Azerbaijan

Strong performance in the oil and gas sector, despite lower international prices, and a countercyclical policy helped sustain buoyant growth in 2009. Transfers from the State Oil Fund propped up public investment, while the authorities eased monetary policy aggressively. High growth is expected to be maintained in 2010 as oil prices climb and as public investment expands. Over the long term, the economy is challenged by its excessive dependence on oil and its low level of diversification. Measures are needed to transform the industry sector and to boost productivity in agriculture.

Economic performance

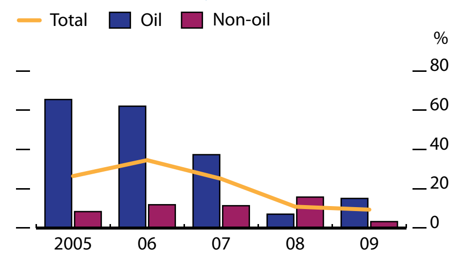
Despite the global financial crisis and fall in international oil prices from their 2008 highs, growth slipped only a little to 9.3% in 2009, from 10.8% in 2008. Helped by higher oil prices in the second half of 2009 and by increased production of hydrocarbons from the Caspian Sea, the oil and gas sector (constituting 55% of GDP and 95% of total export revenue) remained the major driver of growth (Figure 3.2.1). At 370 million barrels, oil production was higher than in 2008, as technical difficulties in a major oil field were overcome (Figure 3.2.2). Accommodative fiscal and monetary policies also worked to counter the impact of the global slowdown.

Construction, though helped by higher public investment, decelerated from 2008 as private demand for housing was damped by uncertain market conditions and lack of confidence in real estate. Mainly due to the slowdown of trade and transport, services growth declined (from 14.0%) but was still a robust 9.1% in 2009. Dynamism in information technology–related services, though still a relatively small area, helped sustain growth in services.

Agricultural growth fell by almost half to 3.5% in 2009 on account of expensive inputs, low credit availability, and water shortages in rainfed agriculture areas—most farmers continued to focus on subsistence wheat production. Overall, non-oil GDP growth at 3.2% of GDP in 2009 was much lower than its 15.7% growth in 2008, as activity was depressed by an uncertain economic outlook that restrained domestic demand and curtailed exports.

On the demand side, higher public investment, which rose to 21% of GDP in 2009, supported growth, reflecting government moves to counter the impact of the global crisis. That impact was, however, seen in falling private sector investment, which came down to only 6% of GDP in 2009. Lower prices constrained investment in the oil sector, which consequently accounted for a smaller proportion of total investment in 2009 than it did in 2008.

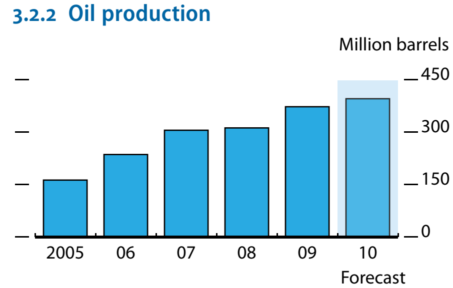
3.2.1 GDP growth by sector



Sources: Central Bank of Azerbaijan. 2009. *Statistical Bulletin*. No. 119. January; State Statistical Committee of the Republic of Azerbaijan. http://www.azstat.org

Click here for figure data

3.2.2 Oil production



Sources: State Statistical Committee of the Republic of Azerbaijan. http://www.azstat.org (accessed 22 March 2010); ADB estimates.

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This chapter was written by Nail Valiyev of the Azerbaijan Resident Mission, ADB, Baku; and Safdar Parvez of the Pakistan Resident Mission, ADB, Islamabad.

Higher public investment was partly financed by the State Oil Fund (SOFAZ), to which a large part of the government's oil receipts are channeled. SOFAZ has become an important source of financing for important socioeconomic and investment projects. It focuses on financing contractual agreements with production-sharing companies and with the State Oil Company of Azerbaijan for operating and developing oil and gas basins. The overall aim is to reduce year-to-year variation in oil revenues and act as a wealth fund that supports long-term economic growth. SOFAZ's assets climbed by 32.8% in 2009 and stood at $14.9 billion (Figure 3.2.3).

