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Ratings

Sovereign Government Credit (LC)	**BB-**
Sovereign Government Credit (FC)	**BB-**
Outlook (LC)	**Positive**
Outlook (FC)	**Positive**

* These ratings are unsolicited

Ratings dynamics

☐ SGC (LC)   ☐ SGC (FC)

	BB-	BB-		BB-	BB-		BB-	BB-
Jan 2019			Jul 2019			Jan 2020		
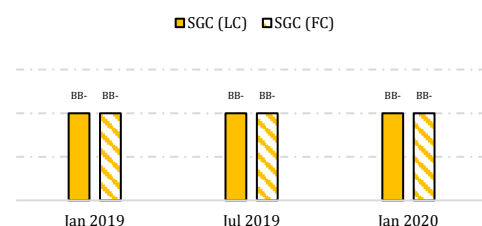
Main Economic Indicators of Armenia

Macro indicators	2017	2018	2019*
Gross gov. debt, AMD bn	2980	3082	3274
Nominal GDP, AMD bn	5569	6005	6541
Real GDP growth, %	7,5	5,2	6,0
Gross gov. debt/GDP, %	53,5	51,3	51
Deficit (surplus)/GDP, %	-4,8	-1,8	-1,5
Inflation rate, %	2,7	1,9	1,5
Current Account Balance/GDP, %	-	-	-7,4
External debt, USD bn	-	-	5,6

Development indicators	2019
Inequality adj. HDI	0,68**
GDP per capita, USD th	11,1

Default indicator	10.01.2020
10Y Gov Bond Yield, %	4,13***

Source: RAEX-Europe calculations based on data from the IMF, WB, UN, Armenia Ministry of Finance, CBA, Finanzen.net
*Forecast ** Figure from 2018 *** Maturity in 2029

Summary

The confirmation of sovereign government credit ratings of Armenia at 'BB-' with positive outlook reflects the continued high economic growth supported by stabilization of the fiscal balance and drop of public debt levels. Furthermore, the quality of the monetary and fiscal policies remains efficient and adequate.

Nevertheless, government debt levels continue to be elevated and exposed to currency risks. In addition, the economy is highly dependent on imports, remittances inflow and main trading partners. Finally, the current account remains negative, making the weak external position one of the key factors constraining the rating.

Economy shows remarkable growth in 2019. The economic activity remained strong during 3Q 2019, driven by solid private consumption and investment, mainly in the construction sector. On the production side, the largest growth belongs to the mining industry with a 45,2% increase since the beginning of the year. However, the energy sector, which is considered an important industry for economic diversification, decreased by 3,5% within the same time frame.

Estimated real GDP growth for 2019 is 6-7%, the highest in the Caucasus region (see graph 1). The large Amulsar gold project run by the foreign company Lydian International is currently facing environmental concerns from Armenian authorities; despite this, the opening of the new gold mine operation will have a positive impact on economy growth.

The banking sector remains stable. Commercial banks are well-capitalized and have sufficient liquidity. According to the Central Bank of Armenia (CBA), regulatory capital to risk-weighted assets indicator is stable at 17,5% as of October 2019, a 0,1 p.p. decrease since our previous review in July 2019. The NPLs to total loans ratio remained stable at 5,2%, however, the real asset quality improvement might be lower due to the overall loans growth. Profitability remained subbed and volatile, ROA stood at 1,7% and ROE 11,1% in October 2019, despite an annual improvement of 0,1 p.p. and 1,7 p.p. respectively.
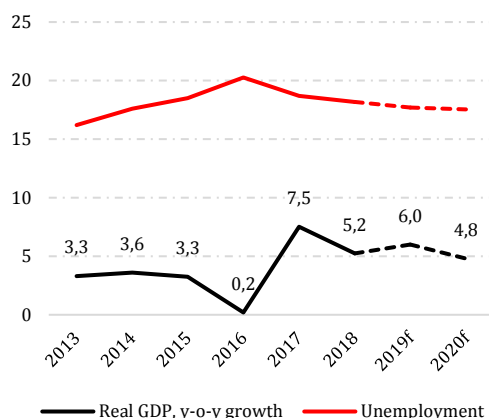
Domestic credit provided by financial sector to GDP is expected to rise by 4% in 2019 up to 67% as total loans grew by 13% since the beginning of the year; it is mostly related to the household sector (increase of 27%) and not to the corporate sector, which contributes to production and growth of

