BANK OF GEORGIA RESEARCH

Azerbaijan Economy

Understanding Azerbaijan

Azerbaijan | Economy

March 10, 2014

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Contents

Terms and Definitions

AZSTAT	The State Statistical Committee of the Republic of Azerbaijan
EIA	US Energy Information Administration
bbl	Barrels
bcm	Billion Cubic Meters
BoG	Bank of Georgia
BOP	Balance of Payments
BP	British Petroleum
CBAR	Central Bank of Azerbaijan Republic
CPI	Consumer Price Index
C/A	Current Account
DB	Doing Business
FDI	Foreign Direct Investments
GCI	Global Competitiveness Index
GDP	Gross Domestic Product
IMF	International Monetary Fund
LHS	Left-hand Scale
mmbpd	Million Barrels of Oil Per Day
mmt	Million Tonnes
RHS	Right-hand Scale
SOFAZ	State Oil Fund of Azerbaijan Republic
WEF	World Economic Forum
WITS	World Integrated Trade Solutions

Executive Summary

Azerbaijan's economy surged 15x between 1999 and 2012 in nominal US$ terms and 4x in real terms. Over US$ 40bn in foreign investments into energy exploration, development, and transportation generated a 13% annual average growth rate over that period. With an expansionary fiscal policy, with a 22x increase in public expenditures since 1999, growth has filtered into improvements in welfare and a reduction of poverty from 49% in 2001 to just 6% in 2012. Annual current account surpluses of over 25% of GDP from 2006 onwards have resulted in average annual fiscal surpluses of 10% since 2007. This has allowed for the accumulation of strong reserves in the State Oil Fund (SOFAZ) and the central bank (CBAR), which, as at end-2012, jointly held US$ 46bn in assets, or 67% of GDP. The country's demographics are also favorable, with a relatively young population. This, combined with the government's commitment to improving human capital, we believe, sets a strong platform for Azerbaijan's economic welfare.

The economy shifted from relative diversification and low per-capita income (US$ 583) in 1999 to oil dependency and 12.8x higher average per-capita income (US$ 7,491) in 2012. A new phase in Azerbaijan's economy started in 2011 as oil production started to decline and the country shifted its emphasis back to economic diversification. Lower oil production has placed a greater emphasis on the development of non-oil sectors, which is reflected in the government's policy paper, "Azerbaijan 2020: Look Into the Future" (Vision 2020). The document calls for per-capita GDP to double by 2020 on the back of non-oil GDP growth to US$ 13,000 in 7 years and for the country to join the high-income group of countries. It also stresses the importance of improvements in education and institutional development.

Azerbaijan is dependent on the oil and gas sectors but diversification is high on the agenda. By the end of 2010, the oil and gas sectors accounted for 50% of output, 95% of exports, and 78% of consolidated fiscal revenue. The downside of this dependency was on full display when oil output fell from 50.8mmt in 2010 to 43.4mmt in 2012. As oil revenues declined in 2012 with expenditures continuing to rise, the State Oil Fund's savings rate – the amount of oil revenue saved – decelerated from a peak of 60% in 2008 to 25% in 2012.

Gas production offers significant upside prospects. In 2012, Azerbaijan produced 26.8 bcm of natural gas, up from 5.6 bcm in 2000. The second stage of the Shah Deniz project is expected to add another 16 bcm to current output, resulting in 43 bcm total by 2020. At the current prices, additional gas output will provide revenue of 10.6% of the current value of oil produced.

The early signs of diversification are positive. The planned doubling of per-capita GDP requires annual 7% non-oil GDP growth (10.4% growth in 9M13). Non-oil sectors have been experiencing a boom in recent years, growing 9% on average annually from 2010 to 2012. Non-oil exports doubled in the six years from 2006 and increased another 13% in the first half of 2013. The government has already approved the "Education Development Strategy" and budget with lower transfers from SOFAZ compared to the previous year. Progress has also been made on the establishment of industrial estates with the Chemical Industrial Park in Sumgayit and the Balakhani Eco-Industrial Park already operational. Special economic zones for export promotion are in the pipeline, with the first planned at Heydar Aliyev International Airport.

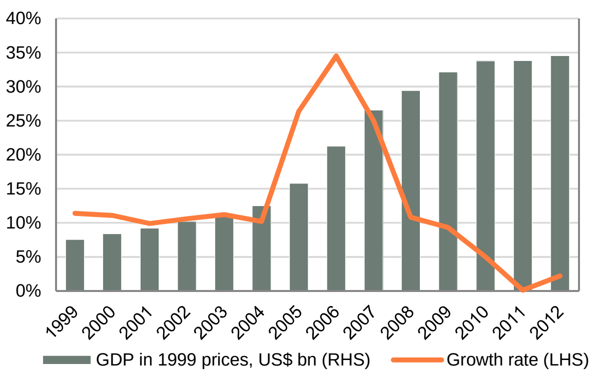
Meanwhile, inflation remains subdued as a reflection of global food prices. Inflation came in at 1.0% and 2.3% in 2012 and 2013, respectively. The currency also remains stable, with the central bank pursuing an exchange rate policy within a US$-linked corridor.

The strong fiscal buffer and external surplus provides a cushion against global market volatility. Azerbaijan's C/A surplus is set to remain strong, in our view, which will feed international reserves. Azerbaijan's combined international reserves of 67% of GDP with marginal public debt of 10% should support the sovereign's credit ratings. Most importantly, Azerbaijan has announced its willingness to diversify its economy through targeted policies and infrastructure investment, which positions the country well to reduce oil dependency and to generate solid economic growth from the non-oil sector.

Drivers of Economic Growth

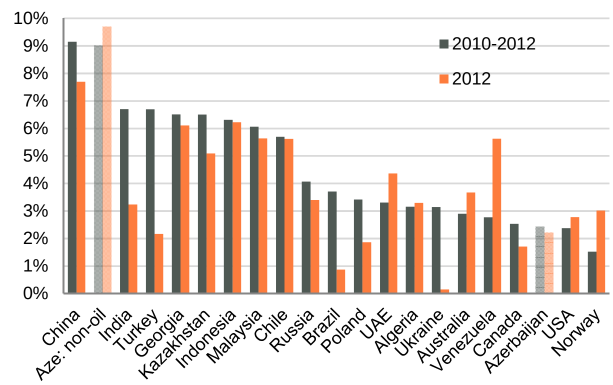
After unprecedented growth over 2000-2009, the Azeri economy slowed in 2010, posted negligible growth in 2011, and returned to marginal growth in 2012. Annual average real GDP growth came in at 15.9% over 2000-2009 – a 4.3x advance overall and a 9.7x increase in nominal US$ terms. Per-capita GDP expanded 8.6x over the period. Growth slowed to 5.0% in 2010 and sharply to 0.1% in 2011 due to falling oil output. Output recovered to +2.2% in 2012. Azerbaijan performed sharply better than certain neighbors and resource-rich developing and developed countries over 2000-2009. Since the boom decade, however, Azerbaijan has performed poorly against those same peers. Despite the recent slowdown, non-oil GDP continued to grow at an impressive 9% average in 2010-2012.

Figure 1: GDP and real GDP growth rate



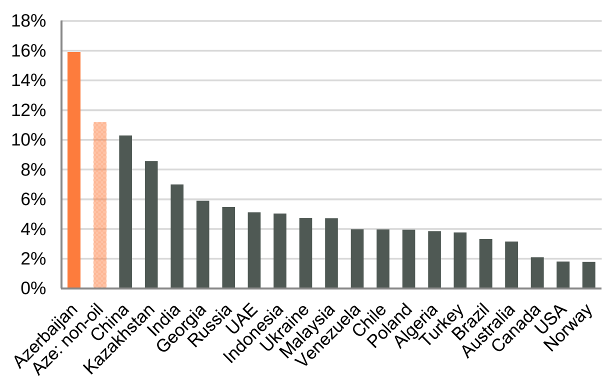
Source: AZSTAT

Figure 2: Real GDP growth vs. peers, 2010-2012



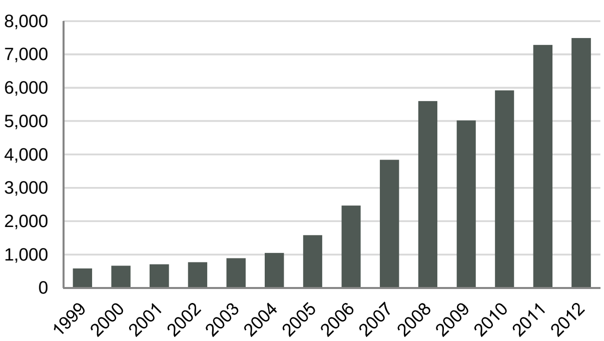
Source: IMF, AZSTAT

Figure 3: Real GDP growth, 2000-09, average per annum, %



Source: IMF, AZSTAT

Figure 4: Per-capita GDP, US$

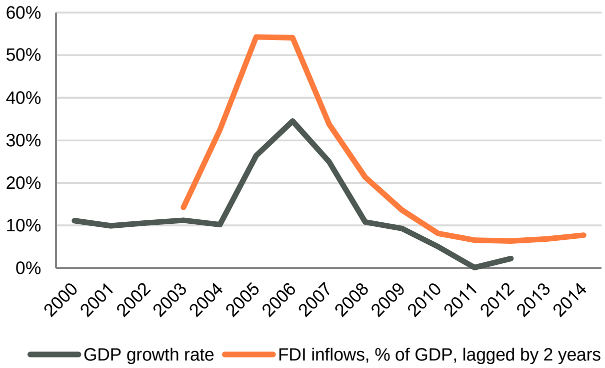


Source: AZSTAT

By the end of 2012, Azerbaijan's economy was 15x bigger than in 1999. It moved from 112th globally to 67th by nominal GDP and from 131st to 77th in nominal per-capita GDP.

