Azerbaijan

Unprecedented economic growth marked 2005, with momentum set to build further in 2006, driven by oil and gas production and exports. Foreign investment is expected to drop off in the immediate future as the major investment projects in the hydrocarbon sector move toward a less intensive development stage, but this fall will be partially offset by domestic investment. As in previous years, the budget calls for a very large increase in spending, but the Government will need to carefully manage expenditure to avoid stoking inflationary pressures. Accelerated structural reform is imperative in order to foster greater investment and productive capacity in the non-oil economy. Other key challenges are controlling inflation, preventing excessive appreciation of the exchange rate, and diversifying the economic base.

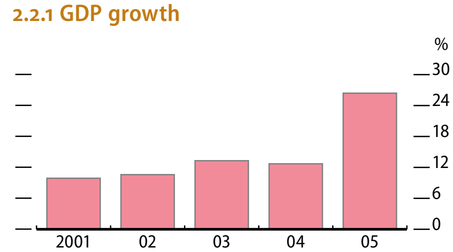
Economic performance

Gross domestic product (GDP) soared by 26.4% in 2005 (Figure 2.2.1). The oil and gas sector, accounting for about 42% of GDP, was the key contributor to the acceleration as production and the volume of exports of hydrocarbons surged by 43.5% and 53.3%, respectively. This was mainly due to new production capacity coming on stream from the Azeri-Chiraq-Guneshi (ACG) oil fields, operated by the main player in the field, the Azerbaijan International Operating Company (AIOC). AIOC increased its oil production by 73.8% in 2005. Services also grew rapidly, at 11%, with transport, communications, and construction the main contributors to growth. Agriculture did relatively well, with a good harvest helping push up output by 4.6%.

In recent years investment in hydrocarbons, most of it from foreign companies, has been the major driver in rapid expansion of total investment, which in turn has been the main stimulus to rapidly expanding GDP. In 2005, growth in total investment moderated, but still remained strong at 12.7%, reflecting a shift to production and exports from newly opened projects as the main source of economic stimulus. With completion of the Baku-Tbilisi-Ceyhan (BTC) oil pipeline in 2005 and the scheduled completion of other major investment projects at the ACG oil field and the Shah Deniz gas fields in 2006, foreign direct investment (FDI) is expected to be markedly scaled down. The Government, however, is optimistic that higher investment by local businesses and individuals could cushion this fall. Recent years have seen growing non-oil investment, particularly in residential dwellings.

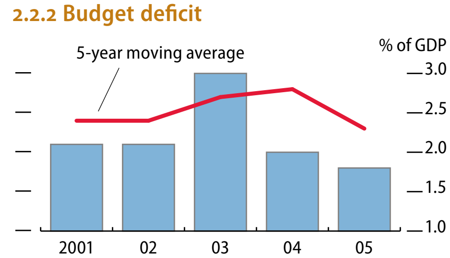
The Government ran an expansionary fiscal policy in 2005 (Figure 2.2.2). Rising by 24.4%, state spending went mainly on public sector wages, pensions, consumer subsidies for gas and electricity, and social services. With substantial gains in both world prices for oil and in its production, tax revenue surged by 24.6%, to bring the hydrocarbon sector share to about half of the tax take. About one third of budget revenue comes from the State Oil Company of the Azerbaijan Republic.

2.2.1 GDP growth



Source: State Statistical Committee of Azerbaijan.

2.2.2 Budget deficit



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

The overall budget deficit amounted to 1.8% of GDP. Assets of the State Oil Fund of the Republic of Azerbaijan, which receives a part of the Government's oil sector income to accumulate for development purposes, reached $1.39 billion at end-2005.

