Rating-Agentur Expert RA upgraded from 'B+' to 'BB-' the ratings of Uzbekistan. The rating outlook is stable.

Rating-Agentur Expert RA upgraded the sovereign government credit rating (SGC) of Uzbekistan from 'B+' (Moderately low level of creditworthiness of the government) to 'BB-' (Sufficient level of creditworthiness of the government) in national currency and from 'B+' (Moderately low level of creditworthiness of the government) to '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:

- Moderately low level of gross government debt with a positive maturity and creditors' structure. Despite the estimated increase in the total volume of public debt over 2018, it is expected to remain bearable at around 24,6% of GDP and 80% of fiscal revenues. In addition, short-term debt represents only around 5% of total debt and it is well covered by international reserves by more than 63x. Moreover, a significant part of the government debt still can be considered as concessional (bilateral loans and credits from international financial institutions), despite the issuance of Eurobonds in 2019;
- The consolidated fiscal balance[1] is expected to be around 2,7% of GDP by end-2018, close to the 2017 metric of 2,1%; while the overall fiscal deficit, which includes policy-based lending operations[2] in 2018 was projected to reach 2,5% of 2018 GDP according to IMF estimates. Both metrics represent a low credit risk according to our internal benchmarks and we expect the latter metric to remain unchanged or be lower by the end of 2019, taking into account fiscal plans of 1,8% consolidated deficit[3] and expected reduction of off-balance sheet operations in 2019;
- The 2018 real GDP growth at 5,1% remains one of the highest among CCA peers[4], and 0,6p.p. higher than the 2017 metric[5]. Such a robust growth was mainly supported by investment growth and accelerated industrial output growing by 10,6% y-o-y in real terms, mostly due to positive dynamics in mining and manufacturing industries. We expect the long-term growth to be close to 5% supported by increasing domestic investment, gradual implementation of economic reforms, as well as positive demographic dynamics. However, output growth will remain sensitive to the external environment, including commodities prices;
- Uzbekistan's banking sector remains profitable and sound with ROA at 2%, capital-to-assets ratio at 12,4% and officially recorded NPLs at 1,3% of total loans in 2018. However, the system stability is still distorted by high concentration levels (the three largest banks account for 55% of total assets) as well as dominance of state owned banks (SOB) (more than 80% of total assets). SOBs remain the key channel for the policy based lending to SOEs (constitute around 60% of total loans), under the preferential interest rates. Taking into account that some of SOEs already faced financial distress after the exchange rate

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[1] Consolidated fiscal balance includes revenues and expenditures for extra budgetary funds (primarily the Fund for Reconstruction and Development), lending and borrowing, and externally financed expenditures.
[2] Policy-based lending operations include investment project financing and on-lending by the FRD, recapitalization or capital injections in SOEs including state banks, and loans extended to construct affordable housing in rural and urban areas.
[3] The figure does not include FRD operations and policy-based lending operations.
[4] Here Caucasus and Central Asia (CCA) oil and gas exporters: Azerbaijan, Kazakhstan, Turkmenistan, and Uzbekistan.
[5] Both figures – according to IMF data and estimates.

liberalization and large share of restructured FX-denominated loans we anticipate the quality of the banks' balance sheets to deteriorate in the mid-term perspective. However, this risk is still partly mitigated by high probability of support from the government.

Restricting factors:

- The currency structure of the public debt remains worrisome as almost 100% is FX-denominated. This makes the debt position of the government extremely vulnerable to currency fluctuations, as was already evidenced by the 2017 dynamic, when debt to GDP and budget revenues ratios almost doubled after the UZS devaluation. Any further currency depreciation would lead to rapid increase in the debt burden, while the share of local currency denominated bonds issued in 4Q 2018 and 1Q 2019 remains negligible (around 1% of total government debt);

- The economy's competitiveness remains subdued as evidenced by estimated trade deficit of 12% of GDP in 2018 as compared to 8,9% in 2017, as well as moderately high concentration of the country's production on agricultural and commodities sectors. However, the picture may change once further international trade reforms[6] materialize into an increased competitiveness of Uzbek exports;

- The ratio of banks' assets and gross loans to GDP remains moderate at 63,4% and 49,5% by end-2018 despite the rapid growth of both components over the last two years; this could indicate a risk of the economy potential overheating. In addition, the government funded and directed a large part of this credit expansion through policy-based lending operations, which restrains the effectiveness of the banking system intermediation and leads to misallocation of funds[7];

- The unemployment rate, as reported by the World Bank, improved slightly but remained high at 6,9% in 2018. However, these levels can sharply increase in case of an economic downturn in the countries accepting Uzbek labor force (mostly Russia and Kazakhstan);

- Due to the rapid domestic demand growth, FX-rate volatility and the unfavorable inflation outlook, the Central Bank of Uzbekistan (CBU) increased the refinancing rate from 14% to 16% in September 2018. In addition, the CBU confirmed its commitment to free float exchange rate regime allowing the UZS to depreciate in 2H 2018, following other emerging market currencies. At the same time, the effectiveness of the monetary policy transmission mechanism remains limited due to heavy segmentation of the credit market, with around 60% of credit allocated at preferential terms, still high dollarization levels (56% of loans and 38% of deposits were FX-denominated by end of 2018), as well as low level of the Central Bank's independence. The latter can be improved after the implementation of the new Central Bank law;

- The quality of the fiscal policy is improving at a slower pace than our previous expectations. The government of Uzbekistan, in the mid-term perspective, is going to continue its wide-ranging tax reform, which includes simplifying taxes, and to strengthen tax administration, reducing labor taxes, and broadening the VAT coverage. In addition, for the first time, the mid-term fiscal plan was approved for the 2019-2021 period indicating key fiscal risks, which have increased the predictability of the fiscal policy. However, it remains heavily distorted by widespread off-budget spending of budgetary organizations (mainly policy-based lending operations), that even increased in 2018 up to 5,2% of GDP as compared to 4,2% a year ago;

- Uzbekistan's long-term growth perspectives remain favorable driven by a significant amount of natural resources (mainly natural gas, gold and cotton). However the lack of water resources makes the agricultural sector, accounting for more than 30% of gross value added, vulnerable to environmental and weather risks.

