22 April 2020
CIS Sovereigns

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Better positioned than 2014/15 but risks loom

Countries in focus

- Azerbaijan
- Kazakhstan
- Russia
- Ukraine

Amid the dual shocks coming from Covid-19 and low oil prices, we turn our attention to the CIS region, focusing on the impact on economic activity, fiscal and external balance sheets as well as sovereign ratings. We also share our views on sovereign and corporate credit issuers.

Notwithstanding the substantial negative impact on growth as well as fiscal and external dynamics, the region's oil & gas sovereigns (**Azerbaijan**, **Kazakhstan** and **Russia**) appear to have sufficient capacity to deal with temporarily lower prices thanks to ample fiscal reserves and sovereign net external assets. Compared to the 2014/15 crisis, improved policy credibility and floating currency regimes have become additional lines of defence (more so for Russia and less so for Azerbaijan). It's however worth noting that dollarization and weak banking systems remain a risk for Azerbaijan and Kazakhstan.

Our base case sees ICE Brent returning above US$40/bbl over the latter part of the year, but an adverse scenario with a prolonged period of weak growth and lower oil prices would gradually feed into credit fundamentals and, more importantly, increase socio-economic risks as time passes by.

Ukraine, meanwhile, finds itself once more at crossroads as it faces a deep recession (we expect -7.5% for 2020 GDP) with increasing concerns on external vulnerabilities. Thus, a new IMF programme has become indispensable. However, this is not a repeat of 2015: Ukraine heads into this current crisis with its head held high, thanks to lower debt levels, higher FX reserves and strengthened by previous policy reforms (notably NBU policy credibility) while geopolitical risks have become less imminent.

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Country Forecasts for 2019-21

	Azerbaijan			Kazakhstan			Russia			Ukraine		
	2019	2020	2021	2019	2020	2021	2019	2020	2021	2019	2020	2021
Activity & prices												
Real GDP (%YoY)	2.2	0.3	2.2	4.5	0.4	3.6	1.3	-2.5	2.0	3.2	-7.5	3.9
Nominal GDP (US$bn)	49.4	42.6	40.5	179	162	183	1690	1458	1668	152	143	151
GDP per capita (US$)	4892	4180	3929	9463	8440	9403	11575	9986	11425	3600	3400	3600
Unemployment rate (year-end, %)	5.0	5.1	5.0	4.8	5.2	4.9	4.6	8.5	5.5	8.7	15.9	11.7
CPI (year-end, %YoY)	2.4	5.5	3.2	5.4	9.0	5.4	3.0	4.2	3.3	4.1	5.9	6.0
Fiscal balance												
General government balance (% of GDP)	9.0	-4.1	4.6	-0.4	-4.6	-1.6	1.8	-3.5	-1.0	-2.0	-7.5	-3.5
Primary balance (% of GDP)	10.9	-1.7	6.7	0.5	-3.6	-0.7	2.6	-2.6	-0.0	0.7	-4.4	-0.3
General government gross debt (% of GDP)	31.0	36.9	33.4	22.7	28.2	27.6	12.5	15.0	16.0	52.0	65.0	60.0
Fiscal breakeven oil price (US$/bbl)	39.8	50.8	48.0	67.6	72.6	71.3	48.0	70.0	66.0	NA	NA	NA
External balance												
Current account balance (% of GDP)	8.9	-4.0	7.6	-3.1	-4.7	-1.5	3.8	1.7	2.7	-2.3	2.0	1.0
FX reserves ex gold (US$bn)	6.3	5.1	5.2	10.0	8.9	8.2	444.0	415.0	440.0	25.3	27.8	30.0
Import cover (months of merchand imports)	6.7	6.3	5.8	3.5	3.6	2.9	20.9	23.7	22.9	6.1	7.5	6.5
Gross external debt (% of GDP)	38.9	49.4	49.3	87.7	100.6	91.1	29.0	30.2	25.2	80.0	89.0	85.0
External breakeven oil price (US$/bbl)	48.7	47.1	47.5	76.7	55.7	63.8	47.0	31.0	43.5	NA	NA	NA
Interest & exchange rates												
Central bank key rate (year-end, %)	7.50	8.50	7.00	9.25	9.25	9.00	6.25	5.0	5.0	13.5	8.0	7.0
Exchange rate vs USD (year-end)	1.7	2.3	2.3	382.9	456.1	446.0	61.9	72.0	71.0	23.7	27.0	27.0

