fact meant a restoration of non-cash payments, as the payment discipline had fallen drastically under the disrupted system and poor administration. Further stages were steps directed towards the application of the internationally accepted payment and settlement

standards, and subsequently, the integration into the world financial communications system. Formation of a legal framework regulating the aforementioned relations was important (the RA law "On Funds Transfer by Payment Orders", the clarification of cheque servicing procedures by banks). One of the most important and effective solutions was the establishment of the CBANet interbank computer network in 1996, and based on it, the design and introduction of the electronic payment system (BANKMAIL). The latter was a dedicated interbank communications system, which provided connection between all the operating banks and their branches in the territory of the RA. It also enabled instant transfer of communications and payment documents, and submission of the CB reports from its branches and head offices on a daily basis. In terms of developing an effective payment and settlement system, it was important to become a member of the Society for Worldwide Interbank Financial Communications (S.W.I.F.T.) network, due to which Armenia became part of the international payment and settlement system.

Measures taken within the economic reforms, the formation of the CB, steps towards regulation of money supply, as well as the ceasefire established in May 1994 resulted in a sharp decline of the inflation rate in the third quarter of the year up to 2.5% per month. Prices rose by about 18 times during the year, however an economic downturn was prevented; the actual economic growth made more than 3% and the food market was fully supplied. The economic reforms were marked by quite impressive economic results as early as the following year. Establishment of macroeconomic stability and the consistent implementation of structural reforms added up to an economic growth (in conditions of low inflation), and to progressive development of the financial sector, in particular - the banking system.

However, the crucial issue was to create a stable and reliable banking system and the solution had to be the regulation and control functions of the CB banking activity. The less reliable current banking system had reacted in a unique way to the high inflationary environment in the market. Due to legislative gaps and poor regulations, various financial institutions which had adapted to operating in the conditions of high inflation were acting as intermediaries. Establishment of macroeconomic stability and a drastic decline in inflation tendencies led to insolvency and default of these entities, which deepened distrust towards banks. The main way to increase the reliability of banks and the efficiency of their activities is the

regulation and control of the activities of commercial banks by the CB, the main way of which at that stage was the formation of a sub-legislative normative base of the CB. In May 1994, the Board of the RA Central Bank adopted the decision "On Economic Standards for Regulation of Banking Activities of the Armenian Banks and Defining Sanction in Case of Violations", which systemized and completed the economic standards of commercial banks, which were as follows:

- Minimum amount of the authorized capital;
- Marginal equity-to-asset ratio (N1);
- Indicators of liquidity balance (N2 and N3);
- The required amount of reserves placed in the Central Bank;
- Maximum level of risk per borrower (N4);
- Marginal ratio between funds attracted from the population and equity (N5).

In terms of content, this was a set of precautionary norms, a system of economic standards, a core element for regulation and control of banking activities. The effective use of the system was central to improving the banking system efficiency, preventing illegal activities of entities that had emerged in the system during the previous years and operating in non-compliance with current requirements. When setting the rates of the above-stated economic standards, as well as the requirement for minimum capital rate, the CB was guided by the following principles: on the one hand, not to disrupt the banking activities, on the other, over a period of time, to bring the duly planned economic regulatory norms closer to the international standards in a transparent manner.

Among the banking system reforms, the approval of the monetary and credit policy program by the Supreme Council of RA, in compliance with the current law, was central. Approval of the monetary and credit policy program by the legislature itself comprises an element of possible political dependence for the CB. However, in terms of developments at the time, this played a certain positive role both for the establishment of the CB and solution of the issues set by law, as well as the establishment of the banking system. This way, the aforementioned problems brought to the attention of the public and political forces, were prioritized and revised. Subsequently, the issue of the banking system development and recovery started to evolve into a program. Steps to be undertaken were developed, approved and publicized, and those in charge, as well as the resources to be involved defined. In terms of expansion of the

CB, effective implementation of the functions defined by law, provision of the first credit funds by the IMF was important, as this became a basis for the formation of the CB's international reserves, unhindered implementation of the RA international obligations and currency market stabilization.

