GALT & TAGGART RESEARCH

Azerbaijan Economy
Sailing Uncharted Waters

Azerbaijan | Economy
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Falling oil prices challenged Azerbaijan's growth model in 2015, which had been heavily oil revenue-financed, particularly through construction and trade in non-oil sectors. A strong local currency, again supported by oil-related inflows, had been another characteristic of the economy, contributing to banking sector stability, low dollarization, and improved welfare. These "givens" were shattered in 2015, forcing Azerbaijan to enter the uncharted territories of low oil prices, low public expenditure, currency fluctuations, and monetary tightening. As a result, growth slowed to 1.1% in 2015 and contracted 3.3% y/y in January 2016. With these challenges, Azerbaijan's growth prospects have worsened, necessitating a new growth model. We believe that the massive capital expenditure seen in previous years has created spare capacity, but it is probably underutilized. Utilizing this capacity, particularly through foreign participation, may be one of the sources of growth.

Non-oil GDP growth rate falls to 1.1% in 2015

The Azerbaijani economy grew 1.1% in real terms in 2015 – the lowest level since 2011. Unlike previous years, oil and gas GDP increased more than non-oil GDP, with the latter posting 1.1% growth – the lowest level since records of non-oil GDP began in 2000. This weak non-oil performance was mainly due to the 13.4% contraction in the construction sector and the 1.7% decline in transport and storage. Trade activity continued to feed growth, along with manufacturing and the rebound in agriculture.

Construction and trade the main drivers of growth until 2015

From 2010 to 2014, Azerbaijan's growth was mainly driven by non-oil GDP, while oil GDP contracted by 2.9% per annum on average. The data indicate that non-oil GDP growth was fed by the booming construction and trade activity. Over the five years to 2014, non-oil GDP grew by a strong 8.8% per annum. Our calculations indicate that 37.1% of this growth was driven by construction, with average annual growth of 18.2% over the five years. However, infrastructure improvements that resulted from this construction boom were probably not fully utilized, as the oil sector dominated revenue generation. Trade activity contributed another 10.0%. Together, trade and construction sectors accounted for almost half of the non-oil GDP growth from 2010 to 2014.

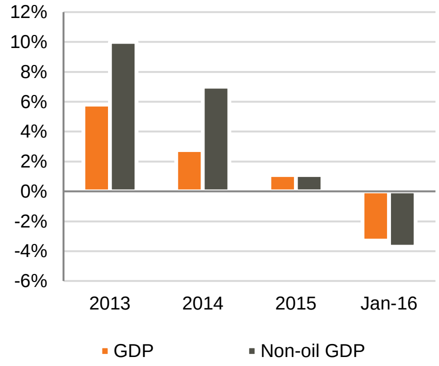
Public investment the main source of finance

Based on this information, we can conclude that construction was at the center of Azerbaijan's growth model from 2010–2014. These five boom years in the sector have probably improved the country's infrastructure, which had been in considerable disrepair since the early 1990s. However, the investment data indicate that most of this construction (72.6%) was financed from the public purse, which itself was 70% funded by oil revenues.

Cuts to public investments affect construction

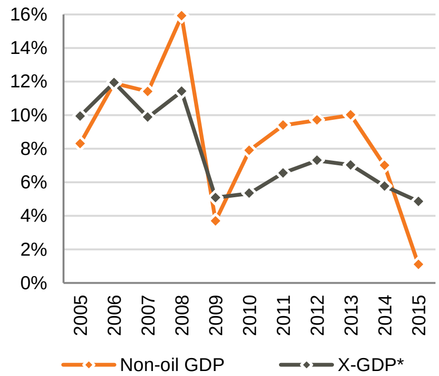
Following the collapse of the oil price, the Azerbaijani government slashed its expenditure, particularly capital investments. The construction sector, which had continued to boom until mid-2015, suddenly ran out of new projects, eventually finishing 2015 with a 13.4% contraction. Other sectors have been much less affected and have generally been less volatile. Excluding mining and construction, the GDP growth rate in 2015 was 4.9%, down from 5.8% in 2014.

