

Azerbaijan

Phenomenal economic growth was recorded in 2006, powered by soaring production and exports of oil and gas. Foreign investment, primarily for hydrocarbons, is beginning to taper off as large projects in the sector become operational. The Government is bullish that much higher domestic public investment, especially non-oil, will partly offset this decline. Yet rapid and deep structural reform is imperative for such investment and—along with controlling inflation and preventing excessive exchange rate appreciation—is the key challenge.

Economic performance

GDP leaped by 32% in 2006 (Figure 2.2.1). The oil and gas sector, accounting for about 54% of GDP (a sizable rise from 42% in 2005), was the key contributor to the acceleration, as production and volume of exports surged by 48% and 60%, respectively. This was mainly due to a production upsurge at the Azeri-Chirag-Guneshi (ACG) oil fields, operated by the Azerbaijan International Operating Company (AIOC). The Baku-Tbilisi-Ceyhan (BTC) oil pipeline, which can transport up to 1 million barrels a day, was formally inaugurated in July. This pipeline greatly increased oil transportation capacity from the ACG fields to international markets—AIOC increased its oil production by 88% in 2006.

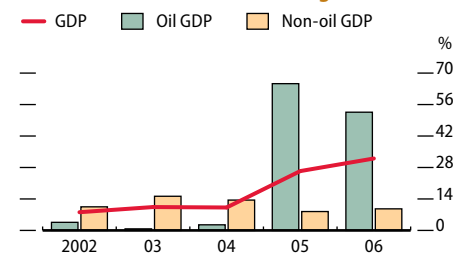
The huge growth in oil and gas completely dwarfed modest non-oil growth, and hydrocarbons' share of GDP is expected to rise further. Still, services grew respectably, at 12.6%, with communications and transport the main contributors. The former increased by 24% due mainly to tariff reforms and rapid expansion of services in the regions; the latter rose by 16%, predominately from transit activities through Azerbaijan and oil transport through the BTC pipeline, which is classified under transport. Construction activities decelerated to 14% from 16% growth in 2005, because of the completion of the BTC pipeline and tougher government regulations on residential construction.

Agriculture expanded by 9.5%, well above recent rates. The Government introduced concessional lending and assistance to the sector and established a state-owned agricultural leasing company to encourage adoption of new agricultural machinery.

In recent years, investment in hydrocarbons, most of it from foreign companies, has been the predominant driver in fast-growing total investment, which in turn has been the main stimulus to rapidly expanding GDP. In 2006, growth in total investment was 15%. With completion of the BTC pipeline and the scheduled completion of other major investment projects at the ACG oil field and the Shah Deniz gas fields in 2007, foreign direct investment (FDI) is expected to markedly scale down.

The Government, however, is optimistic that domestic public investment could cushion this fall. In 2006, such investment jumped

2.2.1 Real oil and non-oil GDP growth



Sources: International Monetary Fund, *Regional Economic Outlook*, Middle East and Central Asia, September 2006; Asian Development Outlook database; staff estimates.

by 49% to \$3.5 billion, of which 75% was from state-owned enterprises (SOEs), 12% from the state budget, and 8% from commercial banks.

Domestic private investment by local businesses and individuals is modest. In recent years, most of this has been in residential dwellings. And given the limited progress made in improving the business environment, it is unlikely that domestic private investment will rise significantly.

The Government ran an expansionary fiscal policy in 2006. Rising by 67%, state spending was mainly on public sector wages, pensions, social services, defense, and infrastructure development. With substantial gains in both world prices for oil and in domestic production, tax revenues (mainly associated with oil and gas) surged by over 80%. About one third of budget revenues come from the State Oil Company of the Azerbaijan Republic, and 17% from transfers from the State Oil Fund of the Republic of Azerbaijan (SOFAZ). The general budget deficit amounted to 3.3% of GDP (Figure 2.2.2), most of which is attributed to increased infrastructure investment.

Financial assets of SOFAZ reached \$1.8 billion at the end of 2006. As well as outlays from the government budget, SOFAZ spent from the oil fund on infrastructure development, assistance to internally displaced persons, and investment in the BTC pipeline. SOFAZ derives its revenues mainly from oil sales, income from oil transport, bonuses paid by foreign oil companies, excess between market and projected oil prices, and income from financial investments. SOFAZ spends its oil revenues mainly on social programs and infrastructure, in compliance with the long-term strategy for managing oil and gas revenues.

