

Azerbajdžan

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Main information

- Current Azerbaijan was originated in 1991 after the collapse of the Soviet Union.
- This presentation deals with the analysis after 2004.
- Between 1991 and 2004
 - the transformation of the economy
 - the oil production was unified into SOCAR (*State Oil Company of Azerbaijan Republic*)
 - conflict with neighbouring Armenia over the Nagorno-Karabakh region
- Change after 2014

GDP

- Small open economy
- Azerbaijan's economy is characterized by oil and gas extraction.
 - Between 2004-2014 the representation of oil sector in real GDP had increased.
 - Maximum in 2009: more than 50% of real GDP.
- GDP's growth rate depends on oil extraction and oil prices
- More than 90 % of total export in Azerbaijan is represented by oil or gas
- Dependence of GDP on oil prices.
 - Between 2004-2009 oil prices and extraction grew -> GDP was rising rapidly – despite 40 % (growth rate of GDP).
 - In 2009 oil shock ->the price of oil has fallen -> recession.
 - After 2009 oil price grew, but price was more volatile and oil extraction was stabilized
 - growth rate of GDP is not extremy as before 2009 (2014 – 2,8 %).

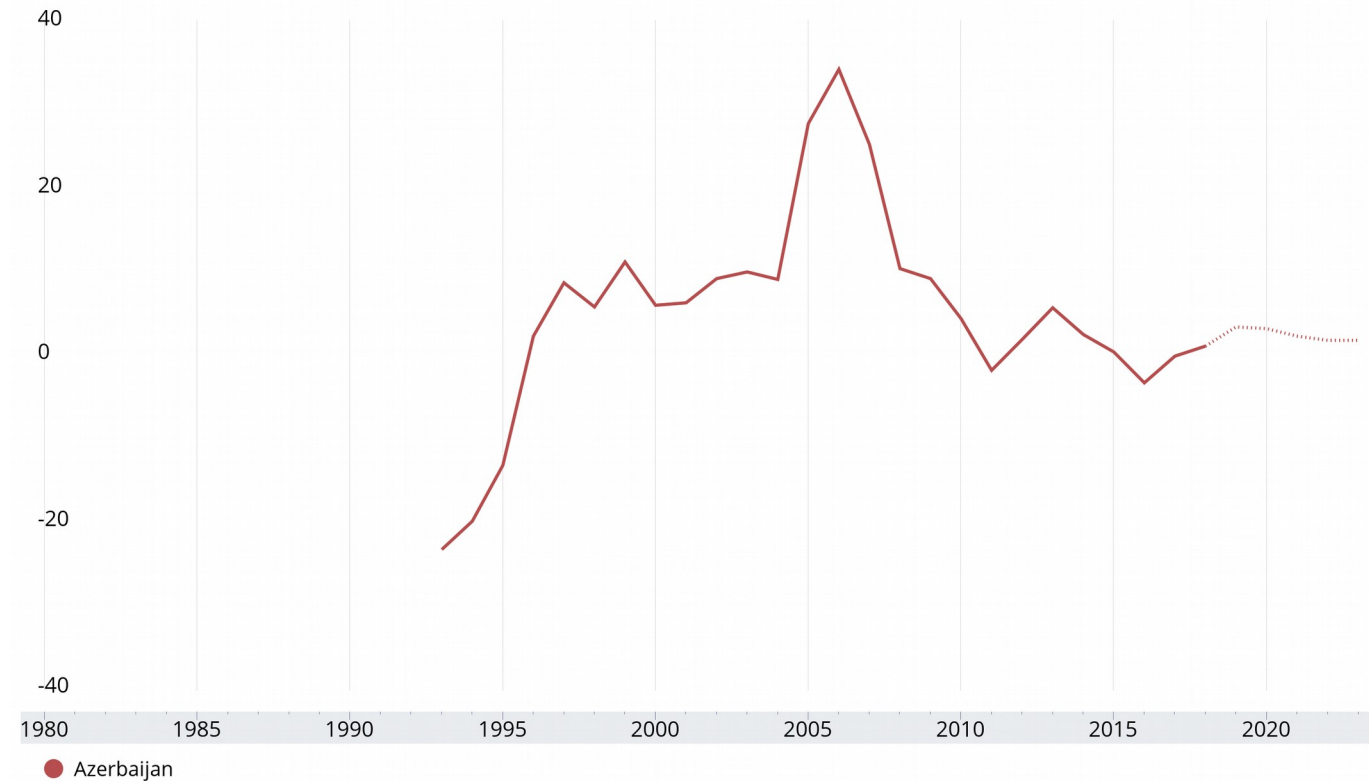
GDP – structure

- Symptoms of Dutch disease.
