Research Report on Uzbekistan

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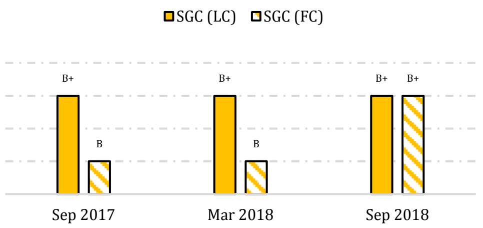
Ratings

Sovereign Government Credit (LC)	B+
Sovereign Government Credit (FC)	B+
Outlook (LC)	Positive
Outlook (FC)	Positive

* These ratings are unsolicited

Ratings dynamics



Main Economic Indicators of Uzbekistan

Macro indicators	2015	2016	2017e
Gross gov. debt, UZS bn	15814	20924	61135
Nominal GDP, UZS bn	171808	198872	249136
Real GDP growth, %	7,9	7,8	5,3
Gross gov. debt/GDP, %	9,2	10,5	24,5
Deficit (surplus)/GDP, %	0,4	0,4	-1,7
Inflation rate, %	8,4	7,9	18,9
Current Account Balance/GDP, %	-	-	3,7
External debt, USD bn	-	-	15,6

Development indicators	2017e
Inequality adj. HDI	0,59*
GDP per capita, USD th	6,9

Source: RAEX-Europe calculations based on data from the IMF and UN
*figure from 2016

Summary

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.

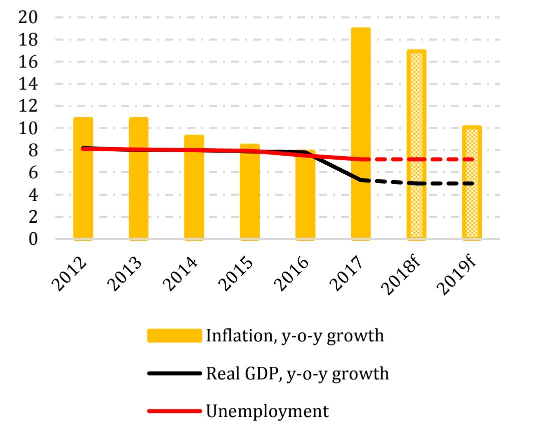
On the negative side, the ratings continue to be constrained by the highly dollarized financial sector, distorted by the government's direct lending, low institutional development, high corruption and still elevated inflation levels. The future development of the ratings will largely depend on how well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

Monetary policy remains tight. Monetary policy was tightened prior to FX liberalization in September 2017 in order to contain credit expansion and inflationary pressures, which translated into the refinancing rate being increased up to 14% from 9% in June 2017. This did not prevent inflation from picking up to 18,9% in 2017 due to the pass-through effects of FX and price liberalization (see graph 1). The tight monetary policy is expected to persist in 2018-2019 given continued inflationary pressures as a result of delayed pass-through and further reforms.

The Central Bank of Uzbekistan (CBU) has articulated its intention to gradually switch from FX to inflation targeting in the medium term, while maintaining a managed float in the meantime. This will need to be accompanied by an increase in the CBU's independence, a strongly improved transmission mechanism of the monetary policy, through continued de-dollarization of the economy and reduction of SOEs' direct lending practices, as well as by advanced analytical and communicational capacities of the bank. Ultimately, monetary policy effectiveness will largely depend on how effectively the aforementioned policy reforms are implemented.

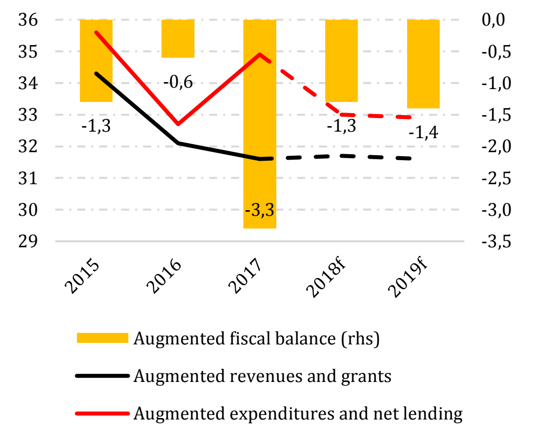
Tighter fiscal policy is a top priority for the government as it will help to reduce inflation. The augmented fiscal deficit widened by 2,7p.p. to 3,3% of GDP in 2018 (see graph 2), as a result of on-lending to critical state

Graph 1: Macroeconomic indicators, %



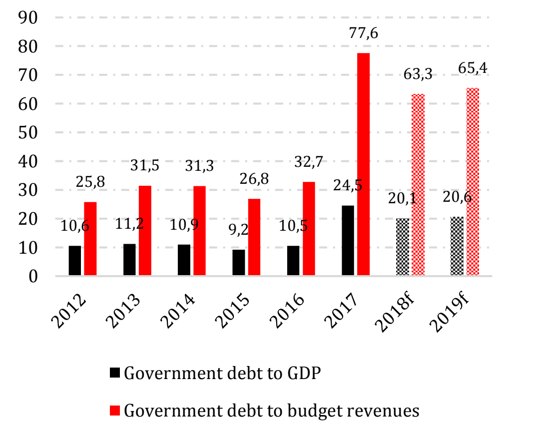
Source: RAEX-Europe calculations based on data from the IMF

