# Country report **AZERBAIJAN**

**Summary**

The economic base of Azerbaijan is very narrow as the country is highly dependent on its energy sector and oil exports in particular. As oil production plateaued in 2011, economic growth was weak at only 0.9%. While new investment will boost oil production this year, a prolonged period of low global oil prices is a significant risk. A large source of concern is the political situation, since a proposal to abolish the two-term presidential limit was approved in 2009, which will allow president Aliyev to run for life. Although this may create more political stability, an even tighter grip on power is expected to be detrimental to the quality of political and governance institutions, which is already low. Public finances and the current account are supported by substantial oil revenues. The external position is very healthy as foreign debt is low at 6% of GDP and the external liquidity ratios are sound.

**Things to watch:**

- Efforts to diversify the economy away from the energy sector
- Volatility of global oil prices
- Increasingly authoritarian regime

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## Azerbaijan

| National facts | | |
|---|---|---|
| Type of government | Republic | |
| Capital | Baku | |
| Surface area (thousand sq km) | 87 | |
| Population (millions) | 9.0 | |
| Main languages | Azeri (90%) | |
| | Dagestani (2%) | |
| Main religions | Muslim (93%) | |
| | Russian Orthodox (3%) | |
| Head of State (president) | Ilham Allyev | |
| Head of Government (prime-minister) | Arthure Rasizade | |
| Monetary unit | New Manat (AZN) | |
| **Economy** | | **2011** |
| *Economic size* | *bn USD* | *% world total* |
| Nominal GDP | 58 | 0.08 |
| Nominal GDP at PPP | 120 | 0.15 |
| Export value of goods and services | 26 | 0.12 |
| IMF quotum (in mln SDR) | 161 | 0.07 |
| *Economic structure* | *2011* | *5-year av.* |
| Real GDP growth | 0.9 | 16.9 |
| Agriculture (% of GDP) | 6 | 6 |
| Industry (% of GDP) | 63 | 67 |
| Services (% of GDP) | 32 | 27 |
| *Standards of living* | *USD* | *% world av.* |
| Nominal GDP per head | 6373 | 59 |
| Nominal GDP per head at PPP | 13180 | 107 |
| Real GDP per head | 3134 | 39 |

| Social and governance indicators | rank / total |
|---|---|
| Human Development Index (rank) | 91 / 187 |
| Ease of doing business (rank) | 66 / 183 |
| Economic freedom index (rank) | 92 / 179 |
| Corruption perceptions index (rank) | 143 / 183 |
| Press freedom index (rank) | 152 / 178 |
| Gini index (income distribution) | 33.71 |
| Population below $1 per day (PPP) | 2% |

| Foreign trade | | | 2011 |
|---|---|---|---|
| *Main export partners (%)* | | *Main import partners (%)* | |
| Italy | 33 | Russia | 18 |
| USA | 9 | Turkey | 12 |
| Israel | 8 | Germany | 10 |
| Russia | 7 | Ukraine | 7 |
| *Main export products (%)* | | | |
| Petroleum products | | | 94 |
| Food products & animals | | | 3 |
| Metals | | | 1 |
| *Main import products (%)* | | | |
| Machinery & equipment | | | 30 |
| Transport equipment | | | 19 |
| Food products | | | 15 |
| Metals | | | 13 |
| *Openness of the economy* | | | |
| Export value of G&S (% of GDP) | | | 44 |
| Import value of G&S (% of GDP) | | | 19 |
| Inward FDI (% of GDP) | | | 1.3 |

Source: EIU, CIA World Factbook, UN, Heritage Foundation, Transparency International, Reporters Without Borders, World Bank.

