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Rating Analyst

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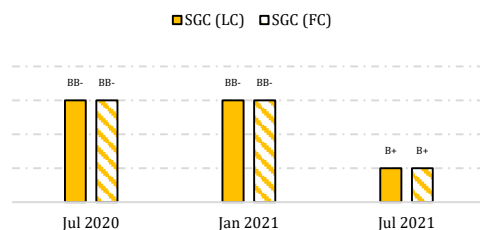
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## Ratings

Sovereign Government Credit (LC)	<b>B+</b>
Sovereign Government Credit (FC)	<b>B+</b>
Outlook (LC)	<b>Stable</b>
Outlook (FC)	<b>Stable</b>

\*These ratings are unsolicited

## Ratings dynamics



## Main Economic Indicators of Armenia

Macro indicators	2018	2019	2020
Gross gov. debt, AMD bn	3083	3278	3883
Nominal GDP, AMD bn	6017	6569	6184
Real GDP growth, %	5,2	7,6	-7,6
Gross gov. debt/GDP, %	51,2	49,9	62,8
Deficit (surplus)/GDP, %	-1,7	-1,0	-7,0
Inflation rate, %	1,8	0,7	3,8
Current Account Balance/GDP, %	-6,9	-7,2	-4,6
External debt, USD bn	-	-	6,6
<b>Development indicators</b>	<b>2020</b>		
Inequality adj. HDI		0,70*	
GDP per capita, USD th		13,8	
<b>Default indicator</b>	<b>8.01.2021</b>		
9Y Gov Bond Yield, %		3,97**	

Source: RAEX-Europe calculations based on data from the IMF, WB, UN, Armenia Ministry of Finance, CBA.

\* Figure from 2019 \*\*Maturity in 2029

**RAEX-Europe downgraded the credit ratings of Armenia from 'BB-' to 'B+'. The rating outlook is stable.**

RAEX-Europe downgraded the sovereign government credit ratings (SGCs) of Armenia from 'BB-' to 'B+' (moderately low level of creditworthiness of the government) in national and foreign currency. The rating outlook is stable, which means that in the mid-term perspective there is a high probability of maintaining the rating score.

## Summary

The change of the credit ratings for Armenia from 'BB-' to 'B+' reflects a higher than expected contraction of the economy due to the COVID-19 outbreak and an increase in the budget deficit and debt levels by the end of 2020. Also, the six-week war with Azerbaijan amplified this dynamic and the achieved peace agreement resulted in a declining support for the government of the prime minister Nikol Pashinyan. In addition, the inflation rate grew significantly due to the sharp depreciation of AMD and increase in the world commodity prices. Progress of the vaccination campaign can be assessed as slow.

**The Armenian economy experienced a significant contraction in 2020 due to the COVID-19 pandemic and military conflict with Azerbaijan.**

As of the end of 2020, the real GDP plummeted by 7,6% y-o-y what was sharper than our expectation of 7,3% (see graph 1). Such a significant decline in business activity can be attributed to the economic shock of the Covid-19 pandemic and effects of the six-week war in the Nagorno-Karabakh region.

The pandemic led to the decrease in consumer demand and a significant slowdown of business activity in 2020, especially in such industries as tourism, transportation, retail trade and entertainment. In 1Q 2021 the economic activity started to recover, mainly due to the increase in the construction sector (4,7% growth y-o-y). Industrial production contracted by 3,9% y-o-y, however, the mining and energy industries demonstrated strong growth rates of 8,1% and 11,2% y-o-y, respectively. According to the Central Bank of Armenia (CBA), remittances inflow dropped in 2020 by 1p.p. to around 10% of GDP. Overall economic decline in the 1Q 2021 slowed down to around 2,0%. Further dynamic of economic growth will depend on the spread of the pandemic in the country and effectiveness of epidemiological measures and vaccination campaign. So far, the