Graph 2: Augmented fiscal budget dynamics, % of GDP



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

Graph 3: Government debt dynamics, %



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

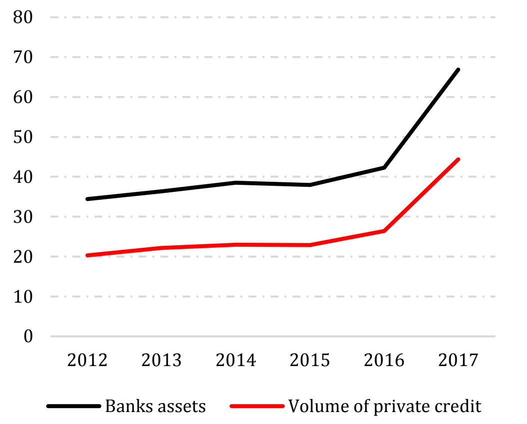
owned enterprises (SOEs) and additional social expenditure following the liberalization reforms. Despite additional expenditure requirements, the fiscal policy has traditionally been prudent with the gross government debt kept low. Additionally, authorities are expected to conduct a tighter fiscal policy, restraining on-lending activities, and are planning to raise foreign financing, setting the augmented fiscal deficit to decrease down to 1,3% in 2018. The newly initiated tax reform will improve the efficiency of the tax system and tax administration and ensure additional budget revenue inflow by ensuring the emergence of a broader private sector tax base; however, it is expected to be the major challenge for the government in 2019-21. Concrete steps were made to improve the transparency of the fiscal policy by consolidating on- and off-budget transactions in the reported fiscal data, with the authorities committed to bringing all fiscal operations on-budget from 2019.

Low relative debt load is expected to persist. As a result of the UZS devaluation, gross government debt figures increased significantly – 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 (see graph 3). Nonetheless, the total stock of general government debt relative to GDP remains modest and, despite a planned issue of Eurobonds by the end of 2018, the ratio is projected to decline down to around 20,1% in 2018, as a result of solid GDP growth and stronger UZS. It is also worth mentioning; that general government debt consists solely of foreign currency denominated external debt, mostly on concessional terms, which along low short-term government debt and solid FX reserves keeps the risk of debt distress rather low.

Financial sector is dominated by state owned banks (SOBs). As a result of the depreciation of the UZS and high credit dollarization of the financial system, Uzbek banks' assets and private credit volumes increased by around 24,6p.p. and 17,9p.p. to 66,9% and 44,4% in 2017 respectively (see graph 4). However, the reform has not improved intermediation in the economy, as the highly concentrated financial system continues to be shaped by state directed lending to major SOEs via government owned banks at concessional rates. Furthermore, ongoing price liberalization and economic reforms are likely to reduce profitability of UZS revenue dependent SOEs, which account for around 60% of total loans in the system, and, consequently, given the still high loan dollarization level, banks may face challenges due to credit quality deterioration.

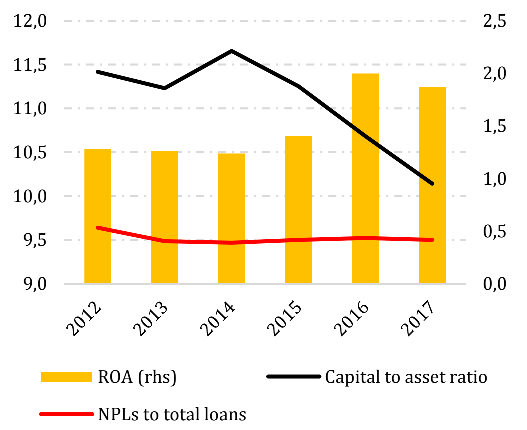
Nevertheless, the sector stays profitable and sound with ROA at 1,9%, NPLs at 0,42% of total loans and capital to assets ratio at 10,14% in 2017

Graph 4: Credit to the economy dynamics, % of GDP



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

Graph 5: Financial soundness indicators, %



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

(see graph 5), although, there is a certain probability of hidden NPLs, which may lead to deterioration of the risk position of the banking sector, if the country's macroeconomic environment worsens. Additionally, it is highly likely that the banking system is going to 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, which increases contingency risk of the government.

Economic growth is expected to continue. The real GDP growth slowed from 7,8% in 2016 down to 5,3% in 2017 due to liberalization reforms. However, supported by increasing domestic investment, gradual implementation of the newly adopted National Development Strategy 2017-21, as well as favorable external demand and commodity prices, the real output growth is expected to remain very high at around 5% in the next two years.

Despite the recent steps towards transparency improvement, institutional development of Uzbekistan remains limited. The country is still characterized by high levels of corruption, diminished rule of law and low government effectiveness. This may harm the country's plan to promote international trade and FDI and, therefore, may affect the necessary job creation and economic growth along the 2017-21 strategy. Uzbekistan has a substantial way to go in terms of development, as it remains one of the most undeveloped countries amongst the CCA peers[1] 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.

One of the top priorities for the authorities will be to continue instrumenting the structural reforms, aimed at creating jobs, especially within the young population, and attracting international investors via increasing the economy's competitiveness, improving business environment and developing infrastructure. Favorable perception of the country's structural change has been reflected in the country's upgrade in the Doing Business ranking by 13 positions up to 74th out of 190 countries in 2017.

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_14.09.2018.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.

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