

Rating-Agentur Expert RA confirmed at 'BB+' the rating of Azerbaijan. The rating outlook changed from stable to negative.

Rating-Agentur Expert RA confirmed the sovereign government credit rating (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 changed from stable to negative which means that in the mid-term perspective there is a high probability of downgrading the rating score.

MAJOR FACTORS THAT INFLUENCED BOTH TYPES OF RATINGS:

Positive factors:

- One of the main strengths of Azerbaijan is its solid external position. As of the end of 2019, despite slightly shrinking, both the trade and current account balances presented surpluses of 12% and 9,2%, respectively, once again led strongly by the oil sector which accounted for 91% of total export of goods in 2019. However, we expect these buffers to decline substantially as a result of the coronavirus crisis which already has taken a toll on oil demand and, conversely, prices have been at record lows. Moreover, the economy's competitiveness remains acceptable as it is ranked 58th out of 141 based on the Global Competitiveness Index 4.0 from 2019;
- Gross government debt, despite increasing moderately, remained low at 19,4% of GDP and 46,7% of budget revenues by the end of 2019, still quite low when compared to the other countries from the Caucasus region¹. In 2020, we expect the government to increase public debt in order to finance some of the measures to face the pandemic. Despite this, we anticipate government debt levels to increase to around 23% staying at manageable levels. Moreover, the level of short-term debt remains stable;
- The unemployment rate remained low in 2019 at 5%. However, we anticipate the metric to rise to around 8% as a result of the coronavirus crisis;
- The level of international reserves in the Central Bank of Azerbaijan (CBA) halted its continued growth in February 2020 and has remained flat for the past two months as a result of the CBA trying to fend off a depreciation of the AZN against the USD due to oil prices having sunk to unprecedented levels. We expect Azerbaijan's reserves to remain under pressure as the CBA continues to hold the AZN/USD at 1,7, while oil prices are expected to underwhelm.

Restricting factors:

- Domestic credit increased consistently in 2019 as we estimate it to have stood at 15% of GDP while total banks' assets hiked to 40% of GDP. We expect the metric to grow marginally in absolute terms reflecting lower credit demand due to the pandemic; however, since GDP is expected to contract, we expect to see a higher domestic debt to GDP ratio in 2020 of around 21%;
- The economy grew by 2,2% y-o-y in 2019; however, we anticipate a contraction of around 2% in real terms following the adverse impact from the coronavirus crisis which has already taken a toll on the oil industry;
- The fiscal policy focused on expenditure tightening in 2019 which allowed the

¹ IMF estimated debt to GDP for 2019: Georgia – 49,9%, Armenia – 50%,

government to increase the surplus up to 9% of GDP. This buffer results now increasingly convenient as it will help finance the measures implemented by the government in order to cushion the adverse effect from the coronavirus crisis. These measures include a hike in health expenditures, creation of the Coronavirus Response Fund and support to businesses and entrepreneurs in an amount equivalent to around 3% of GDP. We also anticipate an increase in other social expenditures as the unemployment rate continues to climb;

- Inflation stood at 2,7% at the end of 2019 showing stability over the past two years. So far, inflation has continued to be balanced, albeit higher than in 2019; as of March 2020, the CPI index grew by 3,3% y-o-y, still within the target of $4\pm 2\%$ set by the CBA. However, as oil prices remain low, the pressure to devalue the AZN increases, and with it, the risk of higher inflation;
- The monetary policy direction remains focused on supporting the peg to the USD amid current deteriorating conditions in the oil market. The CBA along with SOFAZ, have already auctioned FX several times in 2020 in order to maintain a fixed USD/AZN exchange rate. Moreover, on 1 May 2020, the CBA decided once again to keep the refinancing rate unchanged at 7,25. We anticipate the transition to an inflation targeting regime as part of the CBA's monetary policy strategy improvement will remain delayed. In terms of effectiveness, the economy's response to the changes in the reference rate remains limited as a result of high dollarization levels which might increase further due to the USD peg combined with downward pressure on the oil price;
- The level of corruption perception remains high in the country. However, Azerbaijan hiked 26 spots as compared to 208 and was ranked 126th out of 180 countries in the CPI index for 2019. The high perception of corruption continues to limit the willingness of doing business;
- The institutional development remains moderate. According to the Worldwide Governance Indicators (WGI), Azerbaijan was ranked 107th in the Government Effectiveness Index and 167th in the Rule of Law Index out of 214 analyzed countries in 2018.