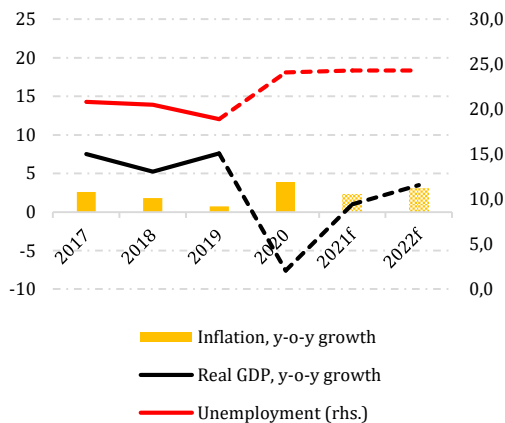
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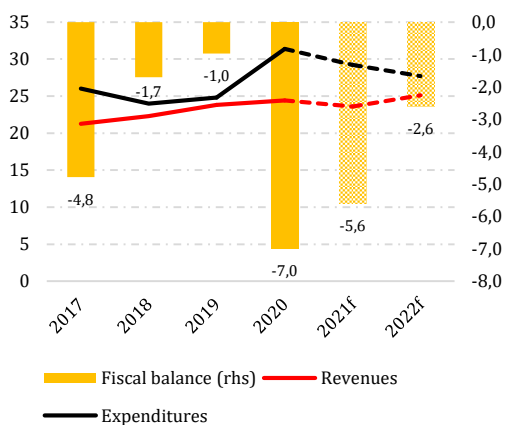
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**Graph 1: Macroeconomic indicators, %**

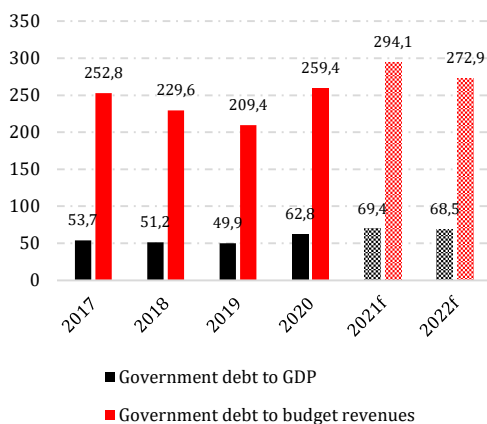


Source: RAEX-Europe calculations based on data from the IMF

**Graph 2: Fiscal budget dynamics, % of GDP**



**Graph 3: Government debt dynamics, %**



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

government lifted the state of emergency and established quarantine for travelers. The vaccination campaign is progressing rather slowly and is constrained by the vaccine supply. Periodically the country receives batches of AstraZeneca and Sputnik V vaccine. However, as of 22 June 2021, only about 65 000 people were vaccinated in Armenia what comprises near 2% of the population.

Despite the signing of a trilateral Armenia-Azerbaijan-Russia ceasefire agreement on 10 November 2020 and presence of Russian forces in the country, there is a potential of another escalation of the conflict since the demilitarized zone has not been established. Moreover, the agreement led to a wave of protests from the country's military and declining support for the government of the prime minister Nikol Pashinyan. This slows down the implementation of structural reforms that are needed to improve the economic competitiveness and institutional development in Armenia since the respective indicators remain subdued. In these conditions Armenia remains reliant on Russia. The two countries signed an agreement under which Russia provides the Armenian government with a financial aid of EUR 10 m to help the refugees from the Nagorno-Karabakh region.

**Fiscal deficit and debt load increased by the end of 2020.** By the end of 2020, due to the high government expenditures related to both pandemic-related measures and military conflict, the fiscal deficit widened to 7% of GDP. We expect it to decrease down to 5,6% of GDP in 2021 (see graph 2) and then to 2,6% in 2022. In February 2021, the government issued a USD 750 m Eurobond to finance the fiscal deficit. Additionally, the IMF has completed its third review of Armenia under the SBA what will help the government to raise USD 37 m and to increase the total amount of lending to USD 322 m. These funds will help the Armenian economy recover from the heavy implications of the second wave of Covid-19 and military conflict in the Nagorno-Karabakh region.