Source: National sources, CEIC, ING estimates

Overview of fiscal and central bank measures in CIS

	Fiscal Measures	Central Bank Measures
Azerbaijan	• Fiscal measures amount to US$1.5bn (3% of GDP) • Increasing spending on public health by US$61m and creating a CV Response Fund of US$72m (in total, 0.3% GDP) • Introducing a special quarantine regime (until 4 May 2020)	• Key rate unchanged at 7.25%, raised the floor of the interest rate corridor by 125bp to 6.75% • Extending the blanket deposit guarantee until 4 December 2020 (the interest rate cap for manat-denominated deposits is 10%, for FX-denominated deposits 2.5%)
Kazakhstan	• Fiscal measures amount to US$14bn (9% GDP) • 10% indexation of pensions/state benefits, $97 monthly unemployment benefits, support to healthcare personnel, support to farmers (US$160m), US$200 per new agro employee • Subsidized lending for priority projects for US$2.3bn and US$1.4bn for loans to SMEs • Sectors most hit by Covid-19 get payroll tax holidays till September 2020, SMEs' profit tax deferred by 3M, VAT on some food products lowered from 12% to 8%	• FX sales by NBK and SOEs to limit KZT depreciation, FX regulations tightened • Key rate raised from 9.25% to 12%, then cut to 9.5%, widened rate corridor from 200bp to 400 bp • Covid-19 affected borrowers allowed loan repayments holidays till mid-June • Risk weights for loans to SMEs in KZT lowered from 75% to 50% and in FX from 200% to 100% • Acquiring fees for debit/credit cards lowered
Russia	• Extra benefits to medical staff, subsidized sick leaves and unemployment benefits, additional social support to lower-income families • 0.3% GDP anti-crisis support to most affected sectors, may potentially be increased by 1% GDP, state guarantees for loans to SMEs and other affected • Tax deferrals for affected SMEs and permanent payroll tax cut from 30% to 15% for all SMEs, deferral of government rent	• FX sales of US$100-200m per day at Urals above US$25/bbl, intensified sales at Urals below US$25/bbl • Key rate on hold at 6.0% despite pick-up in CPI • Banks allowed deferred revaluation of, securities and loans to problem sectors, lower risk weights • 0.5% GDP refinancing facility for 0% loans to SMEs for salaries • Preferential restructuring of loans to affected individuals and SMEs, interest payment deferrals
Ukraine	• Payment of the Single Social Contribution for several categories of payers has been canceled • Entrepreneurs exempted from payroll tax for two months • Postponement of tax audits and inspections • One-off pension increases to low-income pensioners of UAH1,000 in April and a regular monthly UAH500 pension top-up for retirees aged 80 years or more	• To improve liquidity, the frequency of liquidity tenders has been doubled (from bi-weekly to weekly) • Delayed the introduction of capital buffers • Stands ready to reduce reserve requirement rations, lower LCR requirements, hold unscheduled liquidity tenders, expand the list of eligible collateral for emergency loans

Source: National sources, ING

Oil Price Outlook

Big oil cuts coming... but still not enough

It has been an extraordinary time in the oil markets, with the WTI May contract trading into negative territory. Admittedly, a lot of this weakness had to do with the May contract expiry, with longs desperate to close out their position ahead of expiry, or face having to take physical delivery of oil at Cushing, the WTI delivery hub. But the fact that the May contract had to trade down into negative territory in order to find a buyer, highlights the state of the physical oil market, and the issues around limited storage capacity in this surplus environment. The pressure on the WTI market has also weighed heavily on the ICE Brent market, with prices briefly trading below US$16/bbl at one stage.

While recently announced OPEC+ cuts are significant, they are not enough in the short term, and this is evident with the price action since the OPEC+ meeting. There is still a sizeable surplus expected over the second quarter, with Covid-19 weighing heavily on demand. The International Energy Agency forecasts that oil demand over 2Q20 will fall 23.1MMbbls/d YoY. Given that inventories are set to grow only further over the coming quarter, this suggests that prices are likely to remain under pressure, and we could very well see further downside in the short term for both Brent and WTI.

The OPEC+ alliance is set to cut output by a record 9.7MMbbls/d over May and June. These cuts will then be reduced to 7.7MMbbls/d from July through until the end of 2020, and then finally from January 2021 through until the end of April 2022 the group will cut by 5.8MMbbls/d. The reference for cuts would be October 2018 production, whilst for Saudi Arabia and Russia, their baseline for cuts will be 11MMbbls/d. Iran, Libya and Venezuela once again will be exempt from the deal.

Meanwhile, producers outside of OPEC+ have not announced mandated production cuts up until now. But we are still set to see sizeable market driven declines from other producers, with current price levels just too low. Much attention is given to the declines we could see from the US, and in the EIA's latest update they estimate that by the end of this year US oil output will be 1.6MMbbls/d lower than March 2020 levels. Meanwhile, we are also seeing large declines from Canada, where West Canada Select prices are trading sub US$5/bbl. The more recent pressure on prices and infrastructure constraints should speed up the pace of production shut ins globally.

Given the scale of the cuts through until the end of this year, along with market driven declines from other producers, like the US, the outlook for prices over 2H20 does look more constructive. This is particularly the case if we assume a recovery in demand over the latter part of the year. These factors should lead to sizeable inventory draws by the time we enter that period, and therefore we expect ICE Brent to trade back above US$40/bbl over the latter part of the year.

Clearly demand remains a key uncertainty and risk to this view. If travel restrictions and country lockdowns continue into 2H20, this would likely slow the demand recovery expected for the latter part of this year.

