Azerbaijan

Growth reached 2.2% from near stagnation in 2011, as the oil sector contracted less and activity outside of the oil sector accelerated. Smaller oil exports narrowed the current account surplus, but foreign direct investment, mainly in oil and gas projects, rose by more than 20%. Higher public investment spending, supported by transfers from the State Oil Fund, is expected to help spur growth to 3.1% in 2013 and, as oil production increases, to 4.8% in 2014.

Economic performance

Growth improved to 2.2%, following near-zero growth in 2011. Oil output declined less, contracting by 5.0%, and expansion continued in the other sectors of the economy, which grew by 9.7% (Figure 3.2.1).

On the supply side, industry contracted by 1.9%, following the 3.4% increase in 2011 (Figure 3.2.2). The 2012 contraction mainly reflected poor performance in the oil sector, where output fell by 5.3% because of repairs at the main Azeri–Chirag–Ginashli oil platform. Other industrial output rose by 7.8%. Construction continued to grow, rising 18.8% on the back of the government investment program and private initiatives, including the construction of infrastructure linked to hosting the Eurovision Song Contest and the rehabilitation program following a major earthquake early in 2012. Government subsidies and concessional lending programs helped agriculture grow by 3.7%, with increases in both crop and livestock production. Through its agricultural leasing agency, the government continued to support farmers with machinery, imported breeding stock, and other agricultural inputs.

Services were a major source of growth, rising by 9.9%, with wholesale and retail trade growing by 9.6%. Growth also reflected strong performances in oil transportation, which grew by 5.0%, and in communications, which grew by 16.8%.

On the demand side, consumption and investment were the main sources of growth. Consumption rose by 2.9%. This was driven mainly by private consumption, which provides about 40% of GDP and grew by 2.5%, reflecting higher domestic bank lending and increased activity and incomes outside the oil sector. Total investment, at about 23% of GDP, grew by 20.9%, with most of the growth in public investment.

Inflation fell to 1.1% from the 7.9% recorded in 2011 and 4.8% at the start of the year, mainly reflecting slower food price increases. Government-managed food markets helped control food prices while providing farmers direct access to retail food markets. Continuing exchange rate stability helped limit price increases for imported goods (Figure 3.2.3).
Fiscal policy turned more supportive in 2012 but remained hugely dependent on the oil sector. The surplus in the consolidated budget rose to 3.0% of GDP from 0.6% in 2011, because rising revenue greatly outpaced rising expenditure. Revenue grew by nearly 35%, to 29.0% of GDP, mainly reflecting increases in sovereign fund transfers and profits taxes. Transfers from the State Oil Fund—the sovereign wealth fund and a key source of revenue since 2009—provided 60% of budget revenues. Expenditures grew by 22% and totaled 25.8% of GDP. Public investment projects were the major driver of expenditures and absorbed 43% of total spending. The decision to begin repaying savings lost at the Soviet Depositary Bank after the collapse of the Soviet system helped increase social expenditures.

The central bank relaxed monetary policy in 2012 for the first time since May 2011, lowering the refinancing rate from 5.25% to 5.00% as inflation declined. To offset the impact of capital inflows and reflect lower demand for foreign currency, the central bank sold securities to banks to sterilize $1.5 billion of their foreign exchange inflows, prevent significant appreciation of the Azerbaijan manat, and make producers outside of the oil economy more competitive. These moves helped limit the appreciation of the manat against the US dollar to 0.19% in the year to the end of 2012 (Figure 3.2.4).

To strengthen the banking sector, the central bank continued its efforts to formulate a risk-based prudential supervision framework adhering to Basel III standards for banking supervision. In addition, following the bankruptcy of one bank, the central bank announced a fivefold increase in aggregate required capital, both core and supplementary, to AZN50 million, effective 1 January 2014. New banks must have this amount as paid-in capital.

Broad money (M3) grew by 20.7%, reflecting higher economic activity and bank loans to the private sector. Credit extended to the economy, primarily loans to the private sector, rose in 2012 by 24.1%, reflecting personal loans and trade finance. Credit quality improved, as the percentage of nonperforming loans fell to 6.3% in January–November 2012. Foreign currency savings and deposits dropped by 1.2%, while local currency holdings rose.

The current account surplus decreased to 22.6% of GDP from 25.7% in 2011, as exports declined more quickly than imports. Exports fell by 7.5% during first 9 months of 2012 as oil exports, which account for 94% of all exports, declined by 8.8%, mainly because lower oil production reduced export volume. Other exports, mainly of fruits and vegetables, chemical products, and metal, rose by 21.6% during January–September 2012. In addition, exports of services grew by 51.9% with a significant jump in tourism. Imports grew slightly, by 1.0% during January–September 2012, reflecting less need to import most kinds of food in light of higher domestic production, as well as lower demand for equipment and machinery at the early stage of new hydrocarbon projects. However, wheat imports rose sharply, as did imports of vegetable oil. Furniture imports also increased. Foreign direct investment rose by 23.4% in 2012 from 3.2% in 2011, mainly reflecting investments in the second phase of the Shahdeniz gas field and in new oil field exploration.
Official reserves at the end of 2012 totaled $12.0 billion (Figure 3.2.5). Assets of the State Oil Fund totaled another $34.1 billion. Looking ahead, the government adopted a policy to limit external public and publicly guaranteed debt to 10.0% of GDP, which is well above the 6.0% of GDP reported by the Economist Intelligence Unit for end of 2012 (Figure 3.2.6). All external debt amounts to one-eighth of total official reserves.

