INTERNATIONAL GROUP OF RATING AGENCIES
RAEX EXPERT RA RATING AGENTUR EUROPE
Moscow - Ekaterinburg - Almaty - Minsk - Frankfurt - Hong-Kong

Research Report on Armenia

20 July 2018

Responsible Expert:

Hector Alvarez
Rating Associate

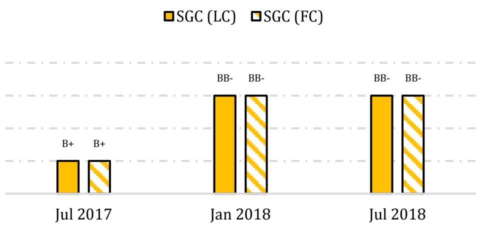
For further information contact:
Rating-Agentur Expert RA GmbH
Walter-Kolb-Strasse 9-11,
60594 Frankfurt am Main, Germany
+49 (69) 3085-45-00
E-mail: info@raexpert.eu
www.raexpert.eu

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	2015	2016	2017
Gross gov. debt, AMD bn	2225	2628	2980
Nominal GDP, AMD bn	5044	5080	5574
Real GDP growth, %	3,3	0,3	7,5
Gross gov. debt/GDP, %	44,1	51,7	53,5
Deficit (surplus)/GDP, %	-4,8	-5,6	-4,8
Inflation rate, %	-0,1	-1,1	2,6
Current Account Balance/GDP, %	-	-	-2,6
External debt, USD bn	-	-	10,5

Development indicators	2017
Inequality adj. HDI	0,67
GDP per capita, USD th	9,5

Default indicator	20.07.2018
10Y Gov Bond Yield, %	5,96

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

Summary

The confirmation of Armenia's ratings at 'BB-' with a stable outlook is underpinned by a strong and resilient banking sector, consistent and solid economic growth, effectiveness of the monetary policy and improving fiscal consolidation efforts by the authorities.

However, the creditworthiness of the sovereign remains constrained by high levels of financial dollarization, elevated government debt levels and high exposure to potential external shocks given the country's high dependence on remittances, imports and commodities' exports. Moreover, even though we consider that the recent political turmoil will not have a material impact on the long-term creditworthiness, it could hurt investor confidence adversely affecting investment in the economy.

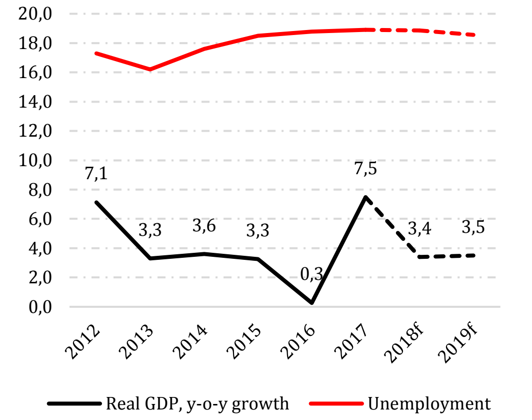
Outstanding economic growth in 2017. Real output increased as much as 7,5% y-o-y in 2017 on the back of higher industrial production, growth in overall trade (especially mineral products), a hike in the services sector and increase in construction. This has been the highest growth figure since 2007 when the economy grew at a pace of 13,7%. Positive real GDP figures were also posted at the beginning of 2018 confirming the positive momentum in the economy (see graph 1).

We expect growth rates to be lower going forward, however, still solid at an average of around 3,5% in the next three years. This will be the result of improving regional conditions translating in higher exports, which will also be propelled by a better outlook on minerals' prices, especially copper, Armenia's main export product. This scenario will also benefit remittances inflows.

Recent political turmoil in Armenia was well weathered by the economy as macroeconomic figures remained quite stable and so did the Armenian financial system. However, we still consider that this situation could potentially hurt foreign investment in the country. Going forward, we expect the government of the newly appointed prime minister Nikol Pashinyan to maintain stability before snap elections take place at the beginning of 2019.

