

### **RAEX-Europe confirmed at 'BB+' the ratings of Azerbaijan. The rating outlook remains negative.**

RAEX-Europe confirmed the sovereign government credit rating (SGC) of Azerbaijan at 'BB+' (Sufficient level of creditworthiness of the government) in national currency and at 'BB+' (Sufficient level of creditworthiness of the government) in foreign currency. The rating outlook is negative which means that in the mid-term perspective there is a high probability of downgrading the rating score.

#### MAJOR FACTORS THAT INFLUENCED BOTH TYPES OF RATINGS:

##### Positive factors:

- Gross government debt stood at 19% of GDP and 46% of budget revenues in 2019, low as compared to the rest of the South Caucasus region<sup>1</sup>. We expect the level of government debt to GDP to increase up to 23% staying at manageable levels. Moreover, the level of short-term debt remains stable;
- Even though the unemployment rate was acceptable at 5% in 2019, we anticipate the metric to rise to around 7% in 2020 as a result of adverse economic effect caused by the pandemic;
- International reserves are still at acceptable levels but have remained flat in 1Q 2020, while the FX reserves<sup>2</sup> have been declining since April 2020 and stand at USD 7,05 bn as of July 2020 as the CBA continued to maintain the USD peg. As a result of low oil prices and the escalating military conflict, we anticipate international reserves to continue to deplete.

##### Restricting factors:

- Azerbaijan's external position has deteriorated due to the negative impact from the pandemic and we expect this stance to weaken further if the military escalation continues. We anticipate the current account to turn from surplus in 2019 to a deficit of around 3,6% of GDP in 2020. Moreover, the share of oil exports remain elevated at around 91% in 2019 which exposes the country to additional risk as oil prices remain low. We also expect the pandemic and the military conflict to exert pressure on AZN which could cause reserves to deplete. Despite this, the government still has strong fiscal buffers in SOFAZ;
- Domestic credit to GDP stood at 14,7% in 2019, in line with our previous projection, while the total banks' assets to GDP ratio was 40,1%. We expect credit to the economy to slow down as a result of the coronavirus crisis;
- Real GDP climbed by 2,2% in 2019 due to an increase in prices of oil, strong external demand and steady private and public consumption. However, as a result of the pandemic taking a toll mainly in the oil industry, real output already contracted by 3,9% y-o-y as of September 2020 and we expect the economy to contract by 4% y-o-y by end-2020. The economy could perform even worse if a peaceful resolution to the military conflict is not reached;
- Under the current pandemic, the fiscal policy of the government turned accommodative in order to cushion the economic impact from the crisis. These measures include increase

<sup>1</sup> Debt to GDP for 2019: Georgia – 42,6%, Armenia – 49,9%.

<sup>2</sup> Excludes gold.

in healthcare spending, social assistance to unemployed, and tax benefits to companies affected by the pandemic, among others. The authorities also announced an increase in the transfers for the oil fund of AZN 850 m in order to cushion the decline in budget revenues;

- The inflation rate 2,7% in 2019 showing stability over the past two years. The CPI index growth has remained balanced at 2,9% y-o-y as of September 2020. We expect the inflation rate to be around 3% by year-end 2020; nonetheless, as the price of oil remains depressed and the military conflict could cause a withdrawal of foreign funds, the pressure to devalue the AZN increases, and with it, the risk of higher inflation;
- The monetary policy of the CBA has loosened through 2020 in order to support economic activity amid a crisis caused by the pandemic. As of end-October 2020, the CBA decided to hold the refinancing rate at 6,5%, while it started the year at 7,25%, in order to propel the economy while maintaining macroeconomic stability. Moreover, the central bank continues to hold the peg to the USD, along with SOFAZ, the central authority has already auctioned FX several times in 2020 in order to keep the USD/AZN exchange rate at 1,7. We still anticipate the transition to an inflation targeting regime as part of the CBA's monetary policy strategy improvement to remain delayed. In terms of effectiveness, the economy's response to the changes in the reference rate remains limited as a result of high dollarization levels which might increase further to the USD peg combined with downward pressure on the oil price;
- The level of corruption perception remains high in the country. However, Azerbaijan hiked 26 spots as compared to 2018 and was ranked 126<sup>th</sup> out of 180 countries in the CPI index for 2019. The high perception of corruption continues to limit the willingness of doing business;
- The institutional development remains moderate. According to the Worldwide Governance Indicators (WGI), Azerbaijan was ranked 113<sup>th</sup> in the Government Effectiveness Index and 146<sup>th</sup> in the Rule of Law Index out of 214 analyzed countries in 2019, mostly stable as compared with 2018.

