AZERBAIJAN

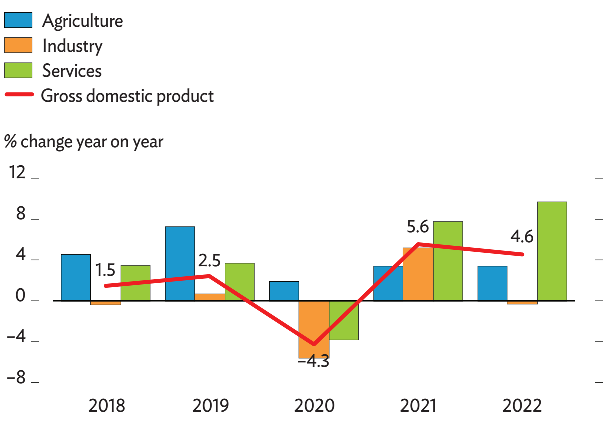
Growth slowed in 2022 because of lower oil production even as high oil prices sharply widened the current account surplus. Annual inflation doubled on rising prices for food and other imported goods. Growth is projected to decelerate further in 2023 with slower expansion in services and construction before rising in 2024. Tight monetary policy and an expected decline in global commodity prices should reduce inflation in both years. Strengthening knowledge management is vital to improving policy making.

Economic Performance

Growth slowed from 5.6% in 2021 to 4.6% in 2022 as oil output dropped (Figure 2.2.1). The slowdown occurred despite strong 9.1% growth outside of the large hydrocarbon industry. Mining declined by 2.6% as oil output fell by 5.6% because major oil rigs were shut down for maintenance, more than offsetting a rise in gas production. The broader industry sector reversed 5.2% expansion in 2021 to contract by 0.3% as the decline in mining from lower oil production outweighed substantial gains in manufacturing and construction. Manufacturing expanded by 9.1% with higher production of construction materials, pharmaceuticals, furniture, and machinery. Construction grew by 13.4% on higher public and private investment. Growth in services, which provide nearly 40% of GDP, rose from 7.8% in 2021 to 9.7%, driven by a 3.2% gain in wholesale and retail trade, 23.2% expansion in transport including freight handling and warehousing, and 58.2% growth in accommodation and public catering. Expansion in agriculture stabilized with 3.4% growth in livestock and 3.3% growth in crop production, both buoyed by a continuing agriculture credit support program and subsidies for inputs.

Figure 2.2.1 GDP Growth

Growth slowed in 2022 as oil production declined.



GDP = gross domestic product.
Source: State Statistics Committee of the Republic of Azerbaijan.

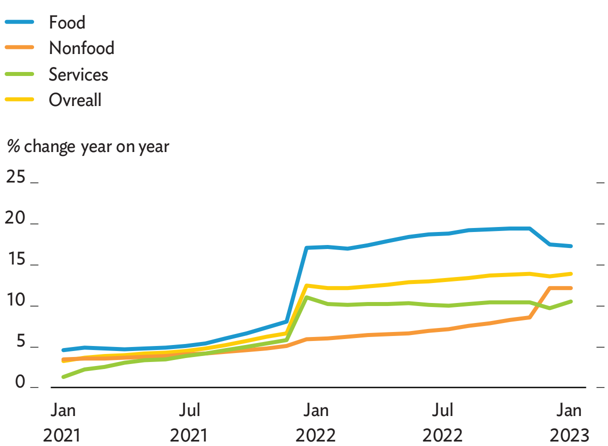
On the demand side, economic activity benefited from easing pandemic restrictions. Growth in private consumption accelerated from 3.7% in 2021 to 4.4% in 2022 as the non-petroleum economy rebounded. Public investment expanded by 8.3% as investment in regained territories picked up, while private investment contracted by 0.1%. After considering changes in inventories, total investment rose by 5.5%, reversing an 8.2% decline in 2021. However, the drop in oil export volume reduced net exports.

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

Both external and domestic factors contributed to a sharp rise in prices. Average annual inflation doubled from 6.7% in 2021 to 13.9% in 2022 on stronger domestic demand, rising food prices attributable to disruption caused by the Russian invasion of Ukraine, and higher prices for other imported goods (Figure 2.2.2). A rise in utility tariffs early in 2022 added to inflation, as did the government's adjustment of minimum salaries in response to inflation. Prices rose by 19.5% for food, 8.6% for other goods, and 10.4% for services. To curb inflation, the central bank increased its policy rate from 7.50% to 8.25% in three steps from January and December 2022, and then raised it a further 25 basis points in January 2023 as inflation remained high (Figure 2.2.3). The continued de facto peg of the Azerbaijan manat to the US dollar held down pressure from imported inflation.

