



Baku Research Institute

THE MAIN MACROECONOMIC TRENDS OF 2019
(Based on an analysis of the first 8 months)

ECONOMIC BULLETIN

BAKU – 2019



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Introduction

It is two months until the end of 2019. In order to estimate the results expected at the end of the year, there is interest in understanding the main trends in the country's economy over the past year, the extent to which the government's economic policies are moving towards the goals set, and the progress of economic processes. In this article, BRI's experts will briefly assess the macroeconomic results of the first eight months of 2019 and reveal important trends in the monetary, budget, foreign, and banking sectors. The article does not cover all the economic results of 2019, but only the key macroeconomic processes.

Our study shows that in January-August 2019:

- While there was a 2.4% real increase in GDP compared to the same period last year, there was a 0.15% decline in GDP per capita;
- The non-oil and gas sector's share of GDP increased by 3.1% compared to the same period last year;
- Investments continued to decline: there was a 5.4% decrease compared to the same period in 2018;
- The Consumer Price Index (CPI) was 102.4% compared to the same period in 2018;
- The national currency, the manat (AZN), was generally under pressure to strengthen due to high oil prices on world markets;
- There was an 11.1% increase in cash in circulation, despite the encouragement of cashless transactions;
- Foreign trade turnover increased by \$3.158 billion (or 16%): 80% of total turnover was imports and only 20% was exports;
- The state accounted for 89% of total import growth during the reporting period, while the private sector accounted for only 11%;
- State revenues increased by 5.8% compared to the same period last year and amounted to AZN 14.9 billion:
- The main source of state revenue growth was the State Customs Committee (SCC): the contributions of customs agencies to the state budget increased by AZN 602.4 million compared to the same period last year, to a total of AZN 2.874 billion;
- The budget share of non-tax revenues has shrunk, falling from 51.8% of total revenues in the first 8 months of last year to 48.1% in the first 8 months of this year;
- Increases in turnover tax revenues played a crucial role in the expansion of the budget: AZN 656 million, or 80%, of the total growth of AZN 819 million came from VAT and excise taxes, which are the basic turnover taxes;
- State expenditures increased by AZN 1.2 billion, or 9.1%, compared to the same period last year: the overall increase in expenditures was mainly due to the expansion of social and investment expenditures;
- The trend toward concentration in the banking sector, which began in 2018, continued in 2019: the market share (concentration rate) of five banks increased by 66.5% in the first half of this year;
- Banks' investments in securities increased by 9.5%, reaching AZN 3.9 billion;
- Consumer lending has reached pre-devaluation levels: consumer loans rose to 43.9% of total credit as of the end of August;
- There was a slight decrease in problem loans: the share of overdue loans declined from 12.2% to 10.8% since the beginning of the year.



In addition, in the first half of 2019 (January-June):

- In the current balance of payments there was a surplus of \$3.06 billion, but the deficit in current accounts in the non-oil sector grew by \$330.0 million (12%) to \$3.1 billion;
- Revenues from tourism services exports were cut in half compared to the same period last year.

1. Macroeconomic indicators

According to the State Statistics Committee (SSC), Azerbaijan's GDP in January-August 2019 was AZN 50.876 billion. Compared to January-August 2018, real GDP growth was 2.4%, and nominal growth was 0.7% (the SSC reports that GDP deflator was 98.7%).

GDP per capita was AZN 5,145.1, which is 0.16% less than the corresponding period in 2018 (AZN 5,153.1). The SSC states that the real increase in GDP per capita was 1.5%.

In the reporting period, the non-oil and gas sector accounted for AZN 30.38 billion (59.7%) of GDP, while the oil and gas sector generated AZN 20.49 billion (40.3%). The SSC reports a 1.6% increase over the reporting period in the value added of the oil and gas sector, and a 3.0% increase in the value added of the non-oil and gas sector.

Note that in January-August 2018, the value added of Azerbaijan's oil and gas sector was AZN 21.87 billion, and the value added of the non-oil and gas sector was AZN 28.48 billion (56.6% of GDP). According to the calculations, the nominal amount of value added in the non-oil and gas sector increased by 6.7% in the first 8 months of this year compared to the same period last year, while the nominal amount of value added in the oil and gas sector decreased by 6.3%. The fact that the GDP deflator was 98.7% during the reporting period was directly related to the oil sector (i.e. world oil prices were lower compared to the previous year).

Table 1

Azerbaijan's main macroeconomic indicators, January-August 2019

Indicators	January-August 2019		January-August 2018	
	actual	Compared to the same period the previous year, %	actual	Compared to the same period the previous year, %
Gross domestic product (GDP) (millions of AZN)	50,875.7	102.4	50,521.9	100.7
<i>non oil and gas sector only (millions of AZN)</i>	<i>30,383.1</i>	<i>103.0</i>	<i>28,478.2</i>	<i>100.9</i>
GDP deflator (%)		98.7		115.0
GDP per capita (AZN)	5,145.1	101.5	5,153.1	99.8
Industrial production (millions of AZN)	30,912.7	102.0	31,572.9	101.9
<i>non-oil and gas industry only (millions of AZN)</i>	<i>7,553.2</i>	<i>115.2</i>	<i>6,599.9</i>	<i>110.8</i>
Fixed capital investment (millions of AZN)	8,627.2	94.6	8,953.6	87.2



<i>non-oil and gas sector only (millions of AZN)</i>	5,365.7	105.7	4,981.0	122.7
<i>non-oil and gas industry only (millions of AZN)</i>	916.4	95.2	944.8	137.7
Shipping sector (millions of tons)	154.4	101.7	151.8	101.2
Passenger transport sector (millions of passengers)	1,303.8	101.9	1,279.1	101.3
Information and communications services (millions of AZN)	1,397.2	117.6	1,188.4	107.6
Retail trade turnover (millions of AZN)	24,175.2	102.9	22,966.4	102.7
Public payment services (millions of AZN)	5,692.9	102.0	5,436.0	102.8
State revenues (million AZN)	14,810.3	105.2	14,029.7	130.0
State expenditures (million AZN)	14,712.1	109.1	13,485.7	119.1
Nominal national income (million AZN)	36,861.6	106.4	34,786.3	109.5
Nominal income per capita (AZN)	3,727.8	105.5	3,548.1	108.5
Public's banking operations (millions of AZN)	8,561.8	106.7	8,020.8	116.3
Credit installments (million AZN)	13,865.5	112.7	12,306.5	99.4
<i>overdue loan (millions of AZN)</i>	1,491.3	84.1	1,772.4	97.2
Consumer Price Index (CPI)		102.6		102.7

Source: State Statistics Committee

According to the SSC, in January-August 2019, industry accounted for 43.6% of the newly created value added, trade and vehicle repair were 10.3%, transportation and storage were 6.4%, construction was 6.0%, agriculture, forestry, and fisheries were 5.9%, tourist accommodation and food service were 2.5%, information and communications were 1.8%, with other sectors accounting for the remaining 14.6%. Net taxes on products and imports accounted for 8.9% of GDP.

In January-August, 2019, the Azerbaijan's industry generated AZN 30.9 billion in **manufactured goods**. Industrial production in the corresponding period of 2018 was AZN 31.6 billion. Despite a nominal decrease in industrial production of 2.2% over the first eight months of this year, real growth was 2.0%. The non-oil and gas sector of industry reported a 15.2% increase in production.

According to the SSC, the state sector accounts for 18.0% of industrial output, and the private sector accounts for 82.0%.



The mining sector accounted for 70.0% of industrial output, the manufacturing sector for 25.1%, electricity, gas, and steam production, distribution, and supply sectors for 4.2%, and water supply, waste treatment and processing sectors for 0.7%.

In the first 8 months of 2019, the commodity production of crude oil was 25.1 million tons, and commodity natural gas production was 15.9 billion cubic meters. Compared to the same period last year, oil production decreased by 2.5% and gas production increased by 30.9%.

During the reporting period, Azerbaijan's processing industry generated AZN 7,553.2 million and provided industrial services. In the same period of 2018, the volume of production and services in the manufacturing industry was AZN 7,032.4 million. According to the SSC, the real increase in the production of goods and services in the processing industry was 14.0%.

In January-August 2019, AZN 8.6 billion was invested in **fixed capital**, or 5.4% less than in the same period of 2018 (for comparison, investment in January-August 2018 decreased by 12.8% compared to the same period of the previous year). According to the SSC, the decline is mainly due to the decline in investments in the oil and gas sector. In the reporting period, investments in the non-oil and gas sector increased by 5.7%. About AZN 5.5 billion (or 64.3%) was spent on the production of goods, AZN 2.2 billion (26.0%) on services, and AZN 835.3 million (9.7%) on residential construction.

In the reporting period, state investors accounted for 48.0% of total investments, while the private sector accounted for 52.0%.

Domestic sources invested AZN 6.1 billion (70.7%) in fixed capital, while foreign sources invested the remaining AZN 2.5 billion (29.3%) (for comparison, in January-August 2018, foreign sources invested AZN 3.6 billion, or 40.6% of total investments).

In the reporting period, enterprises and organizations accounted for AZN 4.8 billion (55.9%) of capital investment, budget and extra-budgetary funds for AZN 2.5 billion (29.3%), bank loans for AZN 678.1 million (7.9%), and the public's personal finances for AZN 574.5 million (6.6%).

In the reporting period, the mining industry accounted for AZN 3.1 billion (36.2%) of total investment, construction for AZN 1.9 billion (22.1%), transportation and storage for AZN 1.2 billion (14.4%), and the manufacturing industry for AZN 513.8 million (6.0%).

According to the SSC, for the first eight months of 2019 compared to the same period in 2018, the consumer price index was at 102.4%, and the producer price index was at 94.6%. In comparison with the corresponding period last year, the prices for food, beverages and tobacco products increased by 3.3%, non-food products by 1.3%, and paid services by 2.7%.