Russia

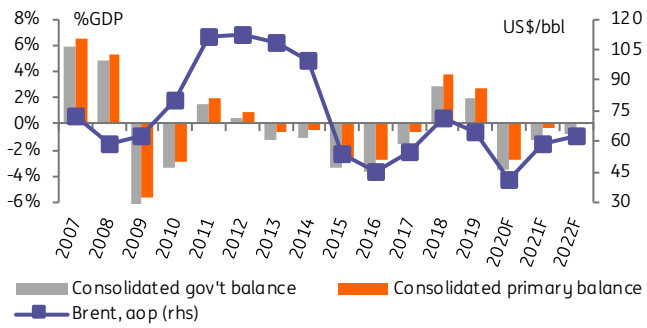
Covid-19 and the fall in oil prices pose a heavy burden for Russia, as a US$1/bbl change in oil prices brings in US$3.5bn of annual exports and US$2.0bn of budget revenues. Each month of lockdown reduces annual local activity by 2.5ppt, while weakening global demand for commodities will see exports falling for the second year in a row. The fiscal position appears strong so far, however it's a result of so far modest 3% GDP stimulus, which may need to be increased in response to darkening GDP and income and credit quality outlook. The good news is that external vulnerability is low thanks to active foreign debt reduction and accumulation of foreign assets since 2014.

Activity: Russia is on quarantine since the end of March, which will be in place at least until the end of April. Assuming one month of lockdown, Russian GDP can drop by 2.5% in 2020, but if extended into May, which is becoming increasing likely - the outlook could be downgraded to 5%. The most hit are SMEs, accounting for 15-20% of GDP and almost 25% of employment, suggesting a spike in underemployment, a negative for income and consumption. Meanwhile, panic buying, growth in global agro prices, and 25% RUB depreciation year-to-date create prospects of a temporary 2-3ppt pick-up in CPI to 4-5%.

Fiscal: So far fiscal stimulus is at a modest 3% of GDP, including 2% of GDP of spending, 0.5% GDP of guarantees and 0.5% GDP of tax breaks. State support could expand as the government has more than 10% of GDP of liquid fiscal savings, public debt is below 15% of GDP, and the government will receive 1.5% of GDP in Sberbank sale proceeds from the CBR. Based on an Urals price of US$36/bbl in 2020, the budget deficit could reach 3.5% GDP, or c.US$50bn in 2020. However, each US$1/bbl deviation implies a change of US$1.5-2.0bn in annual revenues. US$20-25bn will be borrowed locally, with the remainder to be drawn down from the National Wealth Fund. Some external borrowing is possible albeit constrained by sanction risks.

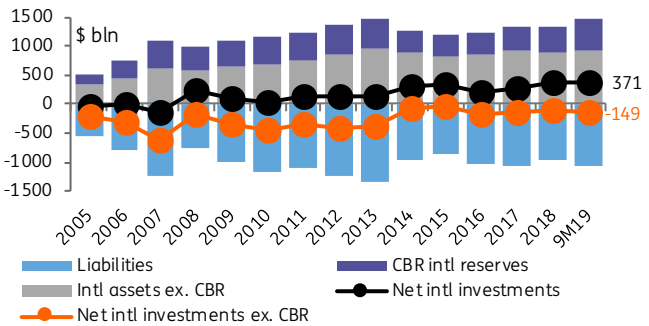
External: A high export reliance on fuel (two-thirds of exports) implies substantial pressure on the current account in 2Q20, however non-fuel items will turn supportive in the longer run as we could see reductions of US$50bn in annual imports, US$30bn in outward tourism and US$30bn in dividend outflows. Also, the capital account appears resilient as corporate foreign debt has dropped by US$280bn since mid-2014 to US$380bn due to the sanctions story, compared to US$563bn in CBR assets. Excluding CBR reserves, Russia's net investment position has improved with net liabilities falling from US$380bn in end-2013 to US$150bn in Sep-19. Banks boast a net creditor position of US$80bn and high net worth households hold US$110bn of liquid FX cash on foreign bank accounts. This sets the stage for a favourable outlook on the capital account and no need for a market-unfriendly measures such as capital controls to protect the ruble, which remains free-floating. One hypothetical risk, which is not our base case, is possible unrest among corporate and regional elites in response to the stringent fiscal approach so far.

Fig 1 Fiscal chart from CEE presentation



Source: CEIC, National sources, ING estimates

Fig 2 International investment position



Source: National sources, ING estimates

Rating (Baa3/BBB-/BBB): Over 2018-19, Russia has seen upgrades by all rating agencies, regaining investment grade status at Moody's and S&P (while not having lost IG status at Fitch over 2014/15). The ratings now seem on a solid footing compared to 2014/15 given much improved policy credibility (notably from the CBR and fiscal rule), fiscal and external buffers in combination with lower external debt and benefits from a floating exchange rate regime.

S&P on 26 March affirmed Russia at BBB- with a stable outlook based on an oil price assumption of US$30/bbl in 2020. Meanwhile, Moody's and Fitch released comments which emphasized improved buffers thanks to previous policy responses.

While we therefore don't expect negative rating pressure in the near-term, downside risks would come from the negative impact on fiscal and external balance sheets from a longer lasting crisis and subdued oil prices throughout 2020. Meanwhile, the ratings already incorporate weak assessments for growth and structural dynamics, so we see less downside here from a rating perspective.

