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Main Economic Indicators of Armenia

| Macro indicators | 2011 | 2012 | 2013 |
|-------------------------------|-------------|-------------|-------------|
| Gross pub. debt, bill Dram | 1348,4 | 1556,3 | 1769,1 |
| Nominal GDP, bill Dram | 3777,9 | 4000,7 | 4272,9 |
| Nominal GDP growth, % | 9,2 | 5,9 | 6,8 |
| Gross gov. debt/GDP,% | 35,7 | 38,9 | 41,4 |
| Deficit (surplus)/GDP,% | -2,9 | -1,6 | -1,7 |
| Inflation rate,% | 4,7 | 3,2 | 5,6 |
| Curr. Account balance/GDP,% | -11,1 | -11,1 | -8,0 |
| Development indicators | 2013 | | |
| Inequality adj. HDI | 0,73 | | |
| GDP per capita (Thou. of USD) | 7,03 | | |

Sources: RAEX (Europe) calculations based on data from World Bank, IMF, Bloomberg

Introduction

The Republic of Armenia has one of the largest Diasporas in the world with 3,3 million inhabitants and nearly 8 million Armenians living outside the country. Due to this situation, the country's economy heavily depends on remittances from abroad. Given that the majority of gross government debt is denominated in foreign currency, recent slowdown of Russia (and consequently a reduction of remittances from abroad) provides one of the strongest risks for the repayment of the country's debt obligations. From a fiscal perspective the recent improvement of budget deficit, which was mainly driven by government underspending, is expected to prevail encouraged by lower capital expenditure.

Government debt load does not pose any risk for the Republic of Armenia. Despite a significant jump in the value of Gross government debt/GDP ratio in 2010 and its constant increase in recent years, current figures stand at reasonable levels (see graph 1). Since ratings of Armenia assigned by the international rating agencies reflect non-investment/speculative grades, the country must pay high interest rates in order to raise funds in international financial markets. For that reason government debt denominated in foreign currency, which represents almost 85% of total debt, is mainly owed to international financial institutions (see graph 2). Additionally, Armenian government faces no risk in terms of short-term debt, which accounted for 8,6% of GDP in 2013.

Reduction of government budget deficit figures over the previous year was driven by capital underspending. Delays in implementing large foreign-financed projects were the main driver for underspending in recent years (see graph 3). The complicated nature of some projects, including multiple donors and requirements, multi-phased financing, complex land acquisition requirements as well as contractors and consultants new to the region contributed to delays. Underspending occurred in the first phase of the complex multi-donor North-South highway construction, among other large foreign-financed projects, and continued to advance more slowly than anticipated.

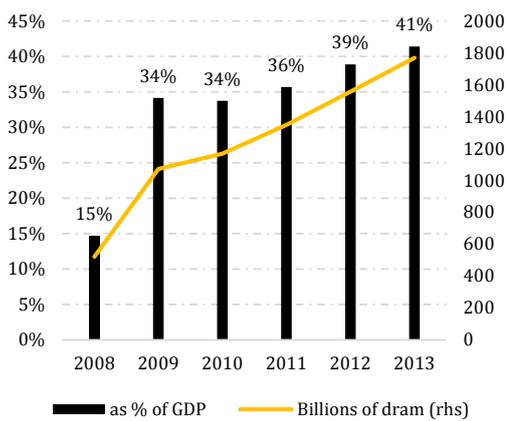
High levels of bank deposit and loan dollarization add risk to the financial system of Armenia. Although the free floating exchange rate

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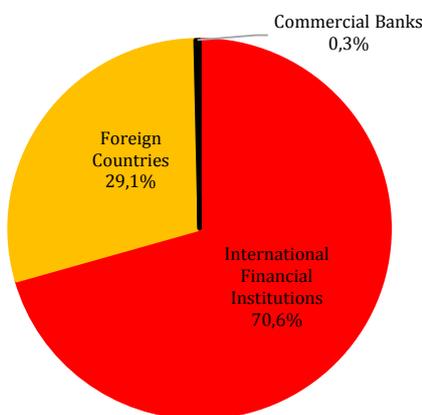
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Graph 1: Gross Government Debt of Armenia



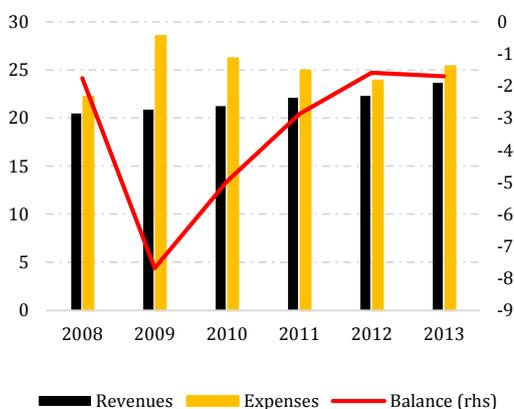
Source: RAEX (Europe) calculations based on data from IMF

