RAEX-Europe confirmed at 'BB-' the ratings of Uzbekistan. The rating outlook is stable.

RAEX-Europe confirmed the sovereign government credit rating (SGC) of Uzbekistan at 'BB-' (Sufficient level of creditworthiness of the government) and at 'BB-' (Sufficient level of creditworthiness of the government) in foreign currency. The rating outlook is stable which means that in the mid-term perspective there is a high probability of maintaining the rating score.

MAJOR FACTORS THAT INFLUENCED BOTH TYPES OF RATINGS:

Positive factors:

- The government's debt continues to grow, reaching 31,3% of GDP as of 1Q 2020. The authorities increased activity on the domestic market by issuing government bonds and, at the same time, they reached an agreement with international financial institutions[1], which together can provide about USD 1,7 bn (around 3% of GDP) of additional external financing to address the negative impact of COVID-19. Even though this will lead to an increase of the public and publicly guaranteed debt to GDP to 35% in 2020-2022, we consider this level to be acceptable and does not create risks for the government. Moreover, most of the debt is represented by long-term concessional agreements;
- After posting a real GDP growth figure of 5,6% in 2019, the economy is expected to slow down significantly as a result of the pandemic. A nationwide quarantine was introduced in 1Q 2020 with restrictions that mainly affected the transport, tourism and trade sectors. In 1H 2020, real GDP grew by 0,2% year-on-year, with a positive contribution from agriculture, construction and service, while the physical volume index of industrial production decreased by 0,9% year-on-year. We expect the year-end GDP growth to stand at 1,5%, with a subsequent recovery to 5-6% in the medium term;
- The banking system's financial soundness indicators remain at an acceptable level. Last year's significant additional capitalization of state-owned banks allowed to maintain the overall capital adequacy ratio of the system at 20,5% and capital to assets ratio at 17,4% as of June 2020. The sector shows profitability with ROA of 2,3% and ROE of 9,9% as of June 2020. The Central Bank of the Republic of Uzbekistan (CBRU) has introduced a number of measures to support banks' liquidity through repo and swap operations, easing reserve requirements, and has introduced a special facility to provide liquidity to banks for up to three years. However, there are elevated risks of materialization of contingent liabilities, and we observe a deterioration in the quality of banks' assets, as NPLs have increased from the beginning of the year by 1,4 p.p. to 2,9% as of June 2020.

Restricting factors:

- The main sources of financing for the government are external creditors, mostly international financial institutions. This led to the prevalence of liabilities denominated in foreign currency (more than 97% of domestic and 100% of external debt) in the structure of public debt, making the debt position vulnerable to exchange rate fluctuations. After a harsh depreciation of the UZS in April 2020, the national currency has continued to weaken further, which will translate in an increase of the debt burden. Although the government has diversified debt structure by issuing domestic bonds, their share remains

[1] IMF, World Bank, Asia Development Bank.

insignificant and further issuance of these instruments is limited by the underdeveloped domestic capital market;

- The current account deficit narrowed to 5,6% of GDP in 2019 due to higher gold exports and the trade deficit declined to 16,5% of GDP. However, in 2020 we anticipate the current account deficit to widen to almost 10% of GDP amidst weaker exports resulting from weak demand (mainly for natural gas) due to the pandemic, and stable high imports fostered by capital spending, as well as higher external borrowings. Thus, the deterioration of the external position can further put pressure on the national currency and, consequently, the level of reserves could deplete. As of July 2020, the international reserves amounted to USD 33,9 bn, covering more than 12 months of import;

- Despite continued active growth of bank assets by 28% per annum on average in 2018-2019, the ratio of banking system assets and domestic loans to GDP as of early 2020 remains at moderate levels of 52,1% and 40,4% respectively. The role of the financial sector for the economy is limited by the high concentration on state-owned banks (85% of the sector's assets in 2020), as well as the still significant share of loans directed to SOE lending;

- The unemployment rate remained elevated at 9,3% in 2019. Given the high share of labor migration to neighboring countries, we expect a sharp increase in the number of unemployed as a result of the contraction of the economies of the main labor markets for Uzbekistan, mainly Russia and Kazakhstan;

- The CBRU continues to improve monetary policy within the framework of inflation targeting and transition to free-float exchange rate regime. In 2020, the policy rate[2] and interest corridor were introduced, as well as short-term liquidity instruments (repurchase operations and overnight facilities as well as emergency liquidity assistance). Given the lower projected inflation, the CBRU has cut the key rate by 100 basis points down to 15% and has committed to achieve the 5% inflation target by 2023. On the other side, the high level of financial dollarization should still restrain the effectiveness of monetary policy transmission mechanisms. In addition, supporting exchange rate flexibility and mitigating recent exchange rate pressure requires the maintenance of the Central Bank's intervention on a regular basis;

- In 2019, a full-scale tax reforms were carried out in Uzbekistan, the results of which were improved transparency and quality of public finances' management, reducing the tax burden on business and expanding the VAT tax base. Taking into account the urgency of measures related to the COVID-19 crisis, the government amended the budget for 2020 by increasing expenditures and implementing tax relief for business. Moreover, the government also created the Anti-Crisis Fund, which consist of around USD 1 bn, equivalent to round 2% of GDP. The authorities are ready to ensure transparency by conducting independent audits of expenditures and publishing the results. At the same time, we continue to observe a latent risk of deviating from the established policy as the off-balance operations an policy-based lending are still ongoing;

