Research Report on Azerbaijan

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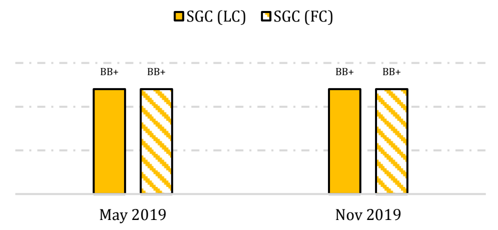
Ratings

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

* 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	80
Real GDP growth, %	0,2	1,4	2,7
Gross gov. debt/GDP, %	22,5	22,6	19,4
Deficit (surplus)/GDP, %	-1,4	5,6	5,3
Inflation rate, %	10,0	2,3	2,8
Current Account Balance/GDP, %	-	-	9,7
External debt, USD bn	-	-	8,9

Development indicators	2018
Inequality adj. HDI	0,757
GDP per capita, USD th	18

Default indicator	08.11.2019
10Y Gov Bond Yield, %	3,99

Source: RAEX-Europe calculations based on data from the IMF, Bridport&co, WB

Summary

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.

Gross government debt metrics stabilized. As was anticipated in our previous review, the gross government debt to GDP ratio stood at 19,7% and to budget revenues at 49% in 2019, which is the lowest in the Caucasus region[1] (see graph 1).

We expect a similar figure for 2020 in line with the "Medium- and long-term strategy for public debt management in the Republic of Azerbaijan". On the other hand, despite being well structured in terms of maturity, potential FX risk of the sovereign debt remains, as more than 90% of the total debt is denominated in foreign currency.

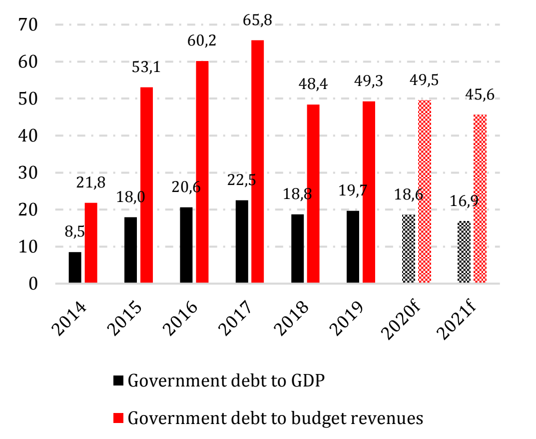
Total guarantees issued by the government are above 30% of GDP in 2019, indicating that a potential materialization of contingent liabilities is still latent.

GDP growth and external position recovers. Favorable hydrocarbon prices contributed to maintain economic growth rate at 2,7% in 2019, 1,3p.p. higher than in the previous year (see graph 2). The current account, despite being solid, is expected to be around 10% of GDP in 2019 - a decline of around 3p.p. as compared to 2018 due to decrease in oil exports. In our mid-term perspective, we anticipate lower economy growth at approximately 2% for 2020-2021.

Despite the incentive measures of the government, such as export subsidies, preferential lending and land provisions on concessional terms, the economy continues to be dependent on the oil & gas industry, which

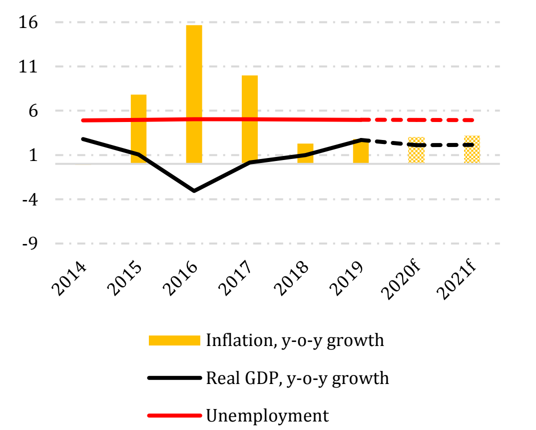
[1] IMF estimated debt to GDP for 2019: Georgia – 49,9%, Armenia – 50%,

