Research Report on Azerbaijan

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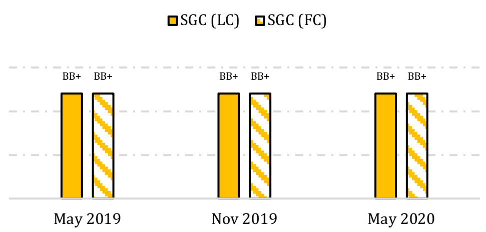
Ratings

Sovereign Government Credit (LC)	BB+
Sovereign Government Credit (FC)	BB+
Outlook (LC)	Negative
Outlook (FC)	Negative

* These ratings are unsolicited

Ratings dynamics



Main Economic Indicators of Azerbaijan

Macro indicators	2017	2018	2019
Gross gov. debt, AZN bn	16	15	16
Nominal GDP, AZN bn	70	80	82
Real GDP growth, %	0,2	1,0	2,2
Gross gov. debt/GDP, %	22,5	18,8	19,4
Deficit (surplus)/GDP, %	-1,4	5,6	9,0
Inflation rate, %	7,9	1,6	2,7
Current Account Balance/GDP, %	-	-	9,2
External debt, USD bn	-	-	9,1*

Development indicators	2019
Inequality adj. HDI	0,68
GDP per capita, USD th	18,6

Default indicator	07.05.2020
10Y Gov Bond Yield, %	5,2**

Source: RAEX-Europe calculations based on data from the IMF, WB
* Government and government guaranteed debt ** Maturity in 2029

Summary

The Agency has confirmed Azerbaijan's ratings at 'BB+' and changed the outlook from stable to negative. Our decision to change the outlook mainly reflects the impact on the economy from the coronavirus crisis. The effects of the pandemic in Azerbaijan have mostly been observed through oversupply and lower demand on oil, which has caused the oil price to sink. This affects directly the country's public finances, external stance and general economic contraction in 2020. In addition, the banking system is expected to weaken ever further as a result.

Despite this, we still consider Azerbaijan to have enough buffers in SOFAZ as well as an adequate fiscal surplus which will support the economy through the crisis. Moreover, although expected to hike, government debt levels remain quite adequate.

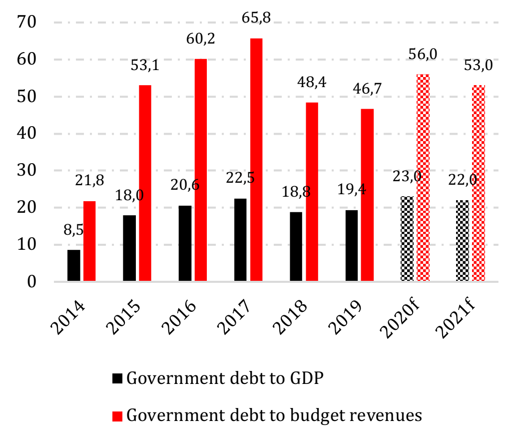
Government debt to remain manageable despite increase. The level of gross government remained stable as we previously anticipated and remains the lowest reading among countries in the Caucasus region[1]. The readings for 2019 stood at 19,4% of GDP and 46,7% of budget revenues. Nevertheless, in order to finance some of the measures announced by the authorities, we expect debt to increase in 2020. This rise, combined with the contraction of GDP, will elevate the level of debt to GDP to around 23% by year-end, still a manageable metric. Total guarantees issued by the government are above 30% of GDP in 2019, indicating that a potential materialization of contingent liabilities is still latent (see graph 1).

In terms of structure, we also anticipate the current adequate level of short-term debt to rise, while the share of FX-denominated debt will remain elevated (currently around 17% of GDP and at 18,9% of GDP when including guarantees) and could potentially represent a risk if a USD/AZN devaluation were to materialize.

GDP to contract but external buffers will cushion the blow. As a result of higher oil prices in 2019 and a positive performance from the non-oil sector, the economy grew by 2,2% in real terms. However, we anticipate a contraction of GDP at around 2% in 2020 as a result of the negative consequences from the coronavirus crisis. The pandemic, alongside an excess supply of oil, has depressed oil prices substantially in the past two

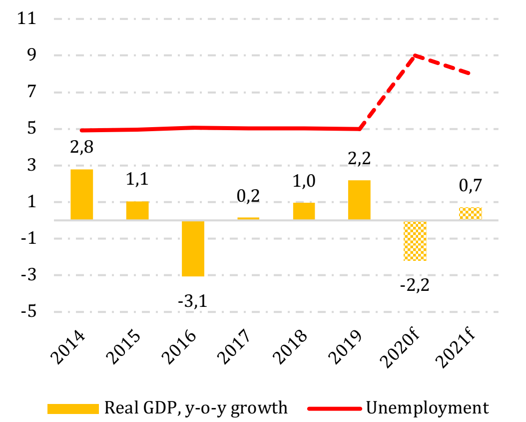
[1] Debt to GDP for 2019: Georgia – 45,7%, Armenia – 51%.

