Growth was virtually nil in 2011, as safety concerns caused a stoppage in oil production at one of the main platforms for much of the year, offsetting gains from government-financed investment in other sectors. With expected more normal oil production, growth should strengthen in 2012 and 2013. Diversifying the economy will be important to maintain growth over the longer term.

Economic performance

Overall GDP grew by a mere 0.1% in 2011, as a 9.3% contraction in the oil sector largely offset a 9.4% expansion in non-oil activity, which was largely driven by public investment in infrastructure. Crude oil production fell by 10.5%, as a review and strengthening of safety procedures halted output at the Azeri-Chirag-Gunashli oil platform for much of the year. Natural gas production declined by 2.2%, as Turkey, the country’s major importer, reduced imports of Azeri gas and no other countries made offsetting purchases.

The non-oil sector recorded growth in agriculture, construction, and services (Figure 3.2.1). Agriculture grew by 5.8%, mainly from higher crops and livestock production, reflecting expanded cultivation and the impact of government tax credits and lending programs for improving access to modern farm equipment. Construction climbed by 20%, lifted by non-oil government projects and foreign investment in tourism. Industry contracted by 4.3% because of the lower oil output. Services rose by 6.5%, led by 10.3% growth in the wholesale and retail sector and some expansion of communications and tourism.

On the demand side, investment—mainly non-oil and largely financed from domestic resources—surged by 27.3%, with machinery and equipment manufacturing, communications, and chemical production receiving most of it. Private consumption grew by 9.9%, fueled in part by a 14.2% salary increase for civil servants introduced in September–November.

Average annual inflation moved up to 7.9%, largely reflecting higher food prices early in the year as a result of crop damage late in 2010 and price increases for imported foodstuffs, as well as inflation in trading partner countries. Monthly inflation spiked in the first half as food stocks declined, and then moderated in the second half with the new harvest (Figure 3.2.2).

Fiscal policy is driven largely by oil income, which accumulates in the State Oil Fund of Azerbaijan (SOFAZ), from where transfers are made to the budget to finance state spending. In 2011 such transfers constituted 57% of total government revenue (versus 52% in 2010); they helped finance

This chapter was written by Nail Valiyev of the Azerbaijan Resident Mission, ADB, Baku.
an expansion of government activities, in particular public investment projects in areas such as transport, energy, and water supply. The transfers allowed a surplus in the state (unconsolidated) budget of 0.6% of GDP; without them, the budget would have run a deficit of 17.3% of GDP (Figure 3.2.3).

Total government revenue, including SOFAZ transfers, was equivalent to 31.4% of GDP. Non-oil receipts grew by 22%, reflecting the strong non-oil performance, although they contributed less than half all budget receipts.

Higher oil prices enabled the government to raise its spending by 30.8%, including the steep rise for civil servants, higher pensions and other social program spending, as well as building projects. Capital expenditure accounted for more than half the government’s outlays.

Responding to rising inflation and concerned over capital inflows, the central bank tightened monetary policy, raising the refinancing rate in June to 5.25% and increasing reserve requirements in May from 0.5% to 2.0% on all deposits and, in July, to 3.0% on foreign currency deposits. To prevent significant real appreciation of the local currency and to create a more competitive non-oil sector, the central bank also used sterilization operations, selling $497 million to the banks (Figure 3.2.4).

The current account recorded a surplus of 28.7% of GDP, smaller than the previous year. Because of higher imports, the trade surplus declined to $16.8 billion from $19.7 billion in 2010, as higher oil prices (despite lower oil production) helped total exports to stay at around the 2010 level of $26.5 billion. Non-oil exports remained small at $1.6 billion. Growing domestic demand helped raise imports, mainly of machinery, electronics, and foodstuffs, by more than 50%.

Remittances jumped by 42.7%, reflecting the revival of the Russian and Turkish economies, the main employment destinations for expatriate Azeris. Foreign direct investment remained less than 0.5% of GDP, reflecting little net private investment in either the oil or non-oil sectors. Overall reserves grew to an estimated $103 billion. Total external debt at end-2011 was estimated at 17.8% of GDP, including public and publicly guaranteed external debt of 8.4% of GDP.

**Economic prospects**

GDP growth is projected to accelerate to 4.1% in 2012 but to moderate to 3.5% in 2013, mirroring higher oil output and continued expansion in the non-oil sector (Figure 3.2.5). Oil output is forecast to pick up moderately in 2012 after completion of upgrades on the three main oil platforms, while the expected opening of new gas platforms may increase gas production if demand also increases (Figure 3.2.6). Continued recession in the eurozone will, however, likely limit demand for petroleum and thus the rise in oil production. Similarly, a steep fall in prices might lead the government to curb output.

Growth in the oil sector will affect transport, communications, and wholesale and retail trade, particularly the development of new rail and sea transport links for petroleum. Current road projects will stimulate transport, while agricultural projects and subsidies for imported seeds should help boost agricultural output. These measures will also encourage farmers to shift more into cash crops.
Services are expected to stay largely driven by trade and tourism in 2012. The government’s investment program should, by expanding infrastructure, support industry and construction through boosting demand for local production of cement, steel pipes, and other building materials. Although the non-oil sector will remain small, its development and an improved business environment would improve domestic employment opportunities, possibly reducing remittances over the medium term.

