

bne:Invest in Azerbaijan

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AZPROMO continues engagement in WAIPA, as Egyptian delegation visits Baku

Last week, the head of Azerbaijan's Export and Investment Promotion Foundation (AZPROMO), Rufat Mammadov, was reappointed as vice president of the World Association of Investment Promotion Agencies (WAIPA). The event took place in Milan, where WAIPA's steering committee recognised Mammadov's accomplishments during his first appointment

and decided to extend his tenure. Founded in 1995, WAIPA aims to connect its 244 members from 162 countries and to advance an understanding and cooperation between them.

Over the past month, AZPROMO continued its efforts to increase the country's foreign trade and investment by hosting events with



delegations from the UK, Egypt, Russia, Poland and Austria.

While Azerbaijan's ties with the European Union and Russia remain strong, the rapprochement with Egypt is an encouraging move, as relations between the two countries were temporarily stalled after the Arab Spring.

The visit of the business delegation led by Khaled Fouda, governor of Egypt's South Sinai province, promises to revamp the traditionally close diplomatic relations between the two countries, and to add a commercial dimension to them. In Baku, the Egyptian delegation met with President Ilham Aliyev, Minister of Economy and Industry Shahin Mustafayev, after which it participated in a bilateral business event at the AZPROMO headquarters.

Trade relations between Azerbaijan and Egypt peaked in 2011 when, thanks to trade with refined petroleum products, the two countries reached almost \$1bn in exchanges, up from \$2mn in 2008. After the Arab Spring broke out, Azerbaijan ceased the processing of petroleum at the MIDOR and Amerya refineries in Egypt, and commercial exchanges dropped to the previously negligible levels.

The recent diplomatic efforts and cultural affinities, such as Azerbaijan's hosting of the Islamic Solidarity Games in 2017, could reflect result in greater trade and investment. This time around, Minister Mustafayev said he would like to see cooperation in areas like agriculture, tourism, industry and alternative energies. ●



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Top story



Azerbaijanis rediscover the dollar as trust in manat falls

The recent currency instability across the Commonwealth of Independent States (CIS), triggered by the collapse in the Russian ruble's value in December, has rattled energy-rich Azerbaijan and prompted a rapid dollarization of its economy.

After 20 years of a fixed exchange rate policy, Azerbaijanis awoke on February 21 to discover that their currency, the manat, had been devalued 33.4% against the dollar by the Central Bank of the Republic of Azerbaijan (CBA). The manat's decline had actually started a week earlier, but

the central bank's surprise move undermined confidence in the national currency, leading savers to suddenly switch their deposits into dollars. The US currency now accounts for 70% of total deposits in the banking sector, up from about 50% in 2014 – the highest proportion in a decade.

According to Alim Hasanov, Baku-based economist for Georgian investment bank Galt & Taggart (G&T), Azerbaijanis' faith in the currency has taken a big hit. "Wouldn't you [distrust it] if you had your savings in manat suddenly slashed

by 33.4%, would you still keep them?" he asks rhetorically. "Azerbaijan didn't experience a radical devaluation for over 15 years, people were not ready for that and many simply panicked."

The central bank's international reserves were another casualty. Its reserves fell from \$11bn at the start of the year to \$8.43bn in May. In May 2014 the central bank sat on a cushy pile of \$15bn. Heavy spending for June's European Games in Baku has further dwindled reserves.

However, the level of reserves in May increased slightly for the first time since January, suggesting that the situation has stabilised somewhat. "The central bank announced it is working on some kind of mechanism to support or increase trust in the local currency, but did not explain the details," Hasanov tells bne IntelliNews. "Maybe it is a temporary adjustment, but... based on those figures we can say that movement from the manat to the dollar has stopped. Eventually the market will have to move back to the manat."

The devaluation nevertheless brought some relief to the Azerbaijani economy, as it partially compensated for the steep fall in oil prices that had begun in 2014, thus helping to balance its public finances. In a research note published on June 5, G&T The fiscal balance remained in deficit in the first quarter as oil-related revenues continued to decline, resulting in a \$ 0.7bn deficit, corresponding to 5.2% of GDP. "Rough calculations indicate that the deficit may have reached 7.2% of GDP in the absence of devaluation," it said.

Not alone

Azerbaijan is not alone – the re-dollarization of CIS economies is a regional phenomenon. Armenia and Georgia wrapped up 2014 with 72.6% and 65.2% respectively of bank deposits in dollars. Georgia has been focusing on "larization" since 2010 and managed to tame the level of dollars in both deposits and loans, but de-dollarizing the economy can't happen overnight.

Figure 2: Reserves, US\$ bn

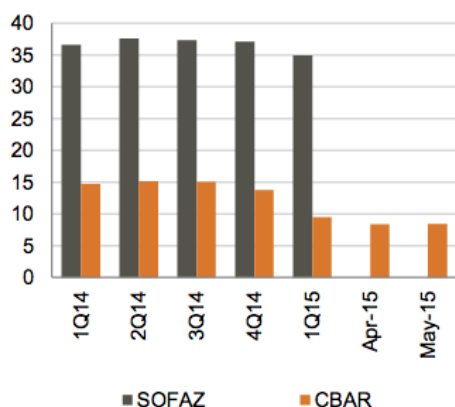
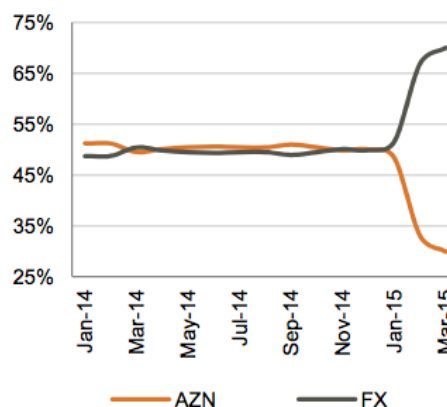


Figure 3: Dollarization ratio of deposits



Oleg Kouzmin, Moscow-based economist at Renaissance Capital, explains that a de-dollarization could be achieved by improving public confidence in national currencies, but this cannot be achieved by just ensuring exchange rate stability, and Azerbaijan is a good example. "Better control over inflation and more flexibility to the exchange rate result in predictability of domestic rates, while the general public feels more comfortable with fluctuations, understanding that the rate can go up and down." In his view Azerbaijan has "good chances to take the level of dollarization lower. The move to a managed floating rate is the important step."

