ing the different sectors of the economy and business. Among them were: initiating and continuing a number of infrastructure projects (in particular, in the zone of the 1988 earthquake) and the provision of funds to what the government considered to be promising business endeavors (a total of 14 billion AMD or 38 million USD were allocated to 44 projects). In particular, the government provided loan guarantees worth a total of 12 million USD to developers for finalizing unfinished construction projects. This action played a significant role in re-activating the construction sector, although it will take time for these measures to take effect. While the other sectors of the Armenian economy again showed rapid growth during the first quarter of 2010, the construction sector continued to shrink, with its apparent revival beginning only in April.

Conclusion

After the drastic fall of the economy during the crisis of 2009, the government was cautious about it future development. The draft budget for 2010 was based on a scenario of 1.5% GDP growth, which in late 2009 seemed cautiously optimistic. In the meanwhile, however, the Armenian economy showed strong growth of 8.8% during January–June 2010, thus much higher than expected. Most importantly, all major sectors of the economy contributed almost equally to this positive result. Thus the crisis to some extent corrected the highly unbalanced economic development of the previous growth period of 2002–2008, which was dominated by expansion in the construction sector. Thus, it looks as if the sharp economic decline or, as Armenia's Minister of Finance put it, the "technical recession," has resulted in serious structural changes in Armenia's economy. Whether this structural change is indeed sustainable and will have long-term positive effects for the country's economy is the subject for another analysis.

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As If Nothing Happened?

How Azerbaijan's Economy Manages to Sail Through Stormy Weather

By Gerald Hübner, Frankfurt am Main

Abstract

Since Azerbaijan seems to have coped with the impact of the global financial crisis far better than initially expected, it is worth taking a closer look at this country which seems far away from the stormy international fore of private sector and sovereign crises. Azerbaijan's financial sector had only limited exposure to international markets and the country's sovereign balance sheet is strong with a public debt ratio that is one of the lowest of all transition countries. However, the country depends heavily on its oil exports, so Azerbaijan felt the crisis directly through the high volatility of world oil prices. As a consequence, state authorities had to design effective policies to steer the economy through stormy weather.

Spring 2010: Rating Upgrade for Azerbaijan

First of all the good news. Fitch, one of the world's top three rating agencies, upgraded Azerbaijan's sovereign credit rating at the end of May 2009 from BB+ to BBB-.[1] Azerbaijan is thus now playing in the same league as Brazil, Peru, Bulgaria and India and even one category higher than Turkey, Iceland and Latvia. Why did Fitch upgrade Azerbaijan to investment grade?

The most recent financial crisis resulted, like financial crises before it, from excessive lending to the private sector. The key consequence was excessive household and banking sector borrowing throughout the advanced

1 A credit rating estimates the credit worthiness of a country. With a rating of BBB- Azerbaijan joins the ranks of investment-grade countries, meeting the minimum grade required by many institutional investors worldwide.

industrial world. This financial crisis, which started in summer 2007 with the US-sub-prime crisis, affected step-by-step all but a handful of advanced industrial countries and contributed to a significant impairment of their fiscal positions.

Before the Crisis

Azerbaijan, whose capital and credit markets were and still are underdeveloped and only have very limited exposure to the international financial markets, did not feel the effects of the crisis immediately. However, these effects began when the global financial crisis turned into a crisis for the real economy. The wave reached Azerbaijan when prices for crude oil and natural gas started to fall dramatically during the second half of 2008 from an all-time high of 146 USD per barrel to below 40 USD per barrel towards the end of 2008. However, this downturn in prices did not hit Azerbaijan instantly as the annual average price of crude oil in 2008 was 97 USD per barrel, a price that was above government expectations, especially considering the substantially lower prices of 73 USD per barrel in 2007 and 65 USD per barrel in 2006.

