Euler Hermes Economic Research

Country Risk Analysis

Azerbaijan

Non-oil sectors have become drivers of growth

General Information

GDP USD67.2 billion (World ranking 67, World Bank 2012)

Population 9.3 million (World ranking 91, World Bank 2012)

Form of state Republic

Head of government Ilham ALIYEV

Next elections October 2013, presidential

Strengths

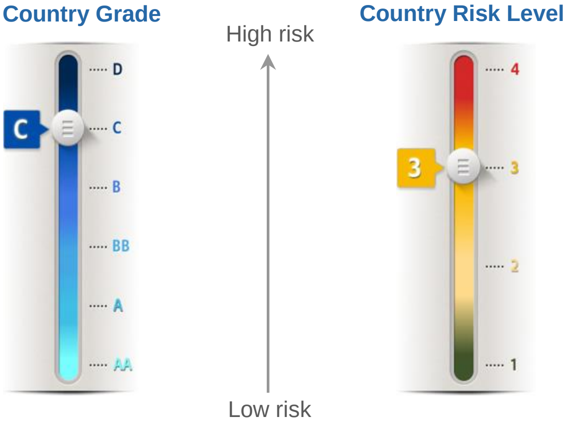
- Ample natural resources in the hydrocarbon sector
- Overall sound fiscal position
- Very high annual current account surpluses since 2006
- Very favourable external liquidity and debt positions

Weaknesses

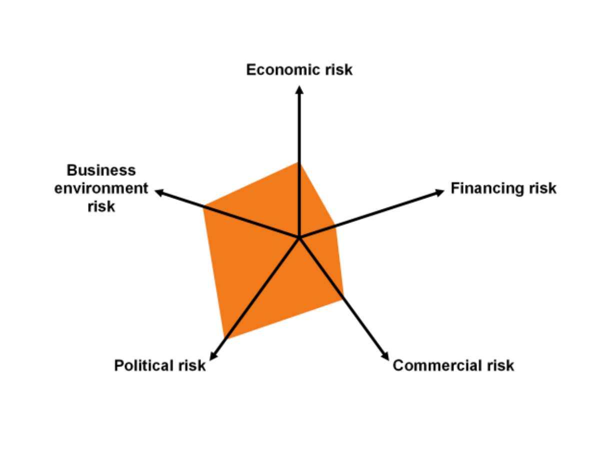
- High regional political instability
- Relatively poor regional relations, including in particular the continued conflict with Armenia over the Nagorno Karabakh enclave
- Authoritarian political regime
- Weak government effectiveness and slow progress of structural reforms
- Generally (too) loose monetary and fiscal policies
- Dependence on hydrocarbon sector creates considerable external vulnerability
- Significant corruption and weak protection of property rights
- Weak banking system

Country Rating

C3



Risk Dimensions



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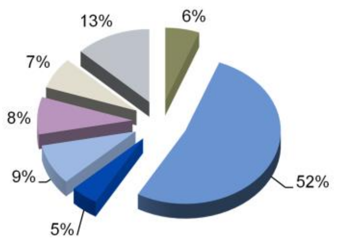
Economic Structure

GDP breakdown (% of total, 2011)



Sources: UN, UnctadStat, IHS Global Insight, Euler Hermes

Trade structure (% of total, 2011)

Exports		Rank		Imports
Italy	34%	1	17%	Russian Federation
France	14%	2	16%	Turkey
United States	8%	3	9%	Germany
Germany	5%	4	7%	China
Indonesia	5%	5	6%	United Kingdom

Exports (% of total)		Rank		Imports (% of total)
Petroleum, petroleum products and related materials	93%	1	10%	Other transport equipment
Gas, natural and manufactured	2%	2	9%	Iron and steel
Vegetables and fruits	1%	3	9%	Other industrial machinery and parts
Sugar, sugar preparations and honey	1%	4	8%	Specialised machinery
Iron and steel	1%	5	7%	Road vehicles