The lack of trust inevitably creates a vicious circle: customers do not want to keep deposits in their currency, so banks end up not having local currency to lend to their clients. Dollars are being increasingly used in loan and real estate transactions to reduce devaluation risks, and banks also prefer to offer loans in dollars rather than manat, according to local reports.

International financial institutions are on the lookout to help. In May, the European Bank for Reconstruction and Development (EBRD) announced plans to issue its first manat-denominated bond, following similar initiatives in neighbouring Georgia in March 2014 and Armenia last January. Other multilateral lenders – the International Finance Corporation (IFC) and the Asian Development Bank (ADB) – followed with Georgian lari-denominated bonds in February this year, a sign of the need for local financing.

The aim is to encourage borrowing in local currencies, which have been caught by a sharp

devaluation, squeezing already meagre household savings across the region. "We are working right now with the [Baku] authorities to create the appropriate legal and regulatory framework [because] it is very important that our bonds are placed in the market at the same [conditions] as the government's, not to create an unfair market between the two instruments," Bruno Balvanera, who heads the EBRD office for the South Caucasus, told bne IntelliNews last month.

While Hasanov agrees the plan would support the local currency, he stresses that "at the moment there are just not enough manats in the market", so he sees the placement as an "open-ended plan."

For an oil revenue-dependent country whose currency was devalued by about a third, Azerbaijan's economy performed better than expected in the first quarter, growing by 5.3%.

However, the G&T report highlights that the growth rate was mainly fed by one-off factors: inaugurations of major sporting complexes, lower oil production base of last year, and an immediate post-devaluation run on shops by those seeking to benefit from manat prices still reflecting the old value against the dollar.

"With reserves falling and the banking sector being 'stress-tested' by post-devaluation developments, we do not expect similar growth rates in the coming quarters," the note reads. "Moreover, the lack of credible forward-looking assurances regarding future monetary policy, particularly exchange-rate policy, is acting as a brake on the new investment needed to drive growth." •

PASHA Bank



PASHA Bank sponsored the London Stock Exchange Financial Markets Forum in Baku.

PASHA Bank receives double recognition, sponsors financial markets forum

In early June, PASHA Bank sponsored the Financial Markets Forum, which gathered 150 British and Azerbaijani financial experts in Baku to discuss the development of capital markets in the country, the integration of the British and Azerbaijani equity markets, and the possibility of international financing. The event was organised by the London Stock Exchange. Taleh Kazimov, member of the board at PASHA Bank, noted that: "It is particularly important to organise such events during periods of macroeconomic uncertainty... Helping to develop Azerbaijan's financial markets is one of PASHA Bank's key priorities, and we hope to continue to expand our business relations with our international partners to achieve this goal."

In other areas of finance, PASHA Bank received two accolades in recent weeks. The first was a trade award from Commerzbank for being Azerbaijan's most active bank in the area of trade finance. The second was an EMEA Finance Europe Banking

award for being Azerbaijan's best bank. Kazimov believes this award reflects the bank's efforts to diversify its portfolio of clients domestically and abroad, and to be a responsible corporate citizen. "Not only have we successfully built our small and medium-sized business client base, and seen excellent results in investment banking, but we have also implemented many projects as part of our corporate social responsibility programme. An outstanding achievement for us last year was establishing our presence in Turkey. I strongly believe that PASHA Bank Turkey will be key to promoting the successful activity within the Baku-Tbilisi-Istanbul economic triangle, and we hope that our presence in the region will be beneficial to all our customers."

The EMEA Finance award for 2014 is a step up from the previous three years, when PASHA Bank was recognised for being Azerbaijan's leading investment bank. ●



Interview



IBA to help Russia's Islamic finance drive

Western sanctions have encouraged Russia to look closer to home for new opportunities and make do with what they already have. Russia has been hard at work lately, figuring out the new ways to attract more funds after sanctions closed off global credit markets to Russian companies.

Islamic finance is one such possibility. With a population of 26mn Muslims, the Russian banking system has big scope for adopting alternative banking systems, such as Islamic banking. Judging by the interest from Arab countries, it seems like a very realistic alternative to getting finance flowing back into the Russian economy.

Probably the biggest obstacle to that happening right now is a lack of relevant skills. And that's where Russia has turned to Azerbaijan for advice.

Sergey Drobyshevsky, director at the Gaidar Institute for Economic Policy, speaking at a conference in Baku in May, said that Russia hopes to learn from Azerbaijan's experience in Islamic banking and that the International Bank of Azerbaijan (IBA) will lead this initiative.

Indeed, according to bank's latest figures, since 2013 IBA's activities in Islamic finance sector brought in \$691mn worth of foreign investment and \$12mn through individual deposit accounts. "Since 2003, when we first introduced Islamic banking, Azerbaijan has made the biggest progress out of all CIS countries in terms of attracting investments into this sector, most of which comes from Islamic finance institutions. Both Azerbaijan and Russia have a similar regulatory base, which makes it easy to transfer our knowledge to the Russian banking system. In addition, we bring with us a wide net of relevant contacts to assist the growth of the sector," Behnam Gurbanzadeh, IBA's director for Islamic finance, tells bne IntelliNews.

Gurbanzadeh says the surge in interest from Arab countries comes as a direct result of the Western sanctions on Russia. "There's a large number of projects in Russia currently on hold, and without someone stepping in and putting in the cash they risk a long-term halt. In terms of popular investment trends, I'd say investors are currently interested in construction projects in Russia, as Russian infrastructure is in great need of modernisation, from building new motorways, bridges and highways, to residential houses and new districts. Russia is very interested in attracting investors and their capital directly into such projects. Real money, real projects," he says.

