



The potential impacts of Brexit on Azerbaijan's economy

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Shahbazov Inqilab

Senior researcher

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Abstract

As one of the centres of the global economy and financial sector, the exit of Great Britain from European Union made significant impacts on different countries in one way or another, and Azerbaijan was not an exception. This paper analysed the short and long-term impacts of Brexit on Azerbaijan by looking at State Oil Fund of Azerbaijan, UK-Azerbaijan relationship and potential benefits for Azerbaijan. The study found that the impacts of Brexit are difficult to gauge now as the referendum took place quite recently, thus, making it necessary to wait for some time in order to reach conclusion on the effects of this political event on Azerbaijan. However, it was found that Brexit's impact on the exchange rates of certain currencies is likely to be important for SOFAZ. Moreover, Brexit can also positively affect Azerbaijani businesses and individuals that have or are planning to make a presence in Britain. The paper also discusses the potential impact of Brexit on Azerbaijan-EU relationships because the political event in Britain has many implications for Europe as well.

Brexit overview and background

In a historic referendum held on 23rd of June, 51,9%% of British citizens voted to leave EU. As expected, financial markets of both Britain and other countries immediately felt impacts of this political event. While the Brexit wiped nearly \$2 trillion off world markets, pound sterling experienced significant drop against dollar, plunging down to \$1,33 from \$1,50 following the referendum.¹ Investors around the world are now turning to US dollar, Japanese yen, Chinese Renminbi and gold, which are much safer than euro and pound. In such an environment, it is crucial to analyse immediate impacts of Brexit on Azerbaijan who is going through difficult economic period, and foresee potential consequences.

Azerbaijan-UK relationship

Established in early 1990s, the mutual relationship between Azerbaijan and UK has developed significantly over time. A significant number of bilateral agreements have been signed and parliamentary cooperation has been established. There are also now large numbers of Azerbaijanis and Britons traveling in between and working in these countries.

British companies play an important role in the Azerbaijani economy. UK is the second largest investor in Azerbaijan's non-oil sector, comprising up to 16% of whole foreign investment portfolio in this sector. There are also more than 540 companies established as a result of British investment in Azerbaijan.² In oil sector, British petroleum corporation BP is the leading foreign company and contributes to Azerbaijani economy enormously. Total value of UK exports to Azerbaijan in 2014 reached nearly £730 million (more than 1,6 billion manats). British investment in Azerbaijan amounted to \$153,3 million in 2014.³ Main exports of the UK to Azerbaijan include services (i.e. audit and law firms) and engineering, as well as oil and gas-related equipment.⁴ In terms of individuals, more than 33,000 British citizens came to Azerbaijan in 2014 (DSK), and nearly 7,000 British citizens work here (GOV.UK)

Although there has not been a significant amount of investment and business activity United Kingdom by Azerbaijanis, UK's importance for us is great. United Kingdom is a major destination for the Azerbaijani students who wish to continue their education abroad. According to the recent figures, 1842 students have studied in 27 different countries in the framework of Education Abroad State Scholarship Scheme for Azerbaijani Youth. 419 of them have taken the advantage of studying in British universities.⁵ In terms of business, few Azerbaijani businesses have offices in the UK. Moreover, British property market is attractive for Azerbaijani clients, such as SOFAZ who has made investment in a property market in London.

¹ Guardian 2016

² Xalq Qəzeti (2014)

³ State Statistics Committee (2014)

⁴ GOV.UK (2016)

⁵ Azerbaijan Embassy in UK (2016)

Brexit impact

Given the significant trade relationships between Azerbaijan and UK, Brexit's impact on Azerbaijan was inevitable. This paper will consider the consequences of Brexit on SofAZ portfolio and British investment in Azerbaijan. The last section will look at the positive impacts of this referendum on Azerbaijan.

