ECONOMIC ANALYSIS (SUMMARY)¹

1. Overview of Economic Performance

1. Azerbaijan has undergone significant economic transformation and development since the country’s independence in 1991. Azerbaijan’s diversified economy collapsed with the breakup of the Soviet Union, and by 1995 the gross domestic product (GDP) was only 37% of what it had been in 1989. However, despite a poverty rate of 49% as recently as 2001, Azerbaijan has quickly transformed itself into an upper middle-income country with a gross national income (GNI) per capita (Atlas method) of $7,350,² GDP per capita of $7,912.5 (2013), and a poverty rate of 5.0% in 2013.³

2. The rapid economic development is mainly attributed to the exploitation of hydrocarbon resources (through production sharing agreements with foreign oil companies and foreign direct investment). Substantial reforms intended to support a market-based economy have been instrumental in facilitating growth. However, the reliance on petroleum resources places the country at risk of volatility and raises concerns about long-term sustainability and macroeconomic stability. The sluggish growth rates in 2011 and 2012 showed the country’s vulnerability to relying on oil production. The near zero growth in 2011 was the lowest since 1995’s GDP contraction and was due to a decline in oil production. Given the long time it takes to establish a diversified, modern economy, Azerbaijan needs to make greater progress in the non-oil economy. With a reserve-production ratio of 21.9 in 2012, oil reserves will essentially be depleted by 2034.⁴

3. The contribution of hydrocarbons to GDP remains high, with about 50% of GDP, despite the government’s intentions to reduce the level. The government’s objective is articulated in key strategy documents such as Azerbaijan 2020: Look into the Future and the State Program on Poverty Reduction and Sustainable Development (SPPRSD), 2008–2015.⁵ Even leading industries in the non-oil economy are indirectly funded by the oil sector, such as construction and transport. Much of the private sector is reliant on government contracts from the public investments. The construction sector, in particular, has been a major beneficiary of public investments.

4. The key economic challenge, then, is to develop a diversified economy that has new and sustainable sources of growth, and one that becomes more competitive in the global and regional markets.

2. Government’s Economic Goals and Objectives

5. The government’s economic goals and objectives are expressed in two main programs and plans. The SPPRSD contains nine strategic goals, including macroeconomic stability and balanced development of the non-oil sector, and increasing income-generating opportunities.

¹ This summary is based on Economic Development in Azerbaijan (accessible from the list of linked documents in Appendix 2).
Azerbaijan 2020: Look Into the Future describes the aspiration of becoming a knowledge-based economy, increasing the country’s competitiveness, and diversifying the economic structure. The various programs and plans aim to achieve sustainable economic development, a diversified economy with a vibrant non-oil sector, global integration, and balanced development throughout the country.

6. To diversify the economy, the government intends to use the country’s oil revenue to finance infrastructure investments and to establish viable non-oil economic sectors. Given the limited oil reserves, which are expected to be essentially depleted by 2034, the government’s strategy is one of frontloading oil wealth into investments that will provide the foundation for sustainable non-oil sectors.6


a. Gross Domestic Product Growth

7. Rapid increases in oil production caused GDP growth to surge in 2006 and 2007, averaging 29.8% annual growth before dropping back to growth levels of about 10% seen in the early part of the decade. The vulnerability of the economy to oil production fluctuations was seen in 2011 and 2012, when annual GDP growth fell to 0.1% (2011) and 2.2% (2012), as a result of lower oil production (Figure 1).

8. The non-oil sector growth rates since the mid-2000s have been steadier than overall GDP growth rates, from nearly 8% to 10% from 2005 to 2013, with the exception of 2009 (only 3.7% growth). From 2010 to 2013, non-oil GDP growth was higher than oil GDP growth.