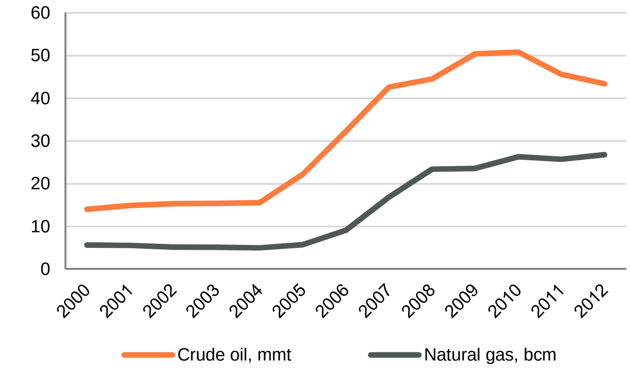
The growth between 1999 and 2005 was mainly driven by investments by multinationals in hydrocarbons. The development of the country's hydrocarbon deposits was spurred by oil consortiums led by British Petroleum (BP), which struck deals in the first half of the 1990s to develop major Azerbaijani oil and gas fields and pipelines (see Appendix).[1] Foreign direct investments surged as a result, reaching 54% of GDP in 2003 and 2004. The charts below outline the relationship between GDP growth and FDI flows. Investment began to taper in 2005, as did the country's growth rate. Nevertheless, growth rates remained high, even by emerging market (EM) standards, until 2009.

Figure 5: FDI and GDP growth rate



Note: The effects of FDI is lagged by several years from the date of investment to output
Source: AZSTAT, CBAR

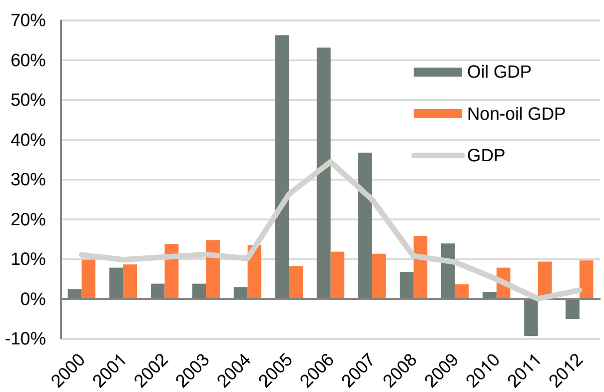
Figure 6: Crude oil and natural gas output



Source: AZSTAT

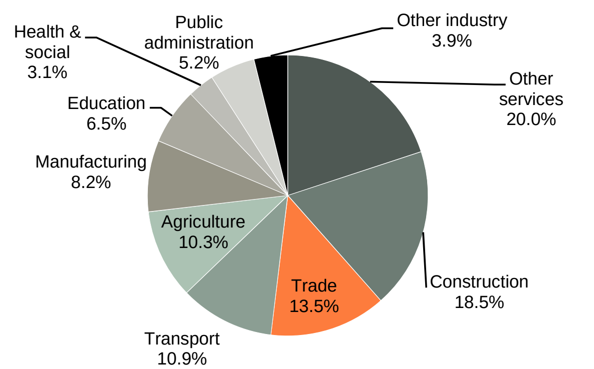
Since 2006, growth has been driven by increasing oil production and exports. Non-oil sectors also started to post robust growth, benefitting from spillover effects from the oil sector. The ramp-up in oil and gas production started in 2005, and within 6 years oil output had more than tripled and gas output had risen more than five-fold, making Azerbaijan the world's 25th largest oil producer and 33rd largest gas producer. In the meantime, increasing energy export revenues filtered through the economy via the state budget, resulting in investments in construction, improvements in communications, and increased consumption in the hospitality, leisure, and travel segments. As a result, the construction, trade, hospitality, transportation, and communication sectors nearly doubled in size from 2005 to 2010 resulting in robust growth in non-oil GDP. These sectors became the main drivers of economic growth in 2012 and 2013.

Figure 7: Oil and non-oil GDP growth rates, %



Source: AZSTAT

Figure 8: Non-extraction GDP in 2012[2]

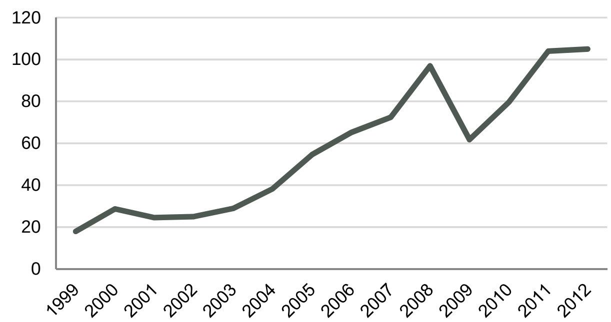


Note: Other services include: accommodation and food service, information and communication, finance and insurance, real estate, professional, scientific and technical activities, administrative and support services, and arts, entertainment and recreation.
Source: AZSTAT

[1] Major projects included the Azeri-Chirag-Gunashli (ACG) oil field, the Baku-Tbilisi-Ceyhan oil pipeline, the Shah Deniz project, the Sangachal Terminal, and the Baku-Tbilisi-Erzurum natural gas pipeline. Additional information regarding ACG and Shah Deniz is available in this report's appendix.
[2] Mining and quarrying accounts for 43.9% of GDP. Extraction here refers to the "Mining and Quarrying" section of GDP in the UN ISIC standards.

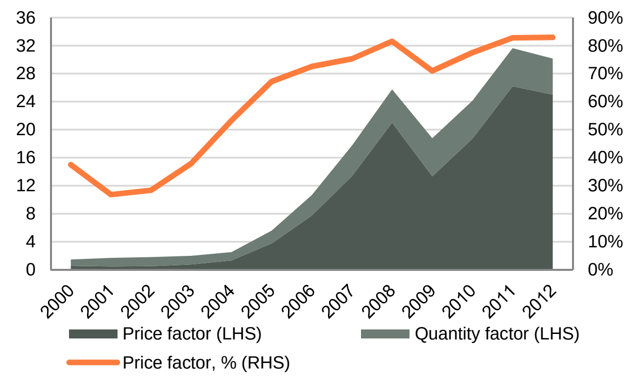
The buoyant crude oil price also played a leading role in GDP growth. The price of crude oil surged from US$ 18/bbl in 1999 to over US$ 104/bbl in 2011. A back-of-the-envelope calculation suggests this price growth boosted the mining and quarrying sector from US$ 5bn in nominal prices to US$ 30bn and to occupying a 45% share of total GDP in 2011. Had the oil price remained constant, Azerbaijan's mining sector, in nominal value terms, would have been 84% smaller, and total GDP would have been half its actual level in 2011 of around US$ 66bn.

Figure 9: Europe Brent spot price FOB, US$



Source: IMF

Figure 10: Price and quantity components in mining, US$ bn



Source: AZSTAT, IMF, BoG Research

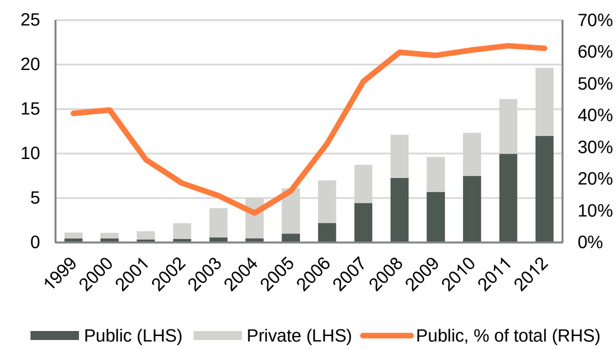
Oil prices stabilized while output retreated after a 2010 peak. The natural exhaustion of operating fields and maintenance works on oil platforms drove the decline. Without the discovery of new reserves, Azerbaijan's oil and gas fields are projected to be depleted within 22 and 28 years respectively, according to the BP Statistical Review. The end-game projection for the country's gas fields is based on the assumption that Azerbaijan will reach its planned annual production of 32 bcm in 2018.

Although output is temporarily down due to maintenance works, additional investment is needed to avoid a drastic drop-off in production. Upon completion of the maintenance works at the ACG oil fields (accounting for around 80% of Azerbaijan's total oil output) in 2013, oil output is expected to stabilize and pick up slightly in 2014. The looming decline in production volumes due to limited reserves, however, is unavoidable without new investments and discoveries.

Gas production offers significant upside prospects. In 2012, Azerbaijan produced 26.8 bcm of natural gas, up from 5.6 bcm in 2000. The second stage of Shah Deniz is expected to add another 16 bcm to the current output, resulting in 43 bcm by 2020. Based on 2012 export prices, the current gas output is equivalent to 17.7% of the current value of oil produced and the additional gas output will add another 10.6%.