SofAZ's investment portfolio and assets

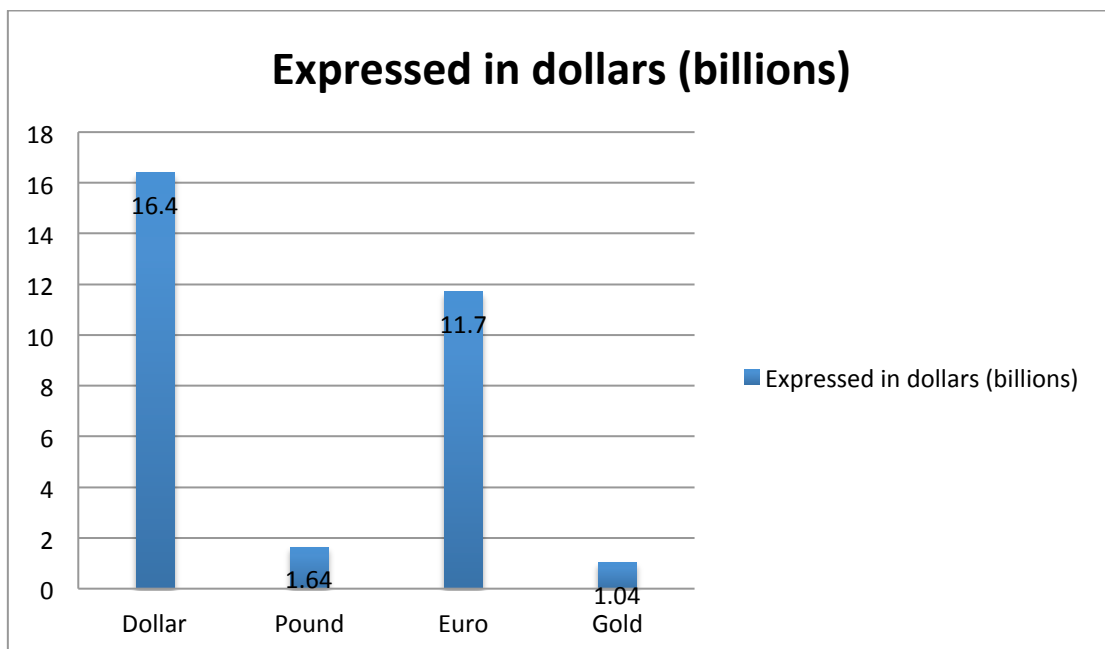
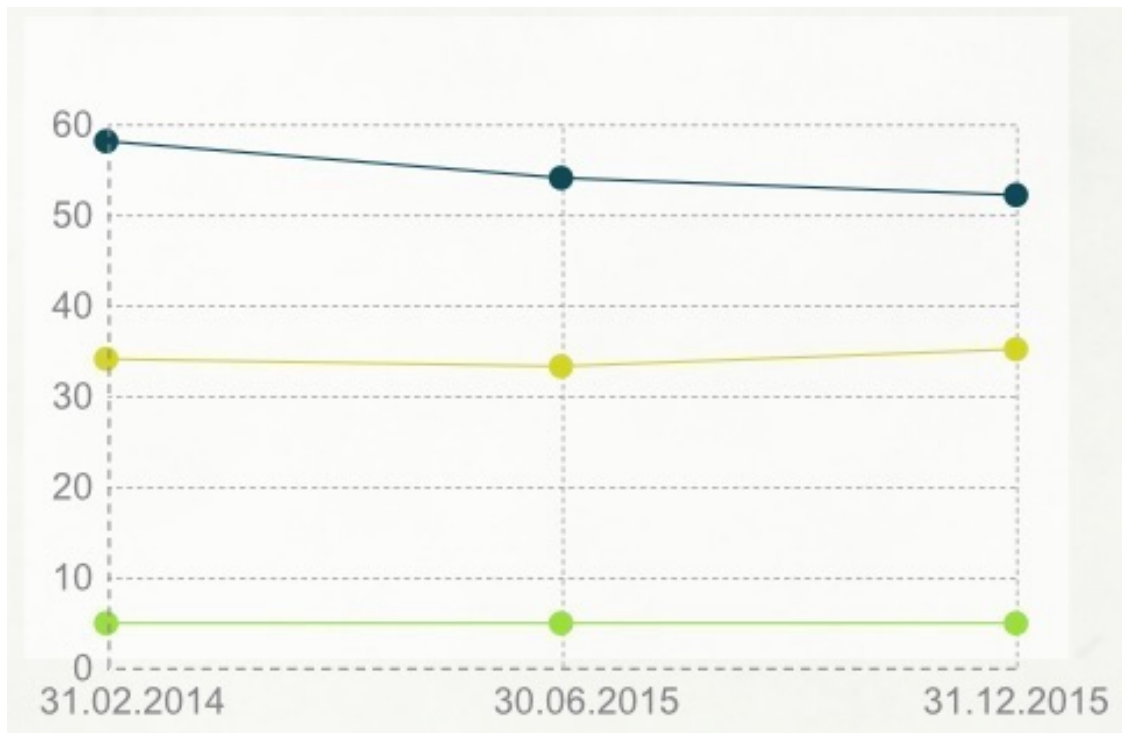
The total value of assets managed by SOFAZ has seen dramatic increase since 2009. While the total amount stood at \$14,9 billion that year, it went up exponentially to \$37,1 billion in 2014, before dropping to \$33,6 billions in 2015. The data released by SOFAZ shows that budget revenues of the State Oil Fund of the Republic of Azerbaijan for the first three months of 2016 amounted to 2,023 billion manats (\$1,313 billion) and total expenditures added up to 1,946 billion manats (\$1,263 billion), thus, creating surplus for SOFAZ.⁶ The revenues from managing assets for first quarter 2016 amounted to 148 million manats (\$96 million). Before Brexit, the breakdown of the investment portfolio of SOFAZ in terms of major currencies was as follows: 16,4 billions in US dollars, 11,7 billions in euros and 1,64 billion in British pounds (all expressed in US dollars).⁷

