BANK OF GEORGIA RESEARCH

Azerbaijan Economy
2013: Meeting Expectations

Azerbaijan | Economy
May 6, 2014

Azerbaijan's economy expanded at its fastest pace in the last 4 years in 2013. Non-oil GDP grew 10%, driven by two key industries – construction and trade – and oil GDP recovered to positive growth territory after two negative years. Imports of goods and services increased 11% y/y, fuelled by private consumption and oil field maintenance needs. This, combined with lower exports on the back of flat oil volumes produced, resulted in a smaller current account surplus. Azerbaijan's C/A surplus at 17% of GDP is still among the world's leaders, and the strong external surplus continues to feed the country's reserves. The State Oil Fund's assets and the central bank's reserves increased by US$ 1.7bn and US$ 2.5bn to US$ 36bn and US$ 14bn respectively. As a result, total reserves were up 2ppts y/y to 68% of GDP. The government's expansionary fiscal policy will continue in 2014 and may result in the first budget deficit in 11 years, although this is dependent on the oil price. In order to prepare for the possibility of a budget shortfall, the government announced plans to scale back its investment program from 2015, meaning private investment will need to step in. Azerbaijan also took steps to ease its access to foreign financing by placing a US$ 1.25bn, 10-year debut Eurobond in March 2014.

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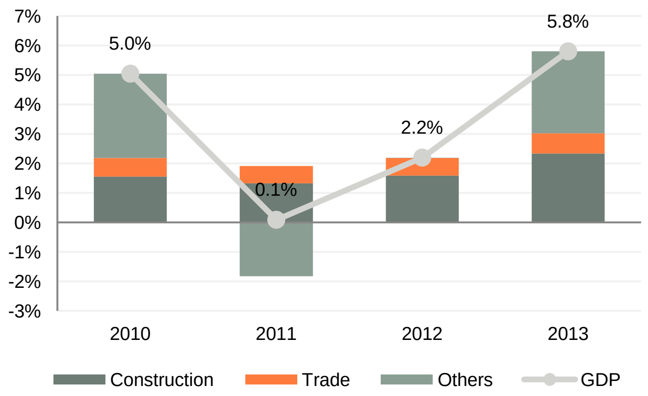
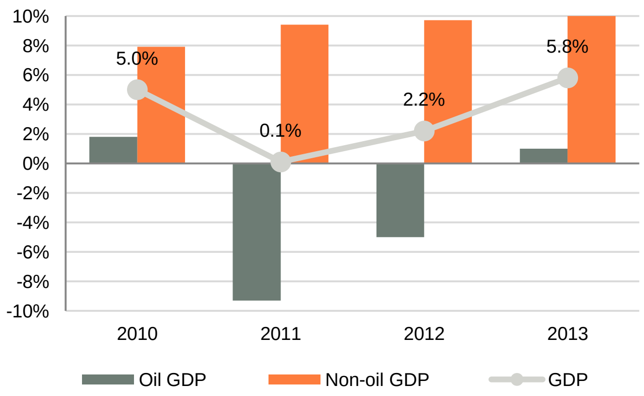
Construction and trade drove Azerbaijan's economic growth to 5.8% y/y in 2013, the strongest pace in the last 4 years. The two sectors accounted for half of the total economic expansion, delivering 23% and 10% growth rates, respectively. With the strong performance in these two sectors, non-oil GDP rose 10% y/y. The oil sector, on the other hand, reversed its downward trend of the previous two years and added 1% y/y in 2013 on a marginal increase in oil output, a 3.6% y/y increase in gas production, and a 6.2% y/y increase in refinery activity. Despite the pick-up, the 43.1mmt produced is still below the 2010 peak level of 50.7mmt. While oil production is unlikely to grow significantly, gas output offers real upside and will become the driving force of oil GDP growth in the coming years, in our view.[1]

Figure 1: GDP growth and sector contributions



Source: AZSTAT

Figure 2: Oil and non-oil GDP growth rates

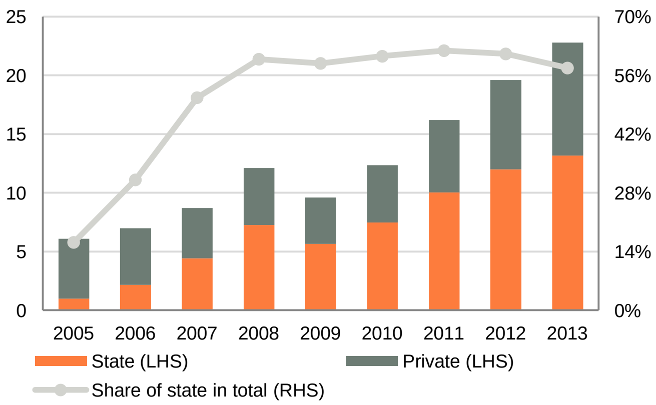


Source: AZSTAT

[1] *See our previous report on Azerbaijan for a full overview of the country's gas production potential*

