Euler Hermes Economic Research

Country Report

Azerbaijan

Supply constraints in oil sector retard growth

General Information

GDP	USD67.2 bn (World ranking 67, World Bank 2012)
Population	9.3 mn (World ranking 91, World Bank 2012)
Form of state	Republic
Head of government	Ilham ALIYEV
Next elections	2015, legislative

Strengths

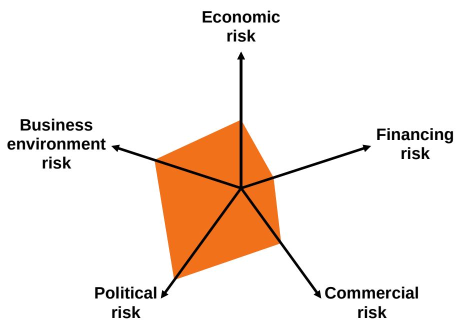
- Ample natural resources in the hydrocarbon sector
- Overall sound fiscal position
- Very high annual current account surpluses since 2006
- Very favourable external liquidity and debt positions

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 loose monetary and fiscal policies
- Hugely dependence on hydrocarbon sector creates considerable external vulnerability
- Significant corruption and weak protection of property rights
- Weak banking system

Country Rating

C3



Source: Euler Hermes

Trade Structure

By destination/origin (% of total)

Exports		Rank		Imports
Italy	28%	1	16%	Turkey
France	8%	2	14%	Russian Federation
India	6%	3	8%	Germany
Indonesia	6%	4	7%	United States
Germany	6%	5	7%	China

By product (% of total)

Exports		Rank		Imports
Petroleum and products thereof	91%	1	10%	Road vehicles
Gas, natural and manufactured	2%	2	9%	Iron and steel
Vegetables and fruits	1%	3	8%	Other industrial machinery, parts
Sugar products and honey	1%	4	8%	Specialised machinery
Non-ferrous metals	1%	5	5%	Electrical machinery, appliances

Source: UnctadStat (2012)

Economic Overview

Vulnerable economic structure

Azerbaijan is classified as an upper middle income economy by the World Bank, with an estimated GNI per capita of USD7,350 in 2013. 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 93% 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. Mining and utilities contributes 52% to GDP, construction 9% and manufacturing only 5%. Agriculture, still the largest employer in the country, accounts for just 6% of GDP. Services contribute the remaining 28%.

Growth slowdown in 2014 but moderate recovery in 2015 forecast

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, +2.2% in 2012 and +5.8% in 2013. Real GDP growth slowed down to +2.5% y/y in Q1-Q3 2014, largely as a result of a -0.6% y/y contraction of industrial output which mainly reflects supply constraints in the oil sector. Non-oil GDP increased by +6% y/y, well above the overall expansion, but nevertheless presenting a continued moderation of this sector (down from +10.4% a year earlier) as public construction investment has been reduced. Agricultural output declined by -3.7% y/y in Q1-Q3 (+4.9% in full-year 2013) while retail trade continued to grow strongly by +9.4% y/y (+9.9% in 2013). EH expects full year growth of about +2.5% in 2014, followed by +4% in 2015 as supply constraints in the oil sector should gradually wane.

Inflation to remain low until end-2015

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, however, in the wake of the recent economic sluggishness and stood at around 1% y/y in mid-2014. Euler Hermes expects it to pick up gradually, reaching about 1.5% at year-end and 2.8% at end-2015, in line with moderately accelerating economic growth.

Exchange rate peg to be maintained

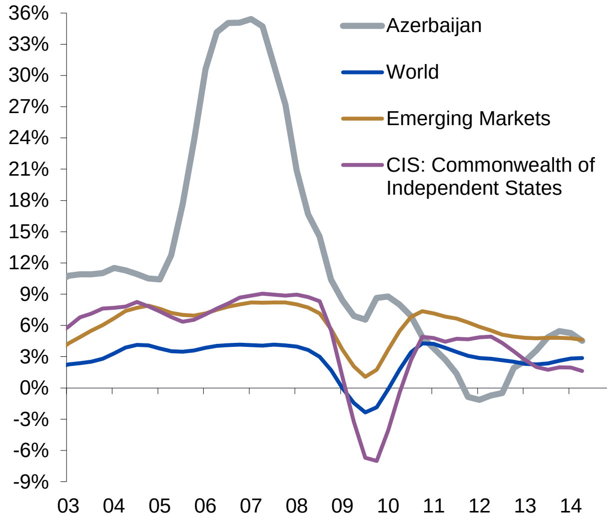
The central bank continues to aim at maintaining the de-facto peg of the manat (AZM) to the USD at close to 0.8AZM/1USD. The peg is intended to hold back upward pressure on the exchange rate stemming from strong foreign exchange inflows, as nominal appreciation could involve further unwanted real appreciation 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. Nonetheless, in June 2014 the manat was estimated to be 7.4% overvalued in real effective terms as compared to the average of the past five years, up from just 2% at end-2012 but still significantly lower than the 16% at end-2010 and the 40% at end-2008.