Graph 1 shows the composition of SOFAZ's investment portfolio (shown in percentage). The graph shows the proportion of assets denominated in US dollars (blue), euro (yellow) and British pound sterling (green) (SOFAZ Annual Report 2015)

⁶ SOFAZ (2016)

⁷ SOFAZ (2015)

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Graph 2 shows the SOFAZ's investment portfolio breakdown by pounds, dollars, euros and gold (SOFAZ Annual report 2015)

State Oil Fund of Azerbaijan holds its investments in currencies and other assets such as gold and real estate properties. Regarding the currency composition of the investment portfolio of SOFAZ, it is comprised of dollar, euro, pound and other commodities or assets. Up to 50% of the total assets are allowed to be invested in assets denominated in USD and gold in total, while this proportion is 35% and 5% for euro and British sterling respectively.⁸ Legislation also allows up to 5% of investment portfolio to be invested into the gold. In practice, nearly 49% and 3,1% of the total assets are the ones denominated in US dollars and gold respectively, while it is 35% for euros. 4,9% is held in British sterling. The proportion for every other currency does not exceed 1-2%.⁹ These currencies include Australian dollars, Turkish liras, Russian rubles, South Korean won, Chinese renminbi, Japanese yen and other currencies. This composition shows significance of euro and relative importance of pound for SOFAZ. Given the fact that referendum affected both currencies notably, it is important to be aware of their impacts.

The proportion of each major currency in the portfolio has seen notable change over recent years. The proportion of US dollar and gold in portfolio has decreased from 58% to 52% between 2014-2015. Euro's share dropped by 1% in 2014, but increased up to 35% in 2015. However, British pound's share remained virtually unchanged during that period.

Short-term and long-term view: calculations of gains and losses of SOFAZ

As noted above, SOFAZ lost an estimated amount of \$500 millions due to 10% and 2,7% reduction in pound's and euro's value respectively immediately after the referendum. However, the increase in dollar and gold's value reduced the total loss by \$40-50 millions.

Although the scale of losses for SOFAZ on the day of referendum was quite significant, SOFAZ can recoup the loss and make gains in long-term. This paper will therefore make certain predictions in relation to the changes in the revenues of SOFAZ obtained through the management of investment portfolio in currencies. To this end, the financial forecasts from a number of large international organisations, rating agencies and private banks will be used.

