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Research Report on Armenia

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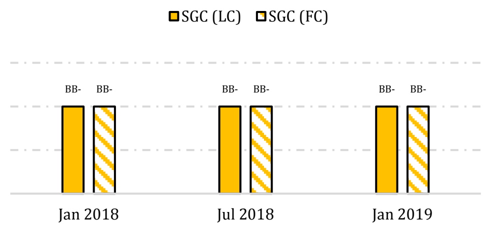
Ratings

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

* These ratings are unsolicited

Ratings dynamics



Main Economic Indicators of Armenia

Macro indicators	2016	2017	2018f
Gross gov. debt, AMD bn	2628	2980	3137
Nominal GDP, AMD bn	5067	5569	6143
Real GDP growth, %	0,3	7,5	5,3
Gross gov. debt/GDP, %	51,9	53,5	51,1
Deficit (surplus)/GDP, %	-5,6	-4,8	-2,7
Inflation rate, %	-1,1	2,7	2,7
Current Account Balance/GDP, %	-	-	-4,1
External debt, USD bn	-	-	261,5*

Development indicators	2018f
Inequality adj. HDI	0,67**
GDP per capita, USD th	10,3

Default indicator	18.01.2019
10Y Gov Bond Yield, %	5,92***

Source: RAEX-Europe calculations based on data from the IMF, WB, UN, Armenia Ministry of Finance, CBA, Cbonds
* Figure for 2Q 2018 ** Figure from 2017 *** Maturity in 2025

Summary

The confirmation of Armenia's ratings at 'BB-' with a stable outlook reflects a well-managed, effective and credible monetary policy, successful consolidation efforts of public finances, as well as robust and stable economic growth. Moreover, the structure of government debt remains quite favorable despite most of the obligations being of external nature. Also, we consider that the political risk has been reduced as the new government won by a high margin in the past December elections.

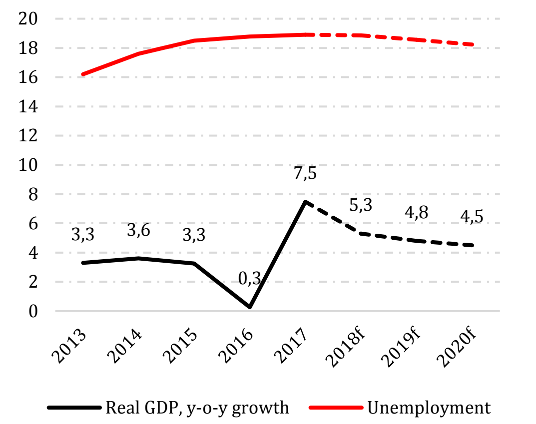
Despite this, government debt is still elevated and the country remains highly exposed to external factors as the economy is still highly dependent on remittances inflows, imports and commodities' exports. Moreover, despite financial dollarization and government debt having decreased, they remain fairly high.

The economy remains robust. After real GDP grew by 7,5% in 2017, it slightly slowed down in 2018 and we expect growth to have been at around 5,3%, still a very solid figure (see graph 1). The reading was mainly affected by lower agricultural production and fairly lower level of growth in the construction sector. On average, private consumption and investment were solid throughout the year. Moreover, higher copper prices, stable remittances and exports also contributed positively to growth. However, government expenditures were lower than anticipated as the authorities held off many planned expenses as a result of a thorough review of the structure of public finances. In addition, towards year-end 2018, we have seen remittances inflow decline, which have hurt private consumption figures, and also a y-o-y reduction in exports as a result of weaker external demand.

As we previously expected, the interim government of prime minister Nikol Pashinyan maintained economic stability in 2018 all the way into the snap election where his party obtained the majority of votes. In this regard, we anticipate political risks to be lower and investor confidence to have picked up.

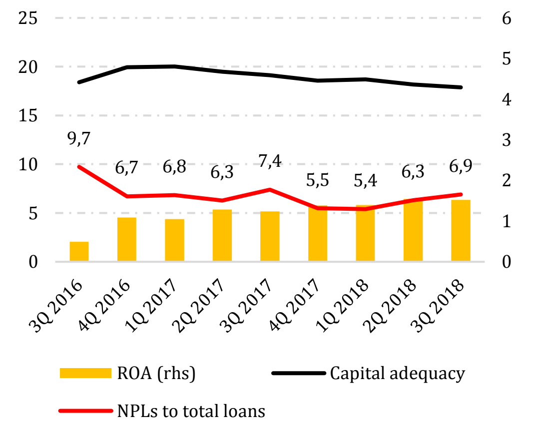
In general we anticipate growth to remain robust for the next years under the assumption of robust external demand, favorable macroeconomic policies of the new government and low inflation environment. However,

