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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

Main Economic Indicators of Azerbaijan

| Macro indicators | 2016 | 2017 | 2018 |
|--------------------------------|-------------------|------|------|
| Gross gov. debt, AZN bn | 12 | 16 | 15 |
| Nominal GDP, AZN bn | 60 | 70 | 77 |
| Real GDP growth, % | -3,1 | 0,1 | 1,4 |
| Gross gov. debt/GDP, % | 20,6 | 22,6 | 19,4 |
| Deficit (surplus)/GDP, % | -1,1 | -1,4 | 4,0 |
| Inflation rate, % | 15,6 | 10,0 | 2,3 |
| Current Account Balance/GDP, % | - | - | 12,6 |
| External debt, USD bn | - | - | 18,2 |
| Development indicators | 2017 | | |
| Inequality adj. HDI | 0,757 | | |
| GDP per capita, USD th | 17,7 | | |
| Default indicator | 08.05.2019 | | |
| 10Y Gov Bond Yield, % | 5,2 | | |

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

Summary

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.

Overall indebtedness is low despite the upward trend. Along with the oil price plunge in 2014 and subsequent depreciation of the local currency, Azerbaijani public debt increased considerably from AZN 5 bn up to AZN 15 bn in 2018 (see graph 1). In order to offset the impact of the negative trade balance and prevent deterioration of national reserves, the Central Bank of Azerbaijan (CBA) in December 2015 introduced a free-floating exchange rate which subsequently caused a 32% depreciation against the USD within one month. Nevertheless, the ratio of gross government debt to GDP is estimated to have stayed at 20% in 2018, making it the lowest in the South Caucasus region. We expect the indicator to decrease if the government follows the approved strategy of debt management "Medium- and long-term strategy for public debt management in the Republic of Azerbaijan".

External debt remains exposed to the exchange rate devaluation risk, as 90% of it is USD-denominated. However, debt is well structured in terms of maturity and 15% of it is issued on concessional terms.

GDP growth and external position recovers. Favorable market environment in terms of oil prices allowed Azerbaijan to resume economic growth with an annual real GDP growth rate of 1,4% in 2018 (see graph 2). At the same time, the current account to GDP increased by 8,5p.p. up to 12,6% (see graph 3).

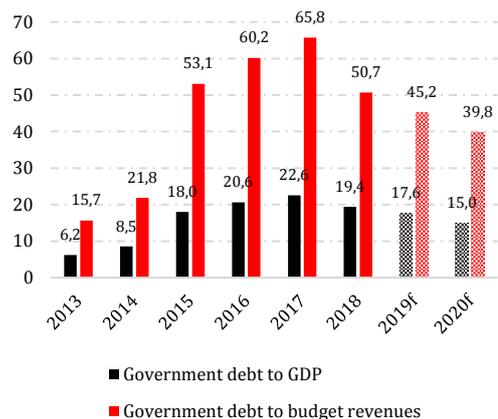
In 2018, there were some positive structural changes, as the non-oil industry growth was 9,1%, mainly due to an increase in gas production by 5,8%. Also, as a result of incentive mechanisms, such as export subsidies,

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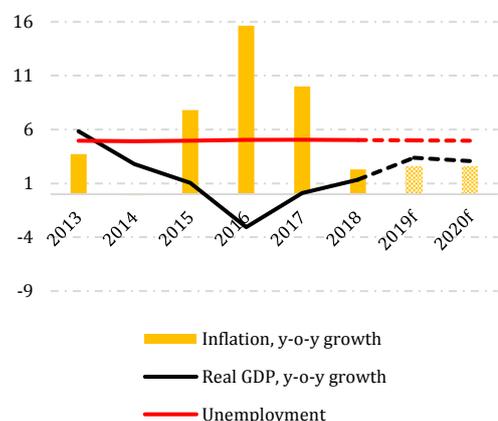
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Graph 1: Government debt dynamics, %



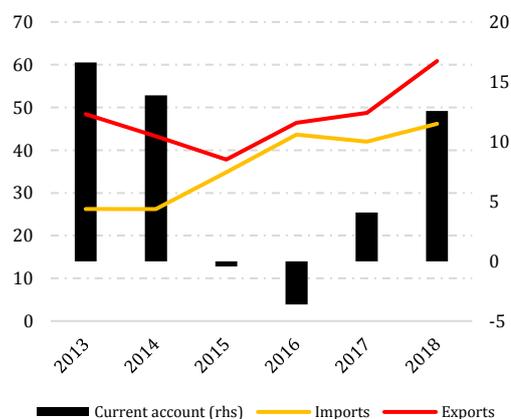
Source: RAEX-Europe calculations based on data from the IMF

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

preferential lending, land provisions and organization of agroparks, the agricultural production posted an increase of 4,6%.

Another achievement was the successful launch of several large projects such as, TANAP (Trans-Anatolian Gas Pipeline) and Baku International Sea Trade Port Complex.

Foreign Direct Investment (FDI) stock is estimated to have been around 3% of GDP in 2018 (1,7p.p. less than the indicator from 2017), and is highly concentrated in the oil industry (more than 80% of total FDI).

According to the “Doing Business 2019” report prepared by the World Bank, Azerbaijan moved up by 32 places and is currently ranked 25th out of 190 countries, having the highest scores on protecting minority investors and ease to start a business.