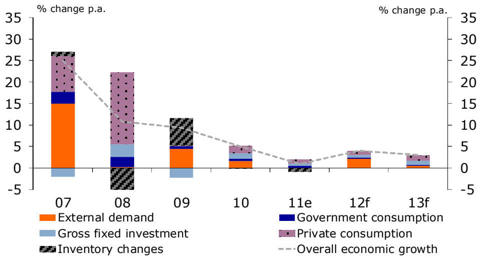
### Economic structure and growth

The Azerbaijani economy is highly dependent on oil revenues from the country's exploited reserves. Oil exports constitute a large 94% of the country’s total exports, although Azerbaijan's oil output is very small in world league terms. The booming inflows of foreign investment into the country were instrumental in facilitating skyrocketing GDP growth. In the boom years of 2005–2007, GDP expansion had averaged 29% and was among the strongest in the world. Per capita income has grown rapidly in the preceding years, from USD 1,570 in 2005 to USD 6,373 in 2011, thereby surpassing per capita income of its direct neighbors, making it the most affluent of the three states in the Caucasus. Income surged as both the production and the prices of hydrocarbons grew rapidly.

An important project for the economic structure and growth of the country was the opening of a new oil export pipeline from the capital Baku to Georgia and Turkey in 2007. With the opening of this new pipeline, Azerbaijan has increased its potential strategic importance as a thoroughfare for the export of Caspian oil and gas, mainly from Kazakhstan and Turkmenistan, through non-Russian networks. In the aftermath of the global financial crisis oil demand decreased worldwide as well as in Azerbaijan’s main export markets, which are Italy, the US and Israel. The economy slowed markedly, as besides external demand, private consumption and government expenditure decreased given the loss in oil revenues.

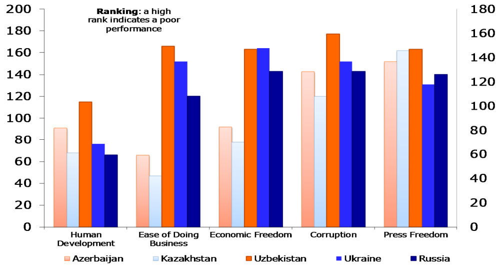
In 2011, the economy is estimated to have grown by a mere 0.9% of GDP as oil production had stalled due to operating difficulties caused by poor maintenance of some major oil refineries. Oil production is expected to resume to normal levels this year as new investments have been planned and rigorous maintenance schemes for the oil installations have finished. The energy sector remains the largest growth driver in Azerbaijan and economic growth is forecasted at 4% in 2012. The banking sector is very small and looks weak, given an average non-performing loan ratio of 10-15% in 2008-2011.

**Figure 1: Growth performance**




Source: EIU

**Figure 2: Social & governance indicators**




Source: UN, Heritage Foundation, Transparency International, Reporters Without Borders, World Bank.

**Political and social situation**

The country is led by President Ilham Aliyev, who succeeded his father in October 2003. Aliyev has a tight grip on the country. There have been presidential elections in 2003 and parliamentary elections in 2005, but the fairness of both is very much in question. In March 2009, a proposal to abolish the two-term presidential limit was approved, which will allow Aliyev to run for life. While the political situation is stable, an even tighter grip on power is expected to be detrimental to the quality of political and governance institutions, which is already low. The sharp slowdown of growth will be a test for Aliyev, as it will make it much more difficult to keep the business elite and the population, both used to rapidly increasing wealth, satisfied. Small-scale anti-government street protests did occur in 2011, but were dealt with swiftly and harshly by the government's security forces. If the economy does not recover and living standards fall, we expect street protests to continue, as the opposition has very limited opportunities to participate in the political system. However, we doubt that these will escalate into massive nationwide anti-government rallies, as the government will continue to crack down hard.

In the international arena, Azerbaijan's strategic importance surpasses its limited size and population. The country not only has substantial reserves of oil and gas, it is also an essential link in any future gas transport routes from Central Asia to Europe that bypasses Russia, such as the Nabucco-pipeline.

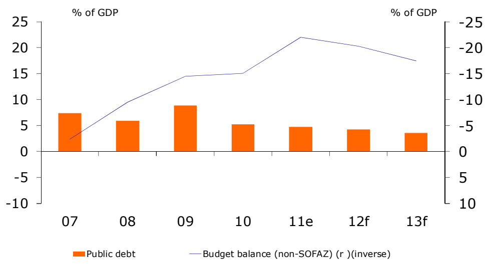
A territorial dispute on the Nagorno-Karabakh continues to create tension between Armenia and Azerbaijan. While Azerbaijan has claimed the territory as its own, it has not exercised power over the Armenian-populated region since 1991. Risks are that this dispute will escalate, as Azerbaijan has increased defence spending recently.