Figure 2.2.2 Inflation

Inflation spiked in 2022 as food prices jumped.

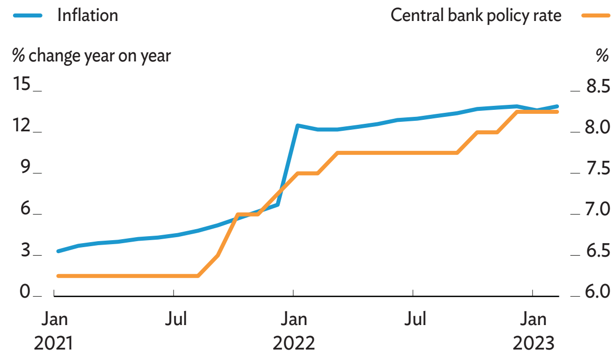


Source: State Statistics Committee of the Republic of Azerbaijan.

Despite higher oil prices, the budget remained in deficit. The budget deficit narrowed slightly from the equivalent of 1.1% of GDP in 2021 to 1.0% as both revenue and expenditure declined as a percentage of GDP (Figure 2.2.4). The non-hydrocarbon primary deficit reached 13.3% of non-hydrocarbon GDP. Transfers from the State Oil Fund of Azerbaijan, the sovereign wealth fund, decreased by 30.2%, amounting only to 25.0% of total revenue as the government managed to raise tax collections. With the cut in wealth fund transfers, total revenue fell from 28.4% of GDP in 2021 to 22.9% despite rising by 16.1% in absolute terms. Expenditure fell from 29.5% of GDP in 2021 to an estimated 24.0%. Public and publicly guaranteed debt, both external and domestic, declined from 16.2% of GDP in 2021 to 11.8% as the government continued its conservative borrowing policy. An update to the government's debt-management strategy set ceilings for total public debt at 20% of GDP in 2025 and 15% in 2030.

Figure 2.2.3 Inflation and Policy Rate

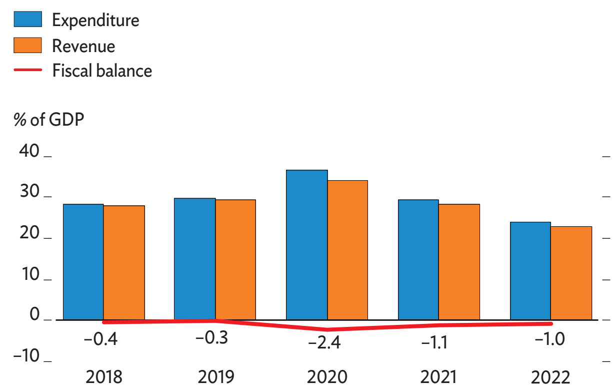
Monetary policy tightened as inflation picked up.



Sources: State Statistics Committee of the Republic of Azerbaijan; Central Bank of the Republic of Azerbaijan.

Figure 2.2.4 Fiscal Indicators

The fiscal deficit narrowed in 2022 as both revenue and expenditure declined in percent of GDP.



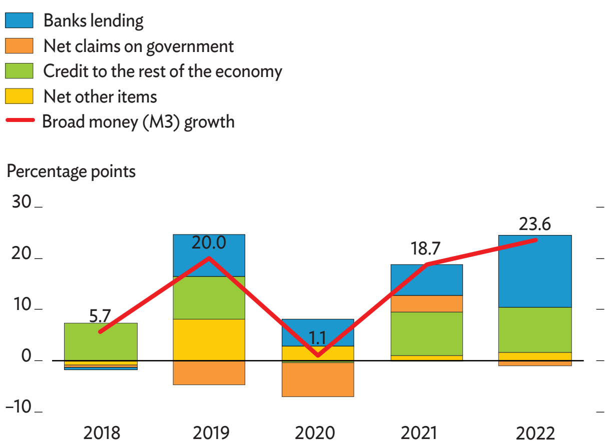
GDP = gross domestic product.
Source: The Ministry of Finance of the Republic of Azerbaijan.

Banks remained resilient. They increased lending by 31.5% in 2022, reflecting growth in private consumption, while deposits grew by 28.0%. Loans to households rose by 11.1%. Net bank profits rose by 70.1% in 2022, supported by high interest margins.

