



AZERBAIJAN

Highlights

- **The oil price decline dented economic growth in 2014.** Growth slowed to 2.8 per cent in 2014, down from 5.8 per cent in 2013, driven mainly by a contraction in the oil sector. Growth in the non-oil sector was also down in 2014 relative to the previous year. In the first nine months of 2015, GDP growth is estimated at 3.7 per cent year-on-year, with non-oil GDP growing by 6.4 per cent.
- **Currency devaluation has improved competitiveness but posed new challenges.** To ease strains on fiscal and external balances, in February 2015 the Azerbaijani manat was devalued against the US dollar by 25 per cent. This has helped competitiveness but has also revealed balance sheet vulnerabilities in the financial and real sectors.
- **Economic diversification remains low.** The oil and gas sector represents an important share of the economy, budget revenues and exports. The low oil price environment points to the importance of continued economic diversification through structural reforms aimed at a level playing field in the private sector.

Key priorities for 2016

- **Diversification of the economy remains the key priority for the authorities.** Development of the non-oil sector will depend on a stable macroeconomic environment as well as a concerted effort to foster competition and improve the business climate. Diversification is all the more essential in the context of the protracted negative terms-of-trade shock due to low energy prices.
- **The authorities should strengthen regulations and implement better supervision and resolution in the financial sector.** Necessary steps include improvements in corporate governance, risk management and monitoring in banks, the phasing out of directed and related party lending, and restructuring the International Bank of Azerbaijan to pave the way for its eventual privatisation.
- **In light of lower growth rates, conservative budget planning and prudent oil wealth management are even more essential.** The authorities should tailor budget planning to new fiscal constraints and target sound returns and fiscal multipliers in the context of implementation of the public infrastructure development agenda.

Main macroeconomic indicators %

	2011	2012	2013	2014	2015 proj.
GDP growth	0.1	2.2	5.8	2.8	3.0
Inflation (average)	7.9	1.0	2.4	1.4	5.0
Government balance/GDP	11.6	3.8	1.4	-0.4	-7.9
Current account balance/GDP	26.5	21.8	16.4	14.1	3.0
Net FDI/GDP [neg. sign = inflows]	-1.4	-1.1	-1.5	-2.9	-3.0
External debt/GDP	20.4	17.0	11.7	14.3	n.a.
Gross reserves/GDP	15.9	16.4	19.1	16.8	n.a.
Credit to private sector/GDP	17.6	20.1	26.7	29.1	n.a.

Macroeconomic performance

Growth slowed in 2014 but rebounded in the first eight months of 2015. The 2014 growth rate was 2.8 per cent, lower than the 5.8 per cent recorded in 2013. The unexpected decline in oil output weighed on growth, with the oil sector contracting by approximately 3 per cent in 2014 after an insignificant expansion of 1 per cent in 2013. In contrast, the non-oil sector expanded by approximately 7 per cent in 2014, albeit at a lower annual pace than in 2010-13. In 2014, a negative real growth contribution of agriculture and mining and quarrying was offset by the positive contribution to real growth coming from construction, trade, transport, storage and communication. In January to September of 2015, the economy grew by 3.7 per cent year-on-year, with non-oil GDP expanding by 6.4 per cent. This growth can be partly attributed to one-off factors, including significant construction projects in the run-up to the European Games in Baku in June 2015 and the lower oil production base of 2014.

Liquidity buffers remain strong. Foreign currency reserves (in convertible foreign currencies) of the Central Bank of Azerbaijan (CBA) fell from US\$ 13.2 billion in November 2014 to US\$ 4.4 billion in April 2015 before increasing to approximately US\$ 5.3 billion in August 2015 (covering 3.2 months of imports). At the end of the first half of 2015, the combined assets of the State Oil Fund (SOFAZ) and of CBA's foreign exchange reserves stood at approximately US\$ 42 billion, that is, approximately 56 per cent of the 2014 nominal GDP in US dollars and 26 months of imports, providing an adequate safety cushion against foreign exchange liquidity and refinancing risks. By the end of 2014, the ratio of public and publicly guaranteed debt to GDP stood at approximately 15 per cent, up by around three percentage points from a year earlier, although still at a low level.

