Research Report on Azerbaijan

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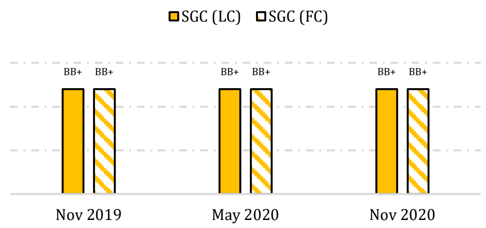
Ratings

Sovereign Government Credit (LC)	BB+
Sovereign Government Credit (FC)	BB+
Outlook (LC)	Negative
Outlook (FC)	Negative

* These ratings are unsolicited

Ratings dynamics



Main Economic Indicators of Azerbaijan

Macro indicators	2017	2018	2019
Gross gov. debt, AZN bn	16	15	16
Nominal GDP, AZN bn	70	80	82
Real GDP growth, %	0,2	1,5	2,2
Gross gov. debt/GDP, %	22,5	18,7	19,0
Deficit (surplus)/GDP, %	-1,4	5,5	8,1
Inflation rate, %	7,9	1,6	2,7
Current Account Balance/GDP, %	-	-	9,1
External debt, USD bn	-	-	9,1*

Development indicators	2019
Inequality adj. HDI	0,68
GDP per capita, USD th	15,1

Default indicator	06.11.2020
10Y Gov Bond Yield, %	4,02

Source: RAEX-Europe calculations based on data from the IMF, WB
* Government and government guaranteed debt ** Maturity in 2029

Summary

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).

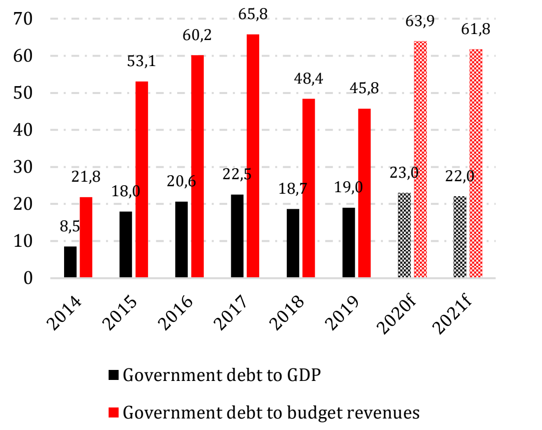
Government debt set to hike but to remain manageable. The level of gross government debt remained low as expected in 2019 standing at 19% of GDP and 46% of budget revenues. The metric remains the lowest among the countries in the South Caucasus region[1] mainly due to its vast buffers in SOFAZ, which are partly used to finance the budget. Even though we expect the level of government debt to GDP to increase up to 23%, this will mainly be a result of the decline in nominal GDP instead of a substantial increase in the absolute level of government obligations (see graph 1).

In terms of structure, short-term debt has remained fairly stable, while the share of FX-denominated debt will remain elevated and could potentially represent a risk if a USD/AZN devaluation were to materialize.

GDP to shrink due to pandemic and military conflict. The level of real GDP increased by 2,2% in 2019 due to solid oil prices, strong external demand and favorable levels of private and public consumption. Nonetheless, the coronavirus crisis has caused the oil price to dip substantially at the beginning of the year and it has yet to recover meaningfully. Thus, real output has already contracted by 3,9% y-o-y as of September 2020 and we anticipate the economy to contract by 4% y-o-y by the end of 2020 (see graph 2). In addition, we also expect that the economy could perform even worse going forward if it takes a long time for the conflict to get resolved. On the same line, depressed economic output is

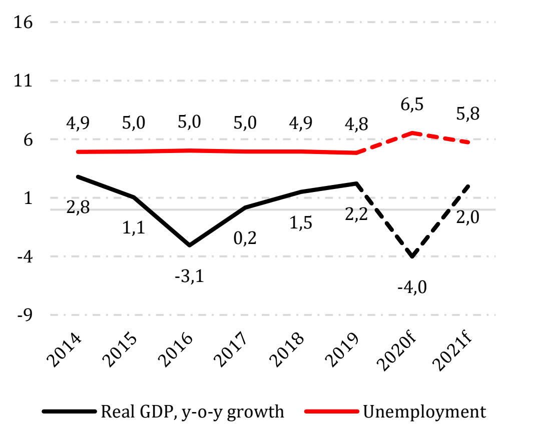
[1] Debt to GDP for 2019: Georgia – 42,6%, Armenia – 49,9%.