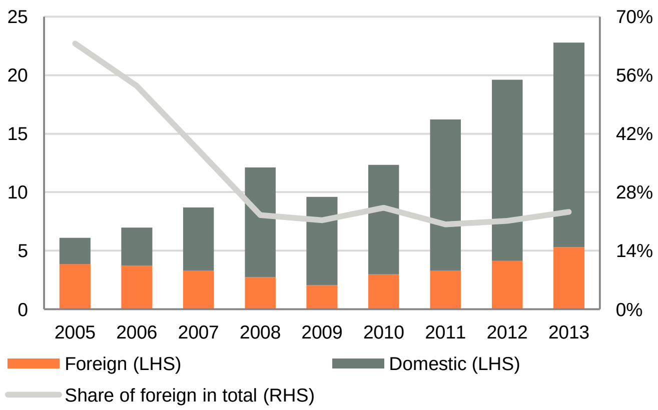
The growth in 2013 was driven by domestic demand. In nominal US$ terms, exports of goods and services declined 2.7% y/y while imports increased 10.5% y/y, shrinking the trade surplus in goods and services from US$ 19bn in 2012 to US$ 16bn in 2013. Domestic demand, however, remained strong and was mainly financed by public investment expenditure, and the government accounted for 75% of all domestic investments.

Figure 3: State vs. private fixed capital investment, US$ bn



Source: AZSTAT

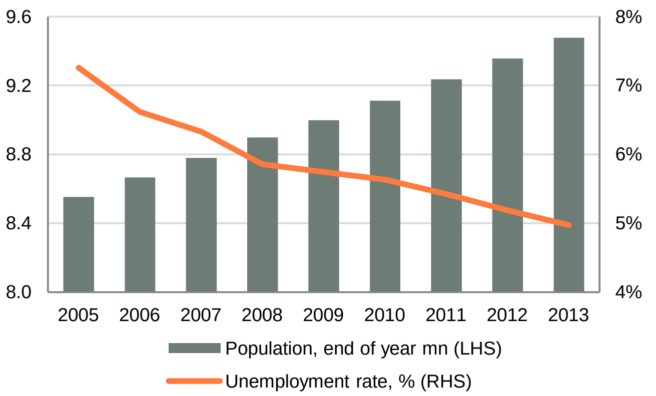
Figure 4: Foreign vs. domestic fixed capital investment, US$ bn



Source: AZSTAT

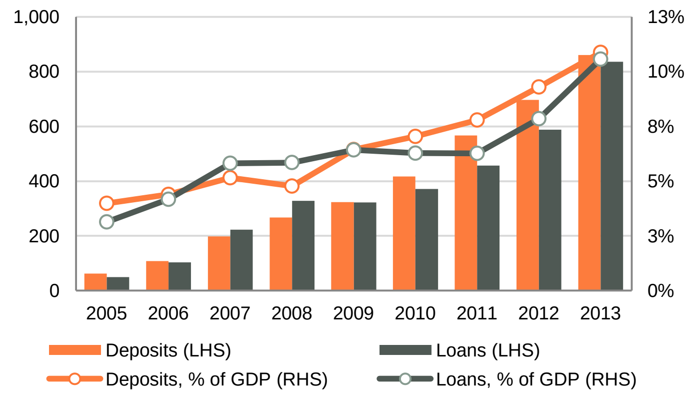
Rising incomes have resulted in a higher savings rate. The pick-up in growth led to the strongest job creation environment in the last 14 years, bringing the unemployment rate down from 5.2% in 2012 to 5.0% in 2013. The average salary increased 6.3% y/y in nominal US$ terms and 3.7% y/y in real terms. Loans-to-households increased 44% y/y, faster than deposits, indicating robust consumer demand boosting trade. However, at US$ 8.2bn, household deposits remain larger than total household loans. Overall, both deposits and loans remain relatively small as a share of per-capita GDP.

