Research Report on Uzbekistan

6 September 2019

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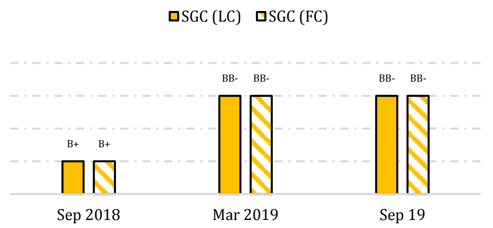
Ratings

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	2016	2017	2018
Gross gov. debt, UZS bn	20924	61192	83529
Nominal GDP, UZS bn	242496	302537	407515
Real GDP growth, %	6,2	4,5	5,1
Gross gov. debt/GDP, %	8,6	20,2	20,5
Deficit* (surplus)/GDP, %	-0,5	-1,9	-2,1
Inflation rate, %	7,9	18,9	14,3
Current Account Balance/GDP, %	-	-	-7,1
External debt, USD bn	-	-	17,0

Development indicators	2018
Non-adjusted HDI	0,71**
GDP per capita, USD th	7,5

Default indicator	06.09.2019
10Y Gov Bond Yield, %	4,1

Source: RAEX-Europe calculations based on data from the IMF, WB, CBU, NSC.
*Overall fiscal balance. **2017 data.

Summary

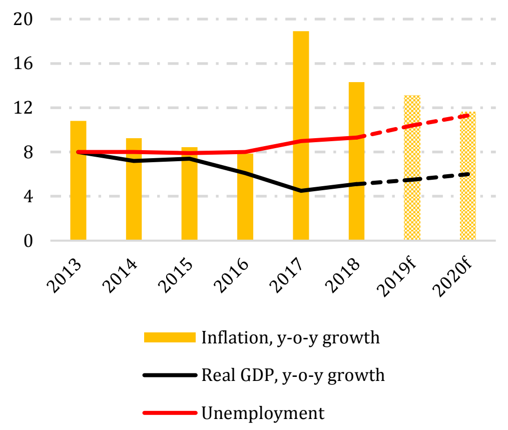
The confirmation of Uzbekistan's ratings at 'BB-' with a stable outlook is driven by the country's strong economic growth, prudent government finances with moderate levels of public debt and improved transparency and governance in fiscal and monetary policies. The ratings are also supported by the fast-growing banking sector, which maintains a favorable level of capitalization, asset quality and profit.

On the negative side, the ratings continue to be constrained by elevated unemployment levels, low institutional development, high corruption and depressed level of GDP per capita, one of the lowest in the region. Additionally, high inflation and exchange rate volatility also have a negative impact on the creditworthiness, aggravated by limited monetary policy, the effectiveness of which is undermined by heavy segmentation of bank lending, high level of financial dollarization and undeveloped local capital market.

Investments and reforms accelerate economic growth, whereas unemployment persists at high levels. Uzbekistan's economy continues to accelerate, showing a y-o-y GDP growth of 5,8% in the first half of 2019, which followed a 5,1% increase in 2018 (see graph 1). The upward trend was driven by high fixed investments' growth after decades of poor development. Tax reforms launched in 2017, as well as the liberalization of prices, foreign trade and currency operations have also contributed to the revitalization of the economy. A significant incentive for the economy was the active state financing of priority projects, mainly in the oil and gas industry, energy and irrigation in agriculture. As a result, the most notable contribution to GDP came from industry, construction and the service sectors while, in contrast, agriculture has subsided due to unfavorable weather conditions. Moreover, booming domestic consumption supported growth; however, this was partly absorbed by high inflation and a substantial share of imports.