In January-August 2019, compared to the same period in 2018, nominal incomes increased by 6.4%, and the average monthly nominal wage increased by 8.4%.

In January-August, 2019, the average exchange rate of the national currency against 1 US dollar was AZN 1.70, 1 euro - AZN 1.92, and 100 Russian rubles - AZN 2.61.

2. Monetary policy

The Central Bank's [Statement on the main directions of monetary policy in 2019 and the medium-term](#) states that the main goal of monetary policy currently and in the medium-term is to ensure stable low inflation. In the document, the Central Bank states that it will continue its stable monetary and exchange rate policies, and will support social welfare, economic growth, and employment. The Central Bank announced that it will maintain price stability by keeping inflation at 4% ($\pm 2\%$), the ultimate monetary policy target for 2019.

According to the State Statistics Committee, in [August 2019](#), average annual inflation was at 2.6%. The highest inflation rate this year was recorded in July (2.7%). The Consumer Price Index (CPI) was heavily affected by food products. During the first 8 months of this year, the average annual price increase for food was 3.3% and for services it was 2.7% (Figure 1).

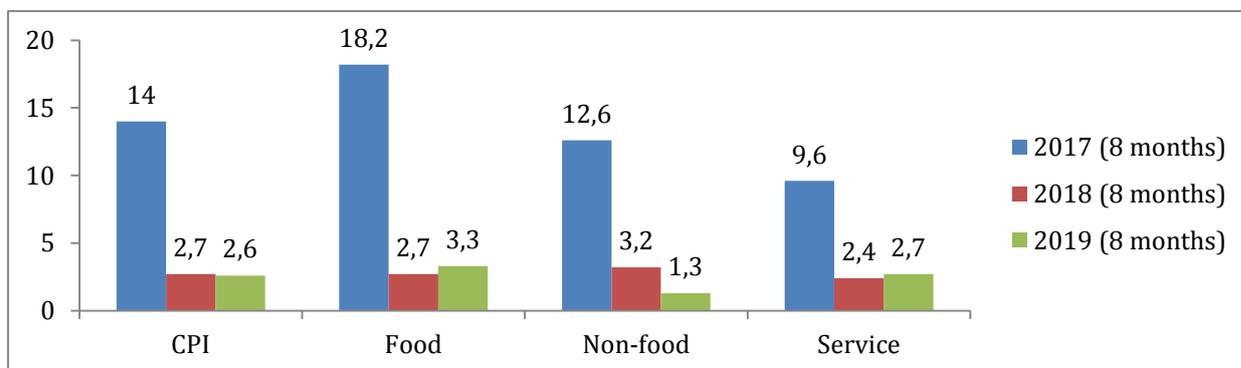


Figure 1. Change in consumer prices for food, non-food products, and services, %
Source: Central Bank

The official inflation rate does not exceed 4% ($\pm 2\%$) as envisaged in the Central Bank's Statement. Commenting on the [recent decision](#) to reduce the refinancing rate in September of this year, the Central Bank stated that actual inflation in Azerbaijan remains within the target range and is expected to do so for the rest of the year.

The inflation rate is low mainly thanks to the stability of the national currency's exchange rate over the reporting period. In the first 8 months of this year, compared to the same period of 2018, the annual inflation rate was 0.1% lower due to the fact that, with the national currency stable, the rise in the prices of non-food products was lower than the rise in the prices of food products and services. Despite the announcement of a floating exchange rate, during the reporting period the average daily exchange rate of the manat against the US dollar remained at AZN 1.7000.

On factor which reduced import inflation was the decline in relation to the manat of the national currencies of some of Azerbaijan's trading partners. During this period, the manat rose by 9.2% against the Turkish lira, by 0.8% against the euro, and by 7.3% against the Georgian lari. At the same time, the national currency fell 5.1% against the Ukrainian hryvnia, 8.9% against the Russian ruble, and 2.7% against the Japanese yen.

However, **the credibility of official data on the inflation rate has been questioned by the public.** There are even independent experts who claim that the actual price increase is higher than the official figures. Since there are no alternative estimates of inflation in Azerbaijan, such claims are based on observations or indirect arguments. For example, one of the arguments made is that *the difference between the official inflation rate and the Central Bank's refinancing rate is very large.* While the current inflation rate is 2.6%, the refinancing rate is 8.0%. During 2019, the discount rate was gradually reduced from 9.25% to 8.0%. However, during this period, the inflation rate rose from 1.7% to 2.7%. The three-fold difference between the inflation rate and the refinancing rate, and the fact that, despite the low inflation rate, refinancing rates have been cautiously lowered (by 0.25% each time), indicate that price stability in Azerbaijan is fragile and inflationary pressure remains. Another argument is related to *the growth of the money supply* in circulation. As of August 31, the volume of money in circulation was AZN 15.95 billion, which



is 24.0% greater than in the same period last year. Currently, the money supply is the largest it's been since 2013. Similar growth was also observed in the monetary base (22.4%). The main driver of the increase was the increase of cash in circulation (23.7%). There is even an impression that the Central Bank, when assessing the real situation on inflation, prefers its alternative estimates to the State Statistics Committee's data.

Due to high oil prices on world markets, **the manat has been under pressure to strengthen in the first 8 months of 2019**. As a result, the Central Bank's foreign exchange reserves increased by \$378.6 million, or 6.7%, to \$6.0 billion in January-August this year. Compared to previous years, **there was a decline in demand for the dollar**. In the first 8 months of this year, total sales at the State Oil Fund's (SOFAZ) foreign exchange auctions, held (twice weekly) by the Central Bank, were \$3,893.9 million, which is 8.3% less than over the same period in 2018 (in that period in 2018, \$4,244.8 million was sold).

According to the Central Bank, in the first 8 months of this year, banks purchased \$1.25 billion of US currency in cash. In the corresponding period last year, this figure was slightly higher - \$1.37 billion. The same is true for dollar sales. During the reporting period, banks sold \$1.59 billion of US currency, which is a drop of \$560.0 million compared to the same period last year.¹

During the reporting period, the Central Bank conducted 35 deposit auctions and 35 auctions for the placement of bills in national currency to regulate the money supply and manage excess liquidity in banks. Through deposit operations, funds were attracted mainly for 14 days (with minor exceptions), and bills were placed for 28 days. By the end of the reporting period, banks' interest income raised through deposit auctions and the placement of bills totaled AZN 66.35 million. In the corresponding period last year, commercial banks' interest income from such operations of the CB totaled AZN 98.9 million.

The policy of reducing the refinancing rate, which began in February 2018, continued in 2019. The Central Bank has gradually lowered the refinancing rate under its policy of relaxing monetary and credit policies. The refinancing rates were lowered in February this year from 9.75% to 9.25%, in March to 9.0%, in April to 8.75%, in June to 8.5%, in July to 8.25%, and in September to 8.0%. During this period, the ceiling of the interest rate corridor was reduced from 11.75% to 9.75%, and the floor was dropped from 7.75% to 6.25%. Despite the decline in the interest rate corridor, the demand for deposit and bill auctions consistently remained several times greater than the supply. In some cases, demand exceeded supply by 6-7 times. The reason for this is the excess liquidity in banks against a background of weakening lending.²



¹ Central Bank. www.cbar.az

² Central Bank www.cbar.az

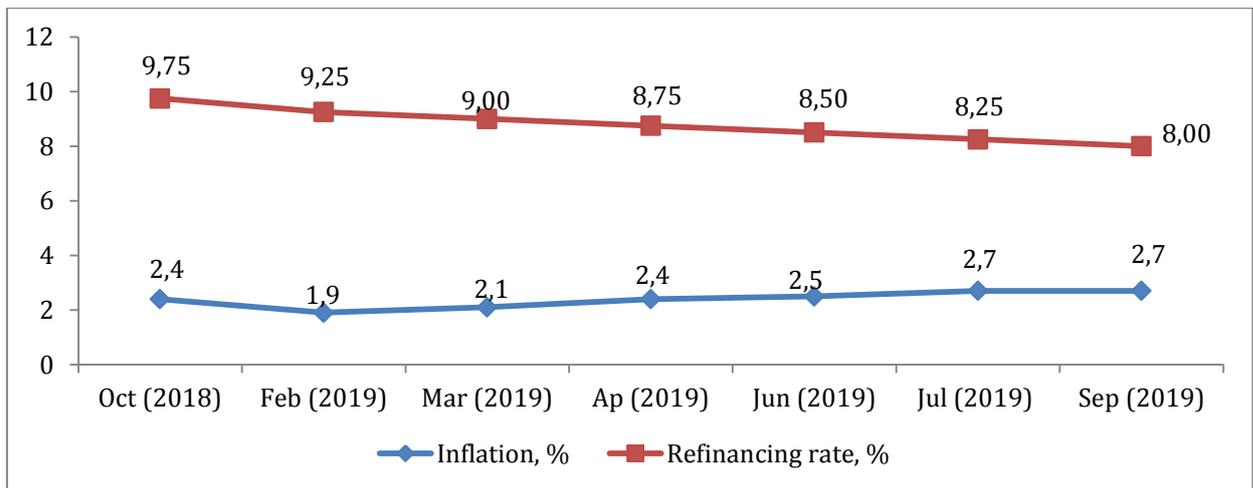


Figure 2. Fluctuations in the consumer price index and the exchange rate, %
Source: Central Bank

The Central Bank maintained its reserve requirements unchanged during the reporting period. The reserve requirement was last modified on March 3, 2016. According to that change, the reserve requirement is set at 1.0% for foreign currency liabilities, 0.5% for liabilities in manats and precious metals, and 0% for non-resident financial sector liabilities and settlements with international financial institutions. During the first 8 months of this year, **the required reserves decreased from AZN 163 million to AZN 157.8 million.**

Despite the encouragement of cashless transactions, there has been an increase in the amount of cash. During the reporting period, cash in circulation increased by 11.1%, reaching AZN 9.3 billion, the highest it has been since 2014. Since the beginning of the year, the overall money supply in manats (M2) increased by 8.9% and reached AZN 15.95 billion by the end of the reporting period. In the structure of the money supply in manats (M2), the growth rate of cash in banks and outside of banks differed. During the reporting period, cash outside of banks rose by 12.4%, while cash in banks rose by 5.2%.

