



### Summary

Azerbaijan has been affected much less by the global financial crisis than some other CIS countries, as it entered the crisis without a large credit bubble or high private external indebtedness. Thanks to high hydrocarbon income Azerbaijan has and will continue(d) to post large surpluses on the current account. Both public and foreign debt are low, while the country has ample foreign reserves. The quality of governance is low though, and the economy remains very oil and gas dependent. Tension between Armenia and Azerbaijan over Nagorno Karabakh is still present, with Azerbaijan using part of its hydrocarbon wealth to boost its military capabilities vigorously. Nevertheless, a renewed outbreak of violence seems unlikely now.

### Things to watch:

- Oil price
- Nagorno Karabakh issue

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Azerbaijan			
<b>National facts</b>		<b>Social and governance indicators</b>	
Type of government	Republic	Human Development Index (rank)	rank / total 97 / 179
Capital	Baku	Ease of doing business (rank)	33 / 181
Surface area (thousand sq km)	87	Economic freedom index (rank)	99 / 179
Population (millions)	8.6	Corruption perceptions index (rank)	158 / 180
Main ethnic groups	Azeri (90.6%) Dagestani (2.2%) Russian (1.8%) Armenian (1.5%)	Press freedom index (rank)	150 / 173
Main religions	Muslim (93.4%) Russian orthodox (2.5%)	Gini index (income distribution)	19
Head of State (president)	Ilham Aliyev	Population below \$1 per day (PPP)	<2%
Head of Government (prime-minister)	Arture Rasizade	<b>Foreign trade</b>	
Monetary unit	New Manat (AZN)	<b>Main export partners 2007 (%)</b>	
<b>Economy (2008)</b>		<b>Main import partners 2008 (%)</b>	
<b>Economic size</b>		<b>Main export products 2007 (%)</b>	
	<i>bn USD</i>	<i>% world total</i>	
Nominal GDP	41	0.07	Petroleum products
Nominal GDP at PPP	99	0.14	Food products & animals
Export value of goods and services	34	0.18	Metals
IMF quatum (in mln SDR)	161	0.07	Chemicals & petrochemicals
<b>Economic structure</b>		<b>Main import products 2008 (%)</b>	
	<b>2007</b>	<b>5-year av.</b>	
Real GDP growth	10.8	21.4	Machinery & equipment
Agriculture (% of GDP)	6	10	Food products
Industry (% of GDP)	61	59	Transport equipment
Services (% of GDP)	34	31	Metals
<b>Standards of living</b>		<b>Openness of the economy</b>	
	<i>USD</i>	<i>% world av.</i>	
Nominal GDP per head	4716	49	Export value of G&S (% of GDP)
Nominal GDP per head at PPP	11406	103	Import value of G&S (% of GDP)
Real GDP per head	2831	35	Inward FDI (% of GDP)
			-1.2

Source: EIU, CIA World factbook, UN, Heritage foundation, Transparency International, Reporters without borders, World Bank.

## Introduction

Thanks to a rising oil output, Azerbaijan's economy steamed ahead in 2009, posting 9.3% economic growth. The non-oil sector was hit somewhat by the crisis, but still grew with 3.2%, as the economy was stimulated by both fiscal and monetary policy. Like we explained in our full report of 2009, Azerbaijan's small financial sector and low external debt ratio's made it less vulnerable to the crisis, unlike countries such as Kazakhstan, Russia and Ukraine. The banking sector has continued its rapid growth, though at a much lower speed. As the size of the financial sector is still rather small, while most credits remain covered by deposits, the government can easily support the banking system if that should be needed. Inflation has decreased sharply, down from very elevated levels in 2007 and 2008, but the effectiveness of monetary policy remains limited. Inflation may pick up once again, especially when non-oil output starts to grow rapidly once again or the central bank engages in currency interventions, thereby increasing the amount of money in circulation, to fight manat appreciation. In collaboration with the World Bank the government will launch a diversification strategy. However, our expectations are rather low, as such a scheme would run against the interest of the political and economic elite, which not only has a tight grip on the hydrocarbon sector through energy giant SOCAR, but has also monopolized many non-hydrocarbon sectors of the economy.