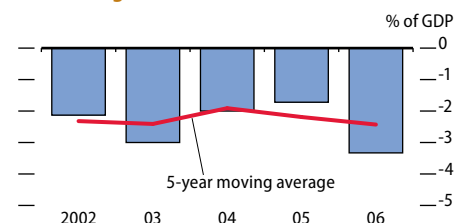
Average official consumer price inflation in 2006 was 8.3% (Figure 2.2.3). It accelerated over the year and averaged just over 11.3% year on year in the fourth quarter. However, independent analysts have suggested that it is much higher. Several factors ramped up prices, including the surge in petrodollars and the limited ability of the National Bank of Azerbaijan (NBA) to sterilize much of the inflow, leading to an excess supply of manat in the economy. M2 jumped by 87% (Figure 2.2.4); reserve money by about 130%; and M1, mostly currency in circulation, by 145%.

Buoyed by burgeoning oil-related revenues, the Government boosted spending on all fronts, putting further pressure on inflation. It issued several decrees to reduce subsidies for utilities services, such as electricity and gas. In response, public utility monopolies raised tariffs to consumers. While reducing subsidies was a positive step toward structural reform, the one-time price rise will pump up inflationary pressures this year. Private monopolies also took advantage of the strong economy to raise prices.

Recognizing the threat of accelerating inflation, the Government introduced various anti-inflationary measures, including agricultural product fairs and price controls on certain agricultural products. However, some of these measures are superficial in nature and distort the pricing mechanism. In addition, NBA tightened monetary policy, lifting the discount rate by 50 basis points to 9.5%. NBA also mopped up excess petrodollars by purchasing over \$1 billion in the foreign exchange market. Despite these moves, the manat appreciated by 5.4% in 2006 (Figure 2.2.5).

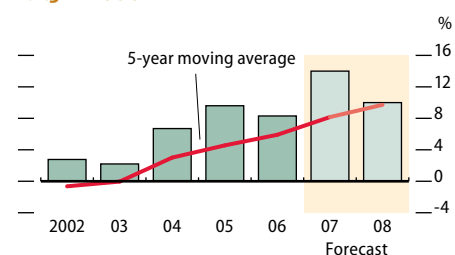
NBA faces two formidable challenges in controlling inflation. First,

2.2.2 Budget balance



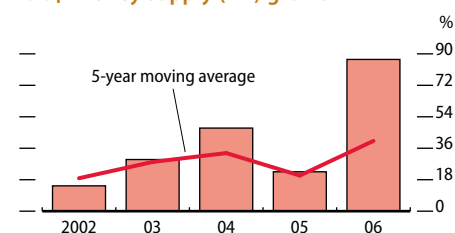
Sources: State Statistical Committee of Azerbaijan; Ministry of Finance.

2.2.3 Inflation



Sources: State Statistical Committee of Azerbaijan; Ministry of Finance.

2.2.4 Money supply (M2) growth



Note: Includes foreign currency deposits.

Source: National Bank of Azerbaijan, available: <http://www.nba.az>, downloaded 19 February 2007.

Azerbaijan is still largely a “cash” economy, and therefore much economic activity will not be directly responsive to its measures (outstanding banking system credit is less than 15% of GDP). About two thirds of the monetary base is held as currency outside the banking system, mainly in the informal economy (which may account for as much as 60% of officially recorded GDP). Second, NBA has only limited capacity to conduct open-market operations, because of the rudimentary nature of domestic financial and capital markets. Given the limited monetary policy options, the authorities need to ensure closer coordination between monetary and fiscal policies, and to pay closer attention to expenditures of SOEs and SOFAZ.

Many analysts have called for a reduction in fiscal spending in the non-oil sector to a more sustainable level to combat the threat of escalating inflation, which could seriously jeopardize the good record of macroeconomic stability.