Finally, Russia's ratings remain negatively impacted by geopolitical risks and sanctions, eg, through a one notch downward reduction at S&P and Fitch. Additional material sanctions could result in downgrade pressure.

Fig 3 Rating drivers/sensitivities, factors that could lead to an upgrade or downgrade

Agency (review date)	Upgrade factors	Downgrade factors
Moody's Baa3 sta (5 Jun)	• Further declines in vulnerability to external shocks (ie, continued build-up of fiscal space and financial buffers, avoidance of actions which materially increase geopolitical tension) • Enactment of policies which enhance other aspects of Russia's credit profile (eg, economic reform to raise productivity and potential growth, fiscal reforms to secure government finances in coming years against demographic shifts)	• Material deterioration in public finances or external position (eg, from sustained fall in oil prices which triggers sizeable negative confidence and income effects, significant pressure on exchange rate and rapid depletion of buffers) • Harder-than-expected imposition of sanctions that materially impair ability to service and refinance debt or undermine finances or the economy • Impaired lending capacity of the banking system (ie, no adequate financing to the government and companies)
S&P BBB- sta (17 Jul)	• GDP per capita trend growth reaches rates comparable with that in countries with similar income levels (eg, through pro-growth policy measures) • Faster accumulation of fiscal buffers, mitigating commodity-related revenue volatility, and effective measures to address long-term fiscal pressures from aging population	• Material deterioration in budgetary performance (eg, looser fiscal framework of pressure stemming from policy efforts to mitigate Covid-19 effects) • Accelerated capital outflows and elevated financial stability risks from global market dislocation • Materially tighter international sanctions (eg, targeting large SOEs, systemically important banks, or secondary market for Russian sovereign debt)
Fitch BBB sta (7 Aug)	• Higher and sustained real GDP growth (eg, through the government's reform strategy implementation while preserving improved macroeconomic stability) • Improvement of structural indicators (eg governance standards) • Significant additional strengthening of fiscal and external savings buffers (eg, through sustained high oil prices and windfall revenues)	• Imposition of additional sanctions that undermine macroeconomic and financial stability, or impede debt service payments • Changes in the policy framework that undermine policy credibility and macroeconomic stability gains, (eg, due to sustained low growth prospects) • Sustained erosion of the sovereign balance sheets (e.g. derived from materialisation of contingent liabilities from public sector)

Source: Moody's, S&P, Fitch, ING

Ukraine

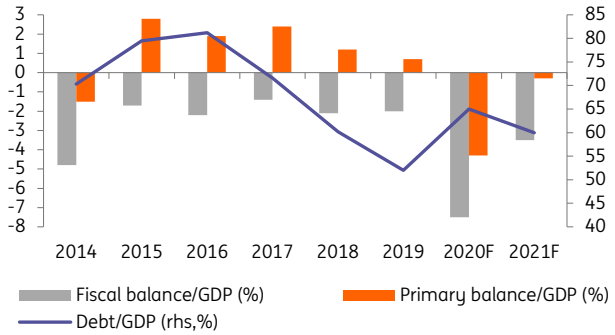
With over 70% of GDP coming from consumption and the economy under lockdown, it is difficult to paint an optimistic picture for Ukraine's 2020 growth and fiscal outlook. We see an IMF agreement as a must-have as financing the 7.5% fiscal deficit and servicing debt is a mounting task. Lower commodity prices come to help somewhat, as large energy imports (mainly oil & gas, c.10% of GDP) have become a lot cheaper while metals & agriculture export prices (c.20% of GDP) have performed much better in relative terms.

Activity: We estimate that Ukraine loses between 3-3.5ppt of GDP for every month of lockdown. The GDP contraction has likely started in 1Q20 for which we forecast -0.2% YoY growth (-2.5% in quarterly sequential terms). The largest impact on growth will be visible in 2Q20 for which we see a 14.1% YoY contraction (-12.5% versus 1Q20). Starting with the third quarter we should see a recovery, though less V-shaped than hoped for, at -8.6% YoY (+7.0 versus 2Q). A fourth quarter recovery should further moderate to -6.0% YoY (+3.0% versus 3Q), leading to a full-year contraction of 7.5% in 2020.

Fiscal/external: We estimate this year's budget deficit at 7.5% of GDP driven mainly by a plunge in revenues, but also increasing healthcare costs and GDP contraction. Debt/GDP should rebound to above 65% in 2020 (vs 52% in 2019). For the remainder of 2020 (Apr-Dec) total government FX-denominated debt service stands at c.US$6.5bn, thereof US$2.2bn in domestic FX bonds. There are two peaks, one in May (c.US$1.3bn) and a larger one in September (c.US$2.1bn). Local currency debt service is somewhat less burdensome at US$3.0bn equivalent, relatively evenly spread throughout the rest of the year. Adding our budget deficit forecast of US$9.8bn for the remainder of this year, this gives us a rounded total of US$19.3bn of funding needs for the remaining of 2020.

