Research Report on Uzbekistan

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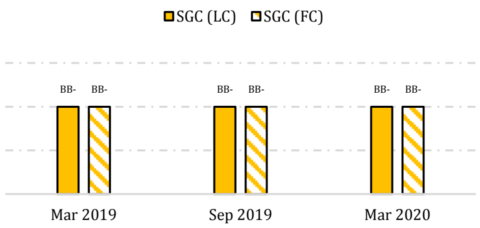
Ratings

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	93 381	118 587	188 414**
Nominal GDP, UZS bn	302 537	407 514	523 373**
Real GDP growth, %	4,5	5,4	5,6
Gross gov. debt/GDP, %	30,9	29,1	36,0**
Deficit (surplus)/GDP, %	-1,9	-2,1	-2,2*
Inflation rate, %	18,8	14,3	15,2
Current Account Balance/GDP, %	-	-	-6,5**
External debt, USD bn	-	-	15,3**

Development indicators	2018
Non-adjusted HDI	0,71
GDP per capita, USD th	8,3

Default indicator	06.03.2020
10Y Gov Bond Yield, %	3,9

Source: RAEX-Europe calculations based on data from the IMF, WB, CBU, NSC.
*Estimates of overall fiscal balance. **Estimates

Summary

The confirmation of Uzbekistan's ratings at 'BB-' with a stable outlook are supported by accelerated economic growth, bearable level of public debt and deficits, as well as continuing structural reforms in the economy. The ratings are also underpinned by the solid stance of the banking sector, which maintains favorable levels of capitalization and profitability.

Nonetheless, rating levels are constrained by widening debt and public deficits, high inflation and exchange rate volatility, as well as elevated financial dollarization. Despite the significant improvements, the level of per capita wealth, institutional development, large contingent liabilities of the government, as well as the limited effectiveness of monetary and fiscal policies restrain our rating assessment.

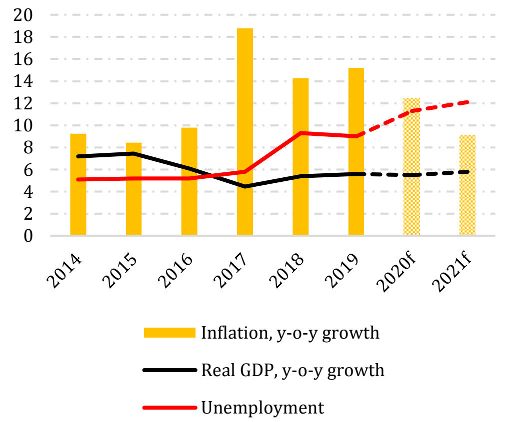
Supported by investments as well as structural reforms, economic growth remains high, whereas low level of per capita income and high unemployment restrain the creditworthiness. Uzbekistan remains the country with one of the highest economic growth in the Central Asia and Caucuses region, with y-o-y real GDP growth of 5,6% in 2019, as compared to 5,4% in 2018 (see graph 1). Such a robust growth is mostly supported by investments from the government, SOEs and foreign companies, with an overall increase of investments in fixed assets of 33% y-o-y in 2019. The positive dynamic was recorded in all major sectors, with growth of 19% in construction, 9,4% in manufacturing, 5,1% in service and trade and 2,5% in agriculture, while the mining industry output decreased by 1% y-o-y.

The government forecast shows GDP growth rates of around 5,5% in 2020 and 6,2% in 2022[1], while IMF expects this metric to be close to 6% over the coming years. We expect the GDP growth to be in the range of 5,5%-6% in 2020-2021, if the macroeconomic environment remains stable, as well as all announced reforms to be implemented on time. However, we can decrease our current forecast in case of a substantial slowdown in the global economy, as well as delays in the investment and privatization programs in Uzbekistan.

Despite the impressive progress over the last years, the level of national wealth expressed in GDP per capita in PPP terms remains very low in

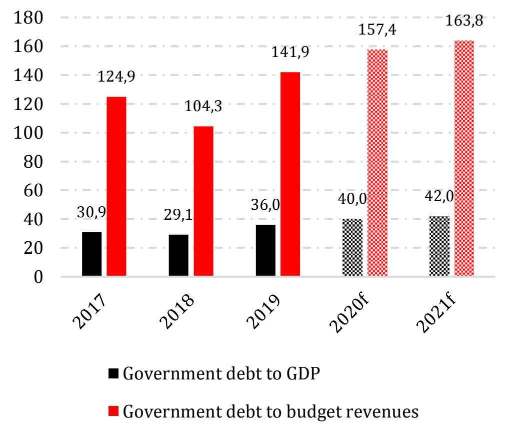
[1] These are the forecast figures included in the Government Fiscal Plans for 2020-2022.