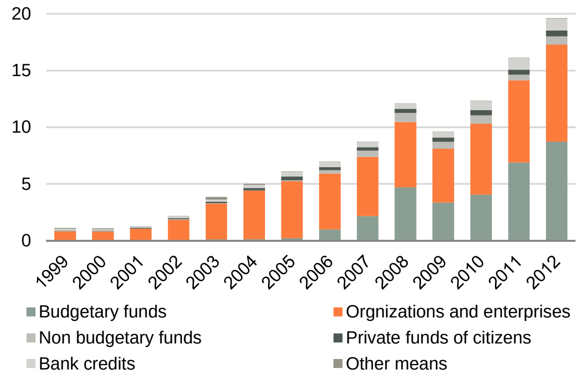
The non-oil sector, boosted by public spending, has substituted the oil sector as the principal driver of growth. Oil GDP shrank 9.3% and 5.0% in 2011 and 2012 respectively, while non-oil GDP growth accelerated from 7.9% in 2010 to 9.7% and 9.8% in 2011-2012. Construction became the main non-oil GDP driver fed by public spending, whose share of total fixed capital investment increased from 9.3% in 2004 to 61.1% in 2012. Benefiting from increasing personal income, trade has become another major driver, posting 10.3% and 10.2% growth rates in 2011 and 2012.

Figure 11: Investments to fixed capital, US$ bn



Source: AZSTAT

Figure 12: Investments by source, US$ bn

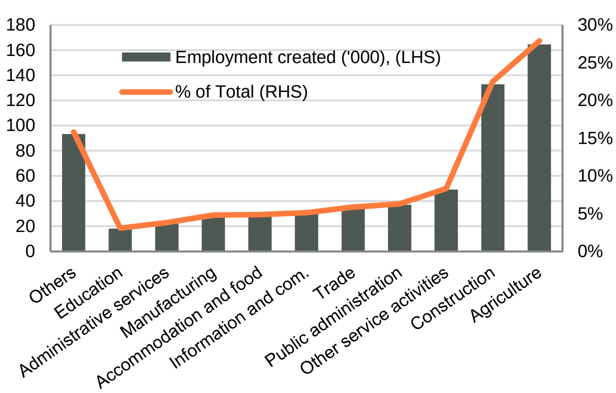


Source: AZSTAT

Growth from public investment has helped smooth weaker oil output. The increase in capital investment by the state was a welcome move given the economy's infrastructure needs, the fallout from the global crisis, and falling oil production. However, the sustainability and robustness of continued growth will depend on the private sector taking over as the engine of growth. Otherwise, with falling oil revenues and a shallow non-oil tax base, the government runs the risk of running out of funds. A dynamic private non-oil sector, on the other hand, can ease pressure to increase budget spending and generate budget revenue by expanding the tax base. The need for a diversified economy that would establish a non-oil tax base is reflected in the government's Vision 2020 strategy approved in 2012. The document targets a doubling of per-capita GDP by 2020 on the back of non-oil GDP growth.

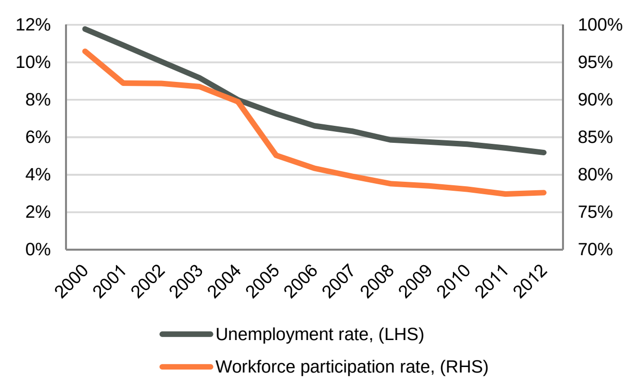
The economic expansion created a total of 0.6mn new jobs, equivalent to 12.6% of the 2012 labor force. From 2000 to 2012, employment increased by 15.3% to 4.4mn. The oil industry, by definition, is capital-intensive rather than labor-intensive. As a result, the surging oil sector only created 600 new jobs, or just 0.1% of total new employment over that period. Agriculture and construction were the main creators of employment; together they accounted for half of the new jobs in 2000-2012. The 0.6mn new jobs and 0.3mn increase in the economically active population brought the unemployment rate down from 12.7% in 2000 to 5.2% in 2012. The labor participation rate – the share of the working age population employed and seeking employment – declined from 96.5% in 2000 to 77.6% in 2012. Had the participation rate remained constant, unemployment would have increased significantly.

Figure 13: Employment created, 2000-2012



Source: AZSTAT

Figure 14: Unemployment and workforce participation

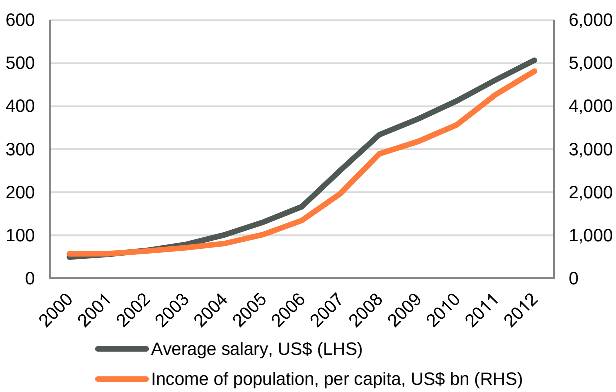


Note: Workforce participation rate: ratio of economically active (employed and unemployed) population to working age population
Source: AZSTAT

The employment growth was accompanied by a decline in poverty. Two main forces reduce poverty: (a) securing a source of income, and (b) securing sufficient income/benefits to escape poverty. Over half a million jobs created since 2000 were likely the main reason for the decline in poverty.

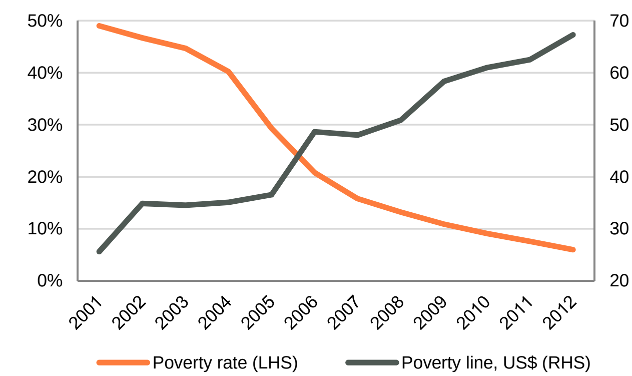
Income growth helped those employed below the poverty line to escape poverty. As the figure below shows, incomes and salaries increased 8.5x and 10.2x in US$ terms over the 12 years since 2000. Over that period, poverty declined from 49% of the population in 2001 to 6% in 2012. That achievement is remarkable given that the poverty line, demarcating the income below which a person is considered poor, has also increased in US$ terms by 2.6x. Another factor behind the poverty rate reduction was a successful targeted social assistance program prepared in close collaboration with IFIs.

Figure 15: Average salary and income



Source: AZSTAT

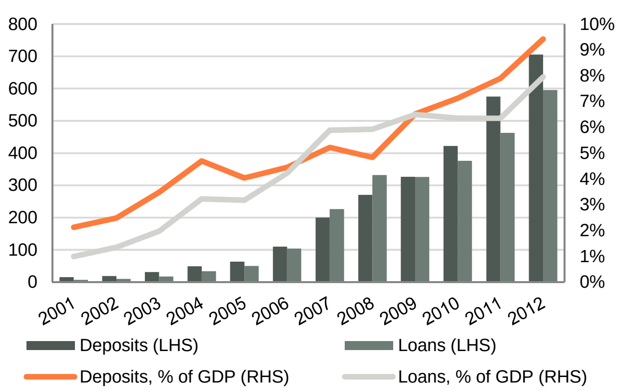
Figure 16: Poverty



Source: AZSTAT

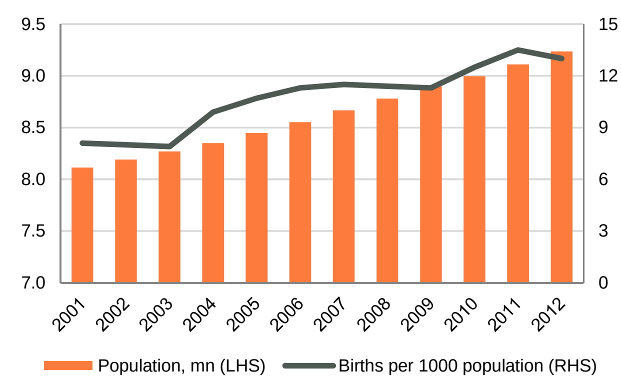
Banking data also point to an improvement in welfare. Household deposit and loan data can be used as an alternative measurement of the populace's welfare. Household deposits per person in Azerbaijan increased from US$ 15.1 in 2001 to US$ 705.3 in 2012, while loans increased from US$ 7.1 to US$ 595.4. It must be noted that Azerbaijan's population increased from 8.1mn in 2001 to 9.2mn in 2012.