Figure 5: Population and unemployment rate



Source: AZSTAT

Figure 6: Per-capita household loans and deposits, US$

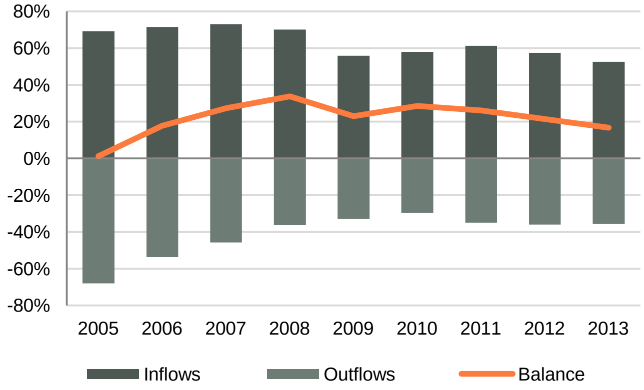


Source: AZSTAT, CBAR

Balance of Payments

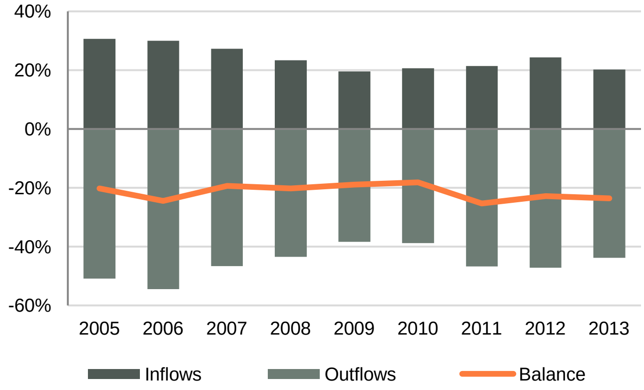
The current account (C/A) surplus declined 4ppts y/y to 17% of GDP in 2013 on the back of slower export growth and rising imports. A decrease in oil & gas exports (2.3% y/y to US$ 30bn) was a key factor, while non-oil exports increased 6% y/y to US$ 1.8bn. Growth in non-oil exports was driven by machinery and equipment trade, up 144% y/y to US$ 0.3bn, while other non-oil exports declined. In nominal US$ terms, total exports of goods fell 1.8% y/y to US$ 31.8bn. Imports, on the other hand, increased by US$ 1bn, or 9.4% y/y in 2013. As a result, the external trade surplus shrank 7% y/y to US$ 21bn. The balance in services worsened as well, to US$ 4.2bn in 2013 from US$ 2.9bn in 2012. Despite the 4ppt y/y C/A decline the surplus remained in strong double digit levels, a reflection of the country's strong external position. As in 2012, oil and gas exports accounted for 94% of total exports in 2013.

Figure 7: Current account, % of GDP



Source: CBAR, AZSTAT

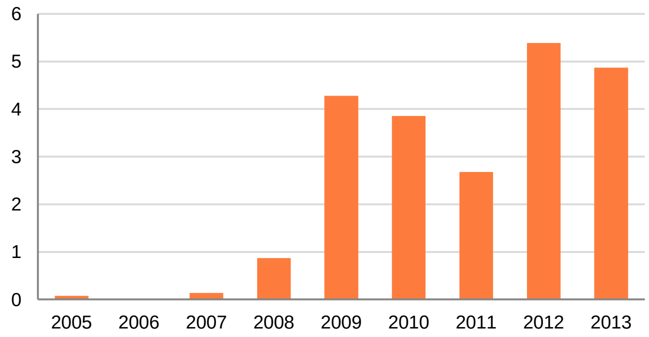
Figure 8: Non-oil current account, % of non-oil GDP[2]



Source: CBAR, AZSTAT

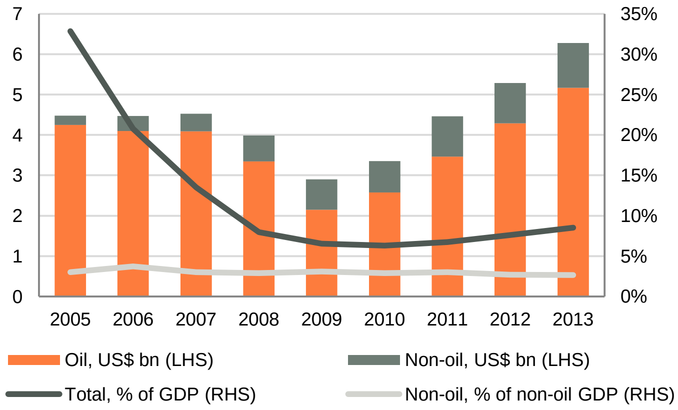
The capital account posted a significant outflow of deposits in 2013. Outflows continued in 2013 at US$ 4.9bn, slightly below the previous year. Cumulative outflows in the last 5 years reached US$ 21bn.

Figure 9: Outflows from the deposit account, US$ bn



Source: CBAR

Figure 10: Foreign direct investments



Source: CBAR

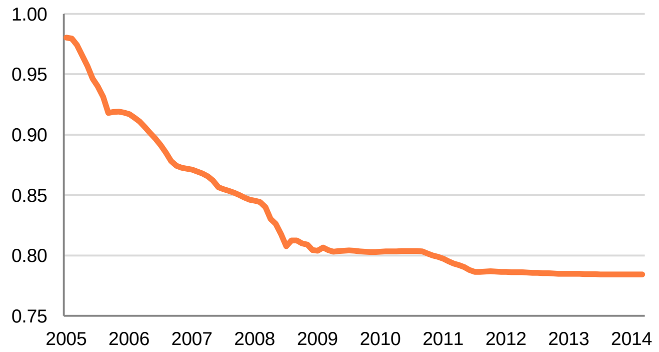
[2] As a result of new methodology introduced last year, the 2013 non-oil balance cannot be compared to previous years. The central bank has not yet published revised numbers for previous years.

However, FDI inflows reached a record high. Traditionally, most investments are directed to the oil sector. Two factors define investments into the oil sector: 1) The rate of wear and tear on oil and gas field equipment, and 2) Investments into the Shah Deniz gas field whose 2nd stage is expected to deliver gas in 2018/19. According to the management of BP, the company is committed to invest over US$ 40bn in the 2nd stage of Shah Deniz over the next few years, keeping oil FDI inflows at elevated levels. The non-oil sectors also attracted record-high FDI, surpassing the previous nominal record of US$ 1.0bn in 2010 to reach US$ 1.1bn in 2013. FDI as a share of GDP, however, is still below the peak of the early 2000s as a result of the rapid expansion of GDP.

