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Research Report on Azerbaijan

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Introduction

Azerbaijan, as many of the countries in the Commonwealth of Independent States (CIS) region, is an important hydrocarbons producer and its economy highly depends on these products. Oil and gas production represents 45% of GDP and 90% of budget revenue, which makes the country susceptible to shocks in the production of oil and gas and sudden fluctuations on prices. Nevertheless, the share of production in the non-oil sector is increasing year after year. As a result of substantial oil sector exports, Azerbaijan has a very strong external position and a stable exchange rate. At the same time, the level of short- and long-term debt is low and the fiscal environment is stable (despite targets for non-oil deficit not being achieved). However, factors such as corruption, socio-political conflicts (Nagorno-Karabakh[1]) and an undeveloped financial sector, halt further growth.

Main Economic Indicators of Azerbaijan

Macro indicators	2011	2012	2013
Gross pub. debt, bill AZN	5,1	6,2	7,9
Nominal GDP, bill AZN	51,1	53,9	57,7
Real GDP growth, %	0,1	2,2	5,8
Gross gov. debt/GDP,%	10,1	11,6	13,7
Deficit (surplus)/GDP,%	11,6	3,8	0,82
Inflation rate,%	5,5	-0,3	3,6
Curr. Account balance/GDP,%	26,4	21,8	17,9

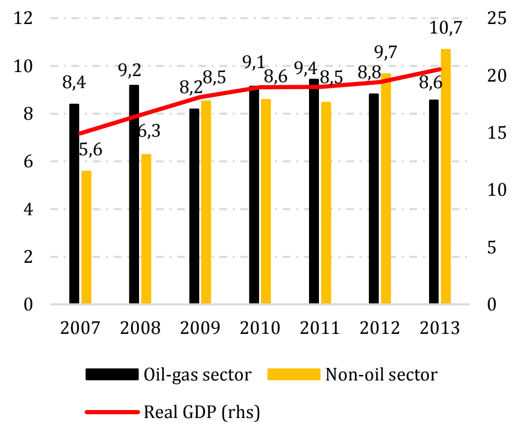
Development indicators	2013
Inequality adj. HDI	0,73
GDP per capita (Thou. of USD)	11,0

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

High dependence on the hydrocarbon sector exposes the country to severe risks if oil prices or output were to decline. The biggest concern threatening the stability of the fiscal balance and the general economy of Azerbaijan is the dependence on gas and oil production. A study by the International Monetary Fund (IMF) showed that if the output of oil is reduced by 12%, the fiscal balance for 2014 could be greatly affected (-5% of GDP). In addition, this organization mentions that a similar impact would occur if the prices fall by 20 USD. The current decline in oil demand has driven prices of Azerbaijani oil to the level of 88 USD a barrel, 12 USD lower than the projected 100 USD a barrel by the government; it is therefore of great importance to further strengthen the non-oil sector. In the previous years there has been a marked growth of this sector compared to the energy industry (see graph 1) alleviating some pressure. However, if additional actions targeted to developing the financial sector and directing public spending to the non-oil sector are not taken, the dependence on energetics will continue to be a delicate factor. Furthermore, plans in place to privatize the telecommunications industry will help to strengthen the non-oil side of the economy.

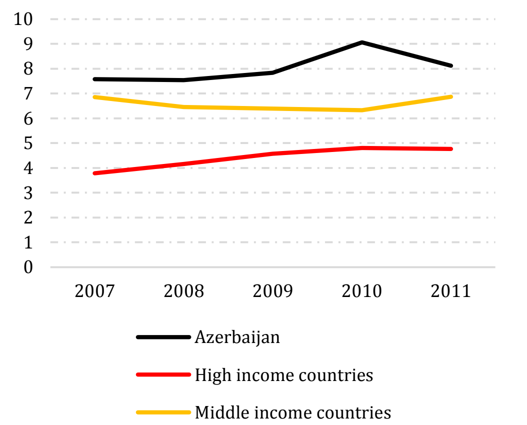
[1] The Nagorno-Karabakh conflict is the subject of a dispute between Armenia and Azerbaijan. The region is located in Azerbaijan, however most of its inhabitants are ethnic Armenian.

Graph 1: Oil and non-oil Real GDP (Bill. of AZN)



Source: RAEX (Europe) calculations based on data from World Bank and the State Statistical Committee of the Republic of Azerbaijan

Graph 2: Bank lending-deposit spread (Bp)



Source: RAEX (Europe) calculations based on data from World Bank

Solid stance in public short- and long-term debt obligations. Azerbaijan's level of short- and long-term debt is well covered by government revenues and foreign exchange reserves. Gross government debt accounts for only 35% of government revenues and current reserves are able to cover 150% of the total debt. Additionally, short-term debt represents a mere 3% of budget revenues. Furthermore, the strong external position and the stable economic environment, allowed Azerbaijan to issue their first USD denominated Eurobond at a 4,75% rate which was well received by investors back in March of 2014.

Positive fiscal balance, though dependent on oil output. Even though the overall fiscal balance has been positive in recent years, it has been shrinking. In 2013 Azerbaijan presented a budget surplus of 0,82% of GDP. Notwithstanding the fact that there was a surplus in the fiscal balance, the non-oil balance was -45,4% of GDP, below the targeted deficit of 35% for the sector. The projected reduced spending will contribute to reach the non-oil sector deficit target of 35% of GDP by 2019.

Stable but undeveloped financial sector. The financial sector is characterized by an undeveloped stock market and low access to financial institutions. The stock exchange in Azerbaijan is primarily used to issue and trade public and corporate bonds and the secondary market trading volume is marginal. The unevolved stock exchange limits potential sources of financing for the private sector, especially for small and medium enterprises (SMEs). This weakens the growth opportunities in the much needed non-oil sector. Regarding the banking system, although stable (levels of adequacy ratio above standard) and profitable, it has several issues to address. First of all, 37% of the assets are concentrated in the state-owned International Bank of Azerbaijan which, at the same time, is not well financially positioned creating a systemic risk for the whole financial system. Secondly, the bank lending-deposit spread in the country is wide compared with similar middle income countries (see graph 2). Adding to this, the real interest rate on loans to the corporate sector is more than 17%. These factors limit private credit lending and spur high levels of monetization in the economy reducing the efficiency of the financial sector and hampering growth, especially in the non-oil industry.

Regional conflict and corruption also represent moderate risks for economic development. Recent rising tensions in the Nagorno-Karabakh conflict must not be overseen. Additionally, corrupt activities within the country cripple competition and hurt the successful execution of structural reforms.

Conclusion

Azerbaijan has maintained low levels of short- and long-term public debt along with a strong external position backed by oil revenues. In general there is an adequate fiscal balance and a stable exchange rate. However, high dependence on hydrocarbons production will bring external and internal imbalances in the case of a continuing decline in oil prices. In addition, the projected reduction in oil output for the following years emphasizes the importance of strengthening the non-oil sector. In order to succeed in the aforementioned attempt, the financial sector should not remain underdeveloped. Banks, although profitable, have high operating costs which, along with low competition and lack of diversification, widen the interest spreads avoiding further growth, mainly for SMEs. Finally, despite having a satisfactory ranking for investor protection from the World Bank, high levels of corruption hurt the investment climate of the region as long as the country's potential for growth.