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## 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
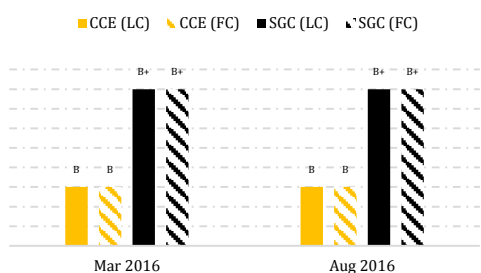


## Main Economic Indicators of Armenia

| Macro indicators | 2013 | 2014 | 2015 |
|---|---|---|---|
| Gross gov. debt, AMD bn | 1729 | 2001 | 2457 |
| Nominal GDP, AMD bn | 4556 | 4843 | 5033 |
| Real GDP growth, % | 3,3 | 3,5 | 3,0 |
| Gross gov. debt/GDP, % | 38,0 | 41,3 | 48,8 |
| Deficit (surplus)/GDP, % | -1,6 | -1,9 | -4,8 |
| Inflation rate, % | 5,6 | 4,6 | -0,1 |
| Current Account Balance/GDP, % | -7,6 | -7,3 | -2,7 |
| External debt, USD bn | - | - | 4,4 |

| Development indicators | 2015 |
|---|---|
| Inequality adj. HDI | 0,73 |
| GDP per capita, USD th | 8,5 |

| Default indicator | 05.08.2016 |
|---|---|
| 10Y Gov Bond Yield, % | 6,26 |

Source: RAEX (Europe) calculations based on data from the IMF, WB, UN, Deutsche Bank, Armenia Ministry of Finance, CBA

## Summary

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.

**Well-structured but increasing government debt load.** Revised figures for 2015 confirm that government debt to GDP and to budget revenues escalated substantially up to 48,8% and 210% respectively (see graph 1). Public debt continued to increase in 2016 and by June it had grown by 3,6% in absolute terms remaining higher than the average of its regional non-oil dependent (RNOD) peers[1].

Despite the hike, the maturity and currency structure of the debt as well as its diversification by debt holders is favorable. Short-term debt remained low at 1,2% of GDP and represented only 2,9% of total debt in 2015. Debt denominated in foreign currency decreased from 85,6% in 2015 to 83,7% in 1H 2016. In addition, 84% of Armenia's creditors are international organizations providing concessional loans.

**Performance of the banking sector has weakened.** The main banking metrics have deteriorated (see graph 2). The average ROA for the sector has been constantly declining since mid-2011 and was negative for most part of 2015 while it turned slightly positive in 2016 (0,1% by May 2016). These low figures are caused by high dollarization and currency mismatches in the balance sheet of the banks.

In the same time span, the ratio of NPLs to total loans increased from 5% in January 2013 up to 10,2% by May 2016. The hike was mainly a result of the steep devaluation of the AMD combined with the amount of loans issued in foreign currency. Despite this, the sector's capitalization has remained stable posting a capital adequacy ratio of 17,2% as of May 2016.
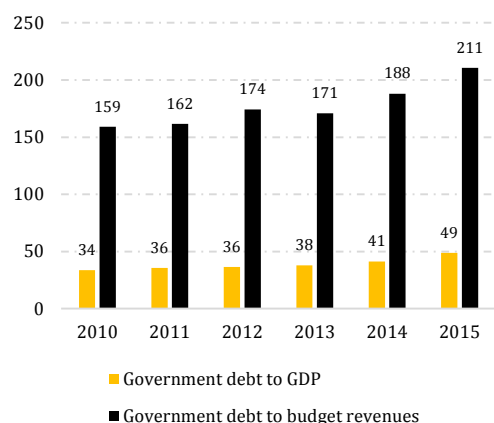
Bank assets and credit to the economy have also been in a downward trend. Bank assets equaled 68,5% of GDP in 2015, a 2p.p. reduction from

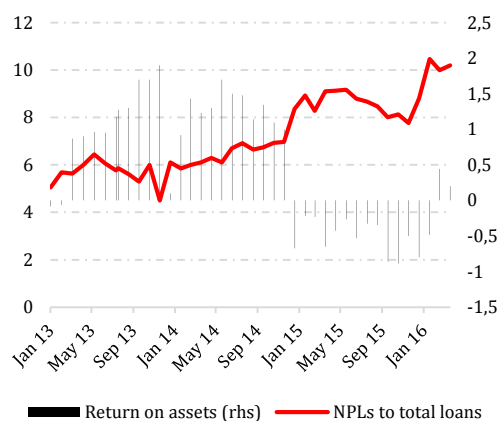[1] Non-oil dependent peers include Georgia, Kyrgyzstan and Tajikistan.
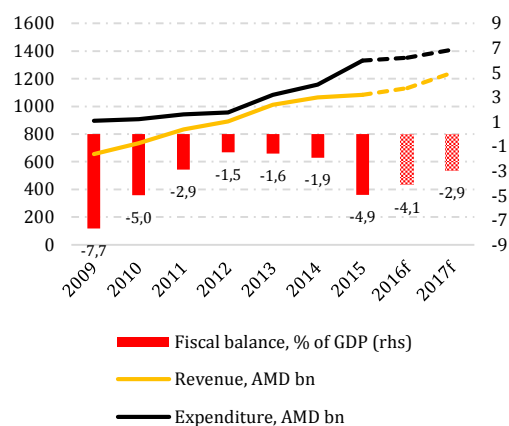
**Graph 1:** Public debt dynamics, %



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

**Graph 2:** Banking system indicators, %



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

**Graph 3:** Fiscal budget dynamics



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

2014, while the amount of credit provided by the banking sector was 42,1% of GDP and contracted by 3p.p. from a year ago. Furthermore, 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 until May 2016.

