



## Report - Azerbaijan and Kazakhstan

### January 2017

- Outlooks more stable with firmer commodity markets
- Banking sector weak after excessive lending
- The large sovereign wealth funds underpin future financial stability

In January, we participated in an investor trip to three cities: Baku – the capital of Azerbaijan, Astana – the capital of Kazakhstan and Almaty, the previous capital and current banking centre. The schedule was very comprehensive and included government representatives from ministries, central banks, sovereign wealth funds and government owned companies; representatives from the private financial sector and international experts from American Consulates and EBRD. There are several similarities in the two ex-Soviet economies, especially the commodity focus, centralised political power and fragile banking sector, but also a heightened willingness to reform and robust sovereign wealth funds. The meetings strengthened our positive view on both countries, supported by recovering growth, decreasing inflationary pressures and an improving external and internal balance. We still view the largest risks to be potential instability in the banking sector and returning oil volatility. These are however balanced by the large sovereign wealth funds and high consolidated currency reserves.

#### **Azerbaijan**

The economy is strongly oil-dependent and the fall in oil prices coupled with the local currency's (manat/AZN) depreciation and the slowdown in trading partners' economies led to difficulties during the last two years. The central bank first devalued twice during 2015 and finally moved to a controlled float, too late compared to other oil exporters (Russia and Kazakhstan) and after having used a large part of central bank reserves to defend the manat. The currency has lost more than half its value against the dollar since 2015 and import-inflation has increased headline inflation to 12.6 % 2016, even though the economy contracted by 3.8 % in 2016. The slowdown was biggest in the non-oil sector (construction -27.6 %). The devaluation improved the competitiveness of the economy (-28 % compared to the ruble since 2014), as service imports decreased and tourism improved. At the same time, however, it had an even stronger impact on the banking sector.

A large part of clients' loans were in dollars, so the asset quality of the banks deteriorated quickly as NPL's increased. The liability side of the banks' balance sheet also included currency mismatches, as the long term debt was mainly in dollars and liquidity in local currency. The government owned International Bank of Azerbaijan constitutes approximately 40 % of the total banking sector and it had up to 80 % NPL's, mostly due to the devaluation, but there were also cases of outright fraud. The government has supported the bank by injecting capital and buying non-performing assets. Furthermore, government related corporations have increased the bank's liquidity with depositions. This broad support is in our opinion a clear signal of the willingness to solve the bank's problem, the inertia in the process is probably due to the bank's high share of the banking sector and the remaining large liabilities in dollars (2.5 bn \$), as their hedging would substantially affect the FX-markets. These FX-liabilities have continued to create losses for the bank, increasing the probability of additional capital needs. This capitalization and the transfer of the remaining non-performing loan portfolio will probably be executed through the macroeconomic stability facility under central bank supervision. The sovereign wealth fund, SOFAZ has already budgeted an up to 4.5 bn \$ transfer to this facility during 2017. Furthermore, the bank has an independent management for the first time. There is no exact assessment of the system wide NPL's, but estimates are 30-50%.

The public debt is mostly in dollars (70 %), and the devaluation deteriorated ratios (public debt/GDP 11 % 2014 and 38 % 2016). The dollarization of the economy also increased (80 % of depositions in foreign currency). The central bank has increased its refinancing rate by 1200 bps since the summer of 2015, with the objective to curtail inflation and stabilize the currency. Managing the monetary base is currently the central bank's principal monetary tool. The dollarization and underdeveloped interbank market render the refinance rate an inefficient instrument at the moment. The CB has decreased the amount of manats in the system through sterilization programs. The bank manages inflation through the exchange rate and the exchange rate through the monetary base. A black market for FX was developing in the fall of 2015 and this evidently accelerated the decision to partly float the currency. The aim is to not grow the monetary base during 2017, leading to an inflation forecast of  $10 \pm 2$  %. The president has, however, indicated that single digit inflation would be preferable. Growth is seen to be 1-2 %, non-oil sector 2.5 %.

The exchange rate is the biggest driver for the inflation and a fully floating currency is probably still far. We understood that the CB will only intervene during volatility spikes, but the FX-market is far from functioning. There are practically only a few sellers of dollars, the dominant one being SOFAZ, selling 50 mio weekly as it transfers manats to the government budget. We got the picture from commercial banks that the exchange rate is given, and the amount is allocated pro-rata. There seems to still be plenty of manats waiting for conversion and the confidence in the central bank did not seem to be high among the people. The black market exchange rate is currently around @2.0, so the largest moves are probably behind us, given that the oil price does not change radically. The CB aims for a three month import-cover, 3.6 bn \$, but SOFAZ has additional reserves of 36 bn \$, 100 % of GDP. Some of the funds moved from SOFAZ to the CB may be used to stabilize the exchange rate.

The large oil-dependency is an additional risk, and oil revenues have enabled the country to defer structural changes. Hopefully the events of the last years will encourage reforms. The government emphasizes social stability and inflation fused demonstrations have no doubt led them to understand the long term risks of a one sided economy. We concluded from our meetings that especially the tourism- and agricultural industries

have potential, even if there are still tendencies to create unnecessary monopolies in the country and the added value in agricultural products is still low. The Southern Gas Corridor, currently under construction, will transfer natural gas from the Shah Deniz-field to Europe and it will almost double gas exports. This project will support the financial position of the country in the future and is estimated to add approximately 3 % of GDP.

