Azerbaijan Economy

Low oil prices: a bumpy ride

Azerbaijan | Economy

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Falling oil prices will have a negative impact on Azerbaijan in 2015. High public expenditure, which was not a pressing problem while oil prices were high, will be putting a strain on the fiscal balance. Our calculations indicate that with approved budgeted expenditure and at US$ 60/bbl, Azerbaijan may face a fiscal deficit of US$ 9.5bn (14.2%) in 2015 of which US$ 6.0bn will be financed by tapping SOFAZ reserves. We acknowledge that at 48.8% of GDP, SOFAZ reserves act as a strong buffer against price fluctuations in the short term and the government has several policy tools to use if the price weakness persists in 2015. The policy tools include cutting capital expenditure (which stands at 44.4% of total) at the expense of economic growth or tapping further into SOFAZ reserves. However, persistently low prices may pose greater challenges and more durable policy changes might be needed to revitalize Azerbaijani economy.

Falling oil prices: a new challenge

As a resource-rich country, Azerbaijan is dependent on oil and gas production and prices. In 2013, oil and gas sector accounted for 94.4% (corresponding to 40.8% of GDP) of total exports, 72.0% (28.6% of GDP) of the consolidated budget revenues and 43.4% of GDP.

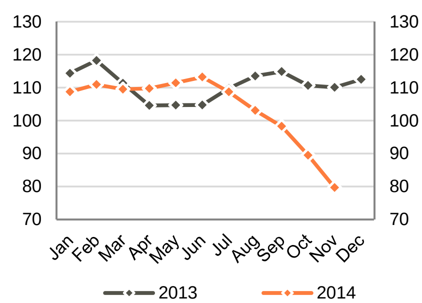
Despite production contracting since 2010 from 50.8mn tons to 43.5mn tons, a higher oil prices kept oil inflows buoyant in 2011-2013, thereby strengthening Azerbaijan's current account balance (21.4% of GDP on average p.a.) and increasing SOFAZ reserves (standing at 48.8% of GDP in 2013). As a result, external financing needs seemed a distant concern.

However, the recent weakness in oil prices is starting to present a challenge similar to that in 2009 when oil prices fell by 36.3%.

The government has planned the 2015 budget at US$ 90/bbl while the price has now fallen to around US$ 60/bbl. Our estimates suggest that oil price drop to US$ 60/bbl, will translate into nominal GDP contracting by 9.9%, consolidated budget revenues falling by 24.0%, SOFAZ reserves declining by 16.3% and current account surplus dropping from an estimated 17.1% of GDP in 2014 to 3.2% of GDP in 2015. However, falling oil prices will push deflator into a negative territory and, contrary to nominal GDP, economy in real terms is expected to grow by 2.8-3.1% in 2015.

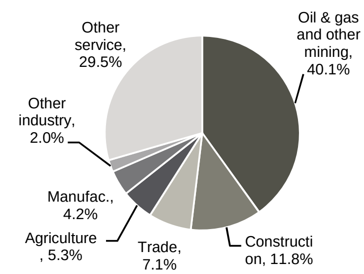
While Azerbaijan has capacity to deal with temporary oil price fluctuations, persistent low prices will require some policy initiatives. These might consist of cutting public capital spending or tapping international bond markets. Azerbaijan's low public external debt to GDP ratio of 8.5% allows easy access to international capital markets.

