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Introduction

Azerbaijan, as other oil dependent countries, is facing internal and external challenges due to the depressed oil market. As of today, the Azerbaijani economy is still in a good position regarding government debt, public finances and external liquidity. In addition, inflation and unemployment have remained at very stable levels in recent years. However, due to the stagnant price of oil, the position of the economy is set to change in the current year. The consolidated fiscal budget is projected to have its first deficit in a long time at the end of 2015. In addition, the recent devaluation of the AZN will bring adverse consequences for the domestic market and the banking sector, and will spur financial dollarization in the economy. Nonetheless, continuing growth in the non-oil sector is expected to help mitigate some of the risks derived from declining oil prices. Moreover, internal and external political risks are other factors which also destabilize the economy.

Main Economic Indicators of Azerbaijan

Macro indicators	2012	2013	2014*
Gross pub. debt, bill AZN	6	8	10
Nominal GDP, bill AZN	54	58	59
Real GDP growth, %	0,9	5,8	2,8
Gross gov. debt/GDP,%	11,6	13,8	16,3
Deficit (surplus)/GDP,%	3,8	1,4	0,3
Inflation rate,%	-0,3	3,6	1,4
Curr. Account balance/GDP,%	21,8	16,9	14,5
Development indicators	2014*		
Inequality adj. HDI	0,66		
GDP per capita (Thou. of USD)	17,9		

Sources: RAEX (Europe) calculations based on data from World Bank, IMF, Bloomberg
 * Assessment of RAEX (Europe) based on current data provided by IMF, the CBA and the Ministry of Finance of the Republic of Azerbaijan

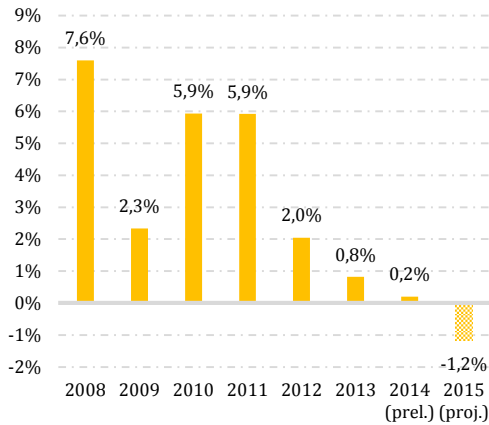
Indebtedness of the government is still at very low levels and additional key macroeconomic indicators are stable. Even though gross government debt to GDP is estimated to grow slightly in 2014 to 16,4% from 13,7% in 2013, it remains at considerably low levels. At the same time, the amount of government obligations is projected to represent around 42% of budget revenues, also a bearable figure. Likewise, short-term debt is stable and set to account for 1,5% of GDP and 3,9% of budget revenues. Regarding unemployment, this figure has stayed below 5% for two years in a row now. The increase in the CPI index for 2014 in Azerbaijan was 1,4%, 2,2 p.p. less than a year ago. Real GDP growth for 2014 was 2,8%, however, this figure is lower than the projected 4,4% by the authorities at the beginning of 2014.

The non-oil sector has been steadily growing and will be key to mitigate the hydrocarbon crisis, though support for SMEs in this part of the economy remains subdued. The non-oil sector grew around 7% in 2014 lead by the construction industry, the third largest industry in Azerbaijan behind the oil sector and the services industry (big part of which is related to the oil sector). Besides construction, information communication technologies and agriculture are areas which also contribute to this part of the economy. The growth and continuously rising strength of this sector, alongside increased taxes, will also help the

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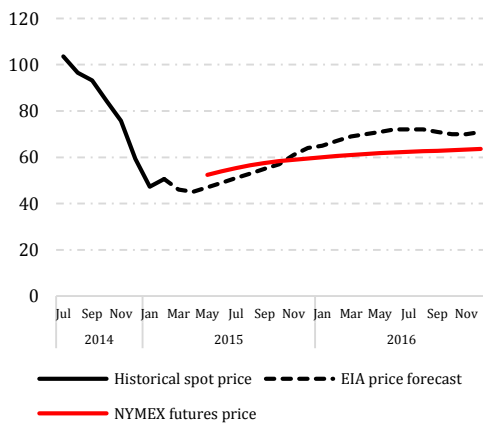
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Graph 1: Consolidated fiscal balance (% of GDP)



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

Graph 2: Spot, future and forecast oil price (USD/b)



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

government to collect more contributions and reduce the impact that low oil prices will have in budget revenues. For instance, in January of the current year, revenue from the non-oil sector was 50% more than a year before driven by a combination of development of the industry and higher taxes. However, further growth of the non-oil related economy also depends on the development of SMEs. Small and medium enterprises have stalled due to financial sector inefficiencies, which will be covered later in this report.