Net FDI, though, was lower due to profit repatriations. As per existing Product Sharing Agreements (see our previous report for details), investors in oil projects are entitled to repatriate original investments as they earn profits. These repatriations are reflected in the FDI category. In 2013, repatriations rose to US$ 3.7bn from US$ 3.3bn in 2012. Along with US$ 1.5bn in FDI outflows, the net FDI figure came in at US$ 1.1bn, up 41% y/y in 2013.

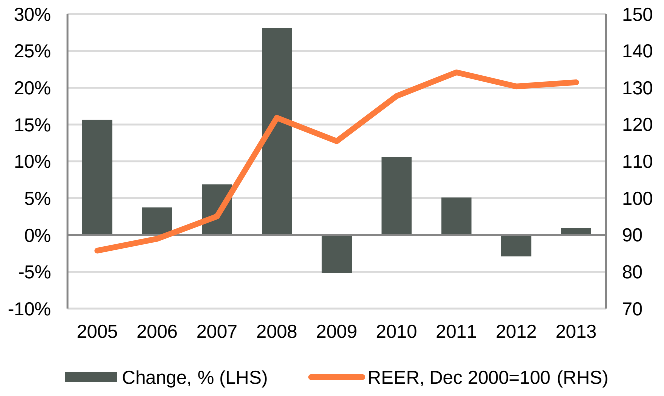
As a result of the strong C/A surplus, the country's international reserves increased further. By the end of 2013 Oil Fund assets and central bank reserves increased by US$ 1.7bn and US$ 2.5bn, respectively. As a result, total reserves reached 68% of GDP in 2013 vs. 66% in 2012. The Oil Fund also increased its gold holdings by 15 tonnes (0.5 mn ounces) to 30 tonnes in the last 2 years.

Figure 11: US$/AZN exchange rate, monthly average



Source: CBAR

Figure 12: Manat real effective exchange rate

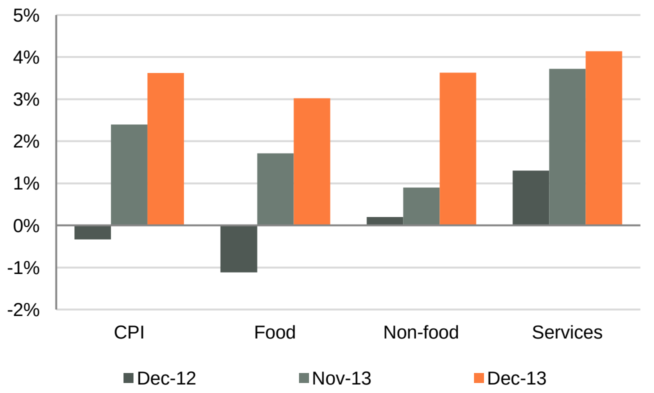


Source: CBAR

The manat exchange rate remains firmly pegged to the US$, within a narrow corridor. The US$/AZN rate appreciated just 0.1% over 2013 to 0.784. With the inflation rate comparable to Azerbaijan's main trading partners, the real exchange rate appreciated just 0.9%. The central bank's increased reserves provide further support for currency stability over the coming years.

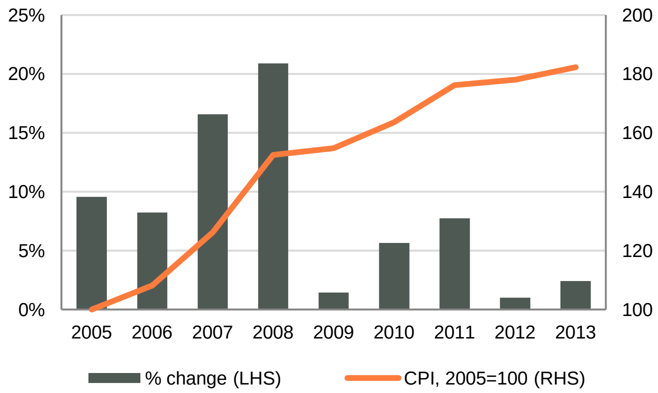
Inflation was propped up by a one-time oil products price hike and an end-of-year jump in vegetable prices. The Tariff Council, which regulates gasoline prices, decided to increase oil products prices in December. For example, price of AI-92 petrol was increased by 27% to AZN 0.7/liter. Regional developments inflated prices for vegetables in Azerbaijan, but also in Georgia and Turkey. As a result, food price inflation surged from 1.7% y/y in November to 3% in December and non-food prices increased from 0.9% to 3.6% in the same two months. These pressures drove CPI up from 2.4% y/y in November to 3.6% y/y in December. Nevertheless, average CPI remained relatively subdued at 2.4% y/y in 2013.

