Country report

AZERBAIJAN

Summary

After Azerbaijan managed to post strong growth in 2009, slow growth in oil and gas output will constrain GDP growth to between 3 and 4 percent in the coming years. Diversification is imperative on the long-term, as the oil and gas sector currently dominates the economy. However, this will require a firm commitment from the ruling political elite, which dominates the Azerbaijani economy. Supported by oil and gas revenues, fiscal policies have been highly expansionary. With monetary policies being relatively ineffective, controlling inflation in the future will require fiscal prudence as well. Azerbaijan's external position is comfortable, supported by wide current account surpluses, low external debt levels and large foreign exchange assets. Politically, Azerbaijan is effectively under authoritarian rule, with President Ilham Aliyev firm in his seat, at the cost of individual freedom.

Things to watch:

- Impact of international oil price movements on economic growth
- Will inflation be contained to below 10%?
- Ongoing tensions with Armenia
- Progress regarding diversification of the economy

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Azerbaijan

National facts		
Type of government	Republic	
Capital	Baku	
Surface area (thousand sq km)	87	
Population (millions)	8.9	
Main languages	Azerbaijani (Azeri) (90%)	
	Lezgi (2.2%)	
Main religions	Muslim (93%)	
	Russian Orthodox (2.5%)	
	Armenian Orthodox (2.3%)	
Head of State (president)	Ilham Aliyev	
Head of Government (prime-minister)	Artur Rasizade	
Monetary unit	New Manat (AZN)	
Economy		**2010**
Economic size	*bn USD*	*% world total*
Nominal GDP	50	0.08
Nominal GDP at PPP	115	0.16
Export value of goods and services	29	0.16
IMF quotum (in mln SDR)	161	0.07
Economic structure	*2010*	*5-year av.*
Real GDP growth	3.7	21.2
Agriculture (% of GDP)	5	7
Industry (% of GDP)	61	63
Services (% of GDP)	34	30
Standards of living	*USD*	*% world av.*
Nominal GDP per head	5525	57
Nominal GDP per head at PPP	12740	109
Real GDP per head	3102	39

Social and governance indicators	rank / total
Human Development Index (rank)	67 / 169
Ease of doing business (rank)	54 / 183
Economic freedom index (rank)	96 / 179
Corruption perceptions index (rank)	134 / 178
Press freedom index (rank)	152 / 178
Gini index (income distribution)	16.83
Population below $1 per day (PPP)	0.5%

Foreign trade			2009
Main export partners (%)		*Main import partners (%)*	
Italy	28	Turkey	17
USA	13	Russia	15
France	11	Germany	9
Germany	10	Ukraine	8
Main export products (%)			
Petroleum products			93
Food products & animals			4
Metals			1
Plastics			0
Main import products (%)			
Machinery & equipment			35
Food products			16
Transport equipment			13
Metals			11
Openness of the economy			
Export value of G&S (% of GDP)			59
Import value of G&S (% of GDP)			21
Inward FDI (% of GDP)			1.2

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

Economic structure and growth

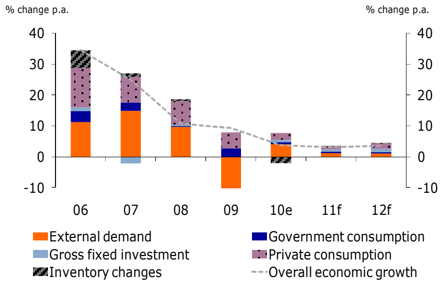
With a nominal GDP of USD 50bn (USD 115bn in PPP terms) and 8.9 million inhabitants, resulting in a GDP per capita of USD 5,525 (12,740 in PPP terms), Azerbaijan is classified as an upper-middle-income country by the World Bank. Since 2001, when Azerbaijan started to seriously develop its oil and gas sector, GDP growth averaged 16% a year on the back of strong investment growth between 2001 and 2009, while strong oil and gas production gains, high international oil prices, and sharply increased public spending propelled growth to an average of 29% a year between 2004 and 2008. On the back of this strong economic performance, nominal GDP per capita increased nearly eight-fold from USD 701 in 2001 to a peak of 5,584 in 2008.

