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Azerbaijan Economy
1Q15: Better Than Expected

Azerbaijan | Economy
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With a 5.3% y/y growth rate (7.0% in non-oil GDP), Azerbaijan performed better in 1Q15 than had been expected from an oil-dependent country that had just devalued its currency by more than 33%. Our analysis indicates that this growth rate was fed mainly by one-off factors: inaugurations of major sport complexes for the European Games in March, the lower oil production base of the previous year, and an immediate post-devaluation run on shops/markets by those seeking to benefit from 'sticky' prices. However, these factors will probably subside in the coming quarters, and March's consumption boom will probably mean less consumption in the following months. With reserves falling and the banking sector being 'stress-tested' by post-devaluation developments, we do not expect similar growth rates in the coming quarters. Moreover, the lack of credible forward-looking assurances regarding future monetary policy, particularly exchange-rate policy, is acting as a brake on the new investment needed to drive growth.

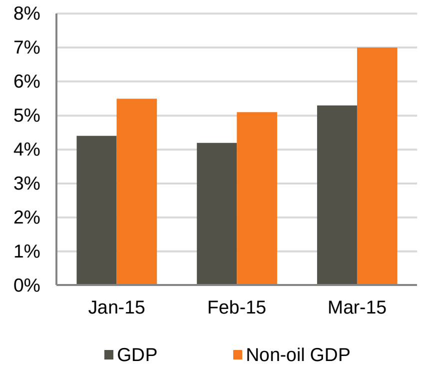
One-off factors result in stronger-than-expected growth in 1Q15

Azerbaijan's economy grew 5.3% y/y in 1Q15 despite the 33.8% devaluation in late February. YTD data indicate that growth actually accelerated in March 2015, taking the figure from 4.2% y/y in 2M15 (i.e. Jan-Feb) to 5.3% y/y in 1Q15. Non-oil GDP increased 7.0% y/y in 1Q15 from 5.1% y/y in 2M15. The inauguration of several sport complexes for the first European Games in March pushed construction-sector growth from 8.3% y/y in 2M15 to 13.2% y/y in 1Q15, and trade accelerated from 8.5% y/y in 2M15 to 9.6% y/y in 1Q15, probably due to people rushing to do post-devaluation shopping as prices remained relatively unchanged. Additionally, oil output increased versus the low base of the previous year, resulting in 3.4% y/y growth in mining and quarrying. These three sectors together accounted for 66.4% of the total 5.3% GDP growth in 1Q15. Contrary to the real growth rate, nominal GDP in US$ terms contracted 23.4% from US$ 17.0bn in 1Q14 to US$ 13.0bn.

Reserves decline by US$ 8.4bn

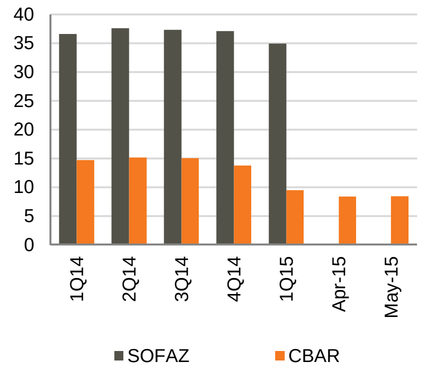
While GDP growth rates have not been significantly affected yet, reserves have been hit hard by oil prices falling from US$ 113.2/bbl in June 2014 to US$ 49.5 in January 2015. Despite the recent recovery to above US$ 65/bbl, central bank reserves continued to decline, falling 44.8% to US$ 8.4bn at the end of April 2015 from US$ 15.2bn in July 2014. The 33.8% devaluation on February 23, 2015 did not reverse the trend, with the Central Bank losing US$ 1.5bn in March and US$ 1.1bn in April 2015. After 8 months of decline, reserves increased marginally by 0.5% m/m in May 2015. Falling oil prices also affected State Oil Fund reserves, which had been declining since reaching a record high of US$ 37.6bn in 2Q14. SOFAZ reserves then declined by US$ 2.7bn (US$ 2.2bn of which was in 1Q15) to US$34.9bn in 1Q15. As a result, consolidated reserves fell by US$ 8.4bn from US$ 52.8bn in 2Q14 to US$ 44.4bn in 1Q15.

