Research Report on Uzbekistan

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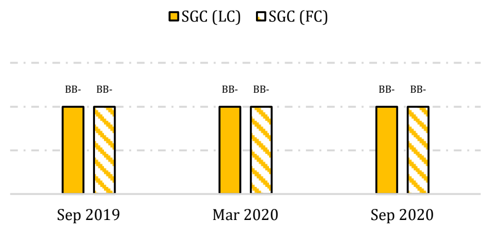
Ratings

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 Uzbekistan

Macro indicators	2017	2018	2019
Gross gov. debt, UZS bn	88 038	118 335	156 111
Nominal GDP, UZS bn	302 537	406 649	511 838
Real GDP growth, %	4,5	5,4	5,6
Gross gov. debt/GDP, %	19,7	29,1	30,5
Overall fiscal Deficit (surplus)/GDP, %	-1,9	-2,3	-3,9
Inflation rate, %	18,8	14,3	15,2
Current Account Balance/GDP, %	-	-	-5,6
External debt, USD bn	-	-	24,0

Development indicators	2019
Non-adjusted HDI	0,71*
GDP per capita, USD th	8,9

Default indicator	04.09.2020
9Y Gov Bond Yield**, %	3,6

Source: RAEX-Europe calculations based on data from the IMF, WB, CBU, NSC.
*2018 **Government bonds with remaining maturity 9 years

Summary

The confirmation of Uzbekistan's ratings at 'BB-' with stable outlook reflects mainly the acceptable level of public debt and the actively developing economy supported by structural reforms. In addition to this, the banking sector remains stable with adequate level of capitalization and profitability. At the same time, we anticipate that the negative impact of the COVID-19 pandemic in 2020 will trigger a slowdown in economic growth, widen the fiscal balance and worsen the external position.

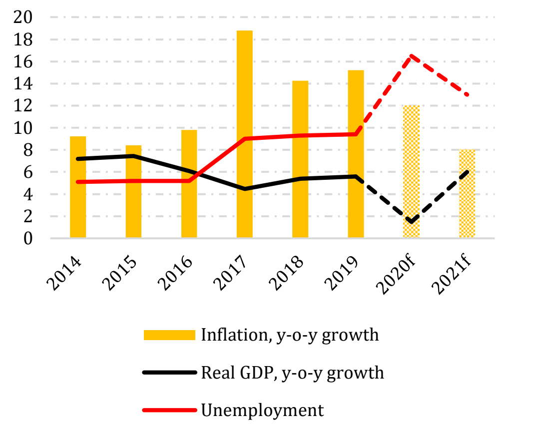
The ratings remain restrained by high inflation, low level of institutional development and national welfare, whereas elevated unemployment persists. Moreover, despite improved management and transparency, the effectiveness of the monetary policy is undermined by the heavy segmentation of bank lending, high financial dollarization and underdeveloped local capital markets.

Due to the COVID-19 crisis, economic growth in 2020 may be substantially lower than expected. After a solid growth of real GDP in 2019 (5,6%), the growth rate of the economy has shrunk substantially in the current year (see graph 1). In 1H 2020 the real GDP growth rate was estimated at 0,2%, as a result of the spread of the COVID-19 pandemic and swift lockdown measures imposed in March. A nationwide quarantine strongly affected the most vulnerable transport, tourism and retail sectors. In response to the crisis, the government urgently amended the budget for 2020 by increasing expenditures and implementing tax relief for businesses. Moreover, the government created the Anti-Crisis Fund of around USD 1 bn (2% of GDP). Despite gradual lifting of the restrictions starting from early April, downfall of external trade turnover by 18,2% y-o-y became a strong decelerating factor. In contrast, a positive dynamic in 1H 2020 was observed in agriculture and forestry, construction and services, while the physical volume index of industrial production decreased by 0,9% y-o-y.

We expect the year-end GDP growth at 1,5%, with a subsequent recovery to 5-6% in the medium term. However, a second wave of the pandemic and further restrictive measures would negatively affect our base case scenario (see graph 1).

