



Rating Action: Moody's changes Armenia's outlook to stable from negative; affirms Ba3 rating

22 Jun 2023

Singapore, June 22, 2023 – Moody's Investors Service ("Moody's") has today affirmed the Government of Armenia's Ba3 local and foreign currency long-term issuer ratings, as well as the foreign currency senior unsecured ratings. Concurrently, Moody's has changed the outlook to stable from negative.

The decision to change the outlook to stable reflects Moody's assessment that risks to Armenia's credit profile are balanced, compared to Moody's last review in March 2022 where risks were assessed to be skewed to the downside. Armenia's economic and fiscal metrics have improved markedly over the past year amid a surge in income, capital and labour from Russia, part of which Moody's expects to be sustained. Moody's expects Armenia's economic growth to remain robust over the next few years, even as it moderates towards trend. The rating agency also expects Armenia's fiscal metrics to stabilise at around the current levels for the next few years, with the debt burden at lower levels than pre-pandemic, making for higher fiscal strength. However, improvements to the country's economic and fiscal profile are counterbalanced against higher geopolitical risks.

The affirmation of the Ba3 ratings balances Armenia's robust growth potential and moderately high institutions and governance strength, against its relatively small and middle-income economy, which constrains its capacity to absorb shocks. Armenia also faces elevated geopolitical risks, which weighs on the sovereign rating.

Armenia's local and foreign currency country ceilings remain unchanged at Baa2 and Ba1, respectively. The four-notch gap between the local currency ceiling and the sovereign rating balances the government's small footprint in the economy and strong institutions against elevated geopolitical tensions with neighboring countries and its moderate current account deficits in most years that expose the economy to external shocks. The two-notch gap between the foreign currency ceiling and local currency ceiling incorporates Moody's assessment of Armenia's moderate policy effectiveness and an open capital account, indicating low transfer and convertibility risks even in times of stress.

RATINGS RATIONALE

RATIONALE FOR THE CHANGE IN OUTLOOK TO STABLE FROM NEGATIVE

NEAR-TERM GROWTH WILL REMAIN ROBUST, ALTHOUGH LONG-TERM OUTLOOK REMAINS UNCERTAIN

The Armenian economy expanded by 12.6% in 2022, well above its trend growth of around 4-5%, amid a surge in income, capital and labour from Russia, which in turn boosted domestic demand.

Foreign direct investment into Armenia increased by nearly three times in 2022 to almost \$1 billion (5% of GDP). Registered new foreign-owned companies were estimated to have increased to around 2,500 in 2022 and new non-resident entrepreneurs increased to 5,300, mainly operating in the IT sector. The increase in business activity contributed to higher gross fixed capital formation growth of 9.5% year-on-year in 2022, well above the average of 4.6% over 2018-2019. Activity in the information and communication sector also picked up, registering growth of 50.6% in 2022, compared to 9.1% in 2021.

Total money transfers also increased by about two and a half times in 2022 compared to a year ago, with about two-thirds of total inflows coming from Russia. The large increase in money transfers is consistent with higher inward

migration from Russia to Armenia. Official data show that the net number of Russians that have arrived in Armenia was about 65,000 in 2022 (equivalent to 2.2% of total Armenian population in 2021), compared to about 16,000 one year earlier. In tandem, household spending also increased, expanding by 8.1% year-on-year in 2022, compared to 3.7% in 2021.

The economy maintained strong momentum in 2023. Moody's projects real GDP growth to moderate to around 7% in 2023 and 5-6% in 2024, on the expectation that financial and labour flows will ease from the heady pace recorded in 2022. A slowdown in global growth and tighter financial conditions will also moderate activity in Armenia. Meanwhile, Moody's does not expect a sharp reversal of financial and labour flows back to Russia over at least the next two to three years. Instead, the inflow of people, income and capital is likely to boost levels of economic activity in a structural way.