## Balance sheet of the government remains strong

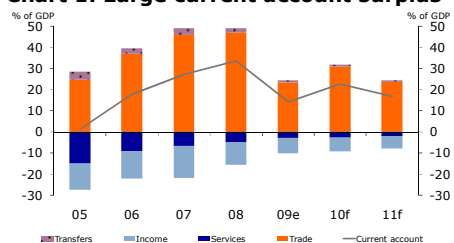
Despite the sharp fall of the oil price, Azerbaijan managed to maintain a strong external and fiscal position. Indeed, after falling in early 2009, the sovereign wealth fund SOFAZ has continued to grow and held USD 13bn at October 2009, while foreign reserves are also growing once again. This



## Country update AZERBAIJAN

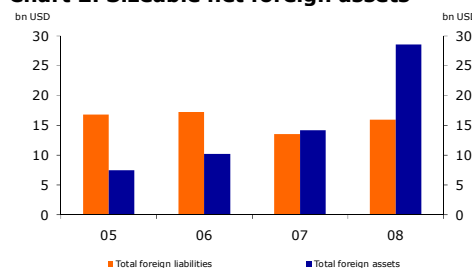
comes as Azerbaijan managed to post a current account surplus of 14.6% of GDP in 2009, despite the sharp fall of the oil price in early 2009. With the oil price now at a much higher level, a substantially higher surplus is expected in 2010. With the 2010 budget based on the assumption of oil at a conservative USD 45 a barrel, a high fiscal surplus can be expected. Thus, net government assets are set to increase further. Indeed, net government assets already surpass those of Kazakhstan and Russia, two other hydrocarbon producers in the region. High current account surpluses have also resulted in a build-up of large net foreign assets (see graph 2).

**Chart 1: Large current account surplus**



Source: EIU, Ecwin

**Chart 2: Sizeable net foreign assets**



Source: EIU

### But some geopolitical risk

The issue of the Nagorno Karabakh has once again obtained some prominence. Azerbaijan saw its chances of regaining the territories under Armenian control since the fall of the Soviet Union decline when Turkey and Armenia came close to striking a deal which would result in the opening of the border between Turkey and Armenia. This would have reduced the bargaining position of Azerbaijan, as Turkey had so far blocked Armenia in support of its ally Azerbaijan. However, recently Turkey has made it clear that it will only open the border with Armenia after the settlement of the Nagorno-Karabakh issue. A somewhat worrying development is the strong increase in military spending by Azerbaijan in recent years, especially as this military build-up was coupled with the government taking a more assertive stance against Armenia. With parliamentary elections later this year, politicians may have incentives to escalate, even as electoral competition is rather low in the system dominated by president Ilham Aliyev. However, we consider the risk of a renewed armed conflict with Armenia still rather low. A renewed conflict would threaten Azerbaijan's lifeline oil and gas industries. Moreover, mediated by regional power Russia, Armenia and Azerbaijan have held peace talks recently, but there remains a wide gap between the positions of both countries.