Figure 13: Inflation, y/y, %



Source: AZSTAT

Figure 14: CPI and the y/y change in inflation



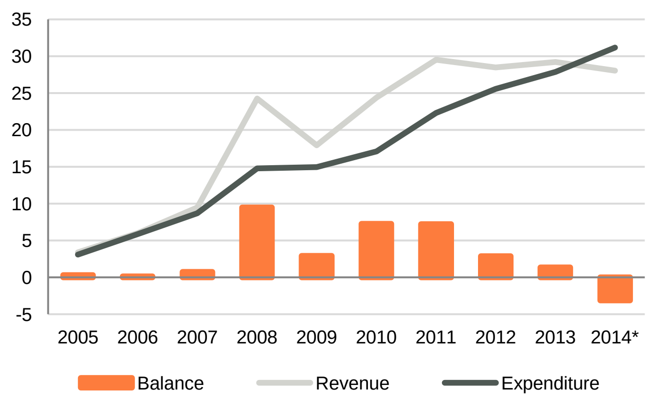
Source: AZSTAT

Budget Revenues a Positive Surprise in 2013

With better-than-expected revenue and lower-than-projected spending, the consolidated budget generated a US$ 1.4bn surplus (1.8% of GDP) vs. an expected US$ 4.8bn deficit. Nevertheless the surplus in nominal US$ terms was the lowest in the past 6 years. As oil revenues stabilize at current levels and expenditures keep rising, the budget surplus is set to turn to deficit territory in 2014, in our view.

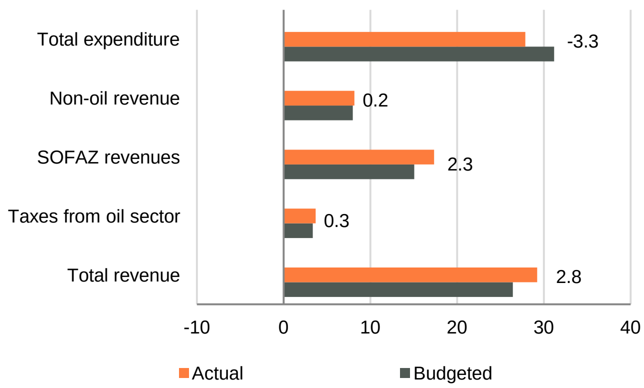
Higher oil prices drove the robust budget revenues. The 2013 budget was based on an oil price forecast of US$ 100/bbl. The resiliency of the oil price, which averaged US$ 109/bbl over 2013, resulted in higher-than-expected revenues. The State Oil Fund's revenues reached US$ 17.3bn vs. a planned US$ 15.1bn. Non-oil and oil tax revenues also surprised to the upside thanks to higher economic growth and the high oil prices. The resulting consolidated budget revenues were US$ 2.8bn higher than budgeted.

Figure 15: Consolidated budget, US$ bn



** budgeted*
Source: Ministry of Finance

Figure 16: 2013 budget: budgeted vs actual, US$ bn



Source: AZSTAT, Ministry of Finance, SOFAZ

Decreased expenditures also fueled the surplus budget. The largest savings came from the State Oil Fund, whose expenditures (less transfers to the central budget) remained at US$ 1bn, 54% below the budgeted US$ 2.1bn. The government was planning to finance its share in various projects through the Oil Fund. With the exception of the STAR refinery in

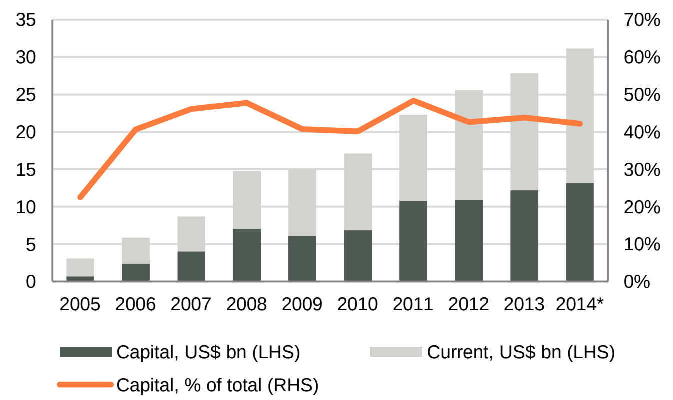
Turkey, other project financing was put on hold.[3] The government also spent less than expected in general expenditures, education, health, and social protection. Overall, the consolidated budget expenditures came in US$ 3.3bn below the budgeted US$ 31bn.

The 2014 budget is set to return to the red. Budget expenditures are expected at US$ 31bn (vs. US$ 28bn actual in 2013) and revenues are expected to drop to US$ 28bn from US$ 29bn, for a US$ 3.1bn deficit, or 4.2% of GDP. The budget is once again built on a US$ 100/bbl oil price. However, the average oil price early in 2014 has been above US$ 100/bbl, offering some ground to believe that actual revenues may again be higher than budgeted.

