INTERNATIONAL GROUP OF RATING AGENCIES
RAEX EXPERT RA RATING AGENTUR EUROPE
Moscow - Ekaterinburg - Almaty - Minsk - Frankfurt - Hong-Kong

Research Report on Armenia

3 February 2017

Responsible Expert:

Hector Alvarez
Rating Associate

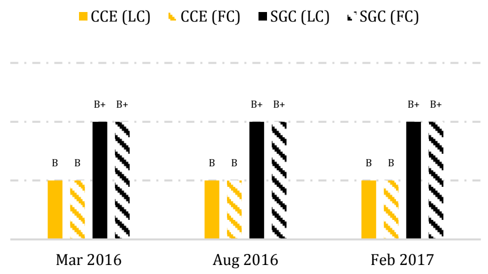
For further information contact:
Rating-Agentur Expert RA GmbH
Walter-Kolb-Strasse 9-11,
60594 Frankfurt am Main, Germany
+49 (69) 3085-45-00
E-mail: info@raexpert.eu
www.raexpert.eu

Ratings

Sovereign Government Credit (LC)	B+
Sovereign Government Credit (FC)	B+
Country Credit Environment (LC)	B
Country Credit Environment (FC)	B

* These ratings are unsolicited

Ratings dynamics



Main Economic Indicators of Armenia

Macro indicators	2014	2015	2016
Gross gov. debt, AMD bn	2001	2360	2872*
Nominal GDP, AMD bn	4829	5032	5151*
Real GDP growth, %	3,6	3,0	2,4*
Gross gov. debt/GDP, %	41,4	46,9	55,8*
Deficit (surplus)/GDP, %	-1,9	-4,8	-5,4
Inflation rate, %	4,6	-0,1	-1,1
Current Account Balance/GDP, %	-	-	-2,9*
External debt, USD bn	-	-	9,2

Development indicators	2015
Inequality adj. HDI	0,66
GDP per capita, USD th	8,9*

Default indicator	31.01.2017
10Y Gov Bond Yield, %	6,45

Source: RAEX (Europe) calculations based on data from the IMF, WB, UN, Armenia Ministry of Finance, CBA
* Forecast for 2016

Summary

Armenia's ratings are still supported by the satisfactory structure of government debt and acceptable management of the monetary policy. In addition, economic growth remains positive despite adverse external conditions.

Nevertheless, the widened fiscal deficit, increase in government debt, high dollarization levels and the amount of NPLs in the banking system, still had a negative impact on the ratings. Furthermore, the country is still highly exposed to external factors which affect the performance of the overall economy and the management of monetary and fiscal policies.

Challenging conditions remain in the banking sector. The banking sector slightly recovered in 2H 2016. As of October 2016, ROA stood at 0,6% and the ratio of liquid assets to total assets was 31,2%. Moreover, the enforcement of the AMD 30 bn minimum capital requirement has caused the regulatory capital to risk-weighted assets to stay high at 19,2% and has already encouraged some mergers (e.g. Armenia's AraratBank with Armenian Development Bank) which will result in a higher quality of the banking system. In addition, fueled by lower interest rates, credit growth showed a recovery in 2H 2016 when total loans grew by 14% in absolute terms y-o-y and by 5p.p. as related to GDP (see graph 1).

However, despite a decrease in NPLs, the metric is still unsatisfactory. The NPLs to totals loans ratio (specially FX denominated) remained high at 9,3% by October 2016. The high figure drags from the high levels of loan dollarization combined with steep credit growth and a sudden AMD depreciation a few years back.

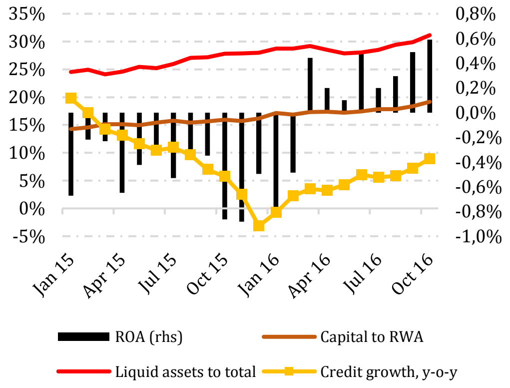
Table 1: Peer comparison of regional non-oil dependent countries for 2016*

Factors	Armenia	Georgia	Kyrgyzstan	Tajikistan
Government debt/GDP	55,8%	42,05%	72,13%	50,27%
Fiscal balance/GDP	-5,4%**	-1,88%	-4,51%	-3,95%
Current acc/GDP	-2,9%	-12,10%	-14,96%	-8,39%
Inflation rate (%)	-1,1%**	3,22%	3,33%	11,04%
GDP growth (%)	2,4%	3,41%	2,21%	6,00%

