

Responsible Expert:

Vladimir Gorchakov
Associate Director

For further information contact:

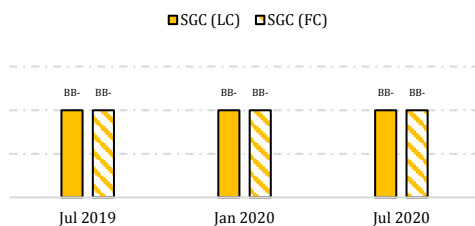
Rating-Agentur Expert RA GmbH
Walter-Kolb-Strasse 9-11,
60594 Frankfurt am Main, Germany
+49 (69) 3085-45-00, ext. 1216
E-mail: gorchakov@raexpert.eu
www.raexpert.eu

Ratings

Sovereign Government Credit (LC)	BB-
Sovereign Government Credit (FC)	BB-
Outlook (LC)	Stable
Outlook (FC)	Stable

* These ratings are unsolicited

Ratings dynamics



Main Economic Indicators of Armenia

Macro indicators	2017	2018	2019
Gross gov. debt, AMD bn	3277	3351	3512
Nominal GDP, AMD bn	5564	6005	6552
Real GDP growth, %	7,5	5,2	7,6
Gross gov. debt/GDP, %	58,9	55,8	53,6
Deficit (surplus)/GDP, %	-4,8	-1,8	-1,0
Inflation rate, %	2,6	1,8	0,7
Current Account Balance/GDP, %	-	-	-8,2
External debt, USD bn	-	-	5,4
Development indicators	2019		
Inequality adj. HDI	0,68*		
GDP per capita, USD th	11,3		
Default indicator	10.07.2020		
9Y Gov Bond Yield, %	4,1**		

Source: RAEX-Europe calculations based on data from the IMF, WB, UN, Armenia Ministry of Finance, CBA.

* Figure from 2018 ** Maturity in 2029

Summary

The change of the rating outlook for Armenia from positive to stable reflects our expectations about a widening of the budget deficit and an increase in debt levels by end-2020, together with the anticipated contraction of the economy. However, the sovereign government credit ratings were confirmed at 'BB-', due to the fact that most of the debt increase is related to donor support at concessional terms. The ratings also remain supported by adequate quality of the fiscal and monetary policies, low inflation and a stable stance of the banking system.

Nevertheless, government debt levels and its currency structure, together with a high exposure to external shocks, high dependence on imports and negative current account balance, continue to be the factors constraining the rating.

After remarkable growth in 2019, a recession is expected. After a strong growth at 7,6% y-o-y reported in 2019, which was the highest over the last decade, the Armenian economy was hit by the COVID-19 crisis. In response to the growing number of infections, authorities declared a national state of emergency, with restrictions for travelling, restaurants and other services. Taking into account the high importance of the tourism and retail trade sectors for the economy, the state of emergency translated into a GDP growth slowdown to 3,8% y-o-y in 1Q 2020, while sectors, such as manufacturing, construction, transportation, tourism and entertainment had already contracted in real terms. Moreover, the monthly indicator of economic activity in May 2020 showed a contraction of 12,8% as compared to May 2019.

Due to the already confirmed prolongation of the state of emergency in July 2020, the expected recession in major trade partners and drop of remittances, we expect an overall contraction of the economy at around 1,5% by end-2020. However, in case of a second wave of the pandemic were to surge and turbulence in the global economy were to be prolonged; we could adjust this figure to the downside. Nevertheless, real GDP output is expected to turn positive by end-2021 and to be in the range of 4,5-5% (see graph 1).

