

# Azerbaijan

Expansion of the hydrocarbon sector sustained strong economic growth, although the conflict between Georgia and the Russian Federation and subsequent disruption to regional export routes has had major spillover effects, including oil and gas exports. Inflation remained high due to expansionary fiscal policy and rising global food prices. The outlook is for further growth at a more moderate pace in 2009–2010 and for inflation to remain elevated. In a longer-term perspective, the Government has substantially improved trade and investment conditions in an effort to spur private sector development, particularly in the non-oil segment.

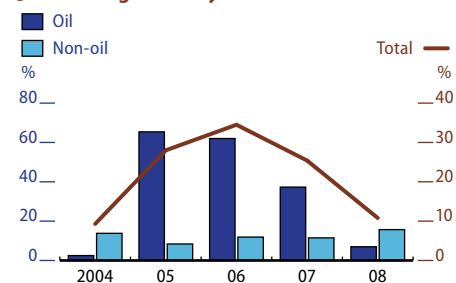
## Economic performance

For the fourth consecutive year in 2008 and despite slowing from an average of 29.3% in 2005–2007, Azerbaijan's economy was among the fastest-growing in the world, with GDP growth estimated at 10.8% (Figure 3.2.1). Net exports, fueled by substantial new oil and gas production, remained the major driver of growth. The conflict between Georgia and the Russian Federation in August was a shock to the economy however, because transport and trade routes, including those for oil and gas, transit Georgia. Although export of hydrocarbons from the Caspian Sea was restored in late September, oil production in 2008 increased by just 6% compared with an earlier-projected 26%. Investment also remained an important contributor to growth, even though its share in GDP fell by around 3 percentage points to about 19% of GDP in 2008. Foreign direct investment, particularly in hydrocarbons and the public sector, remained significant, albeit reduced.

On the production side, growth was led by construction, services, and agriculture. Construction expanded by 36%, reflecting increases in secondary-town and rural infrastructure, in residential buildings and office centers across the country, and in transport facilities. Services rose by 13.7%, underpinned by expansion in transport (13.5%) and communications (28.2%), with reforms driving telecommunications. Trade and transit activities grew with reforms in customs procedures. With good weather and considerable support from the authorities, agriculture improved its weak performance in 2006–2007 to expand by about 7%, with a substantial surge in wheat, fruits, and vegetables. Non-oil GDP grew at almost 16%, the highest rate in 5 years.

Consumer price inflation accelerated to an average of 20.8% from 16.7% in 2007. The increase reflected steeper prices of food mainly, which has a weight of over 30% in the consumer basket. Higher import prices (including food), rapid monetary expansion, and a near doubling of civil service salaries and social security payments also fueled the

3.2.1 GDP growth by sector



Sources: International Monetary Fund, Country Report No. 08/216, available: <http://www.imf.org/external/country/AZE/index.htm>; *Asian Development Outlook* database; staff estimates.

[Click here for figure data](#)

rise. Until midyear, the country experienced a sharp increase in the price of imported wheat, the main staple. The authorities responded by introducing tax holidays both for importers and for local wheat producers, by setting agricultural production targets, and by providing subsidies to farmers and agricultural businesses. With rail networks via Georgia damaged by the conflict, trade disruptions lifted consumer prices in Azerbaijan, because of the country's heavy reliance on imported foodstuffs and consumer goods. End-year inflation, however, moderated to 15.3%, mainly due to easing imported food prices (Figure 3.2.2).

Price stability is the stated monetary policy objective of the National Bank of Azerbaijan (NBA), the central bank. However, NBA is constrained by the fiscal dominance of monetary policy, given that double-digit growth in public expenditure is made possible by the Government's use of its very rapidly growing oil and gas revenues. The large oil-related foreign currency inflows have created pressures for rapid growth in monetary aggregates. NBA has raised its purchases of foreign exchange to limit nominal appreciation of the manat. Broad money (M<sub>3</sub>) was up by 44.0% in 2008, though much less than the 71.4% expansion recorded in 2007 (Figure 3.2.3). The manat appreciated by about 4.5% in nominal terms against the United States dollar.

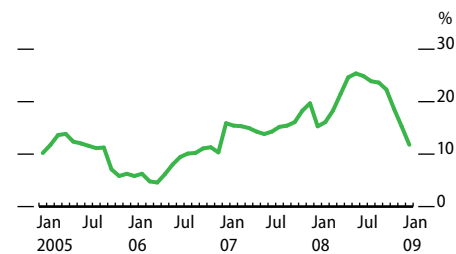
Increases in monetary aggregates also reflect commercial banks' foreign borrowing, which has fueled a rapid expansion in their lending. However, since the global financial crisis intensified in September 2008, banks' access to international capital markets has been hit. Credit to the economy rose by 55.6% in 2008, much of it going to households and small businesses.