Another territorial dispute exists over the Caspian Sea. The principal dispute between the Caspian states is whether to treat the sea as a lake and carve its bed and shore accordingly or as a sea. While Azerbaijan advocates a 12-mile shore and 30-40 mile economic zone for each state, Russia argues that the waters of the sea should be in common use. As long as this issue remains unresolved, it will undermine any attempt to explore the sea's energy resources by any of the countries.

**Economic policy**

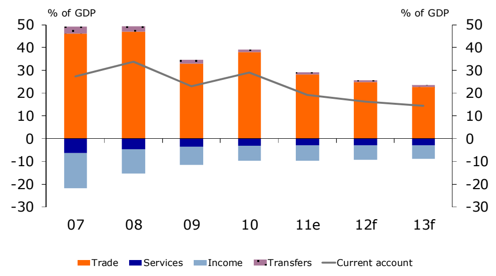
The general direction of government policy is geared towards diversifying into non-energy sectors. The government has secured a USD 175m loan and long-term commitment from the European Bank of Reconstruction and Development to invest in areas such as the production of construction materials. It is set to increase the manufacturing of clinker by 40% in 2011.
In the government budget plan of 2012, projects that involve the development of infrastructure are favored by the government. Social expenditures will also be a priority this year as higher pensions and pay rises are planned. Defense spending is also set to increase and will consist of a high 9% of the total budget, in order to increase the military presence in the Nagorny Karabakh territory.
The 2012 budget forecasts revenues at Azerabaijan manat (AZN) 16.438, equivalent to USD 20.9bn and expenditures at AZN 17.072bn, which would result in a small deficit of 1.5% of GDP. Note that figure 3 and the data table at the last page excludes transfers from the State Oil Fund of the Republic of Azerbaijan (SOFAZ), which oversees and invests the country's oil revenues, as this data was unavailable. As such, the budget deficits are depicted far higher than with these transfers. The revenue forecast is based on the assumption of an average oil price of USD 80 per barrel, which looks rather cautious given that price levels already averaged over USD 100 per barrel in 2011. However, an escalation of the European peripheral debt crisis could result in a renewed global economic downturn and a fall in global commodity prices. Public debt (including SOFAZ) is very low, estimated at only 4% of GDP in 2012.
The Central Bank of the Azerbaijan Republic (CBAR) is still in a monetary tightening mode. In November 2011, it increased reserve requirements on banks' liabilities in AZN from 2% to 3%, after an increase from 2% to 3% in reserve requirements on banks' liabilities in foreign currency in May 2011. The policy rate stands at 5.25%, after the last rate hike in May 2011. The CBAR indicated that it had taken the decision to rein in money supply growth, given mounting foreign-exchange (FX) reserves and high levels of liquidity in the banking sector. M3 money supply was up 31.5% year on year in October 2011. The money supply is likely to have been boosted by FX-inflows into Azerbaijan as global oil prices rebounded. Despite the inflows, the CBAR has kept the exchange rate to the US dollar practically unchanged, at around AZN 0.79 against USD 1, causing a rapid accumulation of FX-reserves. Although the CBAR recently reiterated its intention to move to a more flexible exchange rate in the medium term, it appears to have been unwilling to let the AZN appreciate for fear of damaging competitiveness.