Figure 1: Azeri light, US$/bbl



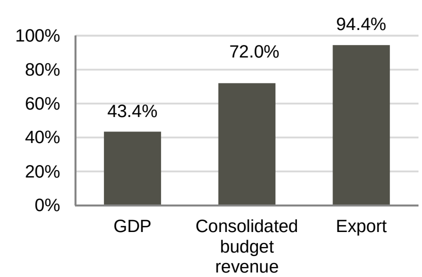
Source: SOCAR

Figure 2: GDP structure 2013, %



Source: AzSTAT

Figure 3: Oil and gas shares, %



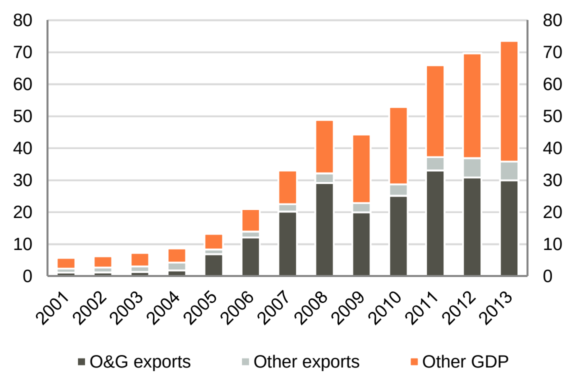
Source: AzSTAT, CBAR, Ministry of Finance, SOFAZ

Ekaterina Gazadze
Head of Research | egazadze@gt.ge | +995 322 401 111 ext.3760
Alim Hasanov
Economist | ahasanov@gt.ge | +995 322 401 111 ext.3933
Eva Bochorishvili
Economist | evabochorishvili@gt.ge | +995 322 401 111 ext.8036

Saved funds absorb negative impact of oil price swings

SOFAZ has been preventing overheating of the economy by partially insulating it from oil and gas windfall. From 2005 to 2012 oil and gas exports averaged to 52.2% of GDP (40.8% in 2013). Export receipts provided essential financing for Azerbaijan's high growth over the previous decade. However, extreme overheating was prevented as from 2008 to 2013 on average 20.1% of export revenue was saved in SOFAZ (state owned fund). As a result, US$ 33.3bn of external revenue was insulated from the economy and saved in the fund over the previous 6 years.

Figure 4: Nominal GDP by expenditure, 2001-2013, US$ bn



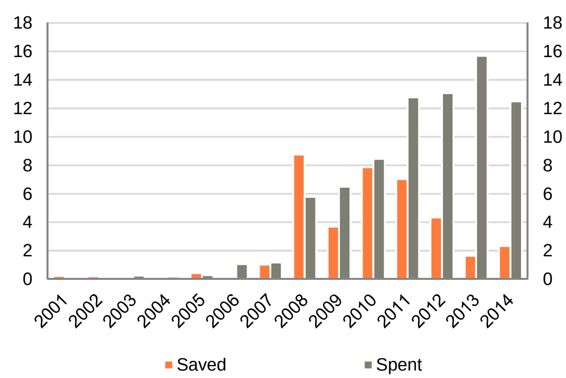
Source: AzSTAT, CBAR

Figure 5: Net saving in SOFAZ

Source: SOFAZ, AzSTAT, CBAR

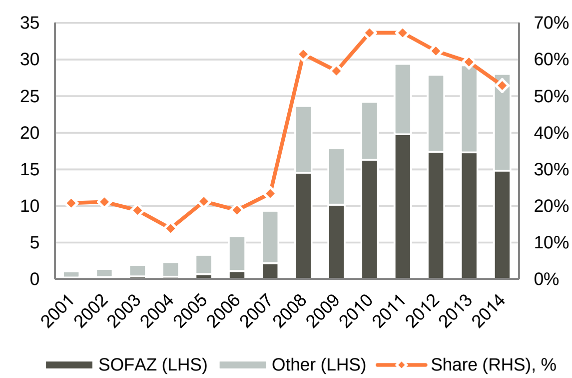
SOFAZ has been crucial in Azerbaijan's consolidated budget's surplus over the previous 6 years accounting on average for 62.0% of annual budget revenue.

Figure 6: SOFAZ flows, 2001-2013, US$ bn



Source: SOFAZ

Figure 7: Consolidated budget revenue, US$ bn



Source: Ministry of Finance, SOFAZ

SOFAZ reserves provide strong buffer to the economy and saved funds are key financing source for future deficits. Currently SOFAZ funds, which reached US$ 37.3bn in 9M14, act as major buffer for Azerbaijan and provide financing sources for deficit financing in the future.

Azerbaijan has faced a sharp oil price drop before, in 2009, when prices fell from US$ 97/bbl in 2008 to US$ 62/bbl. This resulted in its consolidated budget revenues dropping by 24.4% from US$ 23.6bn in 2008 to US$ 17.9bn in 2009. Falling oil prices resulted in nominal GDP shrinking by 11.3% y/y in 2009. However, with deflator falling by 18.8% y/y, real GDP grew by 9.3% y/y in 2009, mainly on the back of accelerating oil production, which increased by 13.2% y/y in 2009.