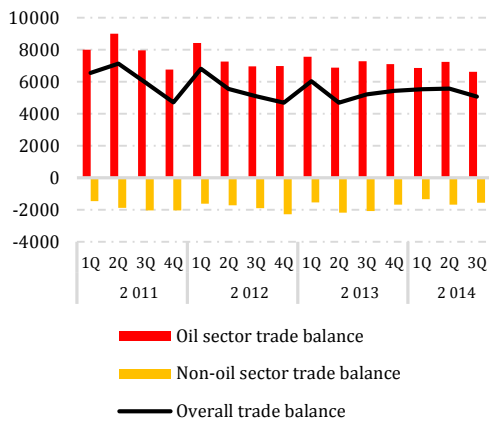
The fiscal budget is projected to post another surplus in 2014, however, the planned fiscal policy and prevailing hydrocarbons prices point to a deficit in 2015. The general fiscal stance of Azerbaijan continues to be solid as it is estimated that, once again, the consolidated budget balance will present a surplus of 0,2% of GDP. However, the positive balance has been steadily shrinking for the past six years (see graph 1) and the IMF estimates that it will show a deficit of 1,16% of GDP in 2015. In fact, this figure might be wider than anticipated due to the expansionary fiscal policy and inaccurate budget revenue projections. In general, the Azerbaijani government has been characterized by loose fiscal and monetary policies. Given the current situation, continuing with this type of policy will further widen the deficit; therefore, it is expected that expenditure cuts will come at some point. Secondly, revenues for the 2015 budget were calculated assuming oil prices at 90 USD per barrel, and current futures contracts for April 2015 are below 50 USD per barrel. To make things worse, projected prices and current future contracts do not surpass the price of 65 USD per barrel through 2015 (see graph 2), e.g. a future contract due in December 2015 is quoted at 56 USD. As mentioned in the previous report, the economy is highly dependent on the oil and gas sector. It represents 45% of GDP and around 90% of budget revenues; thus, the impact on the deficit may be noted at year-end. Nevertheless, the amount of reserves in the oil fund could stand as a buffer to mitigate risks.

Strong external liquidity position due to the high amount of reserves and a positive trade balance, however, both driven by the oil sector. Even though the government external debt amounts up to 6,8 billion AZN (70% of total debt), the external position of the Azerbaijani economy remains strong due to an accumulated amount of international reserves of 11,7 billion USD and a trade balance surplus accounting for 28,5% of GDP in 2014. However, these two figures are mainly driven by the oil sector. On the one hand, when oil exports are removed from the equation, the trade balance would account for around -5% of GDP on average for 2014 (see graph 3). On the other hand, despite having a decent amount of international reserves, these have been declining since mid-2014 (see graph 4) due to the pressure on the currency caused by the decline in oil

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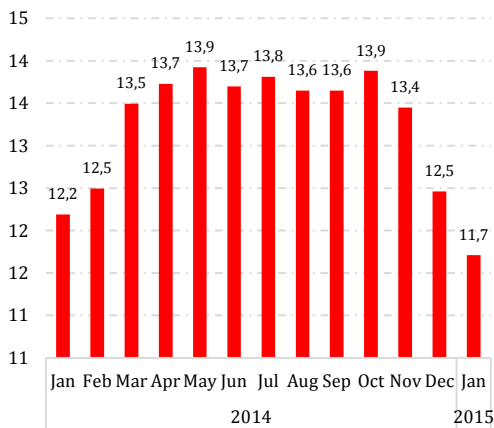
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Graph 3: Trade balance (Mill. of USD)



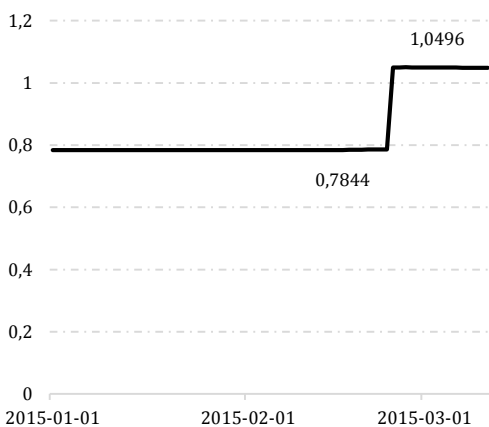
Source: RAEX (Europe) calculations based on data from the CBA

Graph 4: International reserves (Bill. of USD)



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

Graph 5: USD/AZN exchange rate



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

prices. As a consequence of this and the pressure of falling emerging market currencies, the Central Bank of Azerbaijan (CBA) decided to devalue the exchange rate on February 2015.