Key economic forecasts

	2012	2013	2014f	2015f
GDP growth (% change)	2.2	5.8	2.5	4.0
Inflation (%, end-year)	-0.3	3.6	1.5	2.8
Fiscal balance (% of GDP)	3.8	1.4	0.2	-1.8
Public debt (% of GDP)	11.6	13.8	16.0	18.0
Current account (% of GDP)	21.5	16.7	11.0	15.0
External debt (% of GDP)	13.9	14.5	15.0	15.2

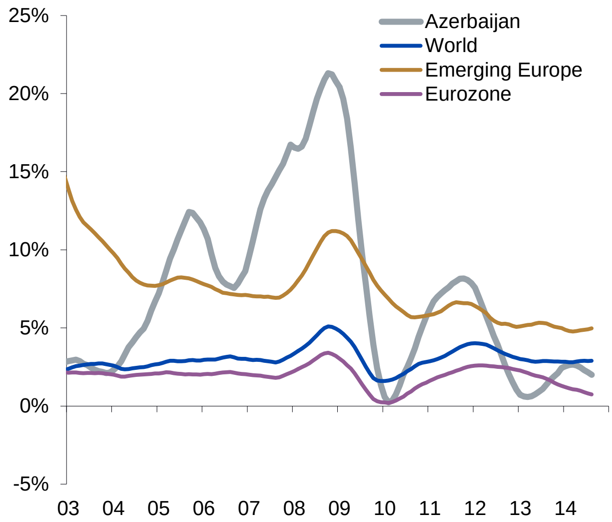
Sources: National sources, IMF, IHS, Euler Hermes

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



Sources: National sources, IHS, Euler Hermes

Inflation rate (12-month moving average, %)



Sources: National sources, IHS, Euler Hermes

Public finances are favourable

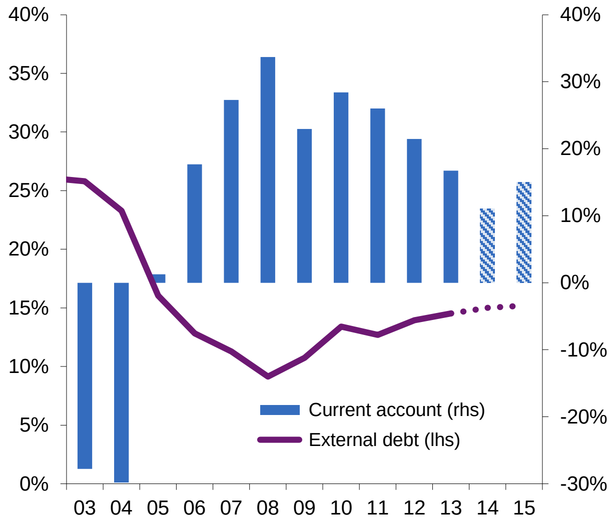
Despite generally loose fiscal policy, Azerbaijan's overall fiscal position is sound thanks to substantial direct state revenues from selling oil in the past 16 years. These revenues have been channelled into the State Oil Fund of Azerbaijan (SOFAZ), which accumulates all of the funds and transfers only portions to the state budget. Assets in the SOFAZ stood at USD37.6 bn in June 2014, while total public debt is low at about USD8 bn or 14% of GDP (end-2013 estimate). The overall fiscal account has been in surplus since 2004. However, if the government continues with currently planned investment spending, the fiscal surplus may narrow close to balance in 2014 and shift to a small deficit in 2015, though this will be unproblematic thanks to the strong fiscal reserves. Even a prolonged period of oil prices at current levels of around USD70/barrel (Brent) would not pose a problem for Azerbaijan's public finances.

External liquidity is sound

Also thanks to the substantial oil revenues over the past 16 years, Azerbaijan has achieved exceptionally sound external liquidity and debt positions. The current account surplus is forecast at around +11% of GDP in 2014, before widening to +15% in 2015. Official foreign exchange reserves stood at around USD16 bn in August 2014, covering nine months of expected imports or eight times all external debt repayments falling due in the next 12 months. Gross external debt is also very low, accounting for around 15% of GDP or 33% of exports.

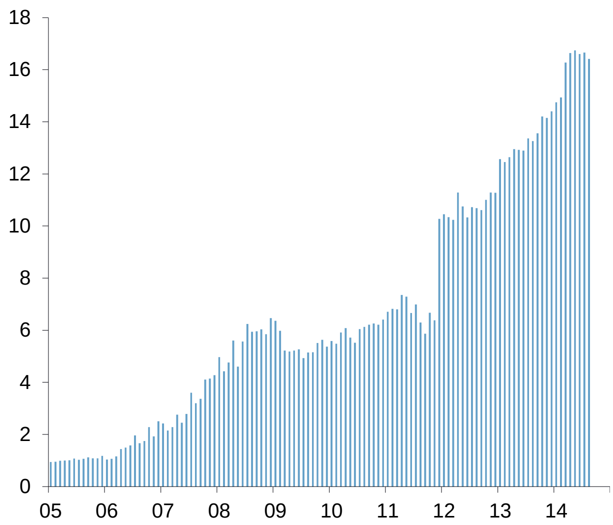
However, despite the sound external macro-economic fundamentals, risks remain on the micro-economic level. For example, Azerbaijani companies were not immune to the impact of the 2008-2009 global crisis when a number of state-owned enterprises and banks faced difficulties refinancing short-term foreign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

Current account and external debt (% of GDP)



Sources: National sources, IHS, Euler Hermes

Foreign exchange reserves (USD bn)



Sources: IMF, Euler Hermes

Last review: 2014-12-01
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