In a broader sense, the core approach to the growth of the banking system was to establish in the short term the CB function for the regulation and control, which is in compliance with international standards and internationally acceptable. As early as 1995, the basic principles of the Basel Committee, the most authoritative international organization for banking regulation and supervisory practices, were put into circulation. Armenia made significant efforts towards it and in 1995 the regional subgroup of Transcaucasia and Central Asia was formed by the Basel Committee. It is noteworthy that the group included the three states of the South Caucasus - Azerbaijan, Armenia and Georgia, and the Central Asian countries - Turkmenistan, Kazakhstan, Kyrgyzstan and Uzbekistan. Due to the effective undertakings in the field of banking supervision and the accomplishments recorded by the international financial organizations, Armenia became the first presiding country of the aforementioned subgroup. It should be noted that later on Russia joined the group. Turkey also took part in the activities.

During the above-specified period the strategy of recovery and development of the banking system was elaborated and introduced. Recovery of the banking system is a complex and extensive process, which includes a comprehensive system of legal and administrative measures aimed at ensuring the reliability of the banking system and securing the guarantees of its efficient development. The Armenian banking system recovery program included a number of key areas, each requiring implementation of a range of multifaceted measures, such as:

- Legal regulation of banking activities;
- Eliminating the external negative pressures on the banking system;
- Restoring the place and role of banks in the economic system by increasing their reliability, transparency of activities and efficiency;
- Recovering former state commercial banks;
- Liquidation of insolvent and unviable banks;
- Increasing the reliability, transparency and publicity of banks' activities;

- Restoring the trust of the population and economic entities towards banks.

Among the key factors contributing to the recovery of the banking system was the recovery of the former state-owned commercial banks - the core of the banking system. At that point in time, they had a significant share in the system's equity capital, assets and liabilities. Under the pressure of state bodies and state-owned enterprises, which were the shareholders, and as a result of the allocation of low-reliability loans on inappropriate market terms, in 1995 all the aforementioned banks were facing bankruptcy, while writing off their low-quality assets. In the current critical situation, a special inter-departmental body for the recovery of banks was formed, which was responsible for the development and coordination of implementation of comprehensive activities. Within the program, the allocation of funds from the state budget for the recovery of banks was envisaged in 1996. However, due to a number of emergency measures, the crisis was overcome and the budget funds were not used; instead the problem was solved by attracting new shareholders. Among these measures, the introduction of an asset classification system in Armenia in line with international approaches was of principal importance. In terms of increasing the efficiency of banking regulation and making full use of the available tools, adoption of the procedure for classification of loans and receivables, and formation of a possible loan loss reserve fund on them was of key importance. This was put in force starting from the end of 1996 in phases; the assets and the provided loan portfolio formed previously was incorporated in the classification system in accordance with the specified procedure, within two years and in parts. In 1998, the risk classification of assets was also supplemented by the investment securities' classification and reservation procedure. These two categories made it possible to reveal the true picture of banks' assets, and based on it, to revalue the amount of capital. This mechanism obliges the bank to continuously revalue the assets, to reflect the possible loss in the balance sheet and to reveal the real amount of the bank's capital, and, accordingly - its financial condition. In fact, the introduction of the system enabled the banks to be more transparent, increase the level of their reliability, and finally get rid of unstable banks. Along with that, the increase in the minimum requirement rate of bank capital, the tightening of the regulation of activities and the clarification of control resulted in a decrease, by half,

of the number of banks in 1994-1996. Due to the considerably tough measures implemented in the aforementioned period and following it, quite high indicators of development were registered in the banking system. Such development of the banking system was also owing to positive tendencies in the economy. Due to the ongoing economic reforms, starting from 1996, macroeconomic stability, low inflation and ongoing economic growth were the main characteristics of economic development.

Sub-legislative regulatory acts have a crucial role to play in increasing the efficiency of the banking system, formation of a reliable banking system, as well as development of a comprehensive legal framework. The CB has the exclusive authority to adopt legal acts of regulatory and individual nature in order to solve the problems set for it by law. The acts of regulatory nature adopted by the CB, according to the tasks set for the CB, can be classified in several groups. A large group of normative acts has to do with the solution of other problems of the CB - development and advancement of an active payment and settlement system, organization and regulation of money circulation, regulation of foreign exchange transactions, and implementation of the CB banking-type transactions. Regulation of control and regulation of banking activity is an extensive part of the CB activity. A significant part of the CB sub-legislative regulations include the regulation of the activities of institutions operating under the control of CB, from their foundation to liquidation. The CB not only regulates and supervises the activities of its licensees in compliance with the law, but also contributes to their sustainable development. The development and application of basic norms of banking regulation was based on the principle of phasal transition to international regulatory standards. Terms of their application were set so as to, on the one hand, ensure the uninterrupted operation of the system, and on the other, provide the reliability and stability of the banking system. According to the principle developed and adopted in Armenia, the main part of legal acts adopted for regulation of the tasks and functions defined by the law on the CB is integrated in regulations, composed and approved in a certain extensive document logical order, and is continuously revised and elaborated. The aforementioned principle – the summary of regulations in the rules of procedures, unique at that point of the time, only later began to be applied in other countries. The above-stated working style aimed to recap and finalize the authorities and functions arising from the