In 2009, when most countries experienced an economic slowdown or were struggling to post a positive growth figure, Azerbaijan still managed to show an impressive growth rate of 9.3%. Partly, this was due to the fact that Azerbaijan lacks a well developed financial sector (credit to GDP amounted to only 21% in 2010) and was thus relatively sheltered from the early stages of the credit crunch. In addition, oil output rose by 13.5% in 2009, as production of the Azeri-Chiraq-Guneshli oil field was no longer hampered by technical difficulties. However, the country was not immune to the global economic deterioration. Supportive fiscal and monetary policies helped to achieve non-oil sector growth of 3%, but fiscal and export revenues declined by over 30% in the wake of the sharp fall of international oil and commodity prices.

In 2010, real GDP growth fell to 3.7% and in the coming years Azerbaijan's economic growth will remain subdued between 3 and 4 percent a year, as increasing oil production, the main engine of growth in past years, has reached a plateau. The agricultural sector, representing 5% of GDP in

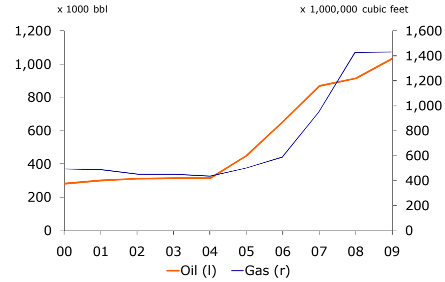
2010, contracted by 3.8% last year due to heavy rainfall, which led to flooding that damaged nearly 68,000 hectares of cultivated land and reduced agricultural output by 9.2% year-on-year.

Chart 1: Growth performance



Source: EIU

Chart 2: Oil and gas production



Source: British Petroleum

As oil output will peak in the next decade and start to decrease in 15-20 years time, the country's economic performance will have to be supported by growth of the non-oil sector in the long-term future. The government, aware of this necessity, is aiming to achieve economic diversification in the medium-to–long term and hopes to see a 50-fold increase of non-oil GDP in the next 25 years. Economic diversification will not only reduce Azerbaijan's dependence on the oil sector and its resulting vulnerability to adverse international oil price fluctuations. At the moment, Azerbaijan derives most of its income from the (oil and gas) industry sector, which accounts for 55% of GDP but employs only 12% of the labor force. At the same time, 38% of the labor force works in the agricultural sector and 50% in the services sector. Therefore, developing these sectors will lead to a better distribution of wealth within the country.

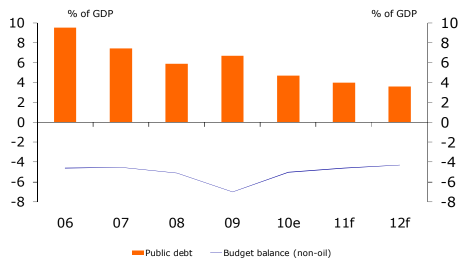
Political and social situation

The republic of Azerbaijan's political scene is dominated by the New Azerbaijan Party, which has an overwhelming majority in parliament and dominates the local government. The party was set up by former President Heydar Aliyev in 1992 and has managed to retain control since. In 2003, in a controversial election characterized by violence and vote-rigging, current President Ilham Aliyev took over the position from his father. With the president having control over all government appointments and policy decisions, the president's rule is effectively authoritarian. In March 2009, the limit on the amount of consecutive terms one person can hold was abolished, opening the way for Ilham Aliyev to rule indefinitely. Therefore, Ilham Aliyev will most likely retain his position in the foreseeable future, by force if needed. The parliamentary elections in November 2010 were deemed the worst in Azerbaijan's history by the opposition and fell short of international standards according to western observers. The government's position is strengthened by the country's energy resources, both domestically and internationally. Large oil revenues have, for example, allowed the government to fight poverty with success, indicated by the drop of the poverty rate (people living on less than USD 2 a day) from 27% in 2001 to only 2% today. However, suppression of individual freedom, corruption and nepotism are problematic, which impede the business climate and also hampers non-oil economic growth. In addition, it could lead to increased public unrest in the future, especially as days of spectacular growth have passed. In spite of its authoritarian nature, Azerbaijan's government has a friendly stance towards the West. Azerbaijan's geographical location is strategic, as it provides the EU with an alternative source and route for its energy needs. Meanwhile, the relationship with the US is under strain due to the US' efforts to push through a Turkish-Armenian reconciliation, which is not in Azerbaijan's interest. Tensions between Azerbaijan and Armenia regarding Armenia's occupation of the Nagorno-Karabakh territory increased last year, following deadly clashes between Armenian and Azerbaijani forces in the disputed region. Azerbaijan has increased military spending by 34% as a result. Tensions are set to remain high.

