

## Author:

**Hector Alvarez**

Expert of Rating-Agentur Expert RA GmbH

## For further information contact:

**Rating-Agentur Expert RA GmbH**

Walter-Kolb-Strasse 9-11,  
 60594 Frankfurt am Main, Germany

+49 (69) 3085-45-00

E-mail: [info@raexpert.eu](mailto:info@raexpert.eu)

[www.raexpert.eu](http://www.raexpert.eu)

## Introduction

The challenges for the Azerbaijani economy due to the unceasing struggles of the hydrocarbon market continue to grow. This sector has negatively affected exports and FX reserves, among other factors. However, public debt indicators and the GDP growth rates have remained strong. Inflation, although growing, has been cushioned by the expanding GDP in 1H 2015 combined with the contraction of the monetary base. Finally, potential political and social stress are still latent risks for the country awaiting the outcome of the next parliamentary elections in November 2015.

The recent devaluation of the AZN driven by low oil prices and external pressures from weakening currencies of the neighboring countries have had mixed effects on the economy. It has helped to balance revenues from external sources, while spurring dollarization and hampering the banking system, which has a significant FX exposure.

## Main Economic Indicators of Azerbaijan

Macro indicators	2012	2013	2014
Gross pub. debt, bill AZN	6	8	10
Nominal GDP, bill AZN	54	58	58
Real GDP growth, %	2,1	5,8	2,8
Gross gov. debt/GDP,%	11,6	13,8	16,4
Deficit (surplus)/GDP,%	3,8	1,4	0,4
Inflation rate,%	-0,3	3,6	1,4
Curr. Account balance/GDP,%	21,8	16,9	15,3

## Development indicators

	2014
Inequality adj. HDI	0,66
GDP per capita (Thou. of USD)	17,6

## Default indicator

	As of 10.09.2015
10Y Gov Bond Yield, %	5,45

Sources: RAEX (Europe) calculations based on data from World Bank, IMF, CBA

**Debt is low, but share of FX is high.** Government debt has steadily grown since 2010, although from very low levels. IMF estimates it to be at 16,4% of GDP and 42,1% of budget revenues at the end of 2014. Short-term debt accounted for a mere 1,5% of GDP and 3,9% of budget revenues. Even though 71,6% of the debt is denominated in foreign currency and FX reserves substantially declined, the ratio of FX reserves to external debt is still strong at 131,2% as of mid-2015.

**GDP resumed growth in 1H 2015 fueled by the non-oil sector.** The economy of Azerbaijan grew at a rate of 5,8% in real terms in 2013 and by 2,8% the following year. The reduction of 3 p.p. in the 2014 growth rate was mainly driven by depressed oil prices. In fact, the overall economic growth in 2014 was, for the most part, supported by the developing non-oil sector growing at a rate of 6,2%. According to the State Statistical Committee of the Republic of Azerbaijan GDP expanded 5,7% in 1H 2015 compared to the same period of 2014. The non-oil sector was positively affected primarily by construction of sport and entertainment facilities for the inaugural European Games held in Baku in June 2015 and by growing exports of agricultural produce to Russia.

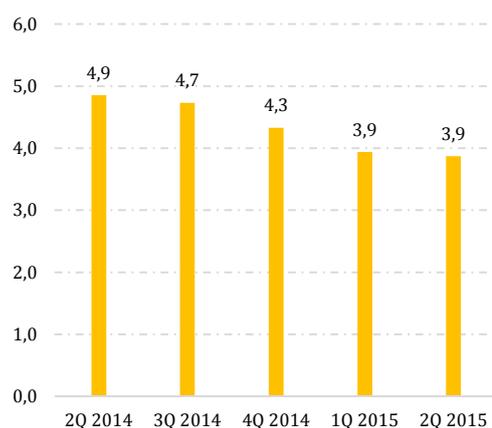
**Fiscal balance under pressure.** The fiscal balance posted a surplus of 0,4% of GDP in 2014, although it has been constantly narrowing in the past years. This negative trend continued and, according to the data from the Central Bank of Azerbaijan (CBA) and the Ministry of Finance, the

## Disclaimer

The Agency disclaims all liability in connection with any consequences, interpretations, conclusions, recommendations and other actions directly or indirectly related to the conclusions and opinions contained in the Agency's Research Reports.