CB tasks, made the CB functions more transparent for the participants and contributed to the efficiency of their application. Here is an example: Regulation 1. "Registration and licensing of banks and branches of foreign banks, registration of branches of banks and representative offices of the banks, qualification and registration of the heads of banks and branches of foreign banks", which describes all possible tasks related to the licensing of banking activity, is an extensive document comprised of 240 articles and 43 appendices. Or, e.g., Regulation 2. "Regulation of banking activities, the main economic norms of banking activities", Regulation 3. "Bank reports, their submission and publication", etc. In 1996, the number of these regulations exceeded two dozen. Additionally, they do not fully cover all the regulatory acts of the CB, the list of which is quite comprehensive. They include by-laws and procedures adopted jointly with the Ministry of Finance – the state body authorized by the Government of RA. The CB by-laws played an exceptional role in drafting the current banking legislation. As a matter of fact, the norms regulated at a sub-legislative level were tested, amended, continuously revised and improved.

In fact, during that period, the main direction of the development of the banking legislation of Armenia was outlined, namely, the application of regulations at the sub-legislative level, which was followed by its formulation at the legislative level. Such a thorough approach to banking regulation at the sub-legislative level, the establishment of macroeconomic stability, economic growth, and structural shifts in the economy required further development of the banking legislation. The need for a banking legislation reform was also due to the fact that with the adoption of the RA Constitution on July 5, 1995, the process of formation of the State was accomplished. The Constitution, endowed with supreme legal power to cover the current developments, defined the diversity of property rights and freedom of economic activities, both being in the core of economic relations. The only constitutional norm directly related to the CB is the authority of the National Assembly to appoint the Chairman and the Deputy Chairman of the CB upon the proposal of the President of the RA.

Following the economic reforms in the middle of the 1990s, the economy of the Republic underwent qualitative changes, with the private sector playing a major role. The establishment of macroeconomic stability, and continuous economic growth, which the Armenian economy was characterized for in 1995-1996, resulted in a swift growth of the banking

system and significant inflow of foreign investment. Qualitative changes had taken place in the financial sector. The growing financial market set new tasks for the banks, the major market participants at that time, and the legal regulation of their activities became a necessary requirement for the development of both the financial market and the banking system. In the current situation, creation of the necessary legislative guarantees to promote the CB role became a priority.

The revised laws "On the Central Bank of the Republic of Armenia", "On Banks and Banking" were followed by the laws of the Republic of Armenia "On Bankruptcy of Banks", "On Banking Secrecy", and the legislation became more comprehensive. Adoption of the aforementioned basic laws became a subject of intense debates, following which, for example, the law "On Banking Secrecy" was vetoed by the RA President in the RA National Assembly and gained legal power after overcoming the veto.

This comes to prove the growing interest of the public and the political forces towards the banking legislation. Norms discussed and adopted this way were more perceptible to the general public, which, in its turn, contributed to the growth of trust in banks. It is noteworthy that the average annual growth rates of the main indicators of the banking system, namely, capital, assets, and credit investments in conditions of stable macroeconomic environment and 6-7% annual GDP growth exceeded 50% in 1996-2000. The banking sector also became a preferred field for foreign investments. In a short time, numerous branches of foreign banks were set up. In 1996, almost half of the capital of Armenian banks belonged to foreign investors, and this is the case up to the present, with only one difference. The dominating part of foreign capital of Armenian banks in 1996 was European capital, whereas currently it is Russian capital or that of a Russian origin.