Despite the central bank’s goal of reducing inflation to 7–7.5% in 2012 and 2013, various factors could take inflation to 9.0% in 2012 before it subsequently recedes to 8.5% in 2013 (Figure 3.2.7). Strong domestic demand fueled by oil income, rising public sector consumption (including planned government salary increases), and expanded domestic credit to the economy may heighten inflationary pressures in 2012. The completion of grain-storage and improved food-processing facilities should, however, reduce food imports, helping moderate inflation in 2013.

The budget envisages a deficit of 1.3% of GDP in 2012 (Figure 3.2.8), as total government spending is planned to rise by 10%, while revenue is forecast to grow by only 4%, based on a very conservative assumption for oil prices ($80 per barrel). Revenue, including SOFAZ transfers, is forecast at 37% of GDP in 2012, but would come in lower if petroleum prices plunged. Higher petroleum prices on the other hand could allow for even steeper increases in salaries and pensions in 2012, although a sharp fiscal expansion risks overheating the economy and stoking inflation.

The budget outlines a 22.2% expansion in social outlays in 2012. The government’s investment plan aims to keep capital spending, mainly for infrastructure projects on irrigation, roads and energy, at 2011 levels.

A budget deficit of 1% of GDP in 2013 is forecast, with total revenue, including SOFAZ transfers, of 32% of GDP. Because of limited non-oil sector income, the budget presumes that transfers from SOFAZ will account for 61% of total government revenue in 2012, and comparable transfers will likely be needed in 2013. Although SOFAZ balances, at close to 60% of 2010 GDP, should be sufficient to support such budget transfers over the next few years, global shocks and unexpected problems with oil production could affect the future sustainability of relying on SOFAZ transfers to fund expenditure.

Monetary policy will continue to focus on restraining inflation, so as to limit nominal interest rates and avoid a real appreciation of the local currency. The central bank plans to improve prudential and capital-adequacy control, as well as risk management, while strengthening the interbank market. Consolidating existing, small private banks and privatizing the state-owned International bank of Azerbaijan (the country’s largest bank) should foster a more competitive environment and cut banking costs.

The current account surplus is expected to remain high, at 22.0% of GDP in 2012 and 19.0% in 2013 (Figure 3.2.9), in light of elevated oil prices and increased output. Oil-related exports are expected to remain the dominant export category, at about 90% of the total.

Services imports, including transport, communications, and construction, are expected to grow once oil operations are back to strength. Continued hydrocarbon development—exploration for new oil
wells and preparations for the second phase of the Shahdeniz (gas field) project—should sustain foreign investment.

Factors that may affect the actual outturn include rising imports of construction machinery and equipment, which may take the current account surplus below current forecasts. In addition, foreign investment could rise sharply if petroleum reserves are found in the area covered by an oil exploration agreement signed between BP and SOCAR in late 2010.

Financing for new projects is forecast to increase public and publicly guaranteed debt slightly, to about 8.7% of GDP in 2012. With international reserves of more than $40 billion (including SOFAZ assets), Azerbaijan’s external position should remain comfortable over the next several years.

**Policy challenge—diversifying from petroleum**

Supporting growth in the non-oil sector and reducing dependence on oil revenue are the most pressing long-term issues for the economy. The key to maintaining long-term growth—diversifying the economy—will depend on developing a strong private sector. In turn this will require access to financing and an improved business and investment climate. Thus financial and regulatory reform making it easier to do business will be essential. Non-oil activity needs to be promoted in the regions especially, in order to reduce urban–rural income disparities.

With the country’s rich natural resources, agriculture appears the most promising area for diversification, and some studies suggest that its productivity can be increased two- or threefold over the medium term. Such gains would require a stronger legal framework, output reoriented toward cash crops, and improved market access, as the relatively few produce-collection points and processing plants hold back earnings opportunities. Heavy investment is thus needed to develop agroprocessing, which requires cold-storage tanks and transport systems, sophisticated processing plants, and strong marketing.

Public investment in the non-oil sector should increasingly be financed by taxes rather than transfers from SOFAZ, to improve the sustainability of public finances. SOFAZ revenue should be used mainly to smooth out public spending and finance large, one-time infrastructure projects.

In financial sector reform, the central bank’s decision to privatize the International Bank of Azerbaijan, is expected to strengthen competition among banks, while the additional capital obtained for that bank should strengthen banking generally (the bank’s liquidity and capital shortages have complicated privatization, however). Proposed consolidation of small banks could also improve competition and increase efficiency, which would benefit the private sector through lower banking costs and easier access to finance.

Azerbaijan improved its ranking in the World Bank’s 2012 Doing Business survey to 66, aided by reforms simplifying tax payments. Nevertheless, the country still rates poorly in many areas and was downgraded in several, including access to electricity and trading across borders (although current energy projects should improve the electricity ranking). Likewise, transport projects and regional cooperation programs may well encourage Azerbaijan and other member countries to streamline trading procedures and so boost cross-border trade.