Euler Hermes Economic Research

Country Report

Azerbaijan

From oil price crisis to banking crisis

General Information

GDP	USD53.0bn (World ranking 78, World Bank 2015)
Population	9.65mn (World ranking 90, World Bank 2015)
Form of state	Republic
Head of state	Ilham ALIYEV (President)
Next elections	2018, presidential

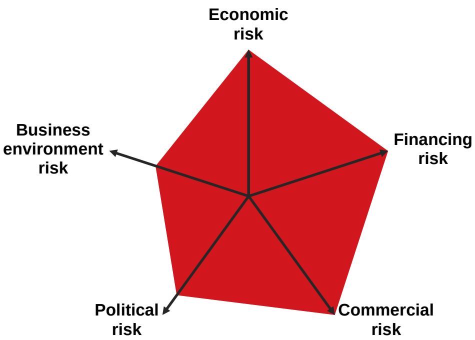
Strengths

- Ample natural resources in the hydrocarbon sector
- Substantial foreign currency assets in the State Oil Fund of Azerbaijan (SOFAZ)

Weaknesses

- High regional political instability
- Relatively poor regional relations, in particular the conflict with Armenia over the Nagorno Karabakh enclave
- Authoritarian political regime
- Weak government effectiveness and slow progress of structural reforms
- Significant corruption and weak protection of property rights
- Huge dependence on oil and gas sector, creating substantial external vulnerability
- Continued exchange rate risk
- Weak banking system; largest bank (IBA; 40% of assets) needs FX debt restructuring in 2017

Country Rating D4



Source: Euler Hermes

Trade Structure

By destination/origin (% of total)

Exports		Rank		Imports
Italy	25%	1	16%	Russian Federation
Germany	13%	2	13%	Turkey
Indonesia	7%	3	9%	United States
France	6%	4	7%	Germany
Czech Republic	5%	5	6%	Italy

By product (% of total)

Exports		Rank		Imports
Petroleum & products thereof	87%	1	13%	Iron and steel
Vegetables and fruits	2%	2	11%	Other industrial machinery & parts
Sugar products and honey	1%	3	6%	Road vehicles
Gas, natural and manufactured	1%	4	6%	Electrical machinery & appliances
Plastics in primary forms	1%	5	6%	Specialised machinery

Source: UnctadStat (2015)

Economic Overview

Vulnerabilities continue to unfold

With ample natural resources in the hydrocarbon sector, Azerbaijan is highly dependent on mineral products – which account for about 34% of GDP, 52% of fiscal revenue and 88% of goods exports. As a result, the economy is very vulnerable to external shocks. The sharp drop in global oil prices in 2014-2015 and marked currency depreciations in competitor countries with regard to foreign trade have been such shocks that have hit hard economic growth, budget revenues, the balance of payments, the manat (AZN, the local currency), foreign exchange (FX) reserves and, recently, the banking sector.

Recession set to extend into 2017

Real GDP growth decelerated from an average annual +13% in 2004-2013 to +2.8% in 2014 and +1.1% in 2015, and shifted to a sharp -3.8% contraction in 2016. Apart from struggling oil output, a -27.6% drop in the construction sector contributed to the slump in 2016.

The recession continued in Q1 2017, with real GDP declining by -0.9% y/y. Notably, the oil-gas sector decreased by -6.8% y/y while non-oil GDP increased moderately by +2.4% y/y. The oil sector is not only challenged by subdued demand and still low prices but also by limited investment and the delayed replacement of aging oil fields. In this context, it is worrisome that Azerbaijan exited from the Extractive Industries Transparency Initiative (EITI; a global transparency initiative to promote the open and accountable management of extractive resources) in March 2017. As a consequence, the EBRD is likely to suspend or withdraw a USD1bn loan intended to support the construction of two gas pipelines from Azerbaijan to Europe.

Overall, we expect the Azeri economy to contract by around -1% in full-year 2017 and to recover to still unimpressive growth of +1% in 2018.

Exchange rate and inflation risks

The slump in oil prices combined with a loss of competitiveness for Azerbaijan (as neighboring countries, notably Russia, depreciated or devalued their currencies) led to downward pressures on the AZN which was long pegged to the USD. In trying to defend the peg, FX reserves of the Central Bank of Azerbaijan (CBA) fell from a peak of USD16.7bn in May 2014 to a low of just USD5.3bn in April 2016. Eventually, the CBA devalued the AZN by -34% in February 2015 and by -48% in December when it also shifted to a floating regime (initially within a corridor, which was abandoned in January 2017). Capital controls were introduced in early 2016.

