Azerbaijan

The boom in production and exports of oil and gas is seeing few signs of ending: operations at large new investments began in 2007, and are expected to reach their peak in the next few years. Earnings from hydrocarbons have led to a large current account surplus and strong currency appreciation in real terms. Significant fiscal loosening in 2007 fueled domestic demand and inflation, as the central bank lacked adequate instruments for controlling monetary expansion. A key policy aim in the medium term is to diversify the economy, and reduce its heavy dependence on oil and gas.

Economic performance

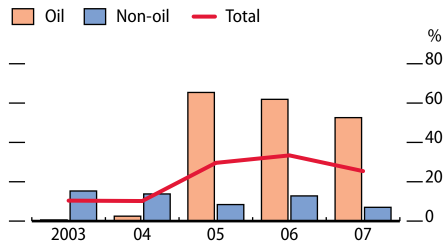
At 25.4% in 2007, GDP growth was underpinned by surging crude oil production and exports, which leaped by 31.5% and 39.1%, respectively. This performance was due to increased production at the Azeri-Chiraq-Guneshi offshore oil field operated by the Azerbaijan International Operating Company, the largest exporter and accounting for over 90% of total crude oil exports. Oil from that field is exported to Western markets through the Baku-Tbilisi-Ceyhan pipeline. Oil production is expected to reach 1 million barrels a day this year. Natural gas production increased by over 70% in 2007 as production at the Shah-Deniz offshore block came on stream.

Services and construction also expanded rapidly. Growth in services at 25.1% was bolstered by the expansion of communications and transport. Services' robust growth was also helped by comprehensive tariff adjustments and policies to expand private sector services in rural areas. Reforms in customs and tax administration have increased the transit of goods (including crude oil) through Azerbaijan. Construction, predominantly residential, grew by 19%, due to substantial improvements in regulations and licensing. These changes included the simplification of regulation procedures and unification of technical requirements in construction.

Despite the strong expansion, the growth rate of non-oil GDP continued its post-2003 decline, showing symptoms of "Dutch disease" (Figure 3.2.1). Agriculture—the largest employer, accounting for nearly 40% of total employment—has in particular been hard hit by the real appreciation of the manat, which has stimulated imports of agricultural commodities from neighboring countries. The sector contracted by 1.7% in spite of administrative attempts at support, including subsidies and concessional loans to farmers.

Foreign direct investment, particularly by international oil and gas companies, has been the main driver of heady investment in the past decade. However, it declined by 28.9% or about $1.3 billion in 2007, with the completion of several significant oil and gas exploration projects

3.2.1 GDP growth by sector



Sources: International Monetary Fund, *Regional Economic Outlook*, Middle East and Central Asia, October 2007; *Asian Development Outlook* database; staff estimates.

Click here for figure data

This chapter was written by Rafael Abbasov of the Azerbaijan Resident Mission, ADB, Baku; and Norio Usui of the Central and West Asia Department, ADB, Manila.

(Figure 3.2.2). A further decline in foreign direct investment is expected over the next 5 years. In 2007, domestic investment (mainly public) balanced the decline in foreign investment, to account for over 53% of the total.

Public investment focused on social sectors and improvement of public utilities. These investments were aligned with the state program on socioeconomic development of the regions and with the national employment strategy. Compared with public investment, growth in domestic private investment was modest. However, the Government consolidated efforts to strengthen the non-oil sector by improving the investment climate. While most reform efforts were more procedural than structural, the authorities achieved solid progress in easing business registration generally and that of small and medium enterprises (SMEs) particularly. The authorities reformed SMEs' registration procedures by introducing a "single window." It is also expected that a unified set of licensing requirements will be designed and that market-entrance requirements, especially for SMEs, will be eased.

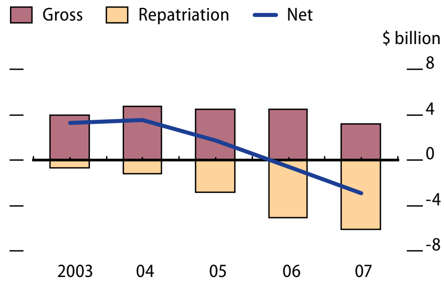
Another significant change was a decline in the average cost and time for opening a new business, from over 50 days in 2006 to less than 30 in 2007. The Government also established the Azerbaijan Investment Company with an initial capital of about $100 million as a public equity fund to invest in private non-oil companies.