In the near-term, there are risks that demand for goods and services increases faster than supply, leading to a build-up of inflationary pressures. While headline inflation has declined, nominal wage growth remains at double-digits while services inflation is elevated by historical standards, pointing to such risks. Moody's assumes that Armenia's fiscal and monetary authorities will contain inflationary pressures, should they build up, through appropriate policies.

Over the longer-term, Armenia's growth outlook is highly uncertain. Armenia's growth potential may weaken, if it was unable to reduce its economic linkages with Russia over time. This is because Moody's expects Russia's potential growth to be lower than before the Russia-Ukraine war. In addition, the labour and capital inflows that Armenia received over the past year may eventually reverse, which would weigh on the country's longer-term economic strength.

DEBT BURDEN WILL REMAIN LOWER THAN PRE-PANDEMIC LEVELS

Armenia's government debt burden reduced significantly to 46.7% of GDP in 2022, from 60.3% in 2021. The decline was driven by a combination of high nominal GDP growth, a smaller-than-budgeted fiscal deficit in 2022, and a significant appreciation of the dram.

Armenia's fiscal deficit narrowed to 2.2% of GDP in 2022, compared to a deficit of 4.5% in 2021. Government revenue increased by 22.3% year-on-year (2021: 8.4%), buoyed by strong growth, high inflation and commodity prices. Meanwhile, current expenditures increased at a more modest pace of 12.6% year-on-year. As a share of GDP, government revenue was about stable at 25.1%, while government expenditure was about 2% points lower, compared to 2021.

Strong financial flows into Armenia drove an around 20% appreciation of the dram against the USD in 2022, which in turn, supported a decline in the debt burden as a large share (58.4% as of December 2022) of the government's debt is denominated in foreign currency.

Moody's expects the government debt burden to stabilise at around 45% of GDP over the next two to three years, lower than the average of 51.7% recorded over 2017-2019. As mentioned above, Moody's assumes that there will not be a sharp reversal of the financial flows, leading to a large depreciation in the dram in the near term. The rating agency also expects the fiscal deficit to remain moderate at about 3% of GDP over the next two to three years.

GEOPOLITICAL RISKS HAVE INCREASED

Geopolitical risks have increased for Armenia over the past year, as the Russia-Ukraine war has led to a structural reshaping of Armenia's security architecture. A diminished Russian regional presence over the past year have coincided with an increase in frequency and intensity of military clashes between Armenia and Azerbaijan over disputed regions. These skirmishes culminated to deadly clashes between the two countries in the second half of 2022. The frequency and intensity of the military tensions remain elevated.

Moody's views it unlikely that there will be a lasting resolution to the conflict between Armenia and Azerbaijan in the

foreseeable future. Tensions between the two countries will remain high, but unlikely to escalate to full-scale hostilities. Increasing presence of the EU and the US in the region will likely contribute to keeping a full-scale conflict at bay. While not Moody's baseline, should geopolitical tensions develop to full-scale hostilities, it may spillover to domestic politics, severely crippling policymaking, weighing on Armenia's economic and fiscal prospects.

RATIONALE FOR THE AFFIRMATION OF THE Ba3 RATING

The affirmation of Armenia's Ba3 rating reflects Moody's assessment of its credit strengths - robust growth potential and moderately high institution and governance strength - which support Armenia's economic resilience. In addition, the government's debt structure, which is anchored by its large stock of multilateral and bilateral financing and borrowed on mostly concessional terms with long tenors and low interest rates, supports debt affordability and reduces government liquidity risk.

The rating also takes into account the constraints on Armenia's credit profile. In particular, the country faces high geopolitical risks, while the small size of its economy and middle-income levels limit its capacity to absorb shocks. In addition, Armenia also faces moderate external vulnerability risk. While it has broadly adequate foreign exchange reserves, its current account records deficits in most years. The current account deficit is mostly financed by debt-generating inflows, rather than foreign direct investment flows, which exposes the local currency and foreign exchange reserve adequacy to any weakening in sentiment.

ENVIRONMENTAL, SOCIAL AND GOVERNANCE CONSIDERATIONS

Armenia's ESG credit impact score is moderately negative (CIS-3), driven primarily by moderately negative social and environmental risks, which relatively robust governance help mitigate.