Figure 17: Household loans and deposits per person, US$



Source: CBAR, AZSTAT

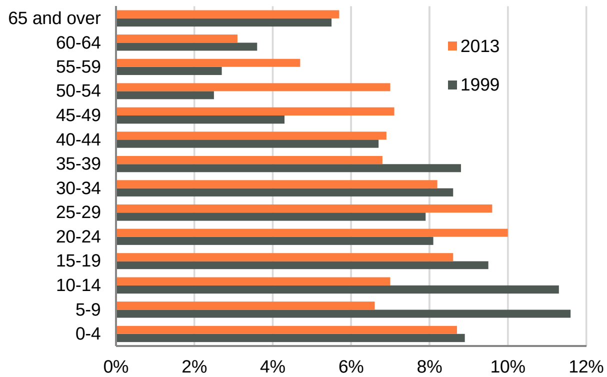
Figure 18: Azerbaijan population



Source: AZSTAT

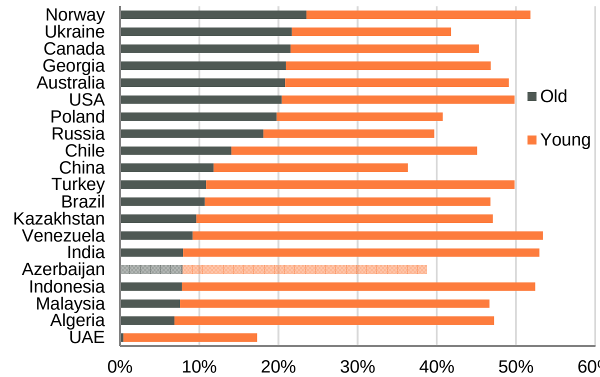
Improving welfare along with growth in the youth population will benefit Azerbaijan in the future. The declining birth rate in the 1990s resulted in the decrease of the younger demographic. This trend has reversed as the birth rate picked up starting in the early 2000s. That trend will further improve Azerbaijan's demographic structure in the future, removing the burden of an aging population on the economy and the budget. In comparative terms, Azerbaijan's old age dependency ratio, at 7.9%, is lower than selected peers and only higher than that of Indonesia, Malaysia, Algeria and the UAE.

Figure 19: Age distribution, % of total



Source: AZSTAT

Figure 20: Age dependency ratio, %

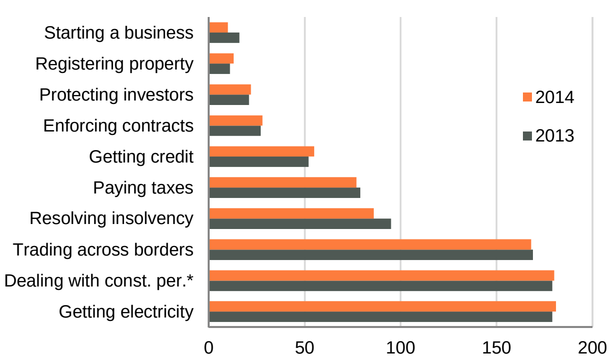


Note: Old is the ratio of people older than 64 to the working age population (15-64); young is the ratio of people under 15 to the working age population.

Source: AZSTAT

Azerbaijan has also achieved important institutional progress, reflected in the Doing Business and Global Competitiveness Reports. According to the World Bank's Doing Business reports, Azerbaijan has improved in the areas of starting a business, registering property, and paying taxes. Azerbaijan now ranks 10th, 13th and 77th in the world in these categories. Reforms have naturally led to an improvement in Azerbaijan's competitiveness in the World Economic Forum's annual report on competitiveness. Since 2005, Azerbaijan has climbed from 62nd to 39th in 2013, mainly due to improvements in institutions and macroeconomic stability, goods market efficiency, technological readiness and innovation pillars.

Figure 21: Doing Business rankings, among 189 countries



**Dealing with construction permits*

Source: Doing Business Report

Figure 22: Global Competitiveness ranking

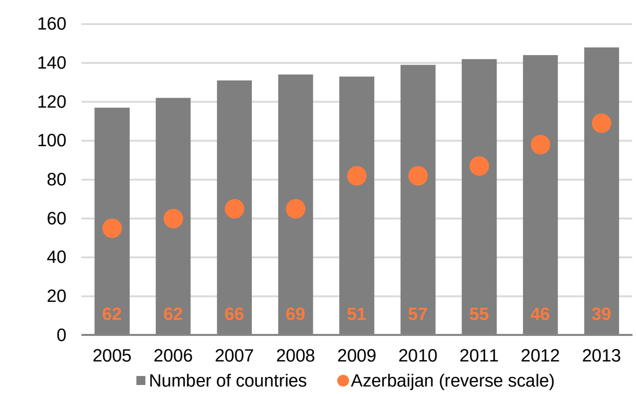


Chart explanation: in 2012 Azerbaijan ranked 46th among 144 countries, better than 98 countries

Source: GCI, World Economic Forum

Despite the progress, challenges still exist. The government is committed to addressing these challenges and has laid out a roadmap in the Vision 2020 document. Vision 2020 aims to double Azerbaijan's per-capita GDP to US$ 13,000 in seven years and enable the country to join the group of high-income countries.[3] The government is aware of the growth bottlenecks that stem from falling oil production and institutional inefficiency. Vision 2020 explicitly states that growth

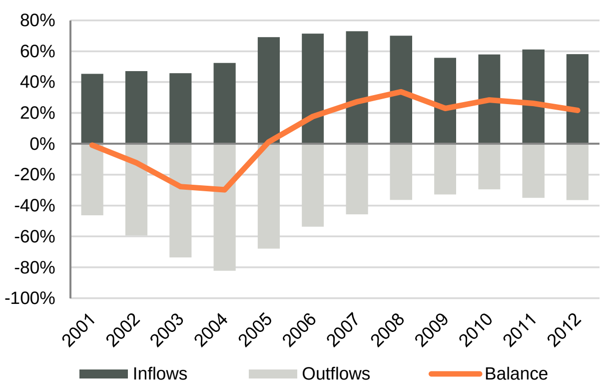
[3] The World Bank divides economies according to GNI per capita, calculated using the World Bank Atlas method. Income classifications are set each year on July 1. In 2012, the groups were: low income, US$ 1,035 or less; lower-middle income, US$ 1,036 - US$ 4,085; upper-middle income, US$ 4,086 - US$ 12,615; and high income, US$ 12,616 or more.

will be driven by non-oil sectors. The government will invest in the development of special/industrial economic zones with the aim of developing the country's regions and to boost export potential. Education is another area in need of reform and is highlighted in the document. In general, Vision 2020 outlines a diversification of the economy beyond the oil sector, and the development of the export-driven non-oil sector with efficient institutions and a skilled labor force.

BOP: From Deficit to Surplus

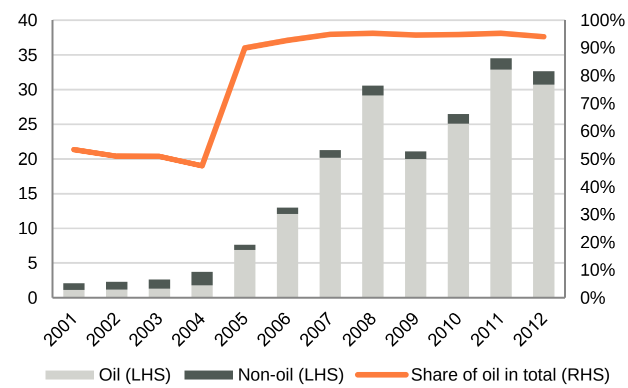
Azerbaijan's current account (C/A) surplus hit more than 20% of GDP in 2012. Azerbaijan had a persistent C/A deficit until 2005 when it started exporting significant volumes of oil. Azerbaijan's external balance then reverted to a surplus, and the positive balance has consistently increased since, reaching US$ 16.5bn, or 33.7% of GDP in 2008. Tracking the path of oil exports and prices, the surplus shrank in 2009 before recovering once more. In nominal US$ terms, the current account balance peaked in 2011 and remains below 2008 levels as a share of GDP. Nevertheless, Azerbaijan was still a global leader with a C/A surplus of over 20% of GDP in 2012.

Figure 23: Current account, % of GDP



Source: CBAR, AZSTAT

Figure 24: Exports, US$ bn

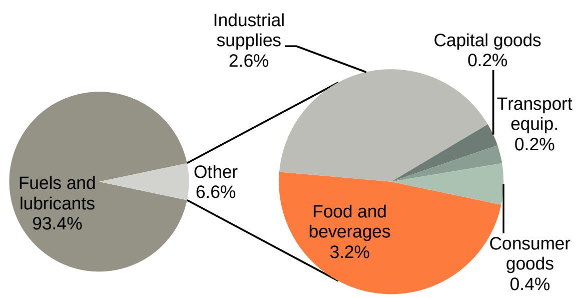


Source: CBAR

The C/A success came at the expense of increasing oil dependence. From 2001 to 2005, non-oil products were the main driver of increased exports. With the start of the oil boom, oil exports increased 3.8x from 2004 to US$ 6.9bn in 2005, while non-oil exports fell by half to US$ 0.9bn, boosting the share of oil in Azerbaijan's total exports from 47.5% to 90%; it has remained above 90% since 2005. But Azerbaijan's non-oil C/A balance has consistently posted a deficit greater than 20% of non-oil GDP. It reached 25.3% of non-oil GDP in 2011 and then improved to 22.7% in 2012.

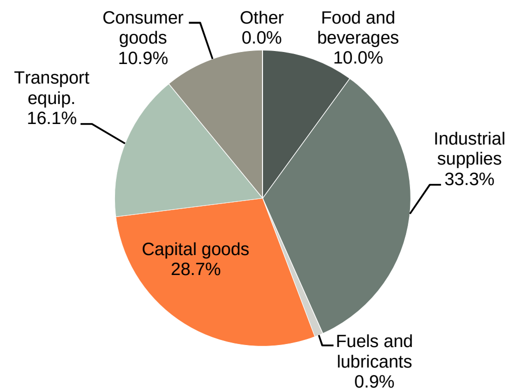
Imports are heavily weighted towards industrial supplies and capital goods (62% of total imports). The dominance of capital goods is natural for an oil-rich country with a development agenda, since the development of oil and gas output requires significant imports of machinery and equipment. Among selected peer countries, only Russia, China, and Malaysia have a higher share of capital goods imports in their total import structures. In Azerbaijan, demand is further supported by extensive public infrastructure investments. Consumer goods, including food and beverages, represented 21% of imports, while fuels and lubricants (a proxy for oil and gas) accounted for less than 1% in 2012.