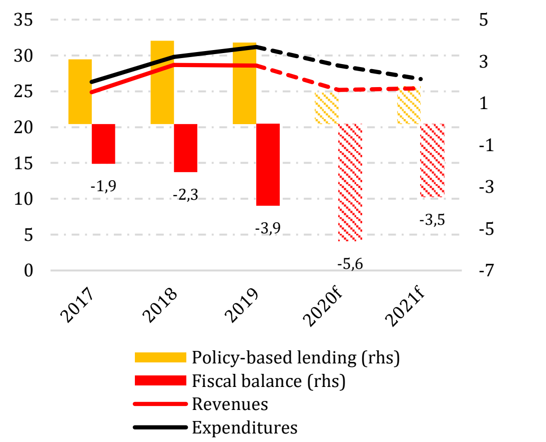
The high unemployment rate (9,3% in 2019) remains one of the main restricting factors. Since a big share of the country's labor force works

Graph 1: Macroeconomic indicators, %



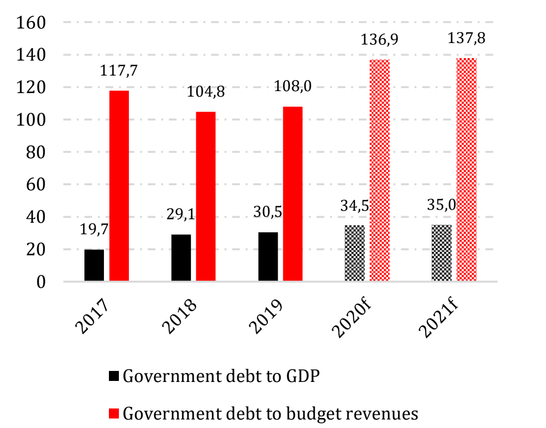
Source: RAEX-Europe calculations based on data from the IMF, WB, State Committee of the Republic of Uzbekistan on Statistics, Ministry of finance of the Republic of Uzbekistan

Graph 2: Fiscal balance dynamics*, % of GDP



Source: RAEX-Europe calculations based on data from the IMF and WB *Overall fiscal balance in IMF definition, that includes policy-based lending.

Graph 3: Government debt dynamics, %



Source: RAEX-Europe calculations based on data from the Ministry of finance of the Republic of Uzbekistan

abroad, we expect a sharp increase in the unemployment rate due to the contraction of the main labor markets for Uzbekistan, namely Russia and Kazakhstan. Additionally, GDP per capita in PPP terms remains very low among regional peers[1] (USD 8,9 th in 2019).

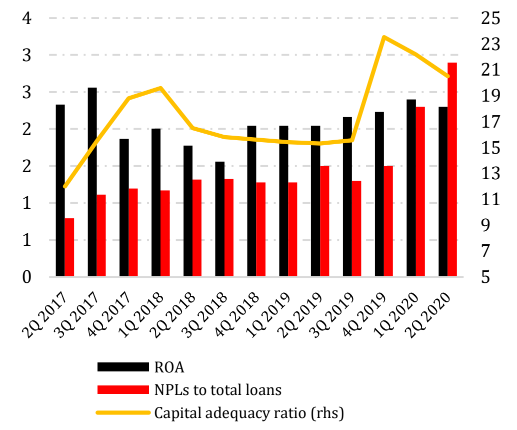
Fiscal position is worsening due to additional expenses in response to COVID-19. After the consolidated budget deficit reached a moderate level of 2,6% of GDP and the overall fiscal deficit[2] was 3,9% of GDP in 2019, pressure on public finances increased significantly in 2020 due to the urgent need to finance the response measures to cushion the effects from the COVID-19 pandemic. Despite a positive trend in tax revenues in 1H of 2020, we expect a decline in the nearest future reflecting the introduction of tax relief measures for SMEs and the negative impact of the downturn of the economy. As for the government expenditures, the budget was amended to provide for a significant expansion of funding for social needs and medical care. At the same time, the need for high capital expenditures for infrastructure projects remains.

Consequently, we anticipate the consolidated fiscal deficit to widen up to 3,5% of GDP, and we also expect a rise in the overall fiscal deficit to 5,6% of GDP in 2020 (see graph 2). However, the low level of public debt allows the authorities to attract external financing to cover the deficit, and currently, budget deterioration is rather short-lived. Further stability of public finances will largely depend on the development of the situation with COVID-19, as well as on the continuation of the government's reforms regarding improvements in fiscal planning and transparency, reduction of the volume of policy lending, and implementation of announced plans for privatization of the massive public sector.