Figure 1: GDP growth rate, y/y % change



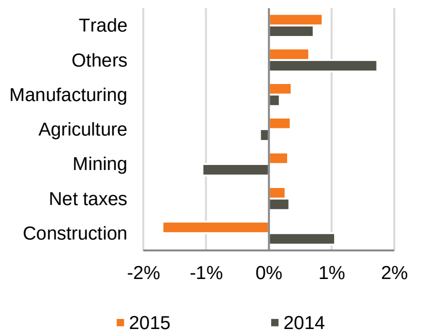
Source: AzSTAT

Figure 2: Growth decomposition



Source: AzSTAT
**GDP excluding mining and construction*

Figure 3: Contributions to growth



Source: AzSTAT

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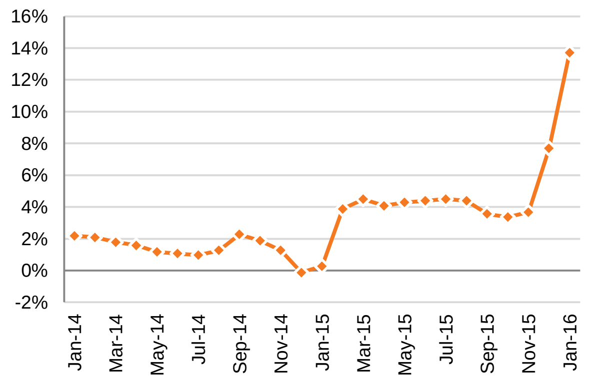
Trade growth steady in 2015. It appears that following the first AZN devaluation in February 2015, people rushed to exchange their devalued currency for goods whose prices were relatively stable, as long as shops and distributors were tapping their stocks. However, anecdotal evidence suggests that activity declined following the second AZN devaluation in December 2015 as stocks were almost depleted. Prices therefore increased relatively quickly, with the annual inflation rate jumping from 3.7% in November 2015 to 7.7% in December 2015 and 13.7% in January 2016. According to the latest data, trade activity slowed to 4.3% y/y in 1M16, down from 10.9% y/y in 2015.

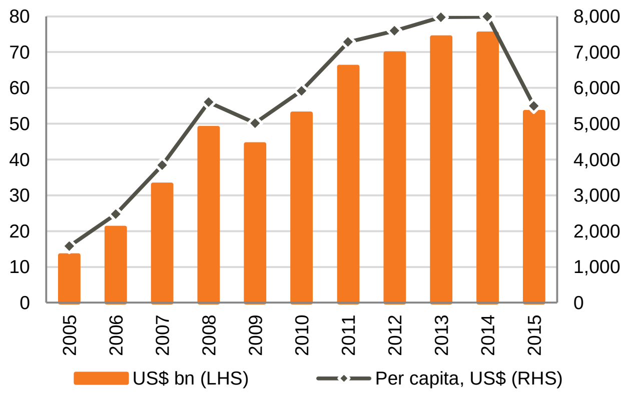
Two devaluations resulted in a 29.2% fall in nominal GDP in US$ terms. In 2015, Azerbaijan underwent two devaluations, which resulted in the AZN losing 49.4% of its value against the US$. As a result, GDP in nominal US$ terms shrank 29.2% to US$ 53.3mn in 2015, and GDP per capita contracted 31.3% to US$ 5,493 – its pre-2010 level. However, on the fiscal side, devaluation helped the public finances by inflating oil revenues.

Figure 4: CPI inflation, y/y



Source: AzSTAT

Figure 5: GDP and GDP per capita



Source: AzSTAT

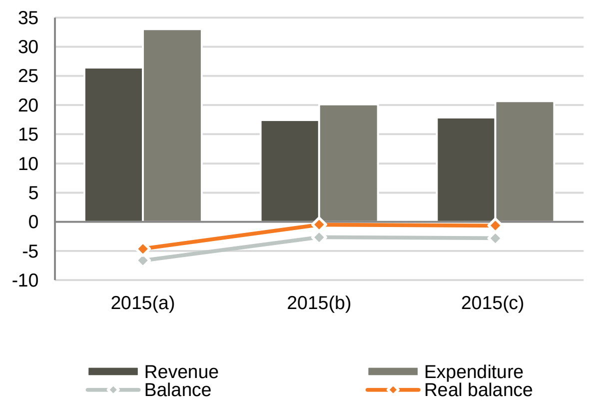
Budget

Falling oil prices and the associated devaluation pushed Azerbaijani authorities to make early amendments to the 2016 budget. Unlike the first (February 2015) devaluation, the December 2015 devaluation resulted in immediate inflationary pressure. To account for the price hike and revenue shortfall, the government announced its intention to amend the budget. An amended version was passed through the legislature on February 23, 2016.

Oil price assumption in the revised budget set at US$ 25.0/bbl. The government showed caution by factoring in an oil price of US$ 25.0/bbl compared to US$ 50.0/bbl in the original budget document and the YTD average of US$ 32.4/bbl. However, the current exchange rate might not be sustainable at US$ 25.0/bbl, as it could lead to a current account deficit. As such, we think that budget revenues in AZN terms are extremely conservative, as they will likely be inflated by either a higher oil price or a further depreciated/devalued AZN.

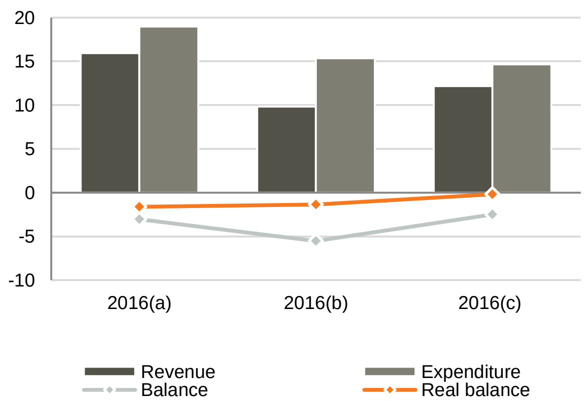
Consolidated budget deficit likely to be lower than official forecasts and fully financed by drawdowns from SOFAZ reserves. According to the revised budget, the consolidated budget deficit is expected to reach AZN 8.8bn (10-14% of GDP), corresponding to US$ 5.5bn at the current exchange rate. We estimate that approximately AZN 6.4bn of this deficit will be financed through drawdowns from SOFAZ reserves. However, we expect the budget deficit to be lower than forecast and fully financed without resorting to debt instruments.

