Research Report on Armenia

26 January 2018

Responsible Expert:

Hector Alvarez
Rating Associate

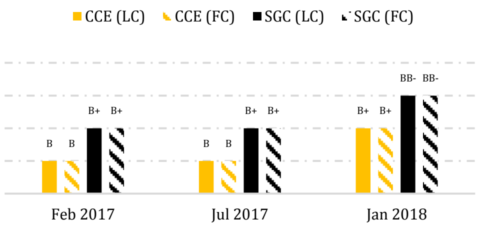
For further information contact:
Rating-Agentur Expert RA GmbH
Walter-Kolb-Strasse 9-11,
60594 Frankfurt am Main, Germany
+49 (69) 3085-45-00
E-mail: info@raexpert.eu
www.raexpert.eu

Ratings

Sovereign Government Credit (LC)	BB-
Sovereign Government Credit (FC)	BB-
Country Credit Environment (LC)	B+
Country Credit Environment (FC)	B+

* These ratings are unsolicited

Ratings dynamics



Main Economic Indicators of Armenia

Macro indicators	2015	2016	2017
Gross gov. debt, AMD bn	2226	2631	2988
Nominal GDP, AMD bn	5044	5079	5405*
Real GDP growth, %	3,3	0,2	3,8*
Gross gov. debt/GDP, %	44,1	51,8	55,3*
Deficit (surplus)/GDP, %	-4,8	-5,5	-3,3
Inflation rate, %	-0,1	-1,1	2,6
Current Account Balance/GDP, %	-	-	-2,5*
External debt, USD bn	-	-	9,9**

Development indicators	2017
Inequality adj. HDI	0,74
GDP per capita, USD th	9,1

Default indicator	26.01.2018
10Y Gov Bond Yield, %	4,7

Source: RAEX (Europe) calculations based on data from the IMF, WB, UN, Armenia Ministry of Finance, CBA, Cbonds
* Forecast for 2017 ** Figure for 3Q 2017

Summary

The upgrade of Armenia's SGC ratings to 'BB-' and CCE ratings to 'B+' reflects the consistent and sustained improvement in fiscal metrics, better economic growth prospects and prolonged stability of the banking system. Moreover, the monetary policy has had better transition to the economy and the external sector metrics have slightly improved, despite the economy remaining highly dollarized.

However, government debt remains high, although expected to decline, the competitiveness of the economy remains subdued and the economy remains highly exposed to external shocks. Going forward, Armenia's monetary policy effectiveness could be further harmed if the current levels of dollarization persist.

Economic performance showing consistency. We expect real GDP growth to be higher than initially expected in 2017. Real output is anticipated to have grown by 3,8% as a result of an increased inflow of remittances (see graph 1) and the loose monetary policy in place; higher private consumption was also a factor causing imports to increase. Moreover, external demand, industrial production and the services sector have also performed positively.

We expect GDP to maintain stable growth levels given the positive economic developments in the region. This, in turn, will support a stable inflow of remittances and higher exports. In addition, the recovery in copper prices and the current stance of copper future contracts, provide a positive view for Armenia's exports of copper, the main export product accounting for around 21% of total exports.

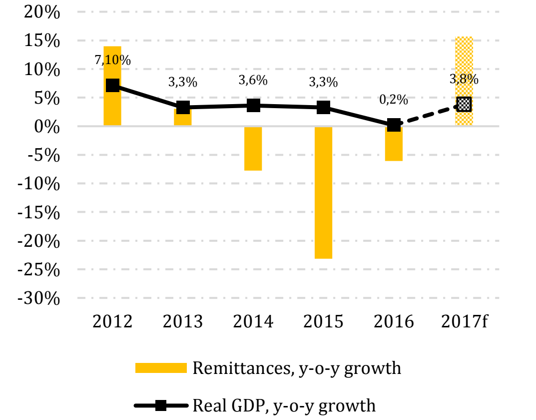
GDP per capita in PPP terms is projected to have finished 2017 at USD 9,1 th which is an acceptable figure when compared to the average of its regional non-oil dependent (RNOD) peers[1].