The Central Bank regulated the growth of the money supply through deposit auctions and bill emissions. During the reporting period, the volume of the money supply temporarily withdrawn from circulation through deposit auctions and bill emissions varied between AZN 1-1.3 billion.

The nominal and real effective exchange rates of the manat are gradually approaching the levels they were at following devaluation. The total nominal effective exchange rate of the national currency increased to 73.6 by the end of August 2019, which is the highest it has been since 2015. The effective rate for the non-oil sector rose to 110. As for the real effective rate, there has been a tendency to decline in recent months, though the rate is still high. The overall real effective exchange rate fell from 99.6 to 98.9 during the first 8 months of this year, and the real effective exchange rate in the non-oil sector fell from 95.4 to 93.8. The decline in the real effective exchange rate has led to an increase in the purchasing power of local goods.

The stability of the national currency has led to a decrease in the dollarization of the banking sector. There was a move away from dollarization in lending and deposits. In the first 8 months of 2019, the share of loans in foreign currency decreased from 38.0% to 34.3%, and the share of deposits in foreign currency decreased from 65.3% to 63.0%. The share of foreign currency in the savings of the public decreased from 62.5% to 56.0%.

For the first time in Azerbaijan, the decision was made to establish an autonomous regime for currency transactions. According to an amendment, dated March 15, 2019, to the "Rules on conducting foreign currency operations for residents of the Republic of Azerbaijan, as well as operations in national and foreign currency for non-residents," currency transactions in the free economic zone in Alat are not subject to this decree, and are regulated by a different law - "On the Alat free economic zone."

3. Main Trends in the Foreign Sector³

The first half of 2019 was favorable for the foreign sector, and the fact that there was no sharp drop in oil prices in world markets was crucial. According to the Central Bank's monetary policy review for the first half of 2019, the average price for Brent oil in January-June was \$ 66.2.⁴ True, this is a relatively low figure compared to the same period last year (the average price for the first 6 months of 2018 was \$ 71).⁵ However, under current conditions, expert estimates based on the real demand for foreign currency in the economy, and especially on international transactions, show that a crude oil price above \$55 is sufficient to provide the country with a surplus in its balance of payments and trade.

3.1. Balance of Payments Analysis⁶: Key Trends. In the first half of 2019, the volume of capital inflow into Azerbaijan as part of current operations totaled \$12.85 billion, and the amount of foreign currency flowing out of the country totaled \$9.79 billion. In current operations there was a surplus of \$3.06 billion.

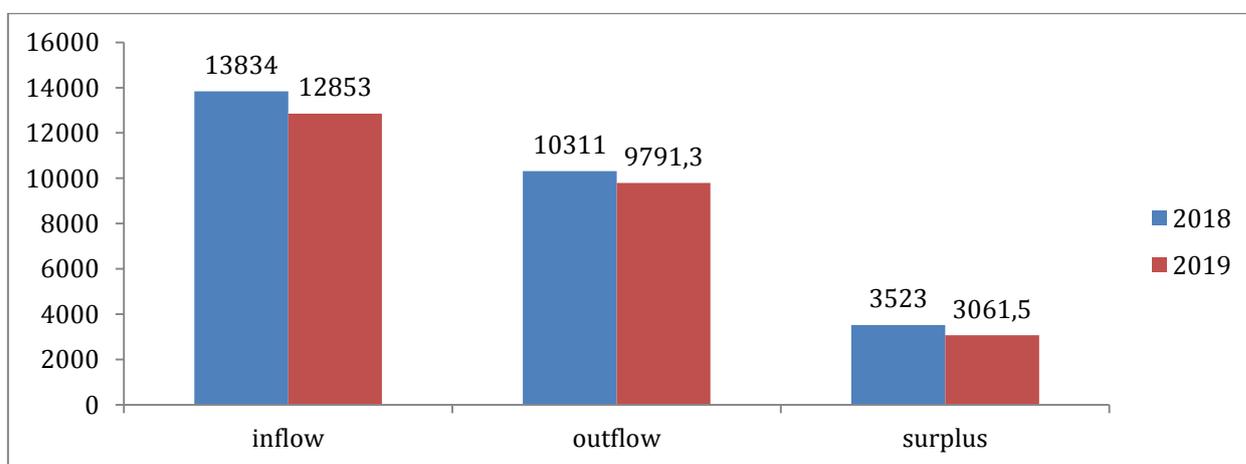


Figure 3. Current account flows (in millions of dollars), data for the first half of 2018-2019 (Source: Central Bank)

Compared to the same period in 2018, the volume of inflow into Azerbaijan in the current account fell by about \$1 billion (7.2%), while outflow dropped by \$520 million (5.3%). The

³ The latest official data on the balance of payments is for the first 6 months of the year.

⁴ <https://uploads.cbar.az/assets/d660fdbcba75adbfc5a8569b0.pdf>

⁵ <https://uploads.cbar.az/assets/44dc4ec7a9f5e4499e918f9aa.pdf>

⁶ All information on the balance of payments was taken from the Central Bank's database:

<https://www.cbar.az/page-43/external-sector-statistics>

current account surplus decreased by \$461 million (13.1%) compared to the first 6 months of last year as a result of the greater decrease in inflow compared to outflow.

As a noteworthy negative trend, it should be noted that the current account's non-oil deficit has expanded by approximately \$330 million (12%) to \$3.086 billion.

In January-June of 2019, as part of current operations, the oil and gas sector accounted for an inflow of \$9.156 billion, or 71.2%, while the non-oil sector accounted for \$3.697 billion (28.2%).

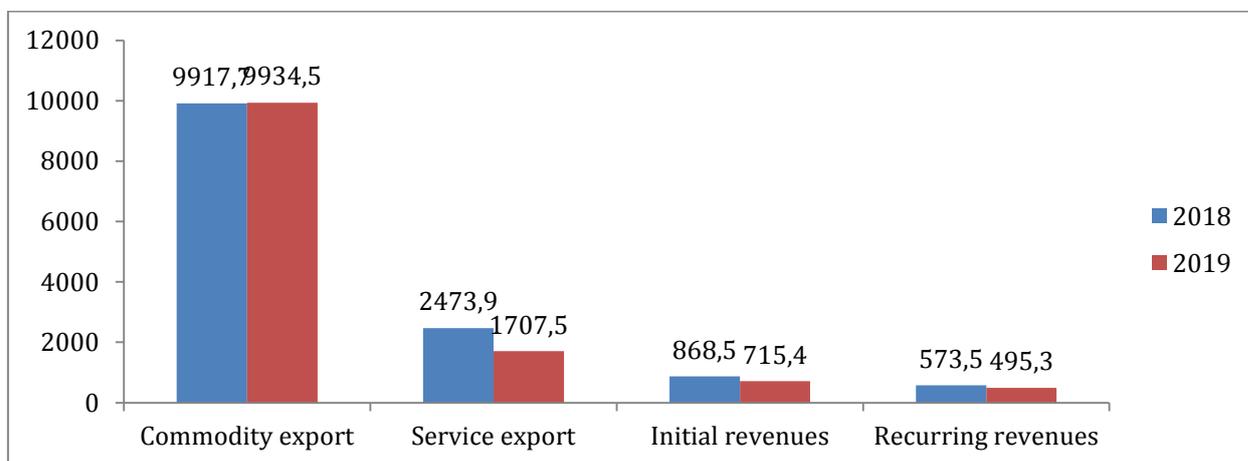


Figure 4: Structure of capital inflow into Azerbaijan in the current account, in millions of dollars

(Source: Central Bank)

In the first 6 months of this year, in current accounts, 77.3% of revenues were generated by commodity exports, 13.3% by service exports, and 9.5% by initial and recurring revenues. In the same period of 2018, commodity exports accounted for 71.7% and service exports for 17.9%. While the amount of commodity exports in absolute terms remains almost the same (an increase of 0.2%), service exports fell by \$766.4 million (31%), income from initial revenues by \$153.1 million (17.6%), and income in the current account from recurring revenues by \$78.2 million (13.6%).

The sharp decline in revenues in the balance of services is due to the tourism sector. The export of tourism services in January-June of 2019 amounted to \$777 million, or only half of what it was last year, a decrease of \$697 million dollars. Meanwhile, revenues from the export of transportation services fell by \$38 (6.8%). In total, in the first 6 months of this year, there was a deficit in the balance of services amounting to \$1.244 billion. This is an increase of \$300 million (31.5%) compared to the previous year.

In initial revenues, foreign payments decreased by about \$200 million to \$1.566 billion. Of these payments, \$952.2 million comes from the repatriation of revenues from international oil and gas companies. In addition, during the period under review, in the securities portfolio, \$177.3 million was paid to non-residents, while \$244.5 million went to foreign loans. In addition, the income earned by non-residents working in Azerbaijan and taking their earnings out of the country is also included in the amount of these payments.

Foreign revenues in the form of Azerbaijan's primary revenues are mainly derived from interest from the management of foreign currency reserves, profits from foreign direct investment, interest from foreign deposits of the local financial and business sectors, etc.



Recurring revenues on the balance sheet are 2.2 times higher than foreign payments, totaling \$495.3 million. About 90% of the inflow is due to remittances sent by citizens living abroad to their families, while 7.4% comes from humanitarian and other forms of assistance. In the first half of 2019, although the inflow of recurring revenues decreased to \$80 million, the outflow rose to about \$17 million.