The outlook is bright, says Gurbanzadeh, "In a country as rich in national resources, the economy can withstand a short-term crisis like Russia's and likely to pick up again in a couple of years' time. Assets are going for next to nothing. But in two years' time, once the economy picks up, they'll probably increase by three or four times."

Introducing Islamic banking to a country with little relevant legislation in place is no walk in a park. Of those 26mn Muslims, many are probably practicing, which means living according to the rules of Sharia Law, which also governs financial matters. Islamic banking is based on laws of Sharia principles and is fundamentally different from conventional banking. In order to attract such clients, Russian Islamic finance will need a whole new set of regulations, approved in the parliament and implemented before a practicing Muslim can bank with them. "We had our first meeting in February, together with members of [the Russian parliament], Russian central bank and the finance ministry. We discussed the initial steps to get the project off the ground. We agreed to set up a working group and had one more meeting, that's it."

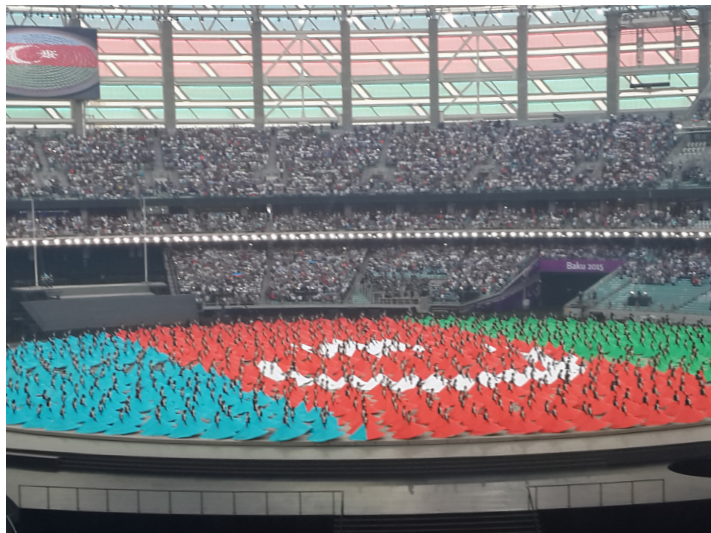
Yet for Gurbanzadeh, the Russian pace seems a bit slow: "We're still at the negotiating level. I think we need a boost, an engine that will keep driving this project through, no matter what. That's why it worked for us in Azerbaijan. Right from the start, in 2003, we had a dedicated team determined

to make it work, we were driven by the idea of pioneering the Islamic banking in Azerbaijan and the excitement of our goal just kept us going, until we got where we wanted to be."

Far from fearing it, Gurbanzadeh welcomes the competition Russian Islamic finance will bring to the region. "The Islamic banking sector in Azerbaijan is pretty advanced and ahead of the existing competition. It'll take some time to catch up with us. We intend to continue working with Russia in this sector, long-term cooperation is important for us as well – there are nearly 2mn Azerbaijanis currently living in Russia. That's an additional platform for us. Similarly, Russia needs us if it wants to access Islamic banking market opportunities in Turkey or Iran. I don't think of it as competition, but rather a partnership," he says.

Gurbanzadeh says his ultimate goal is to turn Azerbaijan into a centre for Islamic finance in the region. "Our goal right now is to work on legislations and regulatory system of Islamic financing in Azerbaijan, so we can become a hub of Islamic finance in the region and within the CIS countries. We have all the necessary components for it – crossroad and original Silk way location, our Muslim ethnicity. A lot has been invested in the necessary infrastructure and pulling in all available expertise and the know-how. I'm excited about our opportunities in Russia, but the hub of it all will be Azerbaijan. That's my goal, anyway." •

Feature



Baku stages greatest show but what will be legacy of European Games?

The organisers of the inaugural European Games had long promised that the opening ceremony on June 12 would be “the greatest show ever staged in Azerbaijan” – and they made good on their promise. The ceremony was a feast of colour, glitter, lights, fireworks, Azerbaijani culture and sportsmanship. A 12-act show woven together by smooth transitions punctuated by abrupt appearances for the wow factor, the ceremony kept the audience on its toes for almost three hours. Whether the legacy of the show will last much past the end of the Games on June 28 remains a matter of conjecture.

To the delight of the Azerbaijani audience, the event started and finished with traditional Mugham music and dance. A famous singer in Azerbaijan, Alim Qasimov, rocked the stadium and

set off the first of several fireworks shows. His act was followed by the delivery of the Olympic flame, which had travelled throughout the country for the last six weeks, and by that of another national symbol, the poet Nizami. The ceremony also featured a giant pomegranate that opened up to let its seeds float all over the stadium; a parade of the 50 national teams participating in the event; speeches by Azerbaijan's first lady Mehriban Aliyeva, and by the president of the European Olympic committee Patrick Hickey; a giant cauldron that was set on fire; and a mythological act with Europa riding the bull Zeus, which might not have resonated with the local audience, but was a wink at Greece from the Greek artistic design team that had planned the ceremony.

Halfway through the ceremony, there was a surprise appearance by Lady Gaga, whose piano-accompanied rendition of John Lennon's “Imagine” had the audience clapping and singing along. Throughout the entire ceremony, the audience was visibly moved and involved; they got up to sing the national anthem, made waves when they were asked to, cheered for the parade of athletes, particularly for the Turkish and Azerbaijani teams, and turned on the flashlight option on their smartphones when messages on giant screens encouraged them to do so. They were vocally supportive of all the acts, except for representatives of the Armenian sports delegation, who were booed when they appeared on stage in what was the low point of the event.

Agent of change?

As befits such a ceremony, the two speeches were brief and congratulatory. Both Aliyeva and Hickey thanked the organisers, audience and athletes,

and shared their belief that the Games would mark a new era in the country's history and in that of European sport. Hickey did not address the mounting criticism of Azerbaijan's human rights record, but did posit that sport was an agent of change, as "sport has a unique power to cause positive change, and to instil values that bring about that change".