Economic policy

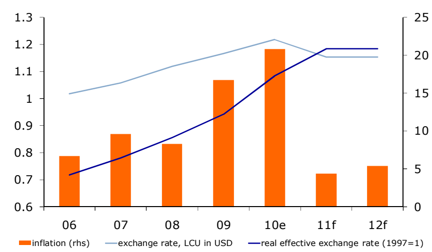
Fiscal policies in Azerbaijan have been aimed at supporting economic growth and reducing poverty levels, and have therefore been highly expansionary. The government has been able to increase expenditures on the back of increasing oil and gas revenues, which led to a more than eight-fold increase in government revenues between 2001 and 2008. During the global economic downturn in 2009, the government acted effectively. Profit and income taxes were cut to support the economy and the government injected capital into the banking sector. Furthermore, government guarantees on loans by state owned oil and aluminum companies were provided, which prevented them from defaulting on foreign debt obligations. In order to reduce the impact of lower revenues on the government budget balance, the oil fund was "allowed" to continue its contributions to the government as planned. Also, expenditures were adjusted for the revenue decline, cutting non-priority spending and limiting investment to ongoing projects only. The non-oil budget balance generally shows a large deficit. However, when oil revenue is taken into account as well, the government budget is in surplus and the government has a comfortable net creditor position.

Chart 3: Public finances



Source: EIU

Chart 4: Exchange rate and inflation



Source: EIU

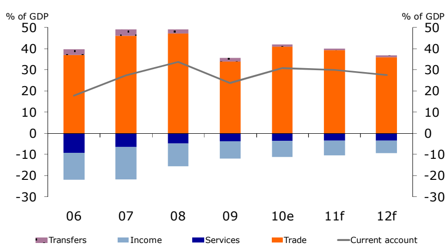
In general, the effectiveness of monetary policy is limited, as Azerbaijan's financial sector is small, credit to GDP low at around 20% and the dollarization of the economy is relatively high (foreign currency deposits equal around 25% of broad money (M3)). As international commodity prices fell sharply in 2009, inflation in Azerbaijan also declined. From its peak of 20% year-on-year in 2008, inflation dropped to only 1.5% in 2009. As rising international commodity prices, especially food prices, have been raising inflationary pressures in the second half of 2010, consumer prices increased by 5.5% over the entire year. The Central Bank's main priority in 2011 is to ensure macroeconomic and financial stability. In this regard, a single digit inflation rate is targeted, but the Central Bank acknowledges that this will require good cooperation with other economic authorities, as the existing expansionary fiscal stance in particular is an important determinant of inflation. The exchange rate of the new manat is managed by the Central Bank, which maintains a de facto peg against the US dollar. Because a significant part of trade is USD denominated, the peg to the USD is beneficial on the short-term. The Central Bank has expressed the desire to increase the effect of market forces on the exchange rate, but a free exchange rate remains a long-term goal.

As mentioned, the diversification of Azerbaijan's economy is vital and a clear medium-to-long-term policy goal of the government. To achieve this, oil revenues will be used to invest in infrastructure and education and to support economic activity in the non-oil sector, with a focus to broaden the industrial base and develop the agricultural and services sectors, which are seen as potentially competitive by the government. In addition, the role of the private sector will have to increase and the financial sector will have to be developed further. The appreciation of the real exchange rate on the back of large oil exports in the past years has made it more difficult for the non-oil sector to compete internationally (a phenomenon called Dutch disease), but the real exchange rate is expected to remain more or less steady in the coming years. More importantly, a firm commitment to increase the role of the private sector by the ruling political elite, which currently dominates the Azerbaijani economy, will be required.