Source: RAEX (Europe) calculations based on data from the IMF, National Statistical Service, CBA
* Forecast for 2016
** Actual figures for 2016

Increasing government debt with satisfactory structure. The debt structure of the government obligations remains satisfactory. Even

Graph 1: Financial soundness indicators

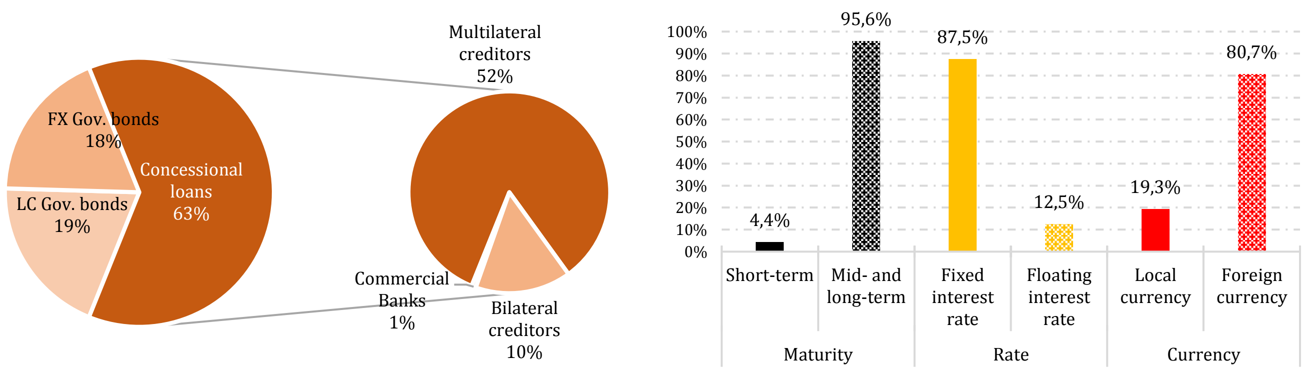


Source: RAEX (Europe) calculations based on data from the CBA

though short-term debt increased slightly, it is still negligible at 2,2% of GDP and 4% of total debt and continues to be well covered by international reserves by 9,1x. In addition, the FX-denominated debt declined further to 80,7% of total debt in 2016 and is mostly held by international institutions at favorable terms. Finally, the share of variable interest rate loans increased to 12,5% of the overall debt in 2016, 2,5p.p. higher than a year ago (see graphs 2 and 3).

The latest IMF projections show government debt figures higher than anticipated for 2016. Government debt is set to end 2016 at 55,8% of GDP and 261,4% of budget revenues, a hike of around 9p.p. and 41p.p. respectively as compared to 2015. Despite this, we expect debt levels to increase at slower levels in 2017 due to the application of the fiscal rule[1] and budget consolidation plans already in place.

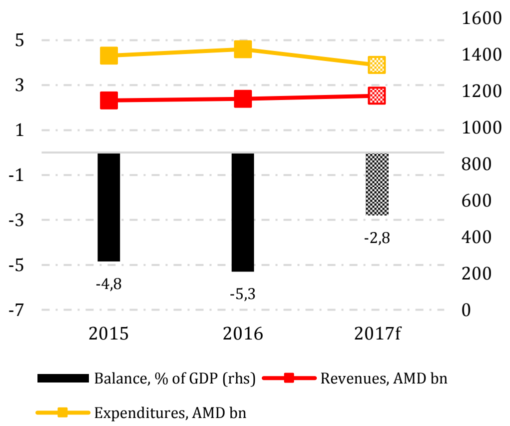
Graphs 2 and 3: Government debt structure, 2016



Source: RAEX (Europe) calculations based on data from the Armenia Ministry of Finance

Fiscal position deteriorated but set to improve in 2017. The fiscal position continued to deteriorate in 2016 when total revenues increased only slightly by 0,7% in nominal terms mainly due to negative external factors. At the same time, total expenditures increased by 2,5% in the same period propelled by the over-execution foreign financed capital expenses and a 267% increase in subsidies. Thus, the fiscal balance widened to 5,4% of GDP, far from the authorities target of 3,5% of GDP (see graph 4).