Figure 25: Merchandise exports, % of total



Source: WITS

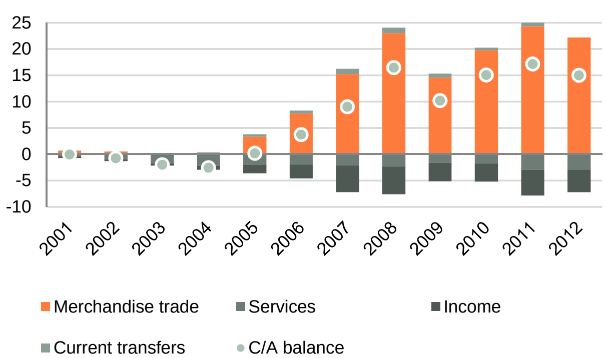
Figure 26: Merchandise imports, % of total



Source: WITS

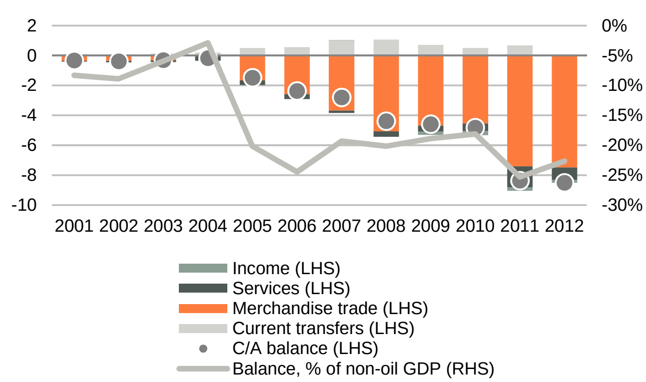
While merchandise trade is in surplus, the services balance has generally remained in the red at around US$ 2.1bn annually for the last 10 years. Of the US$ 2.9bn deficit in services, US$ 2bn stems from oil sector business services. With further exploration and developments on the way, the oil sector will likely continue to shape the services balance for the foreseeable future.

Figure 27: C/A balance by categories, US$ bn



Source: CBAR

Figure 28: Non-oil C/A balance by categories, US$ bn



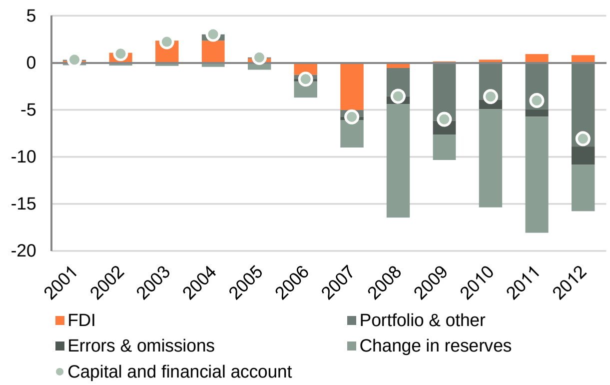
Source: CBAR

Shaped by the realities of an oil-based economy, other components of the balance of payments are also in deficit. From 2001 to 2005, FDI was the main component financing the external balance. However, as oil production took off and Azerbaijan became a surplus country, its financial account fell into the red. Investment repatriations surged in 2007 as PSA projects began generating revenue, which entitled PSA investors to recover their investments. While repatriations have declined since 2008, they still remain significant, offsetting FDI inflows. For example, in 2012, US$ 5.3bn in FDI inflows were offset by FDI outflows of US$ 1.2bn and repatriations totaling US$ 3.3bn, resulting in net FDI of just US$ 0.8bn.

Meanwhile, international reserves continue to increase. Reserves grew US$ 12.1bn in 2008 but slowed in 2009 as a result of crisis-related capital outflows. Growth resumed in 2010 and 2011, before outflows from the portfolio and other investment categories surged in 2012 to US$ 8.9bn. Other investment outflows were driven by increasing deposits abroad (from US$ 2.7bn in 2011 to US$ 5.4bn in 2012) and trade credits (from US$ 2.5bn in 2011 to US$ 4.7bn in 2012).

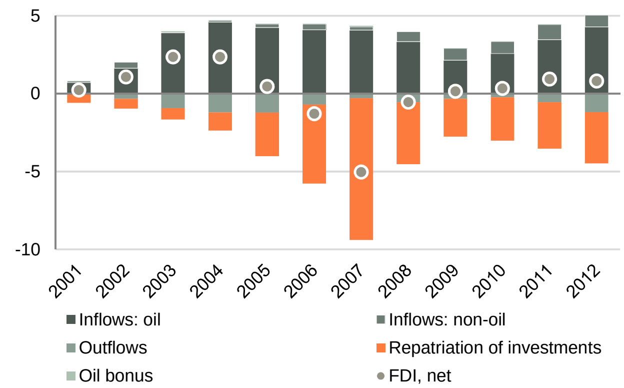
Remittances have been determined largely by non-resident workers and investments, which increased income payments abroad (compensation of non-resident employees and investment income) but have been offset by current transfers from Russia. Remittance inflows reached US$ 1.9bn in 2012, slightly below outflows.

Figure 29: Capital and financial account, US$ bn



Source: CBAR

Figure 30: FDI and components, US$ bn

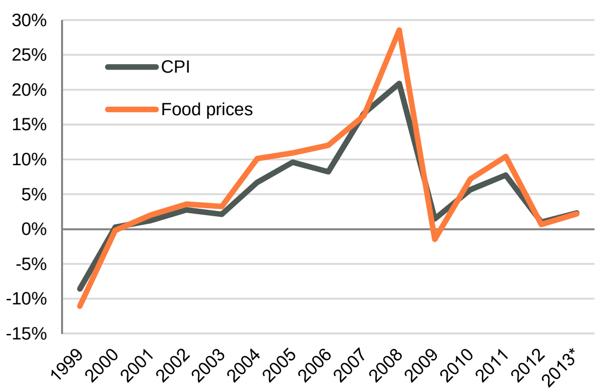


Source: CBAR

Inflation remains subdued. Almost half of Azerbaijan's consumer basket consists of food products, which generally track global food prices. As a result, Azerbaijan's inflation surged to 20.9% in 2008. However, as global food prices declined and stabilized in the following years, inflation in Azerbaijan fell to 1.5% in 2009, and then picked up to 5.7% in 2010 and 7.8% in 2011. In 2012 and 10M13, prices remained relatively stable at 1.0% and 2.3%, respectively.

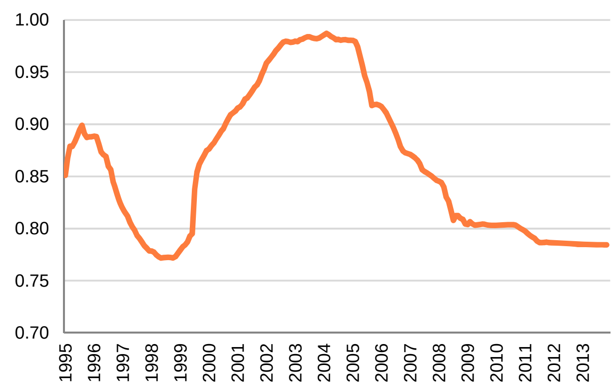
The currency has remained stable, with the central bank pursuing an exchange rate policy within a corridor linked to the US$. The exchange rate has moved in a narrow range of US$ 0.77-0.99/AZN over the last 12 years.

Figure 31: Inflation, annual % change



**January-November*
Source: AZSTAT

Figure 32: US$/AZN exchange rate, monthly average

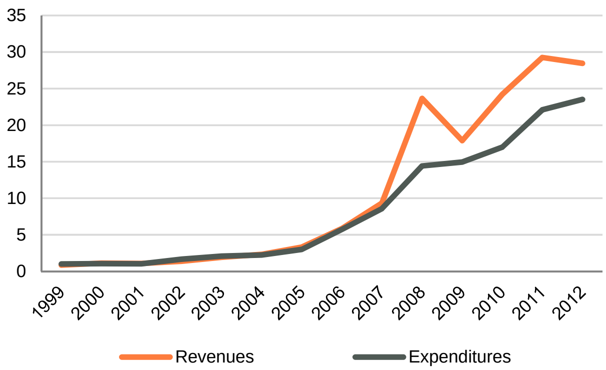


Source: CBAR

Fiscal Policy: Reserve Accumulation

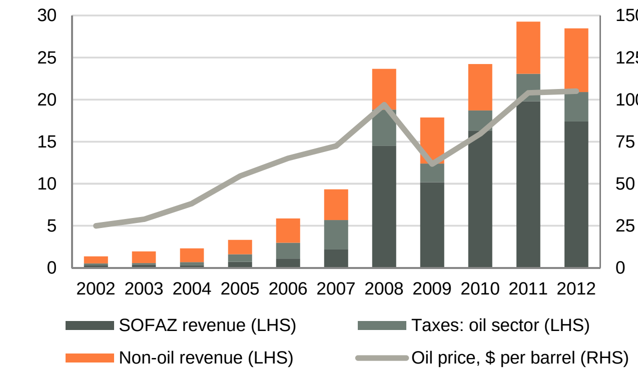
Rising oil output has not only benefitted GDP, but has also fed public finances. Consolidated budget revenues increased 36x in US$ terms from 1999 to 2011 to US$ 29.3bn. Receipts began to accelerate in 2005 and peaked in 2008 alongside the global oil price. As oil output declined and prices stabilized, public revenues remained flat. Expenditures followed a similar upwards path albeit at a slower rate, surging 22x over the same period.

