

COUNTRY REVIEW

Azerbaijan



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EULER HERMES COUNTRY RISK GRADE: C

EULER HERMES COUNTRY RISK LEVEL: SENSITIVE

**Country Risk Grades are on a scale of AA, A, BB, B, C, D
Country Risk Levels are on a scale of LOW, MEDIUM, SENSITIVE, HIGH**

Strengths

- Ample natural resources in the hydrocarbon sector
- Overall sound fiscal position
- Very high annual current account surpluses since 2006
- Very favourable external liquidity and debt positions

Weaknesses

- High regional political instability
- Relatively poor regional relations, including in particular the continued conflict with Armenia over the Nagorno Karabakh enclave
- Authoritarian political regime
- Weak government effectiveness and slow progress of structural reforms
- Generally (too) loose monetary and fiscal policies
- Dependence on hydrocarbon sector creates considerable external vulnerability
- Significant corruption and weak protection of property rights
- Weak banking system

Country Risk Assessment

Ratings	Azerbaijan		Median Grade C	Angola	Peers Gabon	Russia
	Latest	Previous				
Systemic Political Risk:	P3-	P3+	P3+	P3-	P2-	P3+
Systemic Economic Risk:	E4	E6	E5	E5	E5	E5
ME rating:	ME4	ME6	ME5	ME4	ME4	ME4
<i>Structure</i>	5.7	6.0	5.8	5.7	5.7	4.0
<i>Policy</i>	5.2	5.2	5.2	5.2	6.0	5.8
<i>Solvency</i>	1.0	1.0	3.3	2.0	1.7	3.9
<i>External Liquidity</i>	2.8	2.3	4.2	2.8	2.8	1.7
SBE rating:	SBE4	SBE5	SBE4	SBE5	SBE5	SBE5
COUNTRY GRADE:	C	D		C	C	C

Nomenclature:

Political Risk Ratings are on a scale of P1 (lowest risk), P2+, P2-, P3+, P3-, P4 (highest risk).

Economic Risk Ratings are on a scale of E1 (lowest risk), E2, E3, E4, E5, E6 (highest risk).

ME (Macro-Economic) ratings are on a scale of ME1 (lowest risk), ME2, ME3, ME4, ME5, ME6 (highest risk).

The constituent parts of the ME rating are on a scale of 1.0 (best) to 6.0 (worst).

SBE (Structural Business Environment) ratings are on a scale of SBE1 (best), SBE2, SBE3, SBE4, SBE5, SBE6 (worst).

Country Grades are on a scale of AA, A, BB, B, C, D where AA is the lowest and D the highest country risk.

Source: Euler Hermes Economic Studies

ECONOMIC STRUCTURE

Country Profile	
Capital city:	Baku (Baki)
Population:	8.977 mn (2009)
GDP:	USD 43076 mn (2009)
Currency:	Azerbaijani manat (AZM)
Form of state:	Presidential republic
Head of government:	President Ilham ALIYEV (since October 2003)
Next elections:	Presidential: October 2013 / Legislative: November 2015

Major Industries (% of GDP at market prices, 2009)	Global Assumptions	2010	2011	
Industry	61.0%	Real GDP grth (% yr/yr)	3.3	2.9
Services	31.9%	Inflation (% av) *	1.2	1.4
Agriculture	7.1%	Dated Brent (USD/b)	80	115
* Major economies				

Main Exports (% of total, 2007)		Main Imports (% of total, 2007)	
Mineral products	81.5%	Machinery, mech. & electrical equipm	30.2%
Foodstuff	8.4%	Foodstuff	16.0%
Base metals and articles thereof	3.0%	Transportation equipment	15.5%
Transportation equipment	1.7%	Base metals and articles thereof	12.3%
Lead Export Markets (% of total exports, 2009)		Lead Import Markets (% of total imports, 2009)	
Italy	20.4%	Turkey	18.5%
India	10.6%	Russia	16.8%
US	9.1%	Germany	7.8%
France	8.1%	Ukraine	7.2%
Germany	7.5%	China, PR	6.2%