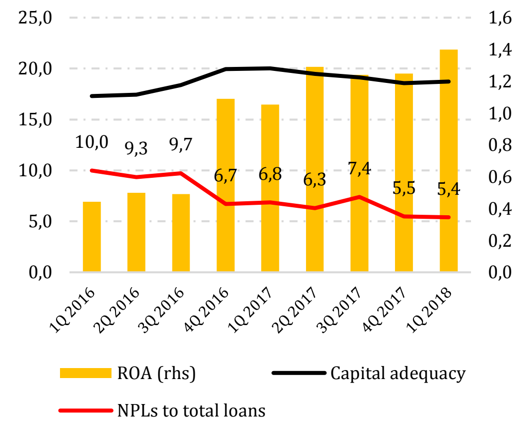
The banking sector remains solid. Banks' assets to GDP in 2017 remained practically similar to 2016 at 78%, while domestic credit to GDP hiked by almost 4p.p. up to 58,2%. This metric has shown a stable increase for the last six years and the positive figures continue to be a result of favorable local currency interest rates in the market and a continuing

Graph 1: Macroeconomic indicators, %



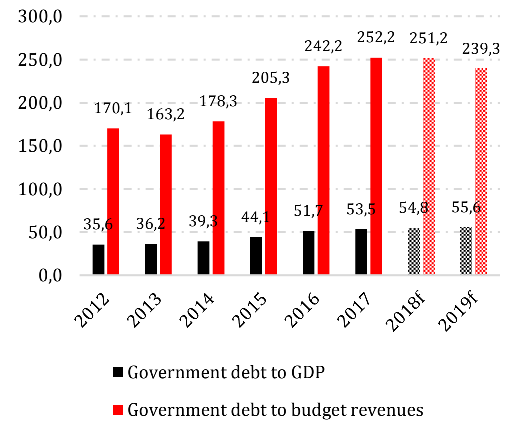
Source: RAEX (Europe) calculations based on data from the IMF

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

narrowing spread between AMD and USD loans (5p.p. as of May 2018). More importantly, credit has also started to grow in the non-financial corporates sector; as of May 2018, it had grown by more than 80% y-o-y in absolute terms. This, coupled with other de-dollarization measures by the CBA, have caused financial dollarization levels to decline further. As of May 2018, FX loans stood at 60% of total loans and FX deposit represented 53,2% of total deposits. Despite such improvements, dollarization levels remain high and could destabilize a so-far effective monetary policy.

Capitalization levels in the Armenian banking sector are still high as the capital adequacy ratio was 18,7% as of March 2018 and has remained stable for the past years. Moreover, as of the same date, NPLs to total loans stood at 5,4% and ROA posted a figure of 1,4%. These metrics reflect the continued stability of the system (see graph 2).

Nevertheless, the banking system remains concentrated as the top-3 banks account for around 41% of total assets.

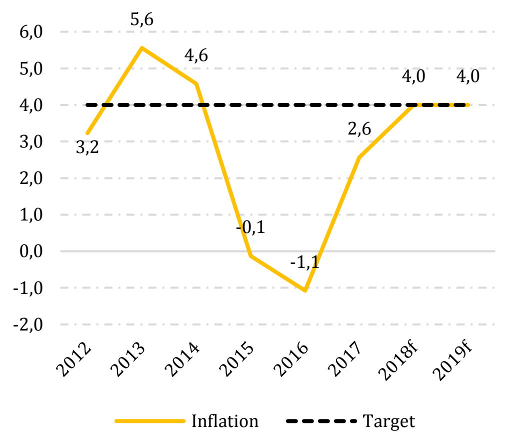
Government debt continued to increase but expected to decline in the long term. Government debt to GDP and to budget revenues increased up to 53,5% and 252,2% in 2017, a hike of 1,7p.p. and 10p.p. respectively as compared to 2016 (see graph 3). Moreover, public debt, a measure of debt including obligations from the CBA, was around 59% of GDP in 2017. In 2018, these figures have remained stable. As of May 2018, government and public debt figures have both declined in absolute terms. This is a positive sign that the authorities are following their debt management strategy. Even though debt figures remain elevated as compared to its non-oil dependent peers[1], we expect this figure to decline further in the long-term perspective as the authorities start to implement a new fiscal framework which includes budget consolidation efforts and a new fiscal rule.