Continued strong foreign currency inflows from oil and gas exports put additional pressure on inflation. Despite sterilization efforts by the National Bank of Azerbaijan (NBA), money supply (M3) rose by about 71.6% in 2007 (Figure 3.2.3). The manat appreciated by about 5% against the United States dollar in nominal terms. A stronger local currency could potentially help alleviate the upward pressure on consumer prices, but the authorities are reluctant to allow further appreciation to avoid harming the non-oil tradable sectors. However, due to higher inflation than in major trading partners, the real effective exchange rate has appreciated by over 20% since end-2004 (Figure 3.2.4). In a parallel move to tighten, NBA also introduced an interest rate corridor of 5–19% for centralized lending operations, and lifted the discount rate by 350 basis points to 13% during 2007.

The central bank's primary objective is price stability, yet it is heavily constrained by the fiscal dominance of monetary policy: it has to buy foreign currency from the Government, which uses oil revenues to finance its expansionary fiscal policy. In 2007, NBA intervened in the foreign exchange market in an effort to maintain a competitive real exchange rate. With a limited capacity to sterilize its purchases, it could not effectively control the monetary base and the expansion in the money supply. As part of structural measures, limits on capital outflows have been liberalized.

The inflation rate doubled from an average of 8.0% in 2002–2006 to 16.7% in 2007. A big jump in consumer inflation was recorded in January 2007 (Figure 3.2.5) when the Government raised public utility tariffs (water supply and sanitation, electricity, and gasoline). The acceleration in consumer prices after October 2007 was attributable to a steep rise in imported commodity prices, in particular wheat, because wheat-related products weigh heavily in the consumption basket and because about half the grain consumed is imported. At year-end, prices were 20.0% higher

3.2.2 Foreign direct investment



Note: Data for 2007 are for January to September.

Source: National Bank of Azerbaijan, available: http://www.nba.az, downloaded 7 March 2008.

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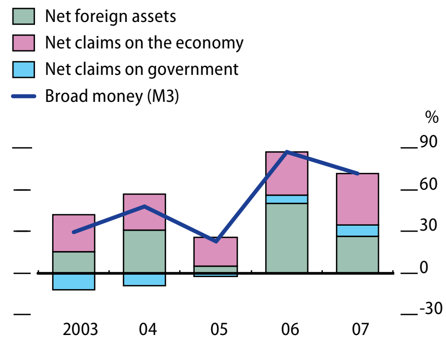
3.2.3 Factors affecting money supply (M3) growth



Source: National Bank of Azerbaijan, available: http://www.nba.az, downloaded 5 March 2008.

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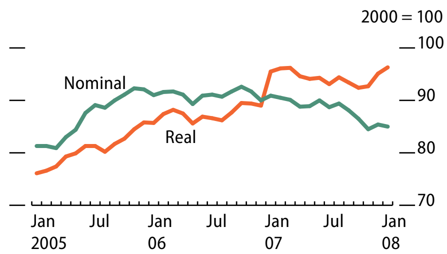
3.2.4 Effective exchange rates



Source: National Bank of Azerbaijan, available: http://www.nba.az, downloaded 5 March 2008.

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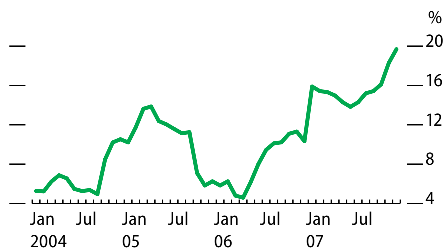
3.2.5 Monthly inflation



Source: State Statistical Committee of Azerbaijan.

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than a year earlier. Although the value-added tax and import duties on agricultural products have been lowered, imports are still hampered by insufficient customs facilities and delays in clearance.

Inflation was also fueled by a surge in government expenditures (including wages and other compensations, and social transfers). In 2007, the total public sector wage bill, for example, soared by over 60%.