Despite the growth, the level of public debt to GDP remains at an acceptable level. Uzbekistan's total public and publicly guaranteed (PPG) debt increased to 30,5% of GDP as of January 1, 2020 (see graph 3), compared to 29,1% of GDP as of January 1, 2019. This was the result of an active policy of external borrowings and guarantees related to capital investments, as well as of the devaluation of the national currency. In 2020, the government debt continues to grow: according to preliminary estimates, it exceeded 31% of GDP in 1Q 2020. In order to implement measures to reduce the impact of COVID-19, the authorities increased its activity in the domestic government bond market and, at the same time, reached an agreement with international financial institutions[3], which

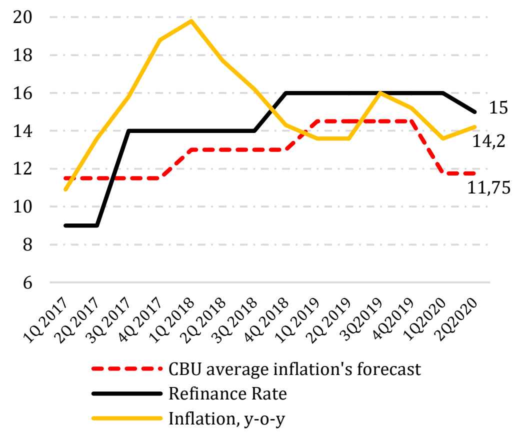
[1] Here Caucasus and Central Asia (CCA) oil and gas exporters: Azerbaijan, Kazakhstan, Turkmenistan, and Uzbekistan
[2] Includes policy-lending operations in IMF definition.
[3] IMF, World Bank, Asia Development Bank

Graph 4: Financial soundness indicators, %



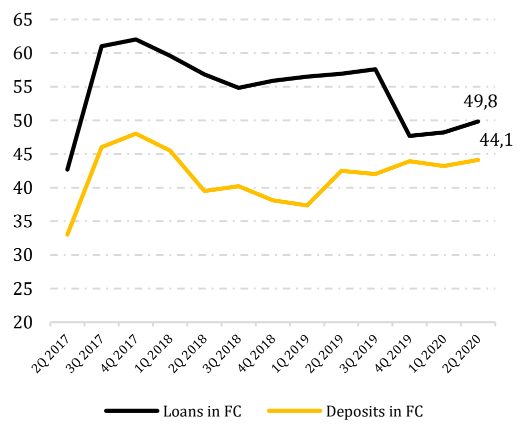
Source: RAEX-Europe calculations based on data from the CBU

Graph 5: Refinance rate vs inflation rate, %



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

Graph 6: Financial dollarization, % of total



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

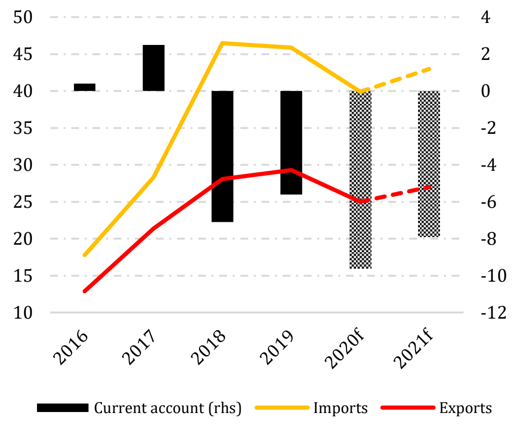
together can provide about USD 1,7 bn (about 3% of GDP) of additional financing.

We anticipate that unplanned urgent borrowings will increase PPG debt to GDP to 35% in 2020-2021, but we consider this level to be acceptable and not to add additional risks to the country's creditworthiness. Moreover, most of the debt is represented by long-term concession agreements with foreign governments and state banks, as well as international financial institutions. In terms of currency structure, the prevalence of foreign currency-denominated debt (99% of debt) remains a key risk factor, making the debt position vulnerable to currency fluctuations. After a sharp devaluation of UZS in April 2020, the national currency continued to weaken, which will increase the debt burden. Although the government has a diversified debt structure by issuing domestic bonds, their share remains insignificant, and further issuance of these instruments is limited by the underdeveloped domestic capital market. In addition, we continue to note the high level of contingent liabilities of the government related to SOE and SOB debts, which may be lowered as the implementation of the recently announced privatization program continues.