Figure 33: Consolidated budget, US$ bn[4]



Source: Ministry of Finance

Figure 34: Consolidated budget revenue, US$ bn[5]



Source: Ministry of Finance, SOFAZ, IMF

Thanks to a better performance on the income side, public finances have remained in surplus since 2004. The budget surplus peaked in 2008 at almost 20% of GDP. A subsequent decline in revenues and an increase in expenditure served to shrink the surplus in the following years. In 2012, the surplus fell to 7.2% of GDP and the government is projecting a deficit in 2013. With the positive net balance, the government was able to keep its debt to GDP ratio at relatively low levels, averaging 10% of GDP in the eight years since 2005.

However, the global oil price, which is determined externally, is a key factor in defining budget revenues. The oil sector provided US$ 20.9bn of revenue in 2012, accounting for 73.4% of total consolidated public revenues. This income was the result of 43.4mmt oil production and an average oil price of US$ 105/bbl. Our rough sensitivity analysis, which shows how sensitive the budget is to fluctuations in oil production (subject to geological factors) and the oil price (subject to international developments), demonstrates that if oil output was 20% higher (52.1mmt) and there was an oil price of US$ 125/bbl, oil revenues might have been 51% higher leading to a budget surplus of US$ 15.6bn. Alternatively, using the same calculations and assuming that expenditure is fixed, if 10% less oil had been produced alongside a US$ 10/bbl fall in oil price the budget balance might have been in deficit.

[4] Consolidated budget revenues consist of: (a) central/state government budget revenues (less transfers from the Oil Fund), (b) Oil Fund revenues, (c) State Social Protection Fund revenues (less transfers from the state budget and contributions by the state enterprises), and (d) Nakhchivan Autonomous Republic budget revenue (less donation from the state budget).
[5] Non-oil consolidated budget revenues are calculated as the difference between consolidated budget revenues and revenues coming from the Oil Fund and taxes from the oil sector.

Table 1: Oil revenue, US$ bn, 2012

Oil price per bbl	Crude oil production, mmt: 34.7	39.0	43.4	47.7	52.1
125	18.8	22.0	25.2	28.4	31.6
115	17.0	19.9	22.8	25.8	28.7
105	15.1	17.8	20.9	23.2	25.8
95	13.3	15.7	18.1	20.6	23.0
85	11.5	13.6	15.7	17.9	20.1
75	9.7	11.5	13.4	15.3	17.2

Source: AZSTAT, Ministry of Finance, IMF, BoG Research

Table 2: Budget balance, US$ bn, 2012

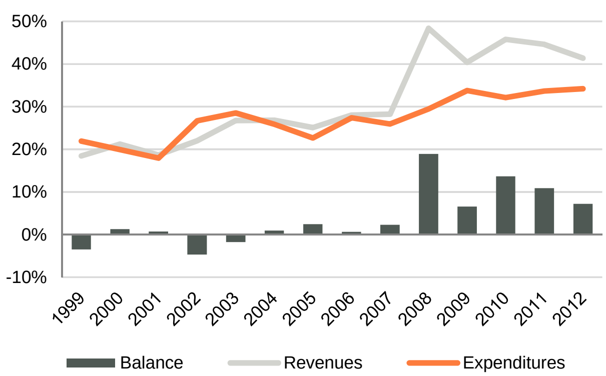
Oil price per bbl	Crude oil production, mmt: 34.7	39.0	43.4	47.7	52.1
125	2.8	6.0	9.2	12.4	15.6
115	1.0	3.9	6.8	9.8	12.8
105	-0.8	1.9	4.9	7.2	9.9
95	-2.6	-0.2	2.1	4.6	7.0
85	-4.5	-2.3	-0.2	2.0	4.1
75	-6.3	-4.4	-2.6	-0.6	1.2

Source: AZSTAT, Ministry of Finance, IMF, BoG Research

In the event of external shocks, buffers do exist as a result of Azerbaijan's strong capital investments, which correspond to 46.3% of the budget for 2014 and can be adjusted if need be. When public revenues declined from US$ 23.7bn in 2008 to US$ 17.9bn in 2009, the government was able to reduce capital investments from US$ 6.3bn to US$ 5.6bn to partially offset the decline.[6] The government announced it will reduce investments in the next few years from the US$ 12.4bn budgeted for 2014 to US$ 8.0bn in 2017. A successful execution will reduce the likelihood of a budget deficit in the next few years.

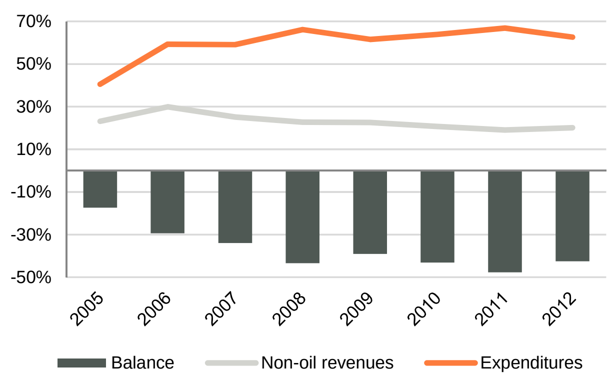
The picture is drastically different without the oil sector, which generated 74% of revenues. Non-oil revenues, as a share of non-oil GDP, have consistently declined since 2006, fluctuating between 19.1% and 20.7% of non-oil GDP in 2010-12. Expenditures, on the other hand, increased until 2008 and have remained at around 65% of non-oil GDP. As a result, the non-oil consolidated budget deficit increased from 17.4% of non-oil GDP in 2005 to 47.7% in 2011. Although expenditures continued to rise in 2012, the pace remained below the growth rate of nominal non-oil GDP, resulting in a slight improvement in the non-oil deficit in 2012.

Figure 35: Consolidated budget, % of GDP



Source: Ministry of Finance, AZSTAT, BoG Research

Figure 36: Non-oil consolidated budget, % of non-oil GDP

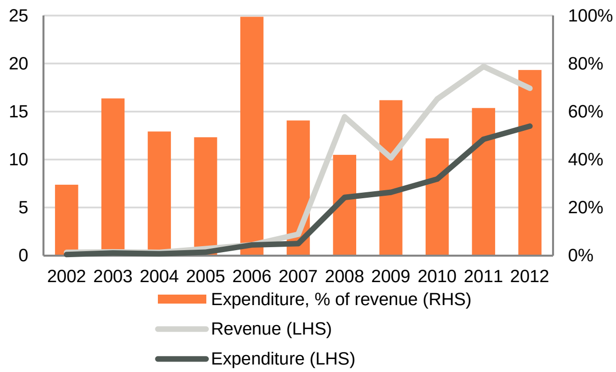


Source: Ministry of Finance, AZSTAT, BoG Research

Combined SOFAZ and central bank reserves reached US$ 45.8bn in 2012, 67% of GDP. As oil output and prices surged in 2008, SOFAZ's revenues increased 9.1x from 2007 to US$ 19.8bn in 2011 (see Appendix). On the heels of lower production volumes, revenues slipped to US$ 17.4bn in 2012. However, the fund's expenditures remained well below income, especially in the early boom years, resulting in higher savings. SOFAZ's assets increased from 7.5% of GDP in 2007 to 43% in 2010. However, as revenues stagnated and expenditures rose, the savings rate declined and the fund's assets-to-GDP increased just 6.6ppts in the following two years to 49.6%.

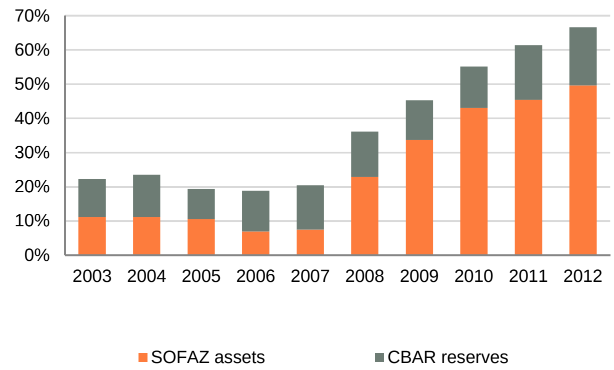
[6] However, the government was able to deliver on all other fiscal commitments. Moreover, the central bank played a key role in smoothing the negative impacts of the global crisis by providing additional liquidity to markets and keeping the exchange rate stable.

