Research Report on Armenia

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Responsible Expert:

Hector Alvarez
Rating Associate

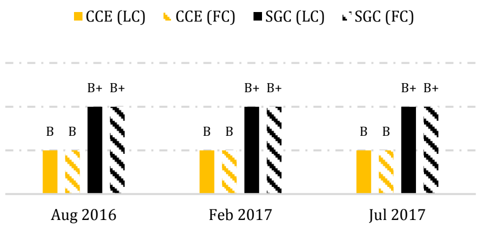
For further information contact:
Rating-Agentur Expert RA GmbH
Walter-Kolb-Strasse 9-11,
60594 Frankfurt am Main, Germany
+49 (69) 3085-45-00
E-mail: info@raexpert.eu
www.raexpert.eu

Ratings

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

* These ratings are unsolicited

Ratings dynamics



Main Economic Indicators of Armenia

Macro indicators	2014	2015	2016
Gross gov. debt, AMD bn	1854	2165	2631
Nominal GDP, AMD bn	4829	5032	5068
Real GDP growth, %	3,6	3,0	0,2
Gross gov. debt/GDP, %	38,4	43,0	51,9
Deficit (surplus)/GDP, %	-1,9	-4,8	-5,6
Inflation rate, %	4,6	-0,1	-1,1
Current Account Balance/GDP, %	-	-	-2,9
External debt, USD bn	-	-	10,0

Development indicators	2016
Inequality adj. HDI	0,67
GDP per capita, USD th	8,6

Default indicator	28.07.2017
10Y Gov Bond Yield, %	5,6

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

Summary

Armenia's ratings remain unchanged supported by improving metrics in the banking sector, positive government debt structure, a favorable real GDP growth perspective and improvement in the management of monetary policy.

However, government and public debt levels have steeply increased and, although we expect the fiscal deficit to narrow going forward, it widened further in 2016. Moreover, still high levels of dollarization as well as NPLs, coupled with considerably high exposure to external factors remain a drag for the country's creditworthiness.

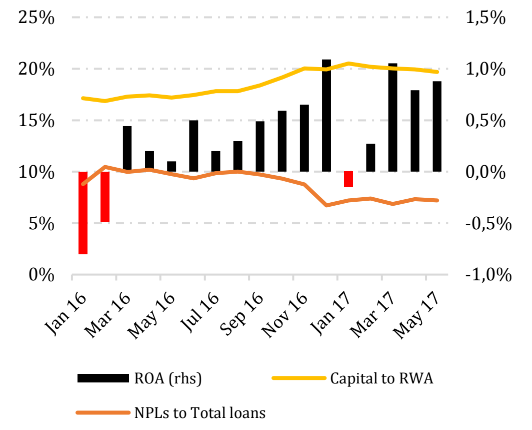
The banking sector has shown improvement. Along 2017, the banking sector has strengthened showing consistent signs of recovery. As of May 2017, the capital adequacy ratio stood at around 20% as a result of the increase in capital in order to meet the new regulatory requirements which came into effect in 2017. Moreover, ROA has remained steadily positive and NPLs to total loans, despite remaining high, have been persistently declining due to loan write-offs which resulted from banks mergers. By May 2017, average ROA was 1% and NPLs ratio stood at 7,2%. In the same period, credit had a y-o-y growth of 7,1% propelled by a relaxed monetary policy and lower lending rates (see graph 1).

Nonetheless, the banking sector concentration and steep dollarization levels are factors which remain a risk of potential disruption of the system's stability.

Government debt structure is favorable but levels are high. The structure of government debt remains positive and consistent. As of May 2017, short-term debt was as low as 4,2% of total debt. Furthermore, foreign currency denominated debt remained almost unchanged since our last review at 80,9% of total debt and it is mostly concessional. In addition, the share of floating interest rate debt to total debt decreased to 12,4% since our last revision.

