Rating-Agentur Expert RA GmbH confirmed at 'B+' the sovereign government and at 'B' the credit climate ratings of Armenia

Rating-Agentur Expert RA GmbH confirmed the sovereign government credit rating (SGC) of Armenia at 'B+' (Moderately low level of creditworthiness of the government) in national currency and at 'B+' (Moderately low level of creditworthiness of the government) in foreign currency.

Rating-Agentur Expert RA GmbH confirmed the country credit environment rating (CCE) of Armenia at 'B' (Moderately low quality of credit environment of the country) in national currency and at 'B' (Moderately low quality of credit environment of the country) in foreign currency.

MAJOR FACTORS THAT INFLUENCED BOTH TYPES OF RATINGS:

Positive factors:

- The structure of Armenia's debt is satisfactory. Short-term debt to GDP is as low as 1,2% and 2,9% of total debt. Debt denominated in foreign currency decreased from 85,6% in 2015 to 83,7% in 1H 2016. In addition, 84% of its creditors are international organizations providing soft loans;

- Real GDP growth slowed down in 2015 (3%) and it is expected to continue this trend in 2016. However, growth continues to be positive despite the decline in remittances, meager copper prices and lower aggregate demand;

- Exchange rate pressures have eased along 2016 and the real exchange rate has been maintained near equilibrium. Additionally, even though the Central Bank of Armenia (CBA) lowered the policy rate, conditions remain tight reflected in inflation levels around zero and slow credit growth. However, easing the policy rate slowly in order to maintain stability has proved to be effective.

Restricting factors:

- The amount of international reserves has declined slightly (USD 1,56 bn as of April 2016) due to the CBA's interventions during 1Q 2016 to contain the pressure on the AMD. Reserves are equivalent to 30,7% of public debt (4p.p. less than in 2015) and cover short-term external debt by 12,2x;

- Official figures from the Ministry of Finance showed a 2015 fiscal deficit of 4,8% of GDP, the widest deficit since 2010 due to the substantial amount of VAT refunds and uncompleted asset sales;

- The country's GDP per capita remains acceptable at USD 8,4 th when compared to its regional non-oil dependent (RNOD) peers'[1] average;

- Inflation rate has been volatile over the past six years and was slightly negative in 2015 at -0,1% due to low domestic demand, depressed import prices and a steep decline in food prices;

- The banking sector performance has deteriorated. The pace of credit growth to the economy constantly decreased for the past years and it finally contracted at end-2015 (42,1% of GDP); however, it grew by 3% in absolute terms from end-2015 until May 2016. Additionally, ROA has been either negative or extremely low (0,1% as of May 2016). The banking system, nevertheless, remains well capitalized with a capital adequacy ratio of

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[1] Non-oil dependent peers include Georgia, Kyrgyzstan and Tajikistan.

14,3% in 2015;

- The government has slightly improved its fiscal policy effectiveness. Revenues and expenditures in 2016 seem to be in line with plans and a new tax reform in 2017 will help to reduce the debt burden and the deficit. However, the limited fiscal space given the wide deficit, limits the government to further apply countercyclical measures in 2016. Also, budget lending increased by 9% in 1Q 2016;

- Acceptable level of institutional development in the country. There are moderate conditions in the country for business, nonetheless corruption remains a drag for economic growth.

Negative factors:

- The government debt dynamic has been negative since 2010 and most markedly between 2014 and 2015. It grew by 7p.p. (up to 48,8%) as related to GDP and 36p.p. (up to 210%) relative to budget revenues. Additionally, the volume of debt increased further in 1H 2016 (by 3,6% from year-end 2015);

- The 6,26% yield on the 10Y government bond as of August 2016 indicates the high cost of financing for the government and the risk aversion of investors towards Armenia's debt;

- Unemployment remained high and consistent at around 18% as of March 2016 but well above that of its RNOD peers;

- NPLs to total loans stood at 10,2% as of April 2016, an increase of 6,5p.p. since end-2012. Since the amount of low quality loans has been increasing, so is the materialization of NPLs. It is yet to be seen how the new financial stability objective from the CBA will affect this metric;

- Stock and bond markets remain undeveloped. There number of companies and bonds listed was marginal (10 and 16 respectively) and stock market capitalization was as low as 2,1% of GDP as of January 2016;

- During 2013-2015 the level of national savings declined by 1,3p.p. to stay at 13,7% by end-2015, reflecting lower investment and government funding potential in the economy;

- Armenia's economic competitiveness is low as measured by a foreign trade deficit of 16,7% of GDP in 2015 (and expected to widen further in 2016) and the country's position in the global competitiveness ranking of the World Economic Forum (82nd out of 140 countries).

Stress factors:

- Financial dollarization, despite easing in 2016, remains high; loans and deposits in FX were equivalent to 66,7% and 67% of total loans and deposits respectively as of May 2016 (weak stress factor);

- The conflict with Azerbaijan for the Nagorno-Karabakh region remains unresolved. Additionally, spill-overs from RNOD peers were reflected in the 2015 macroeconomic figures and could potentially harm the Armenian growth prospects further (weak stress factor).