What is different this time? Unfortunately, compared with 2009, Azerbaijan's oil production is not increasing anymore and its public expenditure is more than twice what it was back then. On the positive side, at US$ 37.3bn SOFAZ reserves are more than double what they were in 2008 and the oil sector accounts for 43.4% of GDP compared to close to 60.0% in 2008.

Given all these factors, with stronger reserves and relatively developed non-oil sectors, Azerbaijan is better positioned to weather a temporary fall in the oil price than did in 2009. We expect contraction in nominal GDP by 9.9% y/y in 2015 as oil sector (which is expected to account for around 40.0% of GDP) may fall by 36.6% y/y, while non-oil sector which currently accounts for larger share compared to previous years is projected to increase by 7.9% y/y in nominal terms. Moreover, falling oil prices will push deflator into a negative territory with the economy (in real terms) expected to experience 2.8-3.1% growth in 2015.

However, given high public spending levels and contracting oil output, persistent low oil prices may present a significant challenge for Azerbaijan requiring structural reforms and private investments.

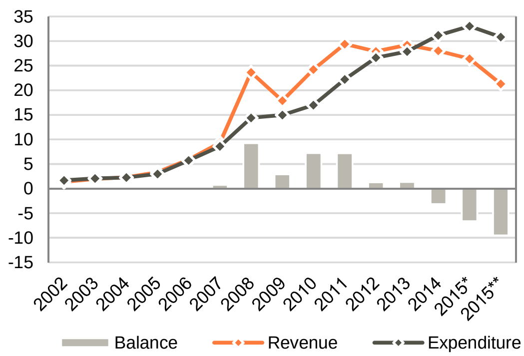
Persistent low oil prices will call for action by the authorities. This might consist of cutting public capital spending, which might undermine the short-term growth rate but would improve the fiscal balance. Obviously, it would have an impact on economic growth, particularly through the construction sector which had benefitted substantially from the government's largesse. However, at 17.3% of GDP, Azerbaijan's public investment is high (compared to 4.2% in Russia, 5.9% in Georgia) and there is a scope to cut it with marginal impact on the growth rate. We estimate that US$ 2.0bn cut in capital expenditures (corresponding to 16.8% of total budgeted capex, 2.7% of GDP) will result in fractional loss of growth.

Tapping international bond markets is another option if lower oil prices persist, especially given Azerbaijan's low debt to GDP ratio of 8.5%. However, the Fed's tightening policy and more risk aversion towards the region might result in higher borrowing costs in the next few years thus lessening the appeal of this option.

Starting the year with weaker oil prices

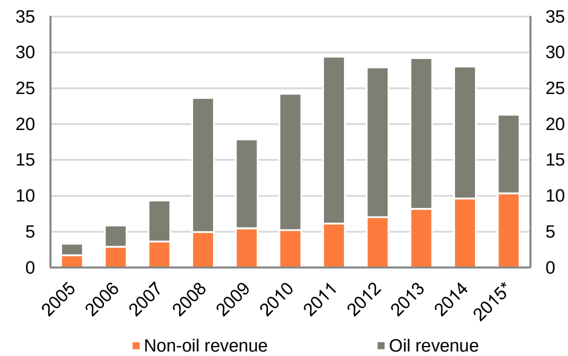
With oil prices at around US$ 60/bbl as we approach 2015, Azerbaijan might need to revisit its 2015 budget. The consolidated budget for 2015 is set at US$ 90/bbl, with total revenues projected at US$ 26.4bn and expenditures at US$ 33.0bn, resulting in a deficit of US$ 6.6bn (8.7% of GDP). Our calculations based on US$ 60/bbl suggest the deficit could reach US$ 9.5bn (14.2% of GDP), of which US$ 6.0bn (around 16.3% of total SOFAZ reserves) is planned to be financed by tapping SOFAZ reserves. The rest will have to be financed through issuance of debt, which would not be a serious challenge given low external public debt (US$ 6.4bn or 8.5% of GDP). Alternatively, government can opt for cutting capex.