**Figure 3: Public debt**




Source: EIU

**Figure 4: Current account**




Source: EIU

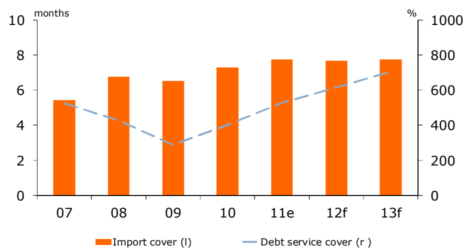
**Balance of Payments**

The rapid increase in oil and gas production has led to enormous trade surpluses in recent years. The record oil prices of 2008 created a trade surplus of 47% of GDP in 2008, a little more than the already high 46% of GDP of 2007. In 2011, this surplus declined to 28% of GDP, which is still very large. The services and income balances are traditionally in deficit and the same is estimated for 2012. The services balance is expected to post a 3% of GDP deficit and the income balance a deficit close to 7% of GDP. The transfer balance is estimated to show a small surplus of 0.8% of GDP in 2012. Due to the large trade surpluses, no external financing via the capital account is required. Even so, net FDI inflows are expected to grow as foreign investors are keen to invest in the country's oil sector. Net FDI flows will increase from USD 200m in 2011 to USD 750m in 2012. The government expects to increase oil output by 4.5% annually until 2015. While this bodes well for the position of the current account, it only increases the country's dependence on the oil sector. FX-reserves are expected to increase from USD 7.1bn at end-2011 to USD 7.5bn at end-2012.

**External position**

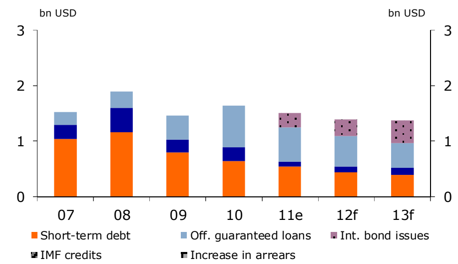
Azerbaijan's foreign debt is low, estimated at 7% of GDP in 2011. There are some uncertainties about the exact size, as estimates vary between different sources. Moreover, in contrast to countries such as Kazakhstan, Russia and Ukraine, where the private sector borrowed heavily abroad, Azerbaijan's foreign debt as a percentage of GDP has actually declined in recent years. A significant part of the foreign debt is public, with official creditors (both multilateral and bilateral) being the most important sources of government borrowing. Short-term debt is low at 14% of total foreign debt. Azerbaijan has large foreign assets. The sovereign wealth fund SOFAZ had USD 22bn at the beginning of 2011, and were estimated at USD 32bn in October 2011, a 42% increase in 10 months. Official FX-reserves stood at USD 7.1bn, which provides ample import cover of 7 months and a debt service cover of 529%. Therefore, the external position of Azerbaijan is strong.