Whether or not Azerbaijan will see positive change in the longer term remains to be seen. Economic growth in the first quarter, 6.5% for the non-oil sectors, was indeed higher than expected, thanks in part to increased public spending in preparation for the Games. But public spending over the last two quarters of the year will most likely drop, which will be reflected in the economic performance. Besides, the full impact of the 33% devaluation of the Azerbaijani currency in February has yet to be felt, as companies have reportedly postponed layoffs until after the Games and consumer prices were kept in check by strict government control.

If recent sporting events like the World Cups in South Africa and Brazil and the Olympics in London are anything to go by, the returns on investment of organising such large-scale competitions are disappointing. Most venues built for these purposes tend to be underused after the events, and become burdens on state budgets due to high maintenance costs. In Azerbaijan's case, the fact that it will be hosting the Islamic Solidarity Games in 2017 means that there will be other opportunities for the country to use these sporting venues in the coming years, but that will hardly be enough to recover the initial investment. The BBC reported that the official cost of the game stands at \$1.2bn, but the real figure could be much higher; the Olympic Stadium alone cost more than \$600mn.

Azerbaijan's country's sports minister said the opening ceremony cost over \$95mn – more than twice that of London's \$42mn, four-hour opener for the 2012 Summer Olympics.

The cost of staging such an event was deemed too high for the much wealthier Netherlands, which pulled out of its initial bid to host the 2019 edition two days before the Baku 2015 opening ceremony. Unlike Azerbaijan, the Netherlands made public an estimate of the price tag for staging the event, €57.5mn, but decided to withdraw its bid because of insufficient support from local, provincial and national authorities.

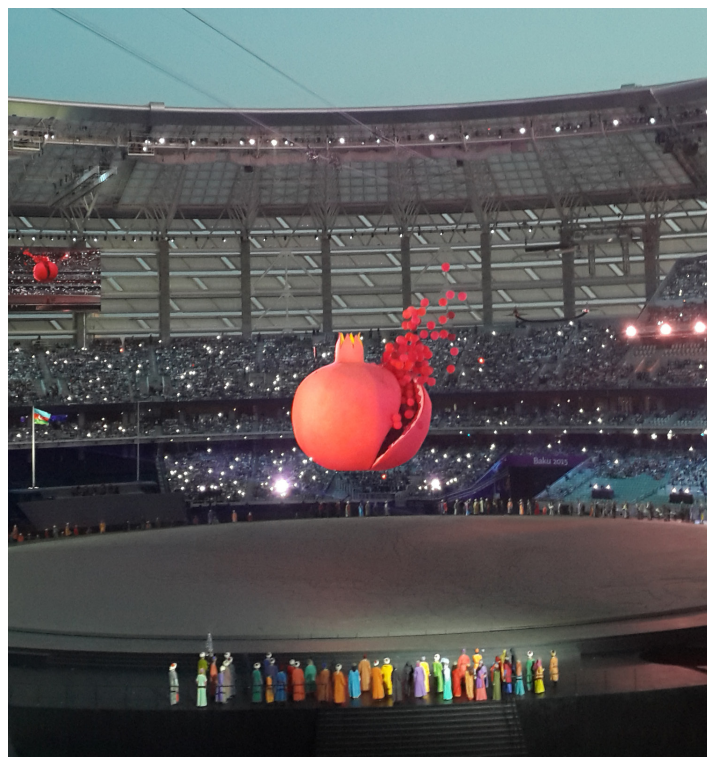
Hotel Baku

In addition to sporting venues and infrastructure projects, Azerbaijan has also invested heavily in its hospitality sector. In Baku alone, three new five-star hotels opened in recent months, and three more are underway. The capital has invested in an extensive network of luxury accommodation aimed at supporting the development of business travel, but for now the average occupancy rate for these venues remains under 50%, so their future will be determined by the extent to which Azerbaijan manages to attract luxury leisure and business tourism in the future. The Formula 1 race planned for 2016 is a start, but more such initiatives are needed to ensure a steady flow of foreign tourism.

Economic considerations are not the only incentive to host such events. The European Games are a clear attempt to bring the people of Azerbaijan together and to foster a sense of national pride. However, to the organisers' frustration human rights groups from around the world have used the opportunity to draw attention to issues like corruption and the limits on freedom of speech in the country. A seemingly un-phased

Azerbaijani administration responded by further cracking down on dissent and by accusing critics of smear campaigns, of disparaging its efforts and of politicising a sporting event. In early June, even the Organisation for Security and Cooperation in Europe (OSCE) fell victim to this drive, when it announced that its Baku office would be closed within a month.

It will take at least another three months to see if Hickey's predictions about sport and change are right, and if the European Games will leave a lasting legacy on Azerbaijan or European sport as a whole. But for now, Azerbaijan is busy cheering for its athletes, who have won the greatest number of medals in the first three days of the competition. After all, nothing brings out national pride like sporting glory. ●



European Games in Numbers

Useful phone numbers in Azerbaijan:

102 – police

103 – emergency healthcare

919 – State immigration office

Baku:

2.1mn – inhabitants

25 km – distance between the airport and the city centre

20-35 manats – cost of a taxi ride from the airport to Baku

The Games:

18 venues – will host the sports competitions

50 countries – participating, including Azerbaijan and Israel, a member of the European Olympic Committee

68,000 – the capacity of the Olympic Stadium, where the opening and closing ceremonies will be held

2 to 5 manats – price of most tickets to regular competitions

20 to 200 manats – cost of an entrance ticket to the opening and closing ceremonies

12,500 – volunteers involved in helping out with the Games

Sector



Renewable wind blows through Azerbaijan

At the end of May the first turbine began turning at the Yeni Yashma wind park, the first of 20 that Azerbaijan's State Agency on Alternative and Renewable Energy Sources (SAARES) say it intends to build at the wind farm located in the north of the country.

"We will commission one turbine every three days," Jamil Melikov, head of SAARES, which is part of the Ministry of Industry and Energy, told Azernews on May 29.

