Research Report on Uzbekistan

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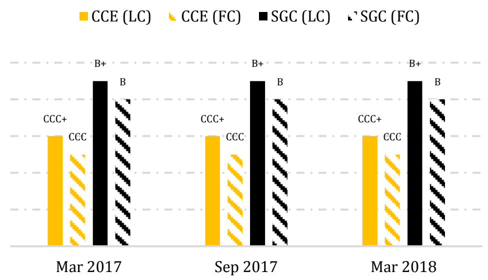
Ratings

Sovereign Government Credit (LC)	B+
Sovereign Government Credit (FC)	B
Country Credit Environment (LC)	CCC+
Country Credit Environment (FC)	CCC

* These ratings are unsolicited

Ratings dynamics



Main Economic Indicators of Uzbekistan

Macro indicators	2015	2016	2017e
Gross gov. debt, UZS bn	15742	20882	61038
Nominal GDP, UZS bn	171107	198872	249136
Real GDP growth, %	8,0	7,8	5,3
Gross gov. debt/GDP, %	9,2	10,5	24,5
Deficit (surplus)/GDP, %	-1,3	-0,6	-3,3
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	6,6

Source: RAEX (Europe) calculations based on data from the IMF, NSC and UN
*figure from 2016

Summary

The ratings of Uzbekistan remain constrained by the underdeveloped SOB-dominated financial sector, low institutional development and high corruption. The country's fiscal and monetary figures have been negatively affected, as Uzbekistan entered a transition period due to the ongoing liberalization of the economy. However, we expect the economy to stabilize, as the government is engaged in coordinating the fiscal and monetary policy.

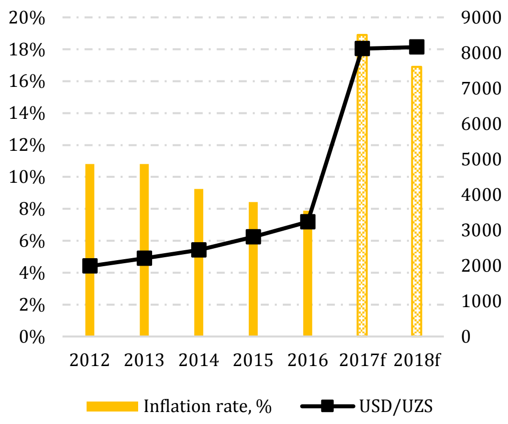
On the positive ground, short- and long-term debt levels continue to be rather low and well covered by the FX-reserves. This provides sufficient room for further indebtedness without harming the country's creditworthiness. The future development of the ratings will largely depend on how effectively the government implements the 2017-2021 policy reforms.

Ongoing FX and monetary policy reforms. In order to improve foreign investment and private sector development, as well as to foster the country's exports the government has initiated an extensive FX reform by moving from a fixed exchange rate to a managed float scheme, removing capital controls and maintaining an independent monetary policy. These measures contributed to the unification of the FX market and the elimination of the associated economic distortion, allowing private firms to convert UZS at market rates and giving the banks more freedom at negotiating loan terms and setting FX transaction commissions. The reform is expected to improve business environment, attract additional FDI, and as a result, facilitate job creation and economic growth.

In order to contain credit expansion and inflation pressures prior to the FX liberalization, the Central Bank of Uzbekistan (CBU) has increased the refinancing rate from 9% to 14% in June 2017. However, this did not prevent inflation rate from rising up to 18,9% in 2017, as it picked up due to the pass-through effects of FX liberalization (see graph 1). In 2018, we expect inflation to stay rather high at 16,9%, hence monetary policy is likely to remain restrained in the course of the year.

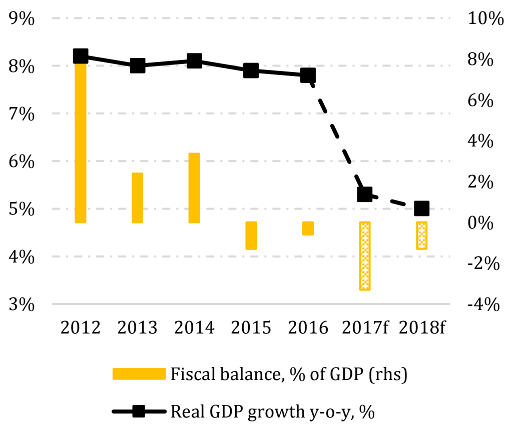
In line with the 2017-2021 monetary policy reforms, the CBU plans to gradually switch from FX to inflation rate targeting, allowing the national currency to trade freely in the next two to three years while maintaining a managed float in the meantime. Additionally, the CBU has recently started

