Analysis

Splendid Isolation?
Azerbaijan's Economy Between Crisis Resistance and Debased Performance

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Abstract

The global financial and economic crisis reached Azerbaijan with a time lag and – so far – to a much lesser extent than most of its peers in Eastern Europe. Two causes are responsible for this outcome. First, the enormous oil revenues received in recent years led to a certain macroeconomic stability and resulted in a financial cushion, which gives enough leeway for the state to mitigate the short-term impacts of the crisis. Second, the financial sector is still small and only integrated into the global financial architecture in a limited way. It was hence less affected by the crisis than financial sectors in other European transition countries. But the dramatic drop in oil prices shows the vulnerability of the economy due to its weak diversification and high dependency on the extractive industries sector. Thus, the country is facing the challenge to diversify its economy and develop its value chains across sectors. This holds true especially for the small and medium-size enterprise segment of Azerbaijan.

Introduction

The global financial and economic crisis has so far hit Azerbaijan much less than most of the other CIS countries. In contrast to neighboring Armenia and Georgia, as well as other CIS countries in Europe and Central Asia, the oil-dominated, but relatively small economy of Azerbaijan suffered neither currency devaluation, nor severe drops in economic production (Gross Domestic Product or GDP). Two major economic reasons are responsible for this crisis resilience. First, the financial sector of Azerbaijan is still much less developed than in other CIS countries, such as Russia, Ukraine and Kazakhstan, and its South Caucasus neighbors Armenia and Georgia. Accordingly, it is only poorly integrated into global financial markets, resulting in a limited impact of the crisis on the local banking sector. Secondly, the extractive oil and gas industries dominate the economy of Azerbaijan. Energy exports, among other effects, cause a continuously positive current account balance and a steady inflow of hard currency. The rise in commodity prices for crude oil on the world markets between 2005 and mid-2008 occurred simultaneously with the country's second oil boom, with all-time records in production and export volumes since the start of industrial oil extraction in Azerbaijan at the beginning of the 19th century. These circumstances bestowed a windfall profit upon the country over the last three years, leading to robust macroeconomic conditions with strong growth figures and low levels of public debt, both national and international. At the same time the country started to boost public spending and private per capita consumption. Escalating prices – both for daily living as well as for real estate – appeared as the first signs of economic overheating and indicated that the country was struggling to absorb this sudden wealth.

Since other economic sectors are of limited importance for GDP and negligible for exports, Azerbaijan's macro economic performance is highly dependent on oil price levels. But as the massive oil and gas production is not yet at its peak, the country should still be able to mitigate the current crisis even despite the sudden drop in proceeds from oil exports. Azerbaijan has so far been quite lucky in its circumstances. But it needs to act with caution now and should use its financial resources in a more sustainable way, above all by diversifying the economy. This is of utmost importance because the extractive sector itself does not contribute to massive job creation, thus, the economic well-being of major parts of the population depend on diversified growth.

The Macroeconomic Situation and the Real Economy

As a result of the break-up of the USSR, the collapse of trade relations, and the military conflict surrounding Nagorno-Karabakh, economic production fell by more than 60 percent between 1989 and 1995. Agriculture accounted for more than 30 percent of GDP in 1995 and industrial production had a share of only 15 percent by this time. It took Azerbaijan one decade to recover (see Figure 1 on p. 16). Since the completion of the oil and gas pipelines to Turkey in 2005/2006, the exploitation of Azerbaijan's hydrocarbon resources accelerated significantly: Azerbaijan grew by an average annual growth rate of 21 percent in 2004–2008 and brought GDP from 9 billion USD in 2004 to more than 46 billion USD at the end of 2008 – making it one of the fastest growing economies worldwide. Oil and gas sector production accounted for more than 60 percent of GDP in 2008 (against 38 percent in 2004) as well as 60 percent of state revenues and nearly all export proceeds. Due to this export growth, Azerbaijan showed a current account surplus with a new historic record of 17 billion USD in 2008, a share of more than 40 percent of the GDP.

The unexpected high oil revenues of the last three years replenished the country's strategic reserves to 18 billion USD by the end of 2008. This amount is twice the state's foreign debt. The biggest portion (11 billion USD) of the reserves sits with the State Oil Fund of Azerbaijan (SOFAZ). The fund's assets are partly invested overseas, which helped reduce the upward pressure on the exchange rate. But a considerable portion was also channeled to Azerbaijan for huge infrastructure investments. In line with a fourfold increase in the state budget between 2005 and 2008, these vast expenditures fueled high demand, above all in the construction sector. The governmental expenditures led also to rapid income growth among the population, resulting in growing per capita consumption and in high demand for real estate.

Due to increased spending, inflation grew by 55 percent between 2005 and 2008, with a peak rate of 21 percent in 2008. At the same time, the Azerbaijani manat (Manat or AZN) appreciated against the US Dollar by roughly 20 percent in nominal terms due to a high influx of foreign currency, which increased demand for the Manat. This combination led, and leads, to an unfavorable environment for productive sectors outside the oil and gas industry. Such real appreciation makes locally-produced goods and services price-wise less competitive with foreign products. This phenomenon – leading to lower exports and higher imports – is termed "Dutch Disease" and has been in full swing in Azerbaijan.