Pound sterling

Starting with pound, it is not expected to make significant gains in the near future. Alongside political uncertainty in Britain due to Brexit, Bank of England's warning of potential interest rate cut is likely to have downward pressure on pound. Dutch ING Bank estimates the fall of pound to \$1,25 in the near future.¹⁰ British bank Citigroup's forecast is that pound, following a drop to \$1,25 by September 2016, will gradually return to \$1,36 in long term. Barclays and HSBC's

⁸ SOFAZ (2016)

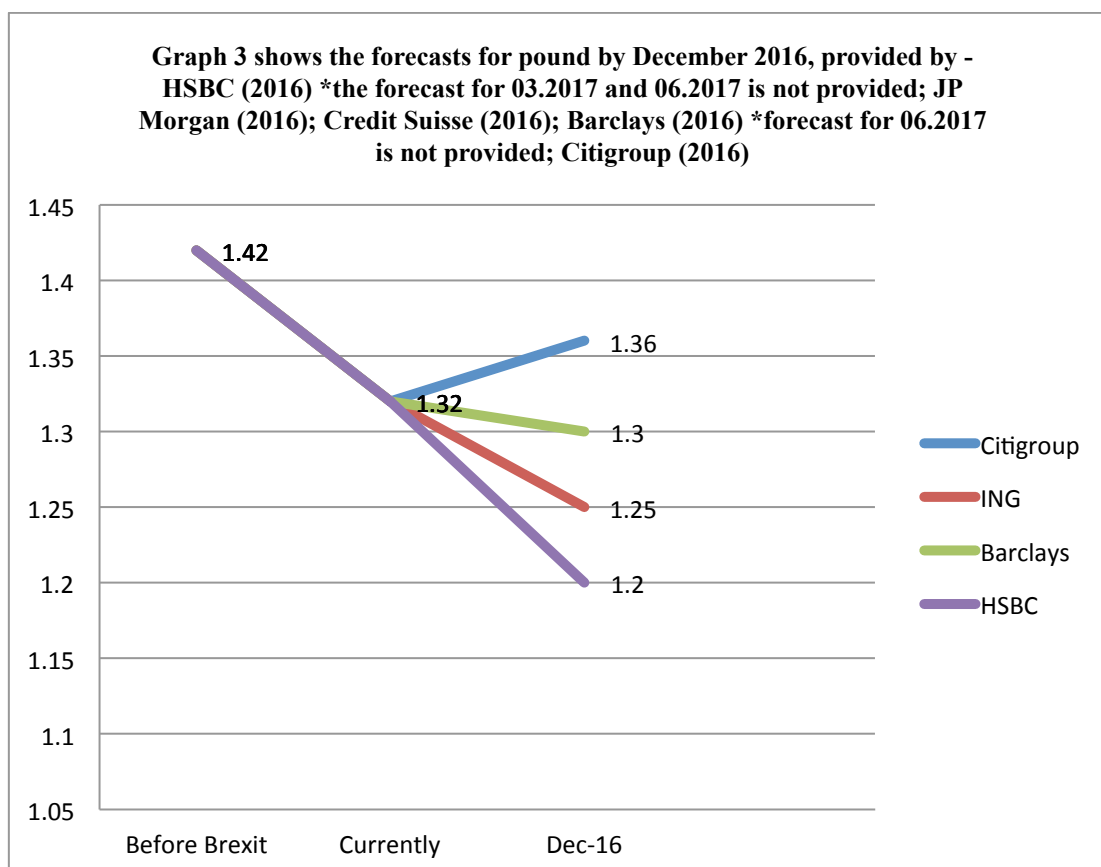
⁹ SOFAZ (2015)

¹⁰ ING (2016)

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prediction shows pound to drop to \$1,30 and \$1,20 respectively by the end of 2016 and early 2017.^{11 12}

Among all the assets denominated in different currencies by SOFAZ, the drop in pound will make the most significant impact on Fund's assets' total value. So far, the loss from depreciation of pound' value has been nearly \$100 million. Looking at the different forecasts provided by various bodies, the worst case scenario expects the drop as low as \$1,20 in sterling's exchange rate. In that case, the total value of SOFAZ's assets denominated in pound will be \$1, billions, a loss of \$240 millions. However in other less pessimistic scenarios, the total loss from pound can be predicted to be \$60 million. Thus, in total, the losses in between Brexit and the end of 2016 can vary in between \$160-340 million.

