Rating-Agentur Expert RA upgraded from 'B' to 'B+' the FC rating and confirmed at 'B+' the NC rating of Uzbekistan. The rating outlook is positive.

Rating-Agentur Expert RA confirmed the sovereign government credit rating (SGC) of Uzbekistan at 'B+' (moderately low level of creditworthiness of the government) in national currency and upgraded it from 'B' (moderately low level of creditworthiness of the government) to 'B+' (moderately low level of creditworthiness of the government) in foreign currency. The rating outlook is positive which means that in the mid-term perspective there is a high probability of upgrading the rating.

MAJOR FACTORS THAT INFLUENCED BOTH TYPES OF RATINGS:

Positive factors:

- Low amounts of gross government (mainly of a concessional nature) and short-term government debt, estimated at 24,5% and 1,1% of GDP in 2017 respectively. These ratios are also solidly covered by FX reserves (at 92% of GDP) by more than 3,7x and 84x respectively, influencing the rating positively;
- Uzbekistan is expected to conduct a tighter fiscal policy, directing public expenditure mainly on social support and to critical state owned enterprises (SOEs) in order to mitigate the effect of the FX rate depreciation. The new fiscal strategy has been adopted and it is designed to improve fiscal stability and transparency. The strategy includes a tax reform focused on revamping the tax administration; however, we anticipate this to be the major challenge for the government in 2019-21;
- The augmented[1] fiscal deficit widened by 2,7p.p. to 3,3% of GDP in 2017 as a result of increased fiscal expenditure on SOE and state owned bank (SOB) support due to the FX market and price liberalization reforms. However, as the government is planning to cover some of the deficits by foreign financing and to restrain fiscal expenditure and collect additional revenue through an improved tax administration, the augmented fiscal deficit is expected to narrow down to 1,3% of GDP in 2018;
- The real GDP growth of the country declined down to around 5,3% in 2017; however, it remains one of the largest among the CCA peers[2] and is expected to accelerate up to 7,9% in 2018. The future economic growth will be supported by increasing domestic investment, gradual implementation of economic reforms, as well as by favorable external demand and commodity prices;
- Uzbekistan's banking sector remains profitable and sound with ROA at 1,9%, NPLs at 0,42% of total loans and capital-to-assets ratio at 10,14% in 2017. However, given the high likelihood with which the economic reforms may reduce SOEs' profitability (constitute around 60% of total loans), banks may face challenges due to loan quality deterioration. Nevertheless, it is highly likely that banking system may be supported further if financial distress arises, as it has already received the necessary liquidity and capitalization support prior to the FX market liberalization reform in mid-2017.

Restricting factors:

- As a result of UZS devaluation in 2017 an unfavorable government debt accumulation dynamic was recorded, with gross government debt increasing by around 14p.p. and 45p.p. y-o-y up to an estimated 24,5% of GDP and 77,6% of budget revenues in 2017.

[1] Augmented fiscal balance includes revenues and expenditures from both consolidated budget and Fund for Reconstruction and Development.
[2] Here Caucasus and Central Asia (CCA) oil and gas exporters: Azerbaijan, Kazakhstan, Turkmenistan, and Uzbekistan.

Additionally, although the government planned to issue Eurobonds in the course of 2018, the gross government debt to GDP is projected to decline down to around 20,1% in 2018, as a result of a stronger UZS and persistently high GDP growth;