Graph 1: Macroeconomic indicators, %



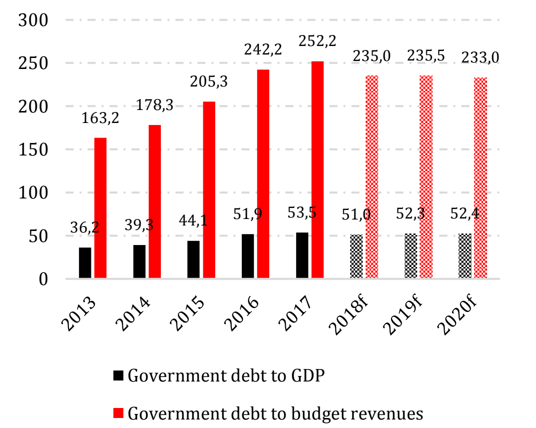
Source: RAEX-Europe calculations based on data from the IMF and ADB

Graph 2: Financial soundness indicators, %



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

Graph 3: Government debt dynamics, %



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

this could be disrupted by a continued decline in copper prices, slowdown in remittances inflow and lower growth in regional partners.

The banking sector remains balanced. Financial soundness indicators of the system reflect stability. As of September 2018, the capital adequacy ratio stood at 17,9% and the ratio of liquid assets to short-term liabilities was 126,5%. The ratio of NPLs to total loans, despite having slightly increased since 2017, was acceptable at 6,9%. In regard to profitability, the reading remained positive as ROA stood at 1,5% and ROE at 9,5% (see graph 2).

Moreover, we expect bank assets to GDP to have grown slightly by about 1p.p. and to have finished 2018 at around 80% of GDP. In the same line, credit to the economy has picked up throughout 2018, which has driven private consumption upwards: as of November 2018, loans had grown by around 20,3% y-o-y and we project domestic credit to GDP to have ended 2018 in the range between 60%-62%. What is more, this growth has been dominated by loans to non-financial corporations; y-o-y growth of this type of loans was as much as 144% as of November 2018.

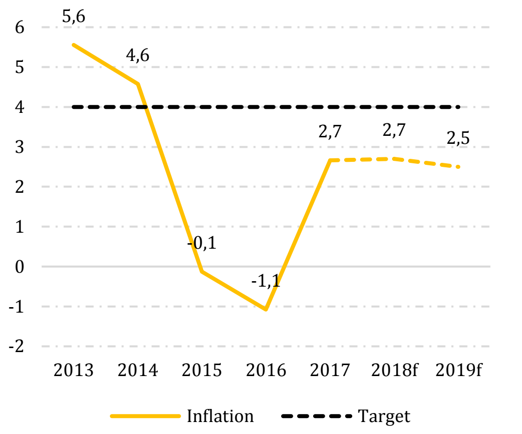
Financial dollarization levels in the country have declined for both loans and deposits. Nevertheless, the banking system remains concentrated as the top-3 banks account for around 41% of total assets.

Government debt starts to stabilize. Government debt is expected to have ended 2018 at around 51,1% of GDP, a 1,5p.p. decrease as compared to 2017. According to our estimate, it would be the first time debt-to-GDP levels decline y-o-y since 2010. Public debt, which includes obligations from the Central Bank of Armenia (CBA), is also expected to have declined. Moreover, we also anticipate debt to budget revenues to have gone downwards by as much as 17p.p. down to 235% in 2018 (see graph 3). Both indicators are a positive reflection of the consolidating efforts by the authorities. As mentioned in our previous report[1], government debt metrics remain quite high as compared to Armenia's non-oil dependent peers[2]. Despite this, we anticipate the government to continue consolidating public finances causing debt levels to decrease further going forward.

In regard to the government's debt structure, we continue to assess this as positive. First of all, the structure of the government's obligation has remained nearly unchanged for the past year. As of November 2018, short-term debt accounted for 2,6% of total debt, 14,3% had floating interest

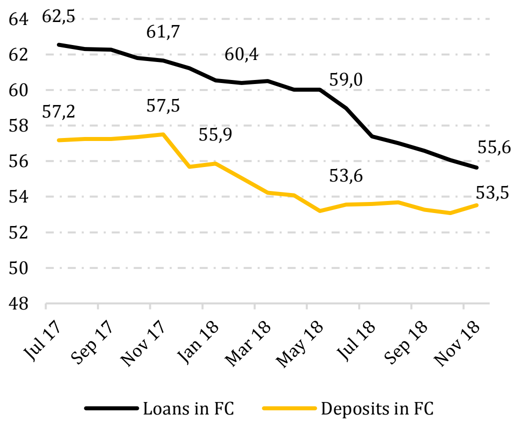
[1] Research report on Armenia from 20 July 2018 (https://raexpert.eu/reports/Research_report_Armenia_20.07.2018.pdf).
[2] Non-oil dependent peers include Georgia, Kyrgyzstan and Tajikistan.