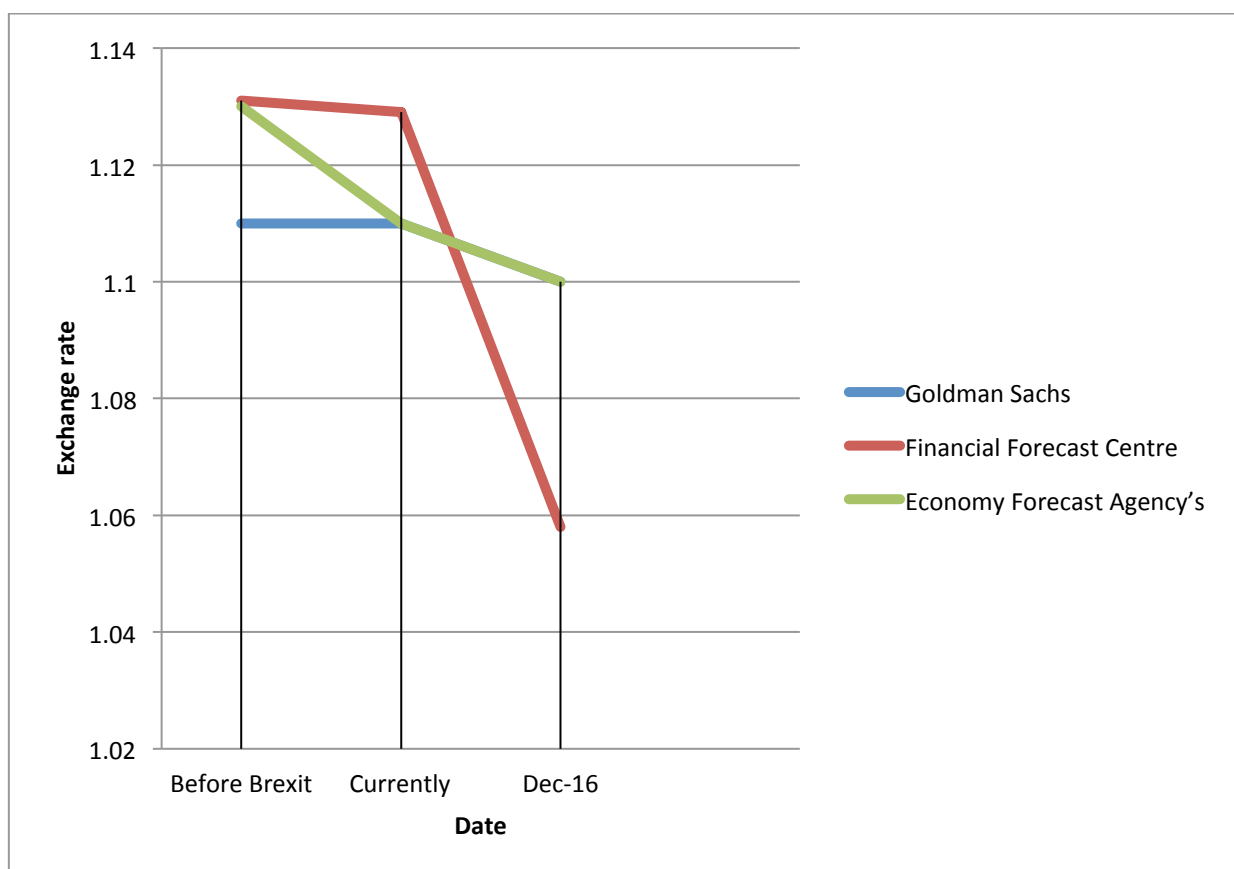


¹¹ HSBC Holdings PLC (2016)

¹² Pound Sterling Live (2016)

Euro

Euro's value against US dollar is also expected to drop, albeit not significantly. Despite gaining value against pound following Brexit due to sell-off of pound for euro, the exchange rate of this currency is not expected to register any significant change. Goldman Sachs puts its prediction for USD/EUR as euro losing only 1% drop (to \$1,10) in its value by the end of 2016, while the Financial Forecast Centre forecast shows euro being \$1,058 by the same time of the year. Another agency – The Economy Forecast Agency's prediction is that euro will be \$1,14 by the 4th quarter of 2016. As seen from the graph, all forecasts are strikingly similar to each other, indicating general consensus among financial sector in relation to the future of euro. Considering this degree of drop in euro's value, the total loss of SOFAZ in euro has so far been \$350 million. Should the predicted drop materialize by the end of 2016, there will be further \$110 million loss for SOFAZ.