The share of impaired loans in total lending declined considerably from 4.2% in 2021 to 0.3% in 2022. Deposit dollarization fell slightly from 49.4% at the end of 2021 to 48.4% a year later, while loan dollarization declined from 25.8% to 19.7%. Broad money expansion rose from 18.7% in 2021 to 23.6% (Figure 2.2.5).

Figure 2.2.5 Money Supply

Broad money growth accelerated on higher lending.

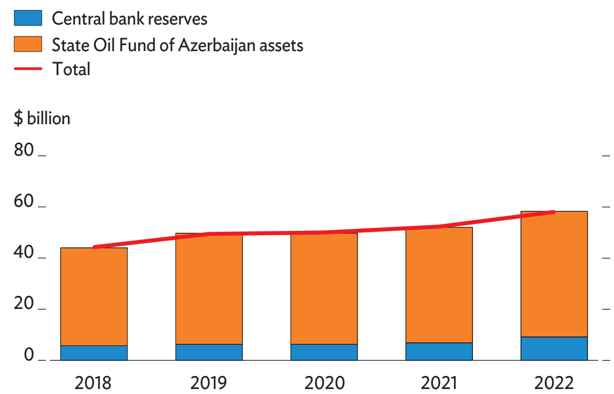


Source: Central Bank of the Republic of Azerbaijan.

High hydrocarbon prices significantly widened the current account surplus. The current account surplus expanded from the equivalent of 15.2% of GDP in 2021 to an estimated 25.7% in 2022 as export earnings skyrocketed by 81.9% on higher hydrocarbon prices. The trade surplus more than doubled from $11.2 billion a year earlier to an estimated $24.2 billion on higher oil and gas export earnings, increased transportation services, and higher income inflow, with hydrocarbons accounting for 90% of exports. Higher domestic demand boosted merchandise imports by 23.7%. Secondary income rose sharply from $0.7 billion in the first 9 months of 2021 to $2.3 billion in the same period of 2022 because of higher remittances and money transfers from Russian migrants. Net foreign direct investment in the first 9 months of 2022 rose by 24% to $4.6 billion, with nearly 70% of investment going into oil. The central bank's foreign exchange reserves rose by 27.1% to $9.0 billion, providing cover for 9.5 months of imports. Together with the assets of the State Oil Fund, Azerbaijan's strategic reserves reached $58.0 billion at the end of 2022, equal to 73.7% of GDP (Figure 2.2.6).

Figure 2.2.6 International Reserves

International reserves increased as oil prices remained high.



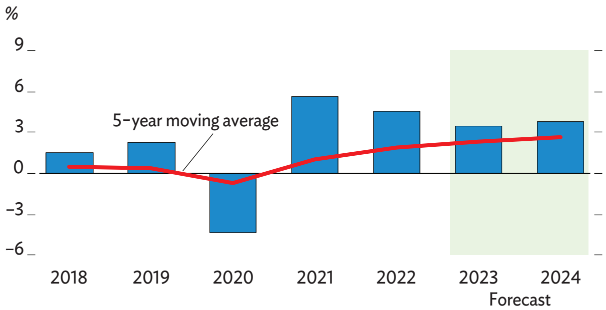
Sources: Central Bank of the Republic of Azerbaijan; State Oil Fund of the Republic of Azerbaijan.

Economic Prospects

Growth is projected to moderate in 2023 and accelerate slightly in 2024 (Figure 2.2.7). Its slowing to 3.5% in 2023 will reflect less expansion in the non-hydrocarbon economy, and it will likely recover to 3.8% in 2024 along with oil production following the rehabilitation of oil field infrastructure in 2022. Meanwhile, gas production will expand further. A surge in mining output will help industry expand by 0.5% in 2023 and 1.0% in 2024. The plan to rebuild regained territories, as outlined by the government in its socioeconomic strategy for 2022–2026, will support public and private investment. Growth in construction will nevertheless slow slightly from 13.4% in 2022 to 12.0% in 2023 and, as the main public infrastructure projects are completed, to 11.0% in 2024. Agriculture is projected to grow by 3.8% in 2023 and 4.0% in 2024 with continued subsidies for fuel and fertilizer, a specialized agriculture leasing facility providing long-term financing at low rates, and other concessional lending to farmers. Growth in services is projected to slow to 7.0% in 2023 before recovering to 7.5% in 2024 with support from retail trade and transportation. KazmunayGaz of Kazakhstan and the State Oil Company of Azerbaijan are close to agreeing on transporting oil from Kazakhstan, which would boost transport services if agreement is reached.

Figure 2.2.7 Gross Domestic Product Forecast