Figure 37: State Oil Fund budget, US$ bn



Source: SOFAZ

Figure 38: International reserves, % of GDP



Source: SOFAZ, CBAR, AZSTAT

Macro Statistics

	2005	2006	2007	2008	2009	2010	2011	2012
Economic activity								
Real GDP, y/y	26.4%	34.5%	25.0%	10.8%	9.3%	5.0%	0.1%	2.2%
Real Oil GDP, y/y	66.3%	63.2%	36.8%	6.8%	14.0%	1.8%	-9.3%	-5.0%
Real Non-oil GDP, y/y	8.3%	11.9%	11.4%	15.9%	3.7%	7.9%	9.4%	9.7%
Nominal GDP, AZN bn	12.52	18.75	28.36	40.14	35.60	42.47	52.08	54.00
change y/y	46.8%	49.7%	51.3%	41.5%	-11.3%	19.3%	22.6%	3.7%
Nominal Oil GDP, AZN bn[1]	5.52	10.09	15.91	22.25	16.07	21.10	25.83	25.52
Nominal Non-oil GDP, AZN bn[2]	7.00	8.65	12.45	17.89	19.54	21.36	26.25	28.47
Nominal GDP, US$ bn	13.24	20.99	33.10	48.88	44.29	52.91	65.63	68.73
change y/y	52.5%	58.5%	57.7%	47.7%	-9.4%	19.5%	24.0%	4.7%
Nominal GDP per capita, US$	1,580	2,472	3,842	5,603	5,018	5,922	7,285	7,491
change y/y	50.7%	56.5%	55.4%	45.9%	-10.4%	18.0%	23.0%	2.8%
Prices								
CPI, eop	5.3%	11.2%	19.6%	15.5%	0.7%	7.9%	5.6%	-0.3%
CPI, average	9.6%	8.3%	16.7%	20.8%	1.5%	5.7%	7.9%	1.1%
PPI, eop	n/a	n/a	n/a	-36.2%	65.2%	18.8%	21.1%	-1.3%
PPI, average	17.3%	10.1%	17.6%	23.4%	-19.4%	30.5%	33.5%	4.5%
GDP deflator	16.1%	11.3%	21.0%	27.8%	-18.8%	13.6%	22.5%	1.5%
Exchange rates								
US$/AZN, eop	0.919	0.871	0.845	0.801	0.803	0.798	0.787	0.785
US$/AZN, average	0.946	0.893	0.857	0.821	0.804	0.803	0.794	0.786
Money & credit								
Base money, AZN bn	n/a	1.60	2.61	4.78	4.86	6.40	8.28	10.52
Chg. y/y	n/a	n/a	63.3%	83.0%	1.7%	31.6%	29.4%	27.1%
Broad money (M2), AZN bn	0.80	2.14	4.40	6.08	6.17	8.30	11.00	13.81
Chg. y/y	16.2%	168.4%	105.9%	38.2%	1.5%	34.5%	32.5%	25.5%
% of GDP	6.4%	11.4%	15.5%	15.2%	17.3%	19.5%	21.1%	25.6%
Broad money (M3), AZN bn	1.84	3.44	5.90	8.49	8.47	10.53	13.90	16.78
Chg. y/y	22.1%	87.1%	71.4%	44.0%	-0.3%	24.3%	32.1%	20.7%
% of GDP	14.7%	18.4%	20.8%	21.2%	23.8%	24.8%	26.7%	31.1%
Money (M3) multiplier	2.10	1.68	1.71	1.71	1.73	1.61	1.64	1.57
Bank deposits, AZN bn	1.37	2.16	4.13	6.46	6.38	7.63	9.45	10.70
Chg. y/y	22.4%	58.0%	90.9%	56.5%	-1.3%	19.5%	23.9%	13.3%
% of GDP	10.9%	11.5%	14.6%	16.1%	17.9%	18.0%	18.1%	19.8%
Bank loans, AZN bn	1.44	2.36	4.68	7.19	8.41	9.16	9.95	12.72
Chg. y/y	45.6%	64.0%	98.2%	53.6%	16.9%	9.0%	8.6%	27.8%
% of GDP	11.5%	12.6%	16.5%	17.9%	23.6%	21.6%	19.1%	23.6%
Loan-to-deposits ratio	1.05	1.09	1.13	1.11	1.32	1.20	1.05	1.19
Lending interest rate (average)	15.8%	16.0%	16.4%	17.9%	16.3%	15.0%	16.3%	15.7%
Deposits interest rate (average)	7.8%	10.5%	11.0%	11.8%	11.6%	11.2%	10.8%	10.2%
Interest rate spread, ppts	7.96	5.58	5.38	6.12	4.75	3.75	5.53	5.46
Fiscal indicators								
General budget revenues, US$ bn	3.32	5.88	9.35	23.66	17.87	24.23	29.27	28.43
% of GDP	25.1%	28.0%	28.2%	48.4%	40.4%	45.8%	44.6%	41.4%
General budget non-oil revenues, US$ bn	1.71	2.90	3.65	4.95	5.48	5.51	6.31	7.55
% of non-oil GDP	23.2%	30.0%	25.1%	22.7%	22.6%	20.7%	19.1%	20.8%
General budget expenditures, US$ bn	3.00	5.75	8.59	14.41	14.96	17.00	22.10	23.50
% of GDP	22.7%	27.4%	25.9%	29.5%	33.8%	32.1%	33.7%	34.2%
General budget balance, US$ bn	0.32	0.13	0.76	9.25	2.91	7.23	7.16	4.93
% of GDP	2.4%	0.6%	2.3%	18.9%	6.6%	13.7%	10.9%	7.2%
General non-oil budget balance, US$ bn	-1.29	-2.85	-4.94	-9.46	-9.48	-11.49	-15.79	-15.95
% of non-oil GDP	-17.4%	-29.4%	-34.0%	-43.4%	-39.0%	-43.2%	-47.7%	-44.0%

	2005	2006	2007	2008	2009	2010	2011	2012
External accounts								
Merchandise trade balance, US$ bn	3.30	7.75	15.22	23.01	14.58	19.73	24.33	22.22
Non-oil merchandise trade balance, US$ bn	-1.66	-2.58	-3.67	-5.07	-4.69	-4.54	-7.41	-7.44
Service trade balance, US$	-1.97	-1.92	-2.13	-2.34	-1.61	-1.73	-3.00	-2.92
Non-oil service trade balance, US$	-0.31	-0.32	-0.16	-0.37	-0.41	-0.49	-1.40	-0.83
Trade balance, US$ bn	1.33	5.82	13.09	20.67	12.97	18.00	21.33	19.29
% of GDP	10.0%	27.7%	39.6%	42.3%	29.3%	34.0%	32.5%	28.1%
Non-oil trade balance, US$ bn	-1.97	-2.90	-3.84	-5.44	-5.09	-5.03	-8.81	-8.27
% of non-oil GDP	-26.6%	-29.9%	-26.4%	-25.0%	-21.0%	-18.9%	-26.6%	-22.8%
Current account balance, US$ bn	0.17	3.71	9.02	16.45	10.17	15.04	17.15	14.92
% of GDP	1.3%	17.7%	27.2%	33.7%	23.0%	28.4%	26.1%	21.7%
Non-oil current account balance, US$ bn	-1.49	-2.37	-2.81	-4.39	-4.58	-4.82	-8.37	-8.52
% of non-oil GDP	-20.2%	-24.5%	-19.3%	-20.2%	-18.9%	-18.1%	-25.3%	-23.5%
Foreign direct investments, US$ bn	4.48	4.47	4.53	3.98	2.90	3.35	4.47	5.29
Non-oil foreign direct investments, US$ bn	0.23	0.37	0.44	0.64	0.75	0.78	1.00	1.00
Capital and financial account balance, US$ bn*	0.57	-1.74	-5.76	-3.56	-6.02	-3.59	-4.02	-8.08
CBAR official foreign reserves, US$ bn	1.18	2.50	4.27	6.47	5.16	6.41	10.48	11.69
Oil Fund Assets, US$	1.39	1.45	2.48	11.22	14.90	22.77	29.80	34.13
Debt indicators								
Gross external debt, US$ bn	4.60	5.91	7.05	9.37	8.96	11.01	13.22	n/a
change y/y	29.6%	28.4%	19.4%	32.9%	-4.4%	22.9%	20.1%	n/a
% of GDP	34.7%	28.1%	21.3%	19.2%	20.2%	20.8%	20.1%	n/a
Government debt, US$ bn	1.76	2.14	2.85	3.39	5.21	5.89	6.55	7.98
of which								
Domestic debt, US$ bn	0.11	0.17	0.36	0.37	1.80	1.98	1.81	1.65
External debt, US$ bn	1.66	1.98	2.48	3.01	3.41	3.92	4.73	6.33
% of GDP	13.3%	10.2%	8.6%	6.9%	11.8%	11.1%	10.0%	11.6%
Total investment, US$ bn	5.50	6.27	7.13	9.14	8.39	9.55	13.30	15.10
% of GDP	41.5%	29.9%	21.5%	18.7%	18.9%	18.1%	20.3%	22.0%
Gross national savings, US$ bn	5.12	9.29	14.77	24.17	17.63	23.37	30.34	30.09
% of GDP	38.7%	44.3%	44.6%	49.4%	39.8%	44.2%	46.2%	43.8%

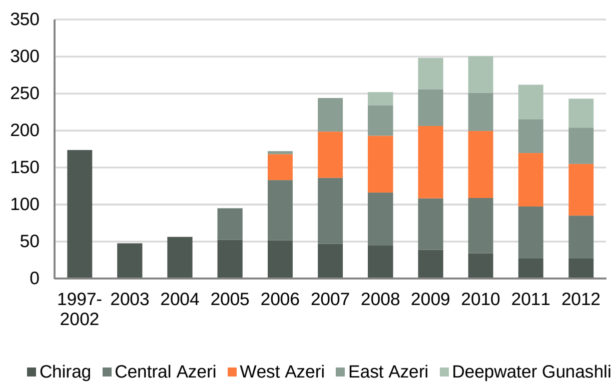
[1] Until 2009 at factor cost
[2] Until 2009 non-oil GDP is calculated as non-oil GDP at factor cost plus net taxes
Source: AZSTAT, CBAR, Ministry of Finance, SOFAZ, IMF, BOG Research

Appendix 1: Mega Projects of 1994-2012

Azeri-Chirag-Gunashli: The largest oilfield in Azerbaijan's Caspian Sea sector

A 30-year production sharing agreement (PSA) to develop the Azeri-Chirag-Gunashli (ACG) oil field was signed on September 20, 1994 between BP and other oil companies and the Azeri government. The companies then formed the Azerbaijan International Operating Company in February 1995 with BP as the operator. The consortium currently consists of nine companies. The first stage of the project was completed in November 1997, resulting in the launch of oil production from the refurbished Chirag-1 platform and then the refurbishment of the Western Route Export Pipeline (WREP, Baku-Supsa) in December 1998.

