Azerbaijan

Although growth in oil output slowed in 2010, higher oil prices led to a large balance-of-payments surplus, while a revival in the non-oil economy, driven by public expenditure, led to solid but slower overall growth. Growth and the balance of payments are both predicted to remain strong in 2011 and 2012. Inflation was moderate but local and external factors will stoke price pressures in 2011. Supporting growth in the non-oil sector and reducing dependence on oil revenue represent a significant long-term challenge.

Economic performance

GDP growth at 5.0% in 2010 was markedly lower than the very high rates of the previous few years when large investments rapidly expanded Azerbaijan's oil and gas resources. Growth in the oil economy (defined to include gas production) is estimated to have slowed to 1.8%. The non-oil economy performed well, growing by 7.9%, as it recovered from the headwinds of the global recession. With oil and gas production growth leveling off (oil production in 2010 was at 377.4 million barrels), the outlook is for moderate overall growth based largely on non-oil activity (Figure 3.2.1).

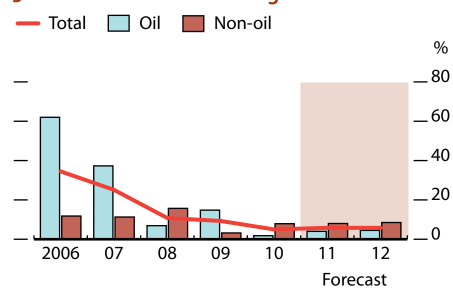
Robust growth in the non-oil economy in 2010 was driven largely by public investment, mainly in infrastructure projects that led to a 20.3% expansion in construction activity (Figure 3.2.2). This was a marked recovery from the 8.3% contraction in investment in 2009, when much lower oil prices and global crisis–related uncertainty reined in public and private investment. Non-oil manufacturing is estimated to have grown by about 6.8%, after 2009's 12.6% contraction. Several public and private industrial plants started operations and SOCAR, the state-owned oil company, expanded into non-oil manufacturing.

Services growth was robust at 7.2%, driven by the strong expansion in the non-oil economy as well as gains in gas transport services and new technologies in mobile communications and Internet access.

Agriculture performed poorly, contracting by 2.2% in 2010 after 3.5% growth in 2009. This reflected a 33% drop in grain production that was caused by flooding, a decline in the area cultivated, and falling yields. Production of other agricultural products such as cotton and tobacco picked up.

Public investment, mainly in the non-oil sector, rose to 13% of GDP, accounting for nearly three-quarters of overall domestic investment. Although private investment fell slightly as a share of total investment, it was well above its low of 2008. Foreign direct investment in oil has been declining since 2006 with the completion of large investment

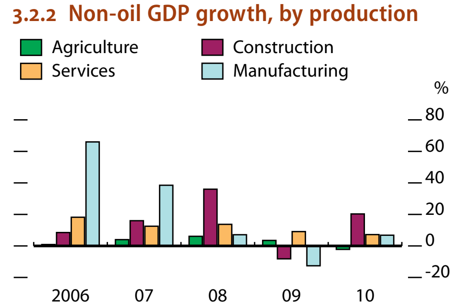
3.2.1 Oil and non-oil GDP growth



Source: State Statistical Committee of the Republic of Azerbaijan. http://www.azstat.org

Click here for figure data

3.2.2 Non-oil GDP growth, by production



Source: State Statistical Committee of the Republic of Azerbaijan. http://www.azstat.org

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This chapter was written by Nail Valiyev of the Azerbaijan Resident Mission, ADB, Baku.

projects as well as SOCAR's self-financing of new projects. Inflows into manufacturing, transport, and communications went up.

Inflation crept up steadily during the year, to 5.7% in December 2010 year on year from 1.5% in December 2009 (Figure 3.2.3). The upturn was largely driven by rising prices of basic food items, including wheat, reflecting both higher import prices and the poor grain harvest. Nonfood prices increased moderately over the year. Demand factors, such as a pay hike for public servants and a robust expansion in credit to the private sector, appear to have put some additional pressure on these supply-side factors.

The State Oil Fund of Azerbaijan (SOFAZ), set up to save a part of the nation's hydrocarbon earnings, is channeling some of its revenue to the budget for financing public investment projects. Despite large transfers of this nature in 2010, SOFAZ assets surged by 52.8% to $22.8 billion at year-end, buoyed by higher oil prices.