In 2020, the level of central government debt increased drastically by 12,9p.p. to 63,1% of GDP. With respect to budget revenues, it grew by 50p.p. to 259,4% and we expect it to grow further up to 294,1% in 2021 and then decrease to 272,9% in 2022 (see graph 3).

**The inflation rate is growing due to the weakening AMD and increasing commodity prices on the international market.** Inflation accelerated by the end of 2020: CPI increased from 1,4% to 3,7% y-o-y between 3Q and 4Q 2020. In 1Q 2021, the inflation rate continued to grow and reached 5,8% what is significantly higher than the CBA target of 4% and out of the target interval of 4±1,5%. In this inflationary environment, the CBA responded by gradually raising the refinancing rate: by 1p.p. to 5,25% in December 2020, by 0,25p.p. to 5,5% in February 2021, to 6% in May and to 6,5% in June (see graph 4). We expect the CBA to keep the

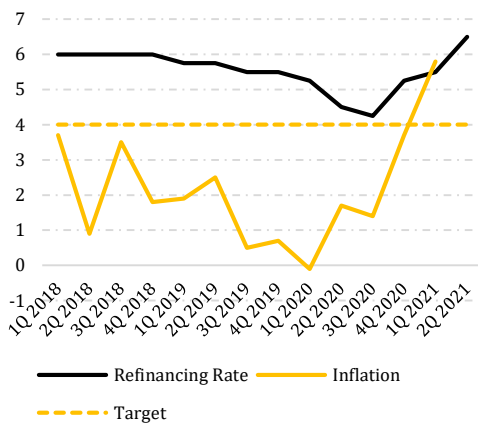
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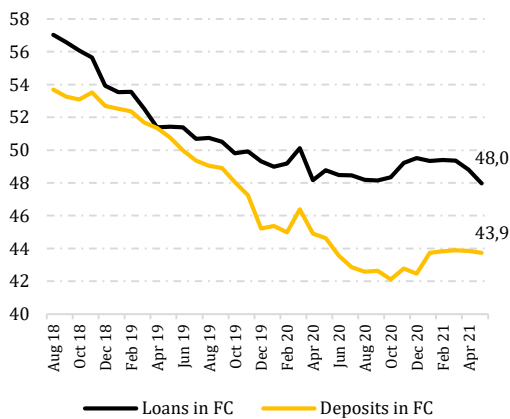
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**Graph 4: Target vs inflation rate, %**



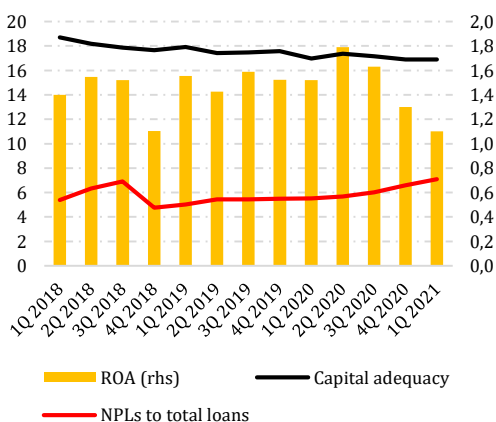
Source: RAEX-Europe calculations based on data from the CBA, IMF and EBD

**Graph 5: Financial dollarization, % of total**



Source: RAEX-Europe calculations based on data from the CBA

**Graph 6: Financial soundness indicators, %**



Source: RAEX-Europe calculations based on data from the CBA

contractionary monetary policy in order to curb inflation. The level of financial dollarization in Armenia remains high: as of December 2020, FX deposits constituted 42,5% of total deposits and FX loans – 49,5% of total loans (see graph 5). By the end of 1Q 2021, FX deposits slightly increased to 43,9% of total deposits, and FX loans decreased to 49,4% of total loans.