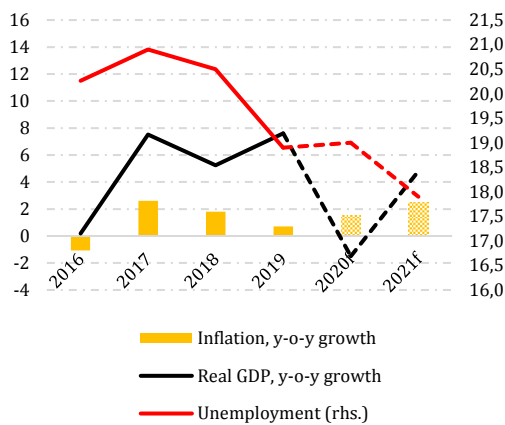
Due to the contraction of business activity, the unemployment rate, which is already very high in Armenia, is expected to rise further up to 19%; and per capita wealth levels to stall in the following year. Both factors restrict our rating assessment. In addition, despite the

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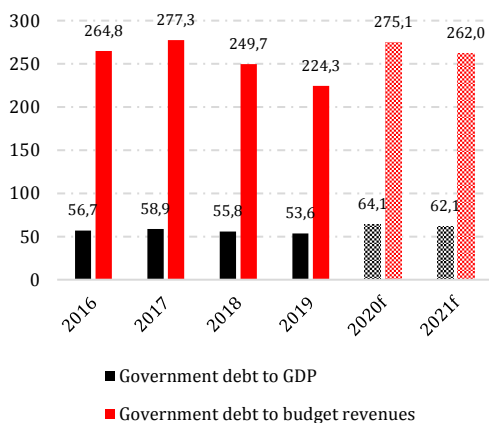
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Graph 1: Macroeconomic indicators, %



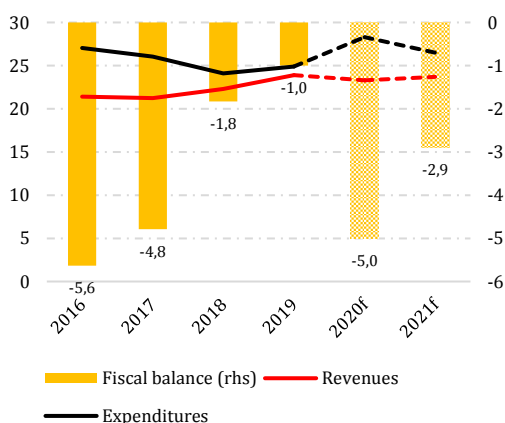
Source: RAEX-Europe calculations based on data from the IMF

Graph 2: Government debt dynamics, %



Source: RAEX-Europe calculations based on data from the IMF and Ministry of Finance of the Republic of Armenia

Graph 3: Fiscal budget dynamics, % of GDP



Source: RAEX-Europe calculations based on data from the IMF and Ministry of Finance of the Republic of Armenia

improvement in some World Bank governance indicators and the positive dynamic in the corruption perception ranking, economic competitiveness and institutional development in Armenia remains limited, negatively affecting our rating.

Sharp increase of debt load by end-2020. According to the 2019 final data, the level of public and publically guaranteed debt reached 53,6% of GDP, and the central government debt dropped below 50%, which is in line with the government’s original objective. However, the government already requested for additional financing mainly from the IMF and other international institutions, as well as local markets, in order to finance increased spending. The IMF already approved around USD 280 m program for Armenia in April 2020, and additional support expected from other donors. In addition, as of May 2020, 77% of public debt was FX-denominated, which makes it heavily exposed to currency shocks.

Due to these factors, we expect a sharp debt increase up to 64% of GDP and 275% of budget revenues by the end of 2020 (see graph 2), which restricts our rating assessment for the next year. However, the negative influence of debt dynamics is partially mitigated by the fact that a major part of new liabilities are related to financial support from international donors, such as IMF and ADB. In addition, the current favorable public debt structure supports our rating assessment: as of May 2020, short-term debt accounted only for 4,8% of total debt and 16% had floating interest rate.

The fiscal deficit is expected to widen considerably. Continued fiscal reforms with the strengthening tax discipline, growth of revenues on the back of strong GDP dynamics together with the capital expenditures below plans, led to a narrow deficit of 1% of GDP in 2019 (see graph 3). In the face of the COVID-19 crisis, the government of Armenia by May 2020 announced a financial support package with a headline amount of USD 300 m (2% of GDP), which includes direct social assistance transfers to some categories of citizens; labor subsidies for SMEs; subsidized loans to some heavily affected enterprises. Moreover, the authorities keep announcing additional support measures according to the development of the current recession.

