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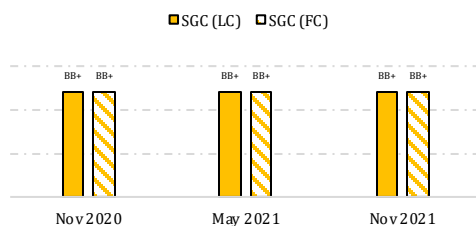
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## Ratings

Sovereign Government Credit (LC)	<b>BB+</b>
Sovereign Government Credit (FC)	<b>BB+</b>
Outlook (LC)	<b>Stable</b>
Outlook (FC)	<b>Stable</b>

\*These ratings are unsolicited

## Ratings dynamics



## Main Economic Indicators of Azerbaijan

Macro indicators	2018	2019	2020
Gross gov. debt, AZN bn	15	14	15
Nominal GDP, AZN bn	80	82	72
Real GDP growth, %	1,5	2,5	-4,3
Gross gov. debt/GDP, %	18,7	17,7	21,4
Deficit (surplus)/GDP, %	5,5	9,1	-6,5
Inflation rate, %	1,6	2,4	2,7
Current Account Balance/GDP, %	-	-	-0,5
External debt, USD bn	-	-	23,4
Development indicators	2020		
Inequality adj. HDI	0,68		
GDP per capita, USD th	14,5		
Default indicator	05.11.2021		
10Y Gov Bond Yield, %	3,39*		

Source: RAEX-Europe calculations based on data from the IMF, WB  
\* Maturity in 2029

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

RAEX-Europe confirmed the sovereign government credit ratings (SGC) of Azerbaijan at 'BB+' (Sufficient level of creditworthiness of the government) in national currency 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.

## Summary

Azerbaijan's ratings were confirmed at BB+ with a stable outlook. This mainly reflects the effects of the economic recovery due to higher oil prices, as well as diminishing adverse impacts from the pandemic. This has also caused the external stance to strengthen and public finances to stabilize in 2021. In addition, the amount of assets in the State Oil Fund of the Republic of Azerbaijan (SOFAZ) provides a substantial buffer for the government and remains one of the key strengths supporting Azerbaijan's creditworthiness.

However, oil dependency in the economy remains in place and the banking system, despite slowly recovering, remains weak.

**Public debt to remain adequate in 2021.** In 2020, gross government debt stood at 21,4% of GDP and 63,2% of budget revenues; however, these figures are expected to decline down to around 18% of GDP and 52% of budget revenues. This will mainly be a result of a better performance of the economy in 2021, while we expect absolute levels of debt to remain constant. Moreover, the level of buffers in SOFAZ remains quite substantial adding another layer of security to a potential hike in debt levels. In our debt calculation, we do not include guarantees issued to Aqracredit for the acquisition of problem assets from the International Bank of Azerbaijan.

Our assessment of the debt structure of Azerbaijan remains contrasting. On the one hand, short-term debt declined further and stood at 2,5% of total public debt by the end of 2020, we expect the reading to remain at a similar level by the end of 2021. On the other hand, the government's FX-denominated debt remained quite high at 84% of total debt as of 1H 2021. However, most of the debt is owed to various international financial institutions and foreign banks at concessional terms. Moreover, the level of

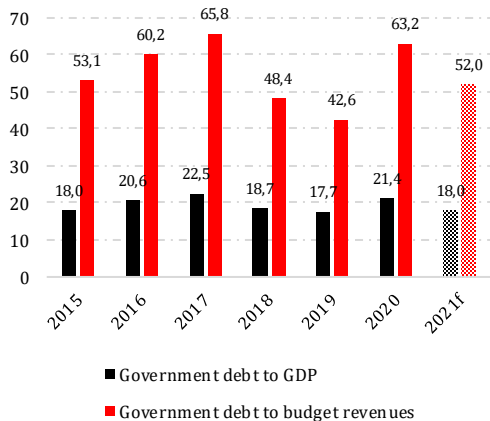
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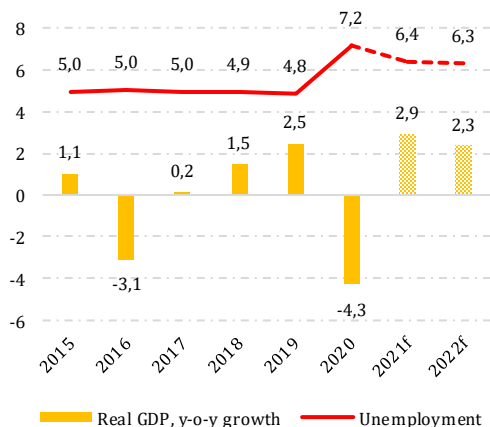
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**Graph 1: Government debt dynamics, %**



