Rating-Agentur Expert RA confirmed at 'BB+' the ratings of Azerbaijan. The rating outlook is stable.

Rating-Agentur Expert RA 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 stable which means that in the mid-term perspective there is a high probability of maintaining the rating score.

MAJOR FACTORS THAT INFLUENCED BOTH TYPES OF RATINGS:

Positive factors:

- The oil-rich nation is a competitive economy ranked 58th out of 141 based on the Global Competitiveness Index 4.0 from 2019, which represents a hike of 10 spots during the year due to improvements in public sector and infrastructure. External balances continue to improve. The current account surplus increased by 8,8p.p. of GDP to 12,9% in 2018 and reached 9,7% in 2019. In the World Bank Doing Business ranking, Azerbaijan improved to the 25th position in 2018 after being in the 57th place in 2017;

- Despite an increasing trend from 2016, the scale of government indebtedness is low relative to the other countries from the Caucasus region[1]. The estimated general government debt to GDP ratio is 19,7% and government debt to budget revenues is 49,3% for 2019. Moreover, debt is well structured in terms of maturity, only 2,3% of total external debt is short term and 15% issued on concessional terms;

- The unemployment rate remained low in 2019 at 5%. As a result of a gradual growth in wages, we estimate a similar figure in the short run;

- The amount of international reserves continues to grow. As of September 2019, the levels of reserves climbed by 7% since 2018, covering short-term debt by more than 5x.

Restricting factors:

- Credit to the economy slightly improved in 2019 as we anticipate bank assets to GDP and domestic credit to GDP to reach 39% and 14% respectively by year-end, an annual increase for both indicators of around 1p.p. In our view, this level is still insufficient to support private sector growth. Despite this, total loans provided by credit institutions to real sector increased by almost 25% since the beginning of the year in absolute terms;

- The fiscal policy of Azerbaijan in 2019 turned towards expenditure tightening, which allowed to maintain the budget surplus to GDP at 4,3% (similar to the year before). At the same time, the government increased the minimum wage twice in 2019 and increased public sector wages making total spending higher by 7%. In order to support social standards, further expenditure rise is inevitable and the overall fiscal balance in 2020 is expected to decline to 3,4%. According to the Ministry of Finance, the draft budget of 2020 shows that the budgeting process complied with the new "Law on Budget System" which limits consolidated budget expenditure growth. Nevertheless, some questions regarding expenditure estimations and allocations remain, therefore the quality of the fiscal policy is assessed as moderate;

- Current economy stabilization allowed bringing inflation risks under control during the

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[1] IMF estimated debt to GDP for 2019: Georgia – 49,9%, Armenia – 50%,

last two years. The expected inflation rate for 2019 is within 2% and 3%, which is inside the target of 4±2 % set by the Central Bank of Azerbaijan (CBA) for the year. However, the risk of returning to high inflation levels still exists due to a potential AZN devaluation, which is the main obstacle to implement inflation targeting;

- The monetary policy is aimed at supporting local currency with the ambitious objective to move toward an inflation targeting regime. In order to support corporate lending the CBA eased its base interest rate by 25b.p. to 7,75% on 25 October 2019. The CBA deposits and notes auctions currently allow to control the monetary base and provide additional liquidity to commercial banks. However, further lowering of the interest rate might not bring desired effect on economy due to the *de facto* USD-pegged exchange rate, which limits banking system development. The interest rate channel continues to be the main mechanism to fight dollarization;

- The level of corruption perception remains high in the country (ranked 152nd out of 180 countries in the CPI index for 2018) which exerts a negative influence in the willingness of doing business;

- The institutional development is moderate. According to the Worldwide Governance Indicators (WGI), Azerbaijan was ranked 107th in the Government Effectiveness Index and 167th in the Rule of Law Index out of 214 analyzed countries in 2018.

Negative factors:

- The economy continues to be concentrated on the oil and gas industry, which accounts for more than 43% of GDP and 92% of total exports. This structure of the economy makes it vulnerable to volatility in hydrocarbon prices. We anticipate that oil production in the country will be reduced, negatively affecting GDP growth and trade balance;

- The banking system is recovering but remains fragile due to a high assets concentration in the top 3 banks and elevated asset risk. We expect the NPLs to total loans ratio to be around 11% for 2019, which would be 1,2p.p. less than the year before and would be the lowest rate since the sharp devaluation of the AZN in 2016. The latest figure, reported by the CBA is 10,1% as of September 2019. Such improvement is mainly driven by the recently announced completion of the restructuring process of the state-owned International Bank of Azerbaijan (IBA). As a result, all bad and overdue loans were transferred in several tranches to Aqrarkredit, a credit institution created by the government during 2015-2019. Profitability indicators represented by ROE will remain at the previous year level, around 1,5%, while capital adequacy ratio we expect to improve slightly to 14% in 2019; however, these dynamics will be mainly triggered by the recovery of IBA, which accounts for 20% of total banking system assets. Moreover, reporting transparency of the smaller participants remains an obstacle for a more granular assessment. The Presidential Decree put into effect in March 2019 on the NPLs resolution program to compensate the AZN devaluation impact had a positive impact on financial stability;

- Since the beginning of 2019 assets of the State Oil Fund of the Republic of Azerbaijan (SOFAZ) increased by 10% thanks to higher sales of hydrocarbons this year. However, the fund continues to be the largest source of current budget expenditures and government debt service. Around 50% of total budget revenues will be covered by SOFAZ in 2019;

- Government debt, despite remaining low, has hiked by more than twice since 2014. In 2019, gross government debt to GDP reached 19,7%, which is 1p.p. higher than a year before and is almost 50% of all budget revenues for the year;

- Around 95% of the total government debt is external and denominated in foreign currency. As a result, a potential local currency devaluation 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 (90% of GDP) on the balance sheet of SOFAZ. As of September 2019, the fund had around USD 42,5 bn, which provides a substantial financial buffer (weak support-factor).

Stress factors:

- Increased dollarization level: as of September 2019 more than 63,6% 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 by the oil sector (weak stress-factor);

- Possible escalation of the frozen conflict over the Nagorno-Karabakh territory continues to constrain the structural transformation of the country (very weak stress-factor).

SENSITIVITY ASSESSMENT:

The following developments could lead to an upgrade:

- Further improvement of banking soundness indicators;

- Long-term sustainability of high oil prices 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:

- Unexpected devaluation of local currency;

- Substantial deterioration of the Central Bank reserves and State Oil Fund of the Republic of Azerbaijan (SOFAZ).

"The Agency confirmed the sovereign credit ratings of Azerbaijan at 'BB+' based on its strong fiscal position, positive trade balance and significant amount of accumulated national reserves. Additionally, the stabilization of the economy brought inflation under control and reduced unemployment.

Nevertheless, the still substantial dependency on the hydrocarbon industry, the highly dollarized financial system, low asset quality of the banking system together with high corruption perception in the country, as well as the lingering geopolitical risk in regard to the Nagorno-Karabakh conflict, continue to be the main factors constraining the rating.." – Clarified Olena Kolokolova, Rating Analyst of Rating-Agentur Expert RA.

Research report on Azerbaijan is available at:

https://raexpert.eu/reports/Research_report_Azerbaijan_08.11.2019.pdf

Next scheduled rating publication: TBD in December 2019.

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Minute's summary

The rating committee for Azerbaijan was held on 6 November 2019.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.

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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Risk warning

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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.

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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.