Economic Forecast

	2009	2010	2011	2012	2013f	2014f
GDP growth (% change)	9.3	5.0	0.1	2.2	5.0	5.2
Inflation (%, end-year)	0.7	7.9	5.6	-0.3	5.4	5.1
Fiscal balance (% of GDP)	6.6	14.0	11.3	3.1	-2.7	-4.4
Public debt (% of GDP)	11.8	11.1	10.1	11.6	13.9	13.4
Current account (% of GDP)	23.0	28.4	26.0	22.6	13.0	17.0
External debt (% of GDP)	10.8	13.6	12.8	13.5	13.3	13.2

Source: IHS Global Insight, national sources, Euler Hermes

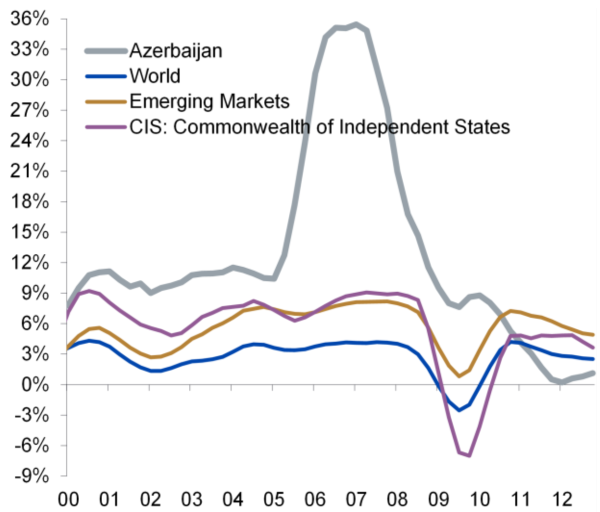
Economic Overview

Azerbaijan is classified as an upper middle income economy by the World Bank, with an estimated GNI per capita of USD6,050 in 2012. With ample natural resources in the hydrocarbon sector, the economy is highly dependent on mineral products—which account for about 45% of GDP, 70% of fiscal revenue and 95% of merchandise exports—and on one single company, the Azerbaijan International Operating Company, which exports around 90% of total crude oil. This makes the country very vulnerable to external shocks. Industry contributes about 64% to GDP while agriculture, still the largest employer of the country, contributes just 6%. Services account for the remaining 30%.

Owing to rapidly increased oil production since 1997, real GDP grew by an average annual +13.4% in 1997-2010. Since 2011, however, oil output has declined as a result of aging oil fields and limited investment in the oil industry. But thanks to accelerating activity in non-oil sectors, the economy avoided contraction, expanding by +0.1% in 2011 and +2.2% in 2012. Real GDP growth picked up further to +5% y/y in H1 2013, with non-oil GDP increasing by +10.9% y/y. On the supply side, industrial output shifted back to growth of +0.3% y/y in H1 after declining by -1.9% in full year 2012. Agricultural output grew by +4.9% y/y in H1 (+3.7% in 2012) and services by +7.5% y/y (+9.9% in 2012). EH expects full year growth of about +5% in both 2013 and 2014.

Monetary and fiscal policy have been generally loose over the past decade. As a result, inflation has been mostly elevated and highly volatile. It moderated,

GDP growth (% y/y, 4 qtrs cumulated)



Sources: IHS Global Insight, Euler Hermes however, in the wake of the recent economic slowdown and shifted to slight deflation in H2 2012. As the economy has picked up again in 2013, inflation is forecast to accelerate to an average 5% in 2013-2014.