**The banking sector is showing slight signs of weakening.** The banking sector of Armenia remains sufficiently capitalized: capital adequacy ratio decreased marginally from 17,1% in 3Q 2020 to 16,9% in 1Q 2021 (see graph 6). Overall, the financial soundness indicators of the banking sector have remained generally stable throughout the first half of 2020. However, as expected, starting from the 3Q 2020 ROA has been gradually declining from 1,6% to 1,1% in 1Q 2021. NPLs to total loans, in contrast, have been demonstrating an upward trend: this metric increased from 6,0% to 7,1% between 3Q 2020 and 1Q 2021. Moreover, concentration of the banking system on the three largest banks (Ameriabank, Armbusinessbank and Ardshinbank) remains high and exceeds 42% of total assets.

**External position worsened during the year.** Both imports and exports experienced a significant contraction during 2020 as a result of the pandemic: imports decreased by more than 15p.p. from 54,6% to 39,4% of GDP, whereas exports shrank by more than 10p.p. from 41,2% to 30,7%. We expect the foreign trade indicators to slowly recover starting from 3Q 2021. Foreign exchange reserves have been relatively stable throughout the second half of 2020 and increased from 2,6 to 3,0 bn USD between December 2020 and May 2021. Moreover, in December 2020 the AMD depreciated by more than 8% against USD (y-o-y) (see graph 7).

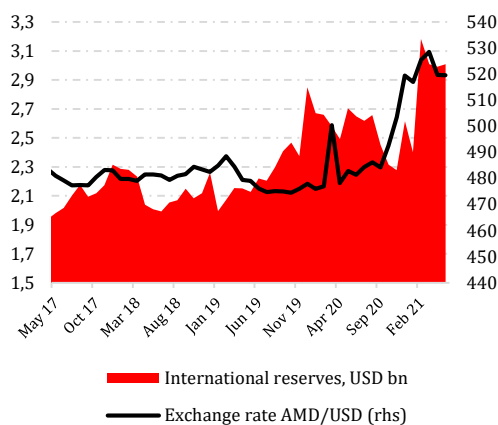
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**Graph 7: International reserves and exchange rate**



Source: RAEX-Europe calculations based on data from the WB, IMF and CBA

**Stress factors:**

- Financial dollarization remains high; loans and deposits in FX were equivalent to 48,0% and 42,7% of total loans and deposits respectively as of May 2021 (weak stress-factor);
- The escalation of the conflict with Azerbaijan for the Nagorno-Karabakh this year and the probability of its further development are another downside risks affecting the rating.

The following developments could lead to an upgrade:

- Faster and stronger than expected recovery of the global economy, as well as the main trade partners, including Russia, which can lead to an improvement of the external position of Armenia and a faster recovery from the current crisis;
- Substantial decrease of the public debt and deficit metrics on a recovery phase of the economic cycle;
- Consistent reduction in the dependence on external factors combined with a steep decrease in levels of financial dollarization.

The following developments could lead to a downgrade:

- Continued lock-down measures in the country and longer period of turbulence in the global economy, including the second wave of COVID-19 pandemic, which would lead to a further deterioration of the external position, as well as a deeper contraction of local economy;
- Higher than expected increase of the government debt and deficit metrics due to the need of additional financing for the government expenses, and underperforming of tax and external revenues;
- Substantial deterioration of the stance of the banking system with sharp growth of NPLs levels, a drop of profitability and capitalization metrics, combined with a lack of liquidity in the system.

ESG Disclosure:

Inherent factors

- Quality of fiscal policy; quality of monetary policy; natural resources; natural and climatic threats; environmental threats; level of corruption, CPI; Government Effectiveness Index; quality of the business environment; position in Doing Business Ranking; level of investment in human capital,

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adjusted for inequality; Rule of Law Index; transparency of government policymaking Index; level of information transparency of the government; Political Stability and Absence of Violence/Terrorism Index; natural disasters, constant exposure to difficult natural conditions.

Drivers of change factors

- None.