Azerbaijan							
Selection of economic indicators	2005	2006	2007	2008	2009e	2010f	2011f
<i>Key country risk indicators</i>							
GDP (% real change pa)	26.4	34.5	25.0	10.8	9.3	9.8	9.4
Consumer prices (average % change pa)	9.6	8.3	16.7	20.8	1.5	5.4	5.1
Current account balance (% of GDP)	1.3	17.7	27.3	33.7	14.3	22.6	16.6
Total foreign exchange reserves (mln USD)	1178	2500	4273	6467	5364	6050	6800
<i>Economic growth</i>							
GDP (% real change pa)	26.4	34.5	25.0	10.8	9.3	9.8	9.4
Gross fixed investment (% real change pa)	11.1	12.2	6.2	17.0	5.0	5.5	6.0
Private consumption (real % change pa)	10.9	14.8	9.1	10.0	8.1	8.5	8.4
Government consumption (% real change pa)	12.0	15.0	11.7	18.0	12.0	12.0	11.0
Exports of G&S (% real change pa)	21.0	31.3	19.4	25.8	10.1	12.0	11.0
Imports of G&S (% real change pa)	11.4	12.8	6.6	4.8	3.6	6.0	6.0
<i>Economic policy</i>							
Budget balance (% of GDP)	-2.3	-4.6	-5.5	-6.1	-8.2	-4.3	-3.6
Public debt (% of GDP)	11	8	6	4	4	3	2
Money market interest rate (%)	9.0	9.5	13.0	8.0	2.0	5.0	6.5
M2 growth (% change pa)	23	87	73	44	-8	14	17
Consumer prices (average % change pa)	9.6	8.3	16.7	20.8	1.5	5.4	5.1
Exchange rate LCU to USD (average)	0.9	0.9	0.9	0.8	0.8	0.8	0.8
Recorded unemployment (%)	1.1	1.0	0.9	0.9	1.0	1.0	1.1
<i>Balance of payments (mln USD)</i>							
Current account balance	167	3708	9019	16454	8022	14900	13300
Trade balance	3299	7745	15224	23012	13125	20440	18970
Export value of goods and services	7649	13015	21269	30586	19942	27810	27070
Import value of goods and services	4350	5269	6045	7575	6817	7360	8100
Services balance	-1970	-1923	-2131	-2342	-1572	-1670	-1570
Income balance	-1646	-2681	-5079	-5266	-4025	-4360	-4590
Transfer balance	484	566	1005	1050	495	480	490
Net direct investment flows	459	-1290	-5035	-541	300	500	600
Net portfolio investment flows	31	-12	9	-221	-10	-50	-30
Net debt flows	64	234	967	-410	-182	130	330
Other capital flows (negative is flight)	-643	-1214	-3229	-13107	-9302	-14760	-13450
Change in international reserves	78	1425	1731	2175	-1172	720	750
<i>External position (mln USD)</i>							
Total foreign debt	1853	2011	3037	2641	2376	2420	2420
Short-term debt	186	302	1027	550	325	300	250
Total debt service due, incl. short-term debt	396	461	518	1491	922	640	600
Total foreign exchange reserves	1178	2500	4273	6467	5364	6050	6800
International investment position	-9349	-7067	632	12589	n.a.	n.a.	n.a.
Total assets	7456	10181	14187	28534	n.a.	n.a.	n.a.
Total liabilities	16805	17247	13556	15946	n.a.	n.a.	n.a.
<i>Key ratios for balance of payments, external solvency and external liquidity</i>							
Trade balance (% of GDP)	24.9	36.9	46.1	47.1	23.5	31.0	23.8
Current account balance (% of GDP)	1.3	17.7	27.3	33.7	14.3	22.6	16.6
Inward FDI (% of GDP)	12.7	-2.8	-14.4	0.0	0.9	1.5	2.1
Foreign debt (% of GDP)	14	10	9	5	4	4	3
Foreign debt (% of XGSIT)	20	13	13	8	11	8	8
International investment position (% of GDP)	-70.6	-33.7	1.9	25.8	n.a.	n.a.	n.a.
Debt service ratio (% of XGSIT)	4	3	2	4	4	2	2
Interest service ratio incl. arrears (% of XGSIT)	1	0	0	1	1	0	0
FX-reserves import cover (months)	2.0	3.7	5.4	6.8	8.1	6.7	6.9
FX-reserves debt service cover (%)	297	542	825	434	582	941	1131
Liquidity ratio	114	153	187	222	191	235	221

Source: EIU

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