Azerbaijan

The economy expanded by 5.8% in 2013, accelerating from 2.2% growth a year earlier as the oil sector recovered and growth continued in the rest of the economy. Declining oil prices squeezed export earnings and narrowed the current account surplus to 16.7% of GDP. Growth is projected to moderate to 4%–5% in 2014 and 2015 as industry grows more slowly.

Economic performance

Growth accelerated to 5.8% from 2.2% in 2012, driven mainly by a 10% expansion in the 52% of the economy not directly connected with oil.

On the supply side, rapid growth in non-oil activity and a resumption of growth in petroleum enabled industry (excluding construction) to expand by 1.2% after the 3.3% decline in 2012 (Figure 3.2.1). Food processing, construction materials, and machinery all expanded, benefitting from significant public investment, bank lending, and support from the Entrepreneurship Support Fund. Petroleum output rose by 1.0%.

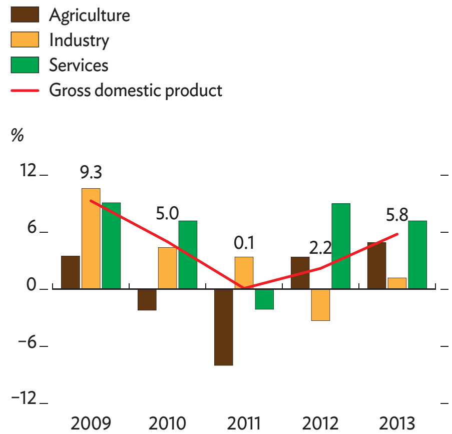
Construction expanded by 23.0%, supported by large public infrastructure projects and private investment. Agriculture grew by 4.9%, largely by tapping concessional government lending and improved access to finance in rural areas. To stimulate local entrepreneurship in agriculture, the government continued to provide exemptions from taxation and customs duties. Services, representing about 30% of GDP, grew by 7.2%, reflecting gains particularly in trade, tourism, and catering. Retail trade grew by 9.6% on higher consumption demand.

On the demand side, private consumption, public investment, and net exports all expanded. Rising incomes attributable to higher salaries and pensions and increased consumer lending fueled private consumption. Gross fixed capital formation rose by 11%, mainly because of higher investment in the non-oil economy, much of which was supported by government development programs.

Average annual inflation rose to 2.4% in 2013 from 1.1% in 2012 as prices for services increased, reflecting higher civil service wages and expanding credit (Figure 3.2.2). Markets for agricultural goods organized by the government and moderating global food prices helped contain inflation. An unexpected increase in fuel tariffs during December raised inflationary pressure at year-end.

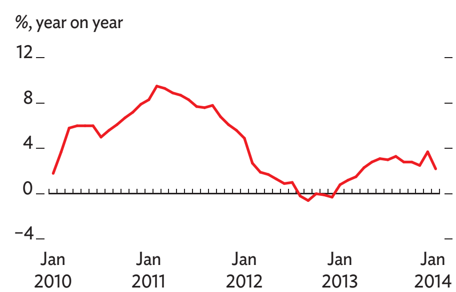
Fiscal policy in Azerbaijan is driven largely by oil income, which accumulates in the State Oil Fund of Azerbaijan (SOFAZ), from which transfers are made to finance budget expenditures. Transfers from SOFAZ provide about 58% of total revenues. Improved tax administration contributed to tax revenues exceeding expectations.

3.2.1 GDP growth by sector



Source: State Statistical Committee of the Republic of Azerbaijan.
Click here for figure data

3.2.2 Monthly inflation



Sources: Central Bank of the Republic of Azerbaijan; International Monetary Fund. International Financial Statistics online database (accessed 17 March 2014).
Click here for figure data

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

Total revenues increased by 12.8% from 2012 and constituted 33.8% of GDP, up from 31.6% in 2012.