Government capital spending remains high. Starting with the oil boom in 2006, capital spending has accounted for over 40% of consolidated expenditures. In nominal US$ terms it has increased from below US$ 1bn in 2005 to US$ 12bn. Capital spending is driven by the need to rehabilitate and upgrade the current infrastructure in the country and oil revenues have provided easy financing in the form of transfers from SOFAZ to the state budget. However, starting in 2009, transfers from SOFAZ exceeded capital spending and have been covering part of current expenses.

However, we believe there is ample capacity to fully finance current expenditures by current revenues, particularly by taxes. Increasing the tax-to-GDP ratio through efficient taxation is the most viable route. From 2010 to 2013, Azerbaijan's tax-to-GDP ratio has remained at 13%, and its non-oil tax (including customs revenue) to non-oil GDP at 16%.[4] The government expects that the current capital investment will yield tax revenue in the future, meaning there is near-term upside in the tax-to-GDP ratio. We believe that with the current low base, there is significant potential for higher current revenue in Azerbaijan, which would minimize pressure on withdrawals from SOFAZ.

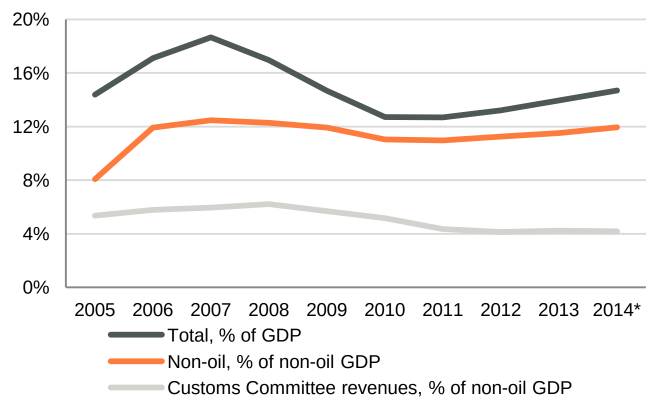
Figure 17: Capital vs current spending



** budgeted*

Source: Ministry of Finance, BOG Research

Figure 18: Tax-to-GDP ratio



** budgeted*

Source: AZSTAT, Ministry of Taxes, Customs Committee, BOG Research

Government spending is the main engine of economic growth. Keep in mind that non-oil GDP growth in recent years has been driven by public infrastructure spending. With the budget expected to post a deficit this year, the government will need to scale back expenditures, something that is already being planned in the 3-year forward budgets starting in 2015. According to the document, spending on the State Investment Program will decline from US$ 12.4bn in 2014 to US$ 8.0bn in 2017. The conservative spending policy will save Oil Fund reserves, but will require the government to attract more private sector investment to compensate for the fall in public investment.

[3] Projects included the construction of a high-speed fibre optic network providing access to all settlements in Azerbaijan, an oil & gas and petrochemical construction project, the construction of the STAR oil refinery in Turkey, and the construction of the TANAP project.
[4] In Azerbaijan Along with Ministry of Finance there is separate Ministry of Taxes and Customs Committee

Table 1: Main directions of State Investment Program for 2014-2017 (US$ bn)

		Infrastructure projects	Social projects	Projects related to institutions, land reclamation, emergency situations, etc.	Total
2014					
1	Total	6.3	2.5	1.0	9.9
1.1	State budget capital investments	4.9	2.5	1.0	8.4
1.2	Financed by foreign credit	1.4	0.0	0.0	1.5
2	SOFAZ	2.2	0.4	0.0	2.6
	Grand total	8.5	2.9	1.0	12.4
2015					
1	Total	4.9	1.4	0.8	7.1
1.1	State budget capital investments	3.5	1.3	0.8	5.7
1.2	Financed by foreign credit	1.4	0.0	0.0	1.4
2	SOFAZ	2.0	0.2	0.0	2.2
	Grand total	6.8	1.6	0.8	9.2
2016					
1	Total	4.0	1.1	1.3	6.3
1.1	State budget capital investments	3.1	1.1	1.3	5.4
1.2	Financed by foreign credit	0.9	0.0	0.0	0.9
2	SOFAZ	2.3	0.2	0.0	2.5
	Grand total	6.3	1.3	1.3	8.8
2017					
1	Total	3.5	1.1	1.1	5.6
1.1	State budget capital investments	2.9	1.1	1.1	5.1
1.2	Financed by foreign credit	0.6	0.0	0.0	0.6
2	SOFAZ	2.1	0.2	0.0	2.3
	Grand total	5.6	1.3	1.1	8.0

Source: Ministry of Finance

Azerbaijan successfully completed a debut sovereign Eurobond placement in March. Azerbaijan issued US$ 1.25bn in 10-year Eurobonds with a 4.75% coupon. Although there is no urgent need for external financing at the moment given the substantial reserves in the Oil Fund, the issuance will raise country's international profile. It will also establish a long term yield curve for the country and pave the way for other corporates to tap into the international capital markets.

