Research Report on Armenia

27th of March, 2015

Author:

Gustavo Angel
Expert of Rating-Agentur Expert RA GmbH

For further information contact:

Rating-Agentur Expert RA GmbH
Office 601a, Mainzer Landstrasse 49,
60329 Frankfurt am Main, Germany
+49 (69) 3085-54-85
E-mail: info@raexpert.eu
www.raexpert.eu

Introduction

Given the geographical, demographic and economic position of Armenia, its dependence on foreign countries is vital for its overall stability. While Armenia showed significant improvements in terms of internal policies in recent months, spillovers from global and regional developments still stand as the main source of risk for the country. The recent accession of Armenia to the Eurasian Economic Union[1] (EEU) could have advantages as well as drawbacks for the country as the current members of the union have shown a significant slow-down in their economies in recent months. From an internal perspective, Armenia has shown a remarkable commitment to maintain government debt at bearable levels, as well as to improve its fiscal and monetary policy.

Main Economic Indicators of Armenia

Macro indicators	2012	2013	2014
Gross pub. debt, bill AMD	1556	1769	1902
Nominal GDP, bill AMD	4001	4273	4528**
Real GDP growth, %	7,1	3,5	3,2*
Gross gov. debt/GDP,%	38,9	41,4	42,0
Deficit (surplus)/GDP,%	-1,6	-1,7	-2,0
Inflation rate,%	3,2	5,6	4,6
Curr. Account balance/GDP,%	-11,1	-8,0	-8,1*

Development indicators	2014
Inequality adj. HDI	0,7
GDP per capita (Thou. of USD)	7,4

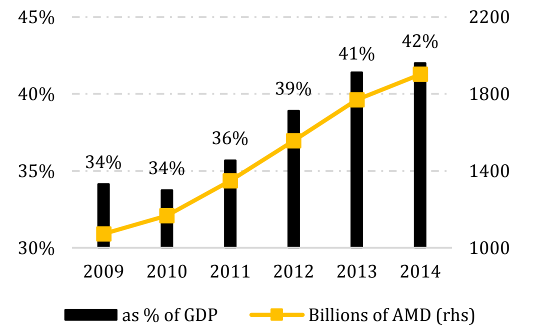
Sources: RAEX (Europe) calculations based on data from World Bank, IMF, Bloomberg. *IMF projection. **IMF preliminary data.

General government debt remains at tolerable levels but it showed an upward trend over the past years. Government debt does not pose a significant risk for the creditworthiness of Armenia as gross government debt and short-term debt represented 42% and 11,5% of GDP in 2014 respectively. Additionally, the volume of foreign exchange government debt remains at 30% of GDP. Despite this, the positive trend which followed the gross government debt load over the last year (see graph 1) calls for keeping this factor on watch.

Fiscal policy is sustainable and reforms are advancing, however, continued capital budget underspending is still in place. Primarily due to lower capital expenditure and lower matching pension contributions, fiscal deficit closed the year 2014 at 0,3% of GDP below the budget target of 2,3% of GDP (see graph 2). Under the new government of Hovik Abrahamyan, who was appointed as prime minister of Armenia in April 2014, the ministry of finance and the state revenue committee[2] were merged. This merge is expected to improve synergies and reduce tax collection gaps. Additionally, authorities are advancing in the assessment of possible new tax measures on high-net-worth individuals. Despite the fact that social expenditures remained

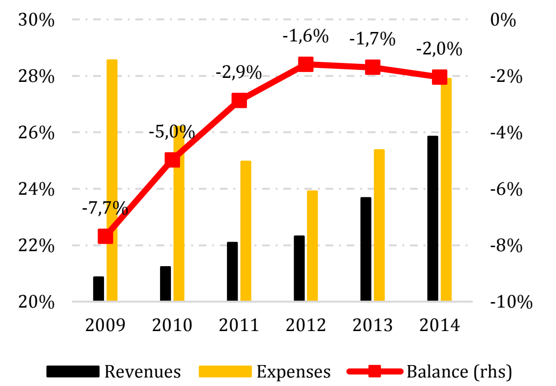
[1] The EEU provides free movement of goods, services, capital and labor and pursues coordinated, harmonized and single policy in the sectors determined by the Treaty and international agreements within the Union. The Member-States of the Eurasian Economic Union are the Republic of Armenia, the Republic of Belarus, the Republic of Kazakhstan and the Russian Federation.
[2] The State Revenue Committee of the Government of the Republic of Armenia is a central government agency competent for tax and customs administration in Armenia.

Graph 1: Gross government debt dynamics



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

Graph 2: Fiscal balance of Armenia (as % of GDP)



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

low, there has been progress in the establishment of integrated social service centers and an increase in allowances under the Family Benefits Program (FBP)[3].

A number of measures were put in place in order to reduce dollarization in Armenia. Significantly volatile inflation and exchange rates have been the main drivers of the long-lasting financial dollarization in Armenia (see graph 3 and 4). After Dollarization rates of deposits and loans fluctuated significantly for more than a decade from over 80% in early 2000's to below 40 percent right before 2008, they stabilized around 60% since the 1Q of 2011. In recent years, Armenia put in place a wide range of de-dollarization measures which range from macroeconomic policies to prudential and forced de-dollarization regulations (see table 1). In addition, the reduction of inflation rate volatility was also a positive factor which contributed significantly to the stabilization of dollarization rates.