Expenditure rose by 9.7%, which was 3.7 percentage points less than projected. Large salary increases, greater support to social services including health and education, and aggressive regional development activities raised total outlays to an estimated 33.1% of GDP from 31.8% in 2012. The budget surplus was estimated at 0.7% of GDP, reversing a deficit of 0.2% in 2012.

The objective of Central Bank of Azerbaijan monetary policy has been to limit inflation to 5% while stabilizing the exchange rate. In February 2013, the central bank further relaxed monetary policy by reducing its policy rate from 5.00% to 4.75%, to strengthen activity and support firms in the non-oil economy. Average interest rates declined in response. Broad money grew by almost 15.4%, reflecting a 20.0% rise in credit to the economy.

Exchange rate policy targets the US dollar/Azerbaijan manat rate. During 2013, the central bank intervened in the market and sterilized $2.5 billion to maintain exchange rate stability. This helped limit the appreciation of the manat to less than 0.1% (Figure 3.2.3). The authorities accepted the recommendation from the International Monetary Fund to move over time to a more flexible exchange rate regime, which should provide additional tools to weather potential shocks as the economy diversifies.

After the bankruptcy of a local bank, the central bank acted to protect the country's banking sector from risks and raised capital requirements fivefold, from AZN10 million to AZN50 million. This measure envisaged banking sector consolidation and recapitalization. However, most of the banks managed to meet the new requirement, and the deadline for compliance was extended a year, until the end of 2014.

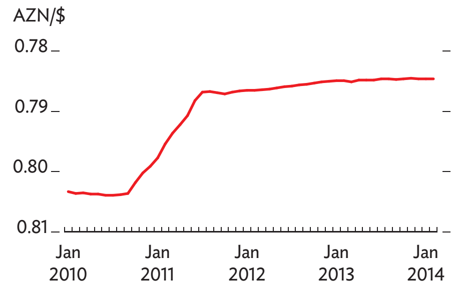
Hydrocarbons contribute 94.4% of export revenues. Exports declined by 1.8% in 2013, as lower global prices reduced oil export earnings, while imports, mainly of food and other consumption goods, rose by 9.4%. Accordingly, the trade surplus narrowed to $20.6 billion in 2013 from $22.2 billion in 2012. The smaller trade surplus contributed to a 17.4% contraction, to $12.3 billion, in the current account surplus, which fell to 16.7% of GDP in 2013, from 21.4% in 2012.

Foreign direct investment amounted to $6.3 billion, 82.4% of which went to the oil and gas sector. Gross international reserves grew to an estimated $14.4 billion at the end of 2013, equivalent to 15.5 months of imports, from $12.0 billion a year earlier (Figure 3.2.4). Strategic reserves—the sum of gross reserves in the central bank and SOFAZ assets—amounted to nearly $50 billion at the end of 2013. External public debt at the end of 2013 was estimated at $6.1 billion, or 8.2% of GDP.

Economic prospects

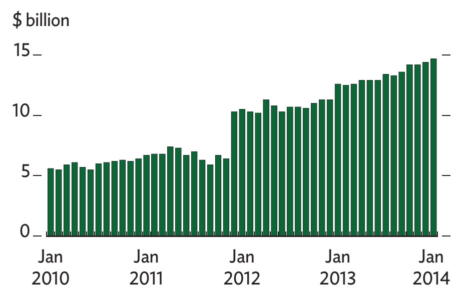
Growth is forecast to slow to 5.0% in 2014 and decelerate further to 4.8% in 2015, mainly because of an anticipated moderation in public expenditure and slowing expansion in the oil industry (Figure 3.2.5). Large public sector programs, including public investments in infrastructure, will continue to propel growth, though declining oil