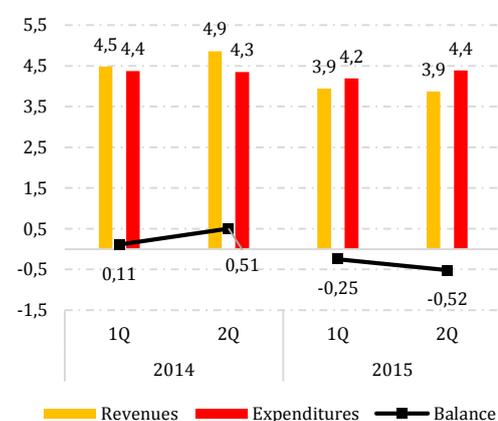
This Report represents the opinion of Rating-Agentur Expert RA GmbH and is not a recommendation to buy, hold or sell any securities or assets, or to make investment decisions.

**Graph 1: Budget revenues (Bill. of AZN)**



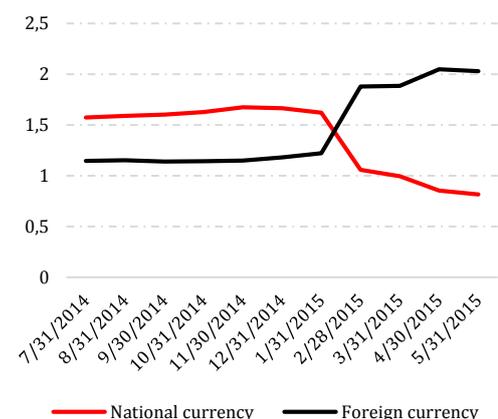
Source: RAEX (Europe) calculations based on data from the CBA

**Graph 2: Budget dynamics (Bill. of AZN)**



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

**Graph 3: Long-term deposits (Bill. of AZN)**



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

government budget posted a 2,9% of GDP deficit in 1H 2015. The steep decrease in oil prices has taken a toll on revenues since the 2Q of 2014. However, the devaluation of the AZN by the CBA in February 2015, along with higher non-oil income, has cushioned the drop in budget revenues (see graphs 1 and 2) preventing a wider fiscal deficit.

The reported mid-year deficit materializes the expectations of the Agency published in the previous report. However the government projects even a wider deficit by the end of 2015. Nevertheless, the 2016 draft budget looks more encouraging and prudent. It takes into account moderate spending and an oil price of 50 USD per barrel. The budget draft projects a small deficit, but spending and revenue projections would be more adapted to the new reality and would reduce transfers from the oil fund.

**Banking sector with external exposure.** The banking system remains profitable, although ROA declined in 1Q 2015 with 27 banks, representing 73% of total assets, reporting a fragile ROA of less than 0,5%. Capital adequacy ratio remained strong at 17,3% in the same period. In addition, the spread of the deposit and lending average interest rates reduced substantially to 512 b.p as of 1 June 2015 compared to 1000 b.p. as of the beginning of the year. However, the devaluation and lower oil prices present a significant risk to Azerbaijan's banking system.

As mentioned in our previous report<sup>1</sup>, the banking system has exposure to FX loans issued to AZN income earners, as well as to exporting companies with FX revenues, which partially mitigates the risks. Furthermore, the concentration of assets in the International Bank of Azerbaijan (IBA) and directed loans to this bank, distort the banking system and reduce competitiveness. Finally, the amount of money outside credit institutions and high levels of dollarization indicate the lack of use of the financial system. Therefore, levels of private debt have not grown consistently.

**Monetary authorities face challenges.** Even though the CBA manages the reference rate, the pass-through of changes in this rate to the real economy is not very efficient<sup>2</sup>. Thus, the Central Bank also maintains a tight control over the exchange rate, which was devaluated in February 2015 by about 34% in a single day following a plunge of oil prices and weakening of neighboring economies' currencies. So far, the devaluation of the AZN against the USD has, as previously mentioned, stabilized budget revenues and FX reserves. However, it caused an increase of more than 70% in FX-denominated long-term deposits and a 48% decrease in AZN-denominated long-term deposits (see graph 3) and has had an impact on inflation, which was 3,5% until June 2015.