In Azerbaijan, hydrocarbon production only started to increase significantly after 2004 and tripled in volume by 2008. At the same time oil prices almost doubled. As a result, Azerbaijan's local economy was almost overwhelmed by trying to absorb the huge amount of revenues from that industry in 2007 and especially when the oil price overheated in 2008. Between 2005 and 2008 nominal GDP tripled and reached 40.1 billion AZN[2] (50.1 billion USD), half of it resulting from hydrocarbon extraction and export. Government budget expenditures increased five-fold during that time to 10.7 billion AZN (12.9 billion USD) and spurred growth in all economic sectors, particularly construction and trade, through increased infrastructure investments and household consumption. Banking sector assets more than quadrupled from 2.3 billion AZN in 2005 to 10.3 billion AZN in 2008 thanks to the tremendous growth in loans to costumers, which were financed through an increasing volume of deposits and refinancing funds from global commercial banks as well as international financial institutions. However, this rapid growth on all levels of the economy also pushed inflation to 20.8% in 2008, the highest since 1995. Over the same period, the Azerbaijani currency Manat further appreciated against the US dollar, which made production outside the hydrocarbon industry prohibitively expensive for export, a condition typically described as the Dutch Disease.[3]

The Impact of the Global Crisis on Azerbaijan Since 2009: Real GDP Growth Versus Nominal GDP Decline

So far, the Azerbaijani economy has handled the impact of the global crisis rather well. Despite a decrease in prices for oil and other export products (chemicals, aluminium and ferrous metals) in 2009, the Azerbaijani economy grew by 9.3% in terms of real GDP. This was the highest growth rate among all transition countries. At the same time Azerbaijan had a current account surplus for the 5th year in a row, albeit at 20.7% of GDP a considerably smaller one than in the previous 2 years (2008: 35.5%, 2007: 27.3%). The reason for this reduction in the current account surplus was a decline in exports by roughly 30% due to a much lower average annual oil price of 64 USD in 2009 than in the year before and falling remittances from abroad.

The cut in exports led also to a decline of the nominal GDP of approximately 14%. This sounds quite paradoxical since the country had a real GDP growth. In fact, Azerbaijan had a considerably lower influx of US dollars from oil exports. Since the Manat did not devaluate against the dollar, nominal GDP in Manat also declined. But to measure real GDP growth one has to adjust nominal GDP by inflation. High levels of Manat inflation in 2007 and 2008 led to a huge distortion between nominal and real GDP figures (see Figure 1 on p. 9 and Table 1 on p. 10). Despite a statistical real GDP growth, household and businesses did not gain more disposable income.

Intervention of the Central Bank of Azerbaijan to Keep the Manat Stable

Against the background of fluctuating and unpredictable demand for local and foreign currencies, the Central Bank of Azerbaijan (CBA) had to closely monitor and intervene in 2009 and 2010 to keep the Manat stable against the US dollar. It first had to overcome strong depreciation pressure at the beginning of 2009[4], which

2 AZN or Manat: Azerbaijani Manat, the official currency of the Republic of Azerbaijan. As of 29 June 2010 one Azerbaijani Manat was equal to 1.01 EUR and 1.24 USD.

3 Compare: Gerald Hübner and Michael Jainzik, "Splendid isolation? Azerbaijan's economy between crisis resistance and debased performance," Caucasus Analytical Digest, No. 6 (The Caucasus in the Global Financial Crisis), 21.05.2009, pp 12–13.

4 All neighboring transition countries, including Russia, Ukraine, Kazakhstan, Georgia and Armenia depreciated their local currencies roughly by around 20% during the first quarter of 2009. At the same time, the Azerbaijani banking system faced large deposit outflows and an exchange of deposits from Manat into foreign currencies, mainly US-Dollar and Euro.

it successfully resisted by making foreign exchange sales totaling 1.26 billion USD in February and March 2009. This step was necessary to mitigate inflation expectations, reverse increasing dollarization and avoid the negative impact on households' and banks' balance sheets caused by the depreciation of deposits and appreciation of debts in foreign currency.

In the first quarter of 2010 this situation reversed, as the trade surplus, capital inflows and investors' confidence started to strengthen. The CBA again successfully intervened on the foreign exchange markets by purchasing 480 million USD and continuing the Manat's peg to the US dollar at an unchanged exchange rate of 1 USD/ 0.8 AZN. Due to this stable exchange rate, lower oil prices and lower domestic and external demand, inflation substantially cooled down from more than 20% in 2008 to 1.5% in 2009. The intervening policy, which led to a stable Manat and a sharp decline in inflation, last but not least also helped to stabilize confidence in the national currency. On the other hand, as mentioned above, the strong Manat makes the export of goods and services apart from extractive industries even more expensive and may hamper attempts by the government to diversify the local economy.