In the first 6 months of 2019, there was a surplus of \$59.2 million in the financial account. However, during the same period last year, a deficit of \$1.789 billion was created in the financial account. Last year's large deficit in the financial account was replaced with a surplus primarily thanks to a positive balance of \$867 million in the "other investments" section. In the first six months of last year, however, there was a deficit of \$626 million. In addition, the deficit in portfolio investments decreased by approximately \$400 million, from \$733 million to \$338.7 million.

A favorable foreign economic situation ensured a large positive balance in the overall balance of payments. In the first half of 2019, the surplus in the balance of payments was \$3.635 billion. This is approximately \$1.2 billion greater than in the same period last year.

3.2. Trade Balance Structure: Key Changes. In January-August 2019,⁷ compared with the same period last year, foreign trade turnover increased by 3.158 billion (16%), reaching \$22.9 billion.

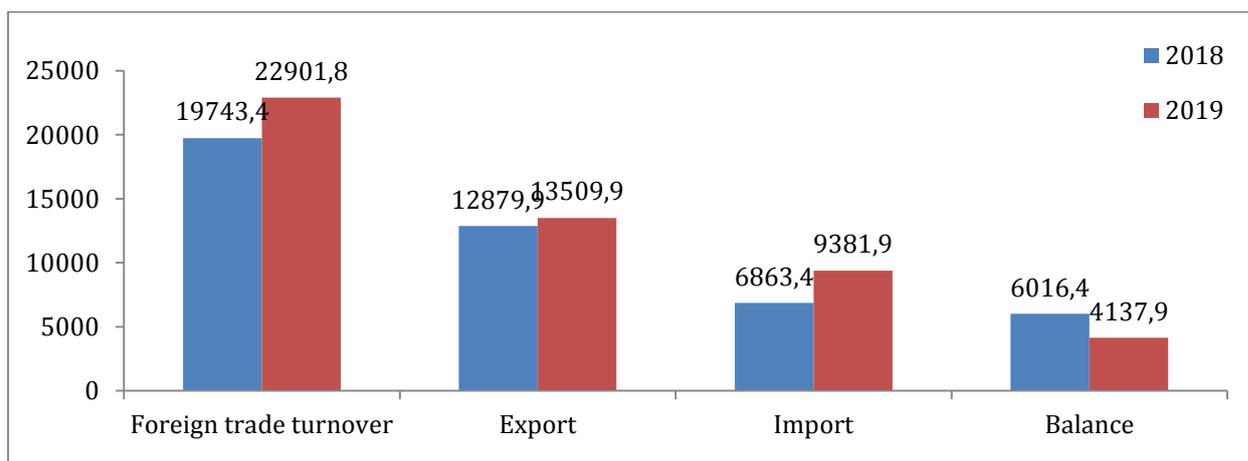


Figure 5. Foreign trade in January-August 2018 and January-August 2019, millions of dollars

(Source: The State Customs Committee of the Republic of Azerbaijan)

A large-scale expansion of imports played a decisive role in the growth of foreign trade turnover. The expansion of imports accounted for 80% of the total increase in turnover, while exports accounted for 20%. During the period under review, exports increased by 4.9%, or \$630 million, to \$13.5 billion, while imports increased by \$2.5 billion, or 37%, to \$9.38 billion. If import operations accounted for 35% of total foreign trade turnover during the first 8 months of 2018, this figure rose to 41% in the same period of the current year. As a result of the faster growth of imports, the positive balance in foreign trade decreased by 32%, or \$1.879 billion, to \$4.138 billion.

⁷ https://customs.gov.az/modules/pdf/pdfolder/84/FILE_94D804-50BC0F-E1409A-8D89FA-A10549-4D8860.pdf

Although there has been a significant increase in the share of the non-oil sector in exports, in absolute terms, exports of non-oil and gas sector products are still small.

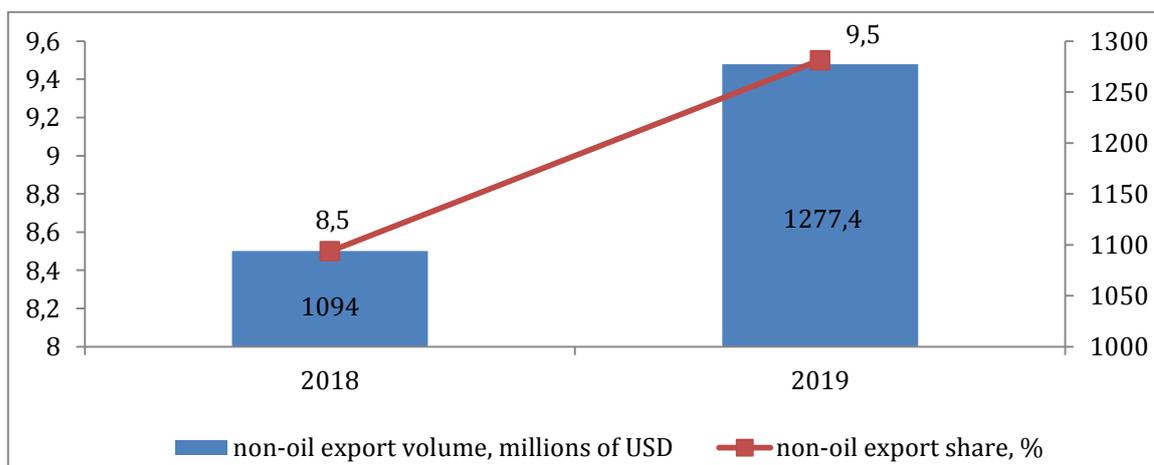


Figure 6. Non-oil exports share (%) and volume (millions of USD), 2018-2019 (January-August)

According to statistical data, the share of non-oil exports increased from 8.5% to 9.5%, and the absolute value increased by \$184 million (16.8%) to \$1.277 billion. When looking at the structure of non-oil exports by commodity groups, of primary importance are food products, metallurgical products, plastic products, chemical products, and raw cotton. In the first 8 months of 2019, food products accounted for 33% (\$418.5 million) of overall non-oil exports, plastic products for 10.7% (\$136.8 million), metallurgical products for 9.6% (\$122.6 million), raw cotton for 8.3% (\$106.4 million), and chemical products for 5.3% (\$68.5 million).

During the period under review, 5 countries (Russia, Turkey, Switzerland, Georgia, and Italy) accounted for \$961.4 million, or 75.3%, of non-oil exports.⁸ In the same period of 2018, this figure was \$820 million, or 74.9%. There was also a high concentration of exports in terms of exporter entities. In the first 8 months of the current year, the 20 largest exporter entities accounted for 56.5% of non-oil exports, or \$722 million. In the same period of 2018, these figures were 40%, or \$437 million.

The main factor in the sharp increase in imports (37%) in the first 8 months of 2019 was the expansion of public sector imports.

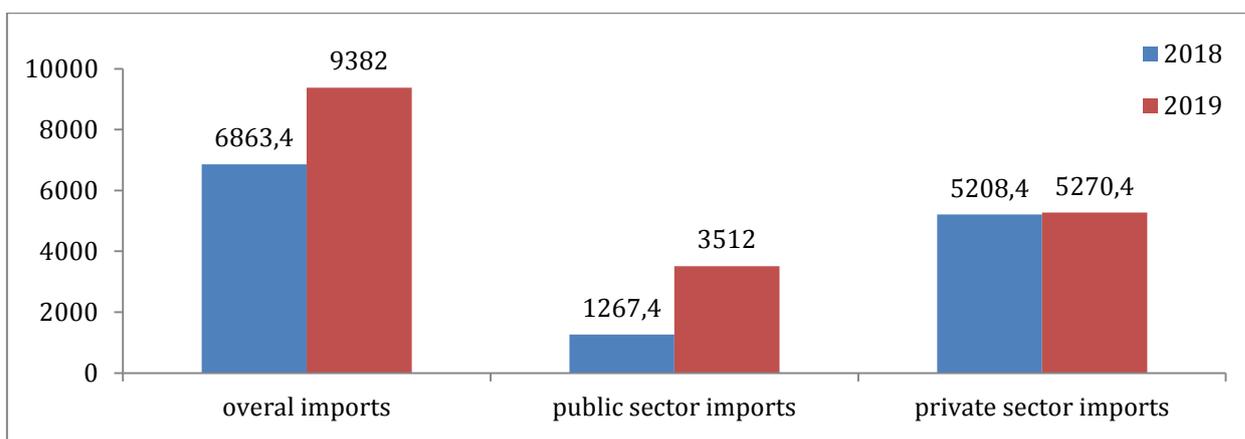


Figure 7. Imports by sector, millions of USD

The public sector accounted for 89% of the total increase in imports, while the private sector accounted for 11%. In the first 8 months of 2019, compared to the same period last year, public sector imports increased by \$2.245 billion (almost tripling) to \$3.512 billion, while private sector imports increased by \$62 million (1.2%) to \$5.270 billion. During the period under review, the share of public sector imports in total imports increased from 18.5% to 37.5%.

In the structure of imports, most significant are machinery and equipment (\$1.710 billion or 18.2%), food products (\$997 million or 10.6%), vehicles (\$749.1 million or 8%), and ferrous metal products (\$ 646 million or 6.9%).

4. State Budget Execution Status⁹

In January-August 2019, state revenues increased by AZN 819 million, or 5.8%, to AZN 14.9 billion. The main source of the rise in revenues was the increase in payments from the State Customs Committee (SCC). In the first 8 months of the current year, compared with the same period last year, the customs authorities' budget contributions increased by AZN 602.4 million to AZN 2.874 billion.