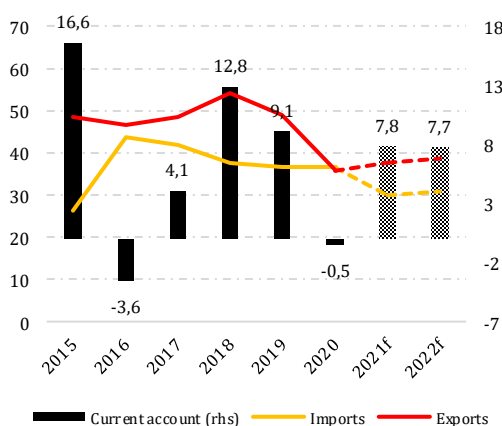
Source: RAEX-Europe calculations based on data from the Ministry of finance of the Republic of Azerbaijan and IMF

**Graph 2: Macroeconomic indicators, %**



Source: RAEX-Europe calculations based on data from the Statistical Committee of the Republic of Azerbaijan and the IMF

**Graph 3: External sector indicators, % of GDP**



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

international and SOFAZ reserves remains quite adequate, and since the AZN is de facto pegged to the USD, we do not anticipate any risk in a potential debt hike in the mid-term perspective.

**The economy recovered in 2021.** After a real GDP contraction of 4,3% in 2020 as the country got hit by the coronavirus pandemic and low oil prices, the Azeri economy recovered in 2021. In 9M 2021, the economy had grown by 4,8% y-o-y; non-oil GDP hiked by 6,2%. On the non-oil side, the recovery was mainly led by industrial production, while the growth in retail sales was also favorable. On the energy sector side, strengthening oil prices throughout the year have also contributed to strong output for the hydrocarbon-dependent Azeri economy. Moreover, Azerbaijan has stated that it will support the OPEC+ of increasing output by 400 000 bopd, which would potentially bring prices down but will remain a strong source of income for the country. The lifting of COVID-19 restrictions and lockdown, as well as the resumption of travel and the ongoing vaccination campaign, have also propelled economic output. We anticipate real GDP growth to be around 2,9% y-o-y by the end of 2021. The unemployment rate in Azerbaijan is set to decline slightly down to 6,4% in 2021 after posting a reading of 7,2% in 2020.

The concentration of the economy on the oil and gas sector remains high and is still one of the main factors constraining the sovereign ratings, as it makes the economy highly vulnerable to oil demand. Despite decreasing slightly, the oil and gas share in total exports was around 87% as of 1H 2021, while it represented 31% of total GDP production in 2020.

**The external stance remains strong.** Despite the economic impact from the coronavirus pandemic and low oil prices, the external position of Azerbaijan is solid. After the trade and current account balances posted negative metrics of -0,77% and -0,9% in 2020 respectively, we anticipate this to turn around in 2021. As of 1H 2021, exports had increased by 18% y-o-y, while imports hike by only 1% y-o-y. The increases are mainly a reflection of stronger external demand, higher oil prices, as well as an increase in private consumption as COVID-19 restrictions have eased. We expect this trend to continue towards the end of 2021 and the trade and current account balance to post readings of around 8,5% of GDP and 7,8% of GDP respectively.