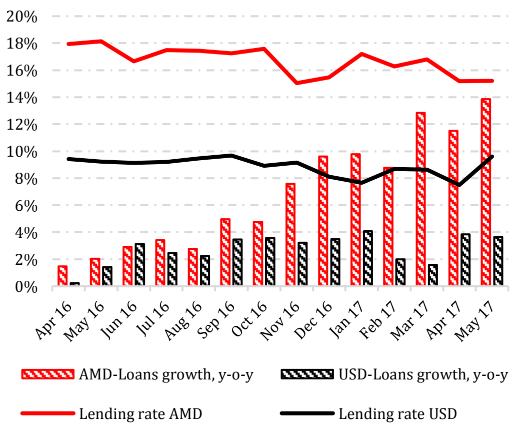
In regard to debt levels, government debt posted a figure of 51,9% of GDP in 2016, an increase of about 9p.p. from a year ago and 13,4p.p. from 2014. In addition, government debt as a percentage of budget revenues was as high as 242%, a 43p.p. increase from 2015, and total public debt to GDP was around 55,1% of GDP in 2016.

Graph 1: Banking sector metrics, %



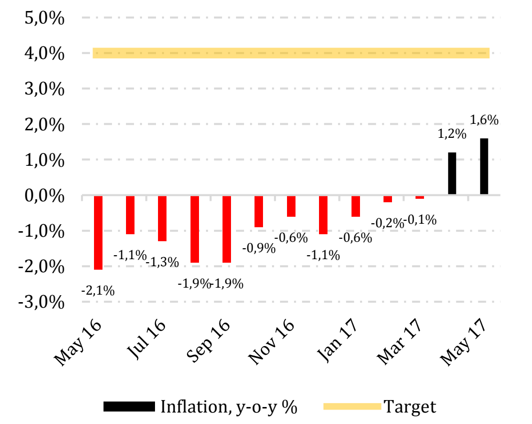
Source: RAEX (Europe) calculations based on data from the CBA

Graph 2: Credit growth, %



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

Graph 3: Inflation dynamics



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

Despite the steep hikes in debt levels relative to GDP and budget revenues, we expect these figures to increase once again in 2017 as a result of additional capital expenditures given the current wide output gap in the economy. However, we anticipate lower levels of government and public debt in the long-term perspective given the authorities' consolidation efforts.

The authorities continue to ease monetary conditions. The Central Bank of Armenia (CBA) slashed the refinancing rate down to 6% in February 2017, a 25b.p. reduction due to the CBA's expectation of lower consumer prices. These moves, as mentioned previously, have already caused an increase in credit growth, especially local currency-denominated loans, due to better economic conditions and decreasing lending rates for AMD-denominated loans (see graph 2). Furthermore, after two years in a row of deflation, the CPI index has started to show a positive trend in 2017 given a recovery in domestic demand. As of May 2017 the y-o-y growth in the CPI index was 1,6%.

Despite the positive dynamics in the aforementioned metrics, inflation expectations remain quite low and lending rates remain high showing slow and ineffective monetary transmission in the economy partly due to the still high level of financial dollarization. Thus, we anticipate further easing from the CBA which we expect will propel additional credit growth and higher inflation levels which could come close to the CBA's target of 4% in the mid-term perspective (see graph 3).

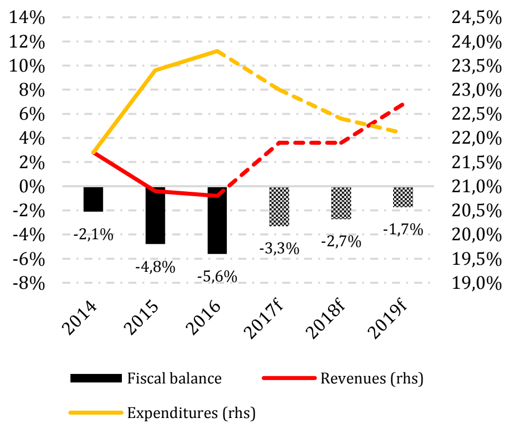
Fiscal indicators showing better performance. As a result of lower than expected revenues and higher expenditures, the budget presented a deficit of 5,3% of GDP in 2016, the widest deficit since 2009 when it stood at 7,7%. However, we have already seen signs of increased revenues, mainly tax collections stemming from the new tax code and better tax administration in 2017.

In 2016 the fiscal rule was triggered for the first time activating the respective corrective actions included in this rule. However, in our previous revision[1] we sustained that the introduction of such rule in an economy which is growing below its capacity could further hurt growth prospects. In that sense, according to information from the IMF, the government will continue capital expenditures of 1% of GDP more than what the fiscal rule suggests.