Figure 8: Consolidated budget 2002-2015, US$ bn



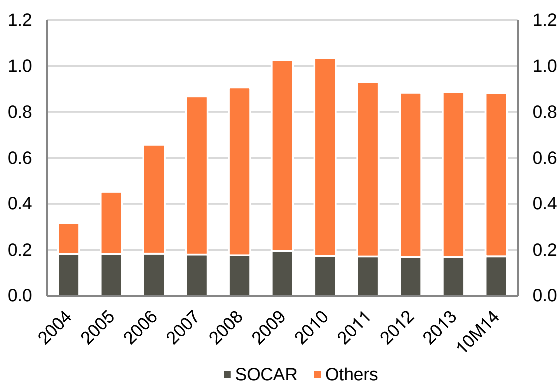
Source: Ministry of Finance, G&T Research
** Official estimate at US$ 90/bbl*
*** G&T Research estimate at US$ 60/bbl*

Figure 9: Oil and non-oil revenue, US$ bn



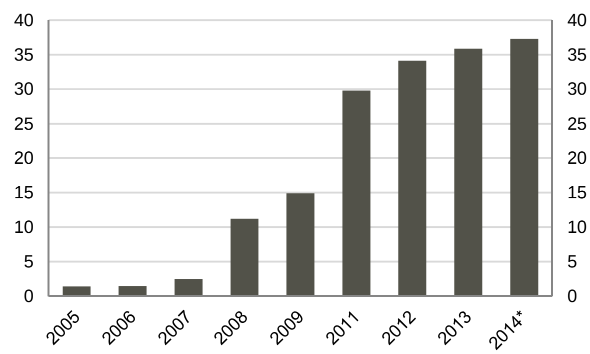
Source: Ministry of Finance, G&T Research
G&T Research estimate at US$ 60/bbl

Figure 10: Average daily oil production, mn barrels



Source: SOCAR, G&T Research

Figure 11: SOFAZ reserves, US$ bn

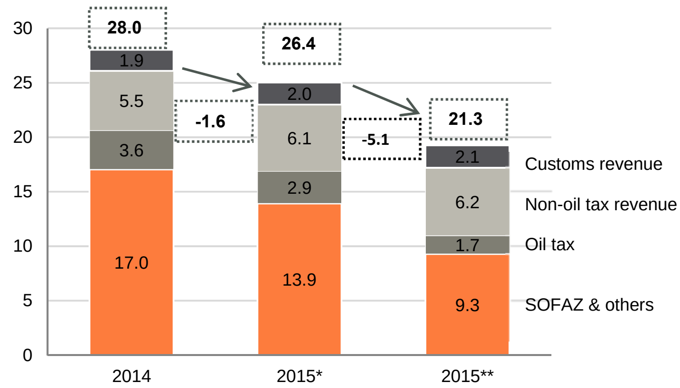


*9M14

Source: SOFAZ

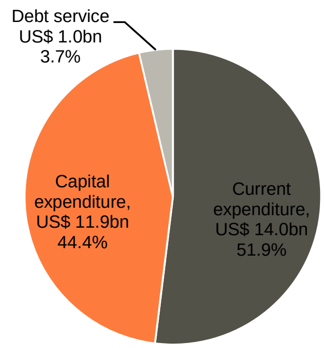
SOFAZ transfers continue to have significant share in budget revenue structure (53.4% of total) enabling to maintain high capex in 2015 state budget at 44.4% of total. However, with falling oil prices oil revenues may fall by 40.4% in 2015 and exert pressure in the long term on capex if low prices persist.