- Budget revenues for the 1H 2020 have not yet been negatively impacted by the coronavirus crisis, having increased by 15% y-o-y. Nevertheless, in 2020 we expect the consolidated fiscal deficit to widen significantly from 1,5% to 4,1% of GDP and the overall fiscal deficit[3] from 3,9% to 5,6% of GDP. The wider deficit reflects tax benefits for businesses and additional spending on financing medical and social measures to cope with COVID-19. However, we consider that the deterioration of the budget position will be short-lived and will not undermine the public finances' stability;

- Uzbekistan has large reserves of diverse commodities (mainly gold and natural gas), which support sustainable economic growth. At the same time, the country faces water

[2] As of beginning of March 2020, both refinancing rate (currently used only for the interbank loans from the CBU to commercial banks) and the key rate are at the same level.

[3] Includes policy-based lending operations according to IMF.

scarcity and water risk is potentially high for the country's sustainable development, especially for the agricultural sector, one of the key industries in the country.

Negative factors:

- Despite a gradual progress over the last years, the GDP per capita in PPP terms stood at USD 8,9 in 2019 and remains very low in global terms and among regional peers[4]. In addition, the unadjusted HDI as of 2018 also remained low, at 0,71 (109th place among 189 countries);
- The annual inflation remained high at 15,2% as of end-2019, with a slight decline to 14,4% as of July 2020. Given the slowdown in economic activity and weaker demand, the CBRU has revised the forecast corridor for 2020 down to 11,0%-12,5%. We expect that at the end of 2020, the inflation rate will be in the range of 12,5%-13,0% and its level will depend on the development of the pandemic;
- Even though from 2017 the authorities launched structural reforms aimed at improving the investment climate, institutional development continues to be restrained by high levels of corruption and a diminished rule of law in the country. According to Transparency International, the Corruption Perception Index was 25 out of 100 in 2019 (Uzbekistan ranked 158th out of 198 countries), while the Government Effectiveness and Rule of Law Indexes stood at -0,55 and -1,1 in 2018. However, Uzbekistan progressed in the World Bank's Ease of Doing Business ranking climbing to the 69th position from the 76 position a year ago out 190 countries in the 2020 report and it also recorded a substantial increase in governance transparency;
- The domestic capital market remains underdeveloped with the capitalization of national companies to GDP below 10% of GDP. Despite ambitious reforms launched in 2019, the stock market is still represented by a limited number of participants with a narrow range of financial instruments and high concentration of trading (the ten largest issuers account for about 73% of annual trading). However, we note a significant growth in the number of market participants, issuers and traded shares, including a 33% y-o-y increase in trading volume on the stock exchange in 1H 2020.

Stress factors:

- Despite the decline in FX-denominated lending and due to the weakening of the UZS, the level of financial dollarization of the economy is not declining. At the end of 1H 2020, the share of FX in total deposits and loans was 44,1% and 49,8% respectively.

SENSITIVITY ASSESSMENT:

The following developments could lead to an upgrade:

- Faster than expected recovery of the global economy, which can lead to an improvement of the external position of Uzbekistan and to enhance the state of government finances;
- Smooth continuation of the initiated structural reforms of the public business sector with reduction of the government footprint in the economy and banking industry;
- Further improvement of the exchange-rate flexibility and monetary policy, providing more freedom to monetary authorities, resulting in a long-term and controlled reduction of inflation and levels of financial dollarization.

The following developments could lead to a downgrade:

- Continued lock-down measures in the country and longer period of turbulence in the global economy, which would lead to further deterioration of the external position, as well as a contraction of local economy;

[4] Here Caucasus and Central Asia (CCA) oil and gas exporters: Azerbaijan, Kazakhstan, Turkmenistan, and Uzbekistan

- Deterioration of the stance of the banking system, which would materialize contingent liabilities of the government;
- Higher than expected increase of the government debt and deficit metrics due to the need of additional financing for the government expenditures, and underperforming of tax and external revenues.

ESG Disclosure:

Inherent factors

- Quality of fiscal policy; quality of monetary policy; natural resources; natural and climatic threats; environmental threats; level of corruption, CPI; Government Effectiveness Index; quality of the business environment; position in Doing Business Ranking; level of investment in human capital, adjusted for inequality; Rule of Law Index; transparency of government policymaking Index; level of information transparency of the government; Political Stability and Absence of Violence/Terrorism Index; natural disasters, constant exposure to difficult natural conditions.

Drivers of change factors

- Natural disasters, such as earthquakes and droughts have negative economic impact through affecting agriculture and damaging of infrastructure. Thus, the factor in our sovereign methodology which could be directly affected by this is ***Level and dynamics of production***.

"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." – Clarified Denys Anokhov, Rating Analyst of RAEX-Europe.