Next scheduled rating publication: TBD December 2021. The full sovereign rating calendar can be found at [Sovereign Rating Calendar 2021](#)

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**RATING HISTORY:**

Date	Review reason	SGC		Outlook	
		National currency	Foreign currency	National currency	Foreign currency
08.01.2021	Scheduled revision of both types of ratings for the country	BB-	BB-	Negative	Negative
10.07.2020	Scheduled revision of both types of ratings for the country	BB-	BB-	Stable	Stable
10.01.2020	Scheduled revision of both types of ratings for the country	BB-	BB-	Positive	Positive
12.07.2019	Scheduled revision of both types of ratings for the country	BB-	BB-	Positive	Positive
18.01.2019	Scheduled revision of both types of ratings for the country	BB-	BB-	Stable	Stable
20.07.2018	Scheduled revision of both types of ratings for the country	BB-	BB-	Stable	Stable
26.01.2018	Scheduled revision of both types of ratings for the country	BB-	BB-	NA	NA
28.07.2017	Scheduled revision of both types of ratings for the country	B+	B+	NA	NA
03.02.2017	Scheduled revision of both types of ratings for the country	B+	B+	NA	NA
05.08.2016	Scheduled revision of both types of ratings for the country	B+	B+	NA	NA
04.03.2016	First assignment of both types of ratings for the country	B+	B+	NA	NA

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### Minute's summary

The rating committee for Armenia was held on 9 July 2021. The quorum for the rating committee was present. After the responsible expert presented the factors, which influenced the rating assessment, the members of the committee expressed their opinions and suggestions within the framework of the Sovereign methodology. The chairman of the rating committee ensured that every member of the committee expressed his/her opinion before proceeding to the voting.

The following methodology was used for the rating assessment: [Methodology for Assigning Sovereign Government Credit Ratings – Full Public Version](#) (from August 2020). Descriptions and definitions of all rating categories can be found under the [Rating scale](#) section. The user of the rating shall read the methodology in order to have a full understanding of the rating procedure.

The definition of default can be found on the Agency's website in the section for [Internal policies](#).

**These ratings are unsolicited. The rated entity did not participate in the rating process.**

Main sources of information: IMF, World Bank, Central Bank of Armenia, Ministry of finance of Armenia.

### ESG Disclosure

We consider Environmental, Social, and Governance (ESG) risks and opportunities in the creditworthiness analysis of our Sovereign entities. The disclosure document can be found on the Agency's website in the section: [ESG factors in RAEX-Europe's Credit Ratings](#)

### Limits of the Credit Rating

During the rating assignment process, Rating-Agentur Expert RA GmbH (the Agency) used publicly available information that was considered to be reliable, complete and non-biased. The responsible expert performed the rating assessment of the country with information considered as the most reliable and up to date in accordance to the overall position of the country and the Agency's internal criteria for selecting data providers. The information and data used for this specific assessment can be considered as of sufficient quality.

### Regulatory use

SGC ratings can be used for regulatory purposes according to the ESMA definition.

### Conflict of interest

The responsible expert was neither influenced nor biased by third parties during the rating assessment. All employees involved in the rating assessment and revision of the rated entity have reported absence of conflicts of interests before initiation of the rating process.

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### Office responsible for preparing the rating

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Rating-Agentur Expert RA GmbH is a credit rating agency established in Germany and therefore shall comply with all applicable regulations currently in force in the European Union.

The European Securities and Markets Authority (ESMA), the EU's direct supervisor of credit rating agencies (CRAs), has registered Rating-Agentur Expert RA GmbH as a CRA under Regulation (EC) No 1060/2009 of the European Parliament and of the Council of 16 September 2009 on credit rating agencies, with effect from 1 December 2015.

Rating-Agentur Expert RA GmbH applies the Code of Conduct Fundamentals for credit rating agencies issued by the International Organization of Securities Commissions (IOSCO Code) and includes the basic principles of IOSCO Code in its Code of Conduct.

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