- Increasing GDP per capita leads to an increase demand for service.
- Non-oil economy
 - Decreasing share of agriculture and fishing in real GDP.
 - Increasing share of transport a construction in real GDP.
 - The main influence on the outflows in the growth rate of real GDP is the construction industry.

Real GDP

IMF DataMapper

Real GDP growth (Annual percent change)



©IMF, 2018, Source: World Economic Outlook (October 2018)

Inflation

- Between 2004-2009 inflation increased (more than 20 %).
- In 2009 – deflation.
- After 2009 – economy returned to low inflation (less than 10%).
- In 2014 inflation is 1,4 %.
- As GDP - inflation is highly dependent on the oil price.
 - if oil price increasing -> then inflation.
 - if oil price decreasing -> then deflation.
 - it is result of increasing demong for goods and services
- Central bank of Azerbaijan cannot totally control the inflation

Inflation

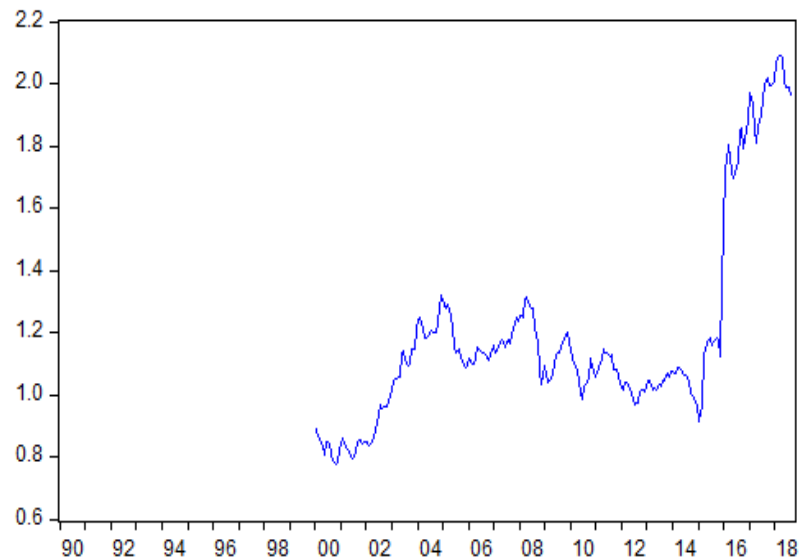


SOURCE: TRADINGECONOMICS.COM | THE STATE STATISTICAL COMMITTEE OF THE REPUBLIC OF AZERBAIJAN

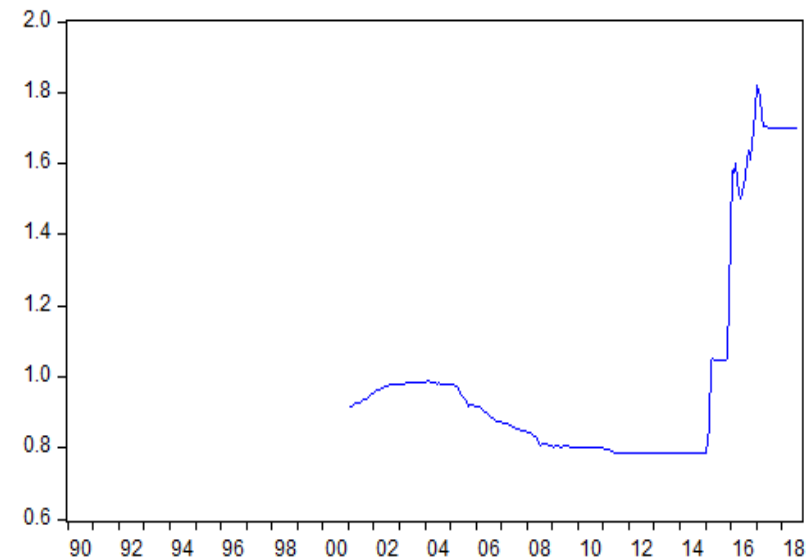
Exchange rate

- Between 2004-2014 – nominal and real appreciation (euro,dollar)
 - appreciation is correlated with higher oil extraction.
- In 2008 new Azerbaijani Manat (AZN)