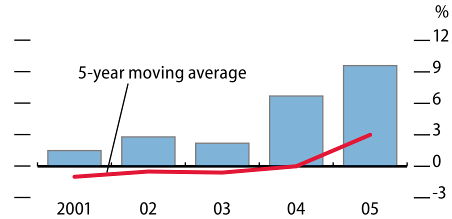
Average consumer price inflation rose to 9.6% in 2005, from 6.7%, representing a significant deterioration from recent years' performance (Figure 2.2.3). Inflation accelerated in the first half of the year, peaking at 15.4% year on year in March. Several factors ramped up prices, including the surge 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 increased by 32%) (Figure 2.2.4) and macroeconomic imbalances. Buoyed by larger oil-related revenues, the Government stepped up spending substantially, including increasing minimum wages by 20%. Monopolies in the distribution sector, especially among state-owned enterprises (SOEs), took advantage of the strong economy to raise prices excessively.

Recognizing the threat that accelerating inflation could potentially derail economic growth, the Government agreed with advice from the International Monetary Fund to reduce core inflation to single digits by end-2005. Accordingly, monetary policy was tightened as NBA raised the discount rate from 7% to 9% in three steps between May and October. NBA adopted a more flexible managed floating exchange rate regime, ending a period when it informally kept a fixed peg to the dollar. The manat gained about 7% in value between February and year-end, and nearly 4% on an annual average basis, as most of the change took place in the second half (Figure 2.2.5). According to NBA estimates, a 1% appreciation of the manat against the dollar would lead to a 0.6–0.7% decline in inflation. The Government carried out a redenomination of the manat on 1 January 2006, exchanging 5,000 old manat for 1 new manat.

NBA faces two formidable challenges if it is to control inflation. First, Azerbaijan is still predominantly a "cash" economy, and therefore much economic activity will not be directly responsive to NBA measures (outstanding banking system credit is less than 10% of GDP). Up to 70% of the monetary base is held as cash 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 development of the country's financial and capital markets.

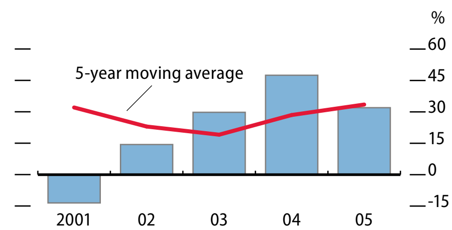
The trade account recorded a record surplus of $2,701 million in 2005, propelled by burgeoning oil exports. The oil sector's large share in trade increased further to reach over 85% of exports and over 55% of imports. Exports increased by 87% in 2005, due essentially to a rise in oil exports from expanded oil production of AIOC and the transport of oil through the newly completed BTC oil pipeline. Growth in imports slowed to 20% in 2005, due mainly to slower imports of machinery and equipment for the oil and gas sector as major investment projects neared completion (Figure 2.2.6). However, strong domestic demand kept growth in consumer goods imports on the rise. Although the current account recorded a deficit of $152.4 million (1.2% of GDP) in 2005, it was significantly below the past 3-year average deficit of about $1.8 billion (Figure 2.2.7). The capital account surplus fell significantly in 2005

2.2.3 Inflation



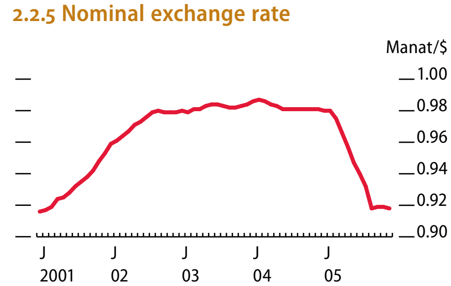
Sources: State Statistical Committee of Azerbaijan; Ministry of Finance.

2.2.4 Money supply (M2) growth



Source: National Bank of Azerbaijan.

2.2.5 Nominal exchange rate



Note: Adjusted for the redenomination of 1 January 2006.
Source: National Bank of Azerbaijan, available: http://www.nba.az/?mod=inside&id=68&sub1=109&sub2=111&lang=en, downloaded 20 March 2006.

because of the steep drop in oil-driven net FDI. Gross official reserves increased to $1.2 billion, 10.3% higher than at end-2004 (Figure 2.2.8).