**Figure 5: External position**




Source: EIU

**Figure 6: Foreign debt**




Source: EIU

## Azerbaijan

| Selection of economic indicators | 2007 | 2008 | 2009 | 2010 | 2011e | 2012f | 2013f |
|---|---|---|---|---|---|---|---|
| *Key country risk indicators* | | | | | | | |
| GDP (% real change pa) | 25.0 | 10.8 | 9.3 | 5.0 | 0.9 | 4.0 | 3.0 |
| Consumer prices (average % change pa) | 16.7 | 20.8 | 1.5 | 5.7 | 7.9 | 6.3 | 5.3 |
| Current account balance (% of GDP) | 27.3 | 33.7 | 23.0 | 29.0 | 19.2 | 16.2 | 14.4 |
| Total foreign exchange reserves (mln USD) | 4273 | 6467 | 5364 | 6409 | 7146 | 7500 | 8100 |
| *Economic growth* | | | | | | | |
| GDP (% real change pa) | 25.0 | 10.8 | 9.3 | 5.0 | 0.9 | 4.0 | 3.0 |
| Gross fixed investment (% real change pa) | -5.9 | 11.1 | -8.4 | 5.6 | 2.5 | 2.5 | 4.0 |
| Private consumption (real % change pa) | 17.9 | 38.5 | 0.1 | 3.6 | 2.1 | 2.0 | 2.5 |
| Government consumption (% real change pa) | 24.1 | 21.3 | 4.9 | 5.1 | 3.0 | 2.6 | 2.6 |
| Exports of G&S (% real change pa) | 43.3 | 11.0 | 2.9 | 4.2 | 1.3 | 5.2 | 2.4 |
| Imports of G&S (% real change pa) | 14.0 | 13.1 | -5.3 | 1.9 | 2.0 | 1.9 | 2.3 |
| *Economic policy* | | | | | | | |
| Budget balance (% of GDP) | -2.3 | -9.5 | -14.5 | -15.1 | -22.0 | -20.3 | -17.5 |
| Public debt (% of GDP) | 7 | 6 | 9 | 5 | 5 | 4 | 4 |
| Money market interest rate (%) | 13.0 | 8.0 | 2.0 | 3.0 | 5.3 | 5.3 | 5.5 |
| M2 growth (% change pa) | 94 | 44 | 0 | 24 | 7 | 6 | 8 |
| Consumer prices (average % change pa) | 16.7 | 20.8 | 1.5 | 5.7 | 7.9 | 6.3 | 5.3 |
| Exchange rate LCU to USD (average) | 0.9 | 0.8 | 0.8 | 0.8 | 0.8 | 0.8 | 0.8 |
| Recorded unemployment (%) | 0.9 | 0.9 | 0.9 | 1.0 | 1.0 | 1.0 | 1.0 |
| *Balance of payments (mln USD)* | | | | | | | |
| Current account balance | 9019 | 16453 | 10178 | 15040 | 11121 | 10560 | 10320 |
| Trade balance | 15224 | 23012 | 14583 | 19730 | 16396 | 16210 | 16270 |
| Export value of goods | 21269 | 30586 | 21097 | 26476 | 23479 | 23710 | 24310 |
| Import value of goods | 6045 | 7575 | 6514 | 6746 | 7083 | 7510 | 8030 |
| Services balance | -2131 | -2343 | -1608 | -1733 | -1840 | -1970 | -2160 |
| Income balance | -5079 | -5266 | -3519 | -3467 | -3932 | -4180 | -4310 |
| Transfer balance | 1005 | 1050 | 722 | 509 | 497 | 500 | 510 |
| Net direct investment flows | -5035 | -541 | 147 | 331 | 200 | 750 | 850 |
| Net portfolio investment flows | -26 | -348 | -139 | -217 | -30 | -30 | -50 |
| Net debt flows | 899 | 673 | -118 | 337 | 348 | 450 | 430 |
| Other capital flows (negative is flight) | -3085 | -14043 | -11171 | -14445 | -10902 | -11370 | -10950 |
| Change in international reserves | 1773 | 2194 | -1103 | 1045 | 737 | 360 | 600 |
| *External position (mln USD)* | | | | | | | |
| Total foreign debt | 3517 | 4224 | 4008 | 3934 | 3886 | 3790 | 3550 |
| Short-term debt | 1043 | 1169 | 810 | 650 | 550 | 450 | 400 |
| Total debt service due, incl. short-term debt | 814 | 1519 | 1855 | 1594 | 1351 | 1220 | 1150 |
| Total foreign exchange reserves | 4273 | 6467 | 5364 | 6409 | 7146 | 7500 | 8100 |
| *Key ratios for balance of payments, external solvency and external liquidity* | | | | | | | |
| Trade balance (% of GDP) | 46.1 | 47.1 | 32.9 | 38.1 | 28.2 | 24.8 | 22.7 |
| Current account balance (% of GDP) | 27.3 | 33.7 | 23.0 | 29.0 | 19.2 | 16.2 | 14.4 |
| Inward FDI (% of GDP) | -14.4 | 0.0 | 1.1 | 1.1 | 1.3 | 2.1 | 2.1 |
| Foreign debt (% of GDP) | 11 | 9 | 9 | 8 | 7 | 6 | 5 |
| Foreign debt (% of XGSIT) | 15 | 12 | 16 | 13 | 14 | 14 | 13 |
| Debt service ratio (% of XGSIT) | 3 | 4 | 8 | 5 | 5 | 4 | 4 |
| Interest service ratio incl. arrears (% of XGSIT) | 1 | 1 | 1 | 1 | 1 | 1 | 1 |
| FX-reserves import cover (months) | 5.4 | 6.8 | 6.5 | 7.3 | 2.1 | 7.7 | 7.7 |
| FX-reserves debt service cover (%) | 525 | 426 | 289 | 402 | 529 | 615 | 705 |
| Liquidity ratio | 184 | 222 | 197 | 232 | 212 | 208 | 206 |

Source: EIU