Nominal exchange rate AZN/EUR (AZN per 1 EUR; AZN)



Nominal exchange rate AZN/USD (AZN per 1 USD; AZN)



Interest rate



SOURCE: TRADINGECONOMICS.COM | CENTRAL BANK OF THE REPUBLIC OF AZERBAIJAN

Government

- Political system is authoritarian
 - The Prezident (Iham Alijev)
 - Problems with corruption (Index of perception of corruption is around 30) and confusing tax system.
- Between 2004-2014 goverment budget is subsidized by oil and gas extraction and was farly balanced (low surplus).
- Goverment spendings were financed by SOFAS (2013 – 35%).
- SOFAZ
 - The **State Oil Fund of the Republic of Azerbaijan.**
 - SOFAZ has been set up to finance the funds, so that they can be used for future populations following the example of Norway.
 - to eliminate the effects of Dutch disease
 - Contains oil and gas profits.
 - Unfortunately, goverment uses this fund to pay government spendings
 - Historical agreement in the gas sector - 2013.

Key Industries in Azerbaijan

- Mining industry – oil and gas extraction: by 2008 Azerbaijan has 0.6% (7 billion barrels of oil) of the world's total recoverable reserves.
- The oil industry is a leading industry, accounting for about 40 percent of GDP.
- This circumstance makes the economy of Azerbaijan very sensitive and dependent on fluctuations in the prices of crude oil.
- Also there are such industries as engineering, including high-tech; chemical, food industry; metallurgy; automobile and shipbuilding.
- Agriculture is not the strongest sector of the Azerbaijani economy. The volume of its contribution to the country's GDP is only 5-6 percent annually.
- Dynamically developing branch of the economy of Azerbaijan is tourism.

Key Sources of Forex Inflow

- For the period from 1995 to 2011, about 120 billion US dollars flowed into the economy of Azerbaijan, 60% percent of which was foreign investment
- Currently, the main investors in Azerbaijan are oil companies. 90% of the shares of AIOC (The Azerbaijan International Operating Company) are owned by foreign investors: British Petroleum (UK, 17.1%), Amoco (USA, 17.0%), Lukoil (Russia, 10.0%), Pensroil (US , 4.8%), Yunokal (USA, 10.0%), Statoil (Norway, 8.6%), Itochu Oil (Japan, 3.9%), Ramco (UK, 2.1%), TPAO (Turkey, 6.7%), Exxon (USA, 8.0%), Delta-Nimir (Saudi Arabia, 1.7%). Investors of the Shah Deniz project are: the association British Oil / Statoil (UK / Norway, 25.5% each), SOCAR (Azerbaijan, 10%), Lukoil (Russia, 10%), Elf Akitan "(France, 10%), Iranian holding company (Iran, 10%), TPAO (Turkey, 9%).

Crisis – 2014-2017

- At the beginning of 2014, the USD/AZN exchange rate was set at 0.78
- 2014 – falling oil prices
- “Azerbaijan will suffer from a sharp drop in oil prices, which is explained by its high dependence on hydrocarbon exports the currency reserves accumulated by the Central Bank and the Oil Fund of the country (State Oil Fund of the Azerbaijan Republic, SOFAZ) will mitigate the impact of external threats, but growth in the non-oil sectors of the economy alone is unlikely to ensure steady growth as a whole” (EBRD’s report)
- December 21 2015, Azerbaijan switched to a floating exchange rate regime due to increased shocks in the foreign economy
- The one-time growth of the official dollar rate was almost 50%: if on Friday, December 18 2014, it was set at 1.05 manats per dollar, on Monday it became 1.55 AZN/USD
- According to the CBA’s report, starting from the end of July 2015, falling oil prices again significantly increased the pressure on the Azerbaijani manat rate.