Graph 1: Inflation vs exchange rate dynamic



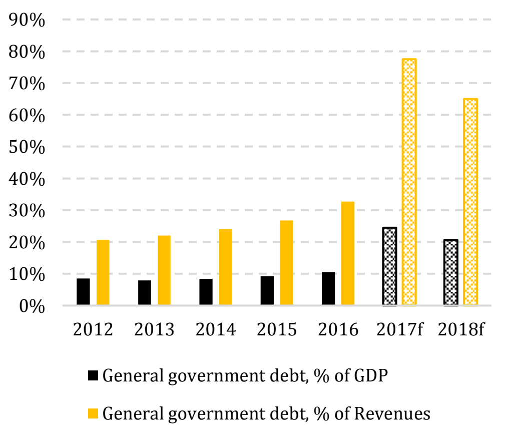
Source: RAEX (Europe) calculations based on data from the IMF and CBU

Graph 2: Fiscal balance vs real GDP growth



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

reporting to the parliament directly, and is expected to gain further independence, which is essential for the monetary policy's transition to inflation targeting. Ultimately, monetary policy effectiveness will largely depend on how effectively the aforementioned policy reforms are implemented.

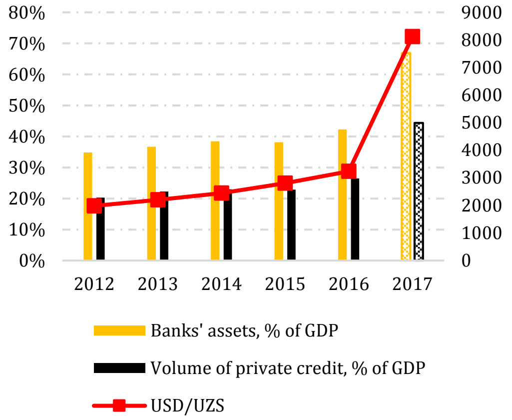
Effective countercyclical fiscal policy. Uzbekistan's countercyclical fiscal policy largely offset the impact of the unfavorable external environment, mainly characterized by declining world commodity prices through 2013-2016 and weaker performance of Russia and China (two of the country's main trade partners). This contributed to create buffers, which prevented a sharp contraction of output as GDP growth rate remained positive in 2016 at 7,8%, only 0,1p.p. below the 2015 figure. Growth is likely to be weaker at around 5,3% in 2017 following the adjustments to the recent UZS devaluation and we expect this figure to stay at around 5% in 2018 in spite of a solid domestic demand and the economic recovery of Uzbekistan's main trading partners (see graph 2).

Fiscal deficit has increased further by 2,7p.p. y-o-y up to 3,3% of GDP in 2017 mainly due to increased fiscal expenditure associated with the FX liberalization reform, as significant additional lending and bank recapitalization was required. In 2018, the fiscal deficit is set to narrow to around 1,3% of GDP (see graph 2) as the government is planning to restrain fiscal expenditure and collect additional revenue from improved tax administration and increased commodity prices in the course of the year. In 2018, a number of deep structural reforms are likely to take place as the government is urged by international organizations to improve the institutional stance of the country. One of the major revisions would be done in the tax legislation which impedes the creation of specialized businesses (important for the value chain of production) as a result of turnover taxation[1] rather than VAT deductibility for smaller businesses. Additionally, the tax system tends to hinder larger businesses, thus discouraging companies from growing beyond a certain size. We anticipate that, if such reforms are instrumented, they could have a positive impact in the rating assessment of the country.

Low debt load, but expected to increase. Debt figures have substantially worsened, however remained favorable with gross government debt standing at around 24,5% of GDP and 77,5% of budget revenues in 2017 (see graph 3). Short-term debt remains historically low at around 1% of GDP and 3,2% of budget revenues. This, combined with a substantial

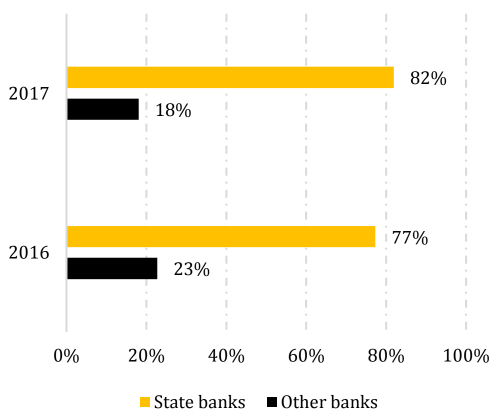
[1] A turnover tax is similar to VAT, with the difference that it taxes intermediate and possibly capital goods. It is an indirect tax, typically on an ad valorem basis, applicable to a production process or stage.