9. Oil constitutes nearly half of Azerbaijan’s GDP. Aside from mining and quarrying, which includes oil, the next largest sectors have typically been construction (7.2% of GDP) and transport, storage, and communication (8.8% of GDP). The composition of GDP by sector has shown little progress in diversifying away from petroleum. The oil boom clearly affected the

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structure of the economy. Agriculture was about 16.0% of GDP in 2000, but by 2013 it fell to only 5.3%.7

10. The private sector share of GDP is over 81%. However, much of the private sector's share of the economy is attributed to public expenditures and government contracts, which are financed mainly by the country’s petroleum export revenue.8

b. Inclusiveness of Economic Growth

11. Elements of inclusive growth have been seen in Azerbaijan since the mid-2000s. Inequality has declined since the oil boom, with the Gini index improving nearly 8% from 36.5 in 2001 to 33.7 in 2008 (latest data available). The mean income difference between cities and rural areas is fairly small, with a Gini index of 33 for urban areas and 27 for rural areas.9 The social protection system has been a major factor in contributing to poverty reduction and reducing inequality. The main pro-poor social transfer programs are pensions and the well-regarded Targeted Social Assistance program, with the latter accounting for about 10% of social transfers and covering about 4% of the population (footnote 9). About 81% of poor households and nearly 93% of households in the lowest income decile received at least one type of social transfer.10 The World Bank concluded that the poverty rate would have been about 25% in the absence of social transfers (footnote 10).

12. Other evidence found by the World Bank of inclusive economic growth include: (i) rural employment has risen despite a rise in rural labor force participation; (ii) the average pension has risen from 42% of the subsistence level to 95%; and (iii) growth has had a broad-based impact on household consumption in urban and rural areas, with growth in consumption expenditures having been pro-poor in rural areas and being nearly the same for almost all income deciles in urban areas (footnote 10).

13. However, despite the relatively high GNI per capita and GDP per capita, very few people have access to higher income jobs in the mining sector (oil), which generates only 1.1% of employment but accounts for over half of the GDP. The majority of the workforce is engaged in low productivity and low wage sectors. Agriculture, for instance, employs 38% of the workforce but comprises only 5.2% of GDP. Wages in agriculture were an average of €118 in 2009 compared with an average of €895 in the mining sector.11 Disparities are also seen across regions—Baku accounted for 78% of the value of goods produced in 2009 (footnote 11). Furthermore, the sustainability of the economic growth, the inclusiveness, and some of the factors that led to a substantial reduction in poverty (i.e., high levels of social transfers) are highly questionable because of the heavy reliance on oil revenue (footnote 11).

c. Inflation

14. Inflation, as measured by the consumer price index (CPI), has declined significantly from nearly 21.0% in 2008 to only 2.4% in 2013. Inflation since the mid-2000s has been driven by a combination of factors such as high oil prices, large fiscal stimulus, a stable exchange rate against the US dollar, monetary expansion, imported food prices, and rapid credit growth for

7 GDP composition in 2013 was agriculture 5.3%, industry 58.1%, services 30.2%, and taxes 6.4%.
households. The government has tolerated frequent high inflation as a short-term tradeoff against the perceived benefits of accelerated public expenditures and a stable exchange rate.

d. Fiscal Policy

15. The oil windfall led to a considerable rise in government expenditures, which were used to stimulate aggregate demand. The government’s expansionary fiscal policy accelerated rapidly in 2007 and 2008, with expenditures rising 181% over 2006. Expenditures have increased since 2008 from AZN10.77 billion to AZN19.1 billion in 2013. Surging oil revenues enabled the government to embark on ambitious public investment programs along with increasing wages and social transfers.

16. The government’s large public investment program since 2006 has been accompanied by frequent periods of high inflation, low non-oil private investment, and low non-oil foreign direct investment (FDI). The fiscal expansion crowded out non-oil private investment, which dropped by over 50% as a percentage of GDP from 2005 to 2008.

17. The large annual increases in budget expenditures since 2005 have been made possible by substantial transfers from the State Oil Fund of Azerbaijan (SOFAZ). SOFAZ was established in 1999 to “ensure the accumulation, effective management, and use of income… related to oil and gas… for the benefit of citizens and future generations…” The fund is held overseas, which helps to sterilize export revenue and limit inflation.

18. The state budget has become highly dependent on transfers from SOFAZ (Figure 2). In 2007, SOFAZ transfers of AZN585 million constituted only 9.7% of total state budget revenues. From 2008 to 2013, SOFAZ transfers as a percentage of the total state budget revenues rose sharply from 35% to 58%. In 2013, AZN11.35 billion were transferred from SOFAZ to the state budget, rising nearly 92% from the amount transferred in 2010.

