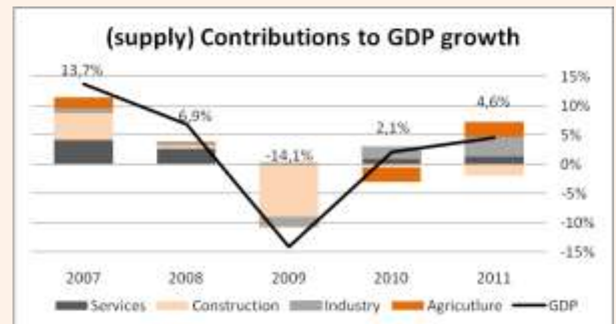
Armenia – off the beaten track for investors

When I mention in professional circles that we're invested in Armenia I am mostly given strange look. „Why? There's is nothing to do, is it?" is the usual reaction. Well for the patient investor, there is.

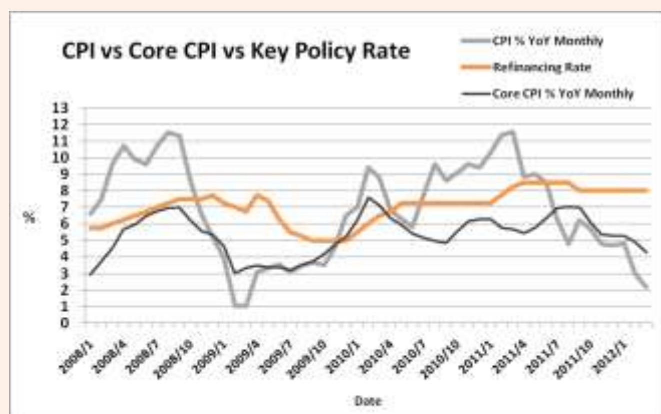
Macroeconomic performance

Investment in Armenia is mainly limited to investing in domestic government debt denominated in local currency, therefore country's macroeconomics deserves closer look. Four key areas to watch are inflation; current account and remittances; real exchange rate development and central bank's reserves.



GDP growth accelerated to estimated 4.5% in 2011 after sluggish 2.1% growth the year before. Industry (ex-construction in Armstat statistics) and Agriculture contributed most to the upswing on the supply side. Industry added >12% mainly thanks to mining and food processing. Agriculture grew by more than 12%, which is notable achievement after 2010's >15% decline. On the demand side net exports helped by +17%, while CBA (Central bank of Armenia) estimated private consumptions only added 3.6%.

The picture on Inflation front is the most positive for investor into domestic debt. Armenian CPI peaked in February and March 2011 above 11%, helped by then rising food prices globally and dry weather conditions in the region. With food having around 50% in the CPI basket and peak in food prices behind us, it was expected that inflation will decrease back into CBA inflation target band of 4% +/- 1.5%. Average annual inflation closed at 7.7% in 2011 with December YoY print at 4.7% and further decreasing to 3% YoY in March 2012.

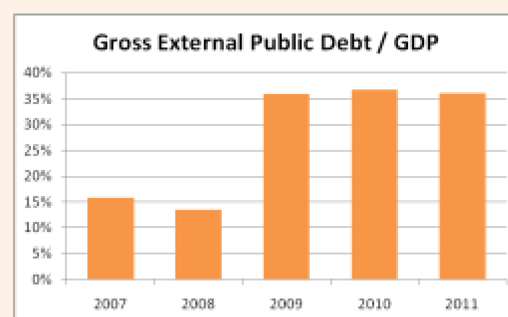


How inflation matters to us? It is the real yield that matters here, e.g. the difference between Government bond yields and the inflation. Back in summer 2011 when we first considered purchasing local debt, inflation was running low double digits while 2.5 year government bonds paid 13,25% p.a. This already gave us some 200-300 basis points in real yield with the view of inflation falling and real yield growing further. As of today the 2 year bond still yields above 13% p.a. and inflation is down to 3% you are (as of late April) purchasing a real yield of 10% p.a. Pretty impressive real yield not found in many investable places, perhaps only Serbia. There's an important lesson to take here: In small economies with high food price share in the basket inflation is volatile. Further, if such economy is also highly dollarized the changes in inflation do not necessary result in adequate rate cuts in policy rates, thus do not necessary result in shifts in yield curve lower. Central bank(s) in such countries may be reluctant to cut rates in magnitude similar to decrease in inflation as monetary policy is less effective in highly dollarized economy. (60% of loans

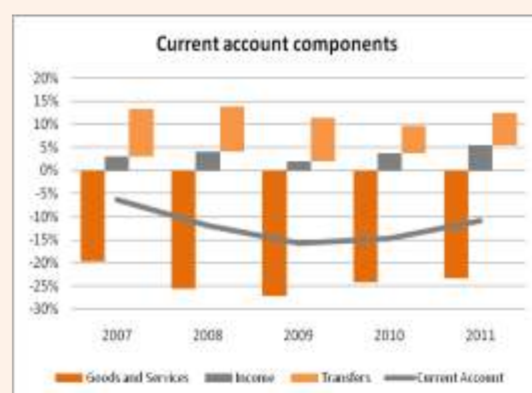
and 70% of deposits are in foreign currency in Armenia.) CBA raised its key policy rate, the refinancing rate, by 125 bp between February and April to tighten monetary in response to flying inflation and kept it steady till September when refi was cut by 50 bp to 8%.