Graph 2: External debt by type of creditor



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

Graph 3: Fiscal balance of Armenia (as % of GDP)



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

regime implemented by the Central Bank of Armenia (CBA) is consistent with the principle of liberalized capital account and sovereignty of monetary policy, high levels of dollarization shown by Armenia's domestic banking system (see table 1) may be harmful for the overall financial system. Given that the CBA is limited by its foreign exchange reserves (USD 1,7 Billion in August 2014) in acting as a lender of last resort in foreign currency, Armenia's financial system can have difficulties in case of a bank run or sudden reversal of capital flows.

Current slowdown of the Russian economy can have a negative impact on Armenia's trade balance and remittances sent from Armenians living abroad. Armenia, as many other countries in the region, depends heavily on trade and remittances from Russia and the European Union. According to the European Commission statistics, Armenia's imports from Russia and the European Union accounted for 50,8% of total imports in 2013, while the percentage of Armenia's exports to these regions amounted to 56,1% of the country's total exports. Additionally, the number of Armenians living abroad is estimated to be 8 million people, a figure that represents 2,4 times the amount of people living inside the country. Armenia has one of the largest Diasporas in the world, which provides the economy with a significant inflow of remittances every month (USD 1,5 Billion net inflows in 2013). According to official statistics, remittances from Russia were 75% of the total amount of remittances received by Armenia in 2013 (see graph 4). Based on these facts, the recent slowdown of the Russian Economy can have a negative impact on Armenia.

Fueled by the recent gas price agreement with Gazprom and Russia, inflation rate is expected to fulfill Central bank of Armenia's target. Driven by significant increases in gas and electricity prices in July 2013, the year ended with an inflation rate of 5,6%. This figure slightly exceeded the upper bound of the 4 (+/-) 1,5% CBA inflation target. Following the recently signed gas price agreement between the government of Armenia and Gazprom Russia, gas prices are expected to decline via a new base price of USD 189/1000 m³ and 30% discount through waiver of export duty charged by Russia. Among other benefits, the agreement also involves the sale of remaining Armenia's share (20 %) in ARG (ArmRosGazprom) to Gazprom Russia for USD 155 Million.

Nagorno-Karabakh conflict stands as the major stress factor for Armenia. Recent escalation of tensions between Armenia and Azerbaijan regarding the Nagorno-Karabakh conflict has influenced negatively the position of Armenia. Constant ceasefire breaches along the line of contact

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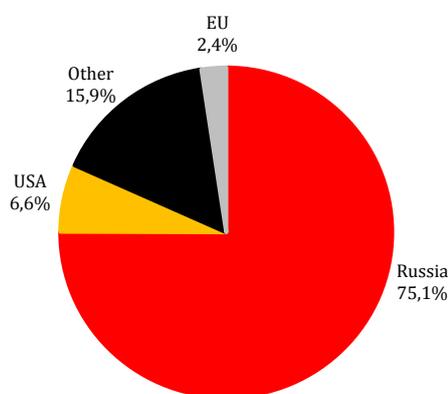
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Table 1: Dollarization in Armenia

| | FX demand deposits/ Total deposit | FX deposits/ Total deposits | FX loans/ Total loans |
|------|-----------------------------------|-----------------------------|-----------------------|
| 2012 | 51,9% | 63,0% | 64,2% |
| 2013 | 47,7% | 59,7% | 61,8% |

Source: RAEX (Europe) calculations based on data from Central Bank of Armenia

Graph 4: Remittances to Armenia by country in 2013



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

between Armenia and Azerbaijan increase the risk of tension escalation and probability of war. Given the efforts of the international community to find a peaceful solution to the conflict, Rating-Agentur Expert RA GmbH will keep the situation on watch.

Conclusion

Even though Armenia's macroeconomic indicators showed a sluggish performance in recent years, there are a number of factors which contributes positively to the creditworthiness of the country. Current levels of debt (especially short-term debt) do not pose any risk on the country. Furthermore, overall creditworthiness of the country profited from recent improvements of fiscal budget deficit as well as lower inflation forecasts. In contrast, high levels of dollarization, combined with a free floating exchange rate regime, introduce risks on the financial system and exposes the economy to external shocks. Recent escalation of the Nagorno-Karabakh conflict constitute the major stress factor for Armenia and will be kept on watch by Rating-Agentur Expert RA GmbH for further developments.

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