Development of the banking system based on the need for further proportional development of the legislation, acquired a certain internal logic. The adoption of the RA Civil Code (1998) was of vital importance in this sense. In addition to finalizing the civil-legal norms, regulation of the legal status of the participants of civil turnover, procedures on the origin and implementation of property rights, other property and non-property rights, contractual and other obligations, regulation of relations arising from the economic turnover, it generalized and supplemented the norms of the banking legislation.

Further development of the legislation was evolving in a specific way. Meanwhile, priority was given to institutional regulation, during which around two dozen laws were adopted covering institutions operating in parallel or carrying out certain types of banking operations and services. Adoption of the law on the introduction of a unified control system was critical; it brought about qualitative changes in the role and position of the CB of Armenia in the financial markets. Institutional changes in banking legislation, which the law of the mainland of Europe is based on, were followed by the adoption of a number of laws aimed to protect the rights of consumers - depositors, borrowers and other participants (this is the direction of Anglo-Saxon law). During the aforementioned period, the law "On the Central Bank" underwent significant elaboration, which reflected the changes that took place due to the revision of macroeconomic and monetary policies, and the reconsideration of the place and role of central banks in current economies. The legislative changes conditioned by the CB transition to the inflation-oriented strategy essentially altered the approach to the development, approval and implementation of monetary policy in terms of quality. The CB monetary policy, according to them, is of a discretionary nature. Each quarter the CB develops and approves a monetary policy program for the next 12 quarters, that is, for three years. This opens up new opportunities for the CB both in terms of solution of the defined goals and the tasks set by law, as well as the impact on macroeconomic policy. The framework of by-law regulations keeps growing. It will play an exceptional role in the development of banking legislation, banking and financial systems as a whole, both at present and in the future.

4. The process of development of commercial banks

The initial period of the activities of the banking system of the newly independent Republic of Armenia (1991-1993) was characterized by: the lack of an efficient system of control and regulation, high risks in the real sector of the economy, lack of a legislative framework which would protect the interests of banks, on the one hand, and that of the population and business community, on the other, lack of corporate culture, low quality of management, and non-transparency of banks. From the perspective of further development of the Armenian banking system, this stage had the following negative effects:

1. There was a loss of public trust in the banking system in the light of the predominance of arbitrariness and impunity for illegal “non-market” transactions in the financial market before 1994. It should be noted that the historical memory of the population is one of the most conservative factors in relation with the banking sector, and is crucial in the process of the banking sector development.
2. During the aforementioned period the assets and capital accrued during the Soviet period had been almost entirely devalued.

In a short period of time, in Armenia, as well as in the other former Soviet republics, many non-state banks were set up. The first bank among them was the Hayq Cooperative Bank, which received a license from the USSR State Bank in 1989. Later, before the collapse of the USSR, a number of non-state banks were established. It is noteworthy that this process continued in Armenia, where in the absence of legislation, the regulations of the former Soviet Union and the Russian Federation were applied (the CB of Russia was actually a single issuing center; however, until the end of 1993 the decisions in the sphere of banking were interpreted and applied in the RA). During that period, until 1994, commercial banks were set up that were licensed by the Central Bank of RA, among them closed and even open joint - stock companies. Many companies were established in the form of branches of Russian commercial banks. The main feature of the above-stated period was the following: on the one hand, the banking sector was attracting the accounts and capital of the state-owned enterprises and organizations, on the other hand, some ministries were setting up banks at the expense of the organizations under their supervision.

In conclusion, we can state that during the whole period of existence of the banking system of independent Armenia, there used to be 88 banks in different periods. Due to various reasons, such as bankruptcy and mergers, 67 banks were left out of the banking system during 1994-2003. Accordingly, 53 banks from 1994-1997 and 14 banks from 1998-2003 were left out of the system. The reasons for the cancellation of commercial bank licenses between 1994-1997 can be divided into three conditional groups.

The first group comprised the banks, which under the new rules of the banking activity regulation, used to violate the toughening regulatory requirements and due to lack of capital had fallen into a hopeless

situation or were simply insolvent. These made up a significant part of the banks which had lost their licenses. Above all, significant requirements were set for the total capital, capital adequacy, liquidity, and mandatory reserves of the bank liabilities. The urgency of recovery of the banking sector through cancellation of banking licenses was due, among many reasons, to the presence of all kinds of risks in the financial market and the aspirations of the majority of ineffective banks to overcome their problems by looking for non-standard solutions to the capitalization issues.