Basic indicators

Selected economic indicators	2007	2008	2009	2010f	2011f
Nominal GDP (USD mn)	33,090	46,378	43,076	47,740	54,125
Population (mn)	8.80	8.90	8.98	9.05	9.12
GDP per capita (USD)	3,759	5,213	4,798	5,276	5,933
Real GDP growth (% yr/yr)	25.0	10.8	9.3	5.0	3.5
Inflation (% eop)	19.5	15.4	0.7	7.8	10.0
Fiscal balance (% of GDP)	-0.2	0.2	-0.7	-0.9	-1.0
Current account balance (% of GDP)	27.3	35.5	23.6	31.5	28.0
External debt/GDP (%)	7.4	6.2	7.7	7.5	7.3
External debt/Exports of goods & services (%)	10.3	9.1	13.8	13.0	12.0
Debt-service ratio (%)	1.3	1.2	1.9	1.7	1.6
Foreign exchange reserves (USD mn)	4,263	6,466	5,126	6,172	7,000
Import cover (months)	5.4	6.8	6.2	8.7	8.4
Exchange rate assumption, AZM:USD (av)	0.86	0.82	0.80	0.80	0.80
Exchange rate assumption, AZM:EUR (av)	1.17	1.20	1.12	1.06	1.10
f: CRU central forecast					

Sources: National figures, IMF, ADB, IHS Global Insight, Euler Hermes Economic Studies

Political Stability

Domestic politics in Azerbaijan are controlled by the ruling New Azerbaijan Party (NAP), which gathers around a close-knit group of insiders from the Aliyev clan and the former communist elite. Ilham Aliyev succeeded his father Heydar as the country's president in the October 2003 election and has consolidated his power since then. In March 2005, NAP elected him as its leader. In October 2008, President Aliyev was re-elected with 89% of the vote and the elimination of presidential term limits in a 2009 referendum offers the prospect of lifetime presidency. In the November 2010 parliamentary election, NAP and other pro-government parties retained a clear majority. NAP members will continue to hold all key positions in the government. Elections in Azerbaijan, however, generally do not meet international standards for democracy and opposition parties are weak as the government has followed a policy of eliminating any potential serious political opposition, giving it an authoritarian nature. President Aliyev has used high oil revenues carefully, distributing them partly to the people (increasing wages and improving infrastructure) to publicize that he shares the benefits of the boom, as well as rewarding loyal members of the political elite. The share of the population living below poverty line has declined from 49% in 2001 to 11% in 2009. Nonetheless, the promise of widespread wealth has remained largely unfulfilled and public discontent appears to have increased in recent years. Anti-government demonstrations in March and April 2011, however, organised by the opposition and inspired by the popular uprising in North Africa, showed a low turnout and were quickly broken up by the police with a minimum of disruption. Although recent events in North Africa underline that authoritarian rulers are not invulnerable, an overthrow of the current regime in Azerbaijan appears unlikely in the short term.

Azerbaijan's international relations remain mixed. A big threat to regional stability continues to stem from the unresolved conflict with Armenia over the Nagorno-Karabakh region, a largely Armenian populated enclave representing about one sixth of Azerbaijani land area but is militarily occupied by Armenia. There has been no progress since a 1994 cease-fire. Whereas Armenia appears willing to make certain concessions, Azerbaijan insists on the handover of the entire region, not excluding the use of armed forces in the future to settle the conflict, after having increased its defence spending massively in the past years. In recent months there have been some deadly clashes along the Nagorno-Karabakh border. Another source of external instability is the ongoing conflict over the partitioning of the oil-rich Caspian Sea with Iran. Despite Azerbaijan's support of Georgia in its 2008 conflict with Russia, the Russian-Azerbaijani relationship is pragmatic and market-driven. Relations with the West are generally good. In the interests of maintaining both domestic and regional stability and because many Western oil companies are operating in Azerbaijan, Western criticism of the authoritarian regime as well as of the Nagorno-Karabakh conflict is likely to remain subdued.

All in all, systemic political risk is assessed as high.

Economic Stability

Azerbaijan is classified as an upper middle income economy by the World Bank, with an estimated GNI per capita of USD4,840 in 2009. With ample natural resources in the hydrocarbon sector, the economy is highly dependent on mineral products which account for 82% of merchandise exports and on one single company, the Azerbaijan International Operating Company, which exports around 90% of total crude oil. This makes the country very vulnerable to external shocks. Industry contributes about 61% to GDP while agriculture, still the largest employer of the country accounting for 38% of the labour force, contributes just 7%. Services account for the remaining 32%.