3.2.3 Nominal exchange rate



Source: Central Bank of the Republic of Azerbaijan.
Click here for figure data

3.2.4 International reserves



Source: International Monetary Fund. International Financial Statistics online database (accessed 17 March 2014).
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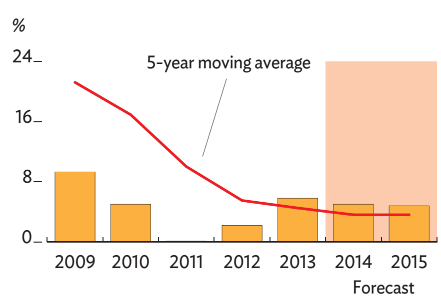
3.2.5 GDP growth



Sources: Central Bank of the Republic of Azerbaijan. http://www.cbar.az (accessed 18 March 2014); ADB estimates.
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prices and limited increases in production will constrain how much petroleum income can finance the promotion of other activities. Recently approved state programs for the development of Baku, the capital, and of the regions will identify new opportunities for public investments to diversify the economy. Attempts to make the budget less dependent on oil revenues may further cut public investments in coming years, possibly slowing growth more than currently projected.

On the supply side, industry is forecast to expand by 0.9% in 2014 and then slow to 0.5% growth in 2015. Oil and gas will contribute modestly to growth, while construction, benefiting from public investment, will remain an important driver, though less so than in 2013 because of an expected plateauing of budget expenditure. The government will continue its support to agriculture and will extend subsidies and concessional lending to farmers through its company Agroleasing. The authorities are expected to prepare a plan to reclaim unused land for agriculture as two big irrigation projects reach completion. Hence, agriculture is expected to grow by 5.5% in 2014 and 5.7% in 2015, reflecting higher crop production. Services are projected to grow by 8.0% in 2014 and 8.5% in 2015 because of tourism and trade.

Inflation is projected to accelerate to 4.0% in 2014, reflecting higher incomes and a rise in fuel tariffs, then moderate to 3.5% in 2015 (Figure 3.2.6). Higher transportation costs may impose additional inflationary pressure on food prices, which will nevertheless remain low. Strict processing rules introduced in 2013 for consumer loans should reduce overheating in consumer markets, helping to contain inflation and widen the trade surplus.

The government budget is expected to return to deficit in 2014 and 2015, with the deficit reaching 2.6% of GDP in 2014 before diminishing to 2.0% in 2015 (Figure 3.2.7). Despite improved tax administration, revenues are expected to decline by 6% in 2014, mainly because of smaller transfers from the SOFAZ sovereign wealth fund, as oil earnings approach a peak and the authorities work to reduce the budget's dependence on oil revenues. Total expenditure is forecast to decline to 32.1% of GDP in 2014 and possibly less in 2015, notwithstanding continued investment in infrastructure and spending for social projects that support education, health care, and social protection. The decline in the ratio of expenditure to GDP will limit domestic demand and retard growth.

Monetary policy during 2014–2015 is expected to target inflation even more narrowly than before. With stronger controls over consumer loans, banks are expected to promote lending to micro, small, and medium-sized enterprises. At the same time, the central bank announced in February 2014 a significant relaxation of provisioning requirements. Both developments may accelerate growth in private sector credit.

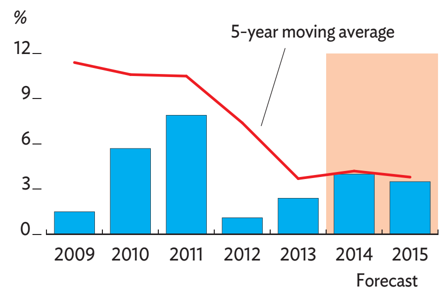
The current account balance is forecast to record a surplus of 16.0% of GDP in 2014 and 15.0% in 2015, reflecting continued sizable oil and gas exports (Figure 3.2.8). Imports are expected to grow by 3.4% in 2014 and 4.0% in 2015. New rules on consumer lending will reduce imports of electric appliances and other household goods, though imports required to build the Shah Deniz gas pipeline will keep total imports rising. Service earnings should expand in 2014 and 2015, buoyed by the transportation of goods and two big international events that Azerbaijan will host.

