

Azerbaijan

Economic Assessment

Spurred by continued large FDI inflows into the oil and gas sector, the economy largely maintained its rapid expansion in 2004 (Figure 2.16). GDP grew by 9.4% in the first 7 months of the year compared with the same period in 2003. These large inflows were reflected in the rapid expansion of investment, which grew by 54%. The agriculture sector, which accounts for about 40% of the labor force but only about 14% of GDP, posted growth of 4.4% in production volume. Average real wages were up by about 19% in the period, though wage rates and gains are uneven across sectors, with employees in the oil and investment-associated sectors the main beneficiaries.

After 3 years of consistently low inflation, price increases have begun to accelerate in 2004. Average monthly prices are more than 5% higher than in the same months of 2003, pushing up the 12-month moving average rate to 4.5% in July. This acceleration occurred despite a slight appreciation of the manat and delays in reducing the effective subsidies on the prices of oil products and electricity. Reductions in prices of locally produced food products in July and August will temper inflation for the remainder of the year, but it will remain above the targeted level of 2.5% set in the economic program with IMF. Even though broad money grew more rapidly in the first 7 months of 2004 than 2003, greater monetization of the economy helped relieve the pressure of money growth on prices. The budget in this period was on track to achieve the planned moderate surplus for the year.

Merchandise exports grew by 8.5% during the first quarter of 2004 from a year earlier, while imports surged by 46.3%. The current account deficit widened sharply to \$737.8 million (about 37% of GDP), mainly owing to large payments for goods and services related to development

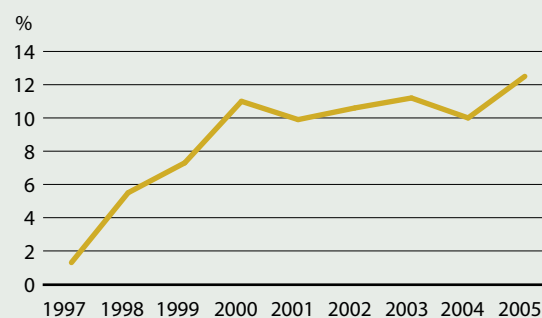
of the oil sector. Inflows of FDI, however, more than covered the current account deficit. Official reserves rose by \$42.0 million (to \$862.9 million) by end-June.

Policy Developments

The uptick in inflation and real exchange rate appreciation indicate that foreign exchange inflows pose challenges for the authorities, especially as oil revenues are expected to rise markedly. In this regard, the adoption of an appropriate oil revenue management strategy and use of the oil fund, SOFAZ, are fundamental. Due to the thin treasury bill market, the National Bank of Azerbaijan is exploring a possible pilot issue of its own short-term bonds to aid sterilization of foreign exchange receipts and so allow better control of monetary and exchange rate developments.

While macroeconomic management has generally been sound, progress on the structural reforms needed to move the country to a sustainable growth path has slowed. In particular, the Government's implementation of the structural reforms agreed with IMF under the PRGF program has been delayed. The outstanding unresolved reforms include adopting a long-term oil

Figure 2.16 GDP Growth, Azerbaijan, 1997–2005



Source: State Statistical Committee of Azerbaijan Republic.

Table 2.17 Selected Economic Indicators, Azerbaijan, 2004–2005, %

Item	2004		2005	
	<i>ADO 2004 Update</i>	<i>ADO 2004 Update</i>	<i>ADO 2004 Update</i>	<i>ADO 2004 Update</i>
GDP growth	9.0	10.0	12.5	12.5
Inflation (CPI)	4.0	5.0	3.0	3.0
Current account/GDP	-32.5	-35.0	-18.1	-23.0

Source: Staff estimates.

revenue management strategy, implementing an automatic adjustment mechanism for domestic energy prices, adopting revenue and expenditure plans for SOEs, and further strengthening the finance sector. Slow movement on these reforms has delayed completion of the fourth and fifth reviews of the PRGF, holding up release of approximately \$38 million from IMF.

Planned reforms in the financial sector are key to establishing a favorable environment for private sector development. As commercial banks dominate the sector, the playing field needs to be leveled for the sector to operate efficiently. In this regard, the Government's postponement to 2005 of the sale of a 20% equity stake in the International Bank of Azerbaijan, the largest commercial bank, to the European Bank for Reconstruction and Development is a retrograde step. While the new Banking Law, which is consistent with the Basle Core Principles, was enacted in December 2003, it is essential that procedures be adopted so that its provisions are made fully operational. Moreover, the Government needs to finalize the new National Bank Law and present it to Parliament.

Outlook for 2004–2005

Clearly, macroeconomic projections for Azerbaijan are very sensitive to world oil price developments, as indicated in *ADO 2004*. Subject to this caveat, performance is forecast to be strong through 2004–2005. GDP growth in 2004 is now projected to be 10.0% (as against 9.0% projected in *ADO 2004*), based on the favorable developments through midyear. Although construction delays on the Baku-Tbilisi-Ceyhan oil pipeline

will affect exports, which could damp GDP growth prospects for 2005, the 12.5% projection is maintained in this *Update*. However, the strong economic expansion has only a limited effect on employment creation, given the capital-intensive nature of oil sector-led growth. Consequently, the Government's plans to promote development in the regions, with a particular focus on the non-oil sectors, especially agriculture, are well directed. Nevertheless, it remains to be seen how the plans will be implemented, and what their actual impact on the extensive underemployment and poverty there will be.

The monetary authorities will likely act to keep inflation in check, and inflation is now expected to be held to 5.0% in 2004 and then reduced to 3.0% in 2005. As projected in *ADO 2004*, the general government budget is forecast to show a surplus of 1.1% and 1.5% of GDP, in 2004 and 2005 respectively, despite tax relief granted in 2004 to foster the non-oil sector and mooted for 2005. Increased oil and gas production from new facilities is expected to keep oil revenues buoyant.

Higher than expected world oil prices have boosted export growth (volume is up marginally as envisaged in *ADO 2004*), though the current account deficit is likely to be wider than earlier projected because of quickened oil sector investment activity. Merchandise exports are projected to increase by 12.0% in 2004 (revised from a slight contraction in *ADO 2004*, based on first quarter performance and continued high oil prices) and by 20.0% in 2005 (revised from the 29.3% projection in *ADO 2004* due to the higher growth expected in 2004 and delays in completing the Baku-Tbilisi-Ceyhan pipeline). Imports will grow rapidly in 2004 but will contract moderately in 2005 as four major investment projects near completion. Overall, the current account deficit is expected to be nearly 35.0% of GDP in 2004, before narrowing in 2005 to 23.0%. FDI and other capital flows are likely to ensure an overall balance-of-payments surplus. While growth and fiscal outcomes are healthy, the Government's response to rising inflation is an area that will require continued monitoring through 2005.