We view the political risks to be limited at the moment. President Ilham Aliyev is only 55 years old and his authority is uncontested. Nagorno-Karabakh remains a potential source of uncertainty. Armenia occupies 20 % of Azerbaijan's area and the countries' relationships have been icy since the early 90's. There is still military activity in the area and Azerbaijan reconquered one kilometre of land during 2016. The conflict has however not escalated, probably thanks to Russian influence. Russia serves as a guarantor of peace, while selling weapons to both sides. The reintegration of Iran into the world economy is seen more as a threat in much smaller Azerbaijan. The fear is that the much larger neighbour will overrun local industrial players. The fear is mutual, as there are around 25 mio ethnic Azeris in Iran, who might be enticed by a sovereign state.

2017 will be a better year for growth and inflation. This coupled with the large fx-reserves, the will and means to strengthen the banking sector and the stabilized oil price all underpin our positive view on the country. We remain positive on hard currency debt. On the local currency side, we are neutral, but view further depreciation as unlikely and the high rates as sufficient protection against possible weakening of the currency. In our view, it is likely that the central bank keeps the refinancing rate high, this supports our investments in the short and medium maturities.

## **Kazakhstan**

The situation in Kazakhstan is very similar to the one in Azerbaijan, but the recovery is further along, much on the account of a decisive central bank that started devaluing a year before Azerbaijan. The devaluation led momentarily to high import-inflation (summer 2016 17.6 %), but the central bank's inflation target (6-8 %) is probably going to be reached already in 2017. The currency has probably bottomed out, as there is a shortage of tenges in the economy (sterilization), the dollarization is decreasing (50 % of deposit) and the oil price has stabilized. The central bank intervenes during volatility spikes, but will not interfere with fundamental trends. In other words, they are not considering buying dollars at the moment, like the relevant comparison Russia. The consolidated reserves are above 90 bn \$ and considered adequate. The improving inflation outlook and the stable currency enable rate cuts and we do not rule out a cut already in Q12017.

The inflation shock that followed the devaluation was quickly overcome, but the impact it had on the banking sector remains unresolved. The sector was unstable already before the devaluation, as it was burdened with a burst real estate bubble from the last decennium. A few smaller banks had their licenses withdrawn in 2016 and KazInvestBank defaulted in December. The systemically critical KazKommertsBank (KKB) was next in line, as speculations about its solvency commenced. One suggested solution is the purchase of KKB by solvent Halyk, referred to as a merger, in order to minimize panic as KKB has a large deposition by the pension fund. The government has realized that it is a poor banker and the management of Halyk is widely trusted. There are fears that the new bank might become too dominant if the merger works out or alternatively that the last functioning bank will be weakened by the poor assets of KKB. The president has promised that government funds will not be used to capitalize banks, but also that they will not let KKB fail, as this would lead to further demonstrations. There is clearly a will to resolve the issue, but nobody could exactly describe how. It would cost around 10 bn \$ to clean up the balance sheet of KKB, which is not a big sum for the country. We believe that KKB will be prepped for purchasing, e.g. with indirect support from the central bank in the form of a cheap subordinated loan.

The most topical question among international investors seemed to be concerning life after Nazarbayev. There didn't seem to be a coherent view locally on the issue, but it seemed to be a much less pressing issue among the locals. The president is still in moderately good health and the efforts to transfer power to parliament are considered important, but only symbolic so far. The succession might very well be collective, i.e. power will be distributed among important groups. Furthermore, the leader following Nazarbayev will be seen to implement the long serving president's agenda and thus lead with his authority. Nazarbayev is genuinely popular in the country, whose identity and welfare he has been building since its birth. The country has not experienced any significant instability or ethnic strife, although the devaluation and the resulting inflation and a separate land reform have resulted in peaceful protests. These have occasionally been labeled as extremist activity by the government.

The consolidated fiscal deficit was -4.5 % in 2016 and it is forecasted to be -4 % in 2017 (government budget deficit 1.2 %), but with a 35 \$/barrel oil price, so it can be much smaller in the end. Public debt is low at 27 % of GDP, so the government can afford an expansionary fiscal policy. The economy grew with around one percent in 2016 and the growth is estimated to be 2 % in 2017, albeit with low, 40 \$ oil price. The deficit is financed locally and the country has ambitions to increase the amount of local currency debt in the future. The objective is to make bonds in tenge Euroclearable, but this will require changes to the law. The short term goal is to facilitate local custody for foreigners. We do however not believe these goals will be achieved very quickly. The oil production cuts agreed through OPEC are very small and the current oil price is considered very accommodative. The Kashagan oilfield, the largest oil discovery in a few decenniums, has finally been completed, adding 14 % to the country's oil production by 2018. The country has oil reserves that will last for 50 years with the current production rate.

We believe that the succession will be orderly, the oil production will increase and that the more stable currency and lower inflation will lead to moderate economic growth. We continue to view the consolidation of the banking sector to be a risk, but believe that the country has ample resources to deal with it. We are constructive in regards to dollar bonds, even if the yield has decreased lately and the market is expecting possible new issues. On the other hand, we are very positive on the currency, where we see potential for strengthening to 300 tenge/USD. Local rates are only attractive in the short end, as the yield curve is strongly inverted (1 year @ 12.0 % and 10 years 7.00 %).

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