In addition, we still consider the government debt structure to remain favorable in general terms. As of our latest revision, this remains almost unchanged with short-term debt accounting for 2,6% of total debt and floating interest representing 13,8% of total obligations as of May 2018. Once again, the negative part of the structure is the amount of FX-denominated debt which remains elevated at 81,8%. Despite this, most of this debt is in concessional terms partially mitigating the credit and exchange rate risk for the country.

Monetary policy remains expansive as inflation has yet to reach the target. The monetary policy of the Central Bank of Armenia (CBA) remains loose which has helped inflation levels to climb towards the 4% target. However, as of 2Q 2018, inflation started to grow at a slower pace and by June 2018 the y-o-y CPI increase was only 0,9% as food prices saw

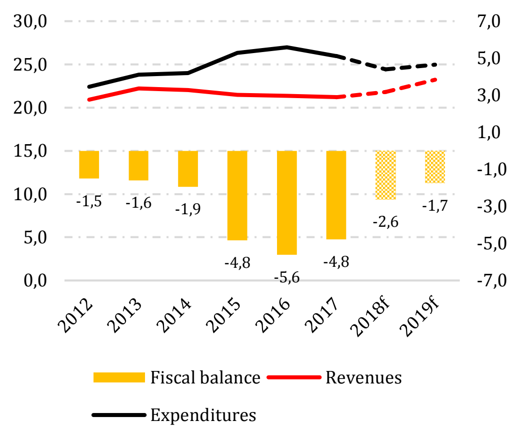
[1] Non-oil dependent peers include Georgia, Kyrgyzstan and Tajikistan.

Graph 4: Target vs inflation rate, %



Source: RAEX (Europe) calculations based on data from the CBA

Graph 5: Fiscal budget dynamics, % of GDP



Source: RAEX (Europe) calculations based on data from the IMF

a sharp drop; however, core inflation was also lower than expected. If the low-inflation scenario were to continue alongside a recurrent halt in credit growth, we would expect the CBA to reduce the refinancing rate further (see graph 4).

In general, we see a positive and highly credible monetary policy with an improved transmission mechanism which has contributed to the fall of lending rates, causing investment consumption to grow and the price level to increase. Nonetheless, still high levels of dollarization could jeopardize the transmission of policy decision into the financial markets.

Fiscal framework in a revamping process. The fiscal deficit was 4,8% of GDP in 2017, a reduction of almost 1p.p. as compared to 2016 showing positive steps in the consolidation efforts by the government. Despite this, the actual figure was wider than the initial target from the authorities. This was mainly a result of a disbursement of a Russian loan which increased the deficit by around 1,5% (see graph 5).

However, as previously mentioned, we expect the overall fiscal picture to improve substantially as the government is introducing a new fiscal framework. The main target of this new strategy is to build up vast fiscal buffers through improved fiscal discipline. Also, the government will focus in augmenting fiscal flexibility with the aim to absorb potential unexpected shocks. The new fiscal rule should also keep government expenditures in check and prepare the authorities to reduce debt if needed.

Armenia is still highly exposed to external shocks. The economy of Armenia continues to be highly dependent on imports, remittances, and commodities exports, especially minerals, such as copper. Moreover, around 82% of the government debt and 45% of private debt is external. Thus, Armenia remains strongly exposed to developments in regional economies, the exchange rate and commodities' prices.

In 2017, Armenia's trade deficit widened up to at 12,3% and the current account's deficit stood at 2,5% as a result of remittances inflows. Additionally, international reserves have declined since November 2017 but remain at adequate levels. 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_20.07.2018.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.