Graph 4 shows the forecast for euro by Goldman Sachs (2016); the Economy Forecast Agency (2016); Financial Forecast Centre (2016)

US dollar

Despite the losses that will incur as a result of drop in euro and pound, stronger dollar will bring some gains to SOFAZ and recoup its losses to certain extent. The chief cause of rise in dollar's value is the increasing demand (both in Azerbaijan and worldwide) for this currency in the face of decrease in pound and euro's value. In other words, due to decreased value of euro and pound, there is a growing capital flows into the dollar, making it stronger. To Azerbaijan's benefit, weakening euro and pound in EU and Britain respectively will make it relatively more affordable for Azerbaijan to make investments in those areas. That is, by using stronger dollar, SOFAZ will be able to buy more euros or pounds and invest in properties of which the prices are in decline since Brexit.

On the other hand the increase in dollar's value is likely to create a downward pressure on already-devalued manat, bringing a risk of third devaluation. Immediately after the referendum, dollar's exchange rate against manat rose to 1,59 manats.

Gold

In terms of gold, right before Brexit, gold's value stood at slightly above \$1250 per troy ounce, but it spiked up following the referendum, hitting \$1330 per troy ounce before fluctuating and eventually falling down to just below \$1320 on the 27th of June.¹³ Gold is expected to experience rise in its value because investors now find it much safer than euro and pound to invest in, thus, creating greater demand on gold. The survey conducted by Bloomberg among analysts and traders from different firms in New York and London found that the financial community predicts gold's value to reach as high as \$1,424 an ounce by the end of 2016. JP Morgan's forecast is that gold will reach \$1370 and \$1407 by September 2016 and December 2016 respectively. As of July 2016, gold price per ounce stays at \$1,353. The kind of increases predicted translates to nearly 4% rise, meaning that SOFAZ's revenues from gold can reach \$1.08-1.09 billions by the end of 2016.

However, given the rising value of dollar, gold could be expected to lose value in long-run. FED's policy in relation to the interest rate is also crucial here. That is, should FED increase the rate, it will make dollar more expensive which will create have downward pressure on gold's price. Generally speaking, strengthening US dollar will have depressing effect on all commodities.

Oil prices

It is beyond doubt that Brexit is going to make a depressing impact on oil prices that is already at a level undesirable for oil-rich Azerbaijan. While the price of a barrel was near \$51 before Brexit referendum, it went down to about \$47,6 in few days, although it regained its \$51 level quickly.

¹³ Investment Mine (2016)

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In 2015, SOFAZ's revenues from the export of oil and the royalties granted to the oil wells operated by other bodies amounted to \$7,229 billion – the average oil price per barrel was \$54,31 (SOFAZ 2015). It was a twofold drop in revenues that amounted to \$16,231 billions in 2014.

In long-run, experts and analysts do not expect significant impact of Brexit itself on oil prices. That is, oversupply of market with oil barrels, coupled with reduced demand in EU and British market are seen as the chief causes of drop in oil price. In other words, the reduced economic growth both in Britain and EU can increase likelihood of further decrease in oil prices in the near future. It is also worth noting that as US dollar becomes stronger, it will have depressing effect on oil price as well since strong dollar tends to reduce price of precious commodities. Taking these factors into consideration, World Bank's prediction is that oil price will fall down as low as \$41-42 towards the end of this year.¹⁴ However, the bank expects the price to register gradual growth over next 10 years and reach \$82,6. IMF, however, expects much more different scenario as the Fund predicts the price to hover in between \$45-50 this year and reach only \$57 by 2020.

Total loss and gains

Considering all the variables above, SOFAZ's losses by the end of 2016 can be different depending on the forecast taken into account. For pound, the loss is expected to be anything in between \$160-340 millions. In terms of euro, \$350-460 million is the estimated amount of loss. Significantly different forecasts in oil price make it extremely difficult to calculate potential loss for the fund. However, forecasts provided by IMF and World Bank regarding the prices in December 2016 point to price in between \$41-57. Thus, taking its average price of \$49, \$2,5 billions of revenue is expected to be made, not so different from the figure for the first 6 months of 2016. However, SOFAZ's expenditure is planned to be more than its revenue. In other words, There will be \$1,5-2,5 billion deficit in budget because Fund's budget will receive \$4,3 billions but is expected to expend \$6,9 billions to run the fund and operations.