Macro Statistics

	2005	2006	2007	2008	2009	2010	2011	2012	2013
Economic activity									
Real GDP, y/y	26.4%	34.5%	25.0%	10.8%	9.3%	5.0%	0.1%	2.2%	5.8%
Real Oil GDP, y/y	66.3%	63.2%	36.8%	6.8%	14.0%	1.8%	-9.3%	-5.0%	1.0%
Real Non-Oil GDP, y/y	8.3%	11.9%	11.4%	15.9%	3.7%	7.9%	9.4%	9.7%	10.0%
Nominal GDP, AZN bn	12.52	18.75	28.36	40.14	35.60	42.47	52.08	54.7	57.7
change y/y	46.8%	49.7%	51.3%	41.5%	-11.3%	19.3%	22.6%	5.1%	5.4%
Nominal Oil GDP, AZN bn[1]	5.52	10.09	15.91	22.25	16.07	21.10	25.83	25.48	25.07
Nominal Non-Oil GDP, AZN bn[2]	7.00	8.65	12.45	17.89	19.54	21.36	26.25	29.26	32.64
Nominal GDP, US$ bn	13.24	20.99	33.10	48.88	44.29	52.91	65.63	69.74	73.56
change y/y	52.5%	58.5%	57.7%	47.7%	-9.4%	19.5%	24.0%	6.3%	5.5%
Nominal GDP per capita, US$	1,580	2,472	3,842	5,603	5,018	5,922	7,285	7,491	7,913
change y/y	50.7%	56.5%	55.4%	45.9%	-10.4%	18.0%	23.0%	2.8%	5.6%
Prices									
CPI, eop	5.3%	11.2%	19.7%	15.5%	0.7%	7.8%	5.5%	-0.3%	3.6%
CPI, average	9.6%	8.3%	16.7%	20.8%	1.5%	5.7%	7.9%	1.1%	2.4%
PPI, eop	n/a	n/a	n/a	-36.2%	65.2%	18.8%	21.1%	-1.3%	2.7%
PPI, average	17.3%	10.1%	17.6%	23.4%	-19.4%	30.5%	33.5%	4.5%	-3.9%
GDP deflator	16.1%	11.3%	21.0%	27.8%	-18.8%	13.6%	22.5%	2.9%	-0.4%
Exchange rates									
US$/AZN, eop	0.919	0.871	0.845	0.801	0.803	0.798	0.787	0.785	0.785
US$/AZN, average	0.946	0.893	0.857	0.821	0.804	0.803	0.794	0.785	0.784
Money & credit									
Base money, AZN bn	n/a	1.60	2.61	4.78	4.86	6.40	8.28	10.52	11.64
Chg. y/y	n/a	n/a	63.3%	83.0%	1.7%	31.6%	29.4%	27.1%	10.7%
Broad money (M2), AZN bn	0.80	2.14	4.40	6.08	6.17	8.30	11.00	13.81	16.43
Chg. y/y	16.2%	168.4%	105.9%	38.2%	1.5%	34.5%	32.5%	25.5%	19.0%
% of GDP	6.4%	11.4%	15.5%	15.2%	17.3%	19.5%	21.1%	25.2%	28.5%
Broad money (M3), AZN bn	1.84	3.44	5.90	8.49	8.47	10.53	13.90	16.78	19.36
Chg. y/y	22.1%	87.1%	71.4%	44.0%	-0.3%	24.3%	32.1%	20.7%	15.4%
% of GDP	14.7%	18.4%	20.8%	21.2%	23.8%	24.8%	26.7%	30.6%	33.5%
Money (M3) multiplier	2.10	1.68	1.71	1.71	1.73	1.61	1.64	1.57	1.64
Bank deposits, AZN bn	1.37	2.16	4.13	6.46	6.38	7.63	9.45	10.70	12.48
Chg. y/y	22.4%	58.0%	90.9%	56.5%	-1.3%	19.5%	23.9%	13.3%	16.6%
% of GDP	10.9%	11.5%	14.6%	16.1%	17.9%	18.0%	18.1%	19.5%	21.6%
Bank loans, AZN bn	1.44	2.36	4.68	7.19	8.41	9.16	9.85	12.24	15.42
Chg. y/y	45.6%	64.0%	98.2%	53.6%	16.9%	9.0%	7.5%	24.3%	26.0%
% of GDP	11.5%	12.6%	16.5%	17.9%	23.6%	21.6%	18.9%	22.4%	26.7%
Loan-to-deposits ratio	1.05	1.09	1.13	1.11	1.32	1.20	1.04	1.14	1.24
Lending interest rate (average)	15.8%	16.0%	16.4%	17.9%	16.3%	15.0%	16.3%	15.7%	14.4%
Deposits interest rate (average)	7.8%	10.5%	11.0%	11.8%	11.6%	11.2%	10.8%	10.2%	9.6%
Interest rate spread, ppts	7.96	5.58	5.38	6.12	4.75	3.75	5.53	5.46	4.84
Fiscal indicators									
General budget revenues, US$ bn	3.42	6.03	9.47	24.25	17.89	24.37	29.53	28.46	29.22
% of GDP	25.8%	28.7%	28.6%	49.6%	40.4%	46.1%	45.0%	40.8%	39.7%
General budget non-oil revenues, US$ bn	1.76	2.98	3.70	5.07	5.49	5.54	6.36	7.55	8.18
% of non-oil GDP	23.8%	30.7%	25.4%	23.3%	22.6%	20.8%	19.2%	20.3%	19.7%
General budget expenditures, US$ bn	3.09	5.89	8.70	14.77	14.98	17.10	22.30	25.57	27.86
% of GDP	23.3%	28.1%	26.3%	30.2%	33.8%	32.3%	34.0%	36.7%	37.9%
General budget balance, US$ bn	0.33	0.14	0.77	9.48	2.91	7.27	7.23	2.89	1.35
% of GDP	2.5%	0.6%	2.3%	19.4%	6.6%	13.7%	11.0%	4.1%	1.8%
General non-oil budget balance, US$ bn	-1.33	-2.92	-5.01	-9.70	-9.49	-11.56	-15.94	-18.02	-19.68
% of non-oil GDP	-17.9%	-30.1%	-34.5%	-44.5%	-39.0%	-43.4%	-48.2%	-48.3%	-47.3%