Graph 4: Target vs inflation rate, %



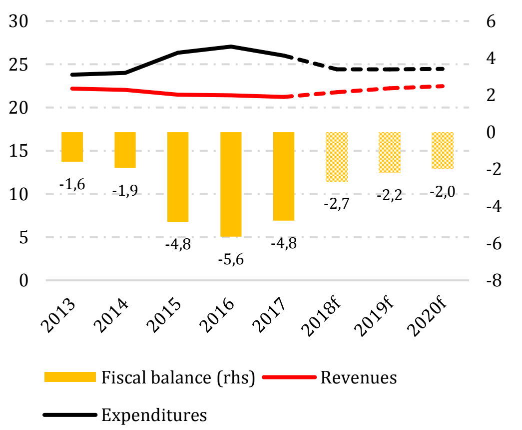
Source: RAEX-Europe calculations based on data from the CBA, IMF and ADB

Graph 5: Financial dollarization, % of total



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

Graph 6: Fiscal budget dynamics, % of GDP



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

rate and FX-denominated debt remained elevated at 80,7%; nevertheless, conditions of this type of debt are mostly favorable.

Monetary policy to remain loose. In the last meeting of the CBA before the end of 2018, it was decided to leave the refinancing rate at 6% committing to keep an expansionary policy given that inflation remains stalled as a result of lower food prices and weaker demand towards year-end 2018. What is more, the level of core inflation was equivalent to the level of overall inflation. Since the target of the Central bank is 4%, we expect the expansionary policy to continue as the CPI growth rate approaches this level (see graph 4).

Overall, we continue to observe an effective monetary policy. The level of inflation remained practically unchanged from 2017 to 2018. This is the most stable the metric has been in recent years. The improvement in the credibility of the policy is partly due to the steps the CBA is taking towards reducing financial dollarization and the fact that the exchange rate has remained fairly stable. However, despite levels having decreased, we still consider dollarization in Armenia to be elevated (see graph 5).

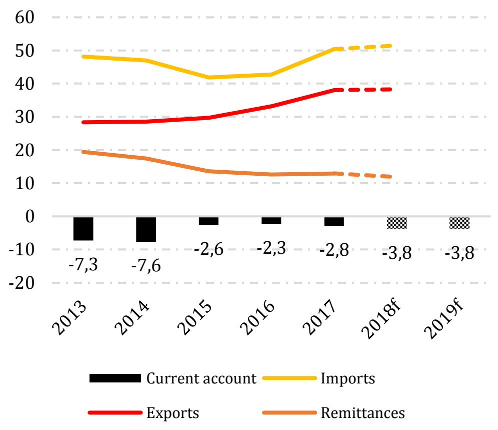
Fiscal consolidation is underway. As shown by reported figures, the fiscal consolidation plan from the authorities has been efficient so far. We expect the fiscal deficit to have narrowed down to about 2,7% of GDP in 2018, which is lower than expected given the contractionary fiscal policy implemented by the government along the year (see graph 6). As the new government has implemented expenditures revision efforts, the expenses set out in the 2018 budget at the end of 2017 were not completely carried out. The budget approved for 2019 already includes the new fiscal rules the goal of which is to stabilize debt without hurting economic growth (e.g. issued debt will only be used for capital expenditures and not current). Also, in the mid-term perspective we still expect the fiscal policy to be contractionary.

At the same time, we anticipate a substantial revamp of the tax reform which we expect will spur the development of SMEs and attract foreign investments. The new policy consists of reducing the profit and dividend tax rates and increasing sales tax rates to compensate for the cuts.

External exposure still a source of risk for Armenia. Despite the fact that Armenia's growth has been solid and the general economy has been resilient to external shocks, as shown by stable inflation figures and a solid banking sector, latent risks from abroad remain a concern for the country.

Armenia's expanding trade deficit, expected at around 13% of GDP in 2018, reflects the country's high dependence on imports. In addition, remittances and commodities exports are important pillars for the

Graph 7: External sector indicators, % of GDP



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

economy. In this sense, the country can be negatively affected in 2019 as we have already observed price decreases in minerals such as cooper. Moreover, towards the end of 2018 we have seen a slowdown in exports of goods and services, as a result of lower external demand (see graph 7). Imports have been also increasing at a declining pace as domestic consumption was modest in 2H 2018. Also, remittances grew by almost nil y-o-y in 2Q 2018 and they declined by 7% in 3Q 2018. This contributed to lower domestic consumption and declining aggregate demand.

Finally, as a result of the new government elected back in December 2018 we do not expect any disruption or deviation in the Russia-Armenia relations. However, 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_18.01.2019.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.