Another reason for AZN's devaluation

- At the same time the devaluation of currencies in the partner countries had a negative impact on the international competitiveness of the national economy
- Another impetus for a decline in the manat was the Russian ruble devaluation
- The prices of goods imported into Azerbaijan from Russia decreased, and the competitiveness of Azerbaijani goods decreased both on the domestic and foreign markets. Due to the exchange rate fall some Azerbaijani retail chains have suspended the sale of imported products.

Monetary policy regime before 2014

- The Monetary Authority of the CBA used to interfere in the financial market and had a preference for a pegged currency rate.
- As a requirement of the pegged exchange rate policy, the Monetary Authority had to interfere in currency market, which diminished the foreign exchange reserves of the Central Bank.
- Before the plunge in oil prices started, the CBA had over 15 billion USD in reserves, while at the end of 2016, the CBA possessed less than 4 billion USD in reserves and lost its supplier position in auctions to commercial banks.

Monetary policy regime after 2014

- After the implementation of the floating exchange rate policy the Monetary Authority followed an Expansion Quantitative Easing policy for foreign currencies in order to obtain financial stability in the local economy and meet market requirements via the support of SOFAZ.
- Twice a week, SOFAZ provided foreign currency to commercial banks through auctions.
- Since September 2016, the Monetary Authority and SOFAZ has committed to a policy of not sharing in advance the amount of US dollars which will be offered during its auctions.
 - *Reason:* to prevent markets from making any speculations, which end up artificially exaggerating rates, bringing instability and leading demand to exceed supply.

Monetary policy regime after 2014

- As a consequence of the prolonged slump in oil prices, national oil windfalls were reduced.
- Due to its high level of reliance on oil rents, the Azerbaijani economy performed badly during this time.
- As a result, the Monetary Authority had to control macro-economic stability through the use of several tools.
- That is to say, the CBA has pursued a strict monetary policy through raising the interest rate of the manat from 9.5% to 15% (on 14 September 2016) and minimizing the manat base by around 600 million manats in the first quarter of 2017.
- The CBA's key objectives in raising interest rates of the national currency were to curb inflation rates, increase the rates applied to deposits and bonds in markets (to extract manats from exchange markets and limit demand for foreign greenbacks) and to enhance confidence in the national currency.

Crisis – CBA's decision

- In February, 2015 Central bank said in its release that, “the economy, the currency market and the manat rate were adapted to the price of oil, which was at \$50-55 level.” When oil price reached a new level below \$40 Central bank of Azerbaijan took a new adaptation: to change the exchange rate regime to the floating one.
- On the 16th February, 2015 and for determining the rate of the AZN a two-currency basket will be used, which will include not only the US dollar, but also the euro, where the share of the euro will be 20-30%
- „The new operating framework will allow for a more flexible exchange rate policy and ensure macroeconomic efficiency, as well as gradually adapt economic agents to new conditions“ (CBA)

Reasons of CBA's decision

- In the face of falling world oil prices, which is the main product of exports and the main source of income for Azerbaijan, such maintenance of exchange rate was rather expensive for CBA and CBA was forced to sell the currency to maintain the AZN rate
- From August to December 2014 the CBA's foreign exchange reserves decreased by \$1,435 from \$15,193 billion to \$13.758 billion
- In January 2015, the CBA spent another \$1,077 billion to maintain the manat rate, as a result of which its reserves decreased to the lowest level since spring 2013.

Reasons of CBA's decision – contd.

- In fact, it was a question of refusing to maintain a stable (fixed) exchange rate of the national currency against the USD, which was constantly growing in price. “Diluting” the currency basket with the euro, which value was decreasing (over the year the euro/dollar rate fell from \$1.4 to \$1.1, and the manat fell from 1.07 to 0,94), the CBA had the opportunity to carry out “the soft” devaluation of manat.