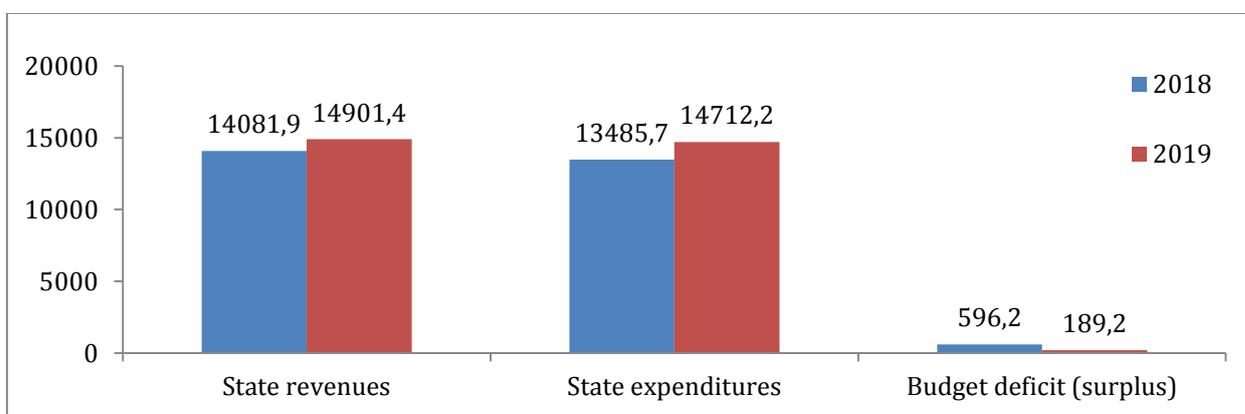


Figure 8. State revenues and expenditures, deficit (surplus) for the first 8 months of 2018 and 2019, millions of AZN

⁹ Data on the execution of the state budget for the first 8 months of the year was taken from the SSC's monthly statistical bulletins: <https://www.stat.gov.az/news/macroeconomy.php?page=1>

The SCC's budget obligations account for 19.3% of state revenues. The main trend in state revenue policy is the expansion of the tax base of foreign economic relations, mainly import operations. Prior to the economic crisis of 2015, the share of customs payments in the budget did not exceed 7-8%. Over the past 4 years, that share has continued to rise and is now approaching 20%. The major part of customs payments - 68.5% (AZN 1.966 billion) came from VAT. In total, in the first 8 months of this year, VAT accounted for 22%, or AZN 3.290 billion, of state revenues. Approximately 60% of VAT payments to the state budget came through the SCC, and 40% (AZN 1.324 billion) through the Ministry of Taxes.

During the period under review, there was a decrease in the share of non-tax revenues in the budget. In January-August of this year, the share of VAT in total revenues was 48.1%. In the same period last year, however, it was 51.8%.

The impact of the 2019 amendments to the Tax Code¹⁰ can be seen in the budget structure of payments. The amount of simplified tax revenues decreased by 20.4%, or AZN 61 million, to AZN 239 million, as a result of limiting the scope of the simplified tax and business structures' losing the right to operate under that tax regime. Instead, the number of entities operating under the income tax regime increased, and as a result, income tax revenues increased by almost 10% (AZN 157 million) to AZN 1.771 billion. The exemption from income tax of up to AZN 8,000 in the non-oil and private sectors has contributed to a 10% (AZN 65 million) reduction in tax revenues.

Finally, in the first 8 months of the year, a noteworthy trend in public budget revenues is that the increase in turnover tax revenues played a crucial role in budget expansion. During the period under review, VAT and excise taxes, the primary turnover taxes, accounted for AZN 656 million, or 80%, of the budget revenue increase of AZN 819 million. This trend also indicates that the tax burden on consumers has become heavier. In the same period, however, the increase in revenues from income tax totaled AZN 92 million, or about 11% of the total increase.

During the first 8 months of this year, compared to the same period last year, state expenditures increased by AZN 1.227 billion, or 9.1%. The main reason for the increase in spending is the expansion of social spending. According to the decisions taken in February 2019, starting from April 1, the minimum wage, tariff wages in state organizations, and pensions increased by 40%. According to statistical reports, education expenditures increased by 14% (AZN 111 million), healthcare expenditures by 22% (AZN 100 million), and social security expenditures by 17% (AZN 275 million). In recent years, especially after the devaluation of the manat in 2015, the strengthening of the socio-economic crisis and, as a consequence, the increased social and political activity among the public, has been accompanied by a more sensitive approach to spending from the government. Undoubtedly, the impact of the public's political activism has played an important role in the short-term increases in social spending. In the reporting period, 27% of budget expenditures were social spending. The same indicator for the previous year was 25.5%.

In addition to social expenditures, there has also been a significant increase in the state's investment expenditures, amounting to AZN 516 million or 17.4%. The share of investment expenditures was 23.6%.

The key trends in state spending over the first 8 months of 2019 were that social and investment expenditures remained a top priority while maintaining their specific shares in overall expenditures, and that, in absolute terms, the growth rate in expenditures for both blocks significantly exceeded the growth rate of overall expenditures in the budget (10%).

In the first 8 months of 2019, the state budget had a surplus of AZN 189.2 million, a decrease of AZN 407 million, or 3.2 times, compared to the same period last year. Such a sharp decrease in the surplus is due to the fact that the growth rate of expenditures is almost double the growth rate of revenues. While budget revenues increased by 5.8% during the period, the increase in expenditures was 9.1%.

5. Banking sector

The banking sector has tended toward concentration since 2018, a trend which continued in 2019. In 2018, the market share of five banks in the banking sector was 65.6%, and in the first half of 2019 the level of concentration rose to 66.5%. Concentration was mainly stimulated by the growth of the assets of the International Bank. The market share of the largest bank in the country increased from 26.9% to 28.3%. As the assets of the second (Pashabank) and third (Capital Bank) largest banks decreased during this period, their share fell from 15.9% to 14.8% and from 12.6% to 12.2%, respectively. The other two of the top 5 banks - Xalq Bank and Bank Respublika have strengthened their positions (Table 2).

Table 2

Fluctuations of assets of the 10 largest banks in Azerbaijan (millions of AZN)

Banks	Assets		Change
	2018	2019 (6 month) (+ increase, - decrease)	
1. International Bank of Azerbaijan	7932,8	8487,7	554,96
2. Pasha Bank	4695,7	4430,4	-265,36
3. Kapital Bank	3716,5	3663,2	-53,27
4. Xalq Bank	2008,2	2135,3	127,09
5. Bank Respublika	983,1	1215,8	232,71
6. AccessBank	878,7	916,2	37,47
7. Azerbaijan Sanaya Banki (ASB)	822,3	811,6	-10,66
8. Rabitabank	772,1	799,5	27,38
9. Unibank	693,9	648,8	-45,12
10. Premium Bank	646,3	611,4	-34,88
Country total:	29465,0	29979,6	

Source: Azerbaijan Banks Association – www.aba.az

The results of our assessment based on the [Herfindahl-Hirschman Index](#) for measuring concentration indicate that the banking sector's concentration level in the first six months of this year was 1300, which is considered the **average level of concentration**.

The relative stability observed in the banking sector continued this year as well. Although the number of banks has not changed, their branches and staff have expanded. While at the end of August 2018, the number of bank branches was 551, by the end of the year their number had

fallen to 508. In January-August 2019, the number of bank branches increased by 6 and reached 514. As the number of branches increased, the number of bank offices declined. As for the number of employees there were 16,900 people employed in the banking sector in the first eight months of 2018, but by the end of the year their number increased to 17,400, and by the end of September this year to 18,700. As of the end of August 2018, the number of employees per bank was 564, compared to 624 during the same period this year (Table 3).

Table 3

Banks currently operating

Banks	First 8 months of 2018	2018	First 8 months of 2019	Difference (+ increase, - decrease)	
				Compared to the first 8 months of 2018	Compared to 2018
Total number of banks	30	30	30	0	0
- Number of foreign capital banks	15	15	15	0	0
<i>foreign capital accounts for 50%-100% of authorized capital</i>	8	8	8	0	0
<i>foreign capital accounts for less than 50% of authorized capital</i>	7	7	7	- 1	0
<i>local branches of foreign banks</i>	2	2	2	0	0
Number of local bank branches	551	508	514	- 37	+6
Number of bank offices	143	130	129	-14	-1
Number of ATMs	2468	2502	2588	+120	+86
Number of employees	16928	17415	18711	+1783	+ 1296

Source: Financial Market Supervisory Authority

The recent growth in banks' assets continued in 2019. An analysis of the Financial Market Supervisory Authority's statistics shows that during the first 8 months of this year, banks' assets increased by 2.3% from AZN 29.5 billion to AZN 30.3 billion. Compared to the same period in 2018, the growth was 7.6%.

The main driver of asset growth was securities investment (+19.8%), credit investments (+13.7%), cash (+13.5%) and nostro accounts (+41.4%). Deposits at financial institutions decreased by 19.5% (**Figure 9**).