Transfers from SOFAZ constituted 47.6% of total state revenue in 2009, up from 35.3% in 2008, as the government used them to finance its accommodative fiscal policy. The share of such transfers in total revenue has been growing since 2006. The budget deficit amounted to AZN242 million (0.7% of GDP). However, excluding SOFAZ transfers, the government ran a fiscal deficit of AZN5.1 billion in 2009 (14.8% of GDP), compared to an AZN3.8 billion (9.5% of GDP) deficit in 2008.

This dependence on SOFAZ points clearly to the need for generating more tax and nontax revenue. The tax-to-GDP ratio of around 15% is low and can be further scaled up. The budget deficit in these circumstances is currently being heavily financed by SOFAZ transfers, although the government intends also to use proceeds of privatization of state assets and domestic borrowing to finance part of the deficit in 2010.

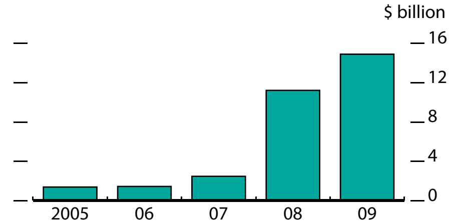
With falling international commodity prices, the consumer price index rose by only 1.5% in 2009, versus 20.8% in 2008 (Figure 3.2.4). The Central Bank of Azerbaijan's heavy market intervention maintained a stable exchange rate to the dollar in 2009 (at AZN0.8/$1), preventing a depreciation that would have caused inflation pressure and raised debt-servicing costs for businesses that have sizable foreign-currency loans. Stable civil service salaries and economic uncertainty helped bring down inflation pressure from the demand side.

Falling inflation allowed the central bank to relax monetary policy through phased but steep reductions in the refinancing rate, which ultimately fell to only 2% in 2009 from a high of 15% in 2008. In addition, the central bank markedly lowered banking sector reserve requirements to 0.5% in March 2009 from 12%. With greater liquidity, commercial banks' ability to lend was strengthened and they reduced lending rates. The central bank received new authority to provide long-term loans in different currencies, as well as subordinated loans. It also provided additional special financing support to banks and private companies.

These measures, as well as new tools employed by the central bank, such as swap operations and repurchase of mortgage notes, helped create additional liquidity and were an important countercyclical response from the monetary side. Domestic assets consequently increased by about 23% in 2009 though the broad money supply stagnated as net foreign assets fell (Figure 3.2.5).

Banking sector resilience grew as a result of monetary policy measures of the central bank. Despite slow growth, banks maintained strong loan portfolios, and the proportion of overdue loans was kept in check, at 4.5% of the total.

3.2.3 SOFAZ assets



Source: State Oil Fund of the Republic of Azerbaijan. *Annual Report*. Various issues. http://www.oilfund.az

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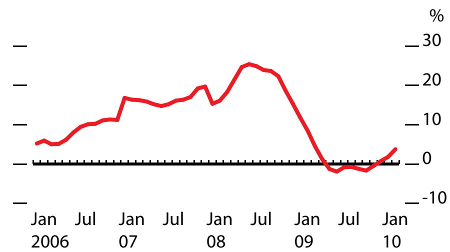
3.2.4 Inflation



Source: International Monetary Fund. International Financial Statistics online database (accessed 22 March 2010).

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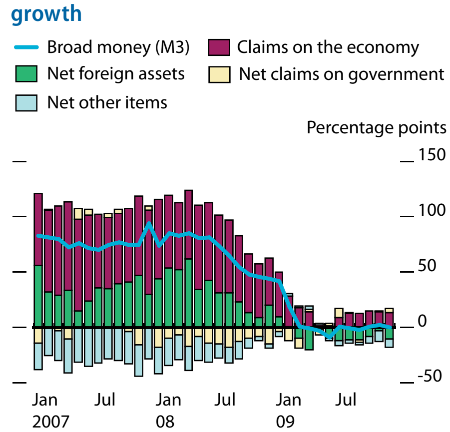
3.2.5 Contributions to money supply (M3) growth



Source: International Monetary Fund. International Financial Statistics online database (accessed 29 March 2010).