Currency devaluation has helped to reduce macroeconomic imbalances but has also revealed vulnerabilities. On 21 February 2015, after almost two decades of relatively stable exchange rates and contrary to emerging expectations of gradual devaluation, the CBA devalued the manat against the US dollar by 25 per cent from 0.784 to 1.05 per US dollar, tightly managing this new exchange rate thereafter. The devaluation helped to contain the deterioration of the fiscal balance and relieved pressure on SOFAZ's assets. The consolidated central government deficit in 2015 is projected at close to 8.0 per cent of GDP, which represents a major change from a deficit of 0.4 per cent of GDP in 2014 and surpluses in preceding years. The current account surplus fell marginally from 16.4 per cent of GDP in 2013 to an estimated 14.1 per cent in 2014 and is projected to drop to approximately 3.0 per cent of GDP in 2015. The devaluation led to balance sheet and asset quality concerns in the banking sector. At the end of 2014, Azerbaijan's banking system ran a large short foreign exchange position of approximately 40 per cent of the system's equity and balance-sheet liabilities were almost 50 per cent dollarised. The devaluation led to pressure on deposits: excluding non-residents and central government deposits, in January to August 2015 deposits in manat decreased by 43 per cent and deposits in foreign currency increased by 28 per cent. It also resulted in shrinkage of loans in national currency by 15 per cent and an increase of loans in foreign currency.

Growth prospects continue to be influenced by the dynamics in the oil sector and its linkages with the non-oil sector of the economy. A low oil price environment enhances the importance of vigilant fiscal and monetary policy formulation. Structural reforms and a forward-looking approach to infrastructure spending are key to enhancing economic resilience, including through decreased break-even fiscal and external prices of oil.

Major structural reform developments

Azerbaijan took steps to bring its trade regime into compliance with World Trade Organization (WTO) rules. The latest bilateral negotiations took place in March 2015 in Geneva. Overall progress has been slow. On 6 March 2015, the chairman of the working party commended Azerbaijan for the steps taken to bring its trade regime in compliance with WTO rules, while at the same time urging the acceding government and members to "change gears" and "move beyond routine".

Some progress has occurred with structural reforms, but challenges remain. In the World Economic Forum's 2015-16 Global Competitiveness Report, Azerbaijan maintained its relatively high overall rank of 40 out of 140 countries, facilitated by the stable macroeconomic environment. At the same time, corruption is still a concern despite steps taken by the authorities to improve governance in public services, for example, through one-stop shops for access to public services. In the World Bank's Doing Business 2016 report, Azerbaijan ranks 63rd out of 189 economies, with particularly low scores in dealing with construction permits, getting electricity, obtaining credit, trading across borders and resolving insolvency. In November 2014, Azerbaijan took steps to create a one-stop-shop for building permits and thus addressing one of the low-score areas in the "Doing Business" ranking. The latest improvements are related to starting a business and the strengthening of minority investor protections.

Implementation of landmark infrastructure projects continued. Construction of the second stage of the Shah Deniz project is under way and is expected to add approximately 16 bcm of annual gas production to the already existing 9 bcm annually under stage one. Almost two-thirds of the gas will be delivered to markets in Europe through the Trans-Anatolian and Trans-Adriatic Pipelines, improving Europe's energy security through route diversification. Construction continued in 2015, with some milestones reportedly achieved ahead of schedule. The first gas supplies to Georgia and Turkey are expected in 2018 and to Europe in 2019. Construction of the Baku-Tbilisi-Kars rail link is also under way, with the new railway expected to enter into service in 2016.

Reliance on the resource sector remains significant. The share of the oil and gas sector in the economy remains large. In 2014, the non-oil share of total GDP was 61 per cent, increasing to 68 per cent in the first nine months of 2015. The resource sector continues to play an important role in the fiscal and external sectors. It accounted for approximately 94 per cent of exports in 2014 and 90 per cent of exports in the first half of 2015. SOFAZ transfers amounted to 51.0 per cent of Azerbaijan's budget revenues in 2014 and 45.6 per cent of budget revenues in the first half of 2015.

The central bank has softened the impact of currency devaluation on the banks. To soften the impact of the devaluation on the financial sector, the CBA introduced forbearance for banks for violation of foreign exchange position limits until the end of 2015, lowered reserve requirements, and expanded state guarantees coverage for retail deposits. A new minimum capital requirement for banks (approximately US\$ 64 million) became effective on 1 January 2015, while financial market regulations and infrastructure continued to be developed. In July 2015, the President of Azerbaijan signed a decree on measures to prepare Azerbaijan's largest bank – the state-owned International Bank of Azerbaijan (IBA) – for privatisation. The International Bank of Azerbaijan (IBA's) distressed assets are expected to be transferred from the IBA into the state-owned non-bank financial institution in exchange for state-guaranteed bonds within six months and IBA's privatisation plan submitted to the president.

Azerbaijan increased its presence in the international capital markets. In 2014, Azerbaijan raised US\$ 1.25 billion with its inaugural sovereign Eurobond issuance. Later that year, the IBA placed a debut US\$ 500 million Eurobond. These transactions paved the way for more deals from Azerbaijan despite the challenging economic conditions in the region. In March 2015, the state energy company, SOCAR, issued its third Eurobond for the principal amount of US\$ 750 million. SOCAR's most recent Eurobond was priced at 6.95 per cent and achieved bond maturity of 15 years.