Tapping into Azerbaijan's renewable energy potential is long overdue. Of all the renewable energy technologies available only tidal power is deemed to have no significant potential in

Azerbaijan. The country's geographical diversity and climate provides a wide choice of renewable energy sources, ranging from biofuels to geothermal energy.

Azerbaijan currently hopes to triple its renewable energy capacity from 830 megawatts (MW) this year to 2,500MW by 2020. According to Melikov, total investment in the renewable energy sector has now reached AZN800mn (€674mn). The government has put the investment required for the renewable programme at \$2.5bn-3.5bn.

Some of that is going into wind parks like Yeni Yashma. Average wind speeds in Baku reach 8-9 meters per second (m/s) thanks to strong gales coming in from the Caspian Sea. A wind turbine requires at least 4 m/s. Thus Baku and the surrounding Apsheron peninsula is seen as having the potential to generate 2,500MW of power, while the country as a whole could produce 4,500MW per year, according to an EU energy committee report. The government's renewable programme specifically targets an increase in wind energy capacity from 240MW to 800MW

Azerbaijan has good potential for solar power also. It receives on average 250 days per year of bright sunlight throughout the country, meaning solar has the potential to bring energy to almost any location in Azerbaijan without the need for expensive large-scale grid level infrastructural developments.

"Solar energy is the most technically effective field for Azerbaijan. Its technical potential is estimated at 5,000MW a year," Melikov told delegates during his speech at the "SOLAR - 2015" international

conference, held in Baku in April. Under the programme to 2020, the government sees solar power increasing from 290MW to 600MW.

And in April, the energy ministry discussed with Iran the possibility of establishing a wind farm and a construction of geothermal power plants in the eastern part of Azerbaijan near the border. The government sees geothermal capacity rising from 15MW to 150MW,

“The financing of this pilot project will be carried out by the International Agency for Renewable Energies, which Azerbaijan is a member of,” said Melikov, adding that the International Agency for Renewable Energy will fund part of the project (5MW from a total of 50MW-250MW), while the expansion of the project will require further investments from other sources.

According to Ramiz Rzayev, head of investment at Azerbaijan’s energy ministry, developing its renewable energy potential will help to increase Azerbaijan’s oil and gas exports, which will improve bring much needed revenue to help further diversify the economy. “We want to is to achieve the environmental balance across Azerbaijan. By tapping into renewable energy potential, we will save a huge amount of natural gas, which can be exported instead. Last year, we produced a total of 1,500MW from renewable energy sources, including biofuel, and saved 0.5bn cubic metres of natural gas.”

“The plans to increase our renewable energy output by 2020 is a strategic decision. We want to secure Azerbaijan’s leadership in the energy sector in the region,” says Rzayev. ●



Economics & finance

Eurasia economies to bottom out in 2015, says World Bank

Growth will be the lowest in years in Central Asia and Caucasus in 2015, but will pick up over the next two years, the World Bank predicts in its Global Economic Prospects report.

"In South Caucasus and Central Asia (including Kazakhstan), growth is expected to bottom out in 2015 and gradually strengthen to 2.9% and 4.9% in 2016-17, respectively, as conditions in the regions normalise," the report said.

In oil-exporting countries - Kazakhstan, Azerbaijan, Turkmenistan and Uzbekistan - growth prospects remain "closely" tied to oil prices, but higher oil prices expected over the next two years should eventually support economic growth.

The bank said almost all economies in the region had been negatively affected to various degrees by the spillovers from the recession in Russia and Ukraine, as well as weakening confidence related to the ongoing geopolitical tensions, and the growth slowdown in oil-exporting Azerbaijan and Kazakhstan. "Only Uzbekistan and Turkmenistan, two relatively closed, resource-rich economies with strong buffers and linkages with the East and South East Asia regions, were reportedly less affected by the commodity price declines and regional headwinds."

Azerbaijan is expected to post a 1.5% growth this year and Kazakhstan 1.7%, according to WB forecasts.

The risks for the region remain tilted to the downside, with the key ones being further declines in oil prices, escalation of geopolitical tensions, and abrupt tightening of global financial conditions, the World Bank said. The Russian economy, on which the regional economies heavily depend, could face a deeper recession in 2015, and possibly in 2016, if oil prices decline or geopolitical tensions in the region escalate. Low oil prices, combined with a delayed recovery in Ukraine, will also slow down in other major oil exporters - Kazakhstan and Azerbaijan - which in turn lead to a "sharp" slowdown in regional growth, the bank said.

Low oil prices and geopolitical tensions have complicated monetary policy in the Caucasus and Central Asian countries, the bank said. "In two relatively large oil-exporting economies of the region, Azerbaijan and Kazakhstan, policy flexibility has been constrained by elevated inflation and balance sheet concerns," the report says. "Efforts to stem currency depreciations in these countries resulted in some losses of reserves and slow external adjustments (current account balances are expected to deteriorate in both countries in 2015)."

With significant buffers in the form of foreign assets, oil-exporting countries have been able to avoid steep spending cuts, despite significant loss in oil revenues, or have implemented countercyclical expenditure increases. Fiscal break-even oil prices are estimated to remain at or over \$90 per barrel in Kazakhstan and Azerbaijan, and considerably above the \$58-64 projected for 2015-16 to cover government spending, which has increased in recent years



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in response to "rising social pressures and infrastructure development goals", the bank noted. "As a result of the oil price decline, all countries in the region are expected to run fiscal deficits in 2015 except Turkmenistan and Uzbekistan. With buffers eroding rapidly, and lower oil prices expected to persist for a prolonged period, most countries will need to re-assess medium-term spending plans and will need to adjust gradually to the new realities in the global oil market."

Structural reforms

The World Bank believes sustained lower oil prices will reduce real incomes and purchasing power in many oil-exporting economies and the economies closely linked to them, and unemployment in oil-importers will remain high. "To accelerate growth and job creation, and to avoid a significant widening of the income gap, requires stepping up the implementation of structural reforms in the entire region."