2016 – changes

- Central bank of Azerbaijan tightened currency exchange rules: the exchange rate at which foreign currency cash is acquired and sold is determined independently by banks.
- When exchanging currency in the amount of more than \$500, it is necessary to present an identity card
- The new rules were introduced to tighten control over cash foreign exchange transactions and reduce speculative effects on the national currency.
- Azerbaijani authorities also planned to limit the export of currency from the country: the introduction of a fee of 20% of the total currency amount exported from the country to buy property, land and securities, as well as direct investments
- On January 2016, the CBA announced a ban on foreign exchange operations outside the head offices and branches of commercial banks.
- From January 22, 2016 the official exchange rate of the dollar to the AZN was set by the CBA at the level of 1.6028 Azerbaijani manat per US dollar.

Azerbaijan Today

Dynamics of main macroeconomic indicators, 2016-2018

Indicators	2016	2017	2018
Nominal GDP, <i>mln. AZN</i>	59987.7	70135.1	79797.3
<i>Nominal GDP from non-oil sector, mln AZN</i>	39403.1	44061.9	46671.3
Non-oil sector's share of GDP, %	65.8	63.0	58.5
GDP deflator, %	114.6	116.0	112.2
Real GDP growth (reduction), %	-3.8	0.1	1.4
Real GDP growth (reduction) in non-oil sector, %	-5.4	2.7	1.8

- The non-oil sector's share of GDP continued to fall for the third year, from 65.8% in 2016 to 58.5% in 2018;
- This means that the oil sector's share of GDP has also grown. This is related to the rise of the world market price of oil.
- In the reporting year, the oil and gas sector accounted for 91.2% of Azerbaijan's total exports, while the non-oil sector accounted for 8.7%.

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Azerbaijan Today

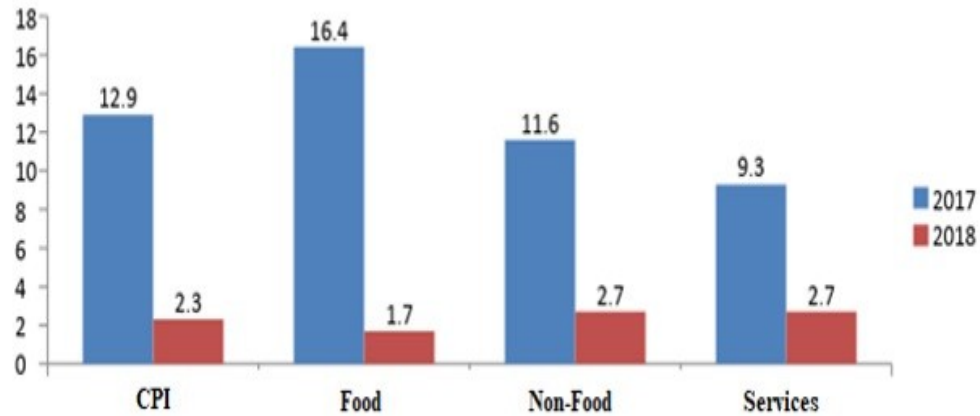


Figure 2. Average annual inflation, %

- The level of inflation, showing a tendency to fall, reached single digits in 2018 - last year 2.3%
- With the manat under no threat of weakening, the Central Bank was able not only to preserve its foreign currency reserves, but to expand them: last year, the Central Bank's foreign currency reserves grew 5.4% to 5.62 bln USD;

Conclusion

- Last year, real GDP growth was only 1.4% despite maintaining monetary and financial stability, serious growth in oil revenues compared to 2017, a positive balance in foreign trade of 8 bln USD, growth of the overall budget by 4.7 bln AZN, 29.1% growth in state expenditures compared to 2017, and 80% growth in state investments;
- With the growth of oil revenues, Azerbaijan's economic dependence on the oil sector is deepening: 1) the non-oil sector's contribution to GDP rose from 34.2% in 2016 to 41.5% in 2018; 2) over the reporting period, the share of state budget revenues coming directly from the oil sector was 59.8%; 3) the oil and gas sector accounted for 91.2% of the country's total exports;
- Although in 2018, using the state budget and other channels, the government invested most of its oil revenues in the economy, this was not enough to end the crisis in the construction sector or to have any serious effect on overall economic growth;
- The growth in oil revenues provided for the growth of the Azerbaijan's foreign currency reserves;
- Despite recent improvements in the business environment, incentives for investment, and the growth of state investment, the fall in the economic growth rate by 2% shows the need for more serious economic reforms.