Azerbaijan Economy in the 3rd Quarter of 2020

Prolonged lockdown took its toll on the economy:

- The overall economy contracted by 3.9%, while the oil sector fell by 6.4%. Production of crude oil was 7.6% lower compared to the Jan-Sep period of 2019. It fell by 11.5% m-o-m to 2.7 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 8.3%;
- Coming to the non-oil GDP, it decreased by 2.4% and accounted for 70% of the total GDP. The non-oil sector fell by 1.4% if the construction stripped out, where the latter contracted by 9.6% year-over-year (y-o-y). The tourism sector experienced a 55.5% downfall due to lockdown constraining non-oil GDP growth;
- Non-oil manufacturing is the highest growing industry in the economy (13%), 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 put downward pressure on the already lower level of inflation:

- The price level increased by 0.1% in September and annual inflation stood at 2.6%. It was lower than Central Bank's target band (2%-6%) center 4%;
- Prices of 80% of the products & services (416 out of 520) included in the consumer basket increased on a y-o-y basis, 10.4% decreased, and 9.6% remained unchanged. Price increase of 52.5% (273) of items is less than headline annual inflation of 2.6%;
- If decomposed into the consumer basket, food prices went up by 4.3%, non-food prices 1.4%, and services by 1.2% y-o-y. The contribution of food, non-food products, and services to the annual headline inflation made 1.8, 0.4, and 0.4 percentage points (total 2.6%), 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 was still a surplus equivalent to 9% of total GDP:

- In Jan-Jun 2020, total exports decreased by 29%, and imports* fell by 5%. Ultimately, trade surplus* decreased by 58% and accounted for $2756 mln. or 9% 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 36.5% in nominal terms, while it fell by 6.5% in real terms;
- The main contributors to import decline were fuels, machinery & equipment, textiles, clothing & footwear products:

- ✓ Imports of fuels fell by 69% as lockdown-induced restrictions on mobility harmed demand for transportation;
- ✓ Imports of machinery & equipment abated by 4% contributing to one-fifth of the total decline in imports;
- ✓ Imports of textile, clothing & footwear products fell by 14% as consumer demand shifted to food and pharmaceutical products due to COVID-19. Pharmaceutical product imports rose by 31%, while imports of food products increased by 3%;

- During the analyzed period, non-oil exports fell by 9% y-o-y, amounting to $1282 mln., equivalent to 16.4% of total imports;
- Trade surplus contributed to CBAR reserves, as of the end of September, CBAR reserve was USD 6491.4 mln. which is 7.6% y-o-y or USD 457.3 mln. (3.7% year-to-date or USD 233.4 mln.) higher compared to the same period of 2019;
- The assets of SOFAZ, as of the end of September, increased by 1.8% y-o-y compared to the contemporaneous period of 2019 and stood at USD 43289 mln. or 94% of total GDP.

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

Loan portfolio grew while deposits shrank; loan guarantee support program of the government to affected industries from COVID-19 containment measures has been on-going since July:

- In September, the total assets of the sector decreased by 6.4% year-to-date (y-t-d) making 30.6 bln. AZN. Excluding license withdrawal of four banks – AtaBank, AmrahBank, AGBank, and NBC in April-May, total assets fell slightly by 2.1% y-t-d. Gross loans decreased by 2.7% on a y-t-d basis. Excluding the banks with license withdrawals, loans rose by 4.1% y-t-d;
- The corporate loan portfolio contracted by 0.3% in y-t-d terms, driven by loans to the firms in transportation & communication (25.9%↓), energy & natural resources (16.5%↓), and construction (9.1%↓), while loans to industry (36.3%↑) grew;
- Loans to households decreased by 2.8% y-t-d, including 11% fall in consumer loans. The y-o-y growth rate of the consumer loan portfolio decelerated to 1.6% from 48.3% in end-2019 due to the macro-prudential intervention in November 2019;
- NPL amount has seen a 16% decrease compared to the end of 2019. The total NPL ratio stood at 7.2% that is 1.1 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 9.1% y-t-d and made 22.5 bln. AZN. Excluding the banks with license withdrawals, the deposit portfolio contracted by

6%. Demand deposits saw a decrease at the rate of 5.7%, while time deposits fell by 13.2% y-t-d, amounting to 9.7 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 a y-t-d basis, households' deposits and NFCs' deposits fell by 9.3% and 12.1%, respectively;

- The dollarization rate of the total deposit portfolio stood at 57.6% falling by 3.4 p.p. compared to Dec 2019. The dollarization rate for time deposits rose by 2 p.p., while demand deposits experienced a 3.8 p.p. dollarization decrease compared to Dec 2019;
- Return on equity of the banking sector was 14.8% (2019, Sep: 11.1%), calculated as the ratio of total net profit to the end of September equity. Interest income increased by 0.2%, while non-interest income fell by 5.2% 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

Both life & non-life segments contributed to the growth of the insurance sector:

- In the January-September period of 2020, total insurance premiums increased by 11.3% y-o-y and accounted for 581.5 mln. AZN. The net premiums (premiums minus claims) have experienced a 14.7% fall and accounted for 0.8% of non-oil GDP (Jan-Sep 2019: 0.9%). 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 17.2% and made 239.3 mln. AZN. The share of LI premiums in total premiums of the market grew by 2.1 p.p. and comprised 41.2%;
    - ✓ Voluntary LI premiums increased by 17.4% and made 197.4 mln. AZN. The share of VLI in total LI premiums remained stable, slightly above 82%.
- Premiums of non-life insurance (NLI) rose by 7.5%. The share of NLI in total premiums decreased by 2.1 p.p. to 58.8%;
- The claims to premiums ratio of the life insurance market was 77.7% (Jan-Sep 2019: 40.5%), while this ratio was 35.6% (Jan-Sep 2019: 37.4%) for the non-life insurance market.

CBAR decreased the refinancing rate by 50 bps to 6.5% during the July-Oct period:

- The lower bound of the interest rate corridor was reduced by 50 bps to 6%, while the upper bound decreased by 50 bps to 7% to support the liquidity;
- Central Bank stated that the dominance of disinflationary factors put downward pressure on inflation and kept inflation below the center of the target interval (4±2%);
- However, CBAR's evaluation of global economic conditions as deteriorating due to the next round of lockdowns in major economies driven by the potential second wave of COVID-19, rising geopolitical tensions, price volatility in oil markets, and

uncertainty in the region limited realization of rate decrease of the Central Bank;

- Central Bank stated that extension of concessions in macro-prudential regulation until the end of the year (previously, 30 September) will improve lending conditions to the real sector and economic activity will be supported by fiscal and monetary policy combined with macro-prudential easing measures. Moreover, CBAR mentioned that reconstruction in the liberated Karabakh region will have a positive impact on economic growth;
- CBAR forecasts inflation to remain in the range of 2.8-3% by the end of 2020 and 3.6-4% in 2021;
- Updated inflation forecasts, dynamics of macroeconomic indicators, and pandemic-induced risks would affect the next interest rate decision of the Central Bank.