



AZERBAIJAN

Highlights

- **Economic growth was negative in the first nine months of 2016.** A steep oil price decline in the second half of 2015 led to a deceleration of growth and economic recession. GDP contracted by 3.9 per cent in the first nine months of 2016, with non-oil GDP declining by 6.1 per cent, and external and fiscal surpluses drying up on the back of lower hydrocarbon revenues.
- **The authorities took steps to mitigate the effects of low oil prices.** The authorities have introduced tax and investment incentives and improved public services to stimulate the non-oil sector. Recent economic reforms in customs, licensing and permits, as well as incentives to encourage export-oriented manufacturing are welcome and will improve the ability of the non-oil private sector to further develop and operate more efficiently.
- **Efforts were made to improve the situation in the financial sector but confidence is still weak.** To stabilise the banking sector which was affected by the devaluation of the manat, the authorities established a new financial sector regulatory authority, introduced new banking supervision tools and transferred a number of undercapitalised banks into resolution.

Key priorities for 2017

- **Macroeconomic policies should continue to target stability.** A flexible exchange rate and reasonably tight fiscal and monetary policies will help to retain foreign exchange buffers at comfortable levels. Public infrastructure development schemes should target projects with sound returns and positive multiplier effects, while taking into account limitations of the fiscal envelope.
- **Further measures are needed to improve the soundness of the banking sector.** The macro-prudential framework should be strengthened and banking sector supervisory capacity enhanced, while further steps should be taken to put the largest bank, state-owned International Bank of Azerbaijan, on a more solid footing and prepare it for an eventual privatisation.
- **Deeper structural reforms are needed to improve the business environment outside the oil sector.** The authorities should build on the reforms implemented in response to the oil price decline. Transparency in business activities and competition in the non-oil sectors of the economy need to be enhanced.

Main macroeconomic indicators %

	2012	2013	2014	2015	2016 proj.
GDP growth	2.2	5.8	2.8	1.1	-3.0
Inflation (average)	1.1	2.4	1.4	4.0	10.2
Government balance/GDP	4.3	1.0	3.2	-6.8	-9.9
Current account balance/GDP	21.4	16.6	13.9	-0.4	0.7
Net FDI/GDP [neg. sign = inflows]	-1.2	-1.5	-2.9	-1.5	-2.4
External debt ¹ /GDP	9.2	11.7	14.5	18.5	n.a.
Gross reserves ² /GDP	17.0	19.2	18.3	9.3	n.a.
Credit to private sector/GDP	22.7	26.7	31.4	40.0	n.a.

¹ Public and publicly guaranteed external debt outstanding.

² Excluding assets of the State Oil Fund (SOFAZ).

Macroeconomic performance

A growth slow-down in 2015 was followed by recession in the first nine months of 2016. GDP growth decelerated sharply to 1.1 per cent year-on-year in 2015 from 5.7 per cent in the first half of the year. The economy slipped into recession in 2016, contracting by 3.9 per cent year-on-year in the first nine months of the year. In the same period, non-oil GDP declined by 6.1 per cent year-on-year. The drop in oil prices from the second half of 2015 led to a contraction in Azerbaijan's export receipts. After growing by 3.7 per cent year-on-year in the first half of 2015, investment in fixed assets – an important contributor to growth in previous years – dropped by 11.1 per cent year-on-year in 2015 and further by 30.4 per cent year-on-year in the first nine months of 2016.

External and fiscal balances deteriorated. The current account moved from a surplus of 13.9 per cent of GDP in 2014 to a deficit of 0.4 per cent of GDP in 2015, as export receipts from the oil and gas sector fell by approximately 45 per cent year-on-year in US dollar terms. The fiscal balance which was in a surplus of 3.2 per cent of GDP in 2014 turned into a deficit of 6.8 per cent of GDP in 2015 due to lower revenues and countercyclical spending. The public debt-to-GDP ratio increased from 11.2 per cent in 2014 to 28.3 per cent in 2015 although it remains relatively low. Faced with a challenging external environment, Azerbaijan devalued its currency and shifted to a more flexible exchange rate regime after decades of exchange rate stability. Two step devaluations by the Central Bank of Azerbaijan (CBA) in 2015 resulted in the manat depreciating by almost 50 per cent against the US dollar during 2015. Currency devaluation helped to contain macroeconomic imbalances but led to balance sheet pressures in the real and financial sectors. The share of foreign exchange deposits as total deposits increased from approximately 50 per cent in the beginning of 2015 to approximately 80 per cent in July 2016, while the share of foreign exchange loans in total loans increased from approximately 25 per cent to approximately 50 per cent in the same period. Inflation accelerated from 4.0 per cent in 2015 to 11.2 per cent in the first nine months of 2016. In response to rising inflation, the CBA raised the refinancing rate five times from 3.0 per cent in February 2016 to 15.0 per cent in September 2016.