Figure 1: GDP growth rate, YTD



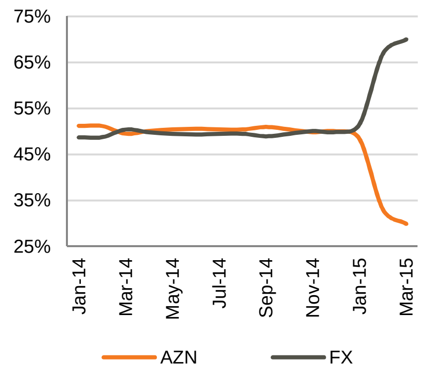
Source: AzStat

Figure 2: Reserves, US$ bn



Source: SOFAZ, CBAR

Figure 3: Dollarization ratio of deposits



Source: CBAR

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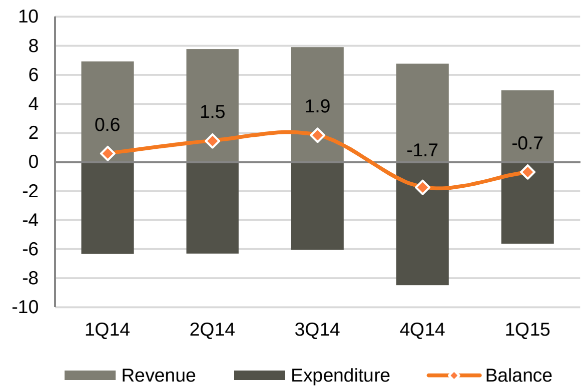
Devaluation has immediate impact on banking stats. The falling oil prices had a significant indirect impact on the banking sector through devaluation. Immediately following the devaluation, there was a strong movement from AZN deposits to foreign exchange. As a result, the dollarization ratio, which had averaged 50% until 2015, increased to a record 70.0% by the end of March 2015 – its highest level since 2005. Monetary squeezing was also reflected in monetary aggregates, with broad money (M3) in US$ terms contracting 47.8% between December 2014 and March 2015, and M2 and M1 almost halving. Unfortunately, the central bank stopped publishing P/L statements for the banking system as a whole in January 2015. However, data from banks indicate that devaluation had a significant negative impact on most of their balance sheets, with several announcing losses for 1Q15.

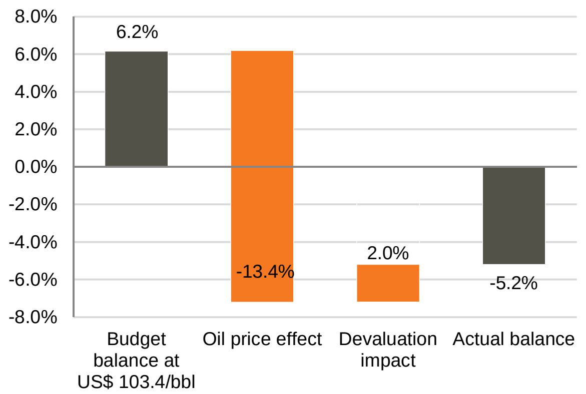
Devaluation partially compensates for falling oil prices in budget performance. Oil-price dependency also took a toll on the public budget. With oil prices falling, Azerbaijan's consolidated budget balance went into deficit territory in 4Q14, with the deficit reaching US$ 1.7bn. Thanks to the surpluses of the previous quarters, the overall annual consolidated budget remained in surplus (US$ 2.2bn, or 2.9% of GDP). The fiscal balance remained in deficit in 1Q15 as oil-related revenues continued to decline, resulting in a US$ 0.7bn deficit, corresponding to 5.2% of GDP. Rough calculations indicate that the deficit may have reached 7.2% of GDP in the absence of devaluation, which helped to feed the AZN value of oil revenues. However, assuming no devaluation and flat oil prices, the budget may have yielded a 6.2% surplus. To sum up, the fall in oil prices ate up roughly 13.4% of GDP in the budget balance, while devaluation brought back 2.0% of GDP. The deficit will likely contract in the following quarters as the government cuts back on capex spending, bringing the consolidated budget balance to around 2.4% of GDP, as forecasted in our previous report.

Figure 4: Consolidated budget, US$ bn



Source: Ministry of Finance

Figure 5: Consolidated budget balance, % of GDP

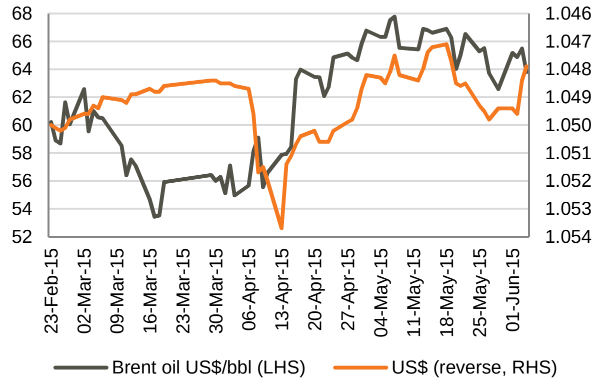


Source: Ministry of Finance, G&T Research

Exchange rate broadly stable following oil-price trend. The exchange rate has remained broadly stable at 1.05 AZN per US$ following the devaluation in late February. However, authorities have been unable to allay rumors surrounding the future of the exchange rate, resulting in the lack of confidence that will probably hinder new investment. However, as the chart below indicates, there seems to be correlation between the central bank's exchange rate and the oil price.

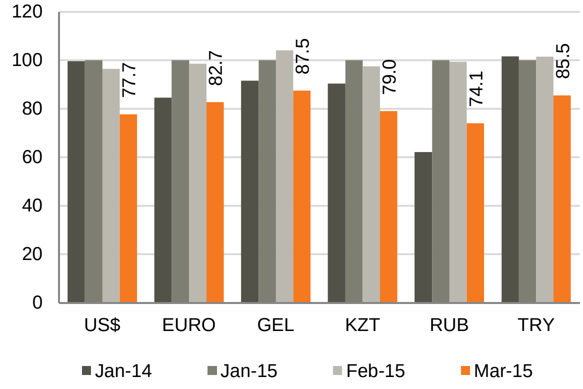
Real exchange rate at lowest level for last seven years. Theoretically, exporters should be the major beneficiaries of the devaluation, as the real exchange rate dropped sharply following the central bank devaluation, and the AZN depreciated 22.3% against the US$ between January and March 2015 (to its lowest level since February 2008). The real exchange rate against the RUB is of particular concern, as a significant share of non-oil exports go to Russia. The AZN appreciated 65.8% against the RUB between July and December 2014, reducing Azeri exporters' competitiveness. Devaluation helped partially to reverse the AZN appreciation; it depreciated 25.9% between January and March 2015. However, this was still 22.8% higher compared to July 2014.

Figure 6: US$/AZN exchange rate and oil price since devaluation



Source: CBAR, Azertag

Figure 7: Real exchange rate, Jan 2015=100



Source: IMF, G&T Research

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