



Azerbaijan Economy Devaluation – Balancing Act

Azerbaijan | Economy

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Following 20 years of a fixed exchange rate policy, Azerbaijan awoke on Saturday 21 February 2015 to news of a 33.4% devaluation of the AZN against the US\$. Since start of 2014 only Russia and Ukraine experienced greater devaluations than Azerbaijan among the country's immediate neighbors, while Georgia and Turkey, at 31.8% and 15.4%, respectively, experienced milder weakenings. We believe that falling central bank (CBAR) reserves were the main reason for the immediate radical devaluation. We also believe that the devaluation will pose short-term challenges, but will lead to benefits in the medium to long term by saving international reserves at both the Central Bank and in the State Oil Fund of Azerbaijan Republic (SOFAZ). It is probable that demand for US\$ surged right after the devaluation in the ensuing panic. However, we believe that eventually the policy will help to balance the budget, precluding the need to tap international debt markets.

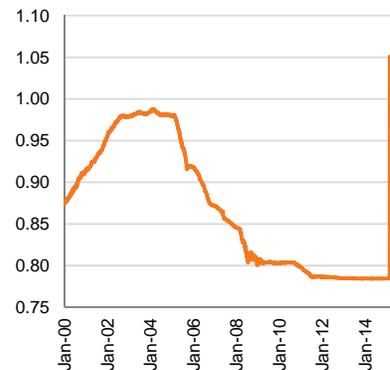
End of a stable currency?

For 20 years, Azerbaijan pursued a fixed exchange rate policy with the AZN, the local currency, which was pegged to the US\$ or a US\$-EUR basket. Thanks to massive oil revenues, the CBAR was able to retain this policy and increase its reserves, which passed US\$ 15bn in mid-2014. During this period, the US\$/AZN rate ranged between 0.7712 and 0.9878, with an overall tendency towards appreciation of the local currency. Oil revenues meant that foreign exchange inflows remained strong, feeding not only CBAR reserves, but also reserves at the SOFAZ, boosting budget revenues and expenditure and improving living standards.

Collapsing oil prices and steadily declining output strained CBAR's exchange-rate policy. Elevated public expenditure and falling revenues meant that Azerbaijan faced its first budget deficit of the decade (double digits), tapped SOFAZ reserves for the first time, and resorted to international debt markets. Declining CBAR reserves, which fell by US\$ 2.5bn in December 2014-January 2015, was the first major indicator of looming problems. Retaining the same policies would have risked eating reserves and been unsustainable in the medium to long term if low oil prices persisted.

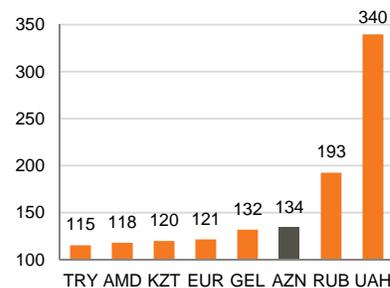
International reserves – one of the most important pillars of stability for Azerbaijan in the medium to long run. SOFAZ's reserves increased by US\$ 1.2 bn to US\$ 37.1bn in 2014. Along with CBAR's US\$ 13.8bn reserves at the end of 2014, consolidated international reserves equaled 67.7% of GDP, making them one of the main factors guaranteeing Azerbaijan's investment grade rating. The previous exchange rate presented the risk of SOFAZ losing US\$ 6.0bn in 2015, along with a fall in CBAR reserves. We estimate that with the devalued AZN, reserves will decline by just US\$ 2.4bn in 2015 and last longer, supporting both Azerbaijan's ratings and fiscal policy in the longer time span.

Figure 1: US\$/AZN Exchange rate, daily



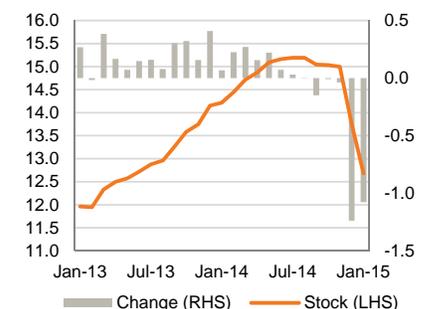
Source: CBAR

Figure 2: Regional currencies to US\$, Dec 30, 2014 = 100



Source: Bloomberg

Figure 3: CBAR reserves, US\$ bn



Source: CBAR

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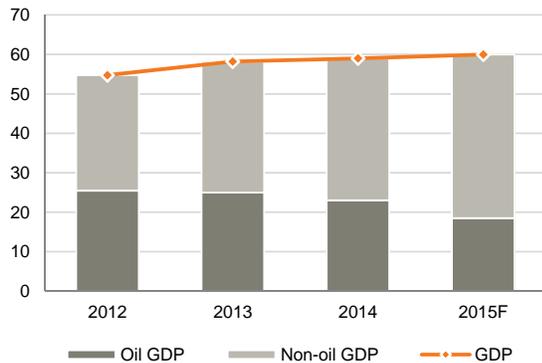