Recent accession to the EEU can bring benefits as well as new risks to Armenia. Following a treaty signed by the presidents of Belarus, Kazakhstan and Russia in October last year, Armenia's accession to the Eurasian Economic Union (EEU) came into force on January 2015. Given the nature of the EEU, Armenia can find advantages as well as disadvantages as a member of this union. On the one hand, EEU membership provides an opportunity for Armenia to increase its exports and deepen partnership with Russia (which is currently the source of 90% of Armenia's remittances). Additionally, EEU membership will eliminate the need for custom declarations and inspections, ultimately reducing non-tariff barriers and delays[4]. Furthermore, Armenians will not be required to obtain a work permit prior to seeking a job in any EEU member state. They are expected to have the same labor rights as Russian citizens, and to be considered legal residents of Russia during the course of their employment. On the other hand, Armenia's EEU membership will imply closer links to Russia, whose economy is significantly volatile, dependent on oil and is expected to grow slowly in the mid-run. Besides, the absence of shared borders with the other three members (Russia, Belarus and Kazakhstan) could make trade difficult if Georgia or Azerbaijan impose trade barriers between Armenia and its EEU partners.

[3] FBP was established in **1999** after Armenia consolidated several Soviet-era categorically-targeted programs into a single cash-based social safety net. The program accords priority to poor and vulnerable social groups, such as the elderly, persons with disabilities, and families with children.

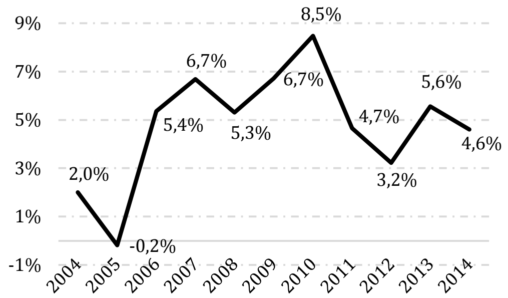
[4] Non-tariff barriers refers to barriers which restrict trade, but are unlike the usual form of a tariff. Among others, non-tariff trade barriers include import quotas, special licenses, unreasonable standards for the quality of goods, bureaucratic delays at customs, export restrictions.

Table 1: Main de-dollarization Measures in Armenia as of June 2014

Category	Instrument	Measure
Macroeconomic policies	Currency denomination of government domestic debt	- Domestic government debt in Armenia is only issued in AMD
Prudential regulation	Reserve requirements	- A reserve requirement of 2 percent applies to banks' AMD liabilities and a reserve requirement of 12 percent applies to dollar liabilities. - All reserve requirements must be denominated in AMD.
	FX position limits	- A limit of 7 percent of capital applies on open foreign exchange positions on individual currencies, and a limit of 10 percent of capital applies on aggregate open foreign exchange positions on all currencies.
	Coverage and payment of deposit	- Bank deposits in domestic currency are covered up to 4 million AMD, while bank deposits in foreign currency are covered only up to 2 million AMD. All payments are made in AMD.
Forced de-dollarization	FX prohibition for payments	- Prices of and payments for, goods, services, wages, and investments in statutory and share capital legal entities are quoted and made in AMD only.
	FX prohibition for lending	- Consumer loans can only be extended in AMD.

Source: RAEX (Europe) based on data from IMF

Graph 3: Inflation rate volatility 2004-14



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

Graph 4: USD/AMD rate volatility 2004-14

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

New escalations in the Nagorno-Karabakh conflict increased the tensions in the area. The Nagorno-Karabakh conflict remains unresolved and stands as one of the main risks for the overall position of Armenia. By mid-March this year, The Nagorno-Karabakh de-facto Defense Ministry said Azerbaijani commandos attacked its soldiers' position killing three soldiers and wounding four. In response to this accusations, Azerbaijan's Defense Ministry accused separatists of triggering the confrontation and claimed that 20 Armenian soldiers had been killed or wounded. Armenia and Azerbaijan have been locked in a conflict over Azerbaijan's breakaway region of Nagorno-Karabakh for nearly 25 years. As international diplomatic efforts to settle the conflict have brought little progress, Rating-Agentur Expert RA GmbH will keep the situation on watch.

Regional and global spillovers remain one of the main risks for Armenia. As a result of its heavy dependence on remittances from abroad and import of goods and services, Armenia remains strongly exposed to the spillovers from global and regional developments. From a global perspective, the recent normalization of the monetary policies in major advanced economies would have a negative impact on Armenia, given the large share of soft loans in Armenia's external debt which are granted from these countries. From a regional perspective, Armenia's economy can suffer from the current position of Russia. In terms of trade, Russia accounts for around 25% of Armenia's exports of goods. Additionally, Armenia receives 18–20% of GDP in remittances, 90 percent come from Russia.

Conclusion

Despite having shown improvements in the fiscal and monetary front, Armenia has new and persistent risks which contribute negatively to the creditworthiness of the country. De-dollarization measures which are currently in place alongside actions to reduce inflation rate volatility have contributed to the stabilization of dollarization rates. Recent accession of Armenia to the Eurasian Economic Union in January this year is expected to have as many advantages as disadvantages for the country. Given the strong dependence of Armenia on foreign countries (especially Russia), external shocks still stand as one of its main risks. The Nagorno-Karabakh conflict remains unresolved and recent escalations in the area of conflict are going to be kept on watch by this agency for further developments.