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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

Main Economic Indicators of Armenia

Macro indicators	2013	2014	2015
Gross gov. debt, AMD bn	1729	2001	2457
Nominal GDP, AMD bn	4556	4843	5047
Real GDP growth, %	3,5	3,4	3,0
Gross gov. debt/GDP, %	38,0	41,3	48,7
Deficit (surplus)/GDP, %	-1,6	-1,9	-4,1
Inflation rate, %	5,6	4,6	-0,1
Current Account Balance/GDP, %	-7,6	-7,3	-5,9
External debt, USD bn	-	-	4,3
Development indicators	2015		
Inequality adj. HDI	0,66		
GDP per capita, USD th	8,4		
Default indicator	04.03.2016		
10Y Gov Bond Yield, %	7,9		

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

Summary

Armenia's ratings mainly reflect the upward and moderately accelerating trend of gross government debt, high levels of financial dollarization and the exposure of the economy to external imbalances.

This exposure has caused a slight slowdown in real GDP growth, exchange rate pressures, volatility in public finances and inflation and a decline in FX reserves. While the substantial amount of dollarization has caused struggles on the monetary policy transmission mechanism and presents a latent risk for the banking system.

The ratings also indicate a satisfactory structure of the public debt regarding maturity and creditors, stable real GDP growth and an effective response of monetary policy tools to absorb external shocks.

Government debt has been rising, but remains at acceptable levels.

Gross government debt rose up to 48,7% of GDP and 224,2% of budget revenues in 2015. This represented an increase of 7p.p. and 36p.p. respectively from a year ago.

Despite the increase, the debt to GDP ratio remains acceptable and slightly higher than the average of its regional non-oil dependent (RNOD) peers¹ (see table 1). However, the level of debt to budget revenues raises concerns due to the marked decline in fiscal revenues.

The structure of debt does not pose a substantial risk for Armenia. Even though 85,6% of the government's obligations were denominated in foreign currency by end-2015 and only 40% was covered by FX reserves, 84,8% of the debt is held by international organizations in the form of soft loans. Additionally, short-term debt to GDP is as low as 1,2% and it is covered by FX reserves by 14x.

Table 1: Peer comparison of regional non-oil dependent countries for 2015*

Factors	Armenia	Georgia	Kyrgyzstan	Tajikistan
Government debt/GDP	48,0%	45,4%	64,3%	32,8%
GDP growth	3,0%	2,8%	3,5%	3,0%
Fiscal balance/GDP	-4,0%	-3,2%	-1,4%	-1,9%
External Debt/GDP	41,1%	76,8%	59,6%	48,9%
FX reserves/GDP	14,5%	16,3%	28,6%	4,3%

Source: RAEX (Europe) calculations based on data from the IMF, WB, UN, Deutsche Bank, Armenia Ministry of Finance, Central Bank of Armenia and the Federal Reserve Bank of St. Louis.
 *Some data is preliminary

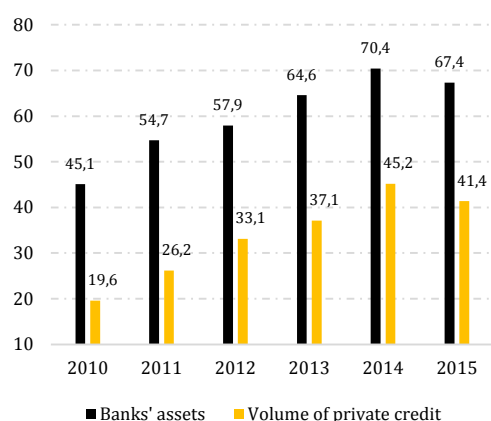
¹ Non-oil dependent peers include Georgia, Kyrgyzstan and Tajikistan.

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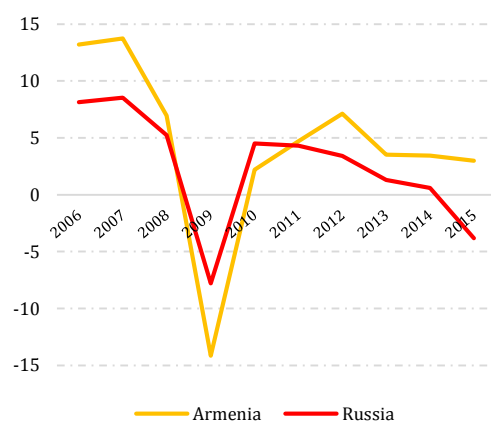
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Graph 1: Credit to the economy, % of GDP