Local industry is coming under increasing pressure. The steel, aluminum, and chemical sectors have suffered from falling prices on the world markets since mid-2008, on one hand, and low productivity and the appreciated Manat, on the other. As a consequence, the big state-owned enterprises in these sectors cut back production or even suspended activities and sent employees home for unpaid leave since the beginning of 2009. Despite the highly visible monetary impact of the extractive industries, they only contribute to slightly more than one percent of countrywide employment. In comparison, the agricultural sector has a share of only 6 percent of GDP, but provides livelihoods to just under half of all households. Azerbaijan had an average per capita income of 5,400 USD in 2008, therefore statistically it is considered an upper middle-income country. Despite this fact, 20 percent of the population still live in poverty, which continues to be one of the challenges for the country.

The direct impact of the current crisis, with reduced oil prices, already is apparent for Azerbaijan. Real GDP growth is expected to slow to just below 3 percent p.a. in 2009, whereas public investment – on the basis of large transfers of the SOFAZ – will become the single largest source of GDP growth. The current account surplus is also expected to contract significantly, from 17 billion USD to just 1.2 billion USD in 2009.

In 2008, the government took formal steps to improve the non-oil business environment, resulting in Azerbaijan being one of the top performers in the last Doing Business Report, issued by the World Bank. However, reality looks different on the ground. Informal monopolies, import protection and pervasive corruption are unresolved issues, which also hamper Azerbaijan's accession to the World Trade Organization.

In order to increase income for the broader population, Azerbaijan needs to develop a more diversified economy with competitive industrial production, a well established segment of small and medium-sized enterprises (SME) and a strong financial sector. SMEs are usually active in a variety of fields across the economy, are labor-intensive and hence contribute significantly to job creation. A strong and sound financial sector can provide reliable long term and local currency refinancing to the real economy.

The Financial Sector in Azerbaijan: Small Banks, Small Business

Azerbaijan's banking sector is still characterized by its post-Soviet heritage and the country's overall resistance to reforms that create competitive markets and industries. As in other CIS countries, Azerbaijan's market-oriented banking system developed after the country gained independence following the collapse of the USSR in 1991. The 1990s were characterized by poor banking regulations and supervision, which made room for a vast number of weak financial institutions to develop that mainly acted as small "pocket banks" for related enterprises or individuals. In parallel, hyperinflation (1,800 percent in 1994) wiped out much of the population's savings and destroyed their faith in banks and local currency.

Between 1994 and 2004, the number of banks fell from 210 to 44, mainly due to closures and some mergers as the Central Bank of Azerbaijan Republic (CBAR or Central Bank) introduced more stringent regulations, such as minimum capital requirements. There have been no cases of sector-shaking bankruptcy among the major financial institutions in the country. Today the banking sector consists of 46 banks, including one state-controlled bank (International Bank of Azerbaijan / IBA) that holds some 40 percent of banking assets. The sector is concentrated at the top: six banks control around 70 percent of the system's assets – all of them with local majority shareholders. The other 40 banks account for the remaining market share. Of these, only seven banks have foreign majority owners with 10 percent of banking assets. This is the lowest share of foreign ownership among its peers in the region (see Figure 2 on p. 17). There are only two "Western-owned" banks in Azerbaijan, the Turkish Yapi Credi Bank (formerly Koc Bank) which belongs to Italy's UniCredito group. The second is AccessBank, a dedicated microfinance bank founded and owned by international financial institutions (World Bank Group's IFC, EBRD, the German Development Bank KfW, Black Sea Trade and Development Bank, and Access Holding). Whereas the first mainly serves Turkish companies and Turkish-Azeri business in Baku, the second mainly serves small entrepreneurs and poor households throughout the country. No major European banking group with a desire to expand in Eastern European, such as Austria's Raiffeisen, France's Société General or Hungary's OTP, have entered the Azerbaijani market despite acknowledged or attributed interest. Thus, a modernization shock for the sector through the entry of efficient foreign mainstream banks is yet to come.

Nevertheless, the banking system grew very rapidly over the last few years, though it started from a small basis, and it is still less developed than in other CIS countries. Banking sector assets, as well as the total loan portfolio, tripled in two years and amounted to 10.273 billion AZN (12.842 billion USD) and 7.017 billion AZN respectively. With total assets lower than those of the Savings Bank of the Northern German city of Bremen ("Sparkasse Bremen") the sector is vanishingly small in absolute figures. (Bremen has approximately 650,000 inhabitants and more than this one bank.) But even in comparison to its own economy, the Azerbaijani banking sector is still small. The financial intermediation ratio – a common indicator of sector development – measured by the ratio of total banking assets to GDP, stood at 27 percent at year end 2008. This is a very low ratio compared with 80 percent in Ukraine or 180 percent in the Euro Area, but it is similar to Georgia and Armenia. This means that the banking sector's economic function – collecting money from savers and allocating it efficiently to investing companies and households – is far from being as effective as in more developed economies, and, thus, the low performance of the banking sector forms one of the crucial bottlenecks for the future economic development of the country.