Figure 12: Consolidated budget revenue, US$ bn



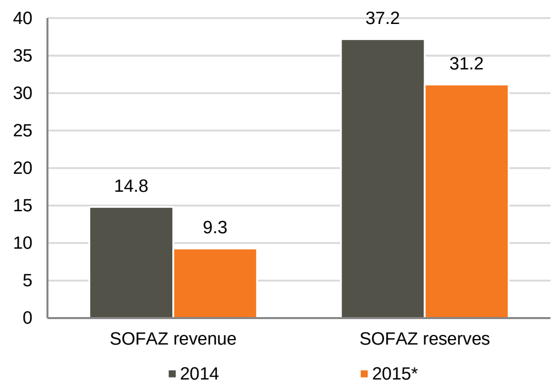
Source: Ministry of Finance, G&T Research
** Official budget at US$ 90/bbl assumption*
*** G&T Research estimates at US$ 60/bbl assumption*

Figure 13: State budget expenditure 2015, US$ bn



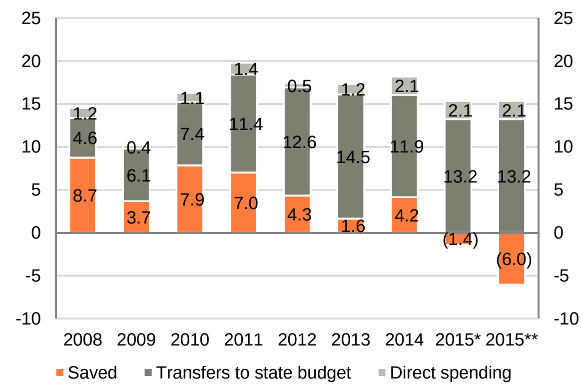
Source: Ministry of Finance, G&T Research

Figure 14: SOFAZ budget projections, US$ bn



Source: SOFAZ, G&T Research
** US$ 60/bbl assumption*

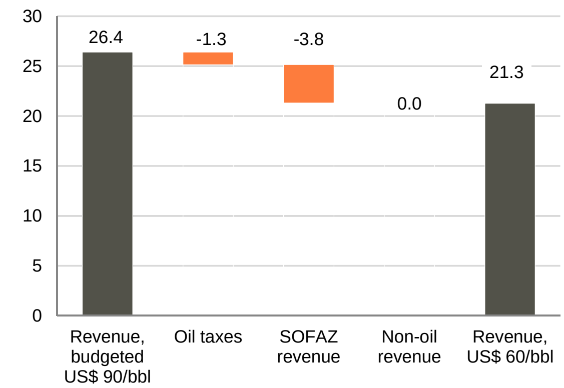
Figure 15: SOFAZ budget, US$ bn



Source: SOFAZ, G&T Research
** US$ 90/bbl assumption*
*** US$ 60/bbl assumption*

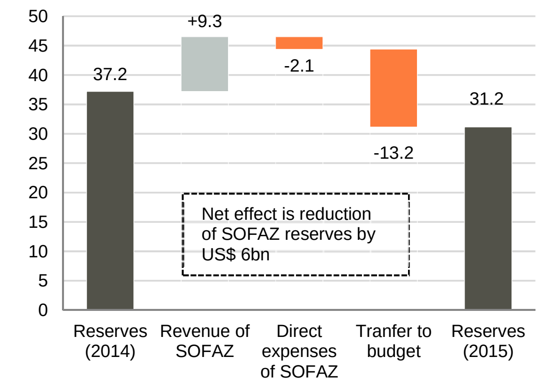
Our calculations indicate that at US$ 60/bbl, tax revenue from the oil sector will be 43.1% lower at around US$ 1.7bn compared with an estimated US$ 2.9bn at US$ 90/bbl. The shortfall in SOFAZ revenues will be substantial with just US$ 9.3bn generated at US$ 60/bbl compared to expected US$ 14.8bn in 2014 and SOFAZ will probably experience its first year of dis-saving in 2015 given the expected transfer to the budget of US$ 13.2bn. In addition, SOFAZ has direct expenses at around US$ 2.0bn each year. With the government's base oil price at US$ 90/bbl, we estimate that dis-saving will be around US$ 1.4bn, while at US$ 60/bbl it could reach US$ 6.0bn.