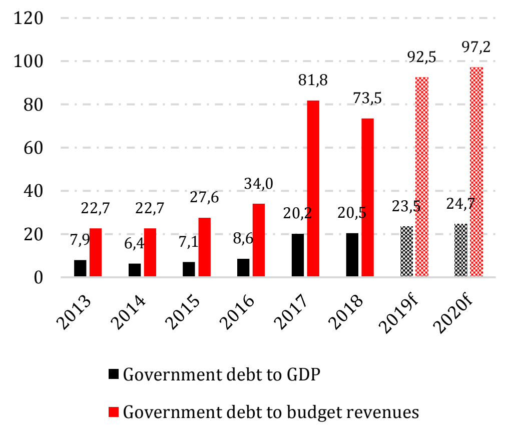
We expect GDP growth in the range between 5,5% and 6% in 2019, with continuing growth in investment and increased domestic demand, further fostered by a series of tax cuts and wage hikes. Meanwhile, the risks of export deterioration amid the global economic slowdown and volatility in agriculture remain. Over the long term, economic growth will depend on the consistency and effectiveness of reforms aimed at modernizing the

Graph 1: Macroeconomic indicators, %



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

Graph 2: Government debt dynamics, %



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

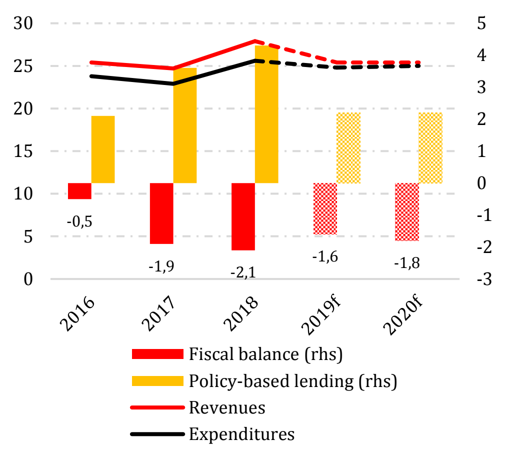
massive sector of state-owned companies, increasing the country's investment attractiveness through reducing the level of corruption and legislative barriers to business.

Despite the reforms initiated to foster the creation of official jobs by cutting the payroll taxes for business, the labor market is characterized by significant unemployment, a presence of low-paying informal sector, and high seasonality. According to the improved assessment methodology, the unemployment rate in 2018 reached 9,3%. The demographic situation in the country contributes to the accelerated increase in labor supply and the economy needs to double its annual job creation to cover the deficit. Currently, 2,6 million people work abroad, mainly in Russia and Kazakhstan, although a slowdown in the economies of these countries could reduce demand for labor from Uzbekistan. Consequently, low employment and labor productivity are reflected in one of the lowest GDP per capita in PPP terms among Central Asia peers at USD 7,5 th in 2018.

Amidst an active borrowing policy, the debt burden is still at an acceptable level with a favorable maturity and conditions. Uzbekistan's active position on external borrowings manifested in a number of new loan agreements with international financial institutions, the launch of a series of government bond issues in national currency from the end of 2018, as well as the issue of Eurobonds worth USD 1 bn in early 2019. In this regard, the public debt (direct and state-guaranteed) at the end of 2018 amounted to USD 10 bn, or 20,5% of GDP, and in August 2019, the public debt increased to USD 11,7 bn (see graph 2).

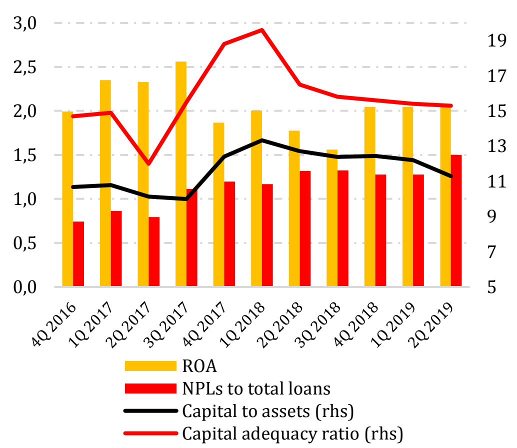
In general, the current government indebtedness level is acceptable and one of the lowest among CIS countries, considering also its favorable terms and maturity structure, as it consists mainly of long-term and concessional borrowings from international organizations and foreign governments. Moreover, short-term liabilities, including debt service, accounted for only 1,5% of GDP in 2018. The only downside risk in terms of public debt is the fact that almost 100% of total public debt is denominated in foreign currency, making it highly sensitive to changes in the exchange rate. The impact of this risk will gradually decrease if the issue of government UZS-denominated bonds in the domestic market, the share of which is still low, continues. We expect that, considering a further depreciation of the national currency and the ongoing policy of external borrowing, the public debt to GDP ratio will reach 23,5%-24% in 2019.