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: Government debt dynamics, %



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

global terms and one of the lowest in the region: USD 8,8 th in 2019 as compared to USD 6,8 th in 2014. In addition, despite the slight improvement over last year, the officially reported unemployment rate remained elevated at 9% in 2019 and heavily exposed to external factors, due to the fact that high share of Uzbek labor force working abroad, especially in Russia and Kazakhstan.

Despite rapid growth over the last years, the debt load is at acceptable levels with favorable maturity and payment conditions. According to preliminary estimates of the Ministry of finance of the Republic of Uzbekistan (MFRU), as of 1 January 2020 total public and publically guaranteed (PPG) debt of Uzbekistan amounted to USD 21,1 bn, which is close to 36% of GDP (see graph 2). The almost 60% growth y-o-y in nominal terms (in UZS) (equal to 7p.p. increase in debt to GDP ratio) was caused by the issuance of a sovereign Eurobond amounting to USD 1 bn in February 2019, investments related borrowings and guarantees, issuing local UZS-denominated bonds as well as depreciation of the national currency within the year.

In terms of debt structure, the prevalence of FX-denominated debt (more than 97% of internal debt and 100% of external debt) remains the key risk factor, taking into account high volatility of the local currency, while UZS-denominated bonds represent only 1% of total debt. However, these risks are partially mitigated by the structure in terms of maturity and types of creditors. Around 32% of overall debt is represented by foreign governments and public institutions (mostly China and Japan), and 33% by international financial institutions on concessional terms (51% from the Asian Development Bank and 37% from the World Bank). Moreover, in our view, the government debt policy improved substantially with the implementation of the "Strategy of the public debt management for 2020-2022", which imposes limits for new borrowings, includes mid-term debt load limits, as well as improves policy transparency. For 2020, raising of new external PPG debt is limited to USD 4 bn; while external borrowings for government programs is limited to USD 1,5 bn.

Overall, we expect the debt load to increase by end-2020 at a slower pace, but to remain at acceptable levels, if the government sticks to the newly implemented limits, and the macroeconomic environment remains stable. We still observe high level of contingent liabilities of the government, related to debt of SOEs and SOBs, but these risks are expected to decrease by the implementation of the privatization program recently announced by the authorities.

The fiscal position is weakening, while reforms improve its transparency and long-run stability. The overall fiscal deficit in the IMF definition[2] has been gradually widening from 0,5% of GDP in 2016 to an expected figure of 1,6% by end-2019 (see graph 3), while the consolidated budget in 2019 was executed with a deficit of 1,5% to GDP[3]. Despite such a negative dynamic, we consider both metrics do not pose substantial risks for the creditworthiness. Moreover, the gradual elimination of discrepancies between these two indicators is also considered as positive. In addition, starting from 2020, the MFRU introduced the official "overall fiscal balance"[4] with a target of -2,7% and -2,1% of GDP for 2020 and 2021, which can be used as a more reliable metric for the assessment of the stance of public finances.

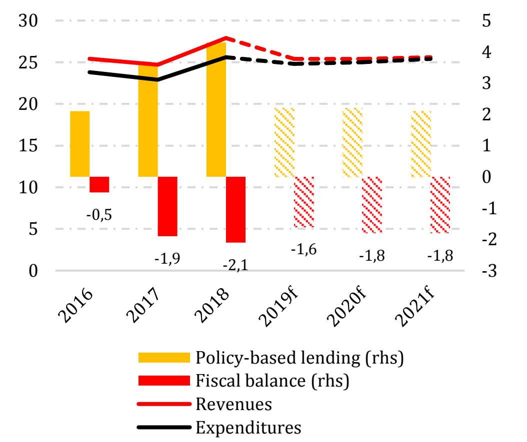
The government keeps performing a large tax reform, initiated in 2018, which already resulted in the increase of the tax base and overall fiscal revenues. The government expects further increase of tax revenues in 2020, due to improvement of collection rates, changes in tax rates, elimination of various tax and duties reliefs, apart from the positive influence of strong economic growth. In addition, from 2020 we expect to observe an improvement in terms of fiscal planning, with all key metrics planned till 2022; increased accountability to the legislative body (Oliy Majlis), as well as substantial increase of transparency and consistency of all fiscal operations (see above).

However, we still observe risks of potential deviations from the policy in the form of directed lending to SOEs and financing of social programs. The former is expected to be partly mitigated by the activation of the privatization program. In late February 2020, the State Assets Management Agency of the Republic of Uzbekistan published the draft resolution project "On additional measures to reduce the state's share in the economy" sating the plan to fully privatize 1 115 companies (including large banks), while 42 companies will become public-private partnerships and 125 state-owned real estate properties will be sold in the period of 2020-2025.