Most local banks were affected by the global credit crunch and liquidity squeeze, and some of them virtually stopped lending. After October 2008, NBA relaxed monetary policy substantially, reducing the refinancing rate several times from 15% to 8% in December. It also halved its reserve requirement for banks from 12% to 6%, and canceled the 5% reserve requirement on domestic banks' foreign liabilities. NBA, as lender of last resort, announced an emergency facility for liquidity support for commercial banks. Also, to help ensure sustainability of the banking system, NBA tightened provisioning ratios and raised collateral requirements for loans from 120% to 150%. In addition, the Government introduced special tax waivers to encourage increased capitalization of banks and insurance companies.

The central bank in March 2008 introduced a new exchange rate arrangement that pegs the manat to a dollar–euro currency basket. This was an important measure intended to limit imported inflation and, as a step toward greater exchange rate flexibility, introduced two-sided exchange risk to the market. Given the significant changes in the dollar–euro rate during the year, the basket arrangement would have led to a sizable depreciation of the manat against the dollar, and was therefore temporarily suspended. During 2008, the manat appreciated by 4.2% against the dollar, but the real effective exchange rate appreciated by 12.9% because of Azerbaijan's higher inflation (Figure 3.2.4).

As in recent years, the Government ran an expansionary fiscal policy, induced by soaring oil revenue. With midyear budget revisions (an increase in revenue and expenditure of 41.8% and 29.8%), consolidated

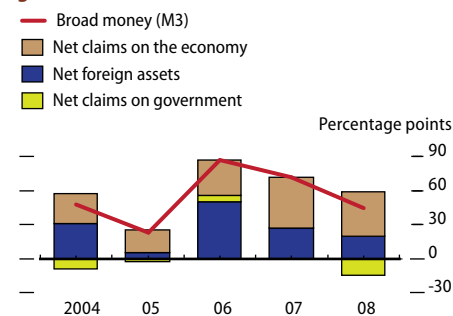
### 3.2.2 Inflation



Source: State Statistical Committee of the Republic of Azerbaijan.

[Click here for figure data](#)

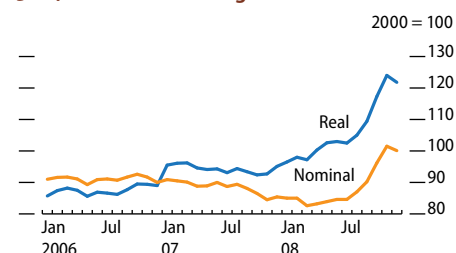
### 3.2.3 Factors affecting money supply (M<sub>3</sub>) growth



Source: National Bank of Azerbaijan, available: <http://www.nba.az>, downloaded 5 March 2009.

[Click here for figure data](#)

### 3.2.4 Effective exchange rates



Source: National Bank of Azerbaijan, available: <http://www.nba.az>, downloaded 5 March 2009.

[Click here for figure data](#)

expenditure jumped by 82.5%. The budget expansion was enabled by a steep rise in direct transfers from the State Oil Fund (SOFAZ). Government receipts were also boosted by the sale of state shares in the largest mobile operator and the smaller of the country's two state-owned banks.

On the expenditure side, capital spending (energy, irrigation, transport, and utilities) rose, as did recurrent spending, mainly because of increased salaries and social security payments. Defense remained the single largest expenditure category, accounting for 12.2% of total spending. The spending surge in 2008 pushed the state budget into deficit and stoked inflation pressures (Figure 3.2.5).

A substantial part of the Government's oil revenue was channeled to SOFAZ, the assets of which climbed by over 50% and stood at \$11.2 billion at end-2008. Accumulating part of oil revenue in SOFAZ helps reduce upward pressure on the exchange rate, reducing the potentially destabilizing effect of large foreign inflows. Part of the budget revenue from high oil prices has been saved in a special treasury account.

As in previous years, hydrocarbon flows dominated the balance of payments. The rise in oil production and exports and relatively high oil prices until midyear helped generate a current account surplus at year-end of an estimated \$22 billion, equivalent to 47.7% of 2008 GDP (Figure 3.2.6). The near doubling of the trade surplus (95.9%) was boosted by a surge in crude oil and gas exports, which together accounted for over 96% of exports. (Growth of non-oil exports rebounded on a recovery in petrochemical, metallurgical, and aluminum production.)

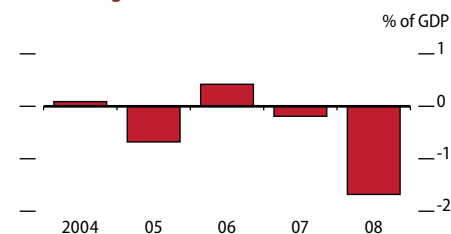
With the completion of major oil and gas exploration projects, the share of hydrocarbons in imports fell. However, overall import growth at 19.4% was driven mainly by increased public spending for infrastructure refurbishment, which required substantial imports of machinery and equipment. Gross international reserves, excluding SOFAZ assets, are estimated to have leaped from \$4.3 billion in 2007 to about \$6.5 billion at end-2008 (Figure 3.2.7). The overall public and publicly guaranteed debt burden was low, at less than 10% of GDP, reflecting the Government's conservative external borrowing policy.

