Research Report on Armenia

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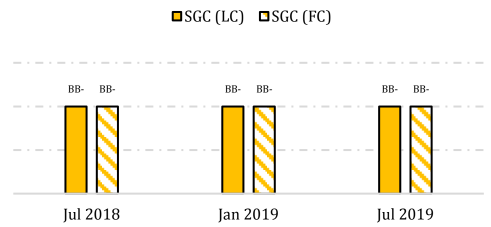
Ratings

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

* These ratings are unsolicited

Ratings dynamics



Main Economic Indicators of Armenia

Macro indicators	2016	2017	2018
Gross gov. debt, AMD bn	2628	2980	3086
Nominal GDP, AMD bn	5067	5569	6003
Real GDP growth, %	0,3	7,5	5,0
Gross gov. debt/GDP, %	51,9	53,5	51,4
Deficit (surplus)/GDP, %	-5,6	-4,8	-1,8
Inflation rate, %	-1,1	2,7	1,8
Current Account Balance/GDP, %	-	-	-9,1
External debt, USD bn	-	-	10,9

Development indicators	2018
Inequality adj. HDI	0,68**
GDP per capita, USD th	10,2

Default indicator	12.07.2019
6Y Gov Bond Yield, %	4,07*

Source: RAEX-Europe calculations based on data from the IMF, WB, UN, Armenia Ministry of Finance, CBA, Cbonds
* Maturity in 2025 ** Figure from 2017

Summary

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.

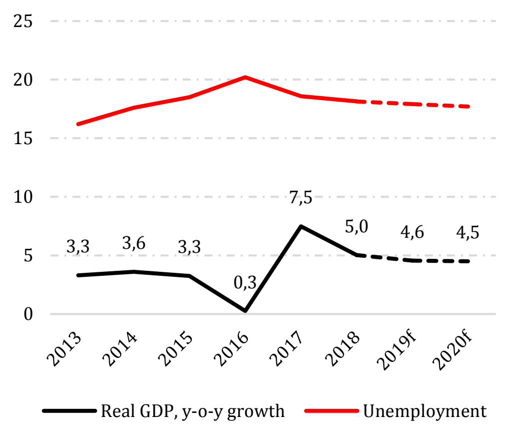
Real GDP growth remains strong. Real GDP growth posted a reading of 5,2% in 2018 resulting from solid private consumption and investment, higher copper prices, as well as stable remittances and exports; however, public spending was weaker than anticipated and construction and agricultural production were lower. In addition, the unemployment figure in Armenia remains quite high as, by the end of 2018, it stood at 18% (see graph 1).

We expect economic output to remain robust at around 4,6% in 2019; nevertheless, the metric will read lower as a consequence of low copper prices and stable but subdued external demand as a result of global trade tensions. Furthermore, the political situation in the country is currently more stable which, in our view, will cope well for additional foreign investment and stable economic growth.

Finally, we believe that the set for structural reforms being implemented by the government, such as, governance, tax policy framework and labor market reforms, if successfully implemented, will enhance the economy in a considerable manner.

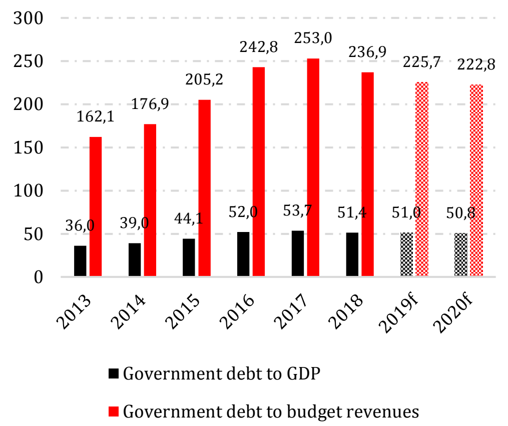
The banking system remains stable. Official metrics from the banking system show low overall risk in the sector. Financial soundness indicators of the system reflect adequate capitalization, strong liquidity, stable and favorable asset quality as well as positive financial results. As of May 2019, the regulatory capital to risk-weighted assets was 17,6%, while the capital

Graph 1: Macroeconomic indicators, %



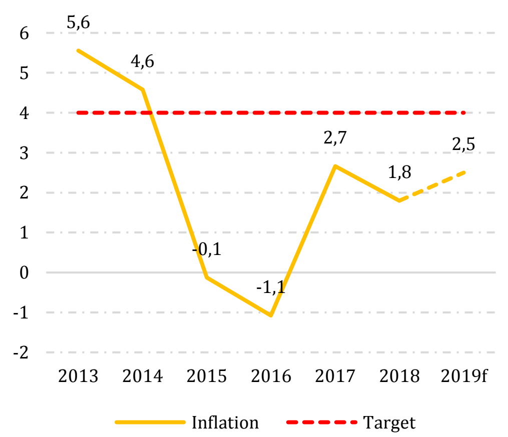
Source: RAEX-Europe calculations based on data from the IMF and ADB

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

to assets ratio stood at 15%. Moreover, NPLs to total loans posted a quite stable figure of 5,3% in the Central Bank of Armenia (CBA) definition of one day past due. In terms of profitability, it has been consistently positive since the beginning of 2017 and ROA and ROE were 1,4% and 9,4% respectively while the ratio of liquid assets to demand deposits was 114% by May 2019.

However, even though domestic credit has increased to 62,5% of GDP in 2018 as compared to 58,3% in 2017, it is mostly related to the household sector. This growth should be monitored as there is an excess of liquidity in the banking system and consumer lending has been rapidly growing which could mean lack of risk awareness from banks. On the other hand, non-financial 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.