Armenia's exposure to environmental risks is moderately negative (E-3), reflecting the country's moderate exposure to heat and water stress, sizeable agricultural sector and its landlocked geography and small land area. Exposure to pollution, water constraints, and carbon transition risk is low, given the economy's limited dependence on hydrocarbon revenue and exports.

Armenia's social risk exposure is moderately negative (S-3), driven by demographic challenges including a small, ageing population and high youth unemployment that may act as a drag on long-term potential growth. Emigration by higher skilled Armenians supports inbound remittances, a mitigating factor, but also exacerbates demographic dynamics. Recent labour inflows into Armenia may durably increase labour supply, contributing to potential growth, if they stay in Armenia for the long term. The pivot to higher productivity services sectors including information technology may also help to mitigate these risks.

Armenia's governance risk exposure (G-2) is neutral-to-low, reflecting relative strength versus peers in economic policymaking, with a track record of fiscal and monetary prudence, and initial progress toward institutional reforms. Ongoing challenges include control of corruption and rule of law, although perceptions have recently improved and institutional reforms to address these issues, in large part with international technical assistance, are among the government's top priorities. The banking system's large size and still-high level of dollarization pose challenges to the effectiveness of macroprudential and regulatory policies to mitigate risks to financial stability.

GDP per capita (PPP basis, US\$): 17,795 (2022) (also known as Per Capita Income)

Real GDP growth (% change): 12.6% (2022) (also known as GDP Growth)

Inflation Rate (CPI, % change Dec/Dec): 8.3% (2022)

Gen. Gov. Financial Balance/GDP: -2.2% (2022) (also known as Fiscal Balance)

Current Account Balance/GDP: -0.9% (2022) (also known as External Balance)

External debt/GDP: 78.2% (2022)

Economic resiliency: baa1

Default history: No default events (on bonds or loans) have been recorded since 1983.

On 19 June 2023, a rating committee was called to discuss the rating of the Armenia, Government of. The main points raised during the discussion were: The issuer's economic fundamentals, including its economic strength, have materially increased. The issuer's fiscal or financial strength, including its debt profile, has materially increased. The issuer has become increasingly susceptible to event risks.

FACTORS THAT COULD LEAD TO AN UPGRADE OR DOWNGRADE OF THE RATINGS

FACTORS THAT COULD LEAD TO AN UPGRADE

Moody's would likely upgrade the rating should it become increasingly likely that the inflows of capital and labour that Armenia received over 2022 and 2023 are permanent, leading to sustained increases in productivity growth, materially higher potential growth and stronger improvements to fiscal strength. There would also be upward pressures on the credit should there be a durable easing of tensions with neighboring countries that leads to a material reduction in geopolitical risks. This could come in the form of a lasting peace agreement or an enduring ceasefire between the two countries.

FACTORS THAT COULD LEAD TO A DOWNGRADE

Moody's would likely downgrade the rating if there were a material reversal of financial or labour inflows that Armenia received over 2022 and 2023, leading to significant deterioration in its economic and fiscal metrics. An increase in inflationary pressures, not contained by policy, would also put downward pressure on the rating. An escalation of tensions with Azerbaijan into full-scale conflict to the extent that it cripples policymaking and weighs on economic activity would also put downward pressure on the rating.

The principal methodology used in these ratings was Sovereigns published in November 2022 and available at <https://ratings.moodys.com/rmc-documents/395819>. Alternatively, please see the Rating Methodologies page on <https://ratings.moodys.com> for a copy of this methodology.

The weighting of all rating factors is described in the methodology used in this credit rating action, if applicable.

REGULATORY DISCLOSURES

For further specification of Moody's key rating assumptions and sensitivity analysis, see the sections Methodology Assumptions and Sensitivity to Assumptions in the disclosure form. Moody's Rating Symbols and Definitions can be found on <https://ratings.moodys.com/rating-definitions>.

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