GALT & TAGGART RESEARCH

Azerbaijan Economy
Act to Attract

Azerbaijan | Economy
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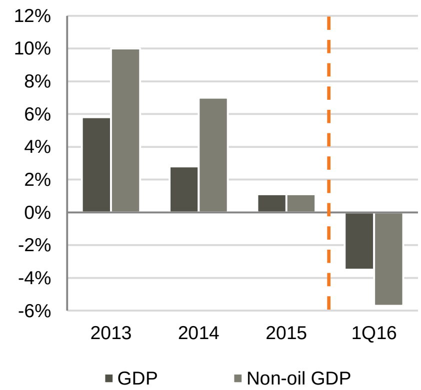
Azerbaijan's economy contracted by 3.5% y/y in 1Q16, sending the country into a technical recession. Economic activity fell due to a 5.7% y/y decline in the non-oil sectors, with construction being the main drag. While the dip has likely now passed, as the contraction slowed compared to 4Q15, the vague prospects for the rest of the year and the need to keep fiscal policy conservative are likely to constrain growth. We believe that the currently conservative fiscal stance and stable monetary policy are necessary and reduce the chance of another devaluation. Challenges remain, with reforms introduced in 2015 having failed to yield tangible results so far, thus hindering private sector investment. Bank loans fell despite FX liquidity increasing; this was one of the likely embodiments of the 'wait and see' approach being adopted by businesses. As a result, banks are beefing up their foreign assets rather than financing domestic growth. We believe that this issue can be addressed by speeding up reforms that yield tangible results and prioritizing policies to attract foreign financial entities to Azerbaijan, thus increasing financing and improving competitiveness.

Growth to return later in the year. The construction and transportation sectors declined a respective 32.5% y/y and 14.5% y/y, bringing Azerbaijan's GDP down 3.5% y/y in 1Q16. There were positive contributions from trade (up 3.4% y/y) and manufacturing (up 5.7% y/y). Oil and gas extraction picked up, boosting oil GDP slightly (+0.8% y/y), while non-oil GDP contracted 5.7% y/y. We expect another significant contraction in 2Q16, followed by relatively flat performances in the last two quarters of 2016 as the high base factor subsides.

Conservative fiscal policy has led to a surplus in the consolidated budget in 1Q16. Public investment used to be the main driver of non-oil growth in Azerbaijan, particularly through construction. As falling oil prices ate into budget revenues, authorities slashed public capex. With capex down 57.4% y/y and social spending up slightly (3.3% y/y) in the state budget, consolidated budget expenditures declined 32.6% y/y to AZN 3.3bn in 1Q16. Meanwhile, revenues increased 2.4% y/y to AZN 4.5bn, resulting in a consolidated budget surplus of AZN 1.1bn in 1Q16, corresponding to 8.9% of GDP (as compared to the 1Q15 deficit of AZN 0.6bn or 5.2% of GDP). As non-oil revenues increased (+18.0% y/y to AZN 2.1bn) and oil revenues declined (-8.4% y/y), the non-oil consolidated budget deficit narrowed from 41.4% of non-oil GDP in 1Q15 to 14.9% in 1Q16.

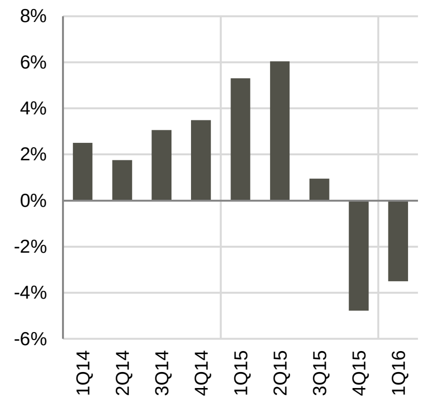
While the current conservative fiscal policy is easing pressure on the AZN, liquidity injections by the central bank are raising questions. For example, the CBAR's claims on commercial banks (aka liquidity injections) increased by AZN 3.9bn in 2015 (to 3.6x the 2014 level) and by another AZN 1.1bn in 1Q16. We believe that this 'quantitative easing' was one of the factors pressuring the AZN and leading to its devaluation in December 2015. The new money was apparently converted to FX and sent abroad as M2 continued to fall and capital outflows surpassed US$ 10.0bn in 2015. However, M2 increased 11.8% from its January 2016 lows to AZN 8.9bn in March 2016, lending some support to the view that the current exchange rate might be at a balancing level. Acquisitions of FX at auctions organized by the CBAR have slowed since late March, though any further local currency injections may reinvigorate pressure on the AZN.