19. The rapid rise in SOFAZ transfers to the budget is a cause for concern on three fronts. First, it shows the government’s spending is becoming increasingly dependent (at least in the short to medium term) on oil revenue as opposed to generating higher levels of other sources of...
revenue such as taxes. Second, by linking its fiscal policy to the global oil price cycle, the government runs the risk of exposing the economy to volatility. \textsuperscript{13} Third, it reveals that the government is opting to spend high levels of the oil revenue now instead of conserving the SOFAZ revenues for future generations, which was one of the key objectives in the establishment of SOFAZ. With a window of less than 20 years in which to extract the petroleum resources before they are essentially depleted, the government must quickly develop a broader revenue base.

20. Overall government revenues have nearly mirrored total expenditures as a percentage of GDP. Both revenues and expenditures as a percentage of GDP have risen from about 15\% in 2001 to 33\%–35\% in 2013. The state budget has experienced small surpluses or deficits of about 1\% or less of GDP since 2001. However, without SOFAZ transfers, the budget deficit would be substantial and growing each year (Figure 3). In 2013, the budget deficit would have been AZN10.9 billion without SOFAZ transfers compared with only AZN493 million in 2006. For 2014, policy measures have been adopted to reduce budget dependency on oil incomes. Despite an increase in budget expenditures, transfers from SOFAZ in 2014 are reduced by AZN2.0 billion compared with 2013.

\begin{figure}[h]
\centering
\includegraphics[width=\textwidth]{budget_balance.png}
\caption{Budget Balance with and without State Oil Fund of Azerbaijan (SOFAZ) Transfers, 2006–2013}
\end{figure}

\textbf{e. Monetary Policy}

21. Azerbaijan’s monetary policy focuses on maintaining a stable exchange rate. The Central Bank of Azerbaijan (CBA) has limited monetary tools at its disposal because of the underdevelopment of the domestic debt market. The emphasis on exchange rate stability has led to periodic inflation volatility because the CBA has pursued an expansionary monetary policy to accommodate the rising demand for Azerbaijan manats as a result of currency appreciation against the US dollar since 2006. The central bank authorities agreed in principle with the International Monetary Fund (IMF) to allow greater exchange rate flexibility and move toward an interest rate-based monetary policy framework, but so far progress has been limited. \textsuperscript{14}

22. Broad money (M2) increased an unprecedented 168\% in 2006 over 2005, signaling the start of a large expansion in the money supply. M2 expanded 546\% from 2006 to 2012. \textsuperscript{15}

\begin{itemize}
\item \textsuperscript{14} IMF. 2012. Republic of Azerbaijan—Aide Memoire of Staff Visit. Washington, DC.
\item \textsuperscript{15} Central Bank of Azerbaijan. http://www.cbar.az
\end{itemize}
f. Exchange Rate

23. The Azerbaijan manat has appreciated every year since the 2006 revaluation. Starting from $1 = AZN0.893 (nominal rate period average) in 2006, the Azerbaijan manat strengthened to 0.784 in 2013. Much of the appreciation has been caused by the large influx of foreign currencies during the oil boom years. Following the global economic crisis of 2008 and 2009, the real effective exchange rate appreciated as a result of oil-related pressures such as (i) SOFAZ transfers to the treasury, (ii) foreign oil firms’ taxes on profits paid in US dollars, and (iii) State Oil Company of Azerbaijan (SOCAR) foreign currency revenues (footnote 13).

24. The real effective exchange rate appreciation could affect Azerbaijan’s competitiveness and its ability to export goods besides hydrocarbons. The exchange rate appreciation also makes it more difficult for Azerbaijan to diversify into agriculture and manufacturing exports. To increase competitiveness in light of the currency appreciation, Azerbaijan will need to boost productivity. Public investment can help in this regard but only in the short run.

g. Balance of Payments

25. The surge of hydrocarbon exports in the mid-2000s transformed Azerbaijan’s previously perpetual negative current account balance (CAB) from the 1990s to 2004 into large surpluses from the second half of the 2000s onward. The CAB peaked at nearly 34.0% of GDP in 2008, but stood at 16.8% of GDP in 2013.

26. The large CAB surpluses have been generated by strong exports since 2006, overwhelmingly for hydrocarbons. Oil and gas exports comprised an average of 94.7% of total exports from 2006 to 2012 (based on CBA data), and amounted to $30.7 billion in 2012. While total exports increased by 327% from 2005 to 2012, imports increased 139% and stood at $10.4 billion in 2012. Azerbaijan has registered a trade surplus every year since 2004. In 2012, the trade surplus was $22.2 billion.