Balance of Payments

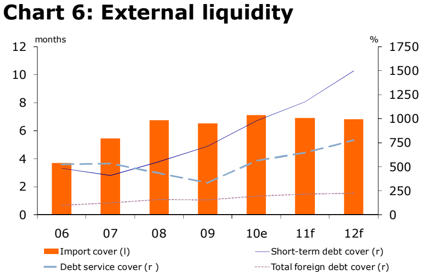
Azerbaijan's trade balance has shown a large surplus from 2005 onwards, as imports have been dwarfed by exports. Total exports of goods are generally about 3.5 times larger than the total imports of goods. In 2009, exports contracted sharply by 31% and imports declined by 14%. As a result, the trade surplus narrowed from 47% of GDP in 2008 to 33% of GDP in 2009. In 2010, the trade surplus widened again to a substantial 41% of GDP. In the coming years, export and import growth will slow down to between 4 and 6 percent a year while the trade surplus will narrow slightly to 39% in 2011 and 36% in 2012. The services and income accounts are generally in deficit, as foreign oil companies are active in Azerbaijan's oil and gas industry. In 2009, the current account surplus fell to around 24% of GDP before recovering to nearly 31% of GDP in 2010. In the years ahead, the current account surplus will narrow slightly in line with the trade surplus to 30% and 28% of GDP in 2011 and 2012 respectively. In spite of the large trade and current account surpluses, Azerbaijan's current account is vulnerable. Exports are extremely undiversified and mainly consist of petroleum products (93% of total exports in 2009). In addition, 62% of Azerbaijan's exports are destined for the EU and the US. As a result, Azerbaijan is dependent on the economic situation in the EU and the US, both of which are facing economic stress at the moment.

Chart 5: Current account



Source: EIU

Chart 6: External liquidity



Source: EIU, Rabobank

In the period 2002-2005, FDI inflows were high, peaking at USD 3.5bn a year in 2004. In 2010, FDI inflows stood at USD 600mln and will expectedly rise to USD 1bn a year by 2012. At the moment, Azerbaijan holds around USD 30bn of strategic foreign currency reserves, which include the Central Bank's FX-reserves, the assets of the state oil fund and funds at the Ministry of Finance. Given Azerbaijan's economic dependency on oil and related external vulnerability, the reserves are needed to shelter the country from liquidity problems in case of adverse external developments in general, and lower international oil prices in particular.

External position

On the back of Azerbaijan's large trade surpluses, its external position has improved to very sound levels in the past 5 years. Foreign debt is low at a mere USD 3.2bn, equal to 7% of GDP in 2010.

Furthermore, only about one-fifth of the external debt is short term debt. As the external debt level is low, debt service is not a risk factor either, especially as current account receipts are relatively high (exports to GDP equals 59%). As a result, the debt and interest service ratios are good at 4% and 1% of current account receipts respectively. Meanwhile, the amount of FX-reserves, not including the foreign exchange saved in the oil fund, increased from USD 2.5bn in 2006 to USD 6.3bn in 2010. As a result, FX-reserves now cover nearly 200% of Azerbaijan's total foreign debt and over 7 months of imports of goods and services. Azerbaijan's liquidity ratio of 235% is further evidence that the country's external position is very good. Given Azerbaijan's vulnerability to adverse international oil and gas price fluctuations, this is a requirement rather than a luxury.