**Economic prospects**

The major driver of growth in 2013 and the next few years is expected to be activity outside the oil sector. Energy output will grow little through 2015 but is expected to expand more once gas field development is completed and the exploration of new oil fields proves successful, most likely after 2015. Planned public spending will boost public investment, while ongoing energy projects will increase foreign direct investment. New regulations on capital adequacy may allow increased lending to boost private investment.

Growth is forecast to accelerate to 3.1% in 2013 and climb further to 4.8% in 2014, mainly because of public spending outside the oil sector and, in 2014, some increase in oil production (Figure 3.2.7).

On the supply side, industry will contract slightly in 2013 as oil output falls, before it revives in 2014. The 2013 fiscal budget includes support for regional development diversifying away from oil. Higher public spending and private investment are forecast to drive annual construction growth of 18.0%. Agriculture is expected to grow by 5.0%–6.0% annually as irrigation projects and reclamation progress. The government’s food security program aims to eliminate the need for wheat imports by 2015.

Inflation is projected to accelerate to 6.0% in 2013 and 7.0% in 2014, reflecting public investment programs and large increases in current public expenditures, as salaries increase and social spending expands. However, moderate food inflation will help offset price increases elsewhere (Figure 3.2.8).

Fiscal policy is expected to be more expansionary, with the budget recording small deficits of 1.1% of GDP in 2013 and 1.3% in 2014. Revenues are expected to grow each year by 20% and expenditures by 27%. State Oil Fund transfers should continue to provide about 60% of budget revenue. Salary increases, social development spending to support minimum living standards, the payment of pension plans inherited from the Soviet Union, and public investment outlays will be the main drivers of government expenditure. The 2013 presidential election may also raise spending.

Monetary policy will adjust to reflect how inflation develops. Open market operations and changes in the refinancing rate will guide broad money growth. New regulations on capital adequacy are expected to stimulate the consolidation of some smaller banks or else foreign investment in them. Regulations may require successful banks to diversify their portfolios. However, delays in privatizing the one state-owned bank—the International Bank of Azerbaijan, which holds at least 40% of all bank assets—will continue to constrain the banking sector, signaling a lack of progress in stimulating private sector activity.

The current account balance is forecast to decline to 13.0% of GDP in 2013, reflecting rising imports of wheat, automobiles, home appliances, and
equipment for ongoing energy projects. The services deficit may widen, reflecting rising demand for imported services in the hydrocarbons sector. In 2014, the current account surplus is expected to rise to 17.0% of GDP (Figure 3.2.9), as output in the main Azeri–Chirag–Ginashli oilfield is expected to increase slightly. In sum, exports, led by hydrocarbons, are expected to contract by 2.1% in 2013 before reversing direction to grow by 1.7% in 2014. Development in the hydrocarbons sector and investment will boost imports of machinery and equipment and keep inflows of foreign direct investment high, though lower than in peak years. Reserves are expected to grow further, reaching $42 billion. External debt is forecast to show little change, remaining at 7.0% of GDP.

**Policy challenge—diversifying the economy**

The recent slowdown caused by declining oil production illustrates the risks arising from the economy’s continued dependence on petroleum. Economic diversification is critical to maintaining stable growth. The government’s recently issued Strategy 2020 aims to double growth in GDP per capita, mainly by expanding activity beyond oil, which is expected to grow at least 7% annually.

Achieving these targets will be difficult without improving the business environment and private sector initiatives. Although Azerbaijan ranks well in terms of starting businesses and registering property, according to the World Bank’s *Doing Business 2013*, it ranks only 169th of 185 countries in dealing with construction permits, getting electricity, and trading across borders. Structural reforms in these and other areas, such as simplifying taxpaying and easing access to credit, will be important to encourage investment outside of the oil sector.

The new strategy is designed to promote regional development, mainly through government projects to improve regional infrastructure. Such intensive regional development programs will require careful public expenditure management and improved budget formulation. Private initiatives, including public–private partnerships, can help contain budget expenditures on public infrastructure and ensure their long-term sustainability if well managed. Securing such private initiatives will require an appropriate regulatory framework for public–private partnership, a better investment climate, and a more effective financial sector with deeper capital markets and more extensive banking services.

The new strategy targets diversifying the economy by encouraging innovation and expanding advanced technical facilities to enable a shift toward knowledge-based industries. Since 2008, growth in the information, communications, and technology sector has averaged 20% a year, reflecting the government’s strong commitment to improve its products and e-services. Further development of the knowledge-based economy may encourage additional investments in human capital and capacity building.