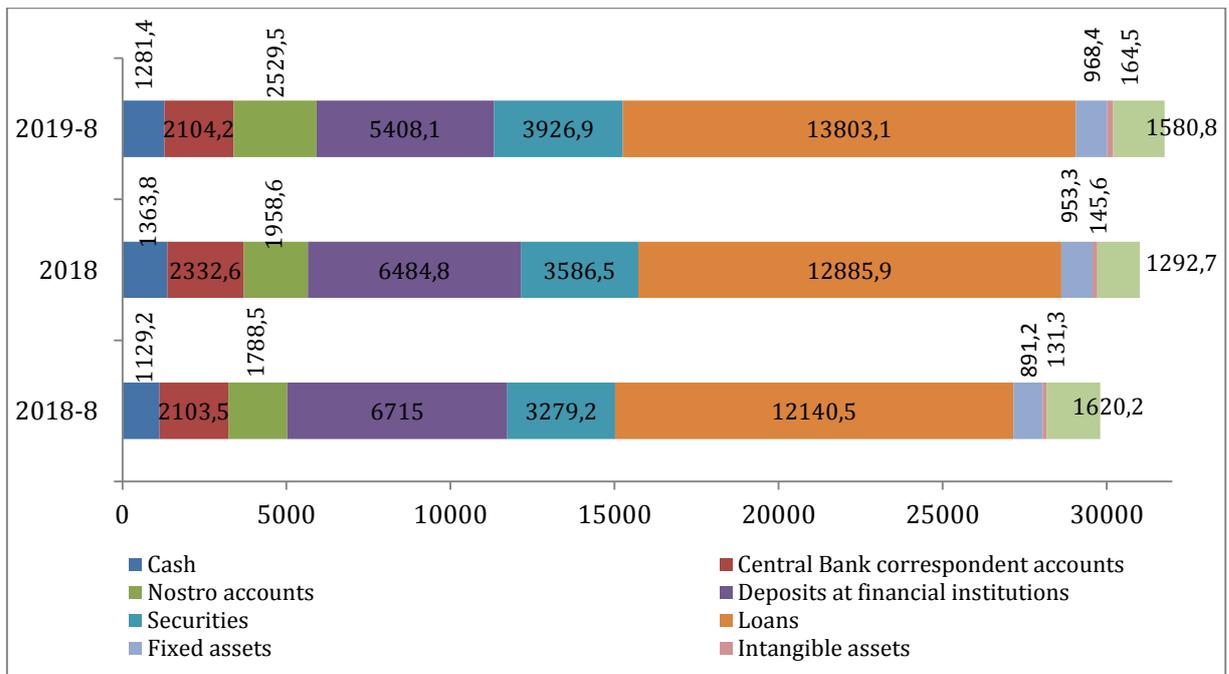


Figure 9. Structure of banks' assets, millions of AZN

Source: Financial Market Supervisory Authority

After a long break, banks have shown an increased interest in lending. In comparison with 2018, the volume of loans increased from AZN 12.9 billion to AZN 13.8 billion. As a result of the increase, the share of credit investments in assets increased from 43.7% to 45.6%. This means that of every AZN 100 at the disposal of the banks, AZN 45.6 went to lending. However, before devaluation in 2015, this figure was AZN 70 (Figure 10).

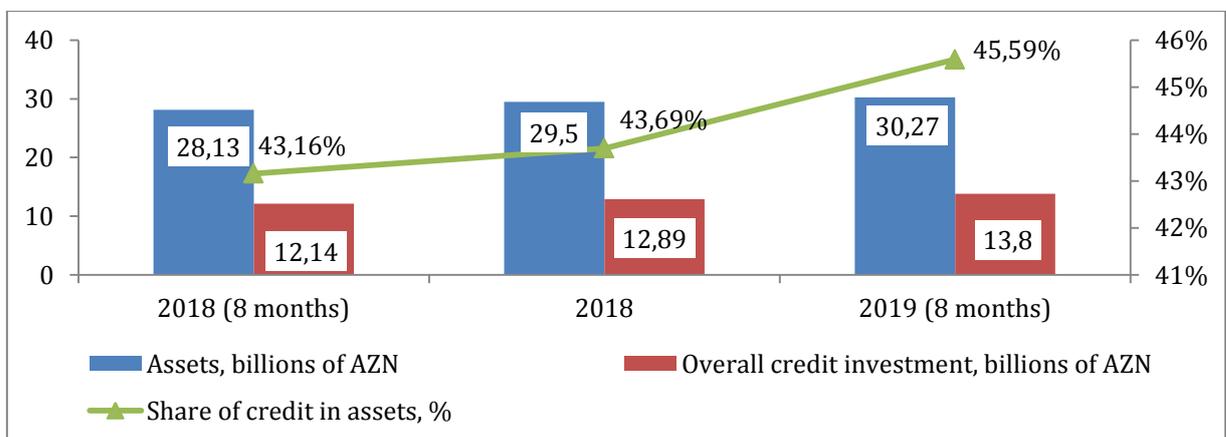


Chart 10. Banking sector assets, billions of AZN

Source: Financial Market Supervisory Authority

The high risk in the real sector has pushed banks to seek alternative sources of income. One such source is investing in securities. Securities remain attractive to banks. *The main reason for the sharp increase in banks' investment in securities is the low risk from this sector.* In January-August 2019, bank investments in securities increased by 9.5% and reached AZN 3.9 billion. At the same time, the share of bank-directed securities in assets increased from 12.2% to 13.0%.

An analysis of banks' liabilities shows that **banks' dependency on deposit resources continued to increase**. In 2019, despite the apparent liquidity in the banking sector, deposits increased by 1% and reached AZN 25.7 billion. In 2017, deposits accounted for 76% of total liabilities, reaching 77.5% in 2018, and 78.8% in the first 8 months of 2019. The reason for the increase in the share of deposits is the banks' gradual withdrawal from foreign liabilities and limited access to loans from banks and other financial institutions (Figure 11).

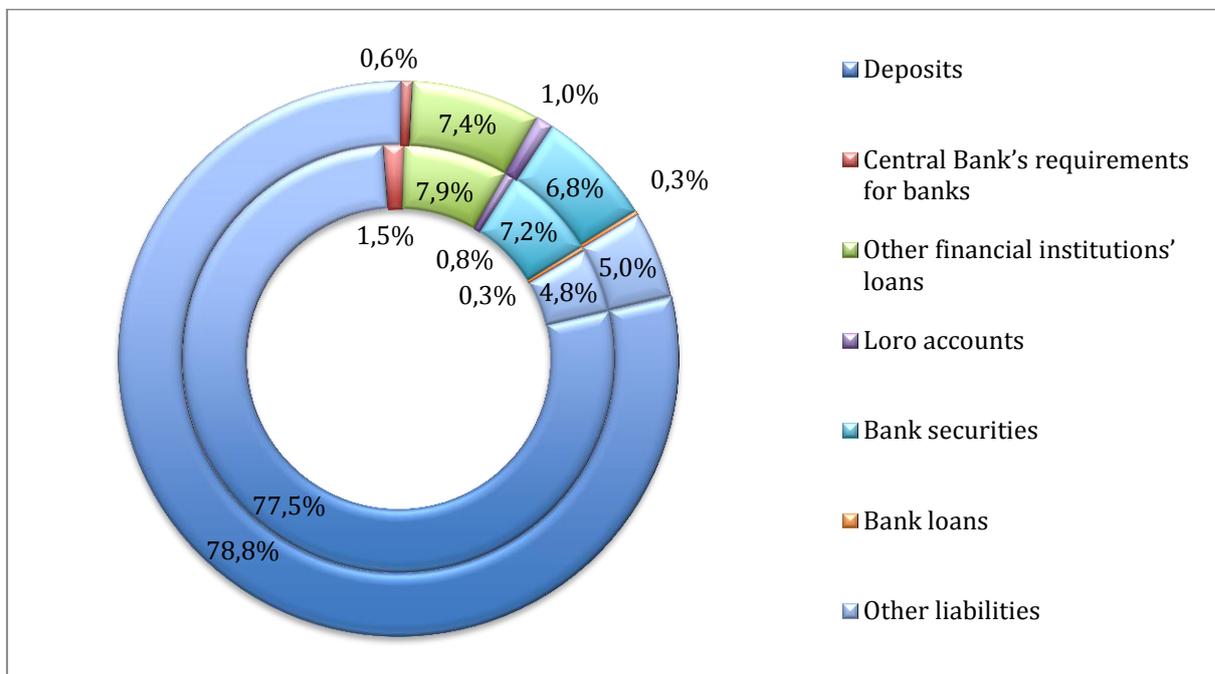


Chart 11. Structure of banks' liabilities, %

Source: Financial Market Supervisory Authority

Loans from banks and other financial institutions were the second major source of finances for banks. The share of these sources fell from 8.1% to 7.7% during the first 8 months of 2019. The reason for the decline was the decrease in loans given by banks. During this period, the share of *securities issued by banks* in banks' liabilities fell from 7.7% to 7.3%.

Banks that actively issue securities a few years ago to attract resources are increasingly leaving the securities market. In 2017, the amount raised by issuing securities increased fivefold to AZN 1.9 billion, but in subsequent years it began to decline, and in 2018, the proceeds from this source decreased to AZN 1.83 billion, further falling in the first 9 months of this year to AZN 1.75 billion. The share of bank securities in liabilities this year decreased from 7.2% to 6.8%.

5.1. Credit market. The main locomotive for lending is private banks with both state and local capital. The volume of co-financing by the International Bank of Azerbaijan and Azer-Turk Bank increased by 5.8% in January-August of the current year from AZN 2,098.4 million to AZN 2,220 million. During this period, private lending increased by 7.4%, from AZN 10,529.8 million to AZN 11,306.4 million. Despite the growth of private banks' lending, lending at banks with entirely foreign capital has declined. Although credit investment from banks with foreign capital increased by AZN 89.3 million, banks with 100% foreign capital decreased by AZN 21.9 million.

After the devaluation, the tendency of non-bank financial institutions (NBFI) to finance the economy has declined. In 2019, the volume of NBFI loans decreased from AZN 392 million to AZN 339.1 million. This is the lowest it has been since 2012.

Consumer lending reaches pre-devaluation levels. [An analysis of the credit investment sectors](#) shows that during the first 8 months of this year, there was a decline in every sector except for industry and manufacturing (+22%), agriculture and processing (+7%), and consumption (+14.5%). In the reporting year, there was a 3.4% decrease in lending in the trade and service sector, 7.4% in the transportation and communications sector, and 3.9% in the construction and real estate sector (*Figure 12*).