Currency devaluation, led by oil prices, reignited an already declining level of financial dollarization in the economy and will carry adverse consequences for the economy. The mounting pressure of dropping oil prices along with the declining value of other currencies against the USD, caused the CBA to devalue the AZN against the USD. The currency weakened by 34% in one day (see graph 5). Even though dollarization levels have been gradually declining (see graph 6), this devaluation shock triggered a sell-out of AZN in the following days which caused an increase in dollar deposits of 5% in just one month. While the authorities argue that devaluing the AZN will be beneficial for budget revenues¹, this action will also bring several adverse consequences. First of all, this decision by the CBA will be translated into higher import prices. In a country that heavily depends on imports, this will cause a pronounced rise in the CPI index. Secondly, the financial system will be affected by the high amount of short FX positions held in their balance sheets. In addition, more than 5 billion AZN in FX loans (around 27% of total loans in the economy) could also raise the rate of NPLs further distressing the banking system.

The banking and financial systems are still sound, nonetheless, it is still inefficient for SMEs and medium-term risks exist. The banking system is still healthy and profitable (ROA for 2014 was 1,7%) showing high levels of capital adequacy (19,2% for 2014). However, the lending-deposit spread is still very wide (10,1%) and the real interest rate is extremely high (17,2%), limiting financing opportunities for SMEs and spurring dollarization as well as money outside banks. At the same time, as mentioned in the previous section, the devaluation of the AZN will bring medium-term risks to the banking sector.

Inefficient monetary policy. Monetary policy in Azerbaijan has been ineffective due to its lack of independence and tools, directed lending programs by the government, high levels of dollarization and the coexistence of a *de facto* fixed exchange rate along with free capital flow. This explains why changes in the refinancing rate are not translated into the economy.

Internal and external political risks and regional conflicts continue to be a threat to economic development. Regarding the hydrocarbon sector, Azerbaijan has yet to decide on two major projects (the Tans-Caspian and Trans-Adriatic pipelines). Due to the economic and energy

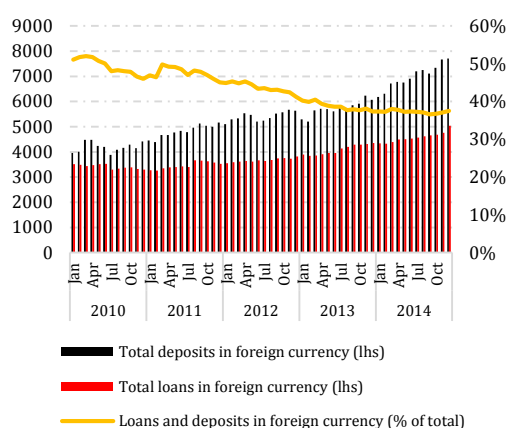
¹ Now that the USD is worth 34% more, when exchanging oil revenues to AZN the actual revenues would, in theory, be 34% higher.

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Graph 6: Dollarization in the economy (Mill. of AZN)



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

relations it still holds with Russia, this will not be an easy task to handle, politically. In respect to political factors inside the country, president Ilham Aliyev has been accused of showing signs of despotism according to different reports. He and his regime are being accused of arresting and oppressing journalists and human rights activists that oppose his government. Finally, the Nagorno-Karabakh conflict has not eased and continued ceasefire agreements have been constantly violated. As a result of the aforementioned issues, it is fair to conclude that Azerbaijan lacks political stability and it could affect further economic development.

Conclusion

The current position of the Azerbaijani economy can be assessed as stable. Government short- and long-term debt levels are low and well covered by reserves and revenues, and public finances are still healthy. Nevertheless, many factors are in place to destabilize the economy. Due to the country's oil dependency, the fall of the oil price and its not-so-fast recovery has triggered a series of harmful events for Azerbaijan. First of all, it drove the recent depreciation of the AZN which will carry adverse consequences in the domestic market and the banking sector. Secondly, expected revenues from the fiscal budget will be hard to realize due to the flawed budget revenues estimation by the authorities. In addition, political risks will most certainly contribute to deteriorate the economic situation. In contrast, the non-oil sector growth could be seen as one of the strong elements that will help mitigate the series of risks the Azerbaijani economy will be facing short- and medium-term.

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