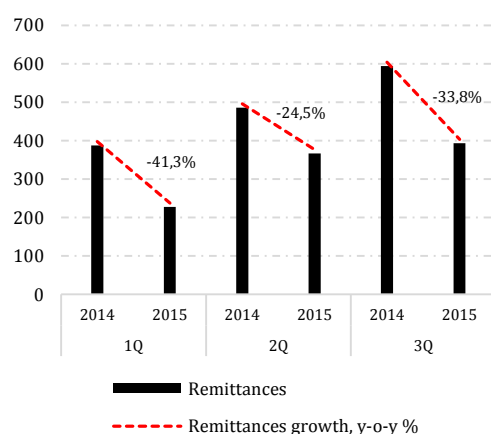
Source: RAEX (Europe) calculations based on data from the Armenia Ministry of Finance and Central Bank of Armenia

Graph 2: Real GDP growth, y-o-y %



Source: RAEX (Europe) calculations based on data from the National Statistical Service of the Republic of Armenia and IMF

Graph 3: Dynamics of remittances



Source: RAEX (Europe) calculations based on data from the Central Bank of Armenia

The financial system remains sound but has deteriorated. The banking system of Armenia is stable. It has presented an average capital adequacy ratio of more than 14% over the last four years and, even though profitability has declined, the sector has remained profitable since 2013 (ROA for 2015 was 0,53%).

However, NPLs in the financial system have risen to worrisome levels in the last four years. In 2012 the percentage of NPLs to total loans was as low as 3,6% and at the end of 2015 it stood at 9,1%, where most of them were denominated in foreign currency. Moreover, assets and private credit have dropped due to lower consumption and government spending. Bank assets to GDP and private credit to GDP dropped by 2p.p. and 3p.p. respectively from 2014 to 2015 (see graph 1).

In order to increase buffers and efficiency, the Central Bank of Armenia (CBA) increased capital requirement in order to reach a goal of AMD 30 bn in 2017 (the requirement was AMD 5 bn before the increase). This measure will create important challenges for the banks as they will have to raise substantial amounts of capital in a moderately short period of time.

Furthermore, the stock and bond markets remain underdeveloped. Total market capitalization was as low as 2% of GDP at end-2015 and there are only ten companies listed. This limits financing streams for the private and public sectors in the country.

External risk of contagion remains high. The Armenian economy remains vulnerable to external imbalances due to its overall dependence on external factors and the tight link with Russia (see graph 2). Armenia has historically incurred in wide current account deficits (around 8% of GDP in 2014) and is dependent on imports (47% of GDP in 2015), external financing and current account transfers (e.g. remittances). External FX-denominated debt represented 41,7% of GDP and 86% of the total debt in 2015 while remittances were as high as 19,8% of GDP in 2014.

The aforementioned exposure took a toll on Armenia's growth in 2015. The economic crisis in Russia caused a steep decline of remittances in the first three quarters of 2015 (see graph 3). Furthermore, spillovers have also exerted pressure on the AMD causing the CBA to intervene the market along 2015. These interventions lowered the level of reserves, which could be harmful in a country with high financial dollarization².

Stable GDP growth with latent risks of external spillovers. Official figures from the Armenia's National Statistical Service showed that the

² FX reserves are useful to mitigate declines in local consumption in the event of a sudden stop of external financing. However, in dollarized economies, a sudden stop of credit is usually followed by a sharp withdrawal of FX deposits.

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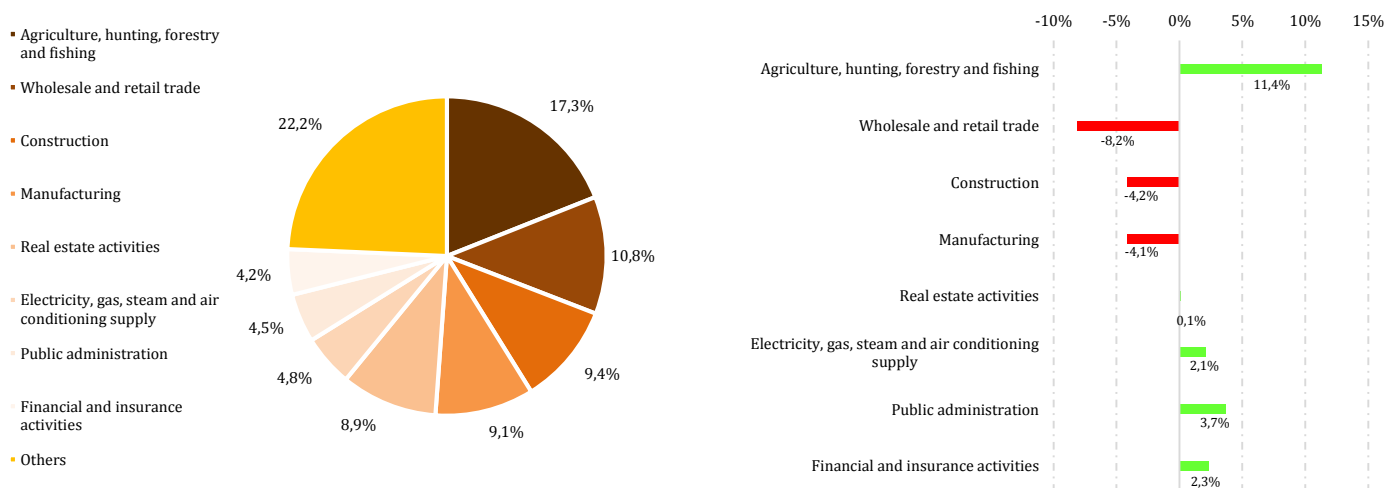
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Armenian real economy grew by 3,0% in 2015. Despite being lower than the official 4,1% estimation, it was a stable figure taking into account the external imbalances in the region.