Economic Stimulus Resulting From Reforms, Reduction of Tax Obligations and Facilitation of Business Activities

To support economic activity, profit and income taxes were cut from the beginning of 2010 to 20% (profit tax) and 30% (income tax) respectively. Financial sector institutions can even make use of a 3-year profit tax holiday from 2009–2011 if they use their profits to increase their shareholders' capital base. Azerbaijan improved its formal business environment by creating a "one-stop-shop" for entrepreneurs willing to open a business, adopting a more flexible labor code, strengthening contract enforcement procedures and expanding the existing simplified tax regime to a broader circle of small and medium-sized entrepreneurs. For its efforts Azerbaijan ranked as one of the top reformers in the World Bank's 2009 Doing Business Report.

Strong sovereign balance sheet and Azerbaijan's sovereign wealth fund SOFAZ

As noted above, the government injected significant amounts of revenue into the local economy in the years after oil production accelerated in 2005/2006. Nevertheless, the authorities showed strong fiscal discipline in their use of hydrocarbon windfall profits. Between 2001 and the end of 2009, the government built up official reserves via the CBA to 4.3 billion AZN (10.7% of GDP). These reserves further increased to a comfortable 4.7 billion AZN during the first quarter of 2010.

With the establishment of the Sovereign Wealth Fund SOFAZ (State Oil Fund of Azerbaijan Republic) in 1999 the central government had, and maintains, a vehicle for employing oil revenues. The Fund not only absorbs a significant part of public oil revenues by investing them overseas in highly rated foreign currency assets but also proved itself as a handy instrument in counterbalancing the volatile public oil revenues and hence to steadily co-fund the governmental budget.[5] While SOFAZ transferred one third of its revenues to the state budget in 2008, it increased this share to 60% in 2009. Nevertheless, the Fund could still build up its asset base by almost 3 billion AZN to 12 billion AZN or 34.6% of GDP at the end of 2009, from only 7.4% in 2007 (see Table 2 on p. 10).[6]

Public external debt in percent of GDP has declined substantially since oil production took off in 2005. It accounted for 3.4 billion AZN (8.5% of GDP) at the end of 2009. Two third of this external debt were long-term loans from international financial institutions and bilateral donors such as Germany. Together with the assets of Azerbaijan's sovereign wealth fund, all external assets and liabilities combined were 12.8 billion AZN (32% of GDP) at the end of 2009, up from virtually zero in 2001. As the system enjoys decent medium-term prospects for macroeconomic growth, it is likely that Azerbaijan's fiscal position will further strengthen over the next decade with low levels of external debt.

Stable Central Government Budget and Social Spending During 2009

Due to SOFAZ's transfers to the central government budget, revenues remained almost the same between 2008 and 2009. The authorities did not have to cut expenditures in general but decided to shift spending priorities. They cut expenditures on financing the local economy by 12% (halting or postponing expensive infrastructure investment projects) but increased spending for social services by 20% (see Table 3 on p. 10).

5 The substantial drop of oil prices caused fiscal oil revenues to fall by 35% during 2009.

6 Although this development looks quite impressive per se, one can also compare these amounts with the upper end of sovereign wealth funds. With a population of nearly 5 million people, Norway's sovereign wealth fund is now worth nearly 400 billion USD (80.000 USD per capita against 1.440 USD per capita in Azerbaijan). This matches exactly with Norway's GDP of 2009. The fund is thus the world's largest sovereign fund outside the Middle East.

This also had a positive impact on the poverty rate in Azerbaijan. According to the State Statistical Committee, the official poverty rate declined from 50% at the beginning of the millennium to 13% in 2008 and further to 11% at the end of 2009. On a political level, this strong sovereign position, the intensive public spending on social welfare as well as the above described state support to the economy has helped to strengthen the authority of President Ilham Aliyev.

