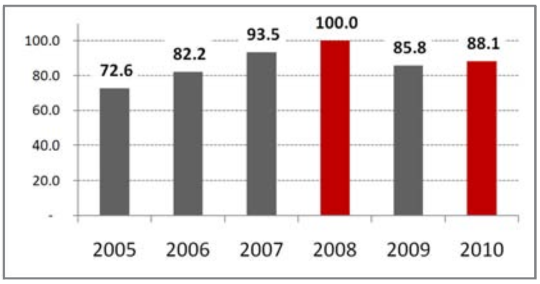
CONTOURS OF ARMENIA'S ECONOMY IN 2010: MINING DRIVES GROWTH

OVERVIEW

Year 2010 was a year of slow revivification after the plummeting decline in 2009. GDP growth comprised 2.6%[1] approaching AMD 3,510 bln (USD 9,394 mln). For the first time in the last 6 years the growing trend of import/export ratio was reversed, while budget deficit level (as % from GDP) decreased after peaking in 2009. However, high inflation and severe decrease in agriculture were major challenges for the economy in 2010.

Exhibit 1.
Armenia's GDP trend, 2008 = 100



Source: NSS
Note: 2008 GDP in constant 2007 prices.

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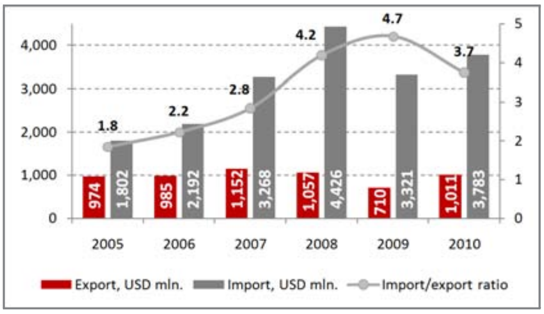
Since 2005 the Armenian economy has been sinking towards import-dependence with imports growing faster than exports. 2010 seems to be a breakthrough sowing seeds of hope that Armenian economy is on its way

[1] Note: All NSS data for 2010 is preliminary and subject to corrections over time.

to lessen the dependence on imports. Overall, the imports grew by 14% and attained level of USD 3.8 bln., while exports recorded as high as 42.5% growth- slightly surpassing USD 1 bln.

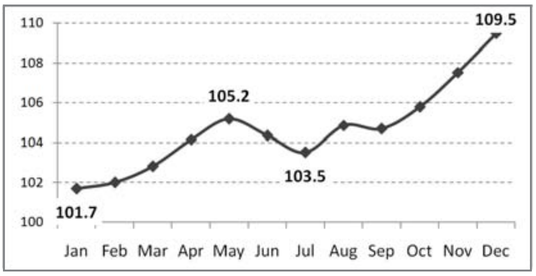
Exhibit 2.
Armenian import and export trends



Source: NSS

Inflation grew throughout the year. A sharp increase wave launched in October and drove the CPI to a cumulative 9.5% growth which entailed in an increased social tension.

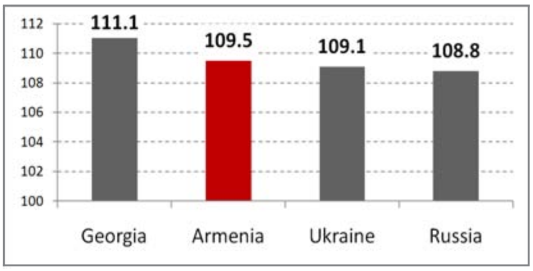
Exhibit 3.
CPI trend in 2010, December 2009 = 100



Source: NSS

However Armenia was not the only country to suffer from inflation. As shown in Exhibit 4 neighboring CIS economies demonstrated quite similar patterns which is largely due to inflation press induced by global commodity markets and increased government spending.

Exhibit 4.
CPI of neighboring CIS countries in comparison, %
(December 2010 over December 2009)

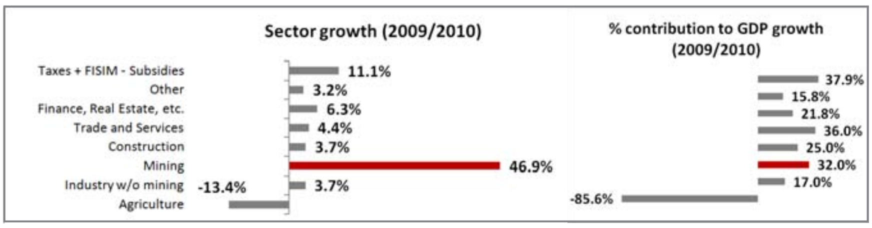


Sources: NSS, National Statistics Office of Georgia, State Statistics Committee of Ukraine, Bank of Russia