Graph 1: Government debt dynamics, %



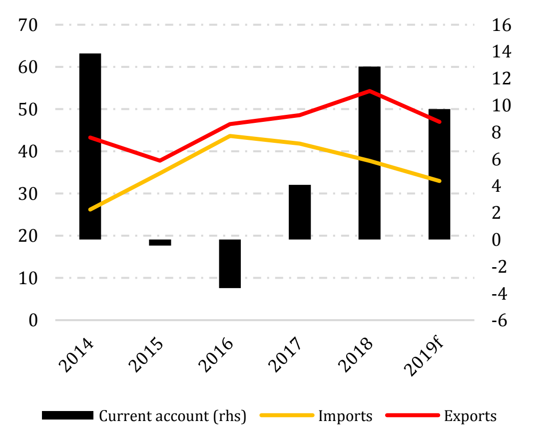
Source: RAEX-Europe calculations based on data from the IMF

Graph 2: Macroeconomic indicators, %



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

Graph 3: External sector indicators, % of GDP



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

formed around 40% of total GDP as of 3Q 2019. However, some positive structural changes have been achieved reflected by the output increase in the agriculture and information and communication services sectors, which grew by 7% and 16% y-o-y as of 3Q 2019 respectively.

The final figure of Foreign Direct Investment (FDI) stock was less than 3% of GDP in 2018, we expect the metric to be twice as lower in 2019 and to remain mainly concentrated in the oil & gas industry (more than 80% of total FDI). Total investment directed to fixed capital as of January-September 2019 decreased by 2p.p. from the corresponding period of 2018 down to 17% of GDP. Market uncertainness, bureaucracy and corruption were listed among the main weak points affecting the investment climate in the “Azerbaijan-EU Business Environment Report” from 2019.

The increase of the cargo volumes transported via the Baku-Tbilisi-Kars railroad and via new Baku International Sea Trade Port Complex propelled the role of Azerbaijan as a transportation hub on the East West transportation corridor in the Belt & Road Initiative, which should help boost the non-oil sector of the economy.

According to the “Doing Business 2019” report prepared by the World Bank, Azerbaijan improved to 25th in 2018 from 57th in 2017 out of 190 countries having the highest scores on protecting minority investors and ease to start a business.

The fiscal policy turned towards a tightening path with the objective of diversifying budget revenues. We expect the overall fiscal balance to be once again positive at 5,3% of GDP. This would mark the second year in a row the budget posts a surplus. Even though we expect the same trend in 2020, we anticipate a slight decrease to 3,2% of GDP.

The share of the oil industry in the state budget remains substantial as we estimate it will account for about 60% of total revenues by the end of 2019, and almost half are direct transfers from the State Oil Fund of the Republic of Azerbaijan (SOFAZ). According to the draft budget 2020, dependence on oil revenues will slightly decrease, but its share will remain as high as 57%.

In August 2018, the law of the Republic of Azerbaijan on the budget system was ratified which includes a new fiscal rule for managing the budget and was introduced in 2019. This rule limits consolidated budget expenditures growth by 3% of the approved budget expenditures for the previous year. Both budgets, the one from 2019, as well as the draft budget for 2020, faced difficulties to comply with the new law. However, according to the data provided by the Ministry of Finance of Azerbaijan, consolidated budget expenditures are already determined in accordance with budgetary rules.

Additionally, authorities have plans to implement the Medium-Term Expenditure Framework (MTEF) standards in order to make budget planning process more transparent and accurate. The plan is to test standards in 2021 budget for several sectors.

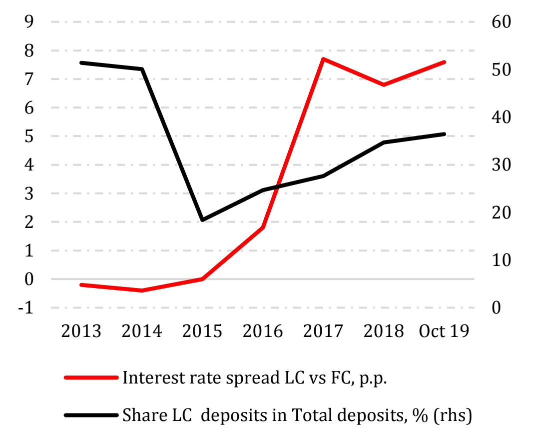
Monetary policy shifts towards inflation targeting. The Central Bank of Azerbaijan (CBA) declared the ambitious objective to move toward an inflation targeting regime in the medium term. During the transition period, the CBA set the target at 4±2 % for 2019. We expect the final inflation figure to be around 2,5% by the end of 2019, within the target range. We also anticipate a slightly higher rate for 2020 at around 3%. The low inflation environment allowed the CBA to further lower its base interest rate by 25b.p. to 7,75% on 25 October 2019 in order to support corporate lending.

