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

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 stable to positive which means that in the mid-term perspective there is a high probability of upgrading the rating score.

MAJOR FACTORS THAT INFLUENCED BOTH TYPES OF RATINGS:

Positive factors:

- The fiscal deficit continued to narrow in 2018 down to 1,8% of GDP, even lower than what we anticipated in our earlier review, as compared to 4,8% in 2017. This was a result of better than expected revenue performance; however, it was also caused by underperforming capital expenditure. For 2019, we anticipate the fiscal policy to remain expansionary with additional social and capital expenditures while revenues will see a solid uptick in VAT as well as profit and income tax. In the mid-term, we continue to expect the fiscal policy to turn contractionary;
- The banking sector remains fairly stable with adequate capitalization, strong liquidity, stable asset quality and positive profits. As of May 2019, the regulatory capital to risk-weighted assets was 17,6%, NPLs to total loans stood at 5,3%, ROA and ROE were 1,4% and 9,4% respectively and the ratio of liquid assets to demand deposits was 114%. However, even though domestic credit has increased, it is mostly related to the household sector while corporate loans have been growing at a declining pace. As of May 2019, household loans grew by 31% while loans to non-financial corporations barely grew at 2,1% y-o-y;
- Government debt structure continues to be stable. As of May 2019, short-term debt accounted for 3,6% of total debt, 15,2% had floating interest rate and FX-denominated debt remained elevated at 80,2%; nevertheless, this type of debt remains mostly concessional;
- Economic performance remained robust in 2018 despite having decreased its growth pace down to 5,2% as compared to 7,5% in 2017 as a result of solid private consumption and investment, higher copper prices, stable exports and remittances, albeit slightly declining towards end-2018. However, public spending was weaker than anticipated. We expect growth to be lower in 2019 as a consequence of low copper prices and subdued external demand;
- The inflation rate finished 2018 even lower than originally expected at 1,9% but has slightly picked up the pace in 2019 as the CPI index grew by 2,8% y-o-y as of May 2019. Despite this, sluggish private spending lingers and food prices remain low causing inflation rate to remain off the Central Bank of Armenia (CBA) target of 4%. As a result, the CBA continues with its expansionary monetary policy as it slashed the policy rate by 25b.p. back in January 2019 down to 5,75%. In general, we continue to observe effective monetary policy with high credibility and an improved transmission mechanism which has contributed to the fall of lending rates;
- The quality of the fiscal policy continued to improve as the budget balance heads towards consolidation while at the same time prioritizing relevant expenses such as capital and

social. Moreover, government debt continues to decline and we anticipate the metric to keep a downward trend. Finally, the government will introduce in 2020 a new tax policy where the profit and dividend tax rates will be reduced and measures will be introduced to compensate for the cuts;

- Armenia has a strong investment potential as showed by a net FDI inflow to GDP at 2% in 2018.

Restricting factors:

- International reserves stood at USD 2,1 bn as of May 2019, only a slight decrease from the figure recorded at the end of 2018. Short-term debt coverage also decreased and now stands at 9x, which is considered as acceptable level;
- GDP per capita in PPP terms posted a figure of USD 10,2 th in 2018. The reading remains quite acceptable when compared to the average of Armenia's regional non-oil dependent (RNOD) peers[1];
- The inflation rate reading came in lower than expected at the end of 2018 at 1,8%. We anticipate the metric to remain stable and slightly higher in 2019 as it converges towards the CBA target of 4%;
- Institutional development in the country remains bearable as there are good conditions for business in the country, with a moderate rule of law and government transparency. Nonetheless, corruption remains a drag for economic growth;
- The spread between the 5Y U.S. government bond and the USD-denominated Armenian government bond maturing in 2025 remained satisfactory as it stood at 2,3p.p.

Negative factors:

- The level of government debt continues in a declining trend and it reached a level of 51,4% of GDP and 237,3% of budget revenues in 2018. Public debt (which includes debt from the CBA) also declined down to 55% of GDP. We expect the government to achieve its goal of lowering debt under the 50% of GDP threshold in the mid-term perspective;
- Levels of unemployment in Armenia remained high in 2018 at 18%;
- The underdevelopment of the stock markets is still a negative factor affecting the creditworthiness of Armenia. As of April 2019, market capitalization in the country remained practically unchanged from year-end 2018 at 2,4% of GDP;
- The country's position in the Global Competitiveness Ranking of the World Economic Forum improved slightly in 2018 as the country was ranked 70th of 140 countries (73rd in 2017). However, business remains dominated by oligopolies and the economy relies heavily on imports, with a trade deficit expanded up to 15,4% of GDP in 2018 as compared to 12,2% a year ago.

Stress factors:

- Financial dollarization remains high but stably declining; loans and deposits in FX were equivalent to 49,9% and 50,8% of total loans and deposits respectively as of May 2019 (weak stress-factor);
- The conflict with Azerbaijan for the Nagorno-Karabakh remains unresolved and escalation is still a latent risk (very weak stress-factor).

[1] Non-oil dependent peers include Georgia, Kyrgyzstan and Tajikistan.

SENSITIVITY ASSESSMENT:

The following developments could lead to an upgrade:

- Consistency in the already evidenced favorable fiscal consolidation: narrowing of the fiscal balance and drop of government and public debt levels as well as successful implementation of tax policies;
- 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:

- Further widening of the fiscal balance and a sustained increase on government debt in the mid- to long-term perspective.

"The confirmation of Armenia's ratings at 'BB-' along with our decision to change the outlook from stable to positive is mainly driven by continuous and stable improvement of the fiscal stance of the country which includes narrowing of the fiscal balance and drop of public debt levels, as well as efficient and favorable quality of the monetary policy, while economic growth remains stable. Furthermore, government debt structure is still positive.

Nonetheless, government debt is still high and the country's main downside risk is the potentially high spillover effects it would suffer in case external shocks were to occur as the economy remains highly dependent on external factors such as remittances inflows, imports and commodities' exports. Finally, despite financial dollarization having decreased, it remains fairly high" – Clarified Hector Alvarez, Associate Director of Rating-Agentur Expert RA.

Research report on Armenia is available at:

https://raexpert.eu/reports/Research_report_Armenia_12.07.2019.pdf

Next scheduled rating publication: TBD in December 2019. The full sovereign rating calendar can be found at Sovereign Rating Calendar 2019

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RATING HISTORY:

Date	Review reason	SGC		Outlook	
		National currency	Foreign currency	National currency	Foreign currency
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 12 July 2019. 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.

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.

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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.