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3.2.1 Selected economic indicators (%)

	2010	2011
GDP growth	9.5	9.7
Inflation	5.8	6.0
Current account balance (share of GDP)	23.0	21.7

Source: ADB estimates.

As oil export income fell due to sliding international prices, the trade account is estimated to have posted a surplus of only $14.6 billion, down from $23.0 billion in 2008. This drop was mitigated by an estimated $1.1 billion fall in imports, largely because of lower food prices and a decline in oil companies' demand for investment machinery.

The lower trade surplus was offset to an extent by a sharp fall in net oil and gas factor income payments, helping reduce estimated net payments for services, income, and transfers by about one-third to $4.4 billion. Still, the current account surplus at $10.2 billion was much less than the $16.5 billion earned in 2008, falling as a share of GDP to 23.6% from 33.7%.

Gross international reserves contracted by $1.1 billion to $5.4 billion at end-December 2009. This decline, in a context of a current account surplus, reflected a buildup in SOFAZ investment assets abroad.

External debt rose slightly to $3.4 billion (8.8% of GDP) in 2009 from $3.0 billion a year earlier. Azerbaijan's debt at these levels remains low and there are no major risks to debt servicing in view of the $14.9 billion SOFAZ sovereign fund and the $5.4 billion in foreign reserves.

Economic prospects

Growth prospects hinge on oil. As oil prices rise in 2010 and as production levels increase, GDP is projected to accelerate a shade to 9.5%. Higher oil revenue through increased SOFAZ transfers in 2010 (for a total of AZN4.9 billion, or $6.1 billion) will also enable greater public investment that will sustain growth at this higher level. At the same time, cuts in corporate profit and personal income taxes should help boost domestic demand. Ample liquidity and a likely continued expansionary monetary policy will permit commercial banks to expand their lending and lower lending rates to the private sector.

Agriculture is expected to be more robust as various public investment projects are completed. Communication and transport sectors will also continue to contribute to growth. With oil prices set to rise further next year, GDP growth will edge up to 9.7%.

The focus of monetary policy in 2010 remains on keeping inflation low. The central bank currently projects inflation at 3%. However, rising commodity and food prices and higher public investment and demand fueled by oil revenue, along with the current relatively liberal monetary policy environment, suggest that estimates of 5.8% (and about 6.0% in 2011) mark a more likely outcome. However, the likely appreciation of the local currency on higher oil revenues this year could complicate monetary policy if the central bank needs to intervene in the market to keep a lid on appreciation.

The external account is expected to remain strong on higher oil export receipts with the current account surplus projected at 23.0% of GDP before easing to 21.7% next year (as stronger GDP growth sucks in imports). The recovery of the global economy will boost non-oil exports, too, while the upturn in the Russian economy will support higher workers' remittances. The larger current account surplus, along with larger transfers from SOFAZ, will preclude the need for net foreign borrowing. External debt is projected to fall over the forecast period.

3.2.1 Development challenges

Excessive dependence on oil is the Achilles' heel of this economy. Forceful moves to diversify are required for strengthening services and the non-oil industry subsector, for raising agricultural productivity (building on the budgetary allocations for irrigation), and for developing fisheries and livestock.

The fact that the country ranks number two among the Central Asian republics and 38 among 138 countries worldwide on the World Bank's *Doing Business 2010* report suggests that the relatively sound business environment offers a springboard from which to catalyze growth and innovation in the non-oil economy.

A linked challenge is to diversify sources of government income to provide for stable public spending during downturns in international oil prices. To a degree, SOFAZ receipts help the government smoothen public spending over oil-price peaks and troughs, but more widely, revenues need to be boosted and the tax-to-GDP ratio raised to provide for sustainable public finances. An already planned measure in this regard, which needs to be fully implemented, includes the online submission of value-added tax invoices.

Finally, electricity supply has to be improved and expanded. Greater investment in the sector is critically needed.