From a production perspective, the figures showed a substantial growth in agriculture and, at a lesser extent, real estate and electricity. However, wholesale and retail trade, manufacturing and construction had a considerable decline (see graphs 4 and 5). Additionally, the exchange rate depreciation contributed to constant exports growth along 2015 driving a reduction on the trade deficit and propelling GDP growth.

External shocks were partially mitigated in 2015. Nevertheless, as previously mentioned, the close relationship and high dependence of Armenia on the Russian economy remain a potential risk for further volatility in real GDP growth.

Graphs 4 and 5: Structure of GDP by production and y-o-y growth in 2015 per sector



Source: RAEX (Europe) calculations based on data from the National Statistical Service of the Republic of Armenia

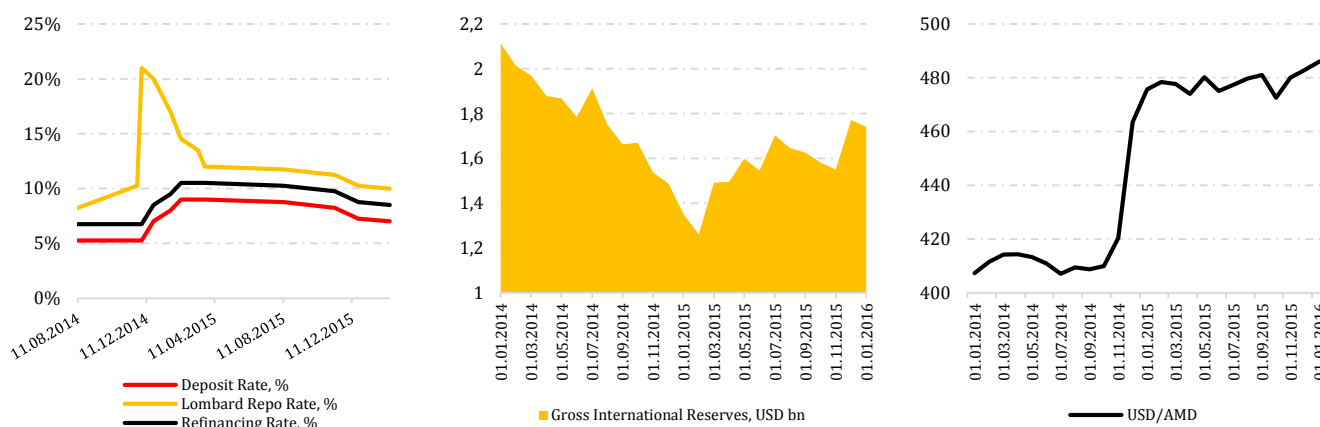
Monetary policy adjustments have worked well against external shocks. Towards the end of 2014, FX pressures started to emerge in the economy. The CBA successfully used its standing facilities as well as FX reserves to mitigate those pressures while at the same time maintaining its monetary policy goals. After the interventions, market rates (especially the Lombard repo rate) have stabilized, reserves were replenished and the exchange rate has been fairly stable (see graphs 6, 7 and 8).

Looking forward, the Central Bank is planning to continue a loose monetary policy while at the same time paying attention to potential external spill-overs.

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Graphs 6, 7 and 8: Standing facilities, international reserves and USD/AMD dynamics during and after exchange rate pressures



Source: RAEX (Europe) calculations based on data from the Central Bank of Armenia

Fiscal goals were missed in 2015. The slowdown in the Armenian economy hampered the achievement of fiscal targets in 2015. Revenues were lower than expected due to the decline in consumption alongside policy amendments (mainly related to tax reductions) and lower import from the Eurasian Economic Union (EEU). Expenditures, on the other hand, increased due to a hike in budgetary lending. These factors contributed to a wider fiscal deficit in 2015 (estimated at 4% of GDP). Nonetheless, the balance is still narrower than most of its RNOD peers (see table 1).

Credit environment is acceptable but border tensions remain a potential source of risk. The level of institutional development in the country is satisfactory. There are favorable conditions in the country for business as reflected by latest World Bank Doing Business ranking (35th out of 180 countries). Nonetheless corruption remains a drag for economic growth.

The Nagorno-Karabakh conflict remains unresolved and presents a threat to the stability of the region.

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:

http://www.raexpert.eu/reports/Press_release_Armenia_04.03.2016.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.

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