Azerbaijan Economy in the 2.nd Quarter of 2020

Prolonged lockdown has taken its toll on the economy, however, the gradual reopening of the economy commencing from August has been announced in July:

- The overall economy contracted by 2.7%, while the oil sector fell by 2.9%. Production of crude oil was 4.9% lower compared to the first half of the previous year. It fell by 5.1% m-o-m to 2.6 mln. tonnes. The decrease in production is mainly related to the realization of Azerbaijan's commitment to the OPEC+ deal. Meanwhile, natural gas production increased by 14.9%;
- Coming to the non-oil GDP, it decreased by 2.5% and accounted for 68% of the total GDP. The non-oil sector fell by 1.1% if the construction stripped out, where the latter contracted by 14.5% y-o-y. Tourism sector experienced a 47.9% downfall due to lockdown constraining non-oil GDP growth;
- Non-oil manufacturing is the highest growing industry of the economy (12.2%), which is mainly thanks to the effect of ''whitening'' and realization of public investment on specific segments of the industry, like chemical, metallurgy, and pharmaceuticals.

Lockdown-induced negative demand shock puts downward pressure on the already lower level of inflation:

- The price level decreased by 0.3% in June and annual inflation stood at 3%. It was lower than Central Bank's target band (2%-6%) center 4%;
- Prices of 78% of the products & services (404 out of 520) included in the consumer basket increased on a y-o-y basis, 13% decreased, and 9% remained unchanged. Price increase of 62% (252) of items is less than headline annual inflation of 3%;
- If decomposed into the consumer basket, food prices went up by 5.3%, non-food prices 1.5%, and services by 1.2% y-o-y. The contribution of food, non-food products, and services to the annual headline inflation made 2.3, 0.4, and 0.3 percentage points (total 3%), respectively;
- In general, lower global food prices and shrinking demand due to national lockdown had a disinflationary effect.

Lower oil price led to further deterioration in the trade balance, however, there is still a surplus equivalent to 13.6% of total GDP:

- In Jan-Jun 2020, total exports decreased by 23%, and imports* fell by 4.7%. Ultimately, trade surplus* decreased by 43.1% and accounted for $2697 mln. or 13.6% of total GDP;
- The decrease in exports is mainly related to crude oil exports. Sharp fall in oil price had a strong impact as crude oil exports decreased by 24.7% in nominal terms, while it fell by 3.1% in real terms;

- The main contributors to import decline were fuels, means of transportation and machinery & equipment products:
  - ✓ Imports of fuels fell by 67.4% as domestic production increased significantly and the lockdown negatively impacted demand;
  - ✓ Means of transportation imports decreased by 27% driven by a steep fall (90%) in the purchase of railway vehicles;
  - ✓ Imports of machinery & equipment abated by 6.6% contributing to one-third of the total decline in imports.
- During the analyzed period, non-oil exports fell by 6.9% y-o-y, amounting to $911.9 mln., equivalent to 18.3% of total imports;
- Trade surplus contributed to CBAR reserves, as of the end of June, CBAR reserve was USD 6468.7 mln. which is 8.9% or USD 529.3 mln. higher compared to the same period of 2019;
- The assets of SOFAZ, as of the end of June, increased by 1.8% compared to the contemporaneous period of 2019 (USD 42463.7 mln.) and stood at USD 43223.4 mln. or 109% of total GDP.

  ***Note:** excluding semi-manufactured gold – HS code 71, which is the gold import of State Oil Fund of Azerbaijan.

Lending is on the decline, however, loan guarantee support program of the government to affected industries from COVID-19 containment measures has started from July:

- In June, the total assets of the sector decreased by 6.7% YTD making 30.5 bln. AZN. Excluding license withdrawal of four banks – AtaBank, AmrahBank, AGBank, and NBC in April-May, total assets fell slightly by 2.4% YTD. Gross loans decreased by 4.9% on YTD basis. Excluding the banks with license withdrawals, loans rose by 1.7% YTD;
- The corporate loan portfolio contracted by 1.4% in YTD terms, driven by loans to the firms in transportation & communication (24%↓), energy & natural resources (10.2%↓), trade & services (3.9%↓) and construction (11.8%↓), while loans to industry (34.3%↑) and agriculture (1.7%↑) grew;
- Loans to households decreased by 6.3% YTD, including 11% fall in consumer loans. It led to 34.6 p.p. deceleration in the y-o-y growth rate of the consumer loan portfolio from 48.3% in end-2019;
- NPL amount has seen a 16.3% decrease compared to the end of 2019. The total NPL ratio stood at 7.3% that is 1 p.p. lower than 2019 year-end. License withdrawal of problematic banks with high NPL was the main driver of this fall;
- The deposit base experienced a decline of 8.8% YTD and made 22.6 bln. AZN. Excluding the banks with license withdrawals, deposit portfolio contracted by