Fiscal policy inclined towards being expansionary, while revenues remain concentrated. Thanks to the favorable oil prices in the market, the fiscal position significantly recovered in 2018. Despite increasing government expenditure by 29%, the budget balance presented a surplus of 4% of GDP as compared to a deficit of 1,4% of GDP one year before. However, budget revenues remained highly dependent on the oil sector. The share of the oil industry in the state budget accounted for 60,2% of total revenues in 2018, where 49% were direct transfers from the State Oil Fund of the Republic of Azerbaijan (SOFAZ). The fund was created to accumulate wealth for the future generations; however, it is often used to cover current government expenditures and support currency reserves of the CBA.

The “Law on Budget System” ratified in 2017 has the aim to raise non-oil tax revenues by providing different tax incentives to businesses and, in the long run, it might propel economic diversification.

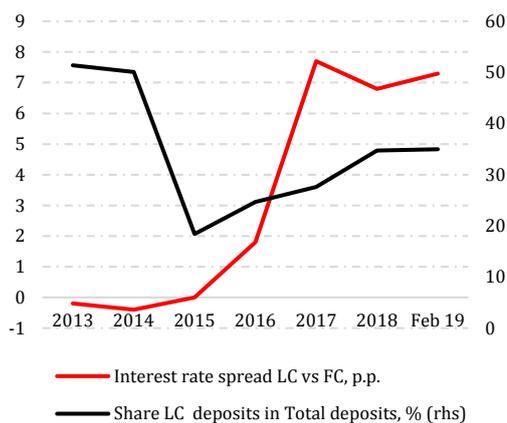
Anti-inflationary monetary policy. In order to control inflation in 2016, the CBA used the base interest rate and deposit auctions to decrease the supply of national currency in circulation. The CBA hiked the interest rate several times that year up to 15% from 3%. Those measures led to the stabilization of inflation (7,7p.p. decrease y-o-y) down to 2,3% in 2018 and to a price increase on the local currency deposits. The average interest rate difference between the deposits in AZN and foreign currency deposits increased from 0,2p.p. up to 7p.p, encouraging the population and businesses to hold AZN-denominated savings. Such outcome decreased financial dollarization levels of the Azerbaijan Republic (see graph 4).

Current monetary policy is aimed to support AZN by selling foreign currency through SOFAZ as the only supplier. In order to prevent speculations, the amount to be traded is not disclosed before the day of

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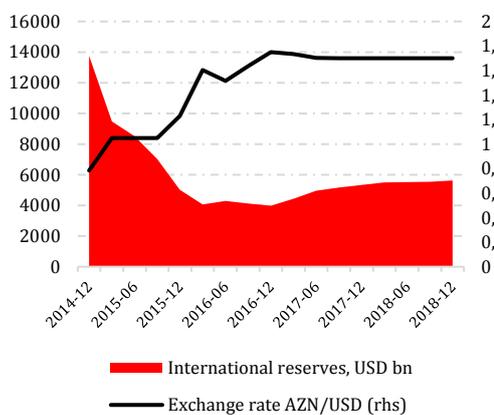
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Graph 4: Financial dollarization



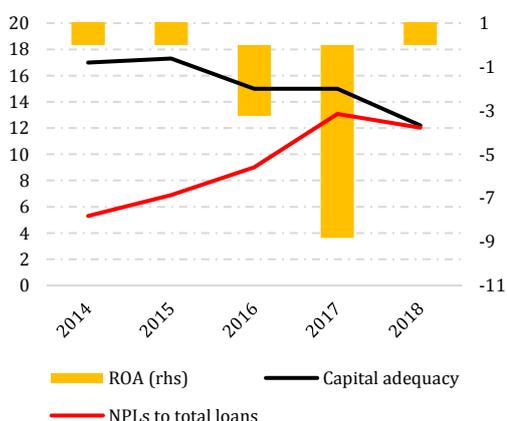
Source: RAEX-Europe calculations based on data from the CBA

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

the auction. That, together with the open intervention of the CBA and existent restriction on foreign currency export, increases the demand on local currency and prevents reserves from deteriorating (see graph 5). Another goal of the CBA is to boost corporate lending as the CBA has lowered its key interest rate multiple times starting from February 2018 until the current rate of 8,75%.

Fragile banking sector, but overdue debt is decreasing. The banks' assets grew at a slow pace of 5% y-o-y in 2018. Despite total loans to the economy having increased by 11% in 2018, they are not sufficient to support private sector growth. Banks' assets to GDP ratio stood at 38,2%, 1,7p.p. less than a year before. Asset quality slightly recovered in 4Q 2018, as the NPL to total loans ratio decreased by 1p.p. after growing constantly during the previous years. The decrease in the level of NPLs was mainly driven by USD 3,3 bn debt restructuring of the International Bank of Azerbaijan (IBA). The bank is primarily state-owned and accounts for 30% of the total banking sector assets. The government announced the decision to complete privatization of the bank by the end of 2019 which should potentially support a decrease in the overall banking sector risk. At the same time, profitability indicators of domestic banks finally turned to a positive territory, with ROA at 1,2% in 2018 after being negative at -8,8% in 2017 (see graph 6).

Elevated political risk. In Azerbaijan, all the executive and judicial powers are concentrated in the hands of heads of local executive offices appointed by the president. In 2018, the president of the Republic of Azerbaijan, Ilham Aliyev, won the election for the third time with a very high percentage of votes (more than 80%), rising concerns about democratic standards.

The territorial and ethnic conflict over the Nagorno-Karabakh region continues to constrain economic development of the country. In 2019 the discussion renewed with a new force during several international summits. Currently there is hope for a long-lasting peace due to the involvement of third parties in the conflict settlement discussions.

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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_10.05.2019.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.

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