Rating-Agentur Expert RA confirmed at 'BB-' the ratings of Armenia. The rating outlook changed from positive to stable.

Rating-Agentur Expert RA confirmed the sovereign government credit rating (SGC) of Armenia at 'BB-' (Sufficient level of creditworthiness of the government) in national currency and at 'BB-' (Sufficient level of creditworthiness of the government) in foreign currency. The rating outlook changed from positive to stable which means that in the mid-term perspective there is a high probability of maintaining the rating score.

MAJOR FACTORS THAT INFLUENCED BOTH TYPES OF RATINGS:

Positive factors:

- The banking sector of Armenia showed a healthy stance at the pre-crisis point. By the end of 1Q 2020 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%. Domestic credit provided by the financial sector and assets to GDP ratios continued its growth in 2019 and reached 65% and 89% respectively, as compared to 62% and 83% in 2018. We expect credit growth to slow down in 2020, but being backed by co- and re-financing government support packages. We also expect deterioration of the banking system metrics by end-2020 with the worsening of asset quality and declining profitability and capitalization metrics. However, the prompt response of the Central Bank of Armenia (CBA), including relaxation of some prudential and reserve requirements and provision of additional liquidity, will help to cushion de blow of the pandemic on the banking system;

- Government debt structure remains favorable. As of May 2020, short-term debt accounted for 4,8% of total debt, 16% had floating interest rate and FX-denominated debt remained elevated at 77%; however, this type of debt remains mostly concessional;

- The inflation rate in 2019 continued its decline and reached 0,7% by the end of the year as compared to 1,8% in 2018. The reading, however, stood well below the initial target of 4% set by the CBA. Such a low level of inflation, allowed the CBA to lower its policy interest rate three times during 1H 2020, the last time being in in June 2020 when it trimmed it down to 4,5%, which is historically the lowest level for this metric, while the inflation rate turned negative by the end of 1Q 2020. We expect that the policy relaxation together with AMD depreciation will elevate the inflation up to 1,5% by the end of 2020. In general, we continue to observe an effective monetary policy with high credibility and an improved transmission mechanism, however, it remains partially distorted by elevated financial dollarization;

- In response to the COVID-19 crisis the fiscal authorities turned to a counter-cyclical loose fiscal policy with accelerated budget support of the economy, at the same time the government keeps improving the quality of such policy by implementing public investment management reforms, Medium-Term Expenditure Framework and program-based budgeting. We assess the quality of the policy as adequate; however, the government's commitments to lower the deficit and debt metrics shall be monitored on the recovery stage;

- Armenia remains attractive for foreign investors, as shown by stable levels of FDI net inflows, which stood at around 2% of GDP over the last two years (1,9% in 2019 as compared to 2,0% in 2018); however, we can expect sharp decrease of FDI in 2020 driven

by the current turbulence in the global economy.

Restricting factors:

- During 2019 the international reserves of the Central Bank of Armenia 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. However, by May 2020 reserves already declined by 5% as compared to the end of year. Despite such drop, the level remains acceptable, covering short-term debt by 9x;

- Estimated GDP per capita in PPP terms for 2019 is expected to be at USD 11,3 th, remaining satisfactory when compared to the average of Armenia's regional non-oil dependent (RNOD) peers[1];

- Despite an improvement in the World Bank governance indicators in transparency of government policymaking and government effectiveness, institutional development in the country remains moderate, corruption remains a drag for economic growth;

- In the face of the COVID-19 economic crisis, the spread between the 10Y U.S. government bond and the USD-denominated Armenian government bond maturing in 2029 increased up to 3,5p.p., but remained acceptable according to our thresholds;

- Reduction of some capital spending, as well as higher than expected budget income, helped the fiscal balance of the government to narrow further with the budget deficit reaching 1% of GDP in 2019, which is 0,8p.p. lower than in 2018. In the face of the COVID-19 crisis, authorities already accelerated spending on healthcare and economic support to vulnerable firms and households (with a total announced assistance package of USD 300 m), while anti-pandemic lockdown measures led to a drop of tax and export revenues. Due to this, we expect the overall fiscal deficit to reach around 5% of GDP by end-2020, but we expect the deficit to go below the 3% threshold as soon as in 2021;

- In 2019 the Armenian economy showed a remarkable growth at 7,6% y-o-y, which is the highest level over the last decade, spurred by internal consumption, manufacturing and service output. However, in 1Q 2019, real GDP growth already slowed down to 3,8%, while the monthly indicator of economic activity[2] in May 2020 showed a contraction of 12,8% as compared to May 2019. Due to the already observed drop in remittances inflow, negative dynamics in most of key industries, including tourism, as well as announced prolongations of lock down measures, we expect an overall contraction of the economy at around 1,5% by end-2020 with a recovery in 2021;

Negative factors:

- More prudent fiscal policy of the government, which led to a narrower deficit, as well as commitment to the debt targets, materialized in the reduction of the government debt load for the second year in a row. The level of public and publically guaranteed debt reached 53,6% of GDP in 2019, while the central government debt dropped below 50%, which is in line with the government's objective. However, due to the current economic crisis, significant fiscal support of the economy and under-performance of the tax collection, we expect a sharp debt increase up to 64% of GDP and 275% of budget revenues by end-2020. At the same time most of this increase is related to the financial support from international organizations, such as IMF and ADB, at concessional terms;

- Levels of unemployment in Armenia remained high in 2019 at 18,9% and are expected to increase slightly up to 19% in the face of the COIVID-19 economic crisis;

- The stock market continues to be underdeveloped, as total market capitalization in the country has remained practically unchanged for the last five years and stood at 2,3% of

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[1] Non-oil dependent peers include Georgia, Kyrgyzstan and Tajikistan.
[2] Indicator of economic activity calculated by the Statistical Committee of the Republic of Armenia on the basis of main sectors performance on a monthly basis.