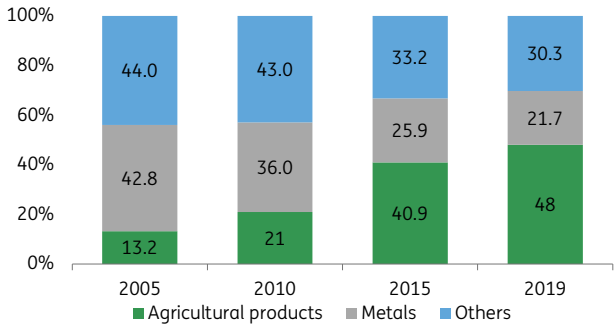
With external markets virtually closed to new issuance, but also with the internal one little supportive at this moment, the need for an IMF agreement becomes stringent. We estimate the government's current FX buffer at around US$1.7bn, which should keep things afloat while the negotiations with the IMF move ahead. We expect an agreement to be reached by end-May and around half of the estimated US$8bn IMF loan to be channelled to the state budget. The IMF financing should unlock extra-financing of US$2-3bn from other IFIs and the EU. Even in the best-case scenario, the Ukraine government would still need to find at least US$10bn in 2020 to cover financing needs. We believe that the local market will eventually accommodate some demand, predominantly in FX-denominated bonds. The market will probably unfreeze once the IMF loan is secured and the NBU will continue its rate cut cycle towards our 8.0% year-end forecast. FX reserves could see a temporary drop from relatively comfortable levels (US$25bn as of March 2020) as the government might purchase some FX to service debt, but this is all dependant on the timing of the IMF agreement.

Fig 4 Debt rebounding higher



Source: NBU, MinFin, ING

Fig 5 Exports skewed towards less cyclical products



Source: NBU, ING

Risks to our view are stemming from an eventual "re-dollarization" of retail savings and capital outflows as some offshore investors that could not offload their positions might still be looking for opportunities to do so. A positive surprise (and a mitigating factor) could come from the C/A side, for which we estimate a surplus of €2.6bn (c.2.0% of GDP) in 2020. There will be several opposite forces acting on the current account side, from lower remittances to lower energy & agricultural product prices, plunging imports and exports, subdued FDI's and capital flights. We estimate C/A sensitives to oil & gas prices to be around 0.3ppt for every 10% change in the oil price and 0.1ppt for the gas price. On the agricultural products side, we take a blended sensitivity rate of 0.25pp, though it depends of course on the exact commodity mix.

Rating (Caa1 pos/B/B): Previous upgrades and favourable outlooks have been largely informed by progress in reducing external vulnerabilities (through improving policy credibility, higher FX reserves and a strong anchor from multilateral support), improving public debt levels and the ongoing reform story.

The virus outbreak has painful consequences for Ukraine's economy and will reverse recent progress in reducing fiscal and external vulnerabilities. The latter remains the key concern for investors and rating agencies alike. Thus, reaching an IMF programme has become indispensable in order to maintain access to external funding and other IFI funding. Doing so is also a condition for lifting the sovereign rating at Moody's out of the Caa into B territory. However, an upgrade also depends on the external balance sheets, notably FX reserves compared to external repayments. Therefore, an upgrade remains more likely, albeit not imminent following an IMF deal. Fitch revised the positive outlook back to stable due to the significant impact of the Covid-19 pandemic.

More broadly, reaching a new IMF deal and renewed confidence in reform progress would help to avert negative rating pressure (and sustaining upward pressure beyond the crisis) while a delay in securing an IMF programme beyond 1H20 would all but certainly result in negative rating pressure across all rating agencies.

Fig 6 Rating drivers/sensitivities, factors that could lead to an upgrade or downgrade

Agency (review date)	Upgrade factors	Downgrade factors
Moody's Caa1 pos (22 May)	• Sustained progress in reduction of sizeable external vulnerability (i.e. maintaining or further increasing FX reserves in relation to external repayments) • Reaching an agreement with the IMF and remaining in broad compliance with new programme conditions (albeit ambitious reform agenda implementation is not a requirement) • Continued evidence that spillovers to economic and fiscal performance from the conflict in eastern Ukraine remains contained	For outlook to stable: • Improvements to external vulnerability will not be sustained over the medium term (e.g. delays in accessing new financing) • Notable and sustained reduction in FX buffers, potentially accompanied by an outflow of foreign investors from domestic market • Further escalation of geopolitical tensions that have a negative spillover on the economic and fiscal profile
S&P B sta (11 Sep)	• Progress on reform agenda while preserving earlier achievements (incl. NBU independence as a monetary authority and financial system regulator) • Outperformance of external liquidity vs projections	• Concerns on ability to meet large FX-denominated repayments due to disruptions to funding from concessional programmes or capital markets over the next year (eg, if the government were to backtrack on key reforms)
Fitch B sta (4 Sep)	• General government debt/GDP returning to a firm downward path over the medium term (e.g. due to post-coronavirus shock fiscal consolidation) • Reduction in external financial vulnerabilities, (e.g. due to a strengthened external balance sheet and greater financing flexibility) • Increased confidence that progress in reforms will lead to improvement in governance standards and higher growth prospects while preserving the improvements in macroeconomic stability	• Increased external financing pressures or increased macroeconomic instability (e.g. stemming from failure to agree an IMF programme or delays to disbursements from it) • Persistent increase in general government debt (e.g. due to a more pronounced and longer period of fiscal loosening, economic contraction or currency depreciation) • Sustained external or political/geopolitical shocks that weaken the macroeconomic stability, growth prospects and Ukraine's fiscal and external position.