Following all these moves, the AZN fell to a low of 1:1.92 against the USD in early February 2017 before slightly recovering to 1:1.70 at end-May. However, we expect it to weaken again to about 1:2.00 by end-2017 due to the recent banking crisis and lower than widely expected growth.

The sharp AZN depreciation over the past 2.5 years has driven up inflation to an average 12.4% in 2016 and 12.5% in early 2017 and we expect it to remain in double digits until end-2017, at least.

Banking sector crisis

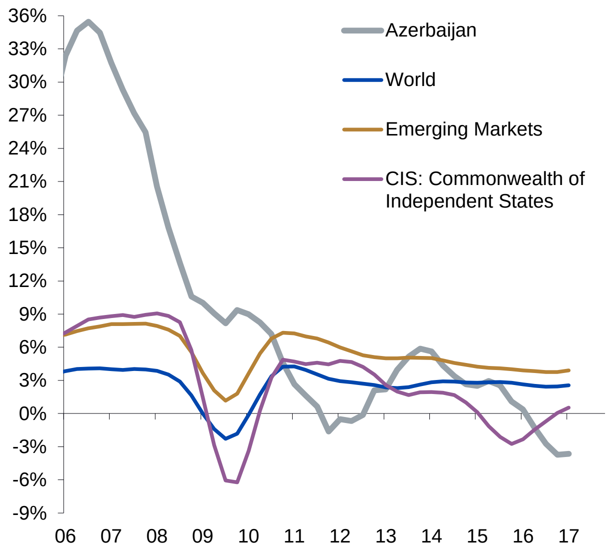
While the AZN devaluation improved overall competitiveness, risks related to the servicing of FX-denominated debt of companies and banks increased substantially. In 2015-2016, the CBA

Key economic forecasts

	2015	2016	2017f	2018f
GDP growth (% change)	1.1	-3.8	-1.0	1.0
Inflation (%, end-year)	7.7	13.3	10.0	7.0
Fiscal balance (% of GDP)	-4.8	-1.4	-16.9	-3.6
Public debt (% of GDP)	28.3	37.7	50.6	52.0
Current account (% of GDP)	-0.4	-3.8	-2.3	-2.2
External debt (% of GDP)	22.1	38.6	53.0	55.0

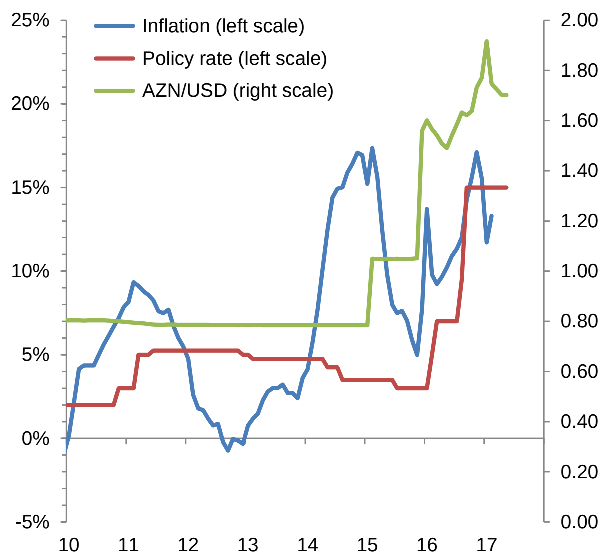
Sources: National statistics, IHS, Euler Hermes

GDP growth (% y/y, 4 qtrs cumulated)



Sources: National statistics, IHS, Euler Hermes

Monetary policy interest rate (%), inflation rate (y/y, %), and exchange rate



Sources: National statistics, IHS, Euler Hermes closed or merged a few small banks. In May 2017, however, the International Bank of Azerbaijan (IBA) – a largely state-owned bank, holding some 40% of total bank assets – presented a restructuring plan for its FX debt, reflecting its huge exposure to FX risk and unsustainable currency mismatch. The plan comprises a maximum 50% haircut on subordinated debt, a maximum 20% haircut on senior debt, and no haircut on trade finance creditors, but with maturity extension. We expect the plan to be agreed by at least 67% of the creditors, the required quota, as it allows 76% of the obligations to avoid formal haircut, and implemented in the course of 2017.