And, still, the financial sector is practically equivalent to the country's banking sector. Insurance companies or the stock exchange are negligible.

The main field of activity of the banking sector is lending to the local economy. The share of credits to households and business amounted to 66.2 percent of total bank assets at the end of March 2009, while the remaining part is attributed to cash (5.2 percent), correspondent accounts (6 percent), credits to the financial sector (5 percent) and investments and other assets (17.6 percent). The main source of refinancing comes from household and corporate deposits, which amounted to 36.5 percent of total liabilities and equity. Credits from the local financial sector amounted to 11.6 percent. Foreign borrowing remained small with a share of 21.6 percent of total liabilities and is only slightly higher than the banks' equity, which is 20.3 percent. This means that the absolute liabilities of Azerbaijani banks to international creditors were only 2.4 billion USD. As international financial markets continue to dry up, this figure is likely to come down over the course of the year.

Despite these limited foreign liabilities, the banking sector is not insulated from the crisis. According to the CBAR, sector assets dropped by 1.4 million AZN or 15 percent since the beginning of the year. The loan portfolio in the sector deteriorated at the same time from 2.2 percent of loans which are delinquent by more than 90 days, to 3.1 percent, or in absolute figures from 160 million AZN to 196 million AZN. Banks reduced or stopped lending to households and enterprises, which resulted first in stagnation towards the end of 2008 and in a sharp decline of crediting by one billion Manat from 7 billion AZN to 6 billion AZN since January 2009. This amount of 1 billion Manat corresponds exactly to withdrawals of US-Dollar deposits from the corporate sector over the course of the first quarter of 2009. The authors believe that indeed a more restrictive crediting policy of the banks drove its business clients to withdraw savings in order to keep their businesses going. Such an overall tighter liquidity situation for the corporate sector can be an early indicator for real economy problems not yet visible. A look at the savings behavior of private households indicates that corporate savings behavior is likely to be driven by real economic motives, not by distrust in the banks (see Figure 3 on p. 18).

Household term-deposits even grew slightly during the same period, indicating a continued confidence in the sector. However, people converted one third of their savings from Manat term-deposits into US-Dollar term-deposits (see Figure 4 and Table 4 on p. 19). This indicates a certain distrust in the stability of the local currency (but not distrust in the banks). Indeed, during recent months there were on-going rumors that Azerbaijan could follow other CIS countries and devalue its currency against the US-Dollar and/or the Euro. Although Azerbaijan's stable trade balance and current account surplus is not delivering a good macroeconomic reason for currency devaluation, such public expectations might ultimately nevertheless cause the currency's value to drop. During the first four months of 2009, the Central Bank spent 1.2 billion USD, or approximately 20 percent of its reserves, to buy Manat and keep the local currency stable.

In the third quarter of 2008, as the liquidity and funding situation for Azerbaijani banks tightened, the Central Bank stepped in. According to the Central Bank, it provided stabilization measures worth more than 500 million AZN. These measures included:

- A steady decrease of regulatory reserve requirements on deposits (funds to be deposited by the commercial banks with the Central Bank) from 12 percent to 0.5 percent since July 2008. This change caused an influx of more than 400 million AZN worth of liquid funds into the system;
- Abolishment of the 5 percent obligatory reserve on foreign borrowing in October 2008, yielding a further 100 million AZN of liquidity;
- A steady decrease in the key Central Bank refinancing interest rate for local banks from 12 percent to 3 percent since July 2008;
- A three-year tax holiday on the profit tax, as long as shareholders reinvest the profit as authorized capital (equity) into the banks. This will also help to strengthen the capitalization of banks. Since the beginning of 2009, bank equity increased by almost 100 million AZN or to 20 percent of total assets (from 16.6 percent at year end);
- Set-up of an emergency facility for liquidity support for commercial banks. In November 2008 the Central Bank provided UniBank, then the country's third biggest bank in terms of assets, with short-term refinancing of 50 million AZN to overcome its tight liquidity situation due to restricted availability of international funding.

All in all, in comparison to most of the other CIS countries the situation in the local banking sector in Azerbaijan is not yet too critical. The Central Bank acted in a reasonable manner in order to prevent signs of crisis from spreading. Nevertheless, it would be naive not to expect longer-term negative effects for the development of the banking sector. A slow-down of economic growth in Azerbaijan will most likely lead to a further increase of delinquent loans (both from households and from enterprises) in the portfolio of the banks, resulting in higher provisions and/or higher write-offs, and, thus, reducing the banks' profit and potentially their equity position.

As long as international capital markets remain parched, Azerbaijani banks will not be able to tap external resources in order to meet domestic demand for credit. Thus, the already low financial intermediation in Azerbaijan may be further reduced. Such a decline in crediting the real sector – particularly the business sector – would be a narrowed bottleneck for the development of the non-oil economy. Such development would constrain the country's long-term economic perspectives. Oil does not always form a solid basis for development as the recent crisis indicates.

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