Political Risk Alert (18 April 2019)

Azerbaijan: Government may be shift focus away from diversification efforts

Event: The state statistics office reported on April 17 that Azerbaijan's economy grew by 3% year-on-year in January-March.

Significance: The 3% increase suggests that the country's recovery from its 2015-16 recession is continuing but that slump, caused by low oil prices, has left a legacy of higher debt and banking fragility. The slowdown pushed the government into reviewing the fiscal framework and placing renewed emphasis on economic diversification. However, with the economy growing, the government may be tempted to reduce its focus on developing non-hydrocarbon sectors despite the risks of doing so. In addition, the legacy of financial stress will constrain future credit expansion and so hamper diversification efforts.

Analysis: The hydrocarbon sector has been the main driver of economic performance for more than two decades, with oil and gas production consistently accounting for around two-thirds of fiscal revenues and 90% of exports.

The decline in global oil prices in 2014-15 brought exchange rate instability and deteriorating public finances that translated into banking problems and falling domestic demand. The country has recovered only slowly from this shock. After a 2016 contraction, output remained virtually flat in 2017 before finally staging a modest recovery in 2018 as GDP increased by 1.4%. The recovery has been boosted by improved terms of trade, a 2% increase in oil production, and some pick-up in agriculture and the tourism sector.

According to the latest IMF projections, GDP is expected to increase by 3.4% in 2019 and 3.1% in 2020, although as ever this is largely due to the development of hydrocarbon resources. Growth will accelerate as production at Shah Deniz 2, the second-stage project at Azerbaijan's most important offshore gasfield, comes on stream.

Average annual inflation fell from 12.9% in 2017 to 2.3% in 2018, creating room for a looser monetary policy. A series of interest rate cuts have left the refinancing rate at 9.0%, down from 15.0% at the beginning of 2018. Further cuts are likely. The manat-dollar exchange rate has remained virtually unchanged since April 2017, despite the recovery in oil prices and movements in the currencies of partners. This stabilisation has resulted in a disinflationary trend.

Past economic performance indicates that fiscal policy has been ineffective in containing the transmission of shocks created by oil price changes. The State Oil Fund of Azerbaijan (SOFAZ), which accumulates hydrocarbons revenues, was not designed primarily as a stabilisation fund to shield the economy from oil-price volatility.

In early 2018, the government approved an upward revision of the budget to spend increased oil revenues. The fiscal loosening contributed to accelerating growth, as public investment boosted non-hydrocarbons sectors. After President Ilham Aliyev secured re-election in April 2018, the government made a fresh policy effort to reduce vulnerabilities through public finance reforms. A new fiscal rule in effect this year limits the annual growth rate of consolidated budget expenditures to no more than 3%.

Public debt, including government-guaranteed debt, has increased rapidly in recent years,

jumping from 14.4% of GDP in 2014 to 54.1% in 2017 before falling back to 48.4% of GDP in 2018, according to IMF estimates.

The increase is largely in government-guaranteed debt accrued by state agencies, worth 30.7% of GDP at the beginning of 2018. These debts stem from costs such as the banking-sector restructuring, the construction of the Southern Gas Corridor and other infrastructure projects.

Concerns about the growth of debt have resulted in a more cautious approach towards financing. A new policy was introduced in mid-2018 that sets ceilings for the ratio of government debt to GDP of 30% in 2018-25 and 20% thereafter. Foreign financing accounts for almost 95% of government debt, and the authorities are trying to reduce this reliance by increasing domestic borrowing and developing local capital markets. Despite these developments, the overall external position remains comfortable. SOFAZ assets increased by 7.6% in 2018 to reach 38.5 billion dollars or 84% of GDP.

Structural transformation has been slow. Although some positive developments have taken place in agriculture and tourism, the focus of particular government attention, the most notable change is the increase of non-tradable sectors. Construction, in particular, accounts for one out of five jobs created over the last decade, although the sector was contracting in the first half of 2018 as some major infrastructure works were completed.

Agriculture remains by far the largest employer but accounts for only 5% of GDP. The sector's share in total employment has declined only slightly over the years from 39% in 2000 to 36% in 2017. By contrast, the oil sector employs directly only around 1% of the labour force.

The challenge for the government is how to move away from over-reliance on hydrocarbons, the source of two decades of growth. Domestic spending of hydrocarbon revenues over the last two decades has contributed to reducing poverty and creating a middle class through increases in employment, real wages and pensions. However, significant disparities remain between urban and rural areas, and between different regions.

Structural adjustment has been slow to adapt to the need for employment opportunities, and the labour market appears inflexible and troubled by skill mismatches. The authorities have started to move to more active labour policies to address these constraints, including by shifting from purely social protection models.

Stabilisation of the financial sector contributed to the economic recovery in 2018, with loans increasing by 11% after two years of contraction. The situation remains fragile, however, with non-performing loans reaching 17% of the total by end-2018. The high degree of dollarisation, which has declined somewhat from a peak of 82% of total deposits in 2015 to 72% in 2018, constrains monetary policy and is a source of vulnerability.

Looking ahead: With improved institutional capacity and public finances, government support for specific non-hydrocarbon sectors will continue. However, the twin aims of diversification and fiscal prudence are liable to be undermined by the expansion of gas production, which is certain to keep hydrocarbons as the key driver of economic performance in coming years.