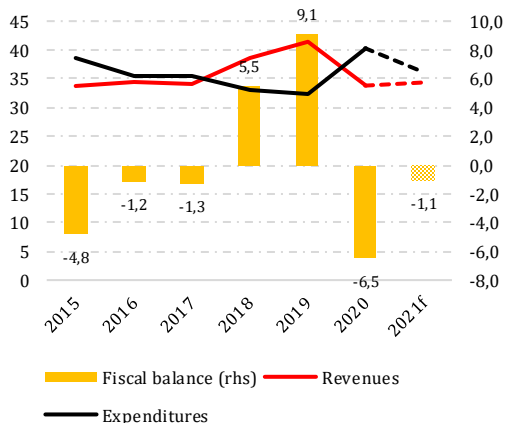
Moreover, the level of international reserves of the Central Bank of Azerbaijan (CBA) has been steadily increasing and, as of September 2021, it stood at USD 7 bn. Further strengthening the external position is the fact that SOFAZ remains with a vast amount of assets.

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**Political risk remains managed.** Political risk derived from the Nagorno-Karabakh conflict, despite remaining latent, appears to be controlled. We still expect peace to hold for the foreseeable future; thus, rendering stability to both countries in economic terms. However, after one year of concluding the peace agreement, there seems to be no sustainable long-term resolution in place to benefit both Azerbaijan and Armenia.

**Graph 4: Fiscal balance, % of GDP**



Source: RAEX-Europe calculations based on data from the Ministry of finance of the Republic of Azerbaijan and IMF

**Fiscal position expected to recover in 2021.** As a result of the strong fiscal package to cushion the effect of the pandemic combined with weak budget revenues, the fiscal budget recorded a deficit of 6,5% of GDP in 2020. However, we expect the deficit to narrow down to -1,1% of GDP in 2021 driven by stronger revenues propelled by higher oil prices, and higher tax income as the economy as whole recovers. On the expenditure side, we expect pandemic-related relief spending to continue at a slower pace and Nagorno-Karabakh reconstruction spending will also push overall budget expenses higher.

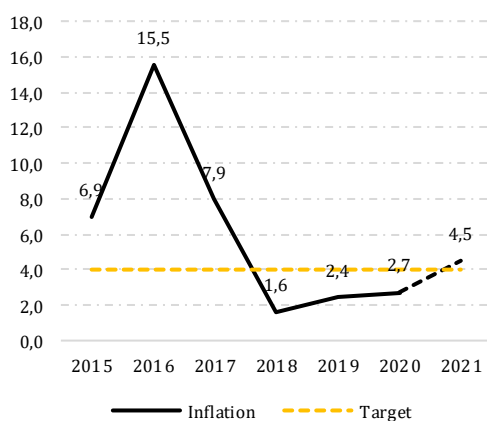
Budget revenues of SOFAZ were AZN 10,4 bn, while budget expenditures stood at AZN 7,3 bn as of 3Q 2021. Moreover, as of August 2021, assets of the fund stood at USD 44,2 bn and increased by 3,5% as compared to the end of 2020. As we have stated in the previous reviews, we still consider the fund to be one of the key strengths for the creditworthiness of the sovereign as it has more than enough room to finance the national budget.

**Monetary policy to remain prudent.** The monetary policy decision has been working well during the pandemic. The Central Bank of Azerbaijan (CBA) made a series of cuts in 2020 in order to provide some support to the economy. However, on the back of higher sustained inflationary pressures as well as inflation expectations, the CBA decided to hike the refinancing rate up to 7%. The level of inflation is expected to be around 4,5% by year-end 2021. In addition, the de facto peg to the USD remains in place and the CBA continues to perform FX auctions alongside the state oil fund.

We still consider that the plan of transition to an inflation-targeting regime as part of the CBA strategy remains in place but has been delayed due to the current pandemic situation. In terms of effectiveness, the economy's response to the changes in the reference rate remains limited as a result of high dollarization levels.

**Banking system remains weak but improving.** The banking sector has fared well during the coronavirus pandemic, albeit remains weak. As of 3Q 2021, the ratio of NPLs to total loans stood at 5,5%, a decline from the 6,1% reading posted at the end of 2020. Furthermore, as of the same date, ROA stood at 1,5%, while ROE posted a figure of 11,1%. In addition, the estimate