Graph 3: Fiscal balance dynamics, % of GDP



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

Graph 4: Financial soundness indicators, %



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

The fiscal deficit is manageable, while a reduction in policy lending and structural reforms in the public sector will have a positive impact. As mentioned in our previous report[1], in spite of the high budget revenues and consolidated budget surplus, the overall budget balance reflecting off-budget and policy-lending operations[2] was negative at -2,1% in 2018 (see graph 3). In 2019, we expect revenues to worsen caused by stimulating business tax reforms. In this situation, the government declared a cautious fiscal policy with a decreasing level of the preferential lending to the economy. As a result, the total budget balance is projected to be below -2%, which does not pose a risk to the deterioration of public finances.

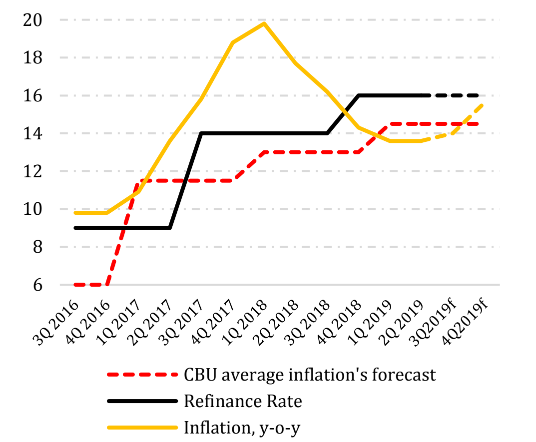
We continue to consider that the risks to public finances stem from the high state presence in major industries and the banking sector. State enterprises operate in a weak competitive environment and benefit from a large number of government preferences, which in the transition to a new economic regime may lead to a decrease in efficiency and losses, followed by the materialization of contingent liabilities. In this regard, plans for the restructuring of state property, including strengthening corporate governance and privatization of a number of companies and banks, are a positive signal. Further improvement in the quality of fiscal policy will depend on the systematic reduction of policy lending and the commitment to the approved fiscal plan for 2019-2021.

The banking sector grew further and remains stable, while concentration and regulatory risks stay high. Due to active loan activity, total assets of the banking system are expanding at an accelerated pace, reaching 53% of GDP in 2018. In addition, growth of domestic loans from the sector amounted to 51% in 2018, where the largest share was attributed to state banks involved in the distribution of public resources for SOEs and priority programs. The state-supported banking sector demonstrates healthy profitability and capitalization with ROA at 2%, capital-to-assets ratio at 11,3%, regulatory capital to risk-weighted assets ratio at 15,3% and low officially recorded level of NPLs to total loans ratio at 1,5% by the end of 2Q 2019 (see graph 4).

Risks of high concentration remain the main factor aggravating competition in the banking system. The three largest banks account for 55% of total assets, while SOBs continue to dominate it accumulating more than 80% of total assets by the end of 2018 and occupying a more advantageous position in the market, receiving funding at below-market

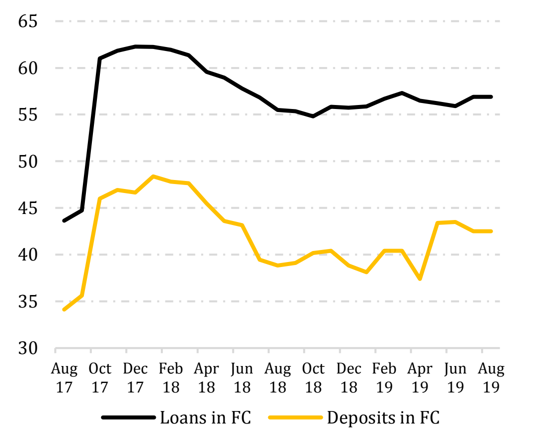
[1] See our previous research report from 8 March 2019: https://raexpert.eu/reports/Research_report_Uzbekistan_08.03.2019.pdf
[2] Such as investment project financing and lending by the Fund of Reconstruction and Development, recapitalization or capital injections in SOEs and SOBs.

