GALT & TAGGART RESEARCH

Azerbaijan Economy
Setting Realistic Targets

Azerbaijan | Economy
October 2, 2015

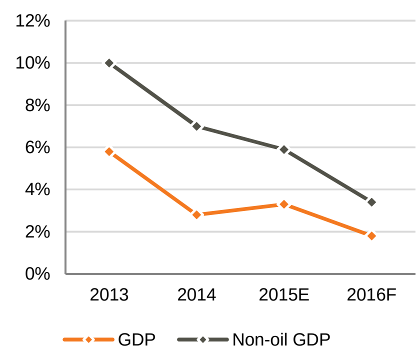
Defying all expectations, Azerbaijan's GDP increased 4.2% y/y in 8M15. According to official figures, non-oil GDP expanded 7.3% y/y, while oil GDP contracted 0.1% y/y. However, our estimates of monthly growth figures indicate a slowdown in July and a probable contraction in August, pointing to a lagged impact of low oil prices and the associated devaluation on the real economy. The delayed impact will continue to weigh on the economy in 2016 and this expectation is taken into consideration in the official draft budget document for 2016. According to the document, growth is estimated to fall from the current 4.2% in 8M15 to 3.3% for the whole of 2015 and further down to 1.8% in 2016. In our view, given the prospects of oil price, official forecasts are broadly realistic.

Slower growth for the rest of the year
Growth in 8M15 was mainly driven by construction, trade, and manufacturing. The construction sector, bolstered by last year's investments related to the European Games, experienced 8.4% y/y growth in 8M15, down from double digit growth rates in 1H15. Relatively suppressed inflation helped boost trade in 8M15, which expanded 11.3% y/y. However, as price pressures gain steam, activity in the trade sector is likely to decelerate in the rest of the year. Activity in the manufacturing sector was another major source of growth, particularly in food processing and refinery. Food processing probably benefitted from devaluation, which made imports more expensive, resulting in increased demand for domestic products. Low base was a key factor explaining the growth in refining, but the effect has already been exhausted and growth fell to below 2% in 8M15. Agriculture and tourism, expanding 7.4% and 16.7% y/y, respectively, in 8M15 were other sectors supporting growth, but given their small shares in GDP, their contributions were limited.

Nominal GDP in US$ terms expected to decrease 24.6% in 2015
Nominal GDP has fallen 7.9% y/y in 8M15 in AZN terms and 27.5% y/y in US$ terms, as the February devaluation resulted in average US$/AZN rate going up from 0.78 in 8M14 to 0.99 in 8M15. According to the draft budget document, nominal annual GDP in AZN terms is expected to fall from AZN 59.0bn in 2014 to AZN 57.2bn in 2015, with a minor increase to AZN 57.7bn in 2016. In US$ terms, the decline is more pronounced, falling from US$ 75.2bn in 2014 to US$ 56.7bn in 2015 (a 24.6% decline) and further to US$ 55.0bn in 2016.

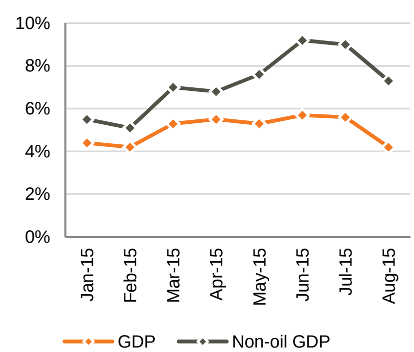
2Q15 external balance surplus at the lowest level
High oil prices have been feeding the strong current account surplus of the previous years, which stood at strong double digit levels. As prices plunged, so did Azerbaijan's oil revenues, which accounted for 94.2% of total exports in 2014. As a result, the surplus has shrunk from US$ 6.4bn in 1H14 (17.6% of GDP) to less than US$ 0.1bn in 1H15 (0.2% of GDP). The external sector was further pressured by strong capital outflows, particularly in 1Q15. Capital outflows (defined as deposits and cash under the assets category of balance of payment statistics) peaked in 1Q15 at US$ 3.7bn, before falling to less than US$ 1bn in 2Q15. The ensuing deficit was financed by outflows from the reserves (as defined in the balance of payments statistics), which amounted to US$ 1.2bn in 4Q14, surging to US$ 4.6bn in 1Q15, and then falling to US$ 1.7bn in 2Q15.