Graph 4: Financial sector dynamics



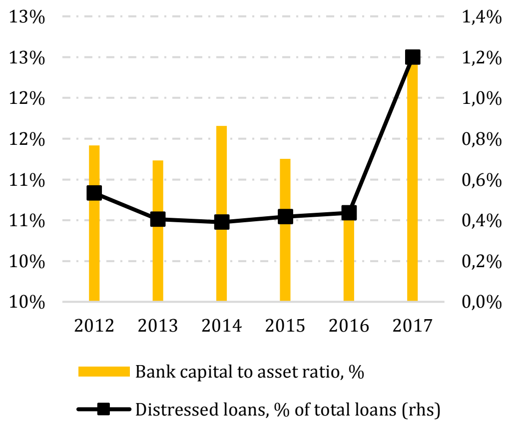
Source: RAEX (Europe) calculations based on data from the IMF and CBU

Graph 5: Banking sector structure



Source: RAEX (Europe) calculations based on data from the CBU

Graph 6: Banking sector indicators



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

amount of FX reserves at more than 90x of short-term debt, reflects the reduced credit risks of the country.

Job creation is one of the key drivers of economic development for Uzbekistan, as the amount of working-age population has been increasing rapidly in the past two decades. The government, therefore, would need to use this demographic window of opportunity and continue financing internal production and infrastructure projects for which additional sovereign debt financing will be required. Hence, Uzbekistan is planning to issue its first Eurobond in 2018, which is designed to set a benchmark to corporate entities, making them more willing for international fundraising and expanding their businesses.

Financial sector depends on government finance. The recent FX liberalization resulted in a sharp increase in bank's assets and private credit volumes relative to GDP by around 24,6p.p. and 17,9p.p. to around 70% and 44% in 2017 respectively (see graph 4). However, the financial system, dominated by low-in-scale banking sector, remains underdeveloped, failing to facilitate sufficient intermediation in the economy. State owned banks, dominating the sector (see graph 5), and effectively serving as an active public spending tool, channel state funds to large export-oriented and manufacturing firms and generally fail to reach small and medium-sized enterprises. Resulted high concentration of bank's assets and persistent receipt of public funding by major SOBs remain a concern and may lead to vulnerabilities.

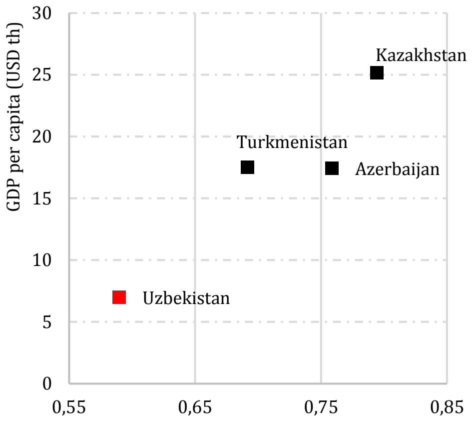
Nevertheless, according the CBU, the sector stays solid and well-buffered with NPLs at 1,2% of total loans and capital to assets ratio at 12,4% in 2017 (see graph 6). Banks have received liquidity and capitalization support prior to the FX liberalization reform in the mid-2017 and are expected to be supported further if difficulties arise.

Institutional development and credit climate Despite the recent steps towards greater transparency, institutional development remains limited and Uzbekistan's perception of corruption stays ranked 157th out of 180 countries in the world. The country is characterised by a diminished rule of law and government effectiveness. This may harm the country's plan to promote international trade and FDI and, as a consequence, may affect the materialization of the 2017-2021 development strategy. Uzbekistan remains one of the most undeveloped countries amongst the CCA peers[2] as shown by the low level of GDP per capita, estimated at USD 6 910 in 2017, and an HDI index of 0,59 in 2016 (see graph 7).

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

The newly elected president, Shavkat Mirziyoyev, seems to favor economic and structural reforms aimed at attracting international investors. The country is willing to foster development, ambitious plans of which are diversification and strengthening of the economy, as well as creation of a more favorable environment for business. Some progress in facilitating the freedom of speech has been made. Involvement of local police in the business was limited, influence on non-strategic companies has been reduced, which along with other reforms, directed to support the real business, facilitated the upgrade of the country in the Doing Business by 13 position up to 74th out of 190 countries in 2017. However, economic openness is still subdued and a lot will depend on how well Uzbekistan can sustain already implemented and instrument further liberalization reforms along the 2017-2021 development strategy of the country. Fighting poverty and unemployment, especially within the young population, will be one of the top priorities for the government, as it may, among other things, help to prevent possible protests and radicalization, hence foster essential stability of the political regime.

Graph 7: Development matrix CCA oil exporters



Source: RAEX (Europe) calculations based on data from the IMF and UN

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_16.03.2018.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.