Gold, however, will recoup some of the losses for SOFAZ. Approximately \$40-50 millions is predicted to be gained from rising price of gold per ounce by the end of 2016.

Considering these facts, Brexit is not expected to make long-lasting significant impact on Azerbaijan's economy. Given the direct relationship between UK and Azerbaijan, the departure of UK from EU is not likely to affect the mutual relationship in the way it affects the one between UK and EU member state.

¹⁴ World Bank (2016)

Brexit impact on euro and EU-Azerbaijan trade relationships

Given that UK has very close connections with EU trade zone, Brexit also put downward pressure on euro. Thus, euro's value decreased from \$1,135 to \$1,105 (European Central Bank). This 2,71% decrease in value led SOFAZ to see €281 millions in its assets denominated in euro. However, quite shortly afterwards, euro made gains against pound due to sell-off of GBP - increase from £0.7608 to £0.8174 (HSBC 2016).

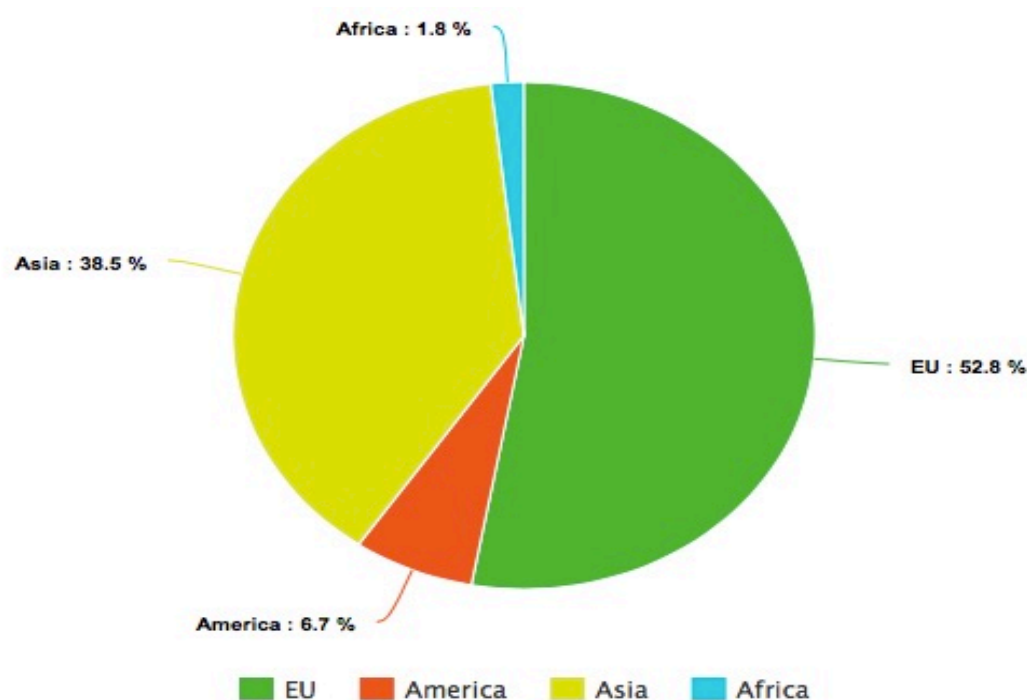
EU is an important trade partner for Azerbaijan as the value of Azerbaijan's foreign trade turnover with EU member states amounted to \$9,7 billion in 2015.¹⁵ As a market with nearly 500 million consumers (larger than US market), EU is world's largest single market with transparent rules and regulations.¹⁶ According to EU Commission's statistics, EU continues to be Azerbaijan's biggest export and import market. Thus, while 48.3 % of Azerbaijan's exports are received by EU, the goods imported from EU to Azerbaijan constitutes 27.7% of total import portfolio. Total value of EU investments in Azerbaijan stood at slightly more than €8 billion in 2014. In terms of composition of exports and imports, while Azerbaijan exports mainly mineral fuels, machinery and transport equipment, chemicals and food and live animals, EU's export portfolio consists of technological products, manufacturing goods and chemicals. These statistics clearly demonstrate the significance of EU for Azerbaijan who greatly depends on EU and other countries for its manufacturing and technological products.