However, competitiveness remains subdued as the economy is mostly dominated by oligopolies and very much dependent on imports. Furthermore, the country's position in the global competitiveness ranking of the World Economic Forum was 73rd out of 138 countries.

The banking system remains sound. Banking system metrics have remained stable throughout 2017. We expect the banks' assets to GDP

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

Graph 1: Dynamics of the economy



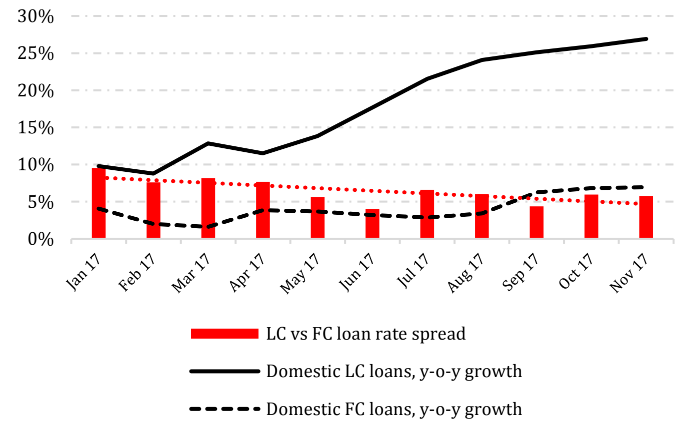
Source: RAEX (Europe) calculations based on data from the IMF, ADB and CBA

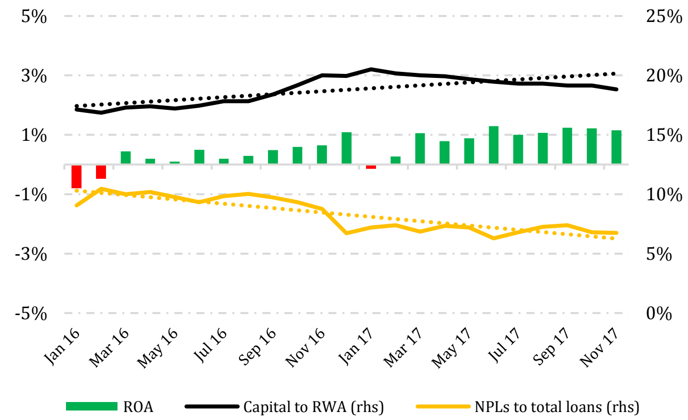
ratio to have increased up to 80,7% of GDP and the private credit to GDP up to 56% of GDP in 2017; an increase of 2p.p. for each indicator from a year before. We attribute the growth in credit, especially in local currency, to the lower lending rates in the system as well as a narrower spread between USD and AMD loans (see graph 2).

Moreover, banking sector metrics remain stable. Capital adequacy ratio was at 18,8%, NPLs to total loans ratio at 6,8% and ROA was still positive at 1,1% as of November 2017 (see graph 3).

However, the levels of financial dollarization, despite having declined, remain quite high as loans and deposits in FX were equivalent to 61,6% and 57,5% of total loans and deposits respectively as of November 2017.

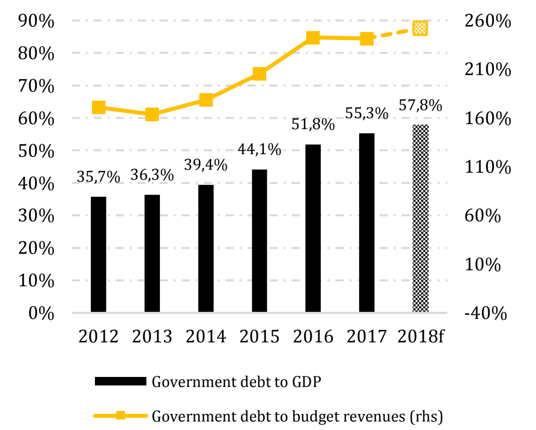
Graphs 2 & 3: LC and FC loans & Financial soundness indicators