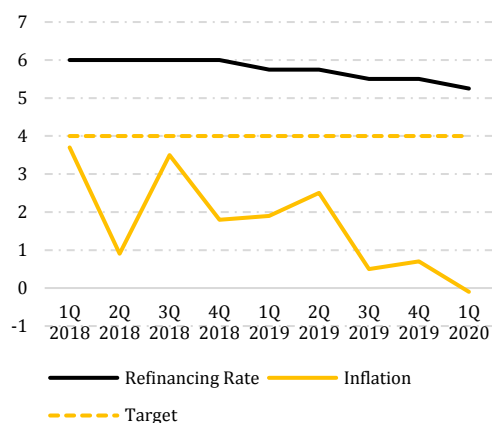
This fiscal stimulus together with the steady contraction of tax and export revenues, will lead to a sharp increase of the deficit, which expected to reach 5% of GDP by end 2020, compared to 2,3% originally planned for 2020 Budget. However, we expect the deficit to go below the 3% threshold as soon as in 2021.

We consider the quality of the fiscal policy as adequate on the face of the current economic crisis, with countercyclical measures and commitment to increase of transparency, accountability and predictability of the

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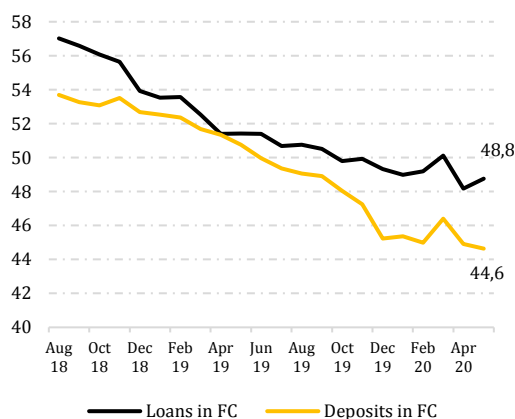
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Graph 4: Target vs inflation rate, %



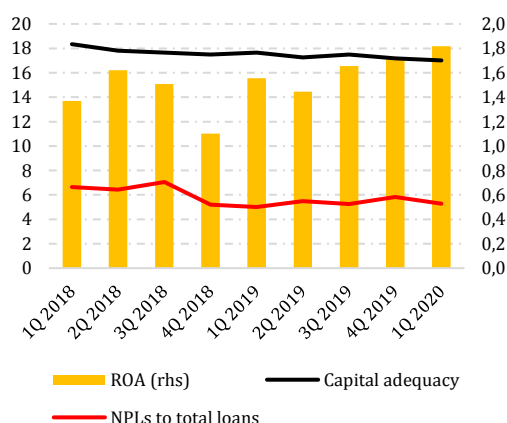
Source: RAEX-Europe calculations based on data from the CBA and IMF

Graph 5: Financial dollarization, % of total



Source: RAEX-Europe calculations based on data from the CBA

Graph 6: Financial soundness indicators, %



Source: RAEX-Europe calculations based on data from the CBA

policy. This includes, transparent public procurement, reporting of program implementation, as well as strengthening of the fiscal risks management. The government also continues public investments management reforms, implementation of Medium-Term Expenditure Framework and program-based budgeting. Moreover, in the long-run the authorities commit to fiscal consolidation and lower debt after the recovery stage.

Low inflation allowed the CBA to accelerate expansionary monetary policy. As compared to the majority of Caucasus and Central Asia (CCA) peers, Armenia has lower inflation, that reached 0,7% by end-2019. Moreover, by the end of 1Q 2020, the inflation rate turned negative, while the CBA’s target over the last two years remains unchanged at 4% (see graph 4). Balancing pressures from capital outflows with the space provided by such a low inflation, the CBA accelerated the policy easing and lowered its interest rate three times during 1H 2020, the last time being in June 2020 when it trimmed it down to 4,5%. We expect that the policy relaxation together with AMD depreciation will elevate the inflation up to 1,5% by the end of 2020, which we still assess favorably.

In addition to the rate cut, the CBA has conducted repos and FX swap operations to ensure ample liquidity conditions across the interbank market. While making limited interventions in March 2020 in order to smooth AMD volatility, the CBA also confirmed its commitments to a free float exchange regime. Therefore, we assess the quality of the monetary policy as a positive factor. However, its efficiency remains limited by lingering and concentrated local capital markets as well as still elevated financial dollarization. The later so far keeps declining despite the volatility on the financial markets (see graph 5).