According to the World Bank's *Doing Business 2009* report, Azerbaijan was one of the world's top reformers in streamlining business regulations, and improved in seven out of 10 areas, including introduction of a one-stop shop for business start-up, introduction of a unified property registry, and greater protection for minority shareholders. The tax authorities have also initiated substantial improvements of the department for large taxpayers, which is responsible for overseeing about 700 enterprises that provide over 90% of tax revenue. Progress in introducing an electronic tax payment and filing system was also made, which benefits medium-sized companies in particular.

## Economic prospects

Prospects are closely linked to oil prices. GDP growth is projected to fall to 8.0% and then to 6.7% over the forecast period, reflecting relatively modest expansion in the hydrocarbon sector and slowing growth in crude oil and natural gas exports. With foreign investments in the oil sector

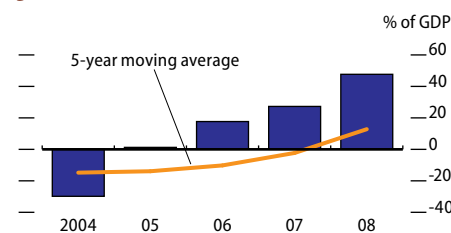
### 3.2.5 Budget balance



Source: National Bank of Azerbaijan, available: <http://www.nba.az>, downloaded 5 March 2009.

[Click here for figure data](#)

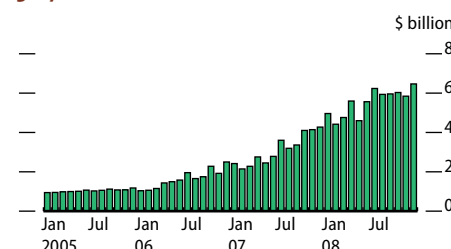
### 3.2.6 Current account balance



Sources: International Monetary Fund, *Country Report No. 08/216*, available: <http://www.imf.org/external/country/AZE/index.htm>, downloaded 5 March 2009; staff estimates.

[Click here for figure data](#)

### 3.2.7 Gross international reserves



Source: International Monetary Fund, *International Financial Statistics* online database, downloaded 5 March 2009.

[Click here for figure data](#)

declining, public investment will become the single largest source of GDP growth, accounting for about 60% of total investments. The expected expansion in the non-oil sector at 5–7% will come largely from services, especially transport.

The authorities recognize the uncertainties in global oil markets when making state budget revenue projections for 2009; their price assumption of \$70/barrel for 2009 would seem optimistic. Public spending growth is set to slow markedly to around 15% versus an average of 65% in the past 3 years. Lower oil prices will particularly affect revenue from corporate profit taxes, and slowing consumer spending and imports will weaken receipts from the value-added tax. Direct budget transfers from SOFAZ are budgeted to grow by 29.3% this year and account for about 40% of total state budget revenue. Continued substantial reliance on SOFAZ could lead to early depletion of its assets, which would of course jeopardize its savings function for future generations. The budget envisages a deficit of only 0.4% of GDP, though this is unlikely to be achieved.

Although the Government is keen to reduce fiscal spending in the medium term, in the 2009 budget it intends to lift capital investment moderately (including roads, and water supply and sanitation in secondary towns) and restructure expenditure in the social sector (it has pledged a 25% increase, mainly in health and education).

In late 2008, the authorities unveiled draft revisions to the tax code, including cuts in the profit tax (of 2 percentage points) and value-added tax (of 1 point). This is part of a stimulus package for developing the private sector, in particular non-oil industries, as part of the wider aim of strengthening national competitiveness.

Inflation is expected to moderate substantially to 12.0% in 2009 and to 7.0% in 2010, reflecting the substantial slowdown in government expenditure and tighter monetary policy. Some upward pressures on prices, however, will remain from budgeted increases in public salaries and social security payments.

Largely on lower oil prices, the current account surplus is expected to decline to 25.5% and 17.7% in 2009 and 2010. Exports are likely to fall by some two thirds in 2009, owing to sharply lower values (despite increased output) of hydrocarbons. The export of non-oil commodities (primarily agricultural products and metals) is forecast to grow strongly. Import growth is projected to slip, reflecting a slowdown in economic activity and a moderation of public investment growth.

#### 3.4.1 Selected economic indicators (%)

	2009	2010
GDP growth	8.0	6.7
Inflation	12.0	7.0
Current account balance (share of GDP)	25.5	17.7

Source: Staff estimates.