Budget expenditure rose by 11.3% in 2010, though as a share of GDP it moderated by about 1 percentage point to 28.3% (Figure 3.2.4). Besides the salary hike, 2010 saw markedly higher social and defense outlays; public investment came in at 13% of GDP. Tax collection increased by only 4.4% in 2010, as customs revenue contracted because of lower imports of machinery and equipment. Total budget revenue declined by 2 percentage points to 27.4% of GDP. The large gap between budget expenditure and revenue was again bridged by substantial SOFAZ transfers, keeping the overall budget deficit small (0.9% of GDP).

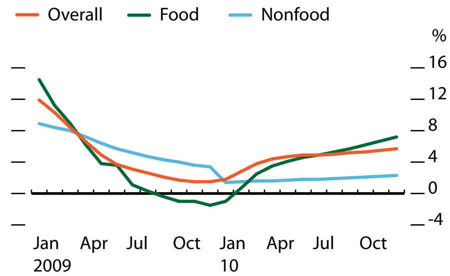
Without the SOFAZ transfers the deficit would have been 15.1% of GDP, and these transfers have been rising in absolute terms and relative to GDP in recent years. They now make up over one-half of the government resources that finance budget expenditure. To arrest this trend, the government would need to increase revenue from taxes and other charges, though a substantial move would stymie policies that seek strong expansion in non-oil economic activity.

The Central Bank of Azerbaijan adopted an expansionary monetary policy in 2009, aiming to counter the impact of the downdraft on growth from lower oil prices and an uncertain economic outlook. It set the refinancing rate at 2.0% and the reserve requirement at 0.5%. It raised the refinancing rate to 3.0% in November 2010 and to 5% in March 2011, responding to the strengthening in the non-oil economy and inflation pressures. It continues, however, to provide long-term loans and additional special financing support to private companies and banks at its discretion.

Evidence of recovery is seen in a 9.7% rise in credit to the private sector and a 24% expansion in the broad money supply (Figure 3.2.5), which in part reflected a rebound in net foreign assets as the overall balance returned to a large surplus. A sign of financial deepening and greater confidence in the banking system was that the ratio of broad money to GDP rose from 23.8% in 2009 to 25.3% in 2010.

In overseeing the commercial banks, the central bank is implementing Basel standards to improve banking regulation and stability, as well as to strengthen public trust in the banking system. Banks have therefore boosted their capital position. Similarly, to extend access to financial and banking services in rural areas particularly, the government has initiated

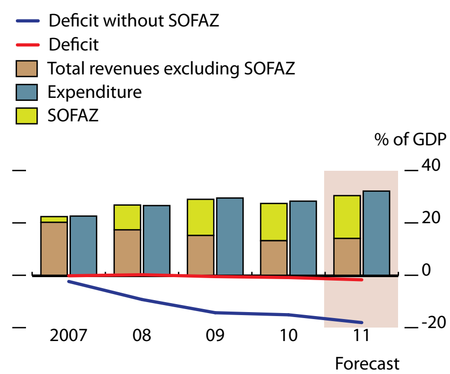
3.2.3 Monthly inflation



Sources: International Monetary Fund. International Financial Statistics online database (accessed 10 March 2011); State Statistical Committee of the Republic of Azerbaijan. http://www.azstat.org

Click here for figure data

3.2.4 Fiscal indicators

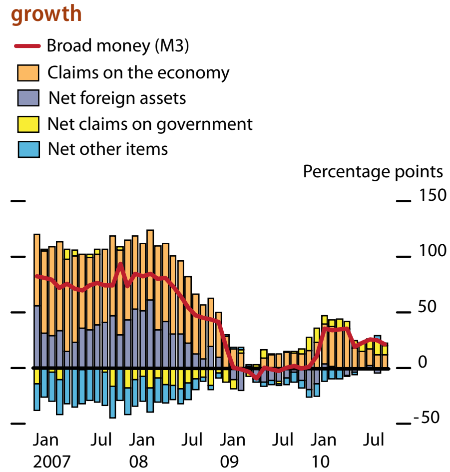


SOFAZ = State Oil Fund of Azerbaijan.

Source: Ministry of Finance. http://www.finance.gov.az

Click here for figure data

3.2.5 Contributions to money supply (M3) growth



Source: International Monetary Fund. International Financial Statistics online database (accessed 1 March 2011).

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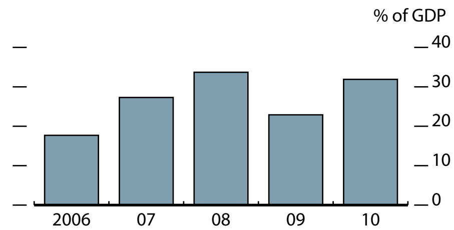
the Azerpost project, which offers services (including microcredit, money transfers, and distribution of pensions) through post offices.