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[6] Research report on Uzbekistan from 14 September 2018 (https://raexpert.eu/reports/Research_report_Uzbekistan_14.09.2018.pdf).

[7] Usually to capital-intensive projects with unclear return-investments levels, partly politically motivated.

Negative factors:

- Despite a gradual improvement over the last years, the country remains one of the least developed amongst its CCA peers as shown by the low level of GDP per capita in PPP terms, estimated at USD 7 338 in 2018, and non-adjusted HDI index of 0,71 in 2017;
- After reaching its maximum at 20,5% y-o-y in January 2018, CPI growth slowed during 2018 and reached 14,3% by the end of the year, still showing the highest and the most volatile metric amongst CCA peers. We expect inflation to be in the range between 15% and 18% by end-2019 due to the delayed effects from the regulated energy and food price hikes in 2018, projected increases in VAT, as well as an increase of public sector salaries and pensions;
- The institutional development is restrained by high levels of corruption and a diminished rule of law in the country, according to the international organizations. This hinders the country's plan to increase net FDI inflow, which is estimated to be only around 1% of GDP in 2018. However, the rapid and comprehensive improvement of the quality and transparency of the official statistics as well as position in the Doing Business Ranking, positively influenced foreign investors' perceptions about the country;
- Despite an improvement over the last year, the country's capital market remains underdeveloped, as evidenced by a low market capitalization of companies listed on the national stock exchange of 6,4% of GDP in 2018 and high concentration of trading.

Stress factors:

- Despite positive dynamics, financial dollarization remains a problem to the economy representing 38% of total deposits and 56% of total loans in December 2018 (very weak stress factor).

SENSITIVITY ASSESSMENT:

The following developments could lead to an upgrade:

- Smooth economic policy transition process leading to the stabilization of the key macroeconomic indicators;
- Continuous stabilization of the fiscal budget figures, together with a reduction of off-balance sheet operations and increase of transparency and predictability of the fiscal policy;
- Significant improvement of the CBU's monetary and currency policy, confirmed by sustainable levels of deposit dollarization below 30% over the long period as well as single-digit inflation.

The following developments could lead to a downgrade:

- Gradual deterioration of the banks' assets quality and emergence of funding and capital gaps in the banking sector;
- Sharp increase of dollarization levels due to adverse conditions on the FX-market;
- Elevation of the government debt load due to devaluation of UZS, taking into account the high share of FX-denominated debt, coupled with gradual decrease of concessional loans' share.

"The upgrade of Uzbekistan's credit ratings reflects the sustained reduction of the financial dollarization as well as the successful entry to the international capital market by issuing the first emission of Eurobonds in February 2019. The solid fiscal stance, including low government debt and narrow budget deficit, robust economic growth, profitable and well-capitalized banking system remain the credit strength of the country.

At the same time, the ratings remain restrained by elevated and volatile inflation, low level of economic and institutional development, high share of FX-denominated government debt as well as underdeveloped local capital markets. In addition, high levels of credit segmentation with a widespread policy based lending on preferential rates, and high concentration of the banking system, led by state-owned banks, are the key credit risks for the country." – Clarified Vladimir Gorchakov, Associate Director of Rating-Agentur Expert RA.

Research report on Uzbekistan is available at:

https://raexpert.eu/reports/Research_report_Uzbekistan_08.03.2019.pdf

Next scheduled rating publication: 6 September 2019. The full sovereign rating calendar can be found at Sovereign Rating Calendar 2019

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RATING HISTORY:

Date	Review reason	SGC		Outlook	
		National currency	Foreign currency	National currency	Foreign currency
14.09.2018	Scheduled revision of both types of ratings for the country	B+	B+	Positive	Positive
16.03.2018	Scheduled revision of both types of ratings for the country	B+	B	NA	NA
22.09.2017	Scheduled revision of both types of ratings for the country	B+	B	NA	NA
24.03.2017	Scheduled revision of both types of ratings for the country	B+	B	NA	NA
23.09.2016	Scheduled revision of both types of ratings for the country	B+	B	NA	NA
15.04.2016	First assignment of both types of ratings for the country	B+	B	NA	NA

Minute's summary

The rating committee for Uzbekistan was held on 7 March 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 May 2018). 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: International Monetary Fund, World Bank, CIA Fact book, World Economic Forum, Doing Business, United Nations, The State Committee of the Republic of Uzbekistan on Statistics, Central Bank of Uzbekistan (CBU), Asian development bank, Ministry of Finance of Uzbekistan, The State Committee of the Republic of Uzbekistan for Privatization, Demonopolization and Development of Competition, Transparency International.

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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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.