Crisis Impact on the Financial Sector and the Government's Intervention

Apart from the extractive industry, the Azerbaijani financial sector remains the country's main economic sector exposed to the international financial and economic crisis. Howsoever, the actions taken by the authorities, particularly the Central Bank mitigated the impact of the crisis. So far, no private commercial bank has failed as a result of the crisis. Besides, the state authority's appropriate policy response to keep the local currency stable, the government and CBA have implemented a whole set of measures and stimulating actions to provide support and liquidity to the banking system since autumn 2008:

1) Reduction in Reserve Requirements and Refinancing Rate

The CBA reduced the mandatory reserve requirement on deposits between October 2008 and March 2009 from 12% to 0.5% and on foreign liabilities from 5% to 0% and has kept them at this level ever since. This move resulted in a long-term cash injection of approximately 420 million AZN. At the same time, the Central Bank further cut the refinancing rate from 15% to 2%.

2) Loans from the Central Bank and Further Funds

A number of amendments were made to the law "On the Central Bank of Azerbaijan Republic" on June 19, 2009. According to the new law, the Central Bank of Azerbaijan now has the right to extend state-guaranteed and subordinated loans to local banks and can independently define its terms and conditions. The amendments enable the Bank even to provide finance to (state-owned) enterprises with critical refinancing needs via the banking sector. This goes now much beyond the Central Bank's traditional function as lender of last resort in emergency situations when banks face short-term liquidity problems such as the Unibank case in 2008.[7] In such situations, the Central Bank could (and still can) extend loans for a term not exceeding 6 months with the option to extend them for another 6 months.

In total, the CBA provided almost 1 billion AZN in liquidity support to banks and another 900 million AZN as a loan backed by a government guarantee.[8] Due to this market intervention policy, the share of Central Bank funds to total banking sector liabilities increased from 2.7% in 2008 to 15.2% in 2009.

The Azerbaijan Mortgage Fund (AMF), which stopped lending due to lack of finance in 2007, resumed its lending activities in July 2009. This was financed through provision of budget funds as well as the (ongoing) emissions of long-term AMF bonds. As a result, from July 2009 up to now, an amount of approximately 100 million AZN was injected into the sector.

3) Tax Holiday

To further stipulate the capitalisation of banks, the president issued a decree implementing a 3-year profit tax holiday between 2009 and 2011, in case banks use their profits for recapitalization purposes. So far, several of the top 15 banks that had relevant profits in 2009 planned to make use of this tax holiday. It still remains to be seen, to what extent this decree helped or stimulated the capitalization of banks.

4) Increase of the Amount of Insured Deposits

In order to avoid bank runs on deposits, the government decided to increase the maximum amount of insured deposits via the Azerbaijan Deposit Insurance Fund. The insured amount per deposit in one bank was raised from 6,000 Manat to 30,000 Manat. In conjunction with the stable currency exchange rate, this decision might also have helped to dispel the most severe scepticism of a population worried about the global economic crisis and a sharp decline in oil prices. Finally, household deposits grew by 30% from 1.9 billion AZN to 2.5 billion AZN between the end of 2008 and end of April 2010.

Financial Sector Impacts and Development since 2009

The relatively small and immature financial sector was not exposed to risky and speculative overseas investments and businesses. On average, banks are predominately active in their home market and use a relatively straightforward set of financial instruments on both the

7 Compare: Gerald Hübner and Michael Jainzik, "Splendid isolation? Azerbaijan's economy between crisis resistance and debased performance," Caucasus Analytical Digest, No. 6 (The Caucasus in the Global Financial Crisis), 21.05.2009, p 15.

8 This loan was extended to the state-owned International Bank of Azerbaijan for on-lending to SOCAR, the state oil company and AZAL, the state-owned aluminium company.

assets and the liability/equity side. Consequently, the governmental interventions had a significant impact and apparently reached their target.