<sup>1</sup> Research Report on Azerbaijan from 13<sup>th</sup> of March 2015 ([http://raexpert.eu/reports/Research\\_report\\_Azerbaijan\\_13.03.2015.pdf](http://raexpert.eu/reports/Research_report_Azerbaijan_13.03.2015.pdf))

<sup>2</sup> See page three of the previous report for reasons resulting in low efficiency of the monetary policy:

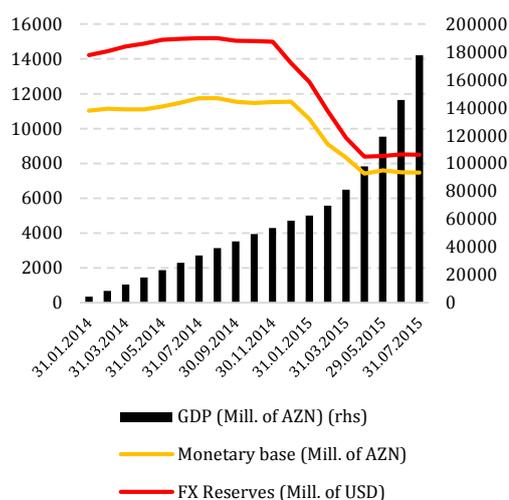
Research Report on Azerbaijan from 13<sup>th</sup> of March 2015 ([http://raexpert.eu/reports/Research\\_report\\_Azerbaijan\\_13.03.2015.pdf](http://raexpert.eu/reports/Research_report_Azerbaijan_13.03.2015.pdf))

**Disclaimer**

The Agency disclaims all liability in connection with any consequences, interpretations, conclusions, recommendations and other actions directly or indirectly related to the conclusions and opinions contained in the Agency's Research Reports.

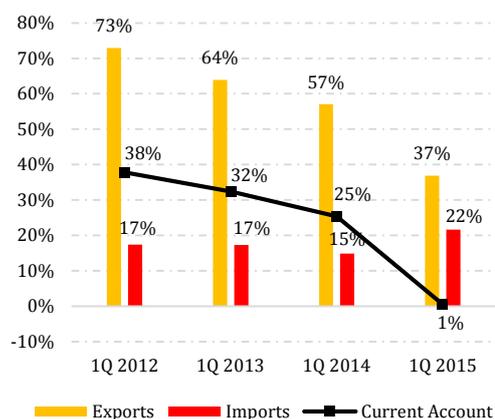
This Report represents the opinion of Rating-Agentur Expert RA GmbH and is not a recommendation to buy, hold or sell any securities or assets, or to make investment decisions.

**Graph 4: Money base, GDP and FX reserves**



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

**Graph 5: Current account (% of GDP)**



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

On the other hand, the attempt from the CBA to hold the peg to the USD before it finally decided to devalue the AZN, caused a massive reduction of FX reserves. It also had a substantial impact on the monetary base (M1), which decreased (and then stabilized) at the same pace as the reserves. However, after the devaluation, the decrease in M1 coincided with a sound real GDP growth (see graph 4). The combination of these effects has helped to contain inflation and, as a consequence, the annual CPI increase by year-end might be lower than expected. Despite this, a contraction of the money supply could also lead to a rise in interest rates, hampering credit growth. The CBA has stated that no further devaluation would take place.

**Deteriorating external position.** The external position of Azerbaijan has slightly deteriorated due to the imbalances in the global hydrocarbon market and the resulting AZN devaluation against the USD. Attempts to maintain the old peg (0,78 AZN per USD) of the AZN to the USD led to the decline of reserves by almost half from July 2014 until April 2015 (15,1 Bill. of USD to 8,4 Bill of USD). However, the reserves have stabilized as pressure on the exchange rate diminished by April 2015.

The current account balance has narrowed substantially due to significant decline in exports revenues in 1Q 2015 compared to the same period in previous years (see graph 5).

**Elevated political risks.** The potential political uncertainties, the frozen Nagorno-Karabakh conflict and the projects of the Trans-Caspian and Trans-Adriatic pipelines, discussed in our previous report, remain key determinants of the development of Azerbaijan. Special attention will be directed to the parliamentary elections in November 2015, which may cause further adjustments of the government policies.

## Conclusion

The state of the Azerbaijani economy is still stable. However, the sharp fall in oil prices and the recent devaluation of the AZN have deteriorated the position of the country, especially, its external stance, while pressure on foreign reserves has eased. Public short- and long-term debt levels along with recent, better than expected, GDP growth figures fueled by non-oil output, and sound external reserves are positive factors for Azerbaijan. Furthermore, the Nagorno-Karabakh frozen conflict and political uncertainty leading up to the parliamentary elections in November, are elements that may present potential risks for the economy.

### Disclaimer

The Agency disclaims all liability in connection with any consequences, interpretations, conclusions, recommendations and other actions directly or indirectly related to the conclusions and opinions contained in the Agency's Research Reports. This Report represents the opinion of Rating-Agentur Expert RA GmbH and is not a recommendation to buy, hold or sell any securities or assets, or to make investment decisions.