ANATOMY OF THE ECONOMIC GROWTH IN 2010

Modesty of 2.6 % economic growth of 2010 was to a large extent conditioned with 13.4% decline in Agriculture – in turn mainly a result of unfavorable weather conditions (further analysis reveals that livestock sector has not suffered losses and the whole heaviness of the shortfall was on the shoulders of the crop sector). The major driver of growth was mining, followed by financial sector. Tax collections captured higher share of gross value added. Noteworthily, in case Agriculture hadn't declined, the GDP growth would reach up to 6.7%.

Exhibit 5.
GDP growth by sector



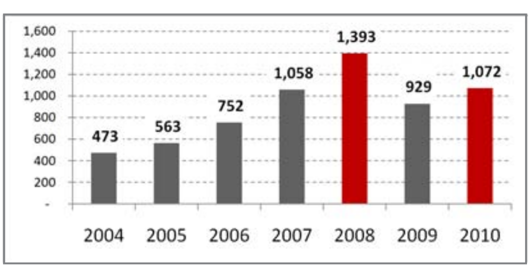
Source: NSS

Mining was the most rapidly developing sector in the economy, recording a significantly higher growth rate compared to other sectors. With only 2.54% share in the total GDP, the mining sector contributed 32% of the total GDP growth in 2010.

The recovery of Armenian economy to pre-crisis levels might be without qualitative improvement of its structure and nature.

The fact that one of the major factors of economic growth was mining partially explains the reasons of exports growing faster than imports: the growth in exports was mainly driven by the dramatic increases in metal prices in international markets in 2010. Whereas, the demand for imported products of mainly FMCG character didn't grow as fast mainly due to the household income growing slower: the net individual private transfers attained only 77% of 2008 level (see Exhibit 6) thus restraining the local demand for imported goods. This, together with the fact that neither exports nor imports have regained pre-crisis 2008 levels, further confirms our doubts that along with growing disposable income of the population the trend of growing import-dependence will restore.

Exhibit 6.
Net transfers of individuals sent to and received from abroad through Armenian commercial banks

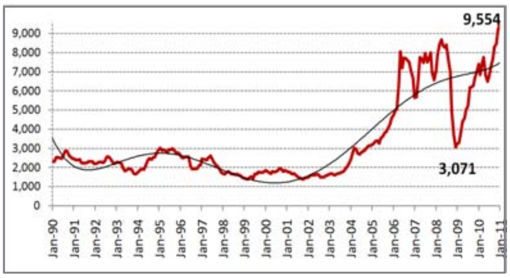


Source: CBA

MINING – THE RESOURCE-BASED DRIVER OF ARMENIAN ECONOMY

Copper industry output comprised 30% of Armenia's total exports in 2010

Exhibit 7.
LME copper price (cash buyer), 1991-2011, USD/t

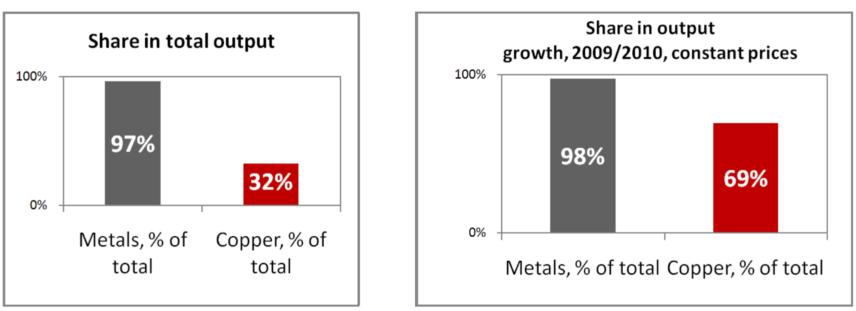


Source: LME

Mining, one of the major contributors to the economic growth, seems to be holding its leading position for coming years. A number of factors are going to foster this trend:

- Global prices for mined goods have recovered from crisis downturn and have been on a steady rise since 2009,
- Most mines plan to expand their production capacities,
- A number of mining projects are on their way to realization (e.g. Teghout, Dastakert, Hrazdan, Abovyan, etc).