After a fourfold increase of the banking sector balance sheet between 2005 and 2008, sector growth cooled in 2009. Sector assets even shrank by 14% during the first quarter 2009 but recovered quickly thereafter. At the end of 2009, the balance sheet stood at 11.7 billion AZN with a year-on-year increase of 13.5% (2008: 52.7%, 2007: 78.0%). As nominal GDP declined in 2009, financial intermediation, measured by the ratio of total banking assets to GDP, increased from very low 25.6% in 2008 to 33.7% at the end of 2009 (Figure 3/Table 4 on p. 11). Loans to costumers increased even by 16.8% during 2009. But this increase certainly does not reflect the true picture of the lending situation, keeping in mind the 900 million AZN loan from the CBA to the state-owned International Bank.[9] The sudden increase in loans to costumers during the third quarter can be attributed mostly to this particular engagement (Figure 4 and 5/Tables 5 and 6 on p. 12 and 13). On the contrary, it is very likely that the number of borrowers stagnated or even dropped slightly in 2009 as many banks stopped lending or only lent to repeat costumers.

As already mentioned, as the CBA expanded its lending activity to the banking industry by 1.2 billion AZN during the second half of 2009, its share in sector liabilities increased greatly to 15.2% of total liabilities. Foreign refinancing dropped by 10% over the first nine months of 2009 but increased since then to an all-time high of the equivalent of 2.23 billion AZN (one fourth of this amount is attributable to a loan from one foreign bank from Dubai to the International Bank of Azerbaijan) (Figure 5/Table 6 on p. 13).

Risk Management and Portfolio Quality as Challenges

One of the bigger challenges banks are facing since 2009 is a deteriorating loan portfolio quality. Currently Central Bank data indicate a modest level of loans (4.26%) are overdue by more than 30 days measured as share of total loan portfolio. However, an analysis of the audited financial statements of ten larger local banks shows a much different picture. Only one of the ten banks was below the CBA reported figure. All other banks had problematic loans[10] ranging from 6.5% to 24% in comparison to their gross loan portfolio. In addition, most banks had also renegotiated a significant amount of loans which otherwise would have been problematic as well. And a third group of loans was structured in a way that borrowers have to repay the loan only at the end of the loan maturity with options to prolong the loan tenor. The quality of these loans is highly unpredictable as there is no repayment at present. Top management of most banks realized this sharp deterioration in loan portfolio quality but started very late to address the problem on an institutional level. The International Finance Corporation (World Bank Group) supports a number of banks in establishing functioning loan risk departments. It also supported the establishment of a new association of risk professionals (ARPA). It remains to be seen to what extent these measures and support on the level of private commercial banks will be fruitful.

Weaknesses of the Current Economic System and Outlook

In spite of all the successes Azerbaijan can show on a macroeconomic and fiscal level, the system faces severe qualitative and quantitative weaknesses which are currently only covered by the extraordinary high oil revenues. Corruption and an opaque allocation of wealth are still in full swing on all levels of the society and economy. The non-oil business and the political system are highly intransparent and prevent non-oil FDI inflow and growth. The macroeconomic environment and fiscal outcomes are—as seen above—volatile due to the high dominance of oil and the related high dependence on commodity prices in a still small economy with only a limited set of instruments to mitigate the problems. If we exclude the oil-related GDP and budget revenues, we see a high non-oil primary budget deficit of 39% of non-oil GDP in 2009. The non-oil economy and especially the banking sector are still weakly integrated into the global financial system. Notwithstanding the relatively strong official figures of the banking sector in the crisis, the sector now has a bumpy road ahead in managing its asset quality and liquidity (independently from CBA resources) and strengthening risk management as well as improving sector-wide governance. The Central Bank should, on the other hand, also keep an eye on sector liquidity and withdraw liquidity support as financial sector health improves, so as to limit fiscal risks and prevent an up-tick in inflation.

The limited impacts of the global crisis on Azerbaijan proved the government's adequate policy response in principle. It also showed that the country generally is on

9 Developments and statistical analysis in the banking market are always accompanied by a significant level of distortion due to the huge market share of the one state-owned bank with a balance sheet almost half as big as the total sector.

10 Defined as the outstanding loan amount of a loan, which is overdue by more than 30 days (which in case of a standard loan usually means that one monthly installment was not paid).

the right path to a stable fiscal and macroeconomic position. Medium-term prospects for growth are also decent. However, government authorities and policy-makers should keep in mind that, with depleting oil resources in the next 15–20 years, this is no perpetual motion machine in the long run. Azerbaijan's economic strategy has to concentrate on one big issue: diversification, diversification and again diversification. This can be accelerated through additional improvements in the business climate. Structural reforms are required through further tax and customs modernization, strengthening of the financial sector and good governance. As a consequence, those reforms should also bring down the still persistent and high level of corruption.