Figure 1: GDP growth rate



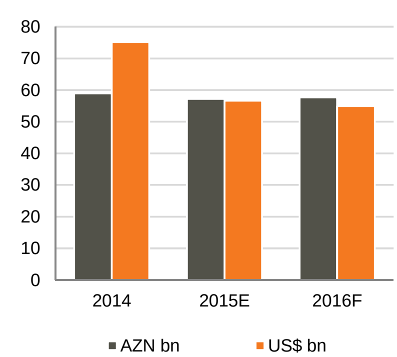
Source: AzSTAT, Ministry of Finance
E&F: official estimate and forecast

Figure 2: GDP growth rate, 2015 YTD



Source: AzSTAT

Figure 3: Nominal GDP



Source: AzSTAT, Ministry of Finance
E&F: official estimate and forecast

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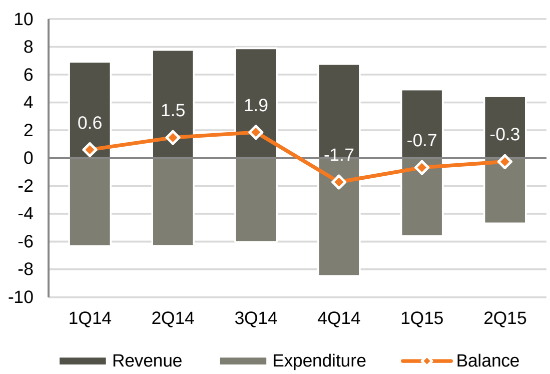
2016 Budget

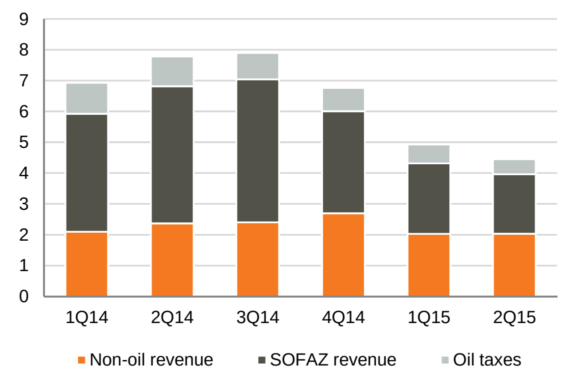
Dependence on the oil price is weighing on budget performance. In 2014, 67.4% of consolidated budget revenues came from the oil sector (SOFAZ revenues and oil sector taxes), down from 72.0% in 2013, reflecting the budget's dependence on oil and oil prices. With average oil price plunging from 108.9 US$/bbl in 1H14 to 58.0 US$/bbl in 1H15, consolidated budget revenues have already fallen 21.7% y/y from AZN 11.5bn (US$ 14.7bn) in 1H14 to AZN 9.0bn (US$ 9.3bn) in 1H15. Faced with this new reality, the government adjusted the budget for the rest of the year, albeit not by changing the budget law. The government now expects that state budget expenditures will be 16.0% less in AZN terms compared to the initially budgeted figure, corresponding to savings of AZN 3.4bn. Savings will be achieved by cutting "non-urgent" infrastructure spending (AZN 2.7bn) and other spending (AZN 0.5bn), with other categories facing limited contraction.

Figure 4: Consolidated budget, US$ bn



Source: Ministry of Finance

Figure 5: Decomposition of consolidated revenue, US$ bn



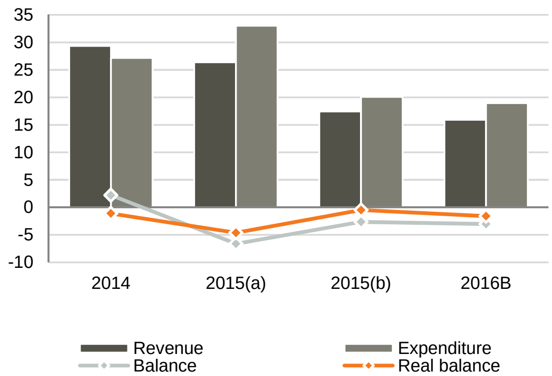
Source: Ministry of Finance, G&T Research

Lower expenditures will help SOFAZ save more than US$ 5bn. The aforementioned cuts will allow the government to reduce transfers from the State Oil Fund from the budgeted AZN 10.4bn to AZN 8.1bn. In US$ terms, savings are far more significant given the devaluation impact. At previous exchange rates, transfers from SOFAZ would have reached US$ 13.2bn, compared to the current US$ 8.1bn, corresponding to a hypothetical savings of US$ 5.2bn for the Fund.