#### Negative factors:

- The concentration of the economy of Azerbaijan in the hydrocarbon sector remains one of the key constraints for the sovereign rating. As of September 2020, the share of oil GDP in the economy was about 30%, even though this figure shows a decline as compared to 2019, it is mostly due to the steep decline in oil output and prices and not due to a substantial development of the non-oil sector. Moreover, hydrocarbon export continue to account for around 90% of total exports. The undiversified economy combined with the low oil price environment and the escalating military conflict could put an extensive pressure of the economy of Azerbaijan and have a direct adverse effect on public finances;
- The banking sector has showed better than expected metrics. As of August 2020, the NPLs to total loans ratio was 7,3%, while ROA and ROE remained positive at 1,4% and 9,3%. The capital adequacy ratio was 22,6% by the end of 2019. However, the sector remains concentrated and highly dollarized, which makes the stability of the system vulnerable to a currency devaluation. In order to cushion the coronavirus effect, the CBA has already introduced different measures to relief banks;
- Around 95% of the total government debt is external and denominated in foreign currency. As a result, we consider this a key downside risk given the current coronavirus crisis, as well as the escalating military conflict with Armenia as a potential local currency devaluation resulting from the low-oil-price pressures would increase the overall indebtedness level of the government; therefore, the debt structure in terms of currency remains a negative factor.

#### Support factors:

- Substantial foreign currency assets on the balance sheet of SOFAZ. The assets of the State

Oil Fund of the Republic of Azerbaijan (SOFAZ) recovered in 3Q 2020 but mainly due to extra-budgetary revenues related to the foreign exchange movements and currently stands at USD 43,3 bn, still lower than the figure posted a year before. As of September 2020, AZN 8,9 bn has been transferred to the budget. The fund remains the largest source of current budget expenditures and government debt service (weak support-factor).

#### Stress factors:

- Increased dollarization level: as of March 2020, 62,4% of total deposits were denominated in foreign currency (moderately weak stress-factor);
- Budget revenues are highly dependent on the oil sector. According to the draft version of the State Budget 2020, 57% of budget revenues will be gained from the oil sector (weak stress-factor);
- Escalation of the frozen conflict over the Nagorno-Karabakh territory continues to constrain the structural transformation of the country, threatens the attractiveness of the country for foreign investors and could potentially lead to a deterioration of the economic relationships with trade-partners (including Russia) and to further increase of fiscal spending (medium stress-factor).

#### SENSITIVITY ASSESSMENT:

The following developments could lead to an upgrade:

- Increase in oil prices higher than our base scenario to support GDP growth and the external trade position;
- Continued economic diversification and lower share of budget revenues from the oil industry.

The following developments could lead to a downgrade:

- Further deterioration of economic activity which will have a direct impact on public finances and external buffers;
- Unexpected devaluation of local currency as a result of pressure from lingering low oil prices;

#### 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, 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

“The ratings of Azerbaijan were confirmed at BB+ and the outlook remains negative. The decision to leave the negative outlook was mainly a reflection of the downside risks for the economy and the government derived from the coronavirus pandemic and the escalating military conflict in the Nagorno-Karabakh region. These events could propel capital outflows from the country, put pressure on the currency and directly affect public finances. Thus, we anticipate that if the status quo continues in the mid-term view, we could perform a negative action on the sovereign credit rating of the country.

On the other hand, we continue to observe adequate levels of government debt and, albeit slightly decreasing, vast buffers in the State Oil Fund of the Republic of Azerbaijan (SOFAZ).” – Clarified Hector Alvarez, Associate Director of RAEX-Europe.

Research report on Azerbaijan is available at:

[https://raexpert.eu/reports/Research\\_report\\_Azerbaijan\\_06.11.2020.pdf](https://raexpert.eu/reports/Research_report_Azerbaijan_06.11.2020.pdf)

Next scheduled rating publication: TBD December 2020. The full sovereign rating calendar can be found at [Sovereign Rating Calendar 2020](#)

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**RATING HISTORY:**

Date	Review reason	SGC		Outlook	
		National currency	Foreign currency	National currency	Foreign currency
08.05.2020	Scheduled revision of both types of ratings for the country	BB+	BB+	Negative	Negative
08.11.2019	Scheduled revision of both types of ratings for the country	BB+	BB+	Stable	Stable
10.05.2019	First assignment of both types of ratings for the country	BB+	BB+	Stable	Stable

## Minute's summary

The rating committee for Azerbaijan was held on 5 November 2020. 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 April 2019). 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 Azerbaijan, National statistical office of the Republic of Azerbaijan, Ministry of finance of the Republic of Azerbaijan, WEF, The State Statistical Committee of the Republic of Azerbaijan, Transparency international, open sources.

## 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.

Rating-Agentur Expert RA GmbH is completely independent from the activities of other agencies of the RAEX group.

## Risk warning

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This press-release represents the opinion of Rating-Agentur Expert RA GmbH and is not a recommendation to buy, hold or sell any securities or assets, or to make investment decisions.

## Office responsible for preparing the rating

The office responsible for the preparation and issuance of this credit rating is the office of Rating-Agentur Expert RA GmbH in Frankfurt am Main, Germany.

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.