GDP as of December 2019. Moreover, the trades are highly concentrated in the 10 largest issuers of shares;

- Armenia is ranked 47th out of 190 countries in World Bank Doing Business report 2020, a drop of six places in the comparison with the 2019 results due to very low score on protecting minority investors rights. In addition, the economic competitiveness of Armenia remains limited, as shown by a persistent trade deficit, which stood at 15% of GDP in 2019 and expected to be around 13,6% in 2020.

Stress factors:

- Financial dollarization remains high but is stably declining; loans and deposits in FX were equivalent to 48,8% and 44,6% of total loans and deposits respectively as of May 2020 (weak stress-factor);

- The conflict with Azerbaijan for the Nagorno-Karabakh remains unresolved and escalation is still a latent risk (very weak stress-factor).

SENSITIVITY ASSESSMENT:

The following developments could lead to an upgrade:

- Faster and stronger than expected recovery of the global economy, as well the as main trade partners, including Russia, which can lead to an improvement of the external position of Armenia as well as faster to a recovery from the current crisis;

- Substantial decrease of the public debt and deficit metrics on a recovery phase of the economic cycle;

- Consistent reduction in the dependence on external factors combined with a steep decrease in levels of financial dollarization.

The following developments could lead to a downgrade:

- Continued lock-down measures in the country and longer period of turbulence in the global economy, including a second wave of COVID-19 pandemic, which would lead to further deterioration of the external position, as well as a deeper contraction of local economy;

- Higher than expected increase of the government debt and deficit metrics due to the need of additional financing for the government expenses, and underperforming of tax and external revenues;

- Substantial deterioration of the stance of the banking system with sharp growth of NPLs levels, drop of profitability and capitalization metrics, combined with a lack of liquidity in the system.

ESG Disclosure:

Inherent factors

- Quality of fiscal policy; quality of monetary policy; natural resources; natural and climatic threats; environmental threats; level of corruption, CPI; Government Effectiveness Index; quality of the business environment; position in Doing Business Ranking; level of investment in human capital, adjusted for inequality; Rule of Law Index; transparency of government policymaking Index; level of information transparency of the government; Political Stability and Absence of Violence/Terrorism Index; natural disasters, constant exposure to difficult natural conditions.

Drivers of change factors

- None.

"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." – clarified Vladimir Gorchakov, Associate Director of Rating-Agentur Expert RA.

Research report on Armenia is available at:

https://raexpert.eu/reports/Research_report_Armenia_10.07.2020.pdf

Next scheduled rating publication: TBD in December 2020. The full sovereign rating calendar can be found at Sovereign Rating Calendar 2020

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RATING HISTORY:

Date	Review reason	SGC		Outlook	
		National currency	Foreign currency	National currency	Foreign currency
10.01.2020	Scheduled revision of both types of ratings for the country	BB-	BB-	Positive	Positive
12.07.2019	Scheduled revision of both types of ratings for the country	BB-	BB-	Positive	Positive
18.01.2019	Scheduled revision of both types of ratings for the country	BB-	BB-	Stable	Stable
20.07.2018	Scheduled revision of both types of ratings for the country	BB-	BB-	Stable	Stable
26.01.2018	Scheduled revision of both types of ratings for the country	BB-	BB-	NA	NA
28.07.2017	Scheduled revision of both types of ratings for the country	B+	B+	NA	NA
03.02.2017	Scheduled revision of both types of ratings for the country	B+	B+	NA	NA
05.08.2016	Scheduled revision of both types of ratings for the country	B+	B+	NA	NA
04.03.2016	First assignment of both types of ratings for the country	B+	B+	NA	NA

Minute's summary

The rating committee for Armenia was held on 9 July 2020. 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 – Full Public Version (from April 2019). Descriptions and definitions of all rating categories can be found 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.

The definition of default can be found on the Agency's website in the section for Internal policies.

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, Cbonds, Asian Development Bank.

ESG Disclosure

We consider Environmental, Social, and Governance (ESG) risks and opportunities in the creditworthiness analysis of our Sovereign entities. The disclosure document can be found on the Agency's website in the section: ESG factors in RAEX-Europe's Credit Ratings

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.

Regulatory use

SGC ratings can be used for regulatory purposes according to the ESMA definition.

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.

Risk warning

The Agency disclaims all liability in connection with any consequences, interpretations, conclusions, recommendations and other actions directly or indirectly related to the conclusions and opinions contained in the Agency's press-release and research report.

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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.

Rating-Agentur Expert RA GmbH is a credit rating agency established in Germany and therefore shall comply with all applicable regulations currently in force in the European Union.

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.