The main instruments to control money supply are short term notes of the CBA placed on the Baku Stock Exchange (only commercial banks can buy the notes) and deposits auction, during which the deposits of commercial banks are placed on CBA accounts. Another objective of the monetary policy is to support the stability the local currency (AZN) against speculation by selling foreign currency only through SOFAZ. That, together with the positive current account made the AZN exceptionally stable and returned some trust of the population in the currency.

The positive results of the aforementioned monetary measures alongside a significant spread between the deposit interest rates in local and foreign currency (7,6p.p. as of October 2019), have propelled a decline in levels of dollarization for the last four years. The share of deposits denominated in local currency increased by 1,8p.p. since the beginning of the current year up to 36,4% (see graph 4). Furthermore, international reserves of the CBA continue to recover, as they grew by 9% annually as of October 2019 (see graph 5).

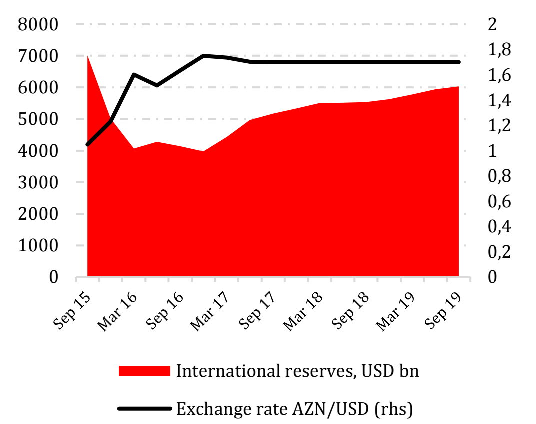
Asset quality improved slightly, but further progress is uncertain. We anticipate the NPLs to total loans ratio to be around 11% for 2019, which would be the lowest rate since the sharp devaluation of the AZN in 2016 (see graph 6). The latest figure, reported by the Central Bank of Azerbaijan (CBA) was 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 during the last four years from the balance sheet of the CBA to Aqrarkredit, a special credit institution

Graph 4: Financial dollarization



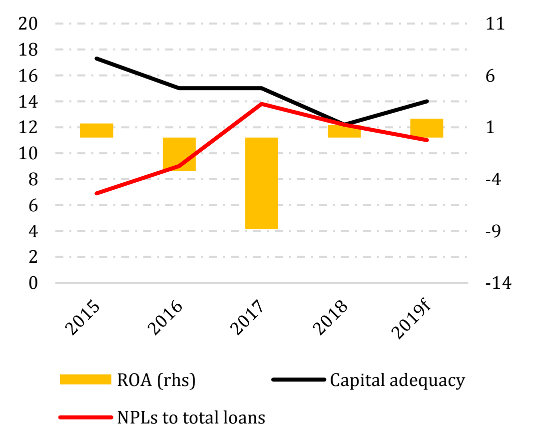
Source: RAEX-Europe calculations based on data from the CBA

Graph 5: International reserves and exchange rate



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

Graph 6: Financial soundness indicators, %



Source: RAEX-Europe calculations based on data from the FISMA, CBA, WB created by the CBA. Additionally, in March 2019 in the Presidential Decree "On additional measures regarding solution of the overdue loans problem in the Republic of Azerbaijan" was put into effect. According to it, the government will guarantee AZN 682 m of additional liquidity provided to commercial banks with the aim to restructure overdue loans of the population caused by the sharp devaluation of the AZN in 2016 and compensate the increased debt burden. The resolution program is also supposed to make a positive impact on de-dollarization of the loan portfolio; however, it has no influence on payment discipline or risk management improvements.

According to our forecast, profitability indicators and capital adequacy ratio will slightly improve up to 1,8% and 14% respectively in 2019. However, the reason of the capital adequacy growth is probably related mainly to IBA restructuring process. Moreover, reporting transparency of the smaller participants remains an obstacle for a more granular assessment.

Additionally, the Financial Market Supervisory Authority (FIMSA) has updated several regulations in order to improve the quality of on-site inspections.

Political and geopolitical risk remains. There are no significant changes in judicial and executive systems, powers are concentrated in the hands of heads of local executive offices appointed by the president.

The territorial and ethnic conflict over the Nagorno-Karabakh region continues to constrain economic development of the country. In September 2019, the foreign ministers of both countries met in New York; however, the negotiations did not bring any positive results. Current focus is on third parties (OSCE Minsk Group from France, Russia and the United States), which have been extremely quiet in the latest conflict settlement discussions.

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_08.11.2019.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.