About the Author

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Tables and Diagrams

Macroeconomic and Financial Indicators of Azerbaijan 2005–2009

Figure 1: Nominal and Real GDP 2005–2009

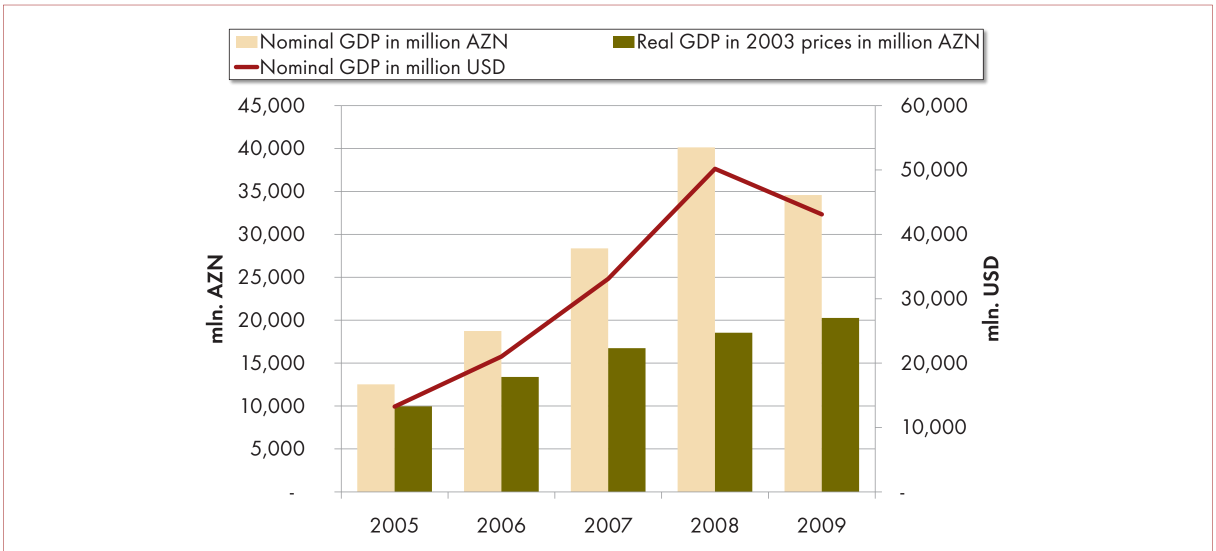
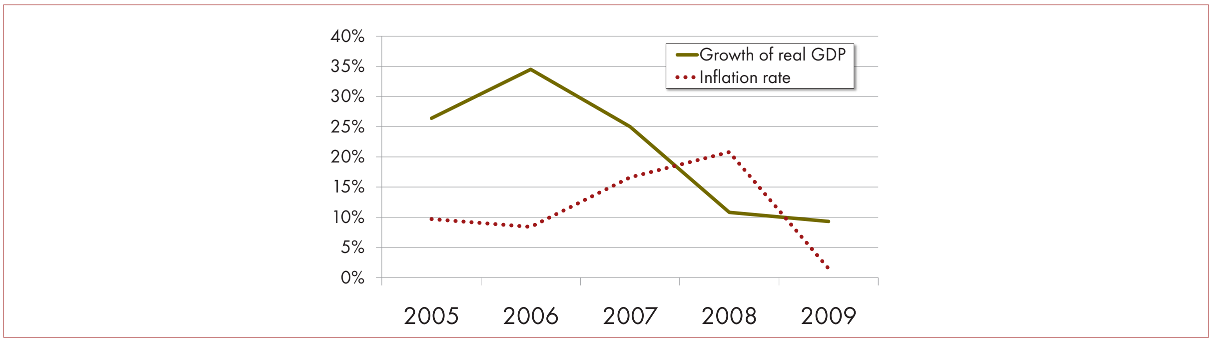


Figure 2: Growth of Real GDP and Inflation Rate 2005–2009



Source: State Statistical Committee of the Azerbaijan Republic, Central Bank of the Azerbaijan Republic, International Monetary Fund