2016 budget: further cuts. Further cuts are budgeted for 2016, which will help save SOFAZ reserves. According to the document, consolidated government expenditures will be down 23.2%, compared to the original 2015 budget. Following an expected AZN 2.7bn cut in capital expenditures in 2015 (defined as expenditure on industry and construction), the government is further reducing this spending category by AZN 0.7bn to AZN 3.6bn. A major cut is budgeted for the "other" expenditure category from an expected AZN 2.2bn in 2015 (compared to budgeted AZN 2.7bn) to AZN 0.9bn in 2016. Expenditures on "debt servicing" (from AZN 0.7bn in 2015 to AZN 1.2bn in 2016) and "culture and sport" (from AZN 0.3bn in 2015 to AZN 0.7bn in 2016) are budgeted to increase.

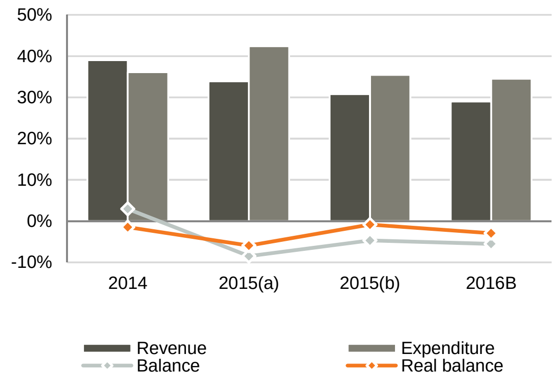
Subdued oil prices will also pressure the 2016 budget. Lower expenditures are a function of lower revenues stemming from the low oil price and a deliberate policy of saving reserves. For the 2016 budget, the government set the oil price at 50 US$/bbl and the exchange rate at 1.05 US$/AZN. With these assumptions, consolidated budget revenues are expected to reach AZN 16.7bn, down from AZN 23.0bn in 2014 (27.4% decrease). According to the document, almost the entire decrease in revenues is caused by the expected drop in SOFAZ revenues from AZN 12.7bn in 2014 to AZN 6.7bn in 2016 and the lower oil tax revenues. Other revenue categories are expected to experience minor declines.

Figure 6: Consolidated budget, US$ bn



Source: Ministry of Finance
Real balance: balance after accounting for SOFAZ withdrawals
(a) - initial 2015 budget
(b) - officially expected 2015 budget
B – 2016 official budget

Figure 7: Consolidated budget balance, % of GDP



Source: Ministry of Finance, G&T Research
Real balance: balance after accounting for SOFAZ withdrawals
(a) - initial 2015 budget
(b) - officially expected 2015 budget
B – 2016 official budget

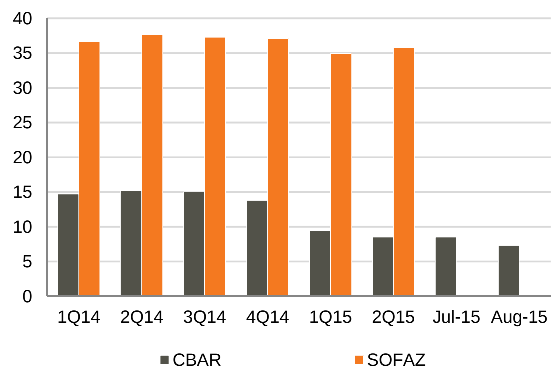
The government has budgeted a manageable AZN 3.2bn deficit for 2016. With that assumption, the consolidated budget balance is expected to remain in deficit for the second year in a row in 2016 at 5.5% of GDP, corresponding to AZN 3.2bn. Of this amount, AZN 1.5bn will be financed by withdrawals from SOFAZ, leaving a financing shortfall of AZN 1.7bn. Non-oil deficit to non-oil GDP, however, will improve from 38.3% in 2014 to an estimated 31.0% in 2015 to 28.2% in 2016.

There is a high probability of an even lower deficit. Our in-house calculations indicate that the government took a cautious tone in drafting the budget, with a slightly pessimistic scenario for revenues. On the expenditure side, the government has generally underperformed, resulting in better than budgeted results in the budget balance. With these assumptions, we expect the consolidated budget deficit to be lower than officially budgeted, further easing the remaining deficit, subject to the forecast that oil price will remain at 50 US$/bbl. According to the latest oil price forecasts from the IMF and the US Energy Information Agency, at 59.6 US$/bbl and 58.6 US$/bbl, respectively, there is upside potential in oil prices in 2016. However, it would probably be impossible to avoid withdrawing funds from SOFAZ, albeit in smaller amounts. With that said, given the devaluation and the fact that SOFAZ reserves are kept in FX, reserves to GDP will probably increase from 49.3% in 2014 to above 60% in 2015 and 2016.