Graph 5: Refinance rate vs inflation rate, %



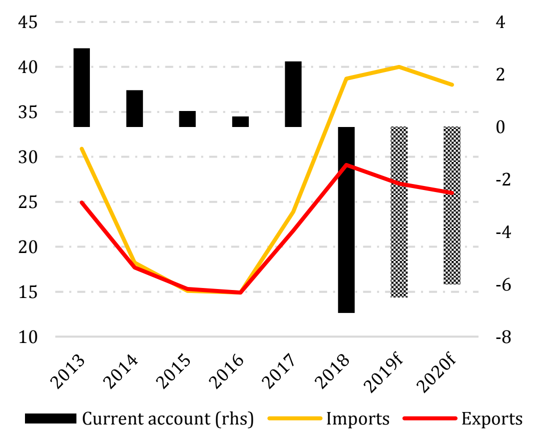
Source: RAEX-Europe calculations based on data from the CBU

Graph 6: Financial dollarization, % of total



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

Graph 7: External sector indicators, % of GDP



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

rates. Furthermore, SOBs loan portfolios are highly concentrated in single large borrowers and, given that some SOEs have already faced financial difficulties following exchange rate liberalization, as well as a significant share of restructured foreign exchange loans, it is likely that the quality of loans will deteriorate in the medium term.

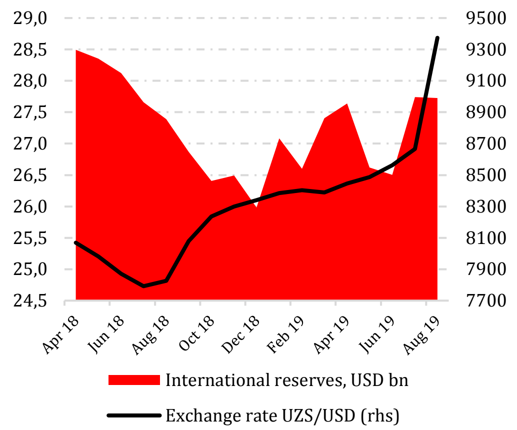
Monetary policy continues to be tight but the transmission mechanism remains limited. The country's reforms, consumer demand and investment growth have caused serious price pressure and have increased inflationary risks. Inflation remains extremely volatile, with sharp fluctuations from a peak of 20,5% in January 2018, followed by a slowdown to 13% in January 2019 (see graph 5). As mentioned in the previous report, given the increased volatility of the exchange rate and unfavorable inflation forecasts, the Central Bank of Uzbekistan (CBU) tightened monetary policy, hiking the refinancing rate from 14% to 16% in September 2018. At the same time, supporting the free exchange rate regime, the CBU carries only neutral interventions, mainly to sterilize purchases of gold for foreign currency. We expect annual inflation to slightly exceed the CBU forecast interval between 13,55% and 15,5% in 2019, pushed by heightened inflationary expectations, strong domestic demand and further liberalization of energy prices.

Regardless of the progress made by the monetary authorities in implementing inflation targeting and improving liquidity, we note that the efficiency of the transmission mechanism remains low, which is still limited by the credit market regulation, low independence of the CBU and underdeveloped domestic capital markets. Besides, the level of financial dollarization remains elevated due to the high demand for foreign currency loans and still insufficient confidence in the national currency. The foreign component in deposits and loans of the banking system reached 43% and 57% respectively as of 1 August 2019 (see graph 6).

Current account deficit is expanding significantly, but the external position remains confident. Fueled by the liberalization of foreign exchange operations, increased demand for fixed capital investments, and reduced import duties on a number of goods, the import rose by more than a third in 2018. Although the export grew slightly by 11% and stable contribution of remittances amounted to USD 5,7 bn, the current account shifted from a surplus of 2,5% in 2017 to a deficit of 7,1% in 2018 (see graph 7).

In 2019, we expect the current account deficit to remain broad, as imports continue to grow through higher investments in modernization, outperforming commodity exports, which represent about 80% of total exports, with gold and gas accounting for more than half. Nevertheless, the

Graph 8: International reserves vs exchange rate



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

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 27 bn as of August 2019, covering almost 13 months of imports (see graph 8).

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_06.09.2019.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.