With a presidential election to be held in October this year, the authorities will probably attempt to use administrative tools, such as price ceilings on key commodities, to avoid further price rises. Controls may be effective at least in the short term, but in the longer term the Government will have to consider their possible impact on agricultural production.

The increases in global oil prices and in the export volume of hydrocarbons resulted in a current account surplus estimated at $8.0 billion, equivalent to 27% of GDP in 2007 (Figure 3.2.6). According to preliminary data, the trade surplus rose by over 30%, driven by crude oil exports, which account for about 90% of the total. Gross international reserves, excluding gold, increased from $2.5 billion at end-2006 to $4.3 billion at end-2007 (Figure 3.2.7).

With some $2 billion in assets, the State Oil Fund of Azerbaijan (SOFAZ) is a key institution for the management of oil wealth. It derives its revenues primarily from oil sales, income from oil transport, bonuses paid by foreign oil companies, the excess between market and projected oil prices, and income from financial investments. In addition to making direct transfers to the state budget, SOFAZ also spends directly on major infrastructure projects and gives assistance to internally displaced people. These expenditures are in line with the annual consolidated budget approved by Parliament.

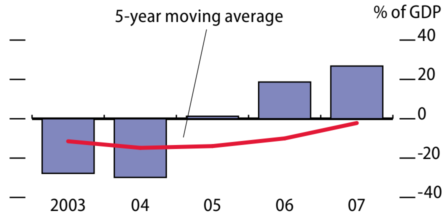
The external debt burden remained moderate, with the end-of-year stock of public and publicly guaranteed debt standing at $2.2 billion, equivalent to about 12% of GDP.

As in previous years, the Government ran an expansionary fiscal policy backed by soaring oil revenues. As a result of a midyear revision to the state budget, consolidated expenditures were increased by over 80%. Revenues and grants amounted to over 30% of GDP, with corporate income tax and value-added tax the main sources of funds. Government spending reached 35% of GDP, lifted in part by increases in public sector wages, pensions, and infrastructure development. The overall deficit came in at 2.1% of GDP (Figure 3.2.8).

Among banking sector reforms, the minimum capital requirement was raised to $11 million (to increase capitalization and induce further bank consolidation), and some components of the Basel II principles were enforced. The Government also privatized the second-largest state-owned bank—Kapital Bank—and passed a new law on deposit insurance. It also took measures to curtail implicit energy subsidies, including the increase in utility prices in January 2007. This led to a reduction in energy subsidies from 21% of non-oil GDP in 2006 to an estimated 11% in 2007. In 2008, it is expected that state energy subsidies will decline to single-digit levels. In addition, the authorities have substantially improved the collection of utility payments from around 40% to 90% of billings.

About 20 state-owned enterprises out of more than 50 have already adopted International Financial Reporting Standards. It is expected

3.2.6 Current account balance



Sources: National Bank of Azerbaijan; staff estimates.

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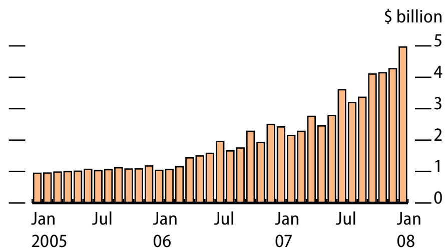
3.2.7 Gross international reserves



Source: International Monetary Fund, *International Financial Statistics* online database, downloaded 5 March 2008.

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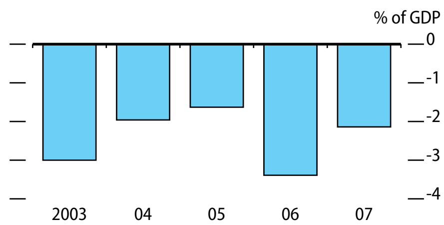
3.2.8 Budget balance



Sources: Asian Development Outlook database; State Statistical Committee of Azerbaijan.

Click here for figure data

that in 2008 the largest state-owned enterprises, including the State Oil Company of Azerbaijan and Azerenergy (the state electricity company) will introduce these standards.