Graph 1: Government debt dynamics, %



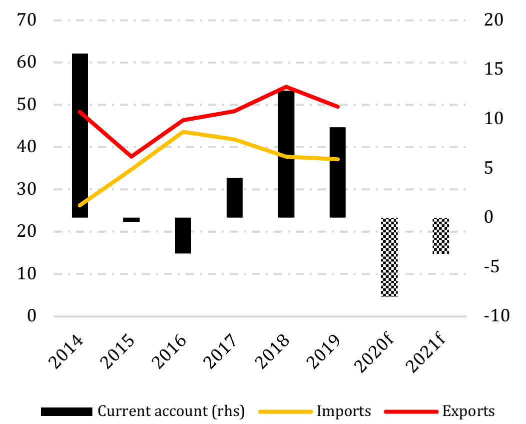
Source: RAEX-Europe calculations based on data from the Ministry of finance of the Republic of Azerbaijan and IMF

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 CBA and IMF

months and we expect them to remain low (see graph 2). Our projection is that the price of Brent crude will remain below USD 40 per barrel until year-end. What is more, the economy continues to lack diversification as the hydrocarbon output represented a 38% share of GDP, while this industry also accounted for 91% of total exports. Thus, low oil prices combined with the concentration of the economy on this sector, translates into a high risk of diminished economic output, the external stance, as well as the stability of public finances. On the other hand, measures taken to prevent the spread on the virus will also take a toll on non-oil output.

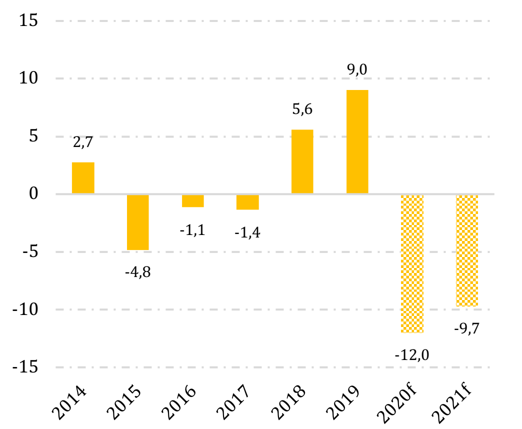
The external position of Azerbaijan remains quite solid with a wide trade balance and current account surpluses, substantial reserves from State Oil Fund of the Republic of Azerbaijan (SOFAZ). By the end of 2019, the trade balance of Azerbaijan was positive at 12,4% of GDP while the current account presented a surplus of 9,2% of GDP; even though both metrics shrank as compared to 2018, they were still solid mainly supported by hydrocarbon exports. We anticipate the reading to deteriorate as exports are expected to sink as a result of lower global demand for goods, especially oil. As a result, we expect the current account to post a deficit of around 8% (see graph 3).

On the other hand, the assets of SOFAZ remain vast at USD 41,4 bn as of the end of 1Q 2020. This represents a fall of around 4,6% from the end of 2019 reflecting substantial sales of FX in order to maintain the peg to the USD. As a result, SOFAZ has already transferred around AZN 4,6 bn to the fiscal budget. The fund remains the largest source of current budget expenditures and government debt service, and we expect it to remain so as the Central Bank of Azerbaijan will continue to maintain the exchange rate fixed in order to provide stability. In addition, the CBA's international reserves have remained flat for the past two months and we anticipate Azerbaijan's reserves to remain under pressure as the CBA continues to hold the USD/AZN at 1,7, while oil prices are expected to remain depressed.

Finally, the territorial and ethnic conflict over the Nagorno-Karabakh region continues to constrain economic development of the country and remains a latent risk threatening the creditworthiness of the country.

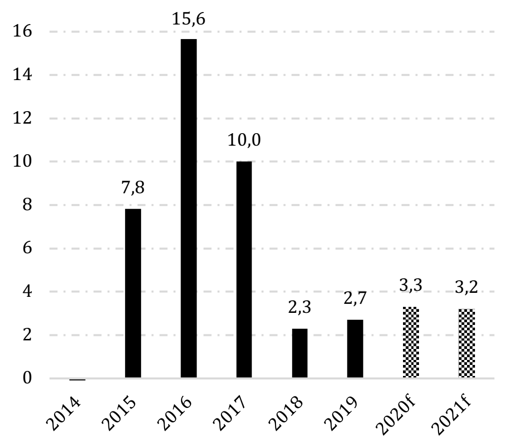
Fiscal balance to turn negative in 2020. The strategy of the fiscal policy in 2019 was directed toward a reduction on expenditures, which translated in a budgets surplus of 9% of GDP. During the year, SOFAZ transferred AZN 11,3 bn to the budget, representing a strong support for public finances; while the source revenues remains highly dominated by the oil sector accounting for around 56% of the overall budget income. Even though the fiscal buffer is a good support in order to contain the