Figure 1: GDP growth rate, y/y



Source: AzSTAT

Figure 2: Quarterly GDP growth, y/y



Source: Galt & Taggart Research
Note: Quarterly figures are calculated based on YTD data

Table 1: Consolidated budget, AZN bn

	1Q15	1Q16
Revenue	**4.4**	**4.5**
Oil	2.6	2.4
Non-oil	1.8	2.1
Expenditure	**5.0**	**3.3**
Balance	**-0.6**	**1.1**
Non-oil balance	-3.2	-1.2
Balance, % of GDP	-5.2%	8.9%
Non-oil balance, % of non-oil GDP	-41.4%	-14.9%

Source: Ministry of Finance, AzSTAT, Galt & Taggart Research

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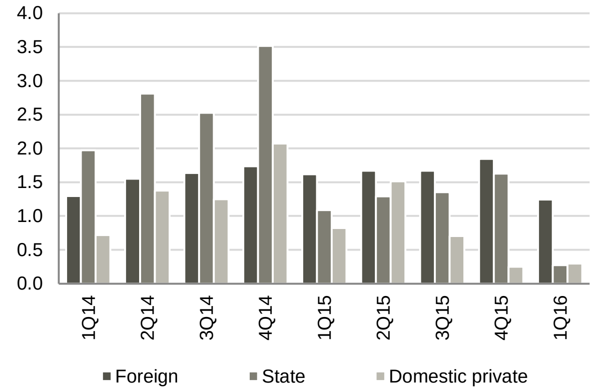
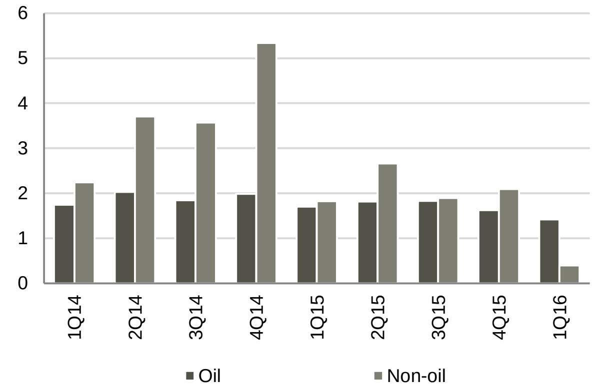
The private sector has followed the public sector's lead in cutting investment, causing the economy to contract. The need to improve infrastructure and available oil revenues resulted in the following growth model in Azerbaijan in the previous years: financing (investment) was provided by the state, while the private sector implemented projects (acting as a client). However, as oil prices collapsed, the model became unsustainable. Preference shifted to long-term fiscal sustainability, which meant cutting public expenditure. Ideally, the falling public investment should have been offset by increasing private sector investment to retain growth momentum. However, relevant data suggest that this did not happen. Public investment in AZN terms contracted by 55.2% y/y, with the domestic private sector following suit, cutting investment by 41.6% y/y in 1Q16 and further hampering growth. Meanwhile, foreign investment, which was directed mainly towards the oil sector, remained robust.

Figure 3: Gross investment by source, US$ bn



Source: AzSTAT

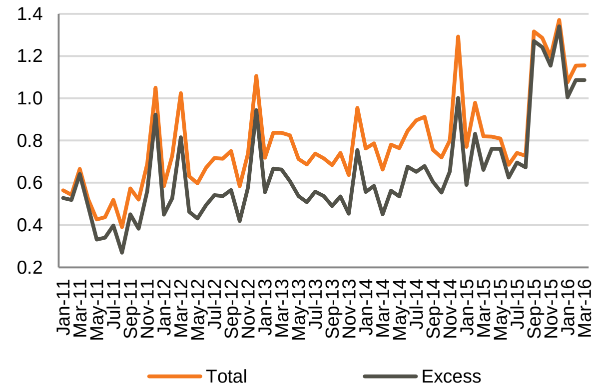
Figure 4: Gross investment by sector, US$ bn



Source: AzSTAT

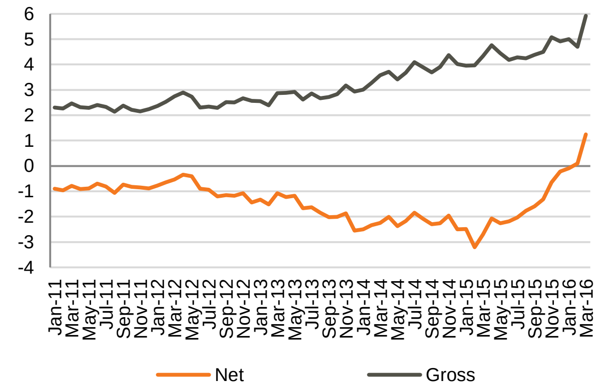
Exchange rate concerns and slowly moving reforms are probably the key factors hindering investment. Banking sector data show that banks' liability structures are skewed towards FX. For example, as of March 2016, the dollarization ratio was hovering above 80%, up from around 50% prior to 2015, indicating a severe lack of AZN liquidity. In the absence of promising prospects, the private sector is unwilling to take on exchange risk by borrowing in FX and investing in AZN. Meanwhile, banks lack local currency liquidity. Commercial banks are, therefore, acquiring foreign assets and increasing their excess reserves with the CBAR, which is indicative of the situation.