Currency volatility – shock at first, good overall

CBAR opts for radical devaluation on 21 February. Following a cumulative devaluation of 0.23% over the preceding week, the bank surprised markets by slashing rates by 33.6% on 21 February. At 1.05 AZN per US\$, that day, the AZN rate was at its weakest ever against the US\$, surpassing the previous low of 0.9878 of February 2004. Another CBAR decision was switching from a US\$ peg to a US\$-EUR basket (the exact composition was not announced). We estimate that the step-by-step process resulted in CBAR losing reserves of US\$1-2bn, forcing the bank into radical action.

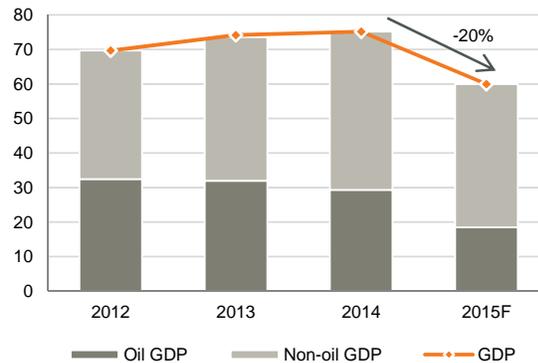
Long-term solutions may require short-term sacrifices. Devaluation is likely to have a serious impact on Azerbaijan’s economy, hurting it in the short term but, subject to other necessary policies, benefitting it in the long term. We estimate that real economic growth will fall to 1.1% in 2015 (non-oil to 2.4%), down from our previous estimate of 2.4% (non-oil 6.3%), due to falling real investments. Falling oil prices will result in negative deflator that will eat up nominal GDP to the tune of 20.2% y/y in US\$ terms in 2015. GDP per capita should also decline, from US\$ 7,986 to around US\$ 6,244, while external debt to GDP is set to increase, albeit marginally, due to the low base. Companies that borrowed in US\$ will face serious challenges servicing debt, including the International Bank of Azerbaijan (IBAR) and State Oil Company of Azerbaijan Republic (SOCAR), which issued Eurobonds recently. However, as both these and other entities are state-owned, and with the state’s balance sheet looking healthy, these companies should have no problems servicing their debt.

Figure 4: Nominal GDP, AZN bn



Source: AzSTAT, G&T Research

Figure 5: Nominal GDP, US\$ bn



Source: AzSTAT, G&T Research

Budget revenues: almost 100% execution? In the short term, the budget and SOFAZ stand to be the main beneficiaries. Various calculations indicate that the oil sector, which generates hard-currency revenues, accounts for approximately 70% of consolidated budget revenues. Expenditures, meanwhile, are in the local currency. With the new rates, we estimate that consolidated budget revenues for 2015 will be AZN 20.2bn (US\$ 20.2bn), up from our previous estimate of AZN 16.6bn (US\$ 21.3bn), representing a 20.8% increase in nominal AZN terms and almost matching the AZN 20.7bn projected in the official budget.

Expenditures in AZN terms may be higher than in 2014, though 16.8% lower in US\$ terms. In line with the general tendency of previous years, we expect consolidated government expenditures to come slightly below the budgeted figure in AZN terms. While it will be challenging with the new exchange rate, it can be achieved



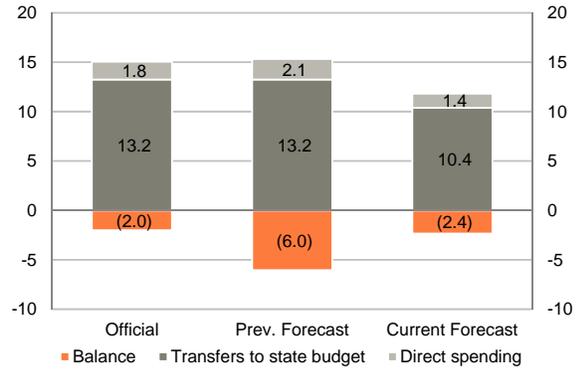
by cancelling some minor projects and improving efficiency of ongoing ones. In US\$ terms, we expect expenditures to fall by 16.8% y/y to US\$ 22.6bn in 2015 compared with US\$ 27.2bn in 2014 (AZN 22.6bn in 2015 compared to AZN 21.3bn in 2014).