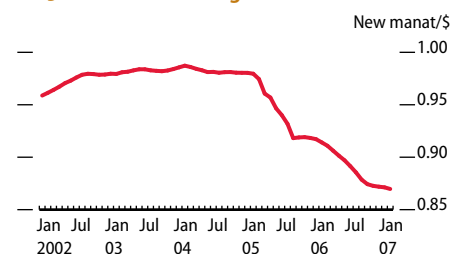
The trade account registered a record surplus of \$7.9 billion (Figure 2.2.6) in 2006, propelled by burgeoning oil exports, which contributed 84% of total exports. Total exports surged by 60.7%. Growth in imports slowed to 4.5% in 2006, as machinery and equipment imports eased and investment in major projects wound down. However, strong domestic demand kept growth in consumer goods imports on the rise. The current account recorded a surplus of \$1.8 billion (9.0% of GDP) in 2006. The capital account surplus fell significantly because of the steep drop in oil-driven net FDI. Gross official reserves more than doubled to \$2.5 billion (Figure 2.2.7).

The major structural issues are similar to those of previous years, including market distortions from anticompetitive behavior of SOEs, lack of corporate governance of SOEs, a weak banking and financial system, and a poor business environment. Most of the SOEs operate as monopolies in their respective markets, such as electricity and gas, agriculture, and sea and air transport. In addition, most operate inefficiently, and, as in the power sector, incur heavy losses that are subsidized by the Government.

The financial and business practices of SOEs need to be reformed urgently, including corporate governance reform, to ensure greater transparency and accountability. There have been positive steps taken to improve this situation; for example, the Government has recently reduced the subsidies to SOEs. SOEs such as the State Oil Company have begun to implement measures under the Extractive Industries Transparency Initiative to improve corporate governance.

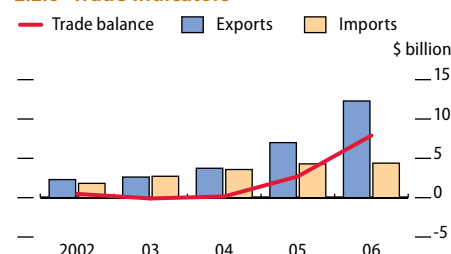
Moreover, the banking and financial segment faces an urgent need to reform, so as to promote confidence and efficiency in mobilizing savings for investment, and ultimately to enhance economic growth. Banking is dominated by two state-owned banks: International Bank of Azerbaijan and Kapital Bank, which together control over half of the assets in the sector. They are significantly undercapitalized and not interested in playing a part in modernizing the banking system. One encouraging sign is that major commercial banks have begun to adopt the principles under Basel II. The market dominance of International Bank of Azerbaijan and Kapital Bank is being slowly whittled away through rapid growth of private banks, which are supported by foreign institutional investors

2.2.5 Nominal exchange rate



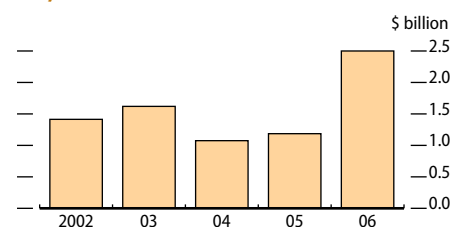
Source: National Bank of Azerbaijan, available: <http://www.nba.az>, downloaded 8 March 2007.

2.2.6 Trade indicators



Sources: Ministry of Economic Development; National Bank of Azerbaijan, available: <http://www.nba.az>, downloaded 30 January 2007.

2.2.7 Gross international reserves



Source: National Bank of Azerbaijan.

and multilateral development banks. Still, their market share and power remain largely intact.

Improving business conditions and the investment climate in the non-oil sector is crucial. While the business environment has improved slightly, according to the 2007 *Doing Business* report, the business climate in neighboring countries has improved much faster. In addition to other reforms required, intellectual property rights also need to be secured.

Economic prospects

Forecasts of key economic variables are based on the following assumptions: NBA monetary policy will aim to keep inflation in check and continue a flexibly managed exchange rate policy; petrodollars will continue to flow into the country; and production and exports of hydrocarbons will make another jump. Given the exceedingly large government spending in previous years, huge growth of money supply from oil revenues, and capacity constraints in the domestic economy, raising government spending to an excessively high level in 2007 and beyond may put at risk macroeconomic stability.

Growth peaked in 2006. It is forecast to grow by a still-sizzling 25% in 2007 (Figure 2.2.8), driven by oil production (from the ACG fields) and expected gas output (coming on stream from the Shah Deniz field) and their export, as well as an expansionary fiscal policy. It is seen slowing further in 2008 to 17%, as growth in production of oil and gas moderates and FDI falls, as hydrocarbons move to a less intensive phase of development. Some of this deceleration will be offset by increased inflows of development assistance.