Source: Moody's, S&P, Fitch, ING

Kazakhstan

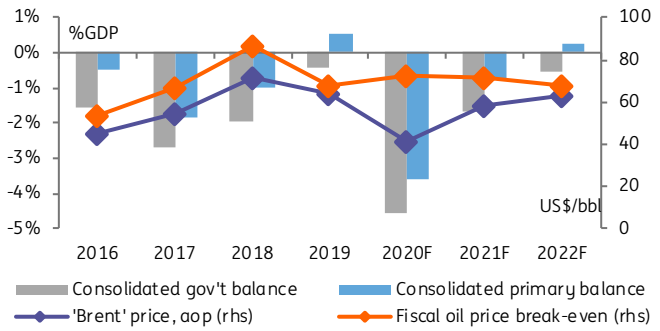
The oil & gas sector accounts for 15% of Kazakhstan's GDP and 40% of budget revenues. Each additional US$1/bbl results in an increase of US$0.9bn in annual exports and US$0.2bn of budget revenues. Covid-19 fiscal measures supporting households and businesses are generous at US$13.8bn (8.6% GDP). The authorities extended subsidies of US$1.4bn for SME loans and lowered risk weights on SMEs and on FX-denominated loans. So far, state guarantees on problem loans are modest at US$0.3bn. Overall, the banking sector remains vulnerable to an economic slowdown and tenge depreciation due to a high problem loans ratio (above 20%) as well as deposit and loan dollarization (around 40% and 15%, respectively), posing a contingent liability for the sovereign.

Activity: We downgraded our GDP growth forecast from 4.2% to 0.4% in 2020 with 2Q20 being most hit. Amid tenge devaluation inflation may accelerate this year from 5.4% to 9.0% YoY. Historically, companies preferred pay cuts to layoffs, suggesting no material increase in unemployment (5.2% in 2020 vs 4.8% in 2019), however falling incomes will put pressure on consumption. Exports may drop from US$52.4bn in 2019 to US$35.9bn this year following the OPEC+ deal and the global lockdown.

Fiscal: Falling oil prices and massive fiscal stimulus this year could result in a 4.6% of GDP budget deficit (vs 0.4% GDP in 2019) which will require higher borrowing (3.2% of GDP). Out of 9% of GDP fiscal stimulus, 5% will come from the budget, while the remaining 4% will be provided from the National Fund. Budget oil revenues will fall by 2.3% of GDP. The negative fiscal impact will be partially offset by SOEs' higher dividend pay-outs (US$4.3bn or 2.8% of GDP). With c.33% GDP in fiscal savings, Kazakhstan's position is far from critical, however a relatively high fiscal breakeven of around US$70/bbl is a long-term challenge. The banking sector (assets total 40% of GDP, including almost 30% GDP loans to SMEs and individuals) remains a watch factor determining whether additional support is needed.

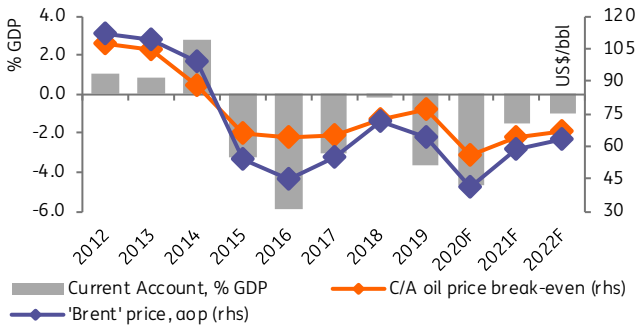
External: The country spent US$2.5bn of reserves in March to limit depreciation of the tenge, which depreciated by c.14% since the beginning of the year (though apparent FX selling by quasi-state enterprises provided some relief). Given low oil prices, declining export volumes and weak institutional environment, the tenge is likely to stay pressured this year. Meanwhile, the banking sector's tolerance to currency depreciation is low with FX liabilities exceeding FX assets. Kazakhstan's central bank reserves are 17% GDP, and in order to support the tenge it also has to rely on administrative measures. Amid higher borrowings and weaker tenge, external public debt (c.90% FX-denominated) may rise from 18.3% in 2019 to 20.1% of GDP in 2020. Meanwhile, corporate foreign debt could rise from 69.4% to 77.8% of GDP.

Fig 7 Fiscal balances, 'Brent' and oil price break-even



Source: CEIC, National sources, ING estimates

Fig 8 External balance, 'Brent' and oil price break-even



Source: CEIC, National sources, ING estimates

Rating (Baa3 pos/BBB-/BBB): Kazakhstan's ratings are on par with that of Russia, leaving aside the positive outlook at Moody's. However, we believe that Moody's will revise the outlook back to stable in the current oil price environment and with growth prospects dimming.