The banks of the second group were notable by the fact that during their activity they had considerable cases of violations of the law, and were trying to solve their current problems by attracting liabilities with unreasonably high interest rates via the pyramid mechanism. During that period, a number of non-bank financial pyramids, which were operating without licenses, adopted that working style ("JMZ", "Norinvest", "Aragast", etc.). The bankruptcy of such financial pyramids caused a wave of unrest throughout the country, creating distrust among the population towards the banking system. This was a serious shock for the fragile banking system of Armenia, undermining the development of banks for quite a long time.

The third group mainly comprised the branches of Russian commercial banks, which were initially set up as branches (with no separated capital). However, after the collapse of the USSR, the parent banks stopped presenting them to the state bodies of the RA and to enact the new legislative requirements. The branches became quasi-independent structures with no statutory fund, and not even a status of a legal entity. They were mainly dissolved due to non-compliance with the minimum legislative requirements.

It should be noted that from 1994-1997 bank mergers, changes in the owners' staff took place along with renaming. The second stage of financial recovery of the RA banking system took place during 1998-2003, when the process of license revocation was completed. During this period, the licenses of 14 banks were revoked.

In terms of promotion of the banking system, elaboration of the banking legislation, adoption in a new edition of the laws "On the Central Bank of the Republic of Armenia" and "On Banks and Banking" was of key importance. Nonetheless, leakage of confidential banking information caused serious problems. The fact that the law enforcement

and tax authorities could freely request information from banks about the taxpayers resulted in negative public and business community attitudes towards banks. Moreover, according to Soviet practice, the tax authorities had the right to freeze the accounts, as well as confiscate funds in favor of the State without a court decision. As a result, businesses and individual entrepreneurs tended not to keep a considerable amount of money in their bank accounts, which affected the amount of the collected cash. As mentioned above, in 1996 the law "On Banking Secrecy" was adopted, which provided access for state officials and other third parties to clients' accounts and information about the depositor/borrower exclusively with the consent of the depositor and/or by a court decision. The bank account balances were equated to ownership and, thus, their confiscation became possible only by a court decision or based on the account holder's acceptance. Delegation to the Central Bank of Armenia of the exclusive powers to carry out inspections, control and other audit-related functions of commercial banks was another revolutionary decision in the field of legislation. It affected the promotion of the banking system significantly and radically reduced the transaction costs of the banks in relations with state bodies, and particularly, the law enforcement authorities. This allowed the commercial banks to become free in their activities and from the direct interference of state officials.

As first steps to reform the banking system, the following requirements, enacted between 1994-1998, were put forth:

1. Mandatory information on sources of information;
2. Sources of information shall be verified by the CB;
3. The CB shall be independent of the Executive Power both in implementation of monetary and credit policy and regulation and control of the banking activity;
4. Investing in the bank's authorized capital to be made exclusively by cash;
5. The bank authorized capital cannot be formed from borrowed funds;
6. Requirements for bank licensing procedure. The Charter draft authorized, proposed organizational structure, business plan for the following three years, financial information on shareholders, future CEO and management work terms and professional experience, sources of capitalization of the new bank, target

market, information on the bank senior management, shareholders regarding their reputation and professional background;

7. Limitation of the maximum level of capital participation by one owner;
8. Disclosure of information on interconnection of shareholders and the senior executives.
9. When measuring fixed capital in accordance with the Basel core principles, the risk-weighted assets are taken into account;
10. Claims on subordinated loans included in the capital;
11. Deductions from the main and additional capital, in accordance with the Basel criteria when measuring the bank capital adequacy;
12. Mandatory classification of loans, investment securities and receivables and formation of reserve for the possible losses;
13. Application of Basel standards for currency risk management;
14. Mandatory external independent audit, criteria for selection of the audit company (licensed and accredited), and submission of a copy of the audit report to the CB;
15. Requirements for diversification of banking assets;
16. Regulatory criteria for implementation of liquidity, capital adequacy, operational risks for one borrower and large borrowers, insider operations;
17. Population deposit insurance with compensation rates, in the event of bankruptcy of the bank;
18. Consolidation of the bank's financial statements, including all subsidiary bank and non-bank financial institutions;
19. Submission of reports to the supervisory body on off-balance sheets;
20. Mandatory quarterly reports in compliance with the form and content defined by the law;
21. Identification of internal risk management procedures;
22. Personal legal responsibility for bank managers for providing unreliable or misleading information to the CB;
23. Defining the authority of the supervisory body to suspend the decisions of the banks on the distribution of dividends;
24. Availability of a strict legislation to deal with bankruptcy, financial insolvency and financial recovery with the right to suspend some or all property rights in the capital of the problematic bank;