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

Graph 4: Government debt dynamics



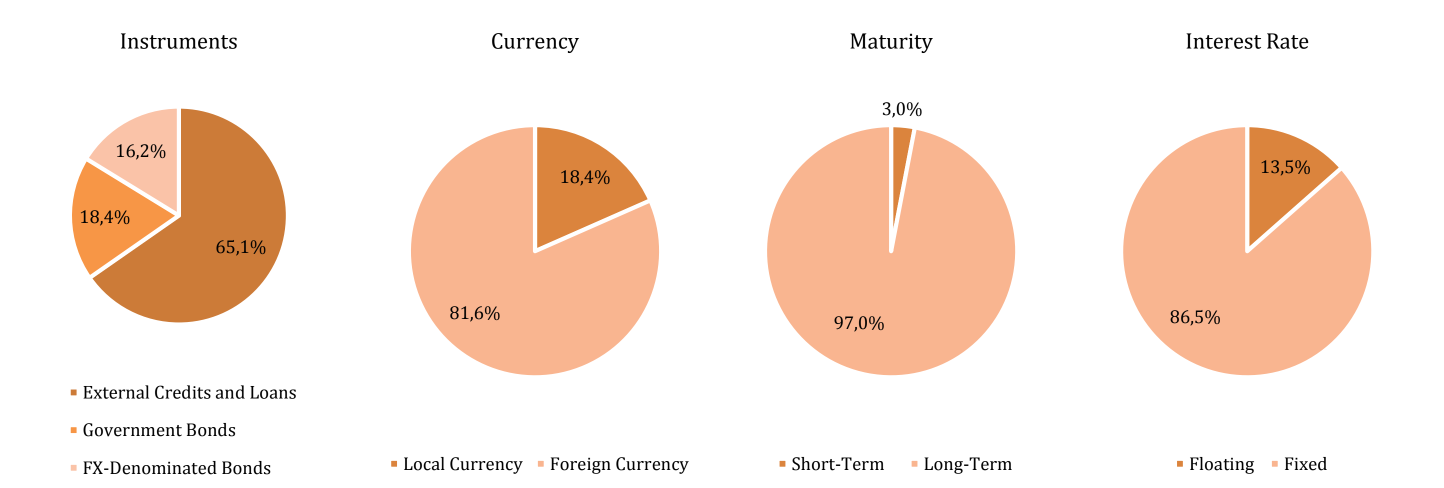
Source: RAEX (Europe) calculations based on data from the IMF and Armenia Ministry of Finance

Government debt expected to stabilize in the mid-term perspective. We project government debt to have risen to 55,3% of GDP and to have slightly reduced down to 241% of budget revenues in 2017. The overall hike in the level of debt to GDP was due to the increase in external loans from the Asian Development Bank and KfW bank. However, the decline in the debt to budget revenues ratio was a result of higher than expected tax income (see graph 4). Additionally, public debt, including debt from the Central Bank of Armenia (CBA), reached 60% of GDP. Nonetheless, the Agency still expects government debt figures to stabilize in the mid-term perspective following the debt management strategy of the authorities.

Even though debt levels are high, the structure remained generally favorable as of the end of 2017, the short-term debt represented as low as 3% of the total debt and floating interest rate debt accounted for 13,5%.

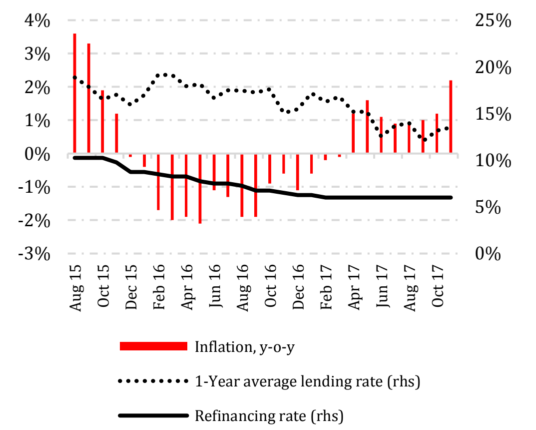
Even though the amount of FX-denominated debt is high at 81,6%, it is mostly at concessional terms (see chart 1).