Together with Azerbaijan and Russia, S&P affirmed Kazakhstan's BBB- rating with a stable outlook on 26 March on the back of strong fiscal and external balance sheets as well as the flexible exchange rate.

Fitch had affirmed Kazakhstan's BBB- rating already ahead of the crisis (21 February) and it is here that we see the highest chance for a negative outlook.

Notwithstanding a strong sovereign balance sheet and external buffers, policy credibility and effectiveness remain weaknesses (a looser implementation of the fiscal rule, high dollarization and lower albeit improving credibility of the NBK). However, it remains a close call at this point. The banking system remains the Achilles' heel, reflected by a one notch downward revision vs indicated ratings at S&P and Fitch. Should we see a renewed weakening of banks' fundamentals or increasing dollarization, this could imply negative rating pressure. Aside, some risks come from the recent and ongoing political transition.

Fig 9 Rating drivers/sensitivities, factors that could lead to an upgrade or downgrade

Agency (review date)	Upgrade factors	Downgrade factors
Moody's Baa3 pos (NA)	• Strengthening of institutional framework, policy credibility and effectiveness, and economic competitiveness through ongoing and further reforms (notably on economic diversification to enhance resilience to shocks) • Material reduction in banking sector risks (through prospects of sustained improvement in banking system health, more effective credit intermediation, enhancements to regulation and supervision)	For outlook to stable: • Significant and long-lasting deterioration in economic and fiscal metrics (eg, through a large, negative oil price shock) • Re-emergence of domestic political risks, with a negative impact on the government's reform agenda and business environment
S&P BBB- sta (4 Sep)	• Significant and tangible devolution of power to the cabinet and parliament (supporting improved policy-making effectiveness) • Meaningful improvement in banking sector health (supported by further advances in regulatory oversight or reduced related party lending)	• Prolonged and sharp fall in oil prices or production beyond our expectations if it leads to deterioration of external performance (e.g. if gross external financing needs exceed 100% of current account receipts plus usable reserves) • Re-emergence of destabilizing factors (e.g. spike on deposit dollarization)
Fitch BBB sta (21 Aug)	• Improved governance indicators and strengthening of policy framework to enhance predictability and effectiveness • Sustainable improvement in banking sector health (eg, improved financial intermediation and asset quality) • Improving economic and public finance resilience to commodity price shocks through economic diversification	• Policies that widen the consolidated fiscal deficit materially or undermine monetary policy credibility • Materialisation of additional significant contingent liabilities from the banking sector on the public sector balance sheet

Source: Moody's, S&P, Fitch, ING

Azerbaijan

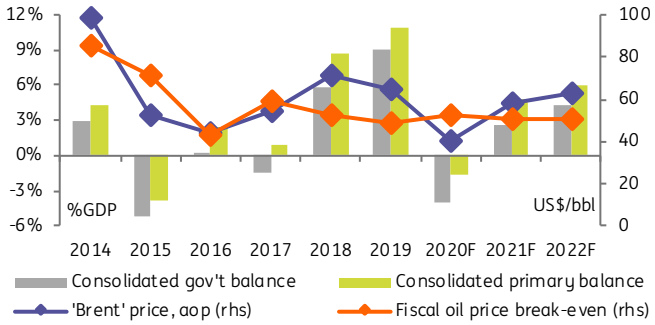
Covid-19's main channel of impact is through the oil sector which accounts for 37% of GDP. The vulnerability of financial flows to oil price is high, since each US$1/bbl assures US$0.3bn for annual exports and US$0.14bn of budget revenues. Also, non-oil exports (14% GDP) and exports of services (7% GDP, mostly tourism) are under pressure. The country's fiscal measures to support business and population are low at US$1.5bn (3% of GDP), as the government is hoping that tight lockdown measures may help Azerbaijan to recover from the pandemic sooner than its peers.

Activity: We downgrade our GDP growth forecast from 2.6% to 0.3% YoY in 2020. The oil sector will suffer most amid merchandise exports sinking by 7% in 2020. Sustained lower oil prices may lead to manat depreciation this year, which may lead to CPI acceleration from 2.4% in end-2019 to 5.5% in end-2020. The non-oil sector may perform relatively better given swift and tight quarantine measures (which has resulted in falling numbers of new daily cases over the last two weeks), suggesting some likelihood of a fast recovery. Still there are the three key risks to activity: i) local and external lockdowns could be prolonged, ii) household income may still fall considerably despite seemingly flat 5.0-5.1% unemployment covering for unpaid leaves, and iii) fiscal support may prove too weak.

Fiscal: Oil accounts for two-thirds of budget revenues and given rising expenditures we revised our fiscal balance forecasts from a 3.5% of GDP surplus to a 4.1% deficit this year. The deficit will be covered by borrowings (with public debt growing from 31.0% in 2019 to 36.9% in 2020) and state oil fund (SOFAZ). SOFAZ's assets stood at a high US$43.3bn in end-2019 (90% GDP), but falling oil prices and huge budget transfers ($2.7bn in 1Q20) could see a drop by at least US$5bn by end-2020. Further pressure could arise in case of: i) increasing fiscal stimulus and ii) the need to support quasi-sovereign banks which have not yet recovered from the 2015 crisis (NPLs in banking sector remain high at 11% at Oct-19). Besides, according to Fitch, government on-lending and guarantees, ie, secured contingent liabilities, grew to 31% of GDP.