The Government envisages, optimistically, domestic public investment as a key driver of growth in the coming years (the Ministry of Economic Development foresees it rising by one third a year). Growth in domestic private investment will likely remain modest. To boost it substantially, the Government will need to advance the pace of structural reforms. It forecasts the non-oil sector growing at an average rate of about 9.6% a year through 2009.

Parliament approved the state budget for 2007 in autumn 2006. State spending is projected to increase by up to 42% in 2007. A large portion of the increase is to be spent, as in 2006, on public sector wages and on pensions, as well as defense and infrastructure. The share of military spending is also rising rapidly.

The general budget deficit is planned to be 1.5% of GDP in 2007. A major concern is whether the economy has the capacity to absorb this increase. However, due to the lagged impact of fiscal policy, the decision to reduce expenditure when inflation accelerates may be too late to combat the threat of a marked increase in inflation. The announcement of increases in the prices of utility services—such as electricity, gas, water, and public transport—by up to 50% will add considerable pressure to inflation in 2007, expected to be 14%.

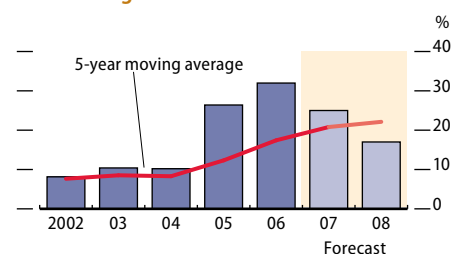
With the substantial increase in oil and gas export revenues, and as import growth is expected to ease, the current account surplus is set to rise to 20.5% of GDP in 2007 and 24.6% in 2008 (Figure 2.2.9). In addition, the authorities have said that there will be no imports of natural

2.2.1 Selected economic indicators

	2007	2008
GDP growth	25.0	17.0
Inflation	14.0	10.0
Current account balance (% of GDP)	20.5	24.6

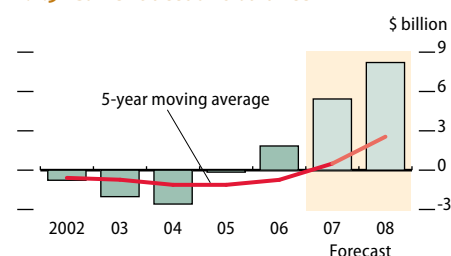
Source: Staff estimates.

2.2.8 GDP growth



Sources: State Statistical Committee of Azerbaijan; staff estimates.

2.2.9 Current account balance



Sources: Ministry of Economic Development; National Bank of Azerbaijan, available: <http://www.nba.az>, downloaded 30 January 2007; staff estimates.

gas from Gazprom (a state-owned Russian gas company) in 2007, having rejected an increase in the price of natural gas from that company.

The income balance will likely deteriorate as rising oil and gas profits are repatriated. Moreover, the Russian Government issued a decree in November 2006, which restricts activities of migrant workers in its territory. With over 2 million Azerbaijani migrant workers there, this will likely stanch remittances from the Russian Federation.

While prospects remain positive, GDP growth is expected to trend downward to a less abnormal level, but still rely on oil and gas, and on transit activities. However, large and unfettered increases in government expenditures will likely stoke inflationary pressures if supply-side factors are not tackled—production capacity needs to be enhanced and productivity improved. The Government's key challenge is to create an enabling environment to attract private sector investment to the non-oil sector. To do this, it would need to lift the pace of domestic reform.

The major risk to the bright economic outlook centers on properly managing oil revenues to maintain macroeconomic stability and avoid excessive appreciation of the exchange rate. The latter would damage competitiveness in the non-oil sector and limit its development. A very sharp downturn in oil prices would put pressure on both the budget and the current account, and would constrain the rapid economic transformation needed to reduce unemployment and poverty.

Development challenges

The country is now at a crossroads—the Government recognizes that it has to implement the necessary reforms and policies that would allow the economy to grow after the oil reserves are depleted. Expectations among the local populace are high, as the Government attempts to deliver on its promises for improved standards of living within the context of limited institutional capacity, highly centralized decision making, and an ineffective legal system. The presence of monopolies and corruption pose further challenges. With a severe gap between those living in Baku and the regions, the country faces the risk of immeasurable wealth with limited development.