Graph 1: Government debt dynamics, %



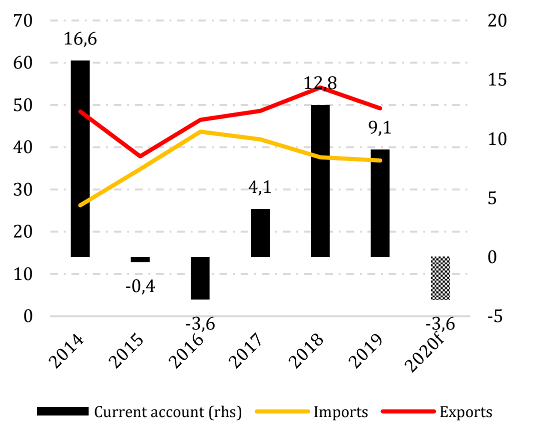
Source: RAEX-Europe calculations based on data from the Ministry of finance of the Republic of Azerbaijan and IMF

Graph 2: Macroeconomic indicators, %



Source: RAEX-Europe calculations based on data from the Statistical Committee of the Republic of Azerbaijan and the IMF

Graph 3: External sector indicators, % of GDP



Source: RAEX-Europe calculations based on data from the WB and IMF

expected to cause an increase in the unemployment rate up to 7% by year-end up from 5% in 2019, still an acceptable level (see graph 2).

The Azerbaijani economy high concentration in the hydrocarbon sector remains in place and is a key factor constraining the sovereign rating, as it makes the economy highly vulnerable to oil demand. As of September 2020, the share of oil-related 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 prices and not due to a substantial development of the non-oil sector. Moreover, hydrocarbon exports 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 on the economy of Azerbaijan and have a direct adverse effect on public finances.

External position set to weaken. Azerbaijan's strong external stance has already deteriorated due to persistent low oil prices along the year which have been mainly a result of the coronavirus pandemic. What is more, we expect the position to lose even additional strength if the military escalation in the Nagorno-Karabakh region remains for the foreseeable future. Thus, we anticipate the current account deficit to be around 3,6% of GDP in 2020 (see graph 3). Moreover, as mentioned above the share of oil exports remains elevated at around 90%, which exposes the country to additional risks as oil prices remain low. We also expect the pandemic and the military conflict to exert pressure on the AZN as it could propel a massive net outflow of funds and may cause reserves to deplete. Despite this, the government still has strong fiscal buffers in SOFAZ.

Moreover, the level of international reserves of the Central Bank of Azerbaijan (CBA) remains at acceptable levels but have remained quite flat in 1Q 2020, while the FX reserves[2] 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.

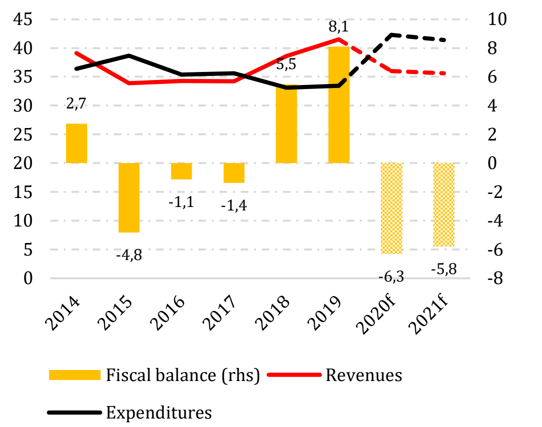
Political risk in the South Caucasus region remains high and is set to increase further. Overall, the conflict has always represented a hurdle for further economic development. In recent months, these obstacles have become even greater as the military conflict with Armenia has escalated fast to an intensity greater than in 2016. What is worse, there currently seems to be no sign for a quick resolution from either side. As mentioned previously, we can expect heavy negative economic and fiscal implications if the conflict lingers for the long term. The consequences will be rapid outflow of funds and less investment in the country, as the war has already

[2] Excludes gold.

translated in a negative view of the business environment and lower economic attractiveness of Azerbaijan. Military spending stood at about 4% of GDP for Azerbaijan in 2019 and is expected to increase substantially if the conflict escalates further.

Public finances will be under stress due to confrontation with Armenia and the coronavirus crisis. The fiscal policy of the government has loosened during 2020 in order to provide support in different ways to soften the adverse effects from the pandemic. The support includes increase in healthcare spending, social assistance to unemployed, and tax benefits to companies affected by the pandemic, among others.

Graph 4: Fiscal balance, % of GDP

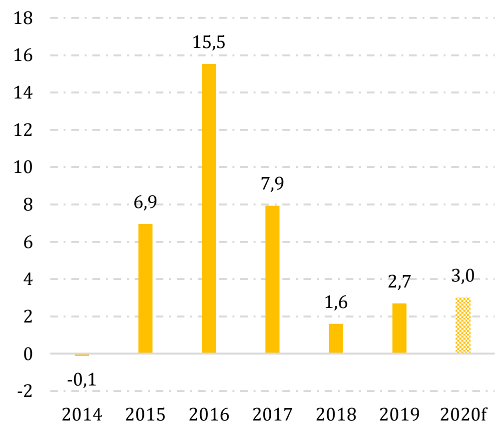


Source: RAEX-Europe calculations based on data from the Ministry of finance of the Republic of Azerbaijan and IMF

The assets of 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. As of September 2020, the fund had around USD 43,2 bn, which provides a substantial financial buffer, which will contribute to weather the coronavirus crisis. Given the set of measures implemented to relive the economy and lower expected revenues, we expect the fiscal balance to turn negative in 2020 and post a figure of around -6,3% (see graph 4).