Economic prospects

The economic outlook for 2008 and 2009 remains positive and GDP growth rates are projected at 15.7% and 18.0% (Figure 3.2.9), reflecting a moderate increase in hydrocarbon production and exports. Crude oil and natural gas production, respectively, are projected to rise by an average of 21% and 26% in the forecast period. While FDI inflows into the sector will gradually decline, domestic investment, largely public, will increase by 8% over the forecast period, supporting growth. Expansion in the non-oil sector, including agriculture, is expected to remain at about 9%. Since GDP growth will be concentrated in capital-intensive sectors, a sharp drop in unemployment is unlikely, although average nominal wages are expected to continue rising.

In late 2007, Parliament approved the state budget for 2008. While high oil prices and increasing hydrocarbon export volumes are the main contributor to growth in the state budget revenues (28.1% of the total), higher tax receipts and customs fees will be the predominant source of government revenues (over 80%) in 2008. It is expected that over 54% of tax revenues will be collected from oil-related industries. SOFAZ will become the second-largest source of government funding, accounting for about 15% of the total. State spending is set to increase by 34.9% to 27.0% of GDP. In the medium term, the Government is keen to reduce fiscal spending to a level consistent with a sustainable expenditure framework that takes into account the long-term oil revenue profile.

Inflation will remain in double digits, given the expansionary fiscal policy. To help keep it in check, NBA will likely make further increases in the refinancing rate, expand open-market operations, and raise commercial banks' reserve requirements for external borrowing in order to limit this source of capital inflows. It will continue to face conflicting pressures in conducting monetary policy, given its limited tools, and the undeveloped local financial and capital markets. Higher inflation than in major trading partners risks weakening non-oil export competitiveness.

Continuing growth in oil export volumes in 2008–2009, in conjunction with high global oil prices, will keep the current account running a large surplus of 38–40% of GDP. Growth in spending on imports of capital goods will gradually decelerate, as government investments slow and as hydrocarbon projects are completed. However, an appreciating currency and rising wages will boost spending on imported consumer goods and luxuries. The large medium-term trade balance will offset a negative income balance resulting from the repatriation of profits by foreign oil investors.

Development challenges

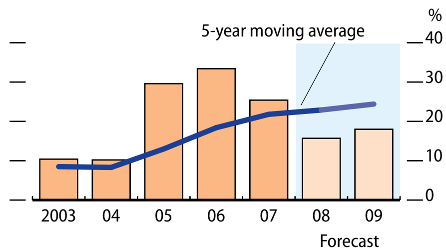
The main challenge for the Government is to maintain macroeconomic stability in an oil-related boom. Growth in public expenditures and robust development in infrastructure in the next couple of years

3.2.1 Selected economic indicators

	2008	2009
GDP growth	15.7	18.0
Inflation	13.0	12.0
Current account balance (% of GDP)	38.0	40.0

Source: Staff estimates.

3.2.9 GDP growth



Sources: State Statistical Committee of Azerbaijan; staff estimates.

Click here for figure data

will increase pressures on inflation and the exchange rate. Further easing business regulations and improving the investment climate are necessary to strengthen the comparative advantage of the non-oil sector, particularly in telecommunications, agriculture, and food processing.

The Government has already taken some steps to diversify the non-oil economy, but needs to accelerate the process. It faces several policy issues, and in response may have to take steps along the following lines. First, it should develop a national strategy for economic diversification, based on an analysis of the country's comparative advantage and development priorities. In particular, decisions to develop any new sectors or industries should take into account financial affordability and economic viability to ensure maximum development impact.

Second, it needs to adopt special policies for developing the non-oil sector that have been identified as priorities by the national strategy. Public investment should be carefully administered, and private investment, both domestic and foreign, attracted through favorable market incentives. These should include simplified business regulations and taxation procedures for start-up companies, and security of property and contract rights.

Third, the Government needs to promote processed products in resource-based sectors (such as petrochemicals and agroprocessing), which are less affected by world price fluctuations and which have greater value added than the basic resources themselves. The country is in a good position to expand output of processed products because of its rich natural resources and its relatively high level of human capital.

Lastly, since regional cooperation is a prerequisite for long-term economic sustainability, it needs to boost intraregional ties. It is expected that a new road connecting Azerbaijan and Turkey via Georgia, which opened last year, will greatly enhance regional cooperation and trade by providing an alternative corridor to those through the Islamic Republic of Iran and the Russian Federation.