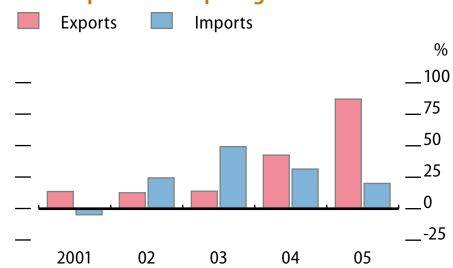
The weak development of the country's financial system was interestingly demonstrated during the year: in the space of just 2 hours, on 17 September, the manat appreciated by 10–15%, causing a state of panic among the many Azeris who hold dollars. NBA intervened to stabilize the situation, but the episode highlighted the lack of depth in the foreign exchange market. It also called attention to an emerging issue, namely that it will be difficult in the period ahead for the monetary authorities to assess the exact demand for money, as sharp rises in oil revenue are likely to pump up the manat, prompting changes in asset-holding behavior in Azerbaijan's highly dollarized economy.

A raft of major structural issues faces the economy, including market distortions arising 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. They set high prices and restrict output and, in many cases, also wield considerable market power when purchasing inputs. Such monopoly and monopsony elements tend to distort the price mechanism, misallocate scarce resources, and retard development of the private sector.

Most SOEs in Azerbaijan are operating inefficiently, and, as in the power sector, are incurring heavy losses that are being subsidized by the Government. Many SOEs' lack accountability in their financial and business practices and fail to record their expenditures and revenues in a meaningful, transparent manner. This adversely affects the effectiveness of fiscal policy, especially if the enterprise is a large one, such as the State Oil Company. Therefore, there is an urgent need for reforming the financial and business practices of SOEs, including corporate governance reform, to ensure greater transparency and accountability. As a positive step, the Government has recently enhanced interministerial exchanges between the Ministry of Finance, NBA, and the Cabinet of Ministers with regard to state treasury accounts management, and fiscal and external borrowing strategies.

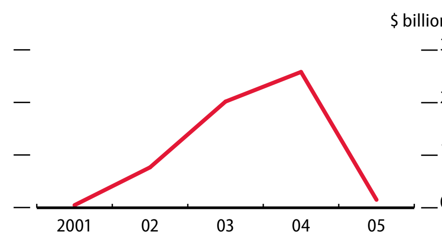
The banking and financial sector is still at a rudimentary stage of development. In part this is due to the public's generally low level confidence in the banking system and its lack of understanding of the nature and benefit of noncash transactions, such as bank transfers and credit cards. It is also the legacy of a banking sector that is dominated by two state-owned banks: International Bank of Azerbaijan and Kapital Bank, which together control about 50% of the assets in the sector. They are significantly undercapitalized and not interested in playing a part in modernizing the banking system. While their market dominance is being whittled away through rapid growth of private banks, which are supported by foreign institutional investors and multilateral development banks, the banking and financial sector faces an urgent need to reform, so as to promote confidence, efficiency in mobilizing savings for investment, and ultimately enhance economic growth. The two banks are in fact being considered for privatization, but neither a well-defined timeline nor a clear commitment to this exists.

2.2.6 Export and import growth



Source: National Bank of Azerbaijan.

2.2.7 Current account deficit



Source: National Bank of Azerbaijan.

2.2.8 Gross international reserves

Source: National Bank of Azerbaijan.

Improving business conditions and the investment climate in the non-oil sector is important to promote private sector development and create new jobs and, while the Government has taken some steps to do this, there are instances where the business operations of some privatized firms have come under external influence. Recently, the Government has renewed its efforts to improve business conditions. For example, it is considering a "white paper" prepared by the American Chamber of Commerce in Azerbaijan, which sets out a reform agenda in key areas and sectors, such as corporate governance; monetary and fiscal policy; banking, finance, and insurance; and protection of intellectual property rights. It is also making headway in negotiating World Trade Organization accession (Box 2.2.1).

Economic outlook

Prospects for 2006 and 2007

Forecasts of key economic variables are based on the following assumptions, namely that: NBA monetary policy will aim to keep inflation in check and continue a flexibly managed exchange rate policy; the Government, while raising spending, will seek to follow policies that are consistent with macroeconomic stability; and production and exports of hydrocarbons will increase significantly.