Despite this, the overall results of the new fiscal framework have already shown signs of effectiveness in 2017. Despite revenues and expenditures being off-target in 2016, the new tax reform introduced in 2017 will help

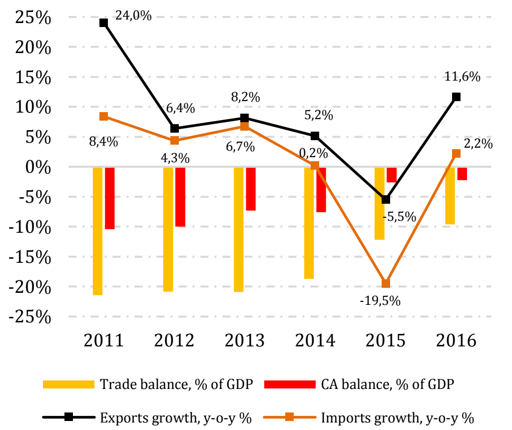
[1] "The trigger of the fiscal rule and the consolidation plan of the government will encourage fiscal discipline but could further hurt economic growth".
Research report on Armenia from 3 February 2017 (https://raexpert.eu/reports/Research_report_Armenia_03.02.2017.pdf).

Graph 4: Fiscal budget indicators, % of GDP



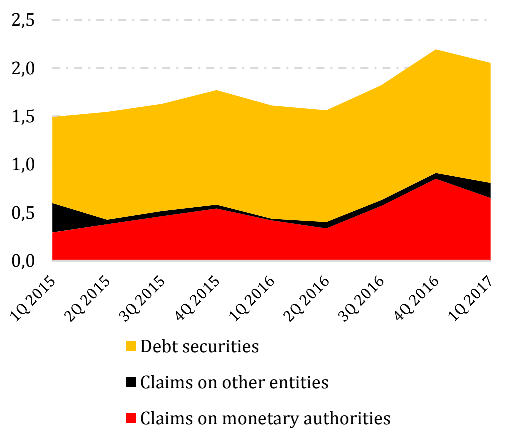
Source: RAEX (Europe) calculations based on data from the IMF

Graph 5: Foreign trade performance



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

Graph 6: International reserves, USD bn



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

to reduce the debt burden and narrow the deficit (see graph 4). In fact, better than expected revenues at the beginning of 2017 led the authorities to increase capital expenditure above the fiscal rule for the current year without incurring in an estimated wider deficit at end-2017.

Weak real GDP growth in 2016 but expected to recover gradually. The total output of the Armenian economy grew by a meager 0,2% in 2016 given external shocks which translated in lower remittances and copper prices. However, the economy grew by 6,5% in 1Q 2017 showing signs of recovery.

We expect GDP to grow at a faster pace in 2017 as a result of better economic conditions in the region, especially Russia causing remittances to grow (see table 1). Moreover, expected higher copper prices and higher capital expenditure by the government will also give a boost to the Armenian economy.

Table 1: Peer comparison of regional non-oil dependent countries for 2016*

Factors	Armenia	Georgia	Kyrgyzstan	Tajikistan
GDP per capita (USD)	8 620,2	10 043,8	3 521,2	3 007,6
GDP growth (%)	0,2%	2,72%	3,77%	6,90%
Inflation rate (%)	-1,1%	1,83%	-0,49%	6,07%
Fiscal balance/GDP	-5,6%	-1,62%	-4,55%	-4,42%
Current acc/GDP	0,0%	-12,41%	-9,38%	-5,09%

Source: RAEX (Europe) calculations based on data from the IMF, National Statistical Service, CBA
* Some figures are estimations for the year.

External exposure remains substantial. The Armenian economy remains widely exposed to external developments due to its high dependence on imports and exports as well as on foreign-financed projects. This dependence combined with high levels of dollarization and a net international investment position (NIIP) of -80% of GDP, make the country highly vulnerable to the state of commodity prices, the performance of trading partners and the volatility of the exchange rate.

Despite the exposure, external metrics have slightly recovered. The current account presented a deficit of around 2,3% of GDP and the trade deficit was 9,6% in 2016, both figures showing an improvement over the past years as a result of more exports (mainly copper) and lower imports (see graph 5).

International reserves have also presented favorable dynamics since 2015 due to a build-up in claims on other Central Banks and debt securities (see graph 6). As of 1Q 2017, the amount of reserves was USD 2 bn, covering short-term debt by 9x and showing an improvement as a percentage of gross government debt at 40%. Furthermore, external debt load of the private sector remains acceptable in 2016 at 94,5% 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_28.07.2017.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.