Graph 4: Fiscal balance, % of GDP



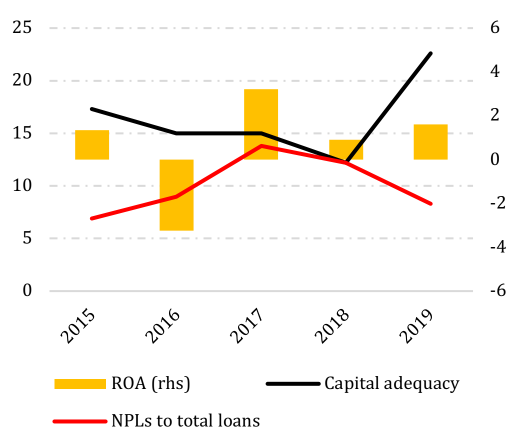
Source: RAEX-Europe calculations based on data from the Ministry of finance of the Republic of Azerbaijan and IMF

Graph 5: Inflation, %



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

Graph 6: Financial soundness indicators, %



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

current situation, we still anticipate the fiscal balance to turn negative to around -12% of GDP reflecting lower revenues due to lower oil prices combined with higher expenditures as the government rolls out measures to support the economy amid the pandemic (see graph 4). These measures include a hike in health expenditures, creation of the Coronavirus Response Fund and support to businesses and entrepreneurs of around 3% of GDP. We also anticipate an increase in other social expenditures as the unemployment rate continues to climb.

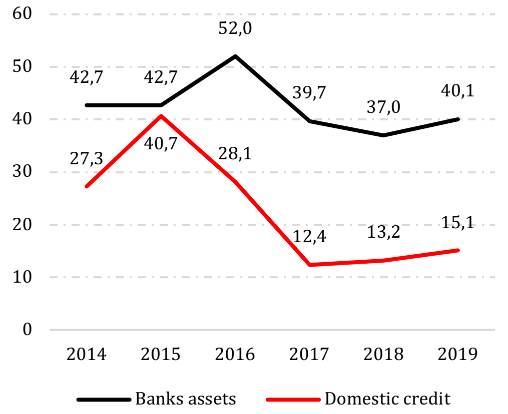
Monetary policy focused on exchange rate stability. The CBA continues to show willingness to maintain a de facto peg to the USD in order to maintain stability. This means that the transition to an inflation targeting strategy is still not a priority, especially taking into account the current crisis. In fact, we have already observed levels of international reserves flatten and SOFAZ auctioning FX through the CBA in order to achieve the abovementioned objective of an exchange rate of USD/AZN 1,7. However, as low prices of oil continue to linger, the pressure of a potential AZN devaluation grows stronger. On the positive side, as we previously mentioned, the country has sufficient buffers to support this policy.

On 1 May 2020, the CBA kept the refinancing rate unchanged at 7,25%, as well as the floor at 6,75%. Nevertheless, the effectiveness of changes in the reference rate, is constrained due to the elevated level of financial dollarization as well as the de facto peg to the USD and no capital controls.

At the end of 2019, the CPI index hiked by 2,7%, while as of March 2019 in increase slightly growing by 3,3% y-o-y; both figures show that inflation has remained quite stable and within the CBA target of 4%±2%. Inflation expectations have remained slightly high, but we still anticipate the inflation rate to stand at around 3,3% by the end of 2020 (see graph 5). Despite this, inflationary pressures might arise as long as oil prices remain low which increases the strain of a potential devaluation.

Banking sector expected to weaken further. The shock of the coronavirus crisis is expected to put an end to the continued recovery of the banking system and threatens an already weak sector. Despite this, improvement continued in 2019 mainly resulting from the rescue which followed the rebound of the state-owned International Bank of Azerbaijan (IBA). The NPLs to total loans ratio continued to fall to 8,3%, the capital adequacy ratio climbed up to 22,6%, while profitability also increased as ROA and ROE stood at 1,6% and 11,7% (see graph 6). Despite this, concentration on the top banks, especially the ones which are state-owned, remains a concern in the system as it continues to disturb competition. As of 3Q 2019, the top-3 banks accounted for 53% of the total

Graph 7: Credit to the economy dynamics, % of GDP



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

sector's assets. In addition, financial dollarization remains high; as of March 2020, 62,4% of total deposits and 34% of total loans were denominated in foreign currency, increasing the potential negative impact in case of a currency devaluation.

On April 27, the CBA appointed administrators in Atabank, AGBank, NBCBank and Amrahbank arguing a degradation in the financial standing in those banks. On 28 April, the regulator removed the licenses of Amrah Bank and Atabank citing substantial losses and reduction of capital levels. Both banks together account for around 2% of the total banking sector assets.

As a response to overcome the blow of the pandemic, the Central Bank along with the central government have introduced measures, such as temporarily modifying the calculation method for capital adequacy, subsides on interest rates to businesses affected, mortgage restructuring for individuals and an extension of the full insurance of all protected deposits until the end of 2020.

Domestic credit continued to hike in 2019; our estimation stands at around 15% of GDP. Moreover, assets of the banking sector as a whole also increase up to 40% of GDP. We expect the metric to grow marginally in absolute terms reflecting lower credit demand due to the pandemic but, since GDP is expected to contract, we expect to see a higher domestic debt to GDP ratio in 2020 of around 21% (see graph 7).

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://www.raexpert.eu/reports/Press_release_Azerbaijan_08.05.2020.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.