Figure 16: 2015 budget inflow with oil price at US$ 60/bbl vs US$ 90/bbl, US$ bn



Source: G&T Research estimates at US$ 60/bbl vs official budget

Figure 17: SOFAZ reserve dynamics in 2015 at US$ 60/bbl



Source: SOFAZ, G&T Research

Falling oil price undermines source of financing for growth in some sectors. The fall in price from above US$ 110/bbl to US$ 60/bbl will cut export receipts from US$ 33.9bn in 2014 to an estimated US$ 21.4bn in 2015, resulting in the current account surplus expected to fall from US$ 12.9bn to US$ 2.5bn in 2015. However, despite this fall, we do not expect a current account deficit any time soon, as imports do not match exports even at the current low oil prices. Moreover, the economic slowdown will further suppress imports, benefitting the external trade balance. Indirectly, falling oil prices might negatively affect construction activity which expanded by more than 20.9% every year from 2010 to 2013 and was mainly financed from oil revenues.

Table 1: Budget parameters, 2009 versus 2015, US$ bn

	2008	2009 oil price drop	2013	2014E	2015E budgeted*	2015E estimated
AZN exchange rate	0.822	0.804	0.785	0.785	0.785	0.785
Oil price, US$/bbl	**97.0**	**61.8**	**104.1**	**100.0**	**90.0**	**60.0**
Consolidated budget						
Revenue	23.6	17.9	29.2	28.0	26.4	21.3
Oil revenue	18.7	12.4	21.0	18.4	-	11.0
Oil taxes	4.3	2.2	3.7	3.6	2.9	1.7
SOFAZ revenue	14.4	10.2	17.3	14.8	-	9.3
Non-oil revenue	4.9	5.5	8.2	9.6	-	10.3
Expenditure	14.4	15.0	27.9	31.2	33.0	30.8
Budget balance	9.2	2.9	1.4	-3.1	-6.6	-9.5
State budget						
Revenue	13.1	13.1	24.8	23.4	24.8	23.2
Taxes	6.9	5.1	8.5	9.1	9.1	7.9
Oil taxes	4.3	2.2	3.7	3.6	2.9	1.7
Non-oil taxes	2.7	2.9	4.8	5.5	6.1	6.2
Customs duties	1.4	1.4	1.8	1.9	2.0	2.1
SOFAZ transfers	4.6	6.1	14.5	11.9	13.2	13.2
Others	0.2	0.5	0.1	0.6	0.4	0.0
Expenditures	13.1	13.1	24.4	25.6	26.9	24.6
Current expenditure	6.3	5.6	12.3	13.9	14.0	12.2
Capital expenditure	6.7	7.2	11.1	10.7	11.9	11.5
Debt service	0.1	0.2	0.9	1.0	1.0	0.9
Non-state budget revenue						
SOFAZ revenue	14.4	10.2	17.3	14.8	-	9.3
Others	0.7	0.7	1.5	1.7	-	2.0
SOFAZ						
Revenue	14.4	10.2	17.3	14.8	-	9.3
Expenditure	6.0	6.6	15.7	13.5	-	15.3
Transfers to state budget	4.6	6.1	14.5	11.9	13.2	13.2
Other expenditure	1.4	0.5	1.2	1.6	-	2.1
Budget balance	**8.4**	**3.6**	**1.7**	**1.3**	**-**	**-6.0**
Reserves	**11.2**	**14.9**	**35.9**	**37.2**	**-**	**31.2**
Central Bank reserves	**6.5**	**5.4**	**14.2**	**15.0***		

Source: AzSTAT, Ministry of Finance, SOFAZ, Central Bank, G&T Research
Note: Non-state budget revenue includes SOFAZ, Social protection Fund, Nakhchivan
** Government has not yet announced SOFAZ budget*

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Head of Research
Ekaterina Gazadze | egazadze@gt.ge

Economist
Eva Bochorishvili | evabochorishvili@gt.ge

Economist
Alim Hasanov | ahasanov@gt.ge

Senior Associate
Giorgi Iremashvili | giremashvili@gt.ge

Analyst
David Kutidze | dkutidze@gt.ge

Analyst
David Ninikelashvili | dninikelashvili@gt.ge

Analyst
Tamar Kurdadze| tamarkurdadze@gt.ge

Address: 79 D. Agmashenebeli Avenue, Tbilisi 0102, Georgia
Tel: + (995) 32 2401111
Email: research@gt.ge