Successful implementation of the announced plans will lead to the reduction of the government contingent liabilities, improve level of competition in the economy, as well as support government non-tax revenues. At the same time, the risks related to policy-based lending persists, since the dynamic and scale of such operations over the last quarters was unclear.

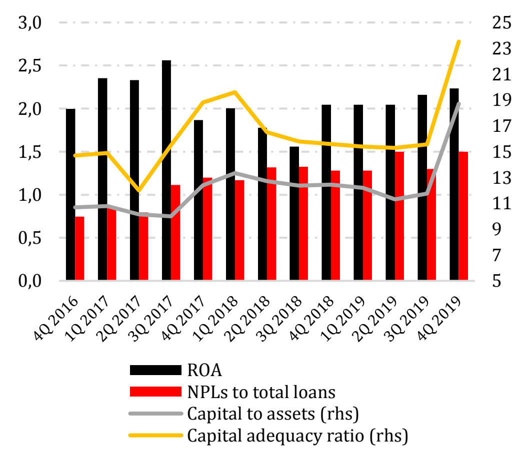
The banking sector resilience improved, while new challenges surged. Amidst the significant capitalization of state-owned banks, in 4Q

Graph 3: 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.

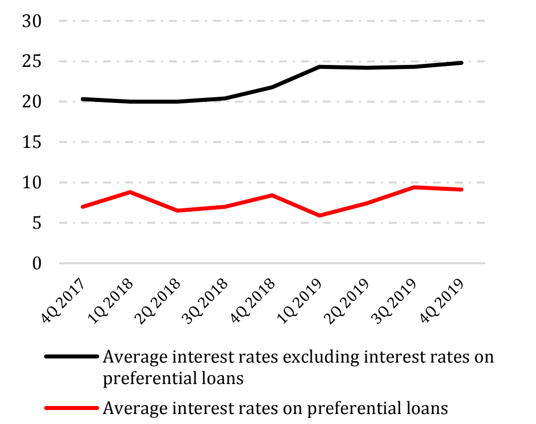
Graph 4: Financial soundness indicators, %



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

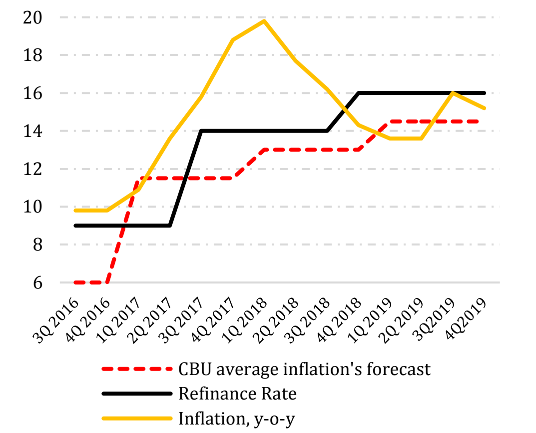
[2] Includes estimation of directed lending and off-budget operations.
[3] Calculated by the MFRU and includes State budget and all "State target funds".
[4] Includes the expenses for National development programs financed by the external government debt.

Graph 5: Average annual interest rates on loans in national currency, %



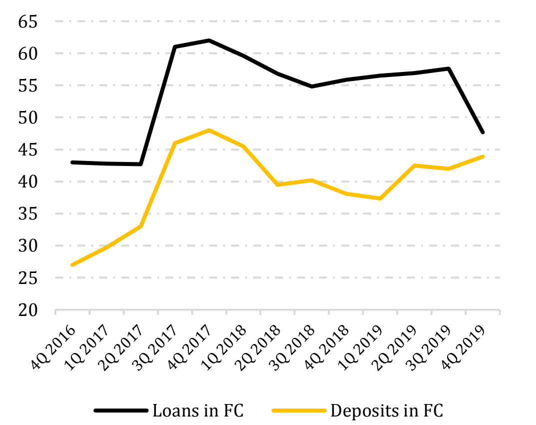
Source: RAEX-Europe calculations based on data from the CBU

Graph 6: Refinance rate vs inflation rate, %



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

Graph 7: Financial dollarization, % of total



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

2019, the banks' regulatory capital grew sharply by almost 2x y-o-y. As a result, despite the accelerated growth of loan portfolios, the banks have significantly improved their capital adequacy ratio (CAR) almost by 8p.p. to 23,5% as of 4Q 2019, which makes their position resistant to further expansion of loans and possible shocks (see graph 4). ROA and ROE improved in 2019 after a slight decrease in 2018 up to 2,2% and 16,7% in 4Q 2019 respectively, mostly driven by net interest income, which climbed almost 3x[5].