Owing to rapidly increased oil production since 1997, real GDP grew by an average annual 11.3% in 1997-2009. Growth was extraordinarily fast in 2005-2007, at an average annual 28.3%, supported by the rapid expansion of hydrocarbon production and exports thanks to the opening of the Baku-Tbilisi-Ceyhan (BTC) oil pipeline in mid-2005, the start of production at the Shah-Deniz offshore natural gas field and the opening of the Baku-Tbilisi-Erzurum (BTE) natural gas pipeline, both at end-2006. Moreover, rising world prices for crude oil and natural gas in those years led to higher revenues. Real GDP growth moderated to a more usual 10.8% in 2008 and remained strong at 9.3% in 2009, despite the global economic crisis and a sharp oil price decline. However, economic growth slowed to 5% in 2010. In contrast to previous years and despite rebounding oil prices, the oil sector was no longer the main growth driver, expanding by just 1.8% after 14% in 2009. Positively, growth in the non-oil sector (including gas) accelerated from 3.2% in 2009 to 7.9% in 2010, probably reflecting some success of government intentions to diversify the economy. The 2010 growth pattern has continued in early 2011. We expect the pace of growth to pick up somewhat in the next months and forecast annual growth of 3.5-4.0% in 2011-2012.

An IMF mission to Azerbaijan in early 2011 called for tighter monetary policy and greater fiscal discipline, suggesting that economic policies are generally too loose. Inflation has accelerated from 0.7% at end-2009 to 7.8% at end-2010 and an estimated 9.5% yr/yr in March 2011, largely owing to rising prices for food and energy and loose fiscal policy. The latter has mainly contributed to a renewed surge in real domestic credit growth to a worrisome 41% yr/yr in Q2 2010 though it has moderated to 10% in Q4. The central bank refrains from adequate monetary tightening—the policy refinancing rate was raised to just 5% on 1 March 2011—as it continues to aim at maintaining the de-facto peg of the manat (AZM), the local currency, to the USD at 0.8AZM/1USD. Moreover, the peg holds back upward pressure on the exchange rate stemming from strong foreign exchange inflows which could ease inflation to some extent. On the other hand, however, to allow nominal appreciation could involve further unwanted real appreciation as well which would increase the risk of the so-called Dutch Disease phenomenon—where currency appreciation in real terms, boosted by high commodity receipts, harms all other economic sectors and weakens sustainable long-term growth (potential). In February 2011, the manat was still estimated to be 20% overvalued in real effective terms as compared to the average of the past five years, though this was down from almost 40% in early 2009.

Despite generally loose fiscal policy, Azerbaijan's overall fiscal position is sound thanks to substantial direct state revenues from selling oil in the past years. These revenues are channelled into the State Oil Fund of Azerbaijan (SOFAZ), which accumulates all of the funds and transfers only portions to the state budget. Assets in the SOFAZ stood at USD22.8bn at the start of 2011, while total public debt is low at about USD6.2bn or 13% of GDP. The overall fiscal account has been near-balanced (0%±1% of GDP) since 2000.

Also thanks to the substantial oil revenues over the past decade, Azerbaijan has achieved exceptionally sound external liquidity and debt positions. The current account surplus has skyrocketed to an average annual 27% of GDP in 2006-2010 and is forecast to remain above 20% in the next few years. Official foreign exchange reserves stood at USD6.5bn in January 2011, covering more than eight months of expected imports or five times all external debt repayments falling due this year. Gross external debt is also very low, accounting for about 7.5% of GDP or 13% of exports in 2010. The debt-service ratio is an almost negligible 1.6% in 2011.

Despite sound external macro-economic fundamentals, however, Azerbaijani companies have not been immune to the impact of the global economic crisis. A number of state-owned enterprises and banks faced difficulties refinancing short-term foreign liabilities, which caused a liquidity shortage in the banking system and an abrupt decline in credit growth.

Structural Business Environment

The Structural Business Environment is below average. Despite significant progress in regulatory reform over the past three years, many deficiencies continue to hamper investment and doing business. Areas of particular weakness include government intervention in the economy, effective implementation of reform measures, high non-tariff barriers to trade, significant corruption and weak protection of property rights.

The small banking system is also weak. Competition in the banking sector is limited as it is largely dominated by two state-owned banks which account for approximately 60% of all bank assets and provide loans to state-owned enterprises at below-market interest rates. In 2009, the central bank stepped in with liquidity support and other measures in order to maintain banking system stability in the wake of the global financial crisis. As a result, system-wide liquidity and capitalisation appear currently adequate, but domestic credit growth has quickly surged again to critical levels (see above), posing inflationary risks and potential for rising non-performing loans.

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Charts

