Azerbaijan Economy

Better Later Than Never

Azerbaijan | Economy
December 23, 2015

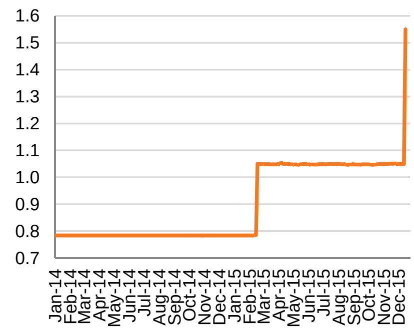
Azerbaijan has become the latest oil-rich country in the region to abandon the exchange rate peg and adopt a floating regime. This has been followed by an immediate appreciation of the US$ from 1.05 to 1.55 (+47.6%). We believe that the move was necessary to address Azerbaijan's external imbalance and save its reserves in light of the continued fall in oil prices. The devaluation will have some unavoidable disruptive impact in the short term. In the medium to long run, however, the move will benefit the Azerbaijani economy as the floating exchange rate will act as an automatic stabilizer against external shocks, subject to necessary structural reforms. The alternative would have been to exhaust the reserves, which would have resulted in an even harsher shock, with associated panic capital outflows and possible rating downgrades. So, better later than never.

On December 21, 2015, Azerbaijan moved from an exchange rate peg to a floating exchange rate regime. This resulted in the AZN falling approximately 32.3% against the US$. The official AZN/US$ exchange rate on Monday, December 21 was 1.55 compared to 1.05 on Friday, December 19. According to a statement from the Central Bank of Azerbaijan (CBAR), the move was needed to save the central bank's reserves, which fell from US$ 15.2bn in mid-2014 to US$ 6.2bn by the end of November 2015. The devaluation was triggered by the continued fall in the oil price – Azerbaijan's main export commodity (94.2% of total exports in 2014). According to news reports, reserves declined a further US$ 0.7bn in the first half of December 2015, falling below US$ 5.5bn.

We believe that the move was justified and will safeguard the CBAR's reserves. While the previous (late February) devaluation of 34% eased the pressure on reserves, it failed to alleviate it fully, with the CBAR losing an additional US$ 6.4bn of reserves through interventions to defend the AZN peg. However, the State Oil Fund of Azerbaijan (SOFAZ) benefited from the previous devaluation – its budgeted expenditure in US$ terms fell from US$ 15.7bn to US$ 11.7bn, saving US$ 3.4bn of FX reserves.

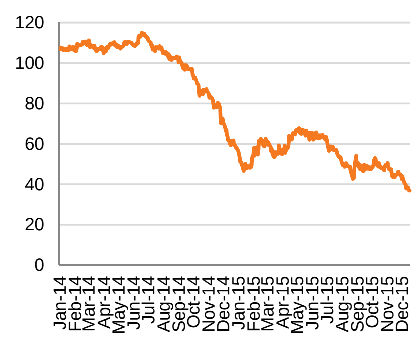
Challenges to debt servicing are manageable. Devaluation is likely to reduce real income as inflation is likely to increase and employment may fall. It is also expected to have a negative impact on corporate and individual FX borrowers whose income is in AZN. Based on available data, Azerbaijani entities have a total of US$ 4.3bn in outstanding Eurobonds (government: US$ 1.3bn; the State Oil Company of Azerbaijan (SOCAR): US$ 2.3bn; and the International Bank of Azerbaijan (IBAR): US$ 0.8bn). The government's strong external position – with SOFAZ reserves at US$ 34.7bn in 3Q15, SOCAR's continued FX revenue stream, and the government's backing of the IBAR – should provide sufficient cushioning against FX risk. Several smaller banks with unhedged external obligations will naturally face challenges.

Figure 1: AZN/US$ exchange rate



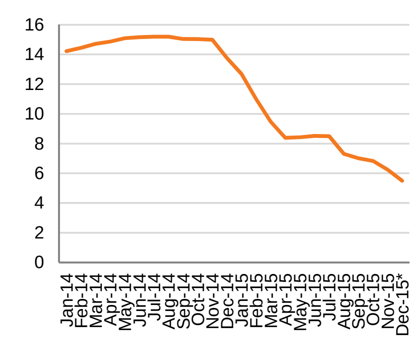
Source: CBAR

Figure 2: Brent oil price, US$/bbl



Source: Bloomberg

Figure 3: CBAR reserves



Source: CBAR
*December 2015 data is based on press sources

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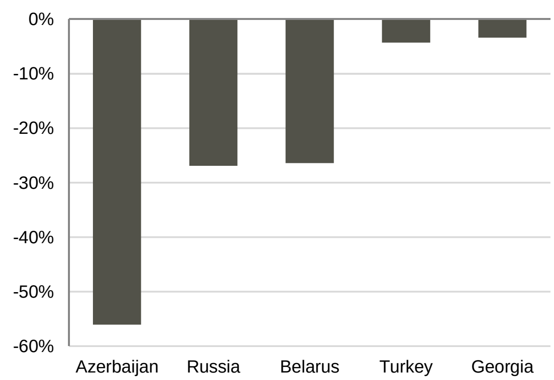
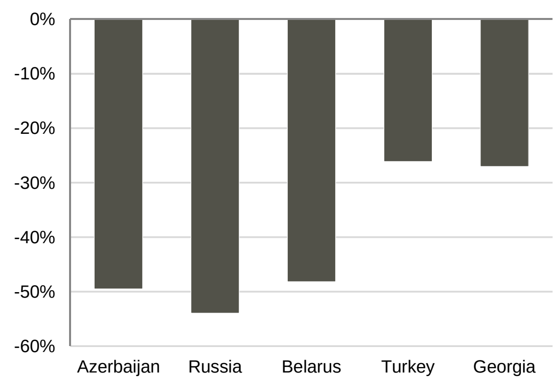
We believe that in the medium to long term, Azerbaijan will benefit from allowing market forces to determine the value of its currency. A floating exchange rate is a natural automatic stabilizer that acts as a shock absorber. This leads to external balancing and saves reserves. Turkey and Georgia are two good examples of successful economies with floating exchange rates. Compared to economies with a fixed exchange rate, the two have been able to preserve their reserves with a minor negative impact on the macroeconomic environment, and have been able to adjust to external pressures quickly with relatively lower depreciation.

Figure 4: Change in reserves, %



Source: Respective central banks
Note: From January 2014 to November 2015

Figure 5: Devaluation/depreciation of local currencies vs US$



Source: Bloomberg, CBAR
Note: US$ per unit of national currency, from January 2014 to December 23, 2015

The devaluation will slash nominal GDP in US$ terms, improving basic ratios. With the new exchange rate, Azerbaijan's economy is expected to contract in nominal terms to US$ 35-40bn in 2016, down from US$ 75.2bn in 2014. As a result, while public and publicly guaranteed external debt to GDP ratio will increase from 14.5% in 2014 to around 30% in 2015, SOFAZ reserves to GDP will surge close to 100%, improving the country's external position. Higher revenues in AZN and falling imports will improve the non-oil consolidated budget and non-oil current account balance, further improving the country's external buffers. Subject to structural reforms, with this new base, Azerbaijan will be able to start a new chapter in its economic growth – a chapter based on its non-oil economy and the development of non-oil exports.

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