Despite the doubling of officially reported non-performing loans since the beginning of 2018, their ratio to total gross loans stood at only 1,5% as of 4Q 2019, owing to an outsized growth of new loans' volumes. In the medium run, we expect the officially reported level of NPLs to remain stable. At the same time, we expect that real asset quality can be lower than officially reported and we expect the reported NPL level to increase substantially in horizon of 2-3 years, triggered by the mentioned privatization of SOBs and companies; gradual reduction of the lending at preferential rates; as well as implementation of obligatory IFRS reporting standards for major financial companies from 1 January 2021[6].

Moreover, the banking system remains heavily concentrated with the dominance of state owned banks (around 85% of assets), which increases the systematic risks. In addition, despite the fact that authorities were going to eliminate the preferential lending at below-market rates from 1 January 2020 (see graph 5), the practical implementation of this decision, as well as its influence, so far were not statistically confirmed.

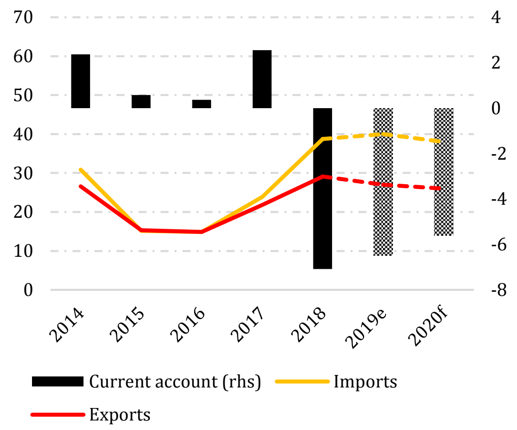
Quality of the monetary policy improved, but the transmission mechanism remains distorted. We observe substantial increase of quality, predictability and transparency of the CBU's monetary policy over the last year. The refinancing rate remains unchanged at 16% since 2018, while the Central Bank confirms its commitment to a free float exchange rate regime providing only neutral interventions, mainly to sterilize purchases of gold and smooth sharp fluctuations. The official inflation in 2019 increased to 15,2% (as compared to 14,3% in 2018), but remained within the CBU's forecast corridor of 13,5%-15,5% (see graph 6).

In addition, from 2020 the CBU implemented new policy instruments, including REPO transactions, currency swaps and overnight deposits in order to have more monetary policy instruments, as well as introduced the new policy rate ("key rate"), with the interest corridor of +/-1 p.p.

[5] For more information about banking system of Uzbekistan, see Research Report on the Uzbekistan Banking System from November 2019: https://raexpert.eu/files/Industry_report_Uzbekistan_Banks_01.11.2019.pdf

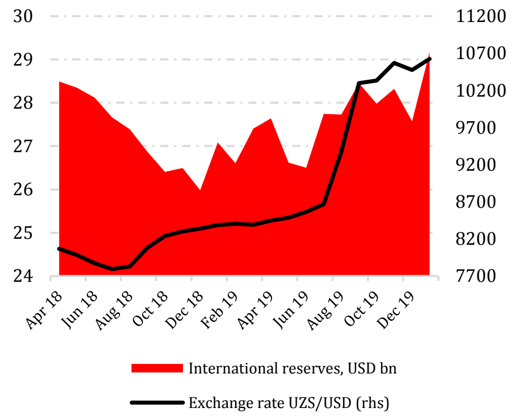
[6] According to the recently announced President Decree, starting from the financial results of 2021 all large enterprises (major tax payers), including banks and insurance companies, will be obliged to publish IFRS financial reports.

Graph 8: External sector indicators, % of GDP



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

Graph 9: International reserves vs exchange rate



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

However, the monetary policy transmission mechanism remains distorted by the elevated level of financial dollarization (see graph 7), underdeveloped domestic capital markets as well as the abovementioned preferential lending.

Current account deficit persists, while overall external position remains confident. According to the preliminary data, the trade deficit in Uzbekistan in 2019 reached 11% of GDP as compared to 10% in 2018, mostly due to the growth of import of machinery and equipment for the modernization of local enterprises, while exports increased at a slower pace. The overall current account deficit is expected to be at -6,5% by the end of 2019 (see graph 8), and we consider the negative balance to prevail in coming years due to the high demand on export goods, while export dynamics continue to lag behind.

Nevertheless, the risks of deterioration of the external position are offset by the moderate level of external debt with a favorable maturity and buffer in the form of significant international reserves which amounted to USD 29 bn as of December 2019, covering more than 13 months of imports (see graph 9).

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_06.03.2020.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.