Moreover, additional military expenditures are expected as the military conflict grows. This would hurt the government's fiscal budget in a period where public finances are already constrained due to the coronavirus crisis.

Graph 5: Inflation, %



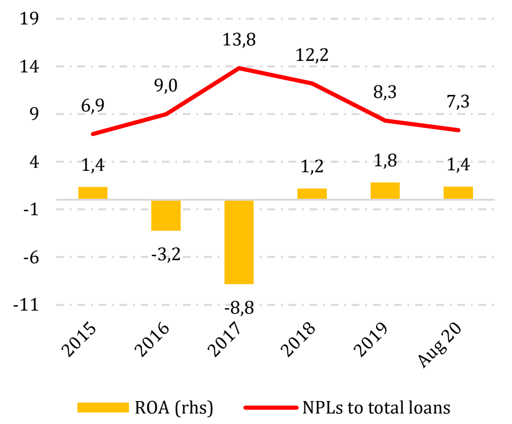
Source: RAEX-Europe calculations based on data from the IMF

Monetary policy to support the economy and focus on USD peg. The monetary policy of the CBA has turned accommodative in 2020 as it tries to propel credit growth and, as a consequence, economic activity amid the coronavirus crisis. After a series of reference rate cuts during the year, the CBA left the rate unchanged at 6,5%, in October 2020 (at the beginning of the year, the rate was 7,25%). Moreover, the de facto peg to the USD remains and the CBA has already used international reserves and resources from SOFAZ in order to hold the exchange rate fixed.

The CPI index grew by 2,7% in 2019 and we expect it to remain stable in 2020. As of September 2020, the inflation rate stood at 2,9% y-o-y and we expect the metric to end the year at 3% showing stability (see graph 5). However, the Nagorno-Karabakh conflict will likely cause higher net outflows of funds from the country, thus, increasing the pressure on the CBA to devaluate the currency consequently increasing inflationary pressures.

We still consider that the plan to transition to an inflation targeting regime as part of the CBA strategy remains in place but has been delayed due to the current situation, which includes a pandemic and a war. In terms of effectiveness, the economy's response to the changes in the reference rate remain limited as a result of high dollarization levels which might increase further due to the USD peg combined with downward pressure on the oil price.

Graph 6: Financial soundness indicators, %



Source: RAEX-Europe calculations based on data from the Azerbaijan Banks Association

Banking system showing resiliency. Despite the banking system of Azerbaijan remaining weak and in recovery mode, it has showed better than expected financial soundness indicators so far in 2020. As of August 2020, the NPLs to total loans ratio continued to decline and stood at 7,3%, while ROA and ROE remained positive at 1,4% and 9,3% (see graph 6). The capital adequacy ratio was 22,6% by the end of 2019. The stability of the metrics stems mostly from capital injection, restructuring process and subsequent recovery of the state-owned International Bank of Azerbaijan (IBA), as well as from the license revocation of four banks, as mentioned in our previous report. However, the sector is still very concentrated and highly dollarized which makes the stability of the system vulnerable to currency deprecations, which is a latent risk as Azerbaijan maintains a de facto peg to the USD. A sudden devaluation could result in an even harder impact on the market if the government would need to devaluate the currency if pressure from the pandemic, oil prices and war escalation persist. In order to cushion the coronavirus effect, the CBA has already introduced measures, such as temporarily modifying the calculation method for capital adequacy. Moreover, the government has also extended the full insurance of all protected deposits until the end of 2020.

Domestic credit to GDP stood at 14,7% in 2019, in line with our previous projection, while the total banks' assets to GDP was 40,1%. We expect credit to the economy to slow down as a result of the coronavirus crisis; however, we have already seen the CBA implement different measures to propel credit, such as reducing the refinancing rates and it also signed a USD 200 m swap agreement with the EBRD to provide credit to the real sector.

Important note for sovereign ratings

This Research Report shall be treated as a supplementary part of the published Press Release included in the following link:

https://raexpert.eu/reports/Press_release_Azerbaijan_06.11.2020.pdf

Both documents shall be treated as essential parts of each other.

For further information on the factors, their weights, methodologies, risks and limitations of these ratings, and other regulatory disclosures, please refer to the Press Release and the website of the Agency.