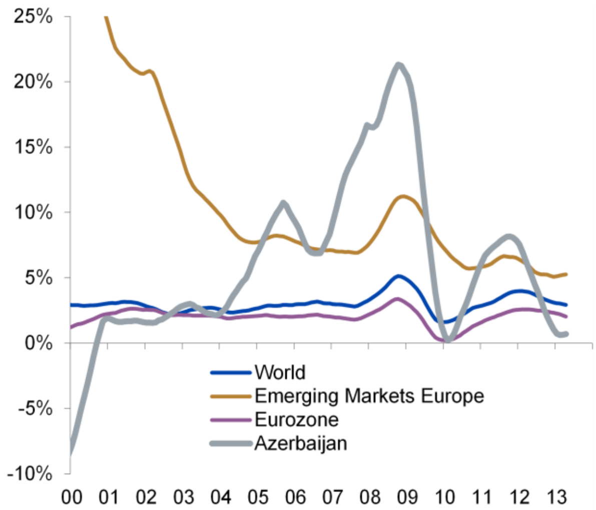
The central bank continues to aim at maintaining the de-facto peg of the manat (AZM) to the USD at close to 0.8AZM/1USD. The peg is intended to hold back upward pressure on the exchange rate stemming from strong foreign exchange inflows, as nominal appreciation could involve further unwanted real appreciation which would increase the risk of the so-called Dutch Disease phenomenon—where currency appreciation in real terms, boosted by high commodity receipts, harms all other economic sectors. At end-2012, the manat was estimated to be 5% overvalued in real effective terms as compared to the average of the past five years, significantly down from 20% in early 2011 and almost 40% in early 2009.

Despite generally loose fiscal policy, Azerbaijan's overall fiscal position is sound thanks to substantial direct state revenues from selling oil in the past 15 years. These revenues have been channelled into the State Oil Fund of Azerbaijan (SOFAZ), which accumulates all of the funds and transfers only portions to the state budget. Assets in the SOFAZ stood at USD34.3bn in March 2013, while total public debt is low at about USD6.3bn or 12% of GDP (end-2012 estimate). The overall fiscal account has been in surplus since 2004. However, if the government pushes through with currently planned investment spending, the fiscal account is likely to record deficits in 2013-2014, though this will be unproblematic thanks to the strong fiscal reserves.

Also thanks to the substantial oil revenues over the past 15 years, Azerbaijan has achieved exceptionally sound external liquidity and debt positions. The current account surplus is forecast at around 15% of GDP in 2013-2014. Official foreign exchange reserves stood at almost USD13bn in May 2013, covering eight months of expected imports or six times all external debt repayments falling due in the next 12 months. Gross external debt is also very low, accounting for around 13.5% of GDP or 23% of exports.

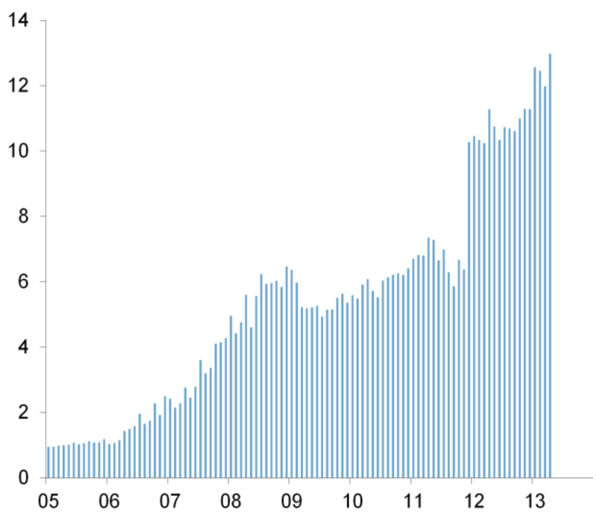
However, despite the sound external macro-economic fundamentals, risks remain on the micro-economic level. For example, Azerbaijani companies were not immune to the impact of the 2008-2009 global crisis when a number of state-owned enterprises and banks faced difficulties refinancing short-term foreign liabilities, which caused a liquidity shortage in the banking system and an abrupt decline in credit growth. The largest bank, International Bank of Azerbaijan is in need of restructuring and got state support in 2012 (0.5% of GDP).

Inflation rate (12-month moving average, %)



Sources: IHS Global Insight, Euler Hermes

Foreign exchange reserves (USD bn)



Sources: IHS Global Insight, Euler Hermes

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