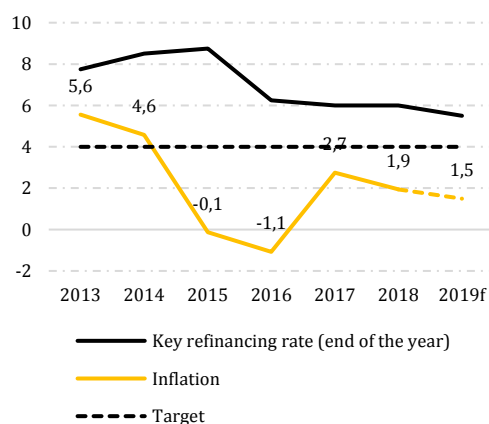**Graph 1:** Macroeconomic indicators, %

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

Graph 2: Government debt dynamics, %
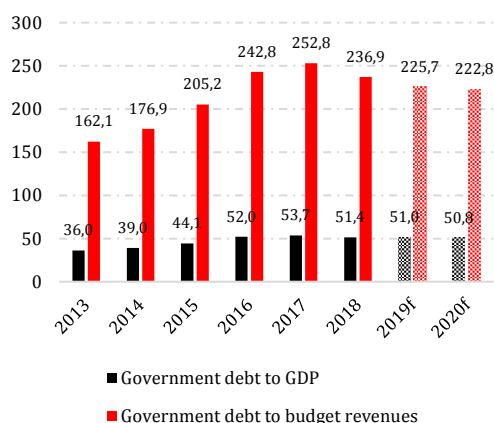
Source: RAEX-Europe calculations based on data from the IMF and Ministry of Finance of the Republic of Armenia

Graph 3: Target vs inflation rate, %

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

the real economy. In order to control rapid consumer lending growth, the CBA tightened the capital adequacy ratio from January 2020 by introducing tree Basel III standards: buffer for systemically important banks, capital conservation buffer and a counter-cyclical buffer. Another aim of the requirements is to create additional reserves to protect the banking system from external shocks and financial instabilities.

Despite the positive trend, financial dollarization continues to be high, as 50% of total loans and 47,3% of total deposits of the residents were denominated in the foreign currencies as of November 2019. Moreover, more than 42% of total banking system assets are concentrated in the hands of the top-3 banks.

Government debt continues in a downward trend. In 2019, Armenia came very close to the target of 50% debt to GDP set by the fiscal rule introduced in 2018, as according to preliminary data government debt will be close to 51% of GDP and 212 % of budget revenues (see graph 2). The structure of the public debt continues to be stable. As of November 2019, short-term debt accounted for 4,6% of total debt, 15% had floating interest rate and FX-denominated debt remained elevated at 78,6%; nevertheless, this type of debt remains mostly concessional.

The 10-year USD-denominated Eurobond issued by the government in September 2019 has a yield spread of around 2,3 p.p. with USA bonds with the same maturity, reflecting relatively low risk.

The CBA continues with its expansionary monetary policy. The low inflation environment allowed the CBA to take action and cut the refinancing rate twice in 2019 by 0,25p.p. each time down to 5,5%. Nevertheless, the inflation rate in 3Q 2019 was 1%, which is lower than originally expected and well below the CBA initial target of 4% (see graph 3). We can expect further monetary policy stimulus of CBA in order to bring inflation closer to the target in 2020. The effect of the monetary policy transmission mechanism together with the stable local currency was reflected in declining dollarization trend (see graph 4).

The fiscal environment continues to improve. Contractionary fiscal policy allowed to narrow budget deficit further in 2019 with the final estimation for the year 1,5% of GDP, lower by 0,7p.p. than initially targeted in the State Budget law and 0,3 p.p. narrower than previous year result (see graph 5) due to the higher VAT revenues and capital underspending.