Liquidity buffers declined but remain sizeable. At the end of September 2016, the combined assets of the State Oil Fund (SOFAZ) and of the CBA's foreign exchange reserves stood at US\$ 40 billion, that is, approximately 75 per cent of 2015 nominal GDP in US dollars and 28 months of imports, providing an adequate safety cushion against foreign exchange liquidity and refinancing risks. Official foreign reserves of the CBA fell from US\$ 15 billion in November 2014 to US\$ 4.1 billion in September 2016 (covering approximately three months of imports).

Growth prospects are affected by the dependence of the economy on the hydrocarbon sector and its linkages with the non-oil sector. Low oil prices, scaled-back public infrastructure spending, financial intermediation challenges and a contraction in the non-oil sector in the first nine months of 2016 weigh on the near-term growth outlook. The economy is forecasted to contract by 3 per cent year-on-year in 2016 and to grow by 1 per cent year-on-year in 2017.

Major structural reform developments

The share of the resource sector in the economy has dropped but remains significant. In 2015, the share of the oil sector in total GDP stood at 31 per cent, decreasing from 39 per cent in 2014. The resource sector accounted for approximately 95 per cent of exports in 2014 and 86 per cent of exports in 2015.

A number of measures have been taken to stimulate diversification and minimise the effects of low oil prices. Since the beginning of 2016, the government introduced tax and investment incentives for entrepreneurs and legal entities in non-oil export sectors. These measures include certain partial temporary exemptions from corporation and property taxes, and favourable tax treatment of imports of manufacturing equipment and facilities. The overall number of business licences has been reduced from 59 to 37, with 33 of these licences being provided by the Ministry of Economy through the “ASAN XIDMET”, a single window agency which aims to issue licences within 10 working days. The simplification of the licensing procedures, decrease of their number, reduced fees and online issuance of licences should reduce the opportunities for corruption. Since the end of December 2015, the transparency of customs operations has improved with the majority of statutory payments being reportedly made to the state treasury on a formal basis. In September 2016, the President of Azerbaijan issued a decree calling for an improvement in the effectiveness of corporate governance of state-owned enterprises.

Despite steps taken by the authorities to improve public services, institutional strength, transparency and governance standards lag behind. Azerbaijan ranks 65th out of 190 countries in the World Bank’s *Doing Business 2017* report, with low scores in dealing with construction permits, getting electricity, getting credit, trading across borders and resolving insolvency. On balance, improvements were achieved in getting electricity, paying taxes and trading across borders. In the EBRD-World Bank joint BEEPS V survey, the top three business environment obstacles identified by Azerbaijani firms were competitors’ practices in the informal sector, access to finance and access to land.

Some progress was made towards the stabilisation of the financial sector but challenges remain. The manat devaluation in 2015 led to balance sheet and asset quality concerns in the banking sector and to pressure on deposits. A new financial regulatory authority (Financial Market Supervisory Authority or FMSA) was established in February 2016, with the aim of strengthening financial sector supervision. Since the beginning of 2016, the licences of some banks that failed to comply with minimum capital requirements and meet creditor obligations were revoked as part of the ongoing sector-wide consolidation effort. Deposit liabilities of the failed banks were transferred to the Azerbaijan Deposit Insurance Fund (ADIF) and to other commercial banks. Steps were taken to enable the CBA to provide liquidity to the ADIF in support of depositor pay-outs. An asset quality review and a top-down stress test were launched by the FMSA with a view to developing capitalisation and restructuring plans for the remaining banks.