3.2.1 Selected economic indicators (%)

	2014	2015
GDP growth	5.0	4.8
Inflation	4.0	3.5
Current account balance (share of GDP)	16.0	15.0

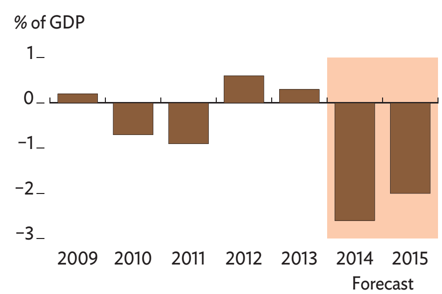
Source: ADB estimates.

3.2.6 Inflation



Sources: Central Bank of the Republic of Azerbaijan. http://www.cbar.az (accessed 17 March 2014); ADB estimates.
Click here for figure data

3.2.7 Fiscal balance



Sources: Ministry of Finance of the Republic of Azerbaijan; ADB estimates.
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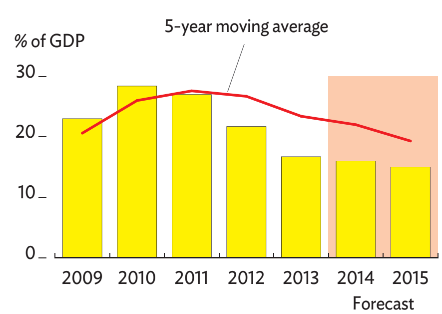
3.2.8 Current account balance



Sources: Central Bank of the Republic of Azerbaijan. http://www.cbar.az (accessed 17 March 2014); ADB estimates.
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Policy challenge—fiscal consolidation and reducing dependence on oil

Much of Azerbaijan's recent growth has come from using oil earnings to finance public investment, as transfers from SOFAZ have provided nearly 60% of budget revenues. Oil revenues are unlikely to rise much over the medium term, however, as production levels off and global prices decline. Thus, the budget may fall under pressure, requiring the government to consolidate its budget and spend its money more productively.

The resulting cuts in public spending will likely reduce public investment in various sectors of the economy. Unless managed carefully, these cuts could undermine growth in the broader economy, especially in construction, and slow its necessary diversification.

The government needs to make its budget planning and implementation more effective by introducing best practices, including the use of effective public–private partnerships, while also creating deeper and more efficient financial markets. Effective public–private partnerships can help the authorities to address infrastructure needs at lower cost to the budget, though such arrangements must be well organized and managed to attain good results. The careful use of such partnerships would allow the budget to devote more spending to programs in health, education, and training, which offer the best hope of addressing the needs of the most vulnerable populations. Developing more effective financial markets would promote private sector development.

The central bank's decision to curb consumer lending in favor of loans to small and medium-sized enterprises should promote growth. Additional lending to small and medium-sized enterprises should assist a wide variety of firms, particularly those in the broader economy apart from oil, and narrow disparities between the capital and the regions. However, more is needed to promote lending in rural areas.

Around 40% of the population of Azerbaijan lives in rural areas, where agriculture is the main pursuit and firms are usually small. At present, agriculture is heavily subsidized by the government, which shields activities in the sector from taxes and exempts several agricultural inputs, such as seed, livestock, and fertilizer, from customs duties. These exemptions reduce revenues and help keep the budget dependent on oil income.

Agriculture has the potential to employ around 30% of the labor force and generate additional income to reduce poverty and promote growth in rural areas. Making finance available in these areas, and using microfinance to reach underserved farmers and other poor households, is important for boosting rural income. Promoting microfinance will require that a sound regulatory framework be established. A new strategic approach for financial inclusion that includes new services, such as micro insurance and micro leasing, would support this effort.

Besides improving microfinance, the authorities need to promote a wider regional network of bank branches, enforce financial consumer protection, and create conditions that will enable financial institutions to reduce real lending rates for rural enterprises. These steps should boost rural income and, eventually, revenue from rural areas, thereby reducing the budget's current dependence on oil earnings.