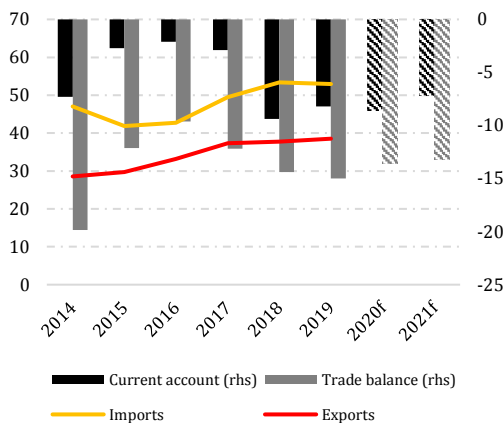
The banking sector remains stable. Before the COVID-19 crisis credit to the economy grew at an accelerated pace. Domestic credit provided by the financial sector and assets to GDP ratios in 2019 reached 65% and 89% respectively, as compared to 62% and 83% in 2018. However, this was mostly led by household credits, which grew by 32% y-o-y. Financial soundness indicators also showed a positive dynamic: the regulatory capital to risk-weighted assets was 17,0%, NPLs to total loans stood at 5,3%, ROA and ROE were 1,8% and 12,6% respectively, while the ratio of liquid assets to demand deposits was 118,1% by the end of 1Q 2020 (see graph 6).

However, in our view, the 1Q metrics are not fully reflecting the consequences of the economy contraction for the banks’ balance sheets, and we expect gradual deterioration of the banking system metrics by end-2020 with the worsening of asset quality, declining profitability and capitalization metrics. We also expect credit growth to slow down in

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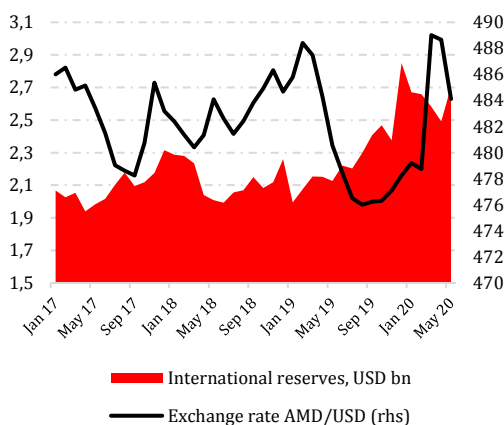
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Graph 7: External sector indicators, % of GDP



Source: RAEX-Europe calculations based on data from the WB, IMF and CBA

Graph 8: International reserves and exchange rate



Source: RAEX-Europe calculations based on data from the WB, IMF and CBA

2020, but being backed by co- and re-financing government support packages. Moreover, some medium and small-sized financial institutions could face liquidity and capital shortage in the mid run.

However, in our view, the already implemented and announced measures of the CBA, including relaxation of some prudential and reserve requirements and provision of additional liquidity, will help to cushion the blow of the pandemic on the banking system.

External position expected to deteriorate. By end-2019 the external position of Armenia slightly improved with a narrower current account deficit at 8,2% of GDP as compared to 9,4% in 2018 (see graph 7), due to stronger transfers from abroad despite the widening trade deficit. However, since the pandemic has already hit tourism receipts, remittances and FDI, and it is expected to cause a reversal of private capital inflows, we expect the current account deficit to widen slightly up to 8,6% of GDP. However, the financial account is expected to drop sharply, on the back of the reversal of private flows in the form of non-resident deposits.

During 2019 the international reserves of the CBA showed a steady recovery and reached USD 2,8 bn by December 2019, which was equal to 5,7 months of imports, as compared to 3,7 in 2018. Since the AMD depreciated by 5% against the USD in March 2020, the authorities intervened by about USD 127 m between mid-March and early April. As a result, by May 2020 international reserves of the CBA declined by 5% as compared to the end of year (see graph 8). However, taking into account free float regime of dram, we consider such levels as adequate, since they are equal to around 6 months of imports and cover short-term debt by 9x.

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:

https://raexpert.eu/reports/Press_release_Armenia_10.07.2020.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.

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