GDP is forecast to accelerate to 30.5% in 2006, driven by a substantial increase in oil and gas production and exports, high domestic investment, and an expansionary fiscal policy. With the completion of the BTC oil pipeline and a ramping up of oil production from the ACG oil fields as well as gas production coming on stream from the Shah Deniz gas field in 2006, hydrocarbon production and exports are likely to power forward. However, GDP growth is seen as slowing slightly in 2007 to 27.3% as increases in oil and gas production moderate and FDI falls. In 2006, total oil production is put at 28.6 million tons, up 42.4%, and expand by a further 21.8% in 2007. Total gas production is expected to be 6.5 billion cubic meters in 2006, up 15%, and in 2007 jump to 11.0 billion cubic meters (up 108.3%).

Foreign investment is predicted to tail off after 2006 as the hydrocarbon sector moves to a less intensive phase of development. Some of this downswing will be offset by an increased inflow of concessional funds and grants over the next 4 years, estimated at around $3 billion. The Government envisages domestic investment as a key driver of growth in the coming years. The Ministry of Economic Development foresees domestic investment rising by 19.5% a year, particularly in services such as transport, communications, and construction. To achieve these investment projections, the Government will need to advance the pace of structural reforms in order to create an enabling environment that will attract domestic investment into non-oil activity. The Government forecasts the non-oil sector growing at an average rate of about 12% a year through 2009.

Parliament approved the state budget for 2006 in autumn 2005. State spending is projected to increase by up to 65% in 2006. A large portion of the increase is to be spent, as in 2005, on public sector wages

2.2.1 Selected economic indicators

	2006	2007
GDP growth	30.5	27.3
Inflation	13.0	7.0
Current account balance (% of GDP)	15.8	32.9

Source: Staff estimates.

and on pensions, in addition to defense and infrastructure. A major concern is whether the economy has the capacity to absorb this increase. The Government aims to finance part of the deficit through selling treasury bills, but a lack of demand and a weak secondary market for debt will limit its ability to raise funds in this way. Greatly increased fiscal spending would put considerable pressure on aggregate demand in an already tight economy and the NBA would face a difficult task in controlling inflation and maintaining exchange rate stability in 2006. Thus there needs to be a close coordination between monetary and fiscal policies to forestall emerging pressures. The Government has stated that it is prepared to trim expenditure if inflation begins to accelerate.

With the substantial increase in oil and gas export revenues, and as import growth is expected to ease—reflecting lower oil and gas-related capital investment—the current account is projected to swing into surplus. However, the income balance will likely deteriorate as rising profits from the oil and gas sector are repatriated.

Medium-term outlook

Prospects are positive. Increased production and exports of oil and gas, of domestic investment, and of fiscal outlays will be the key drivers of growth. However, large increases in government expenditure 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 investment into the non-oil sector. To do this, it should lift the pace of domestic reforms by, for example, improving fiscal management, accelerating the privatization of small- and medium enterprises, speeding up trade and price liberalization, and implementing reforms in banking and finance. Strengthening the business environment is also important. On the foreign policy front, concluding an agreement with Armenia to resolve the conflict over Nagorno-Karabakh would benefit both countries.

The major risk to the bright economic outlook centers on properly managing oil revenue 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, though unlikely, would put pressure on the budget and the current account, putting constraints on the rapid economic transformation needed to reduce unemployment and poverty.

2.2.1 Joining the World Trade Organization

Azerbaijan is in the process of negotiating its accession to the World Trade Organization (WTO). It already has a trade system free of nontariff restrictions and has a relatively low average tariff of 6%. While short-term adjustment costs will be felt as the country undertakes the necessary domestic reforms, in areas such as tariffs, customs procedures, taxation, and banking and finance, and as it opens its markets to greater competition, benefits of accession will be substantial. Joining WTO will help accelerate domestic reforms, invigorate the domestic business climate, improve access to foreign markets, and force domestic companies to adhere to international quality standards for exports. Membership of WTO will also send a strong signal to the international community about the Government's intention to develop the economy along open, market-oriented lines.