Chart 1: Government debt structure



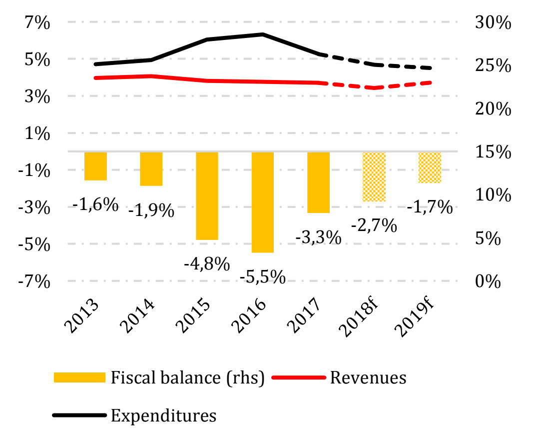
Source: RAEX (Europe) calculations based on data from the Armenia Ministry of Finance

Graph 5: Monetary policy transmission



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

Graph 6: Fiscal budget indicators, % of GDP



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

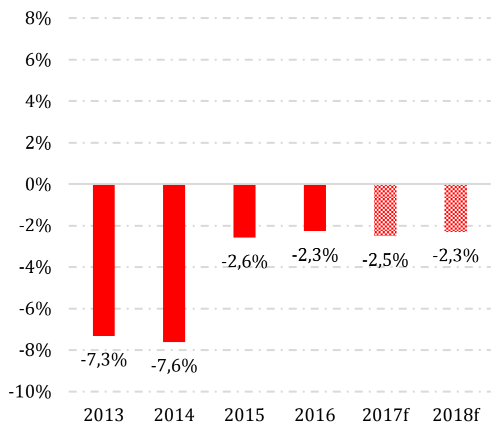
Monetary policy remains loose. After the refinancing rate cut on February 2017, the CBA has left it unchanged. We believe this decision is a result of increasing levels of inflation combined with higher inflation expectations. The y-o-y increase in the CPI index as of end-2017 was 2,6% given domestic demand on the rise and higher food prices. Even though this level is still below the CBA's 4% target, it is headed in that direction. Given the accommodative policy and currently high inflation expectations, we anticipate the inflation rate to continue in an upward trend.

We have noticed an important improvement in the transmission mechanism of the monetary policy, despite high dollarization levels. Lending rates have fallen towards 2H 2017 causing investment consumption to grow and the price level to increase (see graph 5).

Fiscal consolidation continues in Armenia. The budget balance is expected to have narrowed to -3,3% of GDP as a result of a 2,2% decrease in total expenditures and an increase of 5,6% in total revenues. This reflects the positive and consistent result of the Armenian authorities' consolidation efforts (see graph 6).

The fiscal policy effectiveness continues to progress as evidenced by the narrower deficit. Moreover, as mentioned in our previous review, Armenia's fiscal rules were counterproductive with economic growth and unsustainable. Therefore, the country's process towards amending the fiscal rule is a positive factor in our creditworthiness assessment. At the same time, the government is planning more capital expenditures in 2018, which is key to the sustainable growth of their economy.

Graph 7: Current Account, % of GDP



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

External position remains vulnerable. As mentioned above, the Armenian economy is still heavily reliant on imports as well as on commodity exports and remittances; and, despite being concessional, most of Armenia's debt is external and the economy remains highly dollarized. Furthermore, even though we expect the country's net international investment position (NIIP) to recover, we still anticipate it to have remained below -70% of GDP in 2017. Thus, Armenia remains highly vulnerable to external shocks such as the development of regional economies, exchange rate fluctuations and volatility in commodity prices. We see Armenia's external exposure as the most significant vulnerability for its creditworthiness assessment.

Nonetheless, part of this risk has been mitigated by a narrow current account. We expect the current account to have finished 2017 at around -2,5% of GDP, showing sustainable and consistent figures for the last three years (see graph 7). This is the result of the increase in exports and remittances. However, the trade deficit is expected to widen as imports have outpaced exports; as of 3Q 2017 the former had grown by 28% y-o-y while the latter by 23,2% y-o-y.

International reserves stood at USD 2,17 bn by November 2017 which is 35% of gross government debt and they cover short-term debt by more than 11x. Furthermore, the external debt load of the private sector remained acceptable as of 3Q 2017 at around 90% of GDP.

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_26.01.2018.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.