ADDITIONAL FACTORS THAT INFLUENCED CCE RATINGS:

Negative factors:

- High and volatile real interest rate at 16,1% in 2015.

Positive factors:

- Spread between the interest rate on loans and the interest rate on deposits remains acceptable despite widening up to 386b.p. in June 2016;

- Debt load of the private sector is at moderate levels (94,6% of GDP in 2015).

SENSITIVITY ASSESSMENT:

The following developments could lead to an upgrade:

- Successful implementation of the new fiscal reform which would bring down the government debt load and narrow the budget deficit;
- Reduction of the external exposure shown by a more balanced current account.

The following developments could lead to a downgrade:

- Renewed exchange rate pressures which may cause instability in the financial system and hurt the level of international reserves;
- Further deterioration of the fiscal metrics such as budget balance and government debt.

"Armenia's ratings are negatively affected by the continued increase in government debt, the dependence of the economy on external factors, a weak banking system and the still high level of dollarization in the economy. In addition, recent socio-political unrest and remaining border tensions with Azerbaijan continue to negatively impact the ratings.

Nevertheless, the ratings are positively supported by the well-structured government debt in regard to maturity, currency and creditors, good management of the monetary policy and improvement in the execution of the public budget." – Clarified Hector Alvarez, Rating Analyst of Rating-Agentur Expert RA GmbH.

Responsible expert: Hector Alvarez, Rating Analyst of Rating-Agentur Expert RA GmbH

Reviewer: Gustavo Angel, Rating Associate of Rating-Agentur Expert RA GmbH

Research report on Armenia is available at:

http://raexpert.eu/reports/Research_report_Armenia_05.08.2016.pdf

Next scheduled rating publication: TBD in December 2016.

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RATING HISTORY:

Date	Review reason	SGC		CCE	
		National currency	**Foreign currency**	**National currency**	**Foreign currency**
04.03.2016	First assignment of both types of ratings for the country	B+	B+	B	B

Minute's summary

The rating committee for Armenia was held on 2 August 2016. The quorum for the rating committee was present. After the responsible expert presented the factors, which influenced the rating assessment, the members of the committee expressed their opinions and suggestions within the framework of the Sovereign methodology. The chairman of the rating committee ensured that every member of the committee expressed his/her opinion before proceeding to the voting.

The following methodology was used for the rating assessment: Methodology for Assigning Sovereign Government Credit Ratings and Country Credit Environment Ratings. Short Public Version (from April 2015) can be found under the following link: http://raexpert.eu/files/methodology/Methodology-Short-Sovereign.pdf. Descriptions and definitions of all rating categories can be found under the following link: http://raexpert.eu/sovereign.php under the "Rating scale" section. The user of the rating shall read the methodology in order to have a full understanding of the rating procedure.

These ratings are unsolicited. The rated entity did not participate in the rating process.

Main sources of information: International Monetary Fund, World Bank, World Economic Forum, Doing Business, United Nations, NASDAQ Armenia, Central Bank of Armenia (CBA), Ministry of Finance of Armenia, National Statistical Service of the Republic of Armenia, Transparency international.

Limits of the Credit Rating

During the rating assignment process, Rating-Agentur Expert RA GmbH (the Agency) used publicly available information that was considered to be reliable, complete and non-biased. The responsible expert performed the rating assessment of the country with information considered as the most reliable and up to date in accordance to the overall position of the country and the Agency's internal criteria for selecting data providers. The information and data used for this specific assessment can be considered as of sufficient quality.

Despite similar methodologies, credit ratings of Armenia from RAEX (Moscow) (both SGC and CCE) may be different from those assigned by Rating-Agentur Expert RA GmbH due to:
- Possible differences in expert assessments of individual factors;
- Some differences in methodologies (methodologies are similar but not identical);
- Differences in the date/period of assessment for individual factors.

Conflict of interest

The responsible expert was neither influenced nor biased by third parties during the rating assessment. All employees involved in the rating assessment and revision of the rated entity have reported absence of conflicts of interests before initiation of the rating process.

Rating-Agentur Expert RA GmbH is completely independent from the activities of other agencies of the RAEX group.

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Office responsible for preparing the rating

The office responsible for the preparation and issuance of this credit rating is the office of Rating-Agentur Expert RA GmbH in Frankfurt am Main, Germany.

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The European Securities and Markets Authority (ESMA), the EU's direct supervisor of credit rating agencies (CRAs), has registered Rating-Agentur Expert RA GmbH as a CRA under Regulation (EC) No 1060/2009 of the European Parliament and of the Council of 16 September 2009 on credit rating agencies, with effect from 1 December 2015.

Rating-Agentur Expert RA GmbH applies the Code of Conduct Fundamentals for credit rating agencies issued by the International Organization of Securities Commissions (IOSCO Code) and includes the basic principles of IOSCO Code in its Code of Conduct.