Many countries in the region remain well below the frontier of best practices with regard to creating a business environment conducive to productivity growth, while barriers to open markets and access to finance are well above-average in Azerbaijan and Kyrgyzstan. "Reducing these barriers would spur productivity and increase resilience to external shocks," the bank said.

While reform needs are country specific, they fall into a few categories, the bank explained. These include shifting the composition of growth away from consumption in Georgia, or natural resources in Azerbaijan, Kazakhstan, Turkmenistan, and Uzbekistan; easing infrastructure bottlenecks; improving education; reforming labour markets; enhancing competition and easing administrative burdens; improving

access to private and multilateral financing; reducing barriers to trade and facilitating regional integration; and reforming energy subsidies.

Azerbaijani economy to grow by 1.8% in 2015, says IMF

Azerbaijan's near-term macroeconomic outlook "has deteriorated considerably" with non-oil GDP growth expected to decelerate to 3.5% in 2015, but the economy would expand by 1.8%, up from the recent 0.6% projection, the International Monetary Fund (IMF) stated on June 9, following a fact-finding mission in Baku.

The steep decline in oil prices hit the oil-and-gas dependent economy and the wave of currency depreciations in the region led to a sizable devaluation of the national currency, the manat, decided by the Central Bank of the Republic of Azerbaijan (CBRA) in February. While the move has improved the government's balance sheet "it has also raised financial vulnerability concerns, following the sharp rise in dollarization and affecting banks' capital and manat liquidity", stated the IMF.

Foreign reserves have stabilised since mid-April, "covering now a still comfortable 7 months of imports, external buffers including the oil fund amount to about 35 month of import cover".

According to the IMF, the sizable fall in export revenue and the slow down in public investment will spill over in the private sector demand, already weakened by some loss of confidence after the devaluation. "Some recovery in oil prices next year should help bring the non-oil growth to nearly 4.5% in 2016," the mission assessed.

“Inflation is likely to reach 8.5% in 2015, due to lower demand and government’s action to prevent price increases early this year.”

With low oil prices, the current account surplus will narrow to 5% of GDP while the fiscal balance will swing into a deficit of about 7% of GDP. “A sharp and possibly sustained decline in GDP cannot be ruled out if oil prices fall further or the post-devaluation stress in the banking system is larger than anticipated,” the release added.

The mission highlighted the need to support further the private sector and to push for a diversification of the economy – reforms to improve governance, ease the costs of doing business, as well as removing barriers to competition and the very costly customs procedures are listed as key instruments. “Further efforts are needed to improve government effectiveness, broaden anti-corruption efforts, and strengthen the rule of law and the independence of the judicial,” the IMF added.

FDI in Azerbaijan up by 44.8% y/y in Jan-May

Foreign direct investment (FDI) in Azerbaijan grew by 44.8% y/y in the first five months of the year, amounting to AZN2.62bn (€2.22bn), according to data released by State Statistics Committee (SSC) on June 13. On a monthly basis, FDI dropped by 0.8%. The United Kingdom led with investment amounting to AZN839mn (€709mn), followed by Norway with AZN370.4mn (€313mn), and Turkey with AZN363mn (€306mn).

Moody’s assigns CR assessments to six Azerbaijani banks

Moody’s Investors Service has assigned Counterparty Risk Assessments (CR Assessments) to six Azerbaijani banks, following the rating agency’s new bank rating methodology announced in March, the agency stated in a release on June 4. International Bank of Azerbaijan (IBA) was assigned a ‘Ba2(cr)’, Bank of Baku and VTB Bank a ‘Ba3(cr)’, and UniBank Commercial Bank, Commercial Bank Respublika and Xalq Bank a ‘B1(cr)’.

Moody’s also changed the outlooks for IBA, UniBank, and Commercial Bank Respublika from stable to positive, given the challenging operating environment in Azerbaijan (‘Baa3’, stable). The recent slump in oil prices has put downward pressure on the country’s GDP growth, creating an operating environment that exerts pressure on the banks’ fundamentals, it said.

Moody’s forecasts flat lending growth in 2015 - excluding the effect of the 33.4% devaluation of the local currency, the manat, against the dollar in February - on the back of the slowdown in economic activity and the lack of local manat liquidity.

In this environment, Azerbaijani banks appear unwilling to extend more local-currency loans, which will result in a widening of banks’ short open foreign-currency positions; furthermore, customers are unwilling to take on foreign-currency risks. Moody’s anticipates a negative trend in asset quality following the devaluation, as most banks’ foreign-currency loans (40% of gross loans as of March 1) were granted to borrowers that do not have foreign-currency revenues as well as the seasoning of the banks’



loan book amidst the slowdown in lending and higher inflation expectations that will worsen the population's purchasing power.

Moody's upgrades Azerbaijan's Kapital Bank to 'Ba3', outlook stable

Moody's Investors Service has upgraded Azerbaijan's Kapital bank's long-term local and foreign-currency deposit ratings to 'Ba3' from 'B1' and confirmed its stable outlook on long-term ratings, Moody's stated in a report released on May 29. The revision was driven by the bank's strengthened financial fundamentals and the improvement in the macro profile to "weak" from "weak-" for Azerbaijan ('Baa3', stable).

Kapital Bank, fully owned by Pasha Holding, "significantly strengthened capitalisation and profitability, providing a sufficient cushion against expected heightening credit losses amidst the currently challenging operating environment in Azerbaijan", read the report. To support the bank's business growth, shareholders raised the capitalisation by AZN70mn (€60mn) in the first half of 2014 (an 88% increase in authorised capital), and by AZN30mn in 2013 (a 60% capital increase).

Kapital's growth in higher-yielding retail loans has underpinned almost doubling of net interest margin, whilst current pre-provision income provides a healthy buffer against an expected increase in credit costs. The bank's profitability has thus significantly improved, with a reported return-on-assets (ROA) of 4.9% as of year-end 2014 up from 3.13% at year-end 2013.

Moody's also notes that problem-loan write-offs, as well as loan book growth and problem-

loan recoveries have allowed the bank to reduce its non-performing loans ratio (loans 90+ days overdue) to 7.7% as of year-end 2014, down from 13.8% in the first half of 2014.