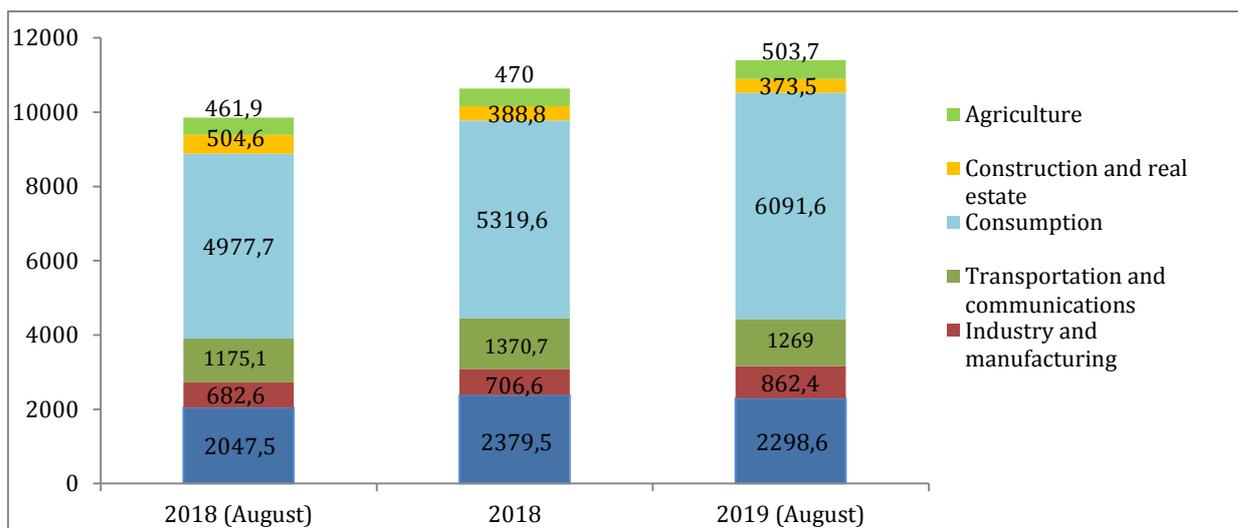


Figure 12. Credit investments by sector, millions of AZN

Source: Central Bank

Increases in the volume and share of consumer loans continued this year. Compared to last year, the share of consumer loans among total loans increased from 40.9% to 43.9%. The volume of loans to households increased during this period, reaching AZN 6.1 billion, the highest it has been since 2015. During this period, the share of trade and services fell from 18.3% to 16.6%, the construction and real estate sector from 3% to 2.7%, and the share of transportation and communications from 10.5% to 9.2%. Only the share of industry and manufacturing increased from 5.4% to 6.2%. Despite the recent increase in the government's efforts to develop the agricultural sector, there has been no significant increase in bank financing in this sector. In the current year, the financing of the agricultural sector has increased by 7%, but its share remained stable at 3.6%.

Lending increased due to national currency lending. [The currency structure of loans](#) shows that in contrast to foreign currency, there has been an increase in lending in the national currency. Loans in the national currency increased by 12.8% over the first 8 months of 2019, amounting to AZN 9,107.3 million. This is the highest lending has been since the devaluation. Loans in foreign currency decreased by 3.8% to AZN 4,758.2 million during this period. Loans in national currency increased mainly due to long-term loans.

The share of the regions in lending has increased. During the first 8 months of 2019, there was an increase in the volume and share of loans to the regions. Lending increased by 19.5% in the regions, while the growth rate was 1.7% in the capital and 5.4% in the Absheron region. As a

result of this increase, the share of regions in total lending increased from 14% to 16.1%. Baku accounted for 80.1% of total loans.

There has been a decrease in problem loans. As a result of the steps taken in relation to the [presidential order](#) addressing the problem loans of physical people, in 2019 the share of overdue loans declined from 12.2% to 10.8%. The volume of problems loans decreased by 6.3% over the first 8 months of this year from AZN 1.59 billion to AZN 1.49 billion. At present, the share of problem loans in the national currency (8.3%) is less than the share of problem loans in foreign currency (15.5%) (*Figure 13*).

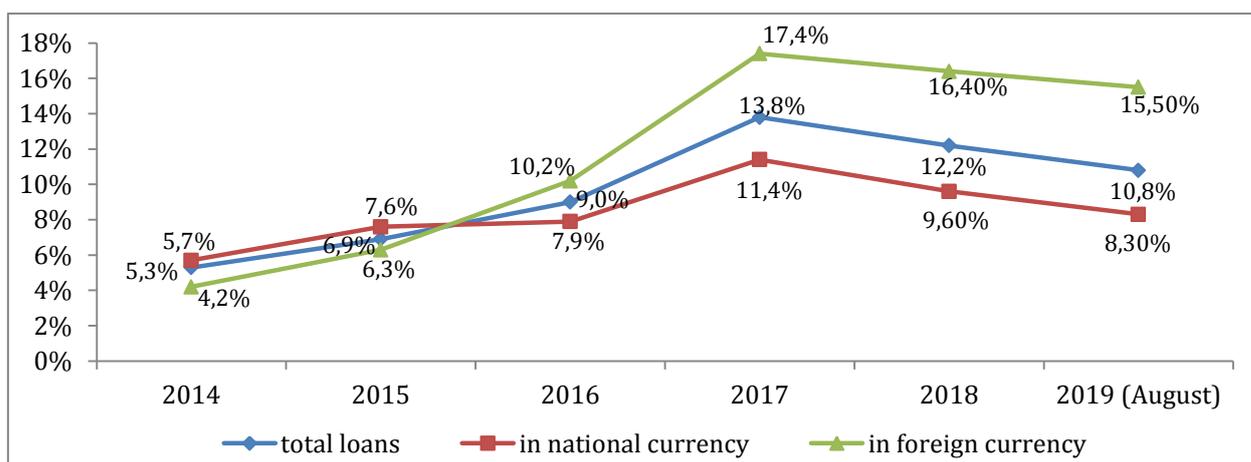


Figure 13. The share of overdue loans.

Source: Central Bank

Although the aforementioned presidential has helped in the resolution of overdue loans, the problem remains. Banks are forced to increase their allocations to targeted reserves as the number overdue loans increases or the amount of time by which they are overdue grows. It is no accident that the volume of targeted reserves for loan repayment losses increased by AZN 5 million over the first 8 months of 2019 to AZN 1.484 billion. At present, the bulk of problem loans are in business loans. Although the presidential order helped the public, it did not fully solve the banks' problems.

5.2. Deposit market. The growth in the deposit market since 2017 has continued this year as well. Excessive liquidity in the banking sector has not prevented growth in the deposit market. Over the first eight months of this year, the total deposit volume in the country increased by 2.6% to AZN 22.5 billion. Growth occurred both in the public's savings and in the deposits of financial and non-financial organizations. In 2016-2018, there was a 72% decrease in the deposits of financial institutions, but in the first 8 months of 2019, there was a 7.1% increase (*figure 14*).

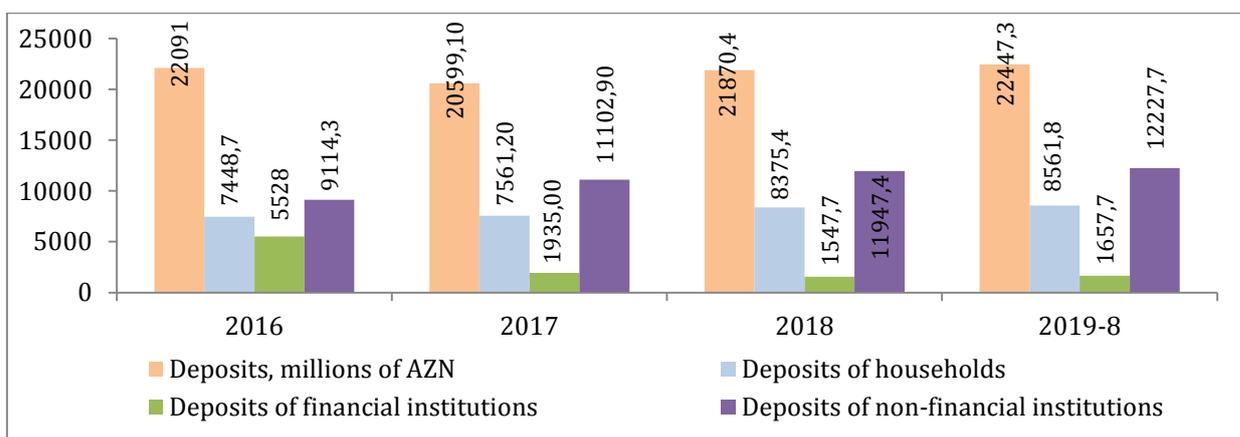


Figure 14. Volume of deposits in 2016-2019.

Source: Central Bank

The currency structure of deposits shows that **the stability of the national currency contributed to the growth of deposits in manats**. Deposits in the national currency increased by 9.7% in 2019, while foreign currency deposits fell 1.1%. The public's savings in the national currency increased by 19.8%, the deposits of financial institutions by 27.8%, and the deposits of non-financial institutions decreased by 0.1%. The public's savings in foreign currency decreased by 8.4% and the deposits of financial institutions by 0.6%, but the deposits of non-financial institutions increased by 3.6%. (*figure 14*).

The Law on Full Deposit Insurance was amended on February 19, 2019, and the mechanism of full deposit insurance was extended for one more year. According to the law, the public's deposits are fully insured at the annual interest rate, regardless of the currency. [The Board of Trustees of the Azerbaijan Deposit Insurance Fund](#), in consultation with the Financial Market Supervisory Authority and the Central Bank, has lowered the maximum interest rate on deposits in the national currency from 15% to 10%, and for foreign currency from 3% to 2.5%, starting from July 1, 2019.