The resilience of the banking sector has been maintained, while new challenges surged. In 2018-2019, the banking sector, while remaining stable, showed a high growth of assets by an average of 28% per year. At the same time, the ratio of banking system assets and domestic loans to GDP at the beginning of 2020 remains at moderate levels of 52,1% and 40,4%, respectively. The role of the financial sector for the economy is limited due to the high concentration of assets on state-owned banks (85% of sector's assets in 2020), as well as a still significant share of preferential loans to public sector enterprises. We expect a reduction on the systemic risks of the banking sector if the authorities' plans to cancel policy lending to SOEs at below market rates are executed.

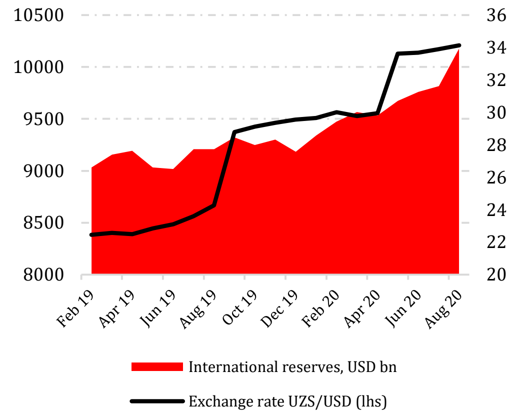
Despite the destructive impact of COVID-19, we note the continued stability of the banking system. Significant additional capitalization of state banks last year allowed to maintain the overall capital adequacy ratio of the system at the level of 20,5% as of June 2020. In addition, the sector demonstrates profitability with ROA of 2,3% and ROE of 9,9% as of June 2020 (see graph 4). We note the timeliness of the Central Bank of Republic of Uzbekistan (CBRU) precautionary measures to ensure financial stability and to maintain adequate liquidity of commercial banks. The regulator makes use of REPO and swap operations; it has reduced reserve requirements and introduced a special credit line to provide liquidity to banks for up to three years.

Graph 7: External sector indicators, % of GDP



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

Graph 8: International reserves vs exchange rate



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

At the same time, we observe the deterioration of asset quality of banks, as NPLs grew by 1,4 p.p. up to 2,9% between the beginning of the year and June 2020. The CBRU recommended banks to provide credit vacations to individuals and companies affected by the introduction of quarantine regime until 1 October 2020. State banks prolonged the terms of repayment mainly for affected companies. Stress tests of the CBRU showed that the share of NPLs may increase by several times, which enhances the risk of materialization of contingent liabilities.

Monetary policy has been eased and inflationary outlook lowered. The CBRU continues to improve the quality, predictability and transparency of its monetary policy within the framework of inflation targeting and the transition to a free-floating exchange rate regime. In 2020, new policy instruments were introduced, namely, a new policy rate ("key rate"), with an interest corridor of +/-1 p.p., as well as short-term liquidity instruments: REPO operations, currency swaps and overnight facilities.

In the face of weak demand, disinflationary factors and a slowdown in annual inflation from 15,2% at the end of 2019 to 14,2% as of June 2020 have been observed. Given the decline in projected inflation, the CBRU eased the policy by reducing the key rate by 100 b.p. to 15%. At the same time, the regulator maintains its course to achieve the inflation target of 5% by 2023. We expect the inflation rate to be 12,5%-13,0% by the end of 2020 and to depend on further developments of the situation around the pandemic (see graph 5).

Monetary authorities continue to maintain stability through irregular interventions, mainly to sterilize purchases of gold for foreign currency. In April 2020, the exchange rate against the USD decreased by 6% and in the current regime of increased pressure on the exchange rate, the policy of intervention is likely to continue. However, a number of factors, including an increased level of financial dollarization (see graph 6) and underdeveloped domestic capital markets, limit the effectiveness of the monetary policy transmission mechanism.

The current account deficit is expected to grow due to the lower net exports. In 2019, the current account deficit narrowed to 5,6% due to higher gold exports, while the trade deficit declined to 16,5% of GDP (see graph 7). However, in 2020, we anticipate the current account deficit to widen to almost 10% amidst weaker exports (mainly gas exports) and stable high imports fostered by capital spending, as well as higher external borrowings. Thus, the deterioration of the external position can withdraw reserves and put pressure on the national currency. As of July 2020, the international reserves amounted to USD 33,9 bn, covering more than 12 months of imports (see graph 8). Additionally, the external position is dependent on remittances, which is slowing down due to the contraction of Uzbekistan's main labor markets (Russia and Kazakhstan).

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_Uzbekistan_04.09.2020.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.