

Rating-Agentur Expert RA assigned ‘BB+’ ratings to Azerbaijan. The rating outlook is stable.

Rating-Agentur Expert RA assigned ‘BB+’ sovereign government credit rating (SGC) to Azerbaijan in national currency (Sufficient level of creditworthiness of the government) and ‘BB+’ in foreign currency (Sufficient level of creditworthiness of the government). 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 (69th out of 140 based on Global Competitiveness Index 4.0, 2018) with a trade balance surplus of 10% to GDP in 2018. We expect energy projects, such as “The Trans-Anatolian Natural Gas Pipeline” (TANAP) will support growth and the trade balance in the medium term;
- Despite an increasing trend from 2016, the scale of indebtedness of the country is low relative to the country’s peers¹. The estimated general government debt to GDP ratio for 2018 is 19,4%. Moreover debt is well structured in terms of maturity, only 2,3% of total external debt is short term and 15% is issued on concessional terms;
- For the first time since 2015 the government budget was executed with a surplus due to higher revenue from the oil industry. The fiscal balance to GDP ratio raised to 4% in 2018 (-1,4% in 2017);
- The unemployment rate remained low in 2018 (5%). In light of gradual wages growth, we estimate a similar figure in the short-run;
- The amount of international reserves has grown continuously since 2016. As of 2018, the levels of reserves climbed by 5%, covering by more than 5x all costs of external government debt for the year.

Restricting factors:

- Credit to the economy remained low in 2018 as shown by the banks’ assets to GDP and domestic credit to GDP at 38,2% and 12,5% respectively; both indicators declined by around 1p.p. from a year before. This level is still insufficient to finance the private sector recovery. Loans in local currency moderately started to resume showing some signs of de-dollarization;
- The quality of the fiscal policy is assessed as moderate. Budget revenues are highly dependent on the oil industry, making it difficult for long term planning and setting achievable fiscal targets. Full implementation of the “Law on Budget System” from 2017 should improve the fiscal position and raise non-oil tax income;
- Monetary policy effectiveness remains subdued as a result of high levels of dollarization and the tight grip of the government in the financial system. Moreover, despite having officially changed the exchange rate regime to a free-floating currency in December 2015,

¹ IMF estimated debt to GDP for 2018: Georgia – 44,5%, Armenia – 48,5%, Russia – 14% and Kazakhstan - 22%.

there are clear signs that the AZN is still supported by the Central Bank of Azerbaijan (CBA). Since 2018, the CBA has lowered its key rates from 15% down to 8,75% (effective from 26 April 2019) in order to stimulate corporate lending (total loans to the economy increased by 11% y-o-y in 2018). The interest rate channel is the main mechanism to decrease dollarization; the average spread between local and foreign currency deposits increased from 0,2p.p. in 2015 till 7,3p.p. in 2018;

- Corruption remains high in the country (ranked 152nd out of 180 countries in the CPI index for 2018). This has a negative influence on costs of doing business in Azerbaijan;
- The institutional development is moderate. According to the Worldwide Governance Indicators (WGI), Azerbaijan was ranked 111th in the Government Effectiveness Index and 142nd in the Rule of Law Index out 214 analyzed countries in 2017.

Negative factors:

- The economy is highly concentrated on the oil and gas extraction industry as the sector accounts for as high as 38,6% of GDP. This exposes the economy to hydrocarbon prices' volatility;
- The banking system's financial soundness indicators deteriorated significantly as a result of the sharp devaluation of the AZN due to the oil price plunge back in 2016. The share of NPLs in total loans reported by the CBA reached 12% in 2018, 1,06p.p. lower than a year before. Taking into consideration the recently announced measures for the restructuring of bad loans, we anticipate the asset quality to improve further in 2019. Moreover, after being negative for two years, profitability indicators returned to positive territory with ROA at 1,2% at the end of 2018. However, despite a declining tendency, the banking sector remained concentrated as the largest bank, International Bank of Azerbaijan (IBA), accounts for around 30% of the total banking sector assets;
- Inflation declined down to 2,3% in 2018 from 10% in 2017 due to economic stabilization. We expect official inflation rates to be within the level of 3%-5% in 2019-2021. However, a potential renewed devaluation of the AZN, raises the risk of returning to high inflation levels;
- National savings accumulated in the State Oil Fund of the Republic of Azerbaijan (SOFAZ) slightly recovered in 2018 with a y-o-y growth of 8%. However, even though the fund was established for future generations' capital investments, it is more often used to cover current expenses and to serve government debt. Around 49% of total budget revenues will be covered by SOFAZ in 2019;
- Even though the gross government debt to GDP metric remains quite low, its dynamics have been negative as it has escalated substantially as a result of the currency devaluation in 2015. Government debt to GDP has hiked by more than twice since 2014;
- Structure of debt in terms of currency is negative. External liabilities denominated in foreign currency form 93,9% of total debt which, under the existing level of currency risks, could potentially increase overall indebtedness in case of devaluation. In order to strengthen financial stability, the "Medium- and long-term strategy for public debt management in the Republic of Azerbaijan" was approved by the president in 2017.

Support factors:

- Substantial foreign currency assets (88% of GDP) on the balance sheet of SOFAZ, USD 40 bn as of March 2019, provides a sufficient financial buffer (weak support-factor).

Stress factors:

- Increased dollarization level: as of February 2019 more than 65% of total deposits were denominated in foreign currency (moderately weak stress-factor);

- Budget revenues are highly dependent on the oil sector. The total projected oil income in 2019 is expected to be 59,8%, down by 0,4p.p. from 2018 (weak stress-factor);
- Possible escalation of the frozen conflict over Nagorno-Karabakh territory continues to constrain structural transformation of the country (very weak stress-factor).

SENSITIVITY ASSESSMENT:

The following developments could lead to an upgrade:

- Improvement of banking soundness indicators, including level of NPLs;
- Long-term sustainability of high oil prices to support GDP growth and trading position;
- Continued economy 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 ‘BB+’ sovereign government credit ratings assigned to Azerbaijan reflect sufficient level of creditworthiness due to a strong fiscal position supported by substantial amount of accumulated national reserves. Moreover, favorable oil prices significantly improved the trading balance and stabilized the local currency.

Nevertheless, high concentration of the economy in one single industry (oil & gas) and weak asset quality of the banking system, are the main factors constraining the rating. The stable outlook indicates high probability that the rating will stay at the same level in the mid-term perspective.”
– Clarified Olena Kolokolova, Rating Analyst of Rating-Agentur Expert RA.

Research report on Azerbaijan is available at:

https://raexpert.eu/reports/Research_report_Azerbaijan_10.05.2019.pdf

Next scheduled rating publication: 8 November 2019. The full sovereign rating calendar can be found at [Sovereign Rating Calendar 2019](#)

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Minute's summary

The rating committee for Azerbaijan was held on 10 May 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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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.