**Graph 5: Inflation, %**



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

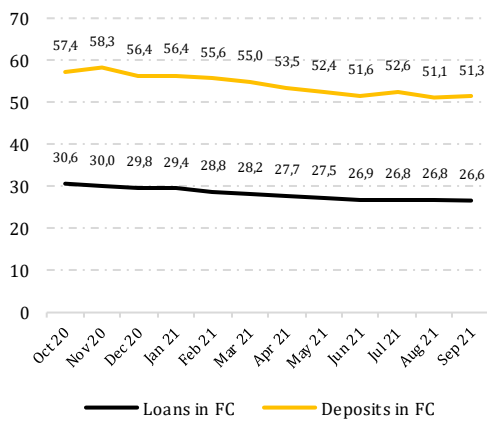
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**Graph 6: Financial dollarization, % of total**



Source: RAEX-Europe calculations based on data from the Azerbaijan Banks Association

of the capital adequacy ratio was at around 22% by the end of 2020. As mentioned in our previous review, the stability of the metrics stems mostly from the capital injection, restructuring process, and subsequent recovery of the state-owned International Bank of Azerbaijan (IBA), as well as from the license revocation of four banks. We anticipate Basel 3 to kick in this year in regard to liquidity and risk management.

Despite financial dollarization in the banking system has eased in the past 9 months, it remains a concern. The level of financial dollarization in the country stood at 51,3% of deposits and at 26,6% of loans as of September 2021. Therefore, a potential devaluation of the local currency could result in an even harder impact on the market if the government would need to devalue the currency due to the pressure from the pandemic, oil prices, or an unlikely potential escalation of the Nagorno-Karabakh conflict.

As mentioned in our previous review, the CBA took measures to support the economy by signing a USD 200 m swap agreement with the EBRD in order to improve the flow of money into the economy. However, in January 2021, the CBA lifted some measures established in 2020 to ease the banking sector of some burdens. The measures lifted include inspections at banks and the capital requirements for consumer loans went back into place.

The level of domestic credit to GDP stood at 15,4% of GDP in 2020, in line with our prediction, banks' assets to GDP posted a figure of 44,3%. We have seen credit growth pick up the pace in 2021 as total loans to the economy grew by 9,8% in absolute terms from December 2020 to September 2021 led mainly by a 18,2% hike in household loans.

**Support factors:**

- Substantial foreign currency assets (expected above 100% of GDP by end-2021) on the balance sheet of SOFAZ. As of August 2021, the fund had around USD 44,2 bn in assets (weak support-factor).

**Stress factors:**

- Increased dollarization level: 51,3% of deposits and at 26,6% of loans were denominated in foreign currency as of September 2021 (moderately weak stress-factor);
- Budget revenues are highly dependent on the oil sector. (weak stress-factor);
- Escalation of the frozen conflict over the Nagorno-Karabakh territory continues to constrain the structural transformation of the country, despite the peace treaty, we still consider the situation as a stress factor (weak stress-factor).

**SENSITIVITY ASSESSMENT:**

The following developments could lead to an upgrade:

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- Continued increase in oil prices higher than our base scenario to support GDP growth and the external trade position;
- Increased economic diversification and lower share of budget revenues from the oil industry.

The following developments could lead to a downgrade:

- Further deterioration of economic activity which will have a direct impact on public finances and external buffers;
- Renewed escalation in the military conflict with Armenia.

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

- None

Next scheduled rating publication: TBD December 2021. The full sovereign rating calendar can be found at [Sovereign Rating Calendar 2021](#)

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## RATING HISTORY:

Date	Review reason	SGC		Outlook	
		National currency	Foreign currency	National currency	Foreign currency
07.05.2021	Scheduled revision of both types of ratings for the country	BB+	BB+	Stable	Stable
06.11.2020	Scheduled revision of both types of ratings for the country	BB+	BB+	Negative	Negative
08.05.2020	Scheduled revision of both types of ratings for the country	BB+	BB+	Negative	Negative
08.11.2019	Scheduled revision of both types of ratings for the country	BB+	BB+	Stable	Stable
10.05.2019	First assignment of both types of ratings for the country	BB+	BB+	Stable	Stable

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### Minute's summary

The rating committee for Azerbaijan was held on 5 November 2021. 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 August 2020). 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: IMF, World Bank, Central Bank of Azerbaijan, National statistical office of the Republic of Azerbaijan, Ministry of finance of the Republic of Azerbaijan, WEF, The State Statistical Committee of the Republic of Azerbaijan, Transparency international, open sources.

### 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.

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