On the external front, the marked global increase in oil prices led to an estimated 24% gain in exports (oil and gas account for about 95% of goods exports). Non-oil exports saw a small gain despite agriculture's contraction. Imports witnessed virtually no upturn despite the revival in non-oil growth.

Similarly, net services and income payments were little changed from a year earlier while workers' remittances, a marginal item in the balance of payments but an important source of support for rural households, tumbled. Resting mainly on strength in oil pricing, the current account surplus was boosted to $16.5 billion in 2010, about 31.9% of GDP, from $10.2 billion a year earlier (Figure 3.2.6).

Gross international reserves jumped by nearly 20% to $6.4 billion at end-2010. With the surge in SOFAZ assets, total foreign assets now amount to about 56% of GDP. Public external debt is relatively small at $3.7 billion, about 9% of GDP.

3.2.6 Current account balance



Source: Central Bank of the Republic of Azerbaijan. http://www.cbar.az (accessed 1 March 2011).

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Economic prospects

As oil prices are projected to go up in 2011 and remain high in 2012, the main challenge for the government will be to maintain macroeconomic stability. Growth in oil revenue will allow a continued rise in social expenditure and investment in infrastructure that should spur private activity and improve the investment climate.

The hydrocarbon economy is expected to grow steadily at about 3%–4% in the forecast period as oil and gas development sets the stage for faster expansion in later years. Robust growth of the non-oil economy is expected to stay driven by public sector investment. The government is planning investment spending of $4.2 billion in 2011, which will drive a rapid expansion in construction with positive knock-on effects on the rest of the economy.

Agriculture is seen growing steadily on the assumption of good weather and continued government support, including reductions in value-added tax on agricultural inputs and in the lending rate of the main agro-leasing company, and completion of irrigation and infrastructure initiatives. Growth of 8% is foreseen in the non-oil sector in 2011 and 2012. Overall GDP growth is projected at 5.8% in both years.

The central bank will aim to meet the credit demands of the non-oil economy while keeping consumer price inflation in check, though price rises will probably be driven mainly by external factors. The exchange rate may come under some upward pressure because of larger surpluses in the balance of payments, but the bank will resist a marked appreciation as it would retard non-oil export development. Inflation is seen reaching 7.5% in 2011 as global price pressures increase, gliding down to 7.0% in 2012 as they moderate.

Higher oil export revenue will outweigh the import growth arising from strengthening investment and the rising income–related consumer spending. The current account surplus is expected to be 27.8% of GDP in 2011 and 25.0% in 2012, as import demand rises in response to growth of incomes and appreciation of the manat, and as growth in oil revenue slows.

3.2.1 Selected economic indicators (%)

	2011	2012
GDP growth	5.8	5.8
Inflation	7.5	7.0
Current account balance (share of GDP)	27.8	25.0

Source: ADB estimates.

Development challenges

Developing the non-oil sector and diversifying the economy is the government's longer-term priority. Agriculture, manufacturing, telecommunications, and tourism all have potential for growth. Agriculture is particularly crucial, as 40% of the population still lives in rural areas. Although government programs have attempted to support the sector, the rural population depends largely on remittances. Further steps include rehabilitating and maintaining irrigation and other infrastructure, improving land-management practices, enhancing inputs as well as credit and agricultural services, and boosting incentives for private participation.

Improved physical infrastructure, particularly roads, railways, and energy, is also essential for the non-oil sector. Additionally, medium- and long-term private sector growth will depend on a stable macroeconomic environment and a better legal and regulatory framework, among other measures. Azerbaijan is now ranked 54 out of 183 in the World Bank's *Doing Business 2011* report, ahead of most countries in the region. This ranking reflects progress over the past year in providing access to credit and simplifying tax payment procedures.

The report shows that trade facilitation, too, requires work, as Azerbaijan is one of the 10 hardest countries from which to trade across borders. If it is to become a successful exporter, it needs to reduce both formal and informal barriers to trade. In addition, the procedures and permits required for certain sectors or operations need to be streamlined, while governance and transparency should be improved to ensure that the large public investment program provides its maximum potential benefit.

3.2.2 Global rankings on the ease of trading across borders, 2011

Niger	174
Burkina Faso	175
Burundi	176
Azerbaijan	177
Tajikistan	178
Iraq	179
Congo, Republic of	180
Kazakhstan	181
Central African Republic	182
Afghanistan	183

Note: Out of 183 countries worldwide.
Source: World Bank. *Doing Business 2011*.