Figure 39: Oil production at ACG, 1997-2012, mn bbl



Source: BP

The second and third phases included the development of the Azeri and Deepwater Gunashli fields (in three stages: central, east, and west). The first oil from the central Azeri field was delivered in February 2005 while the last stage of the Azeri project delivered oil in October 2006. The last phase was completed in April 2008.

Construction of a major pipeline, Baku-Tbilisi-Ceyhan, was started in April 2003 and completed in June 2006. The 1.2mmbpd capacity pipeline starts from the Caspian shore in Azerbaijan, passes through Georgia and eventually reaches the Mediterranean port of Ceyhan in Turkey, traveling 1,768 km.

Today, ACG provides 80% of Azerbaijan's total oil output. According to BP, ACG accounted for 10% of its total liquids production worldwide in 2012.

Shah Deniz: Sea King

A PSA to develop the Shah Deniz Field was signed in October 1996 for 35 years and later extended by five years. According to BP, Shah Deniz is among the largest gas-condensate fields in the world with over 1 trillion cubic meters of gas. The field became operational in December 2006 and the first gas was delivered from the field to Turkey in July 2007 through the just-commissioned South Caucasus Pipeline (Baku-Tbilisi-Erzurum), which extends 692 km and can carry up to 7 bcm of gas per year.

The development of Shah Deniz consists of two stages. The first gas from the field was produced within the first stage and its annual output is about 9 bcm. According to BP, a consortium of companies invested US$ 6bn during the first stage. An additional 16 bcm of gas is expected to be produced during the second stage, with the first gas volumes from this second stage expected in late 2018. According to the operating company, the project will require over US$ 25bn to produce and transport gas to the European market.

Overall, according to media sources, over US$ 40bn has been invested in the projects implemented by BP and a further US$ 25bn is in the pipeline for the development of the second stage of the Shah Deniz field.

List of Projects:

- Azeri-Chirag-Gunashli
- Shah-Deniz
- Baku-Tbilisi Ceyhan pipeline
- Baku-Tbilisi-Erzurum Pipeline
- Sangachal Terminal

Appendix 2: The State Oil Fund

The State Oil Fund of Azerbaijan Republic was established in 1999 to collect and manage revenue flows from oil and gas PSAs and the fund's own operations.

The fund has a three-tier management structure consisting of the President of Azerbaijan (the supreme authority), a supervisory board and the executive director responsible for daily operations.

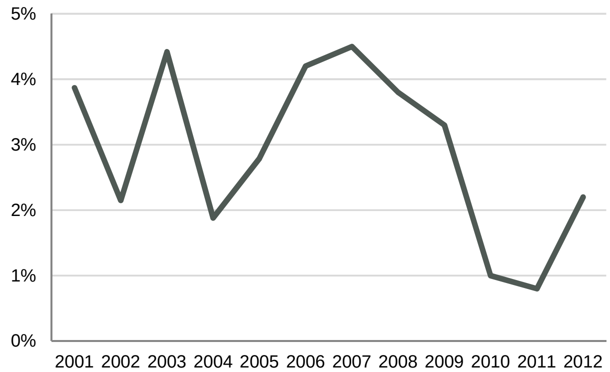
The fund is an independent institution and its budget is not included in the central state budget. However, its investments and budget must adhere to the investment strategy approved by the president and should support the government's macroeconomic policy.

Investment Policy

As an institution entrusted with saving public funds, the fund's investment policy is geared towards lower risk and therefore lower interest-earning instruments rather than riskier high-yield instruments. Originally, the fund's asset management guidelines limited investment options to long-term instruments with a credit rating of "A" (S&P, Fitch) or above. However, mainly due to low interest rates, the policy has generated low revenues. As the fund continued to expand its asset base, the asset management guidelines were amended in 2011 to allow investments into riskier, high-yielding assets. Under the new rules the fund can invest in:

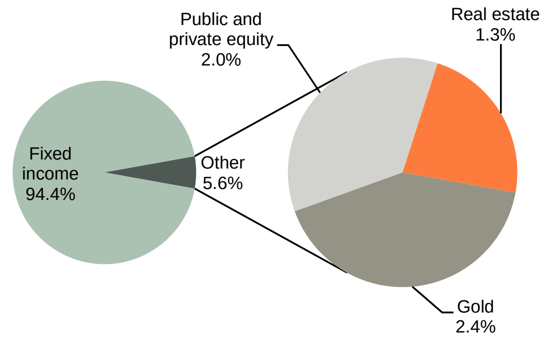
- Deposits in central (national) banks, commercial banks, and other financial institutions;
- Debt issued by governments, government agencies, international financial organizations, for-profit organizations, and other institutions with long-term investment-grade credit ratings (S&P, Fitch, or Moody's);
- Stocks included in major international equity indices;
- Shares of mutual and alternative investment funds;
- Gold bars conforming to the requirements of the London Bullion Market Association;
- Real estate;
- Non-investment grade debt obligations or deposits with a credit rating of not less than BB- (S&P or Fitch) or Ba3 (Moody's). The capital allocated should not exceed 5% of the total value. In this case, the counterparty banks of the Oil Fund providing custodian (depositary) services and holding correspondent accounts for the Oil Fund are permitted to have a non-investment grade credit rating (not less than BB- (S&P, Fitch) or Ba3 (Moody's).

Figure 40: SOFAZ investment portfolio: Rate of Return, %



Source: SOFAZ

Figure 41: SOFAZ's YE12 investment portfolio by asset classes



Source: SOFAZ

Until 2012, SOFAZ was allowed to keep only US$, GBP, and EUR-denominated assets. Since 2012 the currency basket has been expanded to include G8 member countries, countries with a sovereign debt rating of not less than "A", and Turkey and Russia. Expanding the scope of the investment options will increase the riskiness of the investments. However, most sovereign wealth funds follow the same principle.

Table 3: SOFAZ revenues, 2012

	US$ mn	% of total
Total Revenue	**17,405.4**	**100.0**
Proceeds from profit oil and gas sales	16,695.8	95.9
Azer-Chirga-Gunasjhli	*16,257.3*	93.4
Shah-Deniz	*365.5*	2.1
Balakhani	*23.0*	0.1
Binagadi	*12.5*	0.1
Zigh-Hovsan	*9.7*	0.1
Kursengi-Garabaghly	*9.1*	0.1
Surakhany	*9.0*	0.1
Kurovdag	*8.6*	0.1
Neftchala	*0.9*	0.0
Bahar	*0.2*	0.0
Revenues from asset management	693.5	4.0
Transit fee revenues	10.0	0.1
Acreage fees	3.8	0.0
Bonus payments	2.0	0.0
Other revenues	0.3	0.0

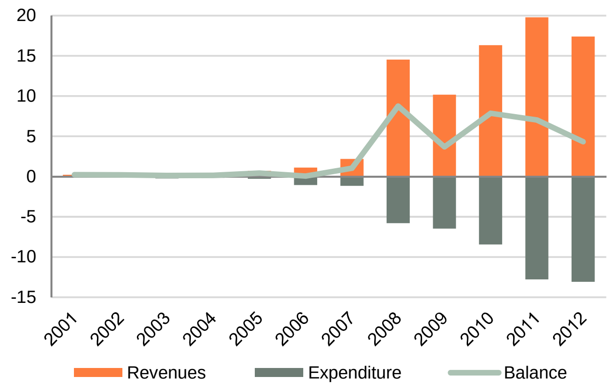
Source: SOFAZ

Table 4: SOFAZ expenditures, 2012

	US$ mn	% of total
SOFAZ Expenditures	**13,071.5**	**100.0**
Transfer to the state budget	12,244.9	93.7
Settlement of refugees and internally displaced persons	370.9	2.8
Samur-Absheron irrigation system	247.2	1.9
New Baku-Tbilisi-Kars Railway	147.1	1.1
SOFAZ administrative expenses	36.6	0.9
Education abroad	24.7	0.2

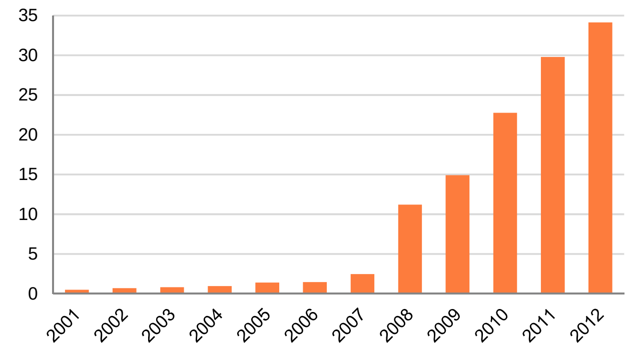
Source: SOFAZ

Figure 42: SOFAZ budget, 2001-2012, US$ bn



Source: SOFAZ

Figure 43: SOFAZ assets, US$ bn



Source: SOFAZ

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