Figure 6: Budget scenarios, 2015, US\$ bn



Source: Ministry of Finance, G&T Research

Figure 7: SOFAZ budget scenarios, 2015, US\$ bn



Source: AzSTAT, G&T Research

Budget deficit to come down from an estimated 14.2% to 4.0%. As demonstrated above, devaluation should boost revenue while expenditure remains stable. As a result, the budget deficit should be below the government's expected AZN 5.2bn (US\$ 6.6bn) and far below our previous estimate of AZN 7.4bn (US\$ 9.5bn). With new exchange rate we expect US\$ 2.4bn deficit in 2015, corresponding to 4.0% of GDP (compared to more than 14% in our previous report). The new deficit will be covered easily by tapping SOFAZ reserves. As a result, there will be no need to resort to international debt markets, which would have cost far more in these turbulent times.

SOFAZ reserves to fall marginally. We expect the government financing its deficit fully by tapping SOFAZ reserves, which are likely to fall by just US\$ 2.4bn in 2015 compared to our previous estimate of a US\$ 6.0bn fall.



Table 1: Budget parameters, 2009 versus 2015, US\$ bn

	2008	2009 oil price drop	2013	2014	2015E budgeted	2015E prev. est.	2015E estimate
AZN exchange rate	0.822	0.804	0.785	0.785	0.785	0.785	1.000
Oil price, US\$/bbl	97.0	61.8	104.1	100.0	90.0	60.0	60.0
Consolidated budget							
Revenue	23.6	17.9	29.2	29.4	26.4	21.3	20.2
Oil revenue	18.7	12.4	21.0	19.8	16.0	11.0	11.6
Oil taxes	4.3	2.2	3.7	3.6	2.9	1.7	2.1
SOFAZ revenue	14.4	10.2	17.3	16.2	13.1	9.3	9.5
Non-oil revenue	4.9	5.5	8.2	9.6	10.4	10.3	8.6
Expenditure	14.4	15.0	27.9	27.2	33.0	30.8	22.6
Budget balance	9.2	2.9	1.4	2.2	-6.6	-9.5	-2.4
State budget							
Revenue	13.1	13.1	24.8	23.5	24.8	23.2	19.1
Taxes	6.9	5.1	8.5	9.1	9.1	7.9	7.2
Oil taxes	4.3	2.2	3.7	3.6	2.9	1.7	2.1
Non-oil taxes	2.7	2.9	4.8	5.5	6.1	6.2	5.0
Customs duties	1.4	1.4	1.8	1.9	2.0	2.1	1.2
SOFAZ transfers	4.6	6.1	14.5	11.9	13.2	13.2	10.4
Others	0.2	0.5	0.1	0.6	0.4	0.0	0.3
Expenditures	13.1	13.1	24.4	24.2	26.9	24.6	17.7
Current expenditure	6.3	5.6	12.3	13.9	14.0	12.2	11.0
Capital expenditure	6.7	7.2	11.1	9.4	11.9	11.5	6.0
Debt service	0.1	0.2	0.9	0.9	1.0	0.9	0.7
Non-state budget revenue							
SOFAZ revenue	14.4	10.2	17.3	16.2	13.1	9.3	9.5
Others	0.7	0.7	1.5	1.6	1.8	2.0	2.0
SOFAZ							
Revenue	14.4	10.2	17.3	16.2	13.1	9.3	9.5
Expenditure	6.0	6.6	15.7	12.9	15.1	15.3	11.8
Transfers to state budget	4.6	6.1	14.5	11.9	13.2	13.2	10.4
Other expenditure	1.4	0.5	1.2	1.0	1.8	2.1	1.4
Budget balance	8.4	3.6	1.7	3.3	-2.0	-6.0	-2.4
Reserves	11.2	14.9	35.9	37.1	-	31.1	34.8
Central Bank reserves	6.5	5.4	14.2	13.8			

Source: AzSTAT, Ministry of Finance, SOFAZ, Central Bank, G&T Research

Note: Non-state budget revenue includes SOFAZ, Social protection Fund, Nakhchivan



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