As mentioned in our previous review[2], in January 2017 the minimum capital requirement for the banking sector will be equal to AMD 30 bn following the decision from the Central Bank of Armenia (CBA). The main purpose of the measure is to consolidate banks and to create a more competitive atmosphere in the system. So far, half of the sector has reached the requirements and, according to the Union of Banks of Armenia (UBA), the institutions not able to reach the requirement would either have to look for merger options, transform into other credit institutions or leave the market.

**Fiscal reform underway.** Official figures from the Ministry of Finance showed a 2015 fiscal deficit of 4,8% of GDP, the widest deficit since 2010 when it stood at 5% of GDP (see graph 3). The substantially negative balance is due to the sizable amount of VAT refunds, uncompleted asset sales and a hike in budgetary lending, which further increased by 9% in 1Q 2016. The limited fiscal space prevents the government from applying countercyclical measures to stimulate the economy.

In spite of the deep fiscal hole, the government has slightly improved its fiscal policy effectiveness. Revenues and expenditures in 2016 appear to be according to plans and a new tax reform in 2017 will help to reduce the debt burden and cut the deficit.

**Monetary policy adjustments stabilized volatility.** A series of adjustments by the CBA late in 2014 helped to stabilize pressures on the exchange rate and inflation. In order to avoid a similar situation at the beginning of 2016, the CBA intervened the FX market by selling foreign currency, which once again stabilized the burden on the exchange rate.

Despite trimming the policy rate seven times since August 2015 (from 10,5% down to 7,5% by June 2016) reflecting a loose policy, conditions remain tight. This is reflected in negative inflation rates of -0,1% in 2015 and -0,6% by May 2016 due to low domestic demand, depressed import prices and a steep decline in food prices. Also, the low, and at times negative, growth rates of credit to the economy show strained conditions (see graph 4). However, by slowly easing the rate cuts, stability will be preserved. In addition the real exchange rate has been maintained near equilibrium.

[2] Research report on Armenia from 4 March 2016 (http://raexpert.eu/reports/Research_report_Armenia_04.03.2016.pdf).
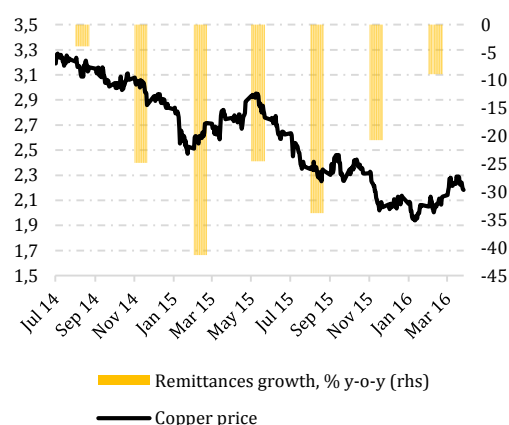
**Graph 4:** Base rate, inflation and credit growth
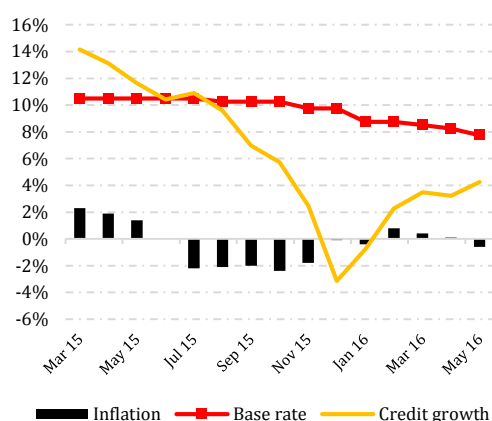


Source: RAEX (Europe) calculations based on data from the CBA

**Graph 5:** Remittances and copper price



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

Furthermore, in order to balance risks stemming from the financial sector, the CBA has included an objective of financial stability in its policy goals. A successful implementation of this objective would positively affect the country's creditworthiness.

**GDP affected by remittances and low aggregate demand.** GDP grew by 3% in 2015, a slight lower figure than the 3,5% rate from 2014. This growth was mainly sustained by agricultural output helped by good environmental conditions and an increase in mining exports as a result of a new copper mine. In 1Q 2016, indicators showed that the growth path has continued being supported by the industry and services sectors. However, the output for 2016 is expected to remain weak (forecast at about 2,2%). Adverse external conditions have mitigated growth in 2015 and are expected to also negatively impact growth in 2016.

Remittances declined by 30% from 2014 to 2015 given the high dependence of Armenia on the Russian economy. This source of income continued its decline in 1Q 2016 contracting by 8,9% y-o-y. Furthermore, an overall decline in aggregate demand and depressed prices of copper (see graph 5) affected growth in 2015 and will continue to do so in 2016.

**Armenia remains vulnerable to external and domestic risks.** As previously mentioned, the Armenian economy has a substantial exposure to external factors. The country depends highly on the performance of regional economies, especially Russia. Additionally, total imports were equivalent to 47% of GDP in 2015 and most the public debt and 50% of private debt is external.

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

Armenia continues with the long-lasting conflict with Azerbaijan for the Nagorno-Karabakh region. Moreover, current socio-political unrest in Armenia, as shown by anti-government protests in Yerevan, may hurt the political stability in the country.

**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_05.08.2016.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.