25. Definition of solvency and the right of the supervisory body to apply immediate and unquestionable intervention.

It is noteworthy that the RA banking legislation developed in the 1990s is considered to be one of the most effective ones as in terms of currency regulation and control, flow of capital and current account liberal modes, to use for banking activity control, licensing and regulatory systems. This is not only in comparison with countries with economies in transition, but also among the recognised internationally successful ones.

In particular, the most efficient decisions include the drafting of a regulatory framework in the sphere of banking secrecy, classification of assets, development of a mechanism for creation of a reserve for possible losses, currency regulation, and the introduction of international standards for accounting and reporting. The RA Central Bank succeeded in providing highly effective institutional solutions, among them the establishment of a bank deposit insurance system and a credit register. There is no doubt the above-mentioned steps, increased the level of public trust to, and risk management efficiency of, banks.

The regulatory solutions for taxation of banking activities enforced in the second half of the 1990s contributed to the formation and promotion of the banking system. Among them were as follows:

- ↖ As opposed to other countries, the RA law “On Profit Tax” stipulated that when calculating the taxable profit base of banks, deductions from gross income will include reserves for possible loss of assets;
- ↖ When defining taxable base of banks’ profits, it was acceptable to reduce the gross income by the amount of lost assets and unearned interest income;
- ↖ Accelerated depreciation of computer facilities was allowed;
- ↖ An unprecedented preferential mechanism was applied in the RA law “On Value Added Tax” to the turnover tax on the sale of real estate pledged previously but owned by banks currently;
- ↖ It was stated that the positive effect of revaluation of foreign currency assets as well as fixed assets is not reflected in the gross income;
- ↖ The positive difference between the nominal and real value of stock is not reflected in the gross income;
- ↖ Establishment of preferential income tax rate for interest income received on bank deposits of natural persons.

The banking system, which stood out as a relatively regulated sphere as the result of the reforms, recorded a fairly high pace of expansion. In fact, as early as in the second half of the 1990s, essential prerequisites were in place in Armenia for the development of the banking system, both in terms of improvement of quality of the delivered services, and reliability of this type of business, investments, and attraction of foreign capital.

The restored trust of investors led to a vibrant and progressive promotion of the banking system capital, attracting funds, assets and liabilities over the next years. There were periods of decline in the past, particularly in the first years of the third millennium; however, following that, and to the present, due to a sound legal and organizational basis, the Armenian banking system has been standing out for a fairly high rate of growth, as compared with other sectors of the economy. In the last decade the key indicators showed an annual growth rate of 30%. It is noteworthy that even the global financial and economic crisis, which had a serious negative impact on both the developed and developing economies, and affecting the Armenian economy significantly (decline for that period was more than 14%), had a minor effect on the Armenian banking system. This is due to a number of factors, in particular, to the fact that the development of the Armenian banking system, in the past and currently, was and still is somewhat self-sufficient and isolated, with poor links with the economy. However, on the other hand, the development of the system is barely characterized by features typical of the Armenian economy, among them a high level of shadow economy, business convergence with the government, oligopolistic system of government and a high level of corruption, patronage of the government or some high-ranking officials.

To avoid the aforementioned risks, as well as thanks to the introduction of the world's best practices of regulation and control of banking activity, the RA banking system recorded significantly high rates of development throughout the whole period, and the 2008-2020 banking assets/GDP ratio increased from 30% to 108%, while the credit/GDP ratio increased from 10% to 63%, which is equivalent to the indicators of countries with fairly developed banking systems.

Yet, the RA banking system is not free from certain risks, which will affect the overall tendencies of the system development in the near future. First, surely, are the risks available in the economy, which will hinder

the RA economy development and penetrate into the banking system. Apart from that, in the current stage of the banking system development much importance should be attached to a number of issues, among them - the quality of system of capital and assets, introduction of up-to-date management systems, improvement of risk management mechanisms, and introduction of new services, which will ensure the harmonious development of the Armenian banking system as part of the world banking network.