At the moment the rate seems on tight monetary side and I can only guess that CBA keeps positive interest rate differential following two goals: foster the ‚dramization' (de-dollarization) of the economy and to protect forex reserves. CBA considers current refinancing rate has "neutral impact on inflation environment". Good still, we believe there is better likelihood of rate cut than rate increase in the future.

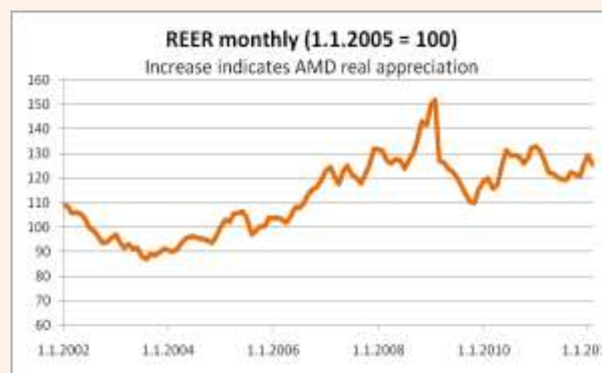
Inflation is expected to remain in 4% area by IFOs, while I tend to be rather cautious and I am ready for a volatile one. In any case the high carry collected in government debt denominated in currency with 10% real yield provides pretty fair cushion for investor.



The government behaved pretty prudently on fiscal side. Budget deficit narrowed to 3.3% of GDP from 5% in 2010. Government debt/GDP ratio climbed substantially in 2009 and continued to grow in 2010 and reached estimated 43% 2011. Local Public Debt Law stipulates 50% a ceiling for debt/GDP. On one hand debt must grow further in ~4% growth and ~4% inflation environments if government continues to pay double digit interest rates on its local obligation. On the other hand ‚expensive' domestic debt constitutes minor part of total government debt, some 14%. External debt, which constitutes majority, is mainly provided on friendly terms by IFOs, thus making debt service manageable. However, external debt is as cheap for the government as the local currency is stable, thus let's not forget that any weakening of the currency will push the value of external debt and this total debt/GDP higher.



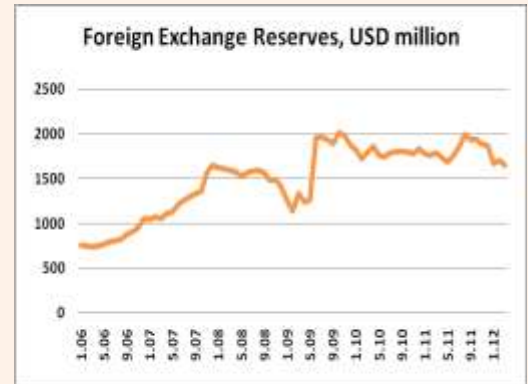
With exports at $1,4 billion and imports at $3,5 billion, the misbalance between export and import in Armenia is the Achilles' heel of this currency trade. Admittedly the dynamics are positive; export grew 20% last year, import only 8.8%. The gap is being closed thanks to remittances and FDI. Armenian workers abroad have sent $1,3 billion back home (+20%) and 2011 FDI is estimated at $650 million. As vast majority of remittances come from Russia as well as half of the FDI, the AMD govt bonds investment is indirect play on Russia. If Russia performs well, Armenia should too and yields are double in Armenia.



Thanks to lower inflation than average in partner countries and nominal depreciation of AMD, real effective exchange rate of Armenian dram weakened a little (5% in 2011 in

CBA statistics), thus Armenia should not be under depreciation pressure from the REER perspective.

CBA has inflation as official target; however it occasionally intervenes on the FX market to smooth volatility or to supply/sterilise excess foreign currency. From start of the year until mid April 2012 CBA intervened 6 times, selling total amount of 36.7 million USD for the period. Thus we could call the currency regime of AMD a managed float. FX reserves fluctuated between 1,6 and 2 bln last year, dropping slowly from their September peak to 1.65 billion USD reported in March 2012. Should reserves continue to decline during summer months, this will be a warning signal. For now reserves cover 5 to 6 month of imports which makes no major concern. Last year nominal depreciation versus USD was 6%, which compares from investor perspective well with 13%+ carry collected on local bond investment. I expect CBA to be willing and able to manage AMD in slight depreciation trend this year, in line with inflation. Risk to such scenario is slowdown in Russia, resulting in slower remittances.



To sum it up for potential AMD bond investor: inflation has been friendly to this trade; current account is the Achilles' heel, but as long as it is decreasing and remittances are growing the pace of nominal exchange rate depreciation should hold below bond yield levels. Watch out for real exchange rate development and central bank's reserves.

In the medium term, it will be important for Armenia to keep on the reform path. In the World Bank's Doing Business 2012 survey Armenia was among the top 10 reformers worldwide, rising six places to 55, however country should not stop there. More competition and fewer monopolies, less state influence and more freedom of doing business will be needed.

Last but not least, for a landlocked country like Armenia it does not help at all to have unfriendly or hostile relationship with two of four neighbours. Negative relationship with Turkey dates back 100 years to Armenian genocide and unsettled Nagorno-Karabakh region affair with Azerbaijan is 20 years old trouble still bubbling. From outside it seems prospect of future economic benefits should prevail over old injuries, however I can understand and respect the right of the nation to its self determination and dignity. Armenia could be more prosperous place with continued business friendly reforms and improved neighbour relations.

Sources for all graphs:

National Statistical Service of the Republic of Armenia, www.armstat.am

Central Bank of Armenia, http://www.cba.am