Pie chart 1 shows the composition of Azerbaijan's foreign trade relations' total volume (European Commission Azerbaijan, 2016)

¹⁵ State Statistics Committee (2015)

¹⁶ European Commission (2016)

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In the time when euro loses its value and the continent faces uncertain future (at least in short-term), it is likely to hamper trade between these two parties due to potential problems EU-based businesses may face and Azerbaijani investors' decision to refrain from investing in volatile EU and buying weakening euro. Generally, the weakening euro will highly likely cause economic slowdown in the whole continent, which can depress consumer spending and thus, profits for businesses. Although it is too early to estimate the degree of slowdown, Dutch bank ING believe that we can observe reduction of Eurozone GDP growth by between 0.01 and 0.03 percentage points each year.¹⁷ If such a slowdown occurs, it can negatively affect European companies dealing with Azerbaijan because those companies will likely to make smaller profits than before due to reduced consumer demand.

However, as already noted, weakening euro and stronger dollar can increase investment inflows into EU from Azerbaijan because stronger dollar will increase purchasing power of SOFAZ and other entities from Azerbaijan who want to invest in European Union. As a result, EU-Azerbaijan trade can make gains out of Brexit.

¹⁷ Vox.com (2016)

Potential benefits of Brexit for Azerbaijan

Brexit, however, is not only full of negative consequences for Azerbaijan. That is, there are certain potential benefits that can be capitalised on by Azerbaijani businesses and individuals. Therefore, it is also worth looking at the impact of Brexit for Azerbaijani businesses and tourists, as well as students who have connections or are planning to establish one with Britain. The drop in pound's value will benefit Azerbaijanis since it has become cheaper to buy pound, thus, making it less costlier to live and do a business in UK. Brexit also led to the drop in property prices, particularly in London and south of England, which will make it cheaper to rent or purchase properties there.

Despite these negative consequences for Azerbaijan, it is important to bear in mind the fact that things could change notably in long-term. First of all, the British government is in negotiations with EU in order to have access to the single EU market. Secondly, once the panic among investors is gone and the future becomes more certain, investments into Azerbaijan by British companies can continue. These two factors are important because if they materialise, pound can regain some of its lost value and Britain-EU relations can be restored to some degree, which would have impact on global commodity prices as well.

Azerbaijan's tourism sector may also benefit from this political event. That is, the Eurozone tourists who used to travel to UK with great ease are likely to experience certain difficulties with visiting UK due to visa procedures and increased cost of getting visa. Azerbaijan, on the other hand, has recently reduced visa fee by two times (\$20 as of now) and made it quicker to obtain electronic visa (3 days of waiting time in total).¹⁸ Thus, more tourists from Europe can be attracted to Azerbaijan in current circumstances, albeit problems in finding cheap flights and underdeveloped nature of tourism in many parts of the country can cause problems.

Finally, though not significant in volume relative to others, British exports are not unimportant for Azerbaijan. Due to decreased value of pound, those exports will also become relatively cheaper, thus, becoming more affordable for Azerbaijani consumers. However, since the majority of those exports are oil and gas-related machinery and technology equipment, this reduction in value is unlikely to affect the bulk of local customers.

¹⁸ CBC.AZ (2016)

Conclusion

In conclusion, it might be too early to assess the effects of Brexit on Azerbaijan and UK-Azerbaijan trade relationships. In fact, it is important to bear in mind that the current chaotic situation in financial markets and economy is partly a product of psychological factors. Following the referendum, both EU and UK have found themselves in an unexpected situation, which caught them rather unprepared. Therefore, however, once things settle down, some of current problems may be solved.

In the heat of events, it would be unwise for SOFAZ to immediately change the structure of its portfolio. Although the financial loss for SOFAZ is not insignificant, some of it can be repaired over time, especially once pound and euro regains some of their lost value. The loss of SOFAZ due to Brexit-related factors (excluding oil prices) can be predicted to be at least \$450 million, at maximum, \$750 million.

Outside SOFAZ, governments of both nations should also review their trade and economic relationships in order to adapt to the new environment if they are to maintain this mutually beneficial links. One has to keep in mind the fact that neither United Kingdom nor Azerbaijan belonged to Schengen visa zone and Eurozone, and Azerbaijan-UK relationships were built without mediation of EU means that the effects of Brexit on Azerbaijan will not be as severe as it is felt in EU countries.

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