	2005	2006	2007	2008	2009	2010	2011	2012	2013
External accounts									
Merchandise trade balance, US$ bn	3.30	7.75	15.22	23.01	14.58	19.73	24.33	22.18	20.62
Non-oil merchandise trade balance, US$ bn	-1.66	-2.58	-3.67	-5.07	-4.69	-4.54	-7.41	-7.44	-8.22
Service trade balance, US$	-1.97	-1.92	-2.13	-2.34	-1.61	-1.73	-3.00	-2.92	-4.19
Non-oil service trade balance, US$	-0.31	-0.32	-0.16	-0.37	-0.41	-0.49	-1.40	-0.83	-1.62
Trade balance, US$ bn	1.33	5.82	13.09	20.67	12.97	18.00	21.33	19.26	16.43
% of GDP	10.0%	27.7%	39.6%	42.3%	29.3%	34.0%	32.5%	27.6%	22.3%
Non-oil trade balance, US$ bn	-1.97	-2.90	-3.84	-5.44	-5.09	-5.03	-8.81	-8.27	-9.84
% of non-oil GDP	-26.6%	-29.9%	-26.4%	-25.0%	-21.0%	-18.9%	-26.6%	-22.2%	-23.7%
Current account balance, US$ bn	0.17	3.71	9.02	16.45	10.17	15.04	17.15	14.92	12.32
% of GDP	1.3%	17.7%	27.2%	33.7%	23.0%	28.4%	26.1%	21.4%	16.7%
Non-oil current account balance, US$ bn	-1.49	-2.37	-2.81	-4.39	-4.58	-4.82	-8.37	-8.52	-9.83
% of non-oil GDP	-20.2%	-24.5%	-19.3%	-20.2%	-18.9%	-18.1%	-25.3%	-22.8%	-23.6%
Foreign direct investments, US$ bn	4.48	4.47	4.53	3.98	2.90	3.35	4.47	5.29	6.28
Non-oil foreign direct investments, US$ bn	0.23	0.37	0.44	0.64	0.75	0.78	1.00	1.00	1.11
Capital and financial account balance, US$ bn*	0.57	-1.74	-5.76	-3.56	-6.02	-3.59	-4.02	-8.08	-6.50
CBAR official foreign reserves, US$ bn	1.18	2.50	4.27	6.47	5.16	6.41	10.48	11.69	14.15
Oil Fund Assets, US$	1.39	1.45	2.48	11.22	14.90	22.77	29.80	34.13	35.88
Debt indicators									
Gross external debt, US$ bn	4.60	5.91	7.05	9.37	8.96	11.01	13.22	n/a	n/a
change y/y	29.6%	28.4%	19.4%	32.9%	-4.4%	22.9%	20.1%	n/a	n/a
% of GDP	34.7%	28.1%	21.3%	19.2%	20.2%	20.8%	20.1%	n/a	n/a
Government debt, US$ bn	1.76	2.14	2.85	3.39	5.21	5.89	6.55	7.98	n/a
of which									
Domestic debt, US$ bn	0.11	0.17	0.36	0.37	1.80	1.98	1.81	1.65	n/a
External debt, US$ bn	1.66	1.98	2.48	3.01	3.41	3.92	4.73	6.33	n/a
% of GDP	13.3%	10.2%	8.6%	6.9%	11.8%	11.1%	10.0%	11.4%	n/a
Total investment, US$ bn	5.50	6.27	7.11	9.13	8.39	9.56	13.37	14.50	18.18
% of GDP	41.5%	29.9%	21.5%	18.7%	19.0%	18.1%	20.4%	20.8%	24.7%
Gross national savings, US$ bn	5.12	9.29	14.77	24.17	17.63	23.37	30.34	30.09	31.09
% of GDP	38.7%	44.3%	44.6%	49.4%	39.8%	44.2%	46.2%	43.1%	42.3%

[1] Until 2009 at factor cost
[2] Until 2009 non-oil GDP is calculated as non-oil GDP at factor cost plus net taxes
Source: AZSTAT, CBAR, Ministry of Finance, SOFAZ, IMF, BOG Research

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