Negative factors:

- The undiversified Azerbaijani economy continues to be one of the creditworthiness constraints. In 2019, the oil and gas output represented a 38% share of GDP, while this industry also accounted for 91% of total exports, as mentioned previously. Even though the share of the hydrocarbon sector in the economy has declined, it remains elevated and, in the current environment of a global recession and low hydrocarbon prices, represents a high risk for economic output, the external stance, as well as the stability of public finances;
- The banking sector recovery is expected to come to a halt as a result of the consequences from the coronavirus crisis threatening to weaken further the system. The NPLs to total loans ratio continued to decline and stood at 8,3% by the end of 2019, the capital adequacy ratio increased up to 22,6%, while profitability also climbed as ROA and ROE stood at 1,6% and 11,7% as of the same date. The improvement in these metrics is mainly a result of the capital injection, restructuring process and subsequent recovery of the state-owned International Bank of Azerbaijan (IBA). However, the banking system remains highly concentrated as the top-3 banks accounted for 53% of the total sector's assets by 3Q 2019. In addition, the impact of the pandemic has been already reflected in the intervention of the CBA by appointing administrators in Atabank, AGBank, NBCBank and Amrahbank on 27 April and subsequently revoking the licenses of Amrah Bank and Atabank on 28 April due to deteriorating financial standing. In order to cushion the coronavirus effect, the CBA has already introduced measures, such as temporarily modifying the calculation method for capital adequacy. Moreover, the government has also extended the full insurance of all protected deposits until the end of 2020;

- The assets of the State Oil Fund of the Republic of Azerbaijan (SOFAZ) have declined by around 4,6% from end-2019 to March 2020 as a result of sales of FX in order to defend the USD/AZN exchange rate which has been pressured by low oil prices. So far, already AZN 4,6 bn has been transferred to the budget, which is around 38% more of what was initially planned. The fund remains the largest source of current budget expenditures and government debt service;
- Around 90% of the total government debt is external and denominated in foreign currency. As a result, we consider this a key downside risk given the current coronavirus crisis as a potential local currency devaluation resulting from the low-oil-price pressures would increase the overall indebtedness level of the government; therefore, the debt structure in terms of currency remains a negative factor.

Support factors:

- Substantial foreign currency assets (90% of GDP) on the balance sheet of SOFAZ. As of March 2020, the fund had around USD 41,3 bn, which provides a substantial financial buffer, which will contribute to smooth the effects of the coronavirus crisis (weak support-factor).

Stress factors:

- Increased dollarization level: as of March 2020, 62,4% of total deposits were denominated in foreign currency (moderately weak stress-factor);
- Budget revenues are highly dependent on the oil sector. According to the draft version of the State Budget 2020, 57% of budget revenues will be gained by the oil sector (weak stress-factor);
- Possible escalation of the frozen conflict over the Nagorno-Karabakh territory continues to constrain the structural transformation of the country (very weak stress-factor).

SENSITIVITY ASSESSMENT:

The following developments could lead to an upgrade:

- Increase in oil prices higher than our base scenario to support GDP growth and the external trade position;
- Continued 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;
- Unexpected devaluation of local currency as a result of pressure from lingering low oil prices;

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

“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 over supply 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”. – Clarified Hector Alvarez, Associate Director of Rating Agentur Expert RA.

Research report on Azerbaijan is available at:

https://www.raexpert.eu/reports/Research_report_Azerbaijan_08.05.2020.pdf

Next scheduled rating publication: 6 November 2020. The full sovereign rating calendar can be found at [Sovereign Rating Calendar 2020](#)

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RATING HISTORY:

Date	Review reason	SGC		Outlook	
		National currency	Foreign currency	National currency	Foreign currency
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

Minute's summary

The rating committee for Azerbaijan was held on 8 May 2020. 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 April 2019). 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.

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.

Rating-Agentur Expert RA GmbH is a credit rating agency established in Germany and therefore shall comply with all applicable regulations currently in force in the European Union.

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.