5.7%. Demand deposits saw a decrease at the rate of 8.4%, while time deposits fell by 9.3% YTD, amounting to 10.2 bln. AZN. License withdrawals and cash needs of households and firms due to lower income induced by the lockdown were the main sources of deposit outflow. On YTD basis, households' deposits and NFCs' deposits fell by 10.8% and 11.2%, respectively;

- The dollarization rate of the total deposit portfolio stood at 60.4% falling by 0.5 p.p. compared to Dec 2019. The dollarization rate for time deposits rose by 2.2 p.p., while demand deposits experienced a 2.8 p.p. dollarization decrease compared to Dec 2019;
- Return on equity of the banking sector was 16.2% (2019, Jun: 9.4%), calculated as the ratio of total net profit to the end of June equity. Interest income decreased by 0.8%, while non-interest income fell by 12.3% y-o-y resulting from fewer transactions in branches due to the pandemic and up to 50% decrease in service fee for non-cash transactions according to CBAR.

Despite some lag, insurance market growth decelerates in line with the economy:

- In the first half of 2020, total insurance premiums increased by 11% y-o-y and accounted for 401 mln. AZN. The net premiums (premiums minus claims) have experienced a 10.8% fall and accounted for 1% of non-oil GDP (Jan-Jun 2019: 1.1%). In the economy, this indicator is considered to be one of the main sources of investments;
- Based on the market segment analysis, total life insurance (LI) premiums increased by 19.4% and made 161.6 mln. AZN. The share of LI premiums in total premiums of the market grew by 2.8 p.p. and comprised 40.3%;
  - ✓ Voluntary LI premiums increased by 19.6% and made 131.5 mln. AZN. The share of VLI in total LI premiums remained stable, slightly above 81%.
- Premiums of non-life insurance (NLI) rose by 5.9%. The share of NLI in total premiums decreased by 2.8 p.p. to 59.7%;
- Claims to premiums ratio of the life insurance market was 67.7% (Jan-Jun 2019: 30.6%), while this ratio was 31.5% (Jan-Jun 2019: 34.4%) for the non-life insurance market.

Interest rates rose driven by higher credit and foreign exchange risks:

- In June, interest rates on new NC deposits increased by 0.7 percentage points (pps) YTD to 9.1%. The main driving factor of the rising deposit rates was the decision of raising the maximum interest rate of deposits that are insured by ADIF (Azerbaijan Deposit Insurance Fund) to avoid deposit outflow and dollarization. Contrary to NC rates, interest rates on new foreign currency (FC) deposits fell by 0.6 pps YTD to 0.8%. Market conditions helped banks to increase FC financing easier and led to lower rates;
- Interest rates on loans rose due to lockdown-induced uncertainty and higher

rates on NC deposits. Interest rates on NC loans increased by 2.6 pps YTD to 17.2%. Similar to FC deposits, interest rates on FC loans fell by 0.2 pps YTD to 4.8%. The decrease in FC deposit rates and less demand for FC loans put downward pressure on loan rates.

CBAR decrease the refinancing rate by 50 bps to 6.75% during the Apr-July period:

- The lower bound of the interest rate corridor was reduced by 50 bps to 6.25%, while the upper bound decreased by 175 bps to 7.25% to support the liquidity. The decision is possibly aimed at decreasing demand for CBAR notes and encouraging banks to lend available funds to support the contracting economy;
- Central Bank stated that the decision is based on low annual inflation (3% vs CBAR target of 4%), improvement in global conditions, stability in the foreign exchange market, and disinflationary effect of the pandemic-induced decrease in aggregate demand.
- CBAR's monitoring of real sector enterprises showed lower inflation expectations in the industry, trade, and services, while only 29% (3 percentage points lower compared to March) of households responded that inflation will rise. Central Bank forecasted inflation to be 3%-3.5% at the year-end;
- CBAR stated that it will help to recover aggregate demand and support employment by expansionary monetary policy. Moreover, Central Bank mentioned that measures taken to ease conditions for the industries affected by the pandemic increased their access to financing;
- Central Bank mentioned that the deviation of inflation from the forecast, situation in global markets, and pace of the economic recovery will affect the next interest rate decision.