PASHA Bank issues term loan facilities to Georgia water utilities

PASHA Bank issued term loan facilities to Georgian Water & Power and Rustavi Water Company worth GEL12.5mn and GEL10mn respectively. Combined exposure of PASHA Bank to the borrower's parent company, Georgian Global Utilities, amounts to GEL22.5mn.

The borrowers are regulated water utilities serving Tbilisi and its environs and the city of Rustavi. They regularly carry out water supply and sewage networks rehabilitation works, replacing old underground facilities with new more efficient systems. Loans in foreign currency taken out by borrowers at the earlier date that are now being refinanced by GEL denominated facilities extended by PASHA Bank will contribute to the successful implementation of these projects.

"We are very glad to have started partnership with GWP & Rustavi Water. This transaction once again shows that PASHA Bank, being focused on serving large and medium enterprises, has both institutional capability as well as appetite to take on transaction of such large a scale. In a light of the current market climate, the fact that these facilities were issued in GEL deserves a special mention too," commented CEO of PASHA Bank, Shahin Mammadov.



Chart

Exchange rate broadly stable and following oil-price trend

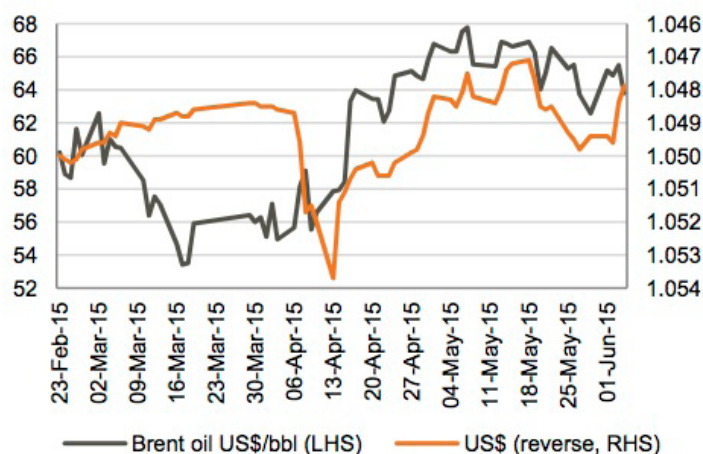
This month's chart shows how the exchange rate between the manat and the US dollar has remained broadly stable at AZN1.05 per dollar following the devaluation of the Azerbaijani currency in late February.

The devaluation was sudden and shocking to the population, but since then there seems to have

been correlation established again between the central bank's exchange rate and the oil price.

However, analysts note that the Azerbaijani authorities have been unable to allay rumours surrounding the future of the exchange rate, resulting in a lack of confidence that will probably hinder new foreign investment in the future. ●

Figure 6: US\$/AZN exchange rate and oil price since devaluation



Source: CBAR, Azertag

News in brief

Trans-Adriatic pipeline opens tender for offshore section

The Trans-Adriatic Pipeline (TAP), which will transport natural gas from the giant Shah Deniz II field in Azerbaijan to Europe, has announced a tender for the engineering, procurement, construction and installation (EPCI) of a 105km-long offshore section of the project, the venture disclosed on its website on June 9.

The tender is open to companies that have pre-qualified following the contract notice Tap launched in February 2015. The EPCI scope includes associated works at landfalls in both Albania and Italy (including micro tunnel), offshore installation, seabed intervention, fibre optic cable supply and installation, as well as pre-commissioning and survey activities.

The 870km-long TAP pipeline will cross the Adriatic Sea, connecting the coastline of Albania and southern Italy. TAP plans to award the contract by the end of the year with the construction set to start in 2017.

TAP will connect with the Trans Anatolian Pipeline (Tanap) at the Turkish-Greek border at Kipoi, cross Greece and Albania and the Adriatic Sea, before coming ashore in Southern Italy. With first gas sales to Georgia and Turkey targeted for late 2018, first deliveries to Europe will follow approximately a year later.

BP, Socar, and StatOil are Tap's main shareholders with 20% stake each, followed by Fluxys (19%), Enagás (16%) and Axpo (5%).

President Aliyev opens Baku White City boulevard

Azerbaijan's President Ilham Aliyev together with his wife and daughter, Mehriban and Arzu Aliyeva, opened the Baku White City Boulevard that is part of a major real estate development project that will transform the capital city in May.

The 2.7km-long shorefront promenade is the centrepiece of the residential and commercial development that is to Baku what Canary Wharf is to London.

Amongst the objects to be built are a children's cinema as well as extensive sports facilities and a 2 km long bicycle track here. All in all the Baku White City development plan envisages the creation of 10 universal urban districts with each of them to offer its residents the best living, working, recreation and entertainment conditions

Baku's hotel sector growing on the back of growing tourism trade

Host to the Eurovision song contest in 2013 and about to host the European Games, Azerbaijan's tourism sector is growing, fuelling the development of the local hotel industry.

Half a dozen firms applied for hotel licenses in the first half of this year on top of the total number of hotels operating currently of 530, the Culture and Tourism Ministry reported on June 1, while the



Azerbaijan Export & Investment
Promotion Foundation



AZERBAIJAN INVESTMENT COMPANY

number of licensed travel agencies in Azerbaijan has increased to 290 as of the start of summer.

Hopes are high that the inaugural European Games that will be held in Baku in June will bring travellers from all over the Continent and introduce new visitors to the country.

The government is already planning to follow up by applying to host the Islamic Solidarity Games, the Formula 1 race and quarterfinals and three group games of the Euro 2020. Currently 2mn tourists a year visit the country bringing in AZN1.3bn (\$1.2bn) and accounting for 2.4% of GDP, but the Culture and Tourism ministry is hoping to increase this number to 5mn a year.

Azerbaijan new wind farm goes into operation

Better known for its rich oil fields, as part of the government's diversification policy, the country just put the first 2.5-megawatt turbine of the Yeni Yashma wind farm in Khizi region in the north of Azerbaijan into operation and plans to commission 20 more.