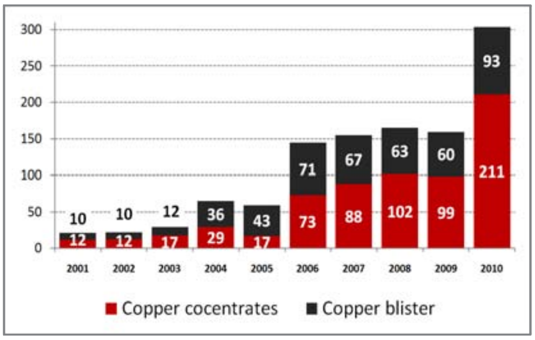
Exhibit 8.
Mining sector output and growth structure.



Source: NSS

Noteworthily, copper mine production was the main driver of the growth in mining in 2010. Exhibit 9 reveals that with total USD 304 mln. exports copper comprised 30% of total exports in 2010. While comprising only 32% of total mining output, copper mining secured 69% of its growth during 2010.

Exhibit 9.
Copper export structure, USD mln.



Source: UN Comtrade

The major source of the copper mining growth in 2010 was the substantially increased output from Kajaran and Kapan mines. High copper prices made it possible to realize such small projects like Hankasar mine with capacity of 2 thous. annual tones of copper concentrates (5-40 times less than other mines in Armenia).

Exhibit 10.
Key figures of the copper industry, thous. tones

	2005	2006	2007	2008	2009	2010
Copper recovery						
Actually recovered copper (contained)	14.9	17.5	18.0	18.2	23.2	31.0*
Copper industry output						
Blister (black) copper	9.9	8.8	7.0	6.5	6.9	7.6
Copper concentrates	62.8	68.2	67.0	71.3	88.3	118.1

Source: NSS, UN ComTrade

* EV Consulting estimate

Overall, the Armenian copper industry demonstrated firm growth trend since 2005 (16% CAGR 2005/2010) attaining output of approximately 31 thous. tons of contained copper[2] as of 2010. Production of copper concentrates increased 34% in 2010 and Alaverdy smelter (with concentrate supplies from Kajaran and Drmbon mines) produced 10% more copper blister.

[2] The main products of Armenian copper industry are copper concentrates and copper blister. Copper concentrates contain 22-30% copper while copper blister contains 99.5%.

ARMENIAN COOPER INDUSTRY: DEVELOPMENT PROSPECTS

The common view on the industry is that Armenia fails to capture the value added by exporting the raw concentrate only. However, at present Armenia grasps almost 95% of the value added in copper industry, since the miners get almost complete compensation for the valuable metals contained in the concentrates produced.

One of the major loss centers of the industry is the transportation. Since mines produce copper concentrate with only ~25% copper content, they have to pay for the transportation of the other 75% valueless weight. Thus, possibility to save on these costs would be one of the main considerations of establishing a copper smelter and refinery in Armenia. Possibilities of spillover development effects to adjacent industries, such as cable and else, are yet another major advantage.

In the meanwhile, the copper industry growth has substantial potential. A number of key projects are currently in progress and are expected to have a major impact on Armenian copper industry.

- **New and revived mining projects.** With copper prices driving high, more and more new and revived mining projects come into sight. Teghout (in Lori), Dastakert (in Syunik) and Armanis (near Stepanavan) are expected to more than double the country's copper output.
- **Establishment of copper refinery being considered.** The establishment of a copper smelter/refinery in Armenia is discussed. Among the options are pyrometallurgical plant or a hydrometallurgical refinery in South. In case of successful launch of the project, the adjacent mines will have the opportunity to significantly save on transportation costs and a higher level of value added will be captured by the country. However, the project is prone to significant technological and market risks which need to be seriously considered before a decision is made.
- **The future of Alaverdy smelter.** Currently Alaverdy smelter is the largest air pollutant in the Northern Armenia with very outdated technology and equipment deployed. The smelter operator – ACP, claims the operations being of more social nature (it provides with employment to 674 people) and not profitable. The mix of economic interests, tremendous social role and ecological problems together make the future of the smelter very vague.

SUMMARY

- Armenia's economic growth prospects are ambiguous. Current statistics indicates that growth is to a large extent conditioned with development of mining sector and high global prices for resources. With further increase of private transfers and local demand, Armenia may retake to the needle of private transfers and continue sinking in import dependence. All this hints that policymakers should stay alerted and proactive to foster export-oriented growth in Armenia.
- Mining (and particularly of copper) is expected to have a key role in the Armenian economy. More and more projects are expected to develop along with increase of metal prices. However, there are little prospects for moving up along the value chain to capture more value added since this is subject to huge capital expenses and opportunity cost considerations.