Figure 5: Commercial banks' reserves with CBAR, US$ bn



Source: CBAR

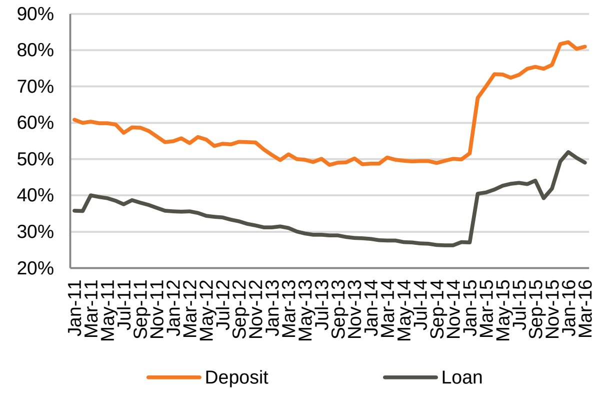
Figure 6: Banks' foreign assets, US$ bn



Source: CBAR

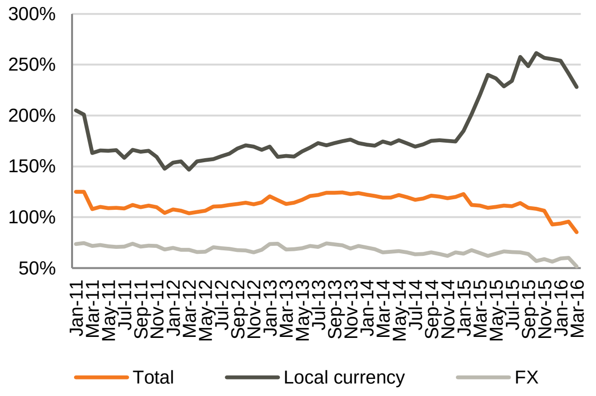
Banking sector health, already hit by two devaluations in 2015, further complicates domestic financing. Leaving aside the issues relating to commercial banks' foreign obligations (for which there are no detailed aggregate data), banks have taken on significant exchange risk (as measured by the loan/deposit ratio). The overall loan/deposit ratio was 85.1% in March 2016, down from 120.0% in late 2014. However, the ratio of AZN loans to AZN deposits was above 220.0%, down slightly from over 250.0% in mid-2015, but well above the 174.4% seen in late 2014. Conversely, the ratio of FX loans to deposits was 51.6% in March 2016, down from 65.3% in late 2014.

Figure 7: Dollarization ratio



Source: CBAR

Figure 8: Loan/deposit ratio



Source: CBAR

Conclusion

Latest data roughly explain Azerbaijan's economic woes. The high base from the previous year – GDP expanded 5.7% y/y in 1H15 and non-oil GDP was up 9.2% y/y – was one issue. However, there are other challenges relating to the current situation and future prospects. High dollarization in the economy suggests that households and businesses are taking a 'wait and see' approach. One reason may be that reforms have not yet produced tangible results and both households and enterprises are opting to retain FX, even in an environment of high returns on AZN state debt instruments and higher interest rates on AZN deposits (covered by insurance). Another challenge is that even if dollarization falls, problems in the banking system will probably continue to limit the financing options available. Thus, we remain of the opinion that policies to attract foreign financial entities to Azerbaijan should take priority. As soon as prospects brighten, businesses will need financing, which could easily be provided by healthy foreign banks. Moreover, the increased competition would cut financing costs.

Private as opposed to public investment should take priority. Long-term fiscal sustainability is necessary to improve Azerbaijan's credit rating – an achievable goal if reserves continue to be saved rather than spent. Furthermore, it is widely accepted that private investment is far more efficient in feeding growth. Thus, Azerbaijan's growth should be shaped by competitive private sector investment and financing should be channeled through commercial banks, FDI, bonds, etc. This would help save Azerbaijan's precious reserves (thus bolstering its country rating), improve its investment efficiency, and, eventually, fuel growth.

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