Graph 4: Fiscal budget indicators

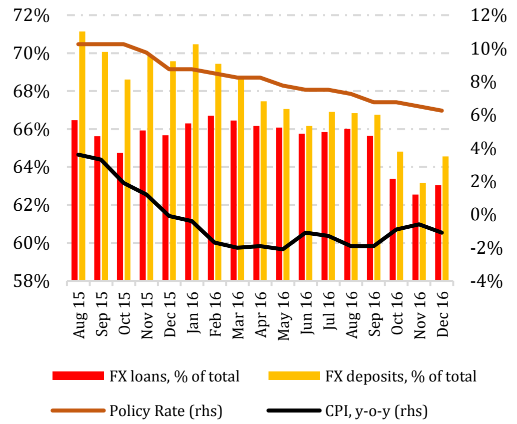


Source: RAEX (Europe) calculations based on data from the National Statistical Service and IMF

Despite this, we anticipate the fiscal balance to narrow in 2017 due to the trigger of the fiscal rule, as previously mentioned, and the introduction of the new tax code (see graph 4). The trigger of the fiscal rule and the consolidation plan of the government will encourage fiscal discipline but could further hurt economic growth. In addition, the new tax code will be another tool which will help to achieve fiscal consolidation. According to

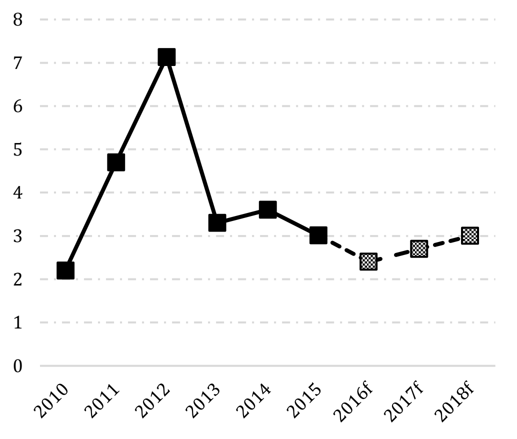
[1] According to the IMF, Armenia's fiscal rule indicates that government debt cannot succeed 60% of GDP and that when it exceeds 50% of GDP, the fiscal deficit for the following year shall be lower than 3% of the average GDP for the last three years.

Graph 5: Monetary policy response indicators



Source: RAEX (Europe) calculations based on data from the National Statistical Service and CBA

Graph 6: Real GDP growth, y-o-y



Source: RAEX (Europe) calculations based on data from the IMF

IMF figures, this will propel revenues by around 2% of GDP in the mid-term perspective.

Monetary policy continues to loosen. The Central Bank of Armenia (CBA) continues to enforce a loose monetary policy; it slashed the refinancing rate seven times in 2016 from 8,5% in February down to 6,25% in late December and also reduced the FX deposit reserve requirements to 18%. Despite this, Armenia posted a deflation figure for a second year in a row as the CPI index declined by 1,1% y-o-y in 2016 due to external shocks. However, we expect the effect of the CBA's easing to translate into inflation in 2017 (see graph 5).

Nonetheless, the accommodative policy already caused an increase in credit, as previously mentioned, and dollarization levels have slightly eased: loans and deposits in FX were equivalent to 63% and 64,5% of total loans and deposits respectively as of December 2016 (see graph 5).

Economic growth was lower than initially anticipated in 2016. Economic growth in Armenia is highly dependent on regional players. In line with the IMF, we expect, the economy to grow by around 2,4% in 2016 driven by external factors such as lower copper prices resulting in lower nominal exports and subdued remittances. The level of remittances continued to decline at an average of 10% in the first 9M 2016. Despite this, the decline was more gradual than in 2015.

For 2017, we expect a slight recovery of real GDP driven by higher hydrocarbon prices which will propel economic recovery in the region (see graph 6). However, lower government spending due to the authorities' consolidation efforts and the exposure to global and regional risk could hurt Armenia's overall short- and mid-term growth perspectives.

External risks remain in place. As mentioned above, Armenia is substantially exposed to the performance of its main trading partners and the volatility of the exchange rate given the high financial dollarization and dependence on imports.

The trade deficit shrunk in 2016 to 14,1% of GDP given a spike in exports – due to the operation of a new copper mine – as well as a decline in imports – due to depressed domestic demand. Despite the slight decrease in the trade deficit, we expect the current account balance to stay almost constant at 2,9% of GDP given the decrease in remittances but still narrower than its peers (see table 1).

Armenia's international reserves have picked up towards the end of 2016 to stay at USD 2,2 bn due to a steep decrease in interventions by the CBA. Reserves as a percentage of government debt increased to 36% and they still cover short-term debt by 9,1x. Furthermore, the exchange rate level has remained in equilibrium providing additional certainty for the economy as well as to the monetary policy and has contributed to the slight decline in dollarization.

Besides, the above mentioned factor, the Nagorno-Karabakh conflict remains a potential source of external risk for the economy.

Important note for sovereign ratings

This Research Report shall be treated as a supplementary part of the published Press Release included in the following link:

http://raexpert.eu/reports/Press_release_Armenia_03.02.2017.pdf

Both documents shall be treated as essential parts of each other.

For further information on the factors, their weights, methodologies, risks and limitations of these ratings, and other regulatory disclosures, please refer to the Press Release and the website of the Agency.