- The economy's competitiveness remains limited, evidenced by an ongoing but narrowing external imbalance of goods and services and a moderately high concentration of the country's production. However, the picture may change once further international trade reforms (as a follow-up to the already implemented FX and trade liberalization reforms) materialize into increased competitiveness of Uzbek exports;
- The depreciation of the UZS mainly benefited the banking sector, which is characterized by a high level of credit dollarization, as banks' assets and private credit volumes relative to GDP increased by around 24,6p.p. and 17,9p.p. to 66,9% and 44,4% in 2017 respectively. The reform, however, has not improved intermediation in the economy, as the financial sector continues to be shaped by state directed lending via SOBs at concessional rates;
- The unemployment rate, as reported by the World Bank, improved slightly but remained high at 7,18% in 2017;
- The last time the CBU increased the refinancing rate was back in June 2017 when it went from 9% to 14% in order to stem inflationary pressures, which resulted from the ongoing economy liberalization reforms. The CBU is likely to hold monetary policy tight, in order to keep inflation under control. Monetary policy effectiveness will ultimately depend on how well the policy reforms 2017-2021 are realized, including enhancing independence of the CBU, transition to inflation targeting and improvement in the effectiveness of the transmission mechanism of the monetary policy;
- Uzbekistan's long-term growth perspectives remain favorable driven by a significant amount of natural resources (mainly natural gas, gold and cotton). However the FDI net inflows (stood at 0,1% of GDP in 2016) remained low due to higher risks and slow improvement of the business environment. Private investment growth will depend on how well the economic reforms are implemented.

Negative factors:

- The country remains one of the least developed amongst its CCA peers as shown by the low level of GDP per capita, estimated at USD 6 929 in 2017, and an HDI index of 0,59 in 2016;
- As a result of a switch in the policy regime, followed by pass-through effect from FX and price liberalization, coupled with an increase in food prices, the inflation rate reached 18,9% in 2017 and is expected to remain around 16,9% in 2018 due to the ongoing liberalization of economic activity, increasing public sector salaries and pensions and rising energy prices;
- Despite the recent steps to improve the quality and transparency of official statistics, the institutional development remains subdued, as indicated by high levels of corruption and a diminished rule of law in the country. This may harm the country's plan to promote international trade and FDI and, as a consequence, may affect the materialization of the 2019-2021 fiscal strategy;
- The country's capital market remains underdeveloped, evidenced by a low market capitalization of companies listed on the National Stock Exchange of just 20,3% of GDP in 2017 and high concentration of trading, with the five most active issuers amounting to 99,7% of total trades.

Stress factors:

- Despite positive dynamics, financial dollarization remains a problem to the economy representing 48% of total deposits and 62% of total loans in January 2018 (weak stress factor).

SENSITIVITY ASSESSMENT:

The following developments could lead to an upgrade:

- Smooth economic policy transition process leading to stabilization of the key economic indicators;
- Continuous stabilization of fiscal budget figures and sustainability of debt metrics.

The following developments could lead to a downgrade:

- Gradual deterioration of the banks' asset quality and emergence of funding and capital gaps in the banking sector.

"The upgrade of Uzbekistan's SGC rating in foreign currency to 'B+' reflects the persistent implementation of economic reforms, which allowed to improve the country's currency risk position, prudent fiscal and monetary policies, as well as very low risk of government debt distress. The positive outlook of both SGC ratings reflects our expectations about a gradual recovery of the economy after liberalization reforms are fully implemented, leading to a continued strong output growth, stabilizing inflation and fiscal budget figures, as well as the authorities' commitment to further increase fiscal and monetary policy coordination.

On the negative side, the ratings continue to be constrained by the highly dollarized financial sector, distorted by the government's direct lending, low institutional development, high corruption and still elevated inflation levels. The future development of the ratings will largely depend on how well the government implements the development strategy 2017-21." – Clarified Ilya Makunin, Rating Analyst of Rating-Agentur Expert RA GmbH.

Responsible expert: Ilya Makunin, Rating Analyst of Rating-Agentur Expert RA GmbH

Reviewer: Hector Alvarez, Rating Associate of Rating-Agentur Expert RA GmbH

Research report on Uzbekistan is available at:

https://raexpert.eu/reports/Research_report_Uzbekistan_14.09.2018.pdf

Next scheduled rating publication: TBD in December 2018.

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RATING HISTORY:

Date	Review reason	SGC		Outlook	
		National currency	Foreign currency	National currency	Foreign currency
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 13 September 2018. 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 May 2018) can be found under the following link: https://raexpert.eu/files/methodology/Methodology_Full_Sovereign_V3.pdf. Descriptions and definitions of all rating categories can be found under the following link: http://raexpert.eu/sovereign.php 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.

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), Ministry of Finance of Uzbekistan, Transparency International.

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

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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.

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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.