Azerbaijan

Selection of economic indicators	2006	2007	2008	2009	2010e	2011f	2012f
Key country risk indicators							
GDP (% real change pa)	34.5	25.0	10.8	9.3	3.7	3.1	3.6
Consumer prices (average % change pa)	8.3	16.7	20.8	1.5	5.5	5.4	4.1
Current account balance (% of GDP)	17.7	27.3	33.7	23.7	30.7	29.8	27.5
Total foreign exchange reserves (mln USD)	2500	4273	6467	5364	6330	6450	6740
Economic growth							
GDP (% real change pa)	34.5	25.0	10.8	9.3	3.7	3.1	3.6
Gross fixed investment (% real change pa)	2.6	-5.9	1.7	-17.0	5.0	4.0	5.0
Private consumption (real % change pa)	26.0	17.9	17.4	10.9	4.5	2.0	4.0
Government consumption (% real change pa)	30.4	24.1	3.1	28.4	5.0	3.0	4.0
Exports of G&S (% real change pa)	40.9	43.3	13.1	-31.4	12.7	6.0	7.5
Imports of G&S (% real change pa)	14.3	14.0	-3.5	-0.4	2.0	3.0	5.5
Economic policy							
Budget balance (% of GDP)	-4.6	-4.5	-5.1	-7.0	-5.0	-4.6	-4.3
Public debt (% of GDP)	10	7	6	7	5	4	4
Money market interest rate (%)	9.5	13.0	8.0	2.0	2.0	3.0	4.0
M2 growth (% change pa)	65	94	44	0	15	10	11
Consumer prices (average % change pa)	8.3	16.7	20.8	1.5	5.5	5.4	4.1
Exchange rate LCU to USD (average)	0.9	0.9	0.8	0.8	0.8	0.8	0.8
Recorded unemployment (%)	1.0	0.9	0.9	0.9	0.9	1.0	1.0
Balance of payments (mln USD)							
Current account balance	3708	9019	16453	10178	15304	16480	17160
Trade balance	7745	15224	23012	14583	20374	21650	22500
Export value of goods	13015	21269	30586	21097	27409	29040	30330
Import value of goods	5269	6045	7575	6514	7035	7390	7830
Services balance	-1923	-2131	-2343	-1608	-1824	-1930	-2070
Income balance	-2681	-5079	-5266	-3519	-3781	-3770	-3800
Transfer balance	566	1005	1050	722	535	530	530
Net direct investment flows	-1290	-5035	-541	147	100	200	450
Net portfolio investment flows	-12	-26	-348	-139	-50	-30	-30
Net debt flows	587	899	667	-212	274	290	620
Other capital flows (negative is flight)	-1670	-3085	-14038	-11077	-14662	-16820	-17910
Change in international reserves	1323	1773	2194	-1104	966	120	290
External position (mln USD)							
Total foreign debt	2550	3436	4072	3440	3263	3030	3000
Short-term debt	520	1043	1169	750	650	550	450
Total debt service due, incl. short-term debt	476	801	1496	1617	1126	1000	870
Total foreign exchange reserves	2500	4273	6467	5364	6330	6450	6740
International investment position	-7067	632	12589	n.a.	n.a.	n.a	n.a.
Total assets	10181	14187	28534	n.a.	n.a.	n.a	n.a.
Total liabilities	17247	13556	15946	n.a.	n.a.	n.a	n.a.
Key ratios for balance of payments, external solvency and external liquidity							
Trade balance (% of GDP)	36.9	46.1	47.1	33.9	40.9	39.2	36.0
Current account balance (% of GDP)	17.7	27.3	33.7	23.7	30.7	29.8	27.5
Inward FDI (% of GDP)	-2.8	-14.4	0.0	1.1	1.2	1.4	1.7
Foreign debt (% of GDP)	12	10	8	8	7	5	5
Foreign debt (% of XGSIT)	17	14	12	14	11	9	9
International investment position (% of GDP)	-33.7	1.9	25.8	n.a.	n.a.	n.a	n.a.
Debt service ratio (% of XGSIT)	3	3	4	7	4	3	3
Interest service ratio incl. arrears (% of XGSIT)	1	1	1	1	1	1	0
FX-reserves import cover (months)	3.7	5.4	6.8	6.5	4.5	6.9	6.8
FX-reserves debt service cover (%)	525	534	432	332	562	648	776
Liquidity ratio	153	184	222	199	235	240	241

Source: EIU