In the mid-term, we continue to expect the fiscal policy to remain prudent and as government introduced in 2020 a new tax policy to decrease a tax burden, fight shadow economy and improve tax administration. The corporate income tax was reduced by 2p.p. to 18,0% and the tax on dividends for non-resident organizations by 5p.p. to 5,0%, while Personal
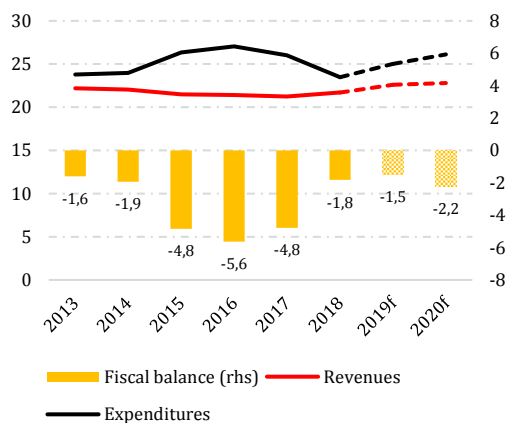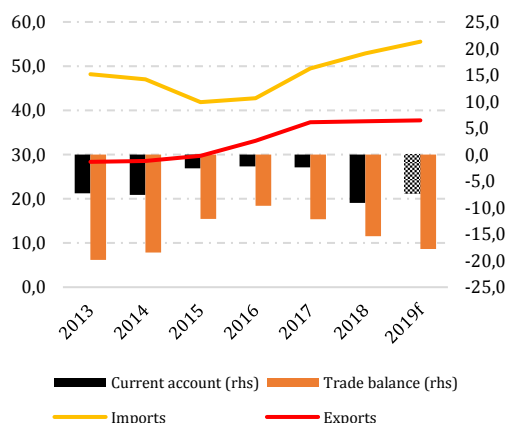
Graph 4: Financial dollarization, % of total
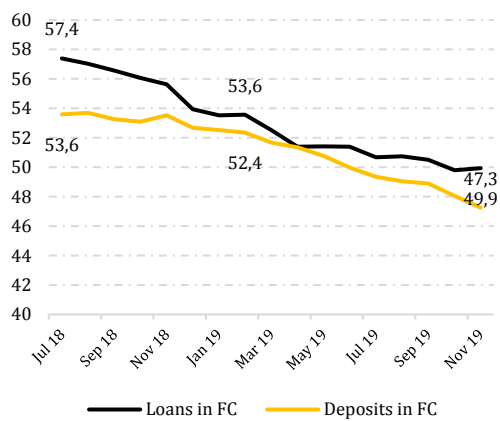
Source: RAEX-Europe calculations based on data from the CBA

Graph 5: Fiscal budget dynamics, % of GDP

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

Graph 6: External sector indicators, % of GDP

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

Income Tax (PIT) was changed to a fixed level of 23%. Higher taxes on special activities and removing several tax exemption should offset the rates cuts, however, the Agency will observe carefully the effects of the new tax system, in terms of budget tax revenues generation and a change of income disproportion within the population.

According to the Medium Term Expenditure Framework for 2020-2022 there will be a change in the budget expense structure with higher capital expenditure prioritization and the budget deficit to GDP ratio around 2,2%.

External position continues to deteriorate. The estimated current account deficit of Armenia is 7,3% of GDP in 2019. The country is heavily dependent on imports and the trade deficit is expected to expand further in 2019 until up to 18% of GDP, 3p.p. higher than in 2018 (see graph 6) due to unfavorable prices on the main export commodity – cooper ore. The wider trade deficit was partly offset by stronger transfers from abroad, 6% y-o-y increase in 3Q 2019.

Starting from January 2020, Armenia will be affected by new import customs duties from the countries that are not members of the Eurasian Economic Union (EAEU), such as USA, Brazil and Ukraine, potentially increasing overall imports. Additionally, the results of the import substitution policy in Russia regarding the food industry had a negative effect on neighboring countries' exports.

At the end of 2019, Gazprom Export LLC signed a new one-year contract with Gazprom Armenia CJSC to supply gas to Armenia in 2020 on the same terms as in 2019 (with a discount of 30%). However, there is a risk of gas prices to rise in 2021 significantly impacting the trade balance, as petroleum gas forms up to 10% of total imports.

Nevertheless, international reserves remained acceptable at USD 2,4 bn as of November 2019, covering short-term debt by 8x.

In 2019, the government adopted a five-year program, which outlines the main foreign relationship development directions and anti-corruption policies in order to improve the investment climate. Despite all the potential, FDI inflows to GDP will remain at 2% in 2019, an average rate for the last five years.

The conflict with Azerbaijan for the Nagorno-Karabakh remains unresolved and has a potential to escalate. Moreover, rising global trade and political tensions could cause a slowdown in Armenia's main trading partners.

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_10.01.2020.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.