The realistic forecast and budget for 2016 will help save reserves and feed trust in the economy. The drop in oil prices had an undeniably negative impact on Azerbaijan's economy and its budget. The authorities have prepared a realistic document, reducing the growth rate forecast to 1.8% and radically adjusting budget figures by cutting expected revenues and expenditures, indicating that they are fully aware of the challenges. As a result, SOFAZ reserves, which have been among the major factors for the investment grade sovereign rating, will be conserved. Lower expenditures will relieve pressure on the local currency and lower the probability of another devaluation in 2016, subject to oil prices remaining at the forecasted level.

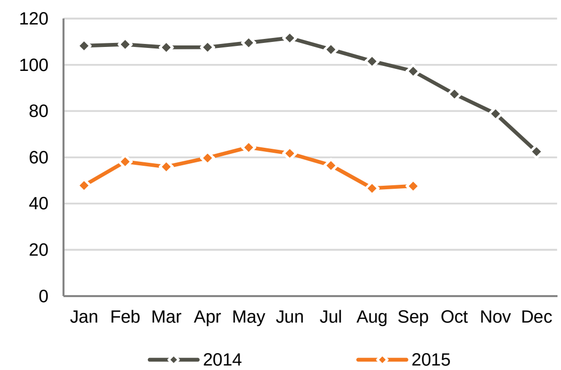
Selected Macroeconomic Charts

Figure 8: Reserves, US$ bn



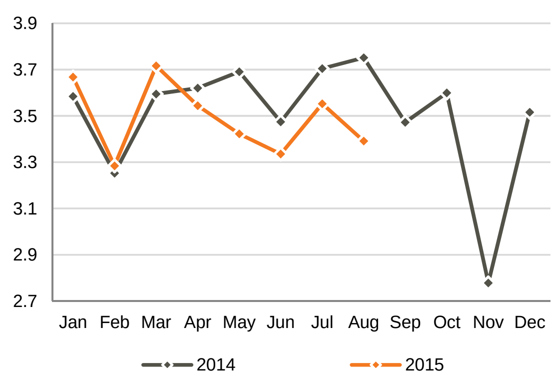
Source: CBAR, SOFAZ

Figure 9: Monthly average oil price, US$/bbl



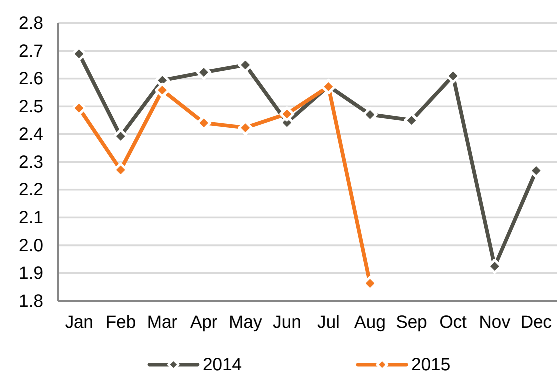
Source: SOCAR

Figure 10: Oil production, mn tonnes



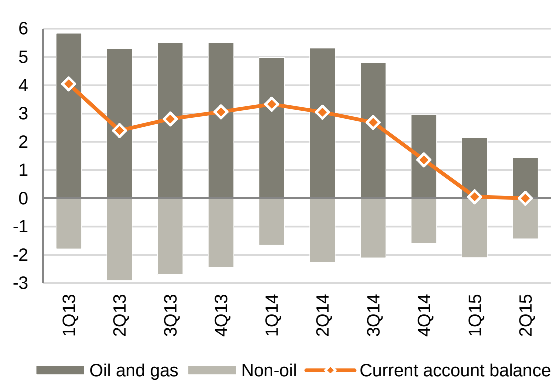
Source: AzSTAT

Figure 11: Gas production, bcm



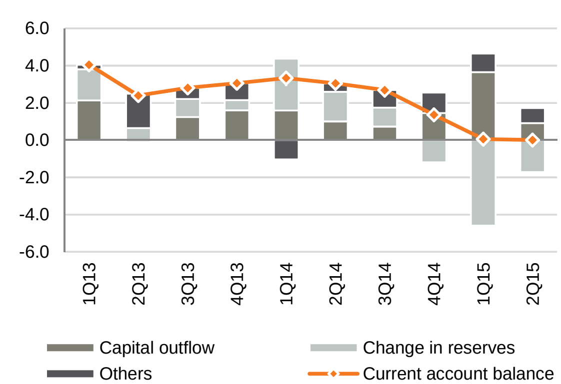
Source: AzSTAT, SOCAR

Figure 12: Current account balance, US$ bn



Source: CBAR

Figure 13: Balance of payments trend, US$ bn



Source: CBAR

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