Fossil fuels won't last for ever so the government is hoping to use the revenues from the hydrocarbon business to invest into renewables for the long-term.

When complete the production capacity of Yeni Yashma wind farm is planned to reach 50 megawatts as part of plans for 100 alternative electricity facilities in Azerbaijan within 5 years. Total investment into the alternative energy sphere for the country is expected to reach ANZ63.6mn in 2014, of which AZN34.9mn will go

into solar energy and AZN28.7mn for wind power. The government has already invested a total of AZN800mn into alternative energy since 2000.

Turkey, Azerbaijan set up oil and gas exploration joint venture

Turkey and Azerbaijan have agreed to jointly explore for oil and gas deposits in a new joint venture, during a visit to Baku by Turkish Energy and Natural Resources Minister Taner Yildiz.

The plan is part of the increasingly close ties Turkey is building in the region, which is expected to sign a similar deal with Iran.

"Turkey is currently engaged in the oil and gas exploration in 13 regions in the north of Iraq," Yildiz said at a press conference. "Turkish Energy Company explores seven regions of Iraq. Turkish Energy Company together with Exxon Mobil conducts the operations in six regions."

Turkey is very keen to tap new energy resources as it imports almost all its fuel, which has put enormous pressure on its current account in recent years. The high-quality oil reserves were discovered in the Magrip field, Kurtalan area, Turkish province of Siirt in January 2013.

Azerbaijan signed a strategic partnership deal with the EU at the Riga summit

Azerbaijan signed off on a strategic partnership deal with the European Union (EU) at the recent summit in Riga.



Azerbaijani Foreign Minister Elmar Mammadyarov made the trip to the northern capital of Latvia and signed an agreement with EU Commissioner for European Neighbourhood Policy & Enlargement Negotiations, Johannes Hahn, during the summit.

A member of the EU's Eastern Partnership programme, Azerbaijan is keen to maintain good relations with EU as part of its policy to balance the regional geopolitical forces. Azerbaijan already has strategic partnerships with many of the EU member states but also has good relations with Russia.

However, Mammadyarov also drew highlighted Baku's concerns over the Nagorno-Karabakh conflict to the European Commissioner, calling for the EU to adopt an unambiguous position on the conflict. Armenia continues the occupation in defiance of four UN Security Council resolutions, all calling for an immediate and unconditional withdrawal, which have been ignored so far. In 2013, the European Parliament adopted a resolution, which confirmed that Armenian troops have indeed occupied Azerbaijani territories and urged all parties to resolve the conflict.

Asian Development Bank, EBRD to buy Azerbaijan's bonds

The European Bank for Reconstruction of Development and the Asian Development Bank said in May they are considering becoming the first international lenders to sell manat-denominated bonds as part of a strategy to develop the local capital markets.

If the plan goes ahead this will be second bite of

the cherry as a similar plan was floated in 2013, according to Rufat Aslanli, head of Azerbaijan's State Committee for Securities.

The government recently pushed through a new securities law to underpin the development of the local capital market. And with price of oil down the government is also keen to develop alternative sources of financing.

The EBRD and the ADB have each invested more than \$1bn in projects in Azerbaijan in the past two decades and are looking to reduce currency risks by selling bonds locally, according to Aslanli.

Russia says "unilateral" trans-Caspian pipeline would undermine trust between littoral states

Russia's Foreign Ministry (MFA) has made a fresh attack on the project of a trans-Caspian gas pipeline between Turkmenistan and Azerbaijan, reiterating the country's opposition based on environmental grounds.

"Unilateral action on the construction of a trans-Caspian pipeline would undermine the trust between Caspian countries," MFA spokesperson Aleksandr Lukashevich said in a statement.

Turkmenistan has long tried to advocate a pipe across the Caspian Sea linking its giant gas fields with Azerbaijan and further with Europe through Georgia and Turkey. European countries have increasingly backed the project, as it would allow them to break loose from Russia's almost exclusive monopoly of European gas supplies.



Yet Russia has always opposed the project, ostensibly on environmental grounds. "The problem of developing pipelines in the Caspian Sea [...] should be looked at primarily through the prism of ecology and only then from an economic perspective," Lukashevich said.

Socar to invest \$1.2bn to upgrade key refineries

The State Oil Company of Azerbaijan (Socar) intends to invest \$1.2bn in the reconstruction and upgrade of its oil refineries named after Heydar Aliyev and Azerkimya PU, Azeri Press Agency (Apa) reported on June 5, quoting the company's vice president, Tofiq Gahramanov. The project will be conducted in stages, with the completion of the initial stage planned in 2018.

According to Gahramanov, Socar has already received expressions of interest by potential investors. He said that the government would support the modernisation of the facilities.

The upgrading would improve the quality of petrol produced and increase production to 2.2mn tonnes from the current 1.3mn tonnes as well as boost diesel fuel output to 2.9mn tonnes (from 2.3mn tonnes) and that of kerosene to 1mn tonnes (from the current 700,000 tonnes).

Azerbaijan kick-starts agricultural census

Azerbaijan has kick-started a comprehensive agricultural census aimed at improving statistic figures to better target reforms and policies in the sector, the State Statistics Committee (SSC) announced on June 1.

On January 12 President Ilham Aliyev signed a decree declaring 2015 the country's agricultural year. The country's focused agenda is part of a new agricultural strategy the government is developing for 2015-2020 which aims at developing non-oil economic potential. Although agriculture accounts for only 6% of GDP, according to World Bank figures, it is a key employer, providing employment to about 39% of the workforce and generating two-fifths of household income in rural areas.

The census, which will be carried out throughout the month and will terminate on June 30, is involving 1,209 controllers and 11,751 interviewers. Based on questionnaires developed by the Food and Agriculture Organisation (FAO), the exercise will collect information on types of farms, agrarian property, lease relations, use of land and fertilisers, source of income, sowing areas of agricultural crops, application of irrigation methods, existence of livestock and poultry on age and gender, lake and bond fishing, buildings, existence of agricultural techniques and equipment and workforce.