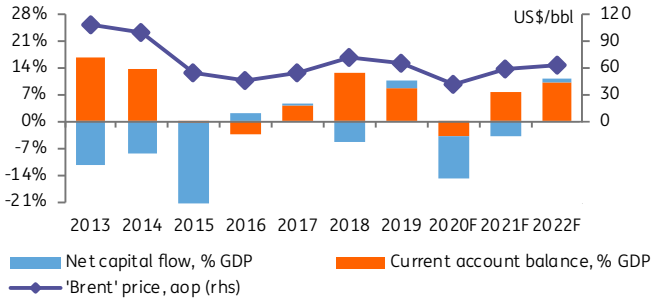
External: With 70% of C/A revenues fuel-related and 14% coming from services exports (mainly tourism), we expect the C/A balance to dip into a 4.0% of GDP deficit in 2020 (vs a 4.8% of GDP surplus expected previously). External buffers, consisting of CBA reserves (US$6.3bn) and SOFAZ assets, are high at above 100% of GDP as of end-2019 and could support the economy. Yet, a prolonged period of low oil prices, restrained FX inflows from tourism (US$2.5bn or 5.1% GDP in 2019) and a weak institutional environment could eventually result in manat depreciation – by 26% in 2Q20, after oil will have stabilized. External debt will rise from 38.9% GDP in 2019 to 49.4% GDP this year.

Fig 10 Fiscal balances, 'Brent' and break-even oil price



Source: CEIC, National sources, ING estimates

Fig 11 Balance of payments and 'Brent' oil price



Source: CEIC, National sources, ING estimates

Rating (Ba2/BB+/BB+ neg): Over the last month, we have seen S&P affirming the BB+ rating with a stable outlook and Fitch revising the outlook on the BB+ rating to negative (from stable). S&P's assessment takes account of Azerbaijan's high hydrocarbon reliance but remains anchored by the strong sovereign and external positions (notably low government debt and high SOFAZ assets). Moreover, S&P believes that the manat exchange rate will be maintained at 1.7 per USD through interventions, although also stating that the authorities would likely be willing to adjust the manat promptly if oil prices prove less favourable than expected.

The latter are key behind Fitch's outlook revision, as interventions weaken external buffers. The risk comes from a prolonged period of lower oil prices, which would render the manat de facto peg unsustainable. Combined with the lack of predictability in policymaking, this could result in "disruptive policy adjustments" similar to 2015 when the authorities allowed for two sudden depreciations (leading to a 99% depreciation vs the dollar that year).

We haven't heard from Moody's yet, with the latest credit opinion from September 2019 now outdated. The Ba2 rating is a notch below that of S&P and Fitch, and we therefore don't expect a downgrade in the near-term.

Given weaker institutional settings (with S&P also noting "shortcomings in relation to the completeness and accuracy of external sector data") and a higher oil & gas dependency than for Kazakhstan and Russia imply a higher risk for negative rating actions, even though Azerbaijan, unlike the other two, remains in non-investment grade territory.

Fig 12 Rating drivers/sensitivities, factors that could lead to an upgrade or downgrade

Agency (review date)	Upgrade factors	Downgrade factors
Moody's Ba2 sta (NA)	• Increased policy credibility and effectiveness from ongoing and further reforms (incl. macroeconomic and financial policies; e.g. through prospects of a more rapid decline in the government's debt burden and contingent liabilities; marked progress in economic diversification)	• Reduced momentum or potentially reversal of fiscal reforms that support macroeconomic stability and a sustained debt burden reduction • Resurfacing banking sector weakness and significant contingent liability risks • Sharp escalation of the Nagorno-Karabakh conflict that would weigh on economic activity and government finances
S&P BB+ sta (24 Jul)	• Higher than expected external surpluses, resulting in a faster accumulation of fiscal assets (eg, through markedly increase in hydrocarbon revenues) • Implementation of reforms addressing structural impediments (e.g. limited economic diversification and substantial constraints to monetary policy effectiveness)	• Material weakening of public finances, external position, or growth expectations vs forecasts (e.g. through further decline in hydrocarbon revenues, without fiscal spending being pared back; larger or prolonged current account deficits and quicker drawings on liquid external assets) • Destabilization of the macroeconomic environment driven by exchange rate regime (including higher risks in the financial system and SOEs)
Fitch BB+ neg (17 Jul)	• Easing of external pressures stabilising public and external balance sheets (eg, higher oil prices) • Improvement in the macroeconomic policy framework (incl. exchange rate policy) that strengthens the ability to address external shocks and reduces macro volatility	• Developments in the economic policy framework that undermine macroeconomic stability (e.g. rapid erosion of sovereign's external balance sheet or disorderly devaluation of the manat exchange rate) • Sustained low oil prices or a more prolonged external shock that would have a significant adverse effect on the economy, banking sector, public finances or the external position

Source: Moody's, S&P, Fitch, ING

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