Figure 6: 2015 consolidated budget, AZN bn



Source: Ministry of Finance
Real balance: balance after accounting for SOFAZ withdrawals
(a) - Initial 2015 budget
(b) - Officially expected 2015 budget
(c) – Actual 2015

Figure 7: 2016 consolidated budget balance, AZN bn



Source: Ministry of Finance, G&T Research
Real balance: balance after accounting for SOFAZ withdrawals
(a) - Initial 2016 budget
(b) - Revised 2016 budget
(c) – G&T Research estimates

US$ 35.0/bbl oil price suggests consolidated budget deficit slightly below AZN 4.0bn. Our calculations, based on an oil price of US$ 35.0/bbl, suggest that actual revenues will be 23.5% higher than forecast in the official budget. On the expenditure side, the government has a track record of under execution. However, this year's budget will most likely be fully executed given the significant cuts already made. Combined with higher revenue, we expect this to result in a considerably lower consolidated budget deficit of AZN 4.0bn (6.5% of GDP).

Conclusion

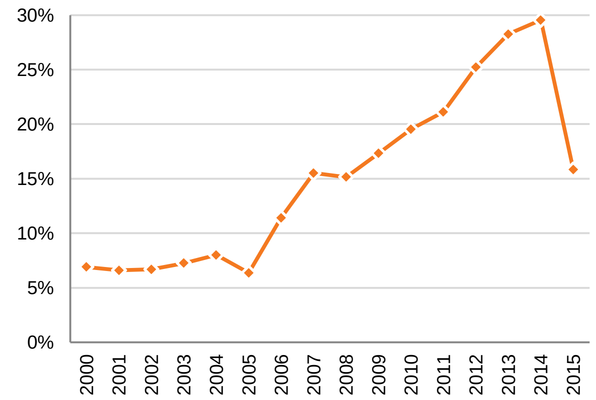
Azerbaijan entering uncharted territories of low oil prices and low fiscal expenditure. Fiscal sustainability in the low oil price environment requires budget adjustments. This was acknowledged by the government in its revised budget. Consolidated budget expenditure in US$ terms has fallen from US$ 27.9bn in 2013 to US$ 20.7bn in 2015 and is budgeted at US$ 14.6bn for 2016. Capital expenditure has been hit particularly hard, down from over AZN 8.0bn (above US$ 10.0bn) in previous years to AZN 4.6bn (US$ 2.9bn) in 2016.

Growth to suffer. GDP growth has already been hurt by cuts to capital investments in 2015, particularly in construction. This trend will continue in 2016 and will likely persist in the years to come, dragging down the overall growth rate, which is forecast to remain in the low single digits. At the same time, monetary tightening (M2 down from 29.5% of GDP in 2014 to 15.8% of GDP in 2015) undermines any prospect of investment financing from the domestic banking sector, leaving foreign investment as the best alternative for growth financing.

Efficient utilization of idle capacity an important source of growth. Massive capital expenditure in previous years, particularly investment in infrastructure, has probably expanded Azerbaijan's potential economic output. However, the booming oil sector has been relegating this potential to second place. The Azerbaijani authorities now need to develop policies to utilize this capacity, particularly by attracting foreign investment and know-how. This could be achieved by welcoming foreign banks. Through competition and by bringing in foreign capital, these banks can take financial intermediation to a new level that will assure the efficient utilization of investments. Foreign banking finance is particularly promising given that at 24.5% of GDP, corporate loans in Azerbaijan are low by international standards, thus there is scope for expansion.

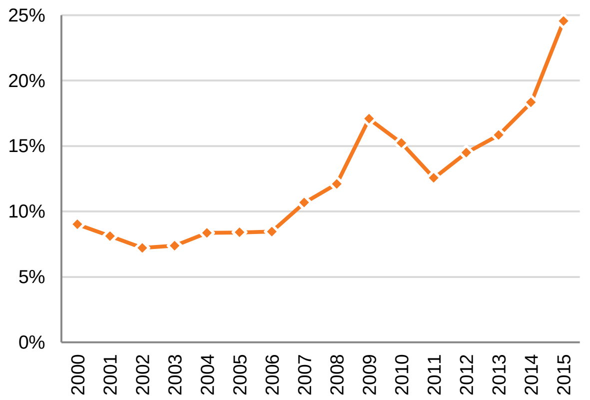
Growth expectations may improve once business environment is reformed. Idle capacity can be complemented by FDI to generate new growth, instead of relying on the publicly financed construction sector.

Figure 8: M2, % of GDP



Source: CBAR, AzSTAT

Figure 9: Non-household loans, % of GDP



Source: CBAR, AzSTAT

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