That said, the IBA debt restructuring will likely come at a high cost for the whole banking sector, reducing access to foreign funding and raising funding costs. This will add to existing challenges, including liquidity strains and weak profitability.

Public finances to deteriorate further

As a result of sharply lower oil revenues, the fiscal balance shifted to manageable deficits in 2015 (-4.8% of GDP) and 2016 (-1.4%), after eight years of large surpluses before that, while public debt surged from 11% of GDP in 2014 to 38% in 2016.

The IBA FX debt restructuring will worsen public finances further. Government injections into IBA and new sovereign securities to be issued in exchange for IBA debt could push up the total fiscal shortfall to as much as -17% of GDP in 2017. Assuming that 80% of this deficit will be financed through transfers from the State Oil Fund of Azerbaijan (SOFAZ) and 20% through new debt, and adding all arising contingent liabilities, total public debt could rise to around 51% of GDP (USD17bn) at end-2017.

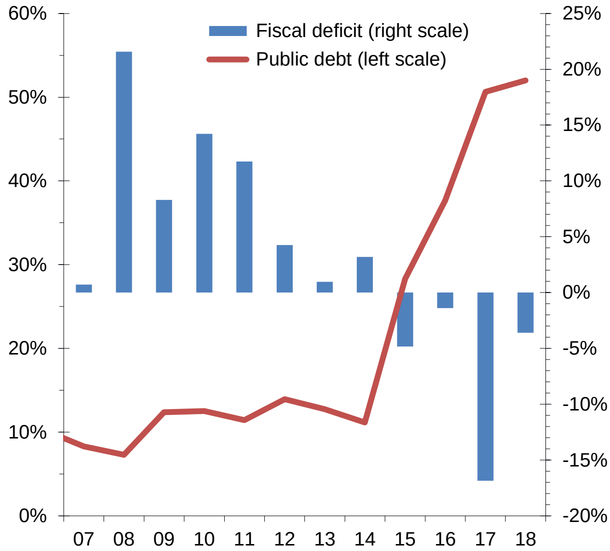
At the same time, SOFAZ assets would decline from USD33bn (98% of GDP) at end-2016 to about USD23bn (68% of GDP) at end-2017. Note that even in this relatively conservative scenario, the sovereign would remain a net creditor this year.

External liquidity weakens but buffers remain

After nine years of double-digit surpluses (in % of GDP) the current account shifted to manageable deficits in 2015 (-0.4% of GDP) and 2016 (-3.8%). We expect the shortfalls to remain controllable in 2016-2017. Meanwhile, gross external debt rose from 16% of GDP in 2014 to 39% in 2016 and is forecast at 53% at end-2017.

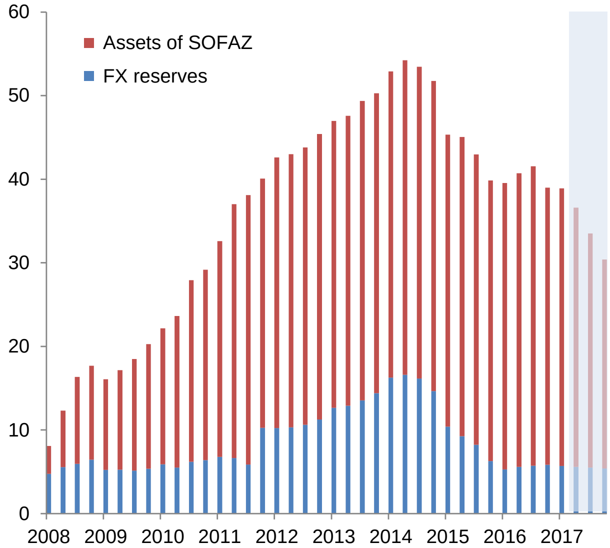
However, combined FX reserves of the CBA and SOFAZ should continue to cover at least 15 months of imports over the next year, even under conservative assumptions, providing a sufficient buffer for standard trade finance.

Public finances (% of GDP)



Sources: National statistics, IHS, Euler Hermes

Foreign exchange reserves (USD bn)



Sources: National statistics, IHS, Euler Hermes

Contact Euler Hermes Economic Research Team

research@eulerhermes.com

Last review: 2017-06-06
Country Risk Analyst:
Manfred Stamer
manfred.stamer@eulerhermes.com