If the term of the law does not extend, the amount of compensation for fully insured deposits will be regulated by the Deposit Insurance Law, in effect since December 29, 2006. According to Article 26.1 of that Law, insured deposits are compensated by the Deposit Insurance Fund in the amount of 100% of the deposit, but not more than AZN 30,000.

Deposits have increased in the regions. Although deposits are concentrated in Baku, deposits in the regions increased significantly in 2019. Over the first 8 months of the current year, the growth rate of savings deposits in Baku (2.2%) was lower than the growth rate in the regions (15.3%), leading to a decrease in the capital's share of deposits (from 92% to 91%). The highest growth in the regions occurred in the economic regions of Mountainous Shirvan (43.8%), Lankaran (39.2%), Shaki-Zagatala (31.6%), and Aran (26.2%). In the Ganja-Gazakh economic region alone, there was a 5.6% decline (*diagram 15*).

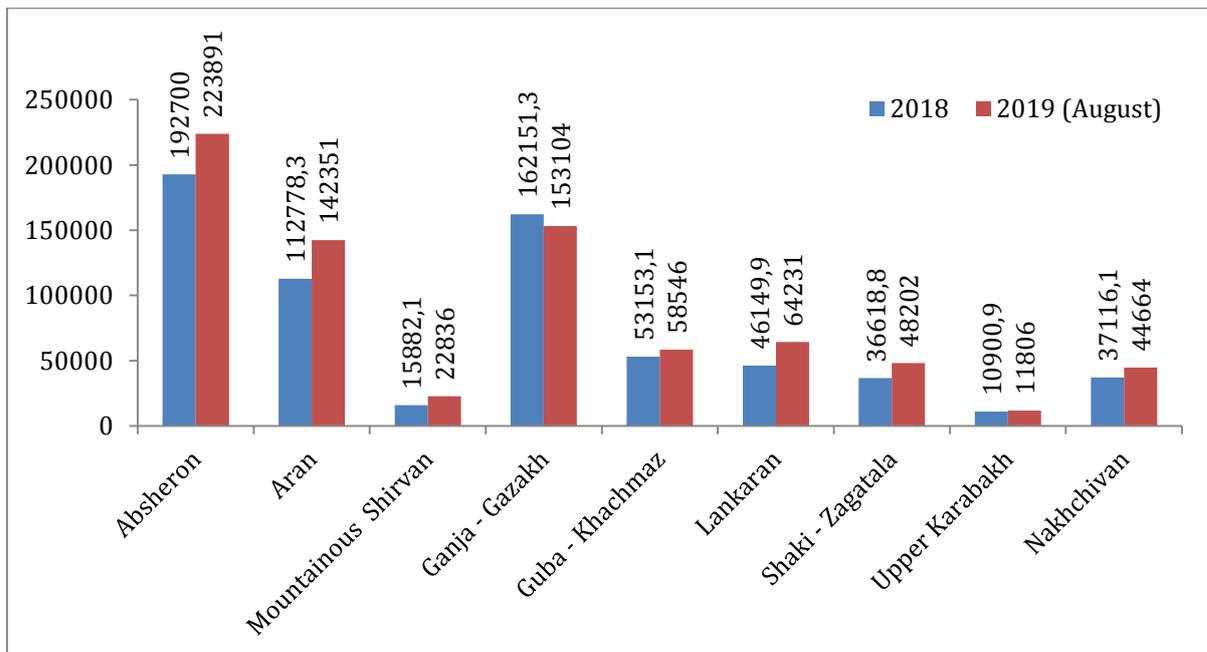


Figure 15. Deposits by region, millions of AZN.

Source: Central Bank

5.3. Dollarization in the banking sector. The dollarization of the banking sector continued to decrease in 2019. Dedollarization was observed in both in credit investment and deposit attraction. In 2015, the rate of dollarization (49.4%) reached its highest point since 2006, but with the stabilization of the manat's exchange rate, there has been a decrease in dollarization. During the first 8 months of 2019, the share of loans in foreign currency decreased from 38% to 34.3%. This is the lowest it has been since 2014 (*figure 16*).

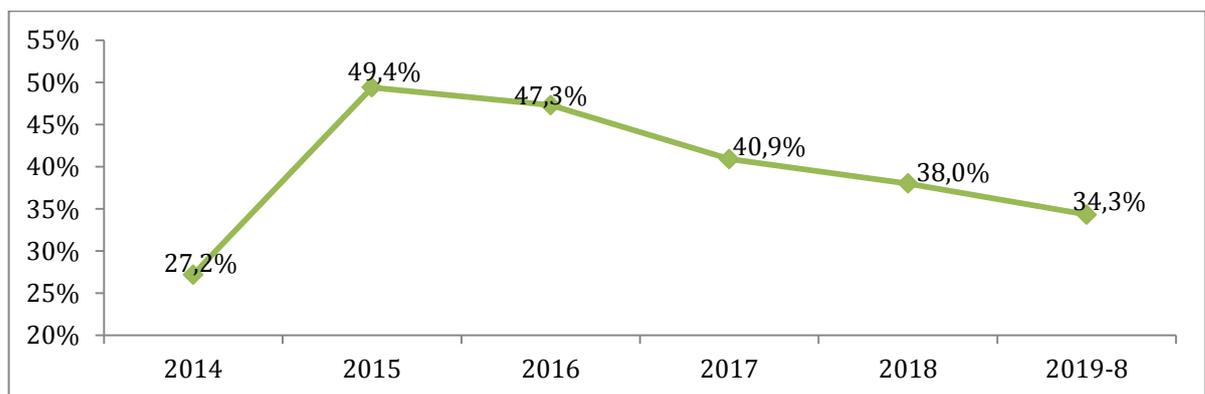


Figure 16. Fluctuations in the share of foreign currency in lending

(2014-2019). Source: Central Bank

The stability of the national currency and the low return on foreign currency deposits supported dedollarization. The tendency of dollarization to decline in total deposits has continued, down from 65.3% at the beginning of the year to 63% in the first 8 months of 2019. The lowest level of dedollarization was recorded in the public's savings. During this period, the dollarization of deposits decreased from 62.5% to 56.0%. Due to the devaluation, the share of foreign currency in the deposits of financial institutions, which had the highest level of

dollarization (89.1%), fell to 67.6%. In the deposits of non-financial institutions, however, the level of dollarization increased from 66.4% at the beginning of the year to 67.2% (figure 17).

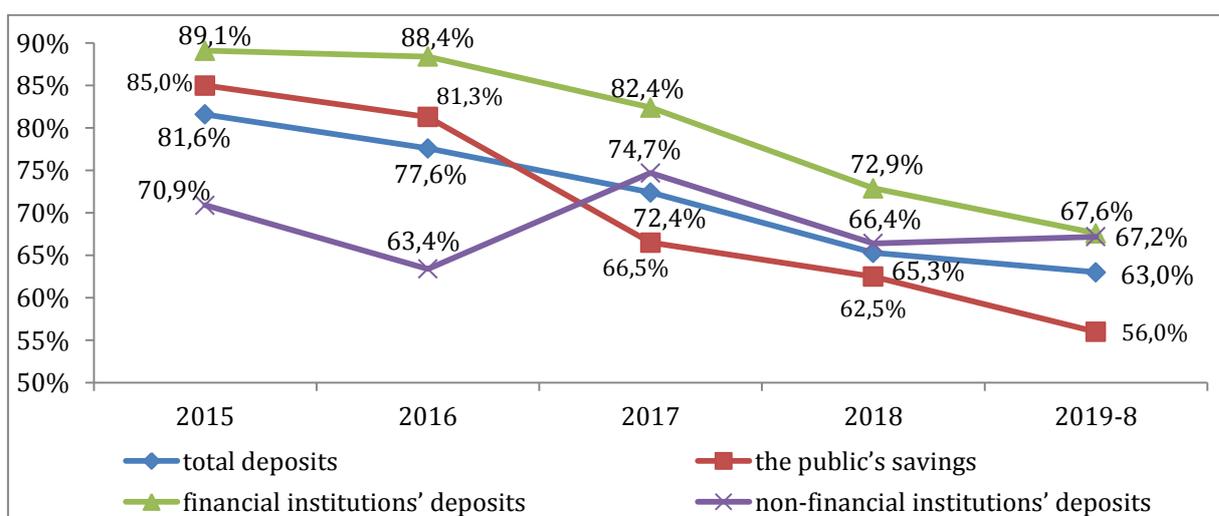


Figure 17. Fluctuations in the share of foreign currency in deposits, 2015-2019
Source: Central Bank

5.4. Changes in banking legislation. On February 28, 2019, the [Decree on additional measures to resolve the problem loans of individuals in the Republic of Azerbaijan](#) was adopted in order to offset the financial losses resulting from the devaluation of individuals with loans in foreign currency, including resolving problem loans with government support. According to the decree, individuals who took loans in foreign currency after January 1, 2012, received compensation for their main loan debts to banks not exceeding \$10,000 for the specific dates 02.21.2015-12.21.2015. In addition, the debt remaining after compensation was restructured, including loans in manats (not exceeding AZN 17,000) at a discounted rate (an annual interest rate of 0.1% for 5 years).

In 2019, the Financial Market Supervisory Authority adopted a number of regulations to regulate the banking sector:

- Rules for risk management in banks
- Rules for credit risk management in banks
- Rules for the certification of bank administrators
- Procedure for reviewing materials on the application of sanctions in connection with the dismissal of bank administrators and the termination of banking licenses, and for formalizing the results
- Criteria for determining whether a bank is a systemically important bank
- Rules for banking inspection
- Rule for determining the mechanism of repayment of the main part of physical persons' loans in foreign currency which became more expensive in manats as a result of the devaluation, as well as the deductions on interest and penalties on the same amount (fines, penalties)
- Rules for opening, managing, and closing bank accounts
- Corporate governance standards in banks