Financial dollarization levels in the country continue in a downward trend as both FX-denominated loans and deposits have declined down to 49,9% and 50,8% respectively as of May 2019. Nevertheless, the banking system remains concentrated as the top-3 banks account for around 42% of total assets.

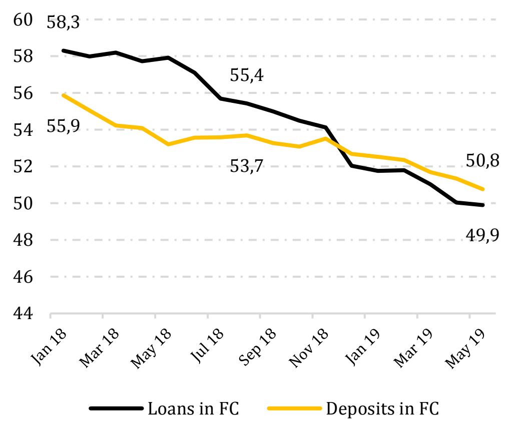
Government debt starting to head downward. Government debt continues to point down as a result of the government plan to bring debt down to under 50% of GDP as of 2023. By the end of 2018, government debt reached a level of 51,4% of GDP and 236,9% of budget revenues (see graph 2). Public debt (which includes debt from the CBA) also declined down to 55% of GDP. We expect the government to achieve the aforementioned goal of lowering debt under the 50% of GDP threshold according to the plan.

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.

Monetary policy to remain accommodative. As a result of inflation metrics being below the target and inflation expectations remaining depressed, the CBA continues to implement a loose monetary policy.

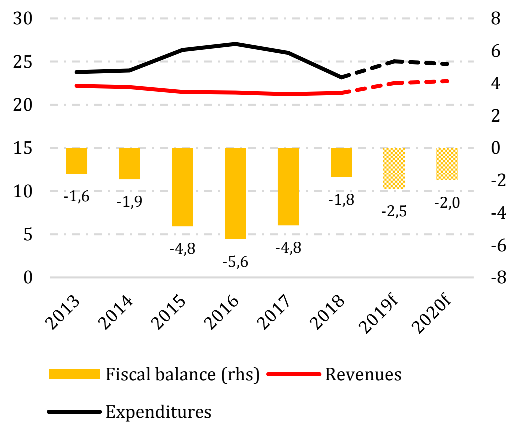
Since the beginning of 2018, inflation has been suffering downward pressures and by the end of 2018 the inflation rate was even lower than originally expected standing at 1,8% (see graph 3). This has been the reflection of lower domestic demand as well as depressed food prices. As a result, the CBA continues with its expansionary monetary policy as it slashed the policy rate by 25b.p. back in January 2019 down to 5,75% causing inflation to pick up the pace in 2019 as the CPI index grew by 2,8%

Graph 4: Financial dollarization, % of total



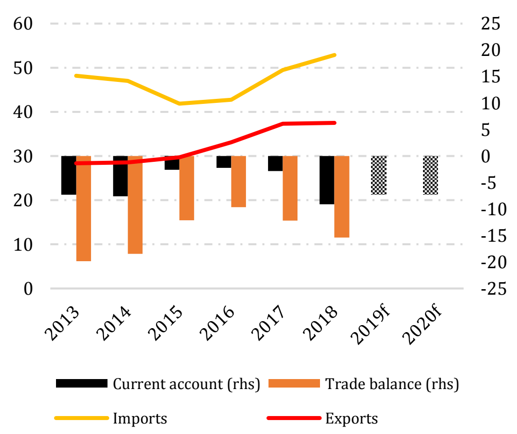
Source: RAEX-Europe calculations based on data from the CBA

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

y-o-y by the end of May. The slash in the rate was also effectively transmitted to the financial sector as we also saw declines in the banks' interest rates. Moreover, we have seen a more stable exchange rate and balanced levels of inflation and de-dollarization measures have been so far successful (see graph 4).

Despite this, sluggish private spending lingers, food prices remain low and the inflation rate is still off the Central Bank target of 4%. Going forward, we anticipate further cuts in the reference rate from the CBA if inflation were not to pick up and non-finance corporate credit growth remains staled. Moreover, we also expect the exchange rate to continue to be dictated by the market with the CBA only intervening slightly to absorb potential shocks.

The fiscal environment continues to improve. The effectiveness of the fiscal policy implementation remains in a favorable path towards consolidation. The budget deficit narrowed further in 2018 down to 1,8% of GDP as revenues were better than expected; however, the decline was also due to capital underspending. In any case, we anticipate this type of expenditure to rise in the current year thus expanding the deficit slightly to around 2,5% of GDP in 2019 as the fiscal policy will remain slightly expansionary (see graph 5). We also foresee additional social expenditures while revenues will see a solid growth as a result of tax policies and better tax administration.

In the mid-term, we continue to expect the fiscal policy to turn contractionary. The government will also 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, such as taxes on special items and removing tax exemptions.

External stance still weak. The main source of risk for the economy is the high dependence of Armenia on the external sector. Despite the economy growing at stable levels, it still has no strong foundation for growth in terms of domestic production. The consumption is mostly fueled by remittances inflow and it relies heavily on imported products.

Armenia's trade deficit expanded up to 15,4% of GDP in 2018 as compared to 12,2% in 2017 as a result of a pick-up in imports due to additional domestic demand while exports were lower. Moreover, the current account deficit widened to 9,1% as the primary income was lower resulting from an exodus of profits (see graph 6).

International reserves remained acceptable at USD 2,1 bn as of May 2019, covering short-term debt by 9x. Finally, the conflict with Azerbaijan for the Nagorno-Karabakh remains unresolved and escalation is still a latent risk.

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_12.07.2019.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.