27. Azerbaijan continues to accumulate large amounts of international reserves. A vast increase occurred in 2011, in which gross official international reserves grew 60% over 2010 to nearly $10.3 billion. Subsequently, reserves reached $14 billion in 2013. In addition to the reserves held by the central bank, Azerbaijan has $35.87 billion accumulated in SOFAZ. The combination of gross official international reserves and SOFAZ funds amounted to 68% of GDP in 2013.16

28. Azerbaijan’s public and publicly guaranteed external debt outstanding is growing gradually, estimated from over $7.0 billion annually in 2009–2011 to $9.2 billion in 2012, but this level is sustainable in the short to medium term given the high export earnings from oil. The debt level has remained low because of the oil boom since the mid-2000s and the government’s decision to use oil revenues to finance investment projects and social spending.

4. Economic Prospects

29. In the short run, GDP is expected to grow 5.2% in 2014 and 5.8% in 2015, driven by continued expansion of the non-oil sector and slight increases in oil production. However, oil production will probably have plateaued by 2015 and could decline thereafter. In April 2012, the

16 Author’s calculations based on CBA and SOFAZ data.
State Statistical Committee and SOCAR announced the government’s intention to prolong the duration of oil production and reserves by reducing extraction rates.\textsuperscript{17} Lower production levels in the near future would restrain economic growth and adversely affect government revenue and expenditures. Non-oil economic growth will continue to be driven by public sector investments, which are dependent on oil revenue.

30. With resumed growth in the economy and the non-oil economy likely having reached its output capacity in 2012–2013, inflation is expected to rise to 3.5% in 2014 and 3.8% in 2015. Increasing public investments, salary increases, a fuel price hike (from late 2013), and greater allocations to social spending will likely be the drivers behind the inflation.

31. While the near-term growth prospects are favorable, the long-term prospects are a concern. Azerbaijan has been pursuing a strategy that involves short-term maximization of oil revenues to obtain the necessary revenue for state expenditures. Some 58% of the budget expenditures are made up of SOFAZ transfers. This strategy of present consumption of oil funds has clearly benefited the country’s population in the short run, with a remarkable reduction in poverty, higher living standards, and higher wages since the mid-1990s. Yet this resource dependence has a finite span, so Azerbaijan must make greater strides toward a non-oil economy. Azerbaijan has an estimated 7 billion barrels (or 1 billion tons) of oil reserves. Its reserve-production ratio is only 21.9 years, which is considerably lower than the world average of 52.9 years.\textsuperscript{18} Hence, Azerbaijan faces a difficult challenge in managing its oil resources and revenues for future generations, while spending on the infrastructure needed to support diversification of the economy that would enable long-term, sustainable economic development.

32. The government’s current levels of annual increases in public expenditures—both in nominal terms and as a percentage of GDP—are not sustainable because they rely on significant transfers from SOFAZ to the state budget. Given the limitations of the oil sector’s lifespan and the possibility of lower fiscal revenue in the near to medium term, the government may need to moderate its expenditures in the short and medium term to become more fiscally sustainable. Reducing the dependency of the budget on oil revenues has been a priority for the government. SOFAZ transfers are mainly used to finance large-scale projects, and the completion of such projects will help reduce transfers from SOFAZ.

33. Private sector investment as a percentage of GDP declined from 2007 to 2012, from 11.8% of GDP to 6.7%, while consolidated government investment as a percentage of GDP grew 81% over that period and accounted for 70% of Azerbaijan’s gross investment in 2011.\textsuperscript{19} Private sector investment needs to increase, but this likely requires overcoming the key obstacles in the business environment that constrain the private sector. Among the main constraints are (i) limited access to finance and an underdeveloped financial system,\textsuperscript{20} (ii) monopolies that dominate most business sectors and hinder competition, (iii) high levels of corruption, (iv) poor infrastructure, and (v) a lack of skilled labor.

\textsuperscript{20}For example, total financial sector assets represent just 31% of GDP. In addition, compared with other Central Asian countries, Azerbaijan ranks low in several indicators such as outstanding loans and deposits from commercial banks (as a percentage of GDP) and depositors with commercial banks per 1,000 adults.