Research report on Uzbekistan is available at:

https://raexpert.eu/reports/Research_report_Uzbekistan_04.09.2020.pdf

Next scheduled rating publication: TBD in December 2020**.** The full sovereign rating calendar can be found at Sovereign Rating Calendar 2020

For further information contact:

Responsible expert:
Denys Anokhov, Rating Analyst of RAEX-Europe
+49 (69) 3085-45-00, ext. 1212
anokhov@raexpert.eu

Reviewer:
Hector Alvarez, Associate Director of RAEX-Europe
+49 (69) 3085-45-00, ext. 1213
alvarez@raexpert.eu

Rating-Agentur Expert RA GmbH (RAEX-Europe)
Walter-Kolb-Strasse 9-11,
60594 Frankfurt am Main, Germany
+49 (69) 3085-45-00
E-mail: info@raexpert.eu
www.raexpert.eu

RATING HISTORY:

Date	Review reason	SGC		Outlook	
		National currency	Foreign currency	National currency	Foreign currency
06.03.2020	Scheduled revision of both types of ratings for the country	BB-	BB-	Stable	Stable
06.09.2019	Scheduled revision of both types of ratings for the country	BB-	BB-	Stable	Stable
08.03.2019	Scheduled revision of both types of ratings for the country	BB-	BB-	Stable	Stable
14.09.2018	Scheduled revision of both types of ratings for the country	B+	B+	Positive	Positive
16.03.2018	Scheduled revision of both types of ratings for the country	B+	B	NA	NA
22.09.2017	Scheduled revision of both types of ratings for the country	B+	B	NA	NA
24.03.2017	Scheduled revision of both types of ratings for the country	B+	B	NA	NA
23.09.2016	Scheduled revision of both types of ratings for the country	B+	B	NA	NA
15.04.2016	First assignment of both types of ratings for the country	B+	B	NA	NA

Minute's summary

The rating committee for Uzbekistan was held on 4 September 2020. The quorum for the rating committee was present. After the responsible expert presented the factors, which influenced the rating assessment, the members of the committee expressed their opinions and suggestions within the framework of the Sovereign methodology. The chairman of the rating committee ensured that every member of the committee expressed his/her opinion before proceeding to the voting.

The following methodology was used for the rating assessment: Methodology for Assigning Sovereign Government Credit Ratings – Full Public Version (from April 2019). Descriptions and definitions of all rating categories can be found under the Rating scale section. The user of the rating shall read the methodology in order to have a full understanding of the rating procedure.

The definition of default can be found on the Agency's website in the section for Internal policies.

These ratings are unsolicited. The rated entity did not participate in the rating process.

Main sources of information: International Monetary Fund, World Bank, CIA Fact book, World Economic Forum, Doing Business, United Nations, The State Committee of the Republic of Uzbekistan on Statistics, Central Bank of Uzbekistan (CBU), Asian development bank, Ministry of Finance of Uzbekistan, Transparency International.

ESG Disclosure

We consider Environmental, Social, and Governance (ESG) risks and opportunities in the creditworthiness analysis of our Sovereign entities. The disclosure document can be found on the Agency's website in the section: ESG factors in RAEX-Europe's Credit Ratings

Limits of the Credit Rating

During the rating assignment process, Rating-Agentur Expert RA GmbH (the Agency) used publicly available information that was considered to be reliable, complete and non-biased. The responsible expert performed the rating assessment of the country with information considered as the most reliable and up to date in accordance to the overall position of the country and the Agency's internal criteria for selecting data providers. The information and data used for this specific assessment can be considered as of sufficient quality.

Regulatory use

SGC ratings can be used for regulatory purposes according to the ESMA definition.

Conflict of interest

The responsible expert was neither influenced nor biased by third parties during the rating assessment. All employees involved in the rating assessment and revision of the rated entity have reported absence of conflicts of interests before initiation of the rating process**.**

Rating-Agentur Expert RA GmbH is completely independent from the activities of other agencies of the RAEX group.

Risk warning

The Agency disclaims all liability in connection with any consequences, interpretations, conclusions, recommendations and other actions directly or indirectly related to the conclusions and opinions contained in the Agency's press-release and research report.

This press-release represents the opinion of Rating-Agentur Expert RA GmbH and is not a recommendation to buy, hold or sell any securities or assets, or to make investment decisions.

Office responsible for preparing the rating

The office responsible for the preparation and issuance of this credit rating is the office of Rating-Agentur Expert RA GmbH in Frankfurt am Main, Germany.

Rating-Agentur Expert RA GmbH is a credit rating agency established in Germany and therefore shall comply with all applicable regulations currently in force in the European Union.

The European Securities and Markets Authority (ESMA), the EU's direct supervisor of credit rating agencies (CRAs), has registered Rating-Agentur Expert RA GmbH as a CRA under Regulation (EC) No 1060/2009 of the European Parliament and of the Council of 16 September 2009 on credit rating agencies, with effect from 1 December 2015.

Rating-Agentur Expert RA GmbH applies the Code of Conduct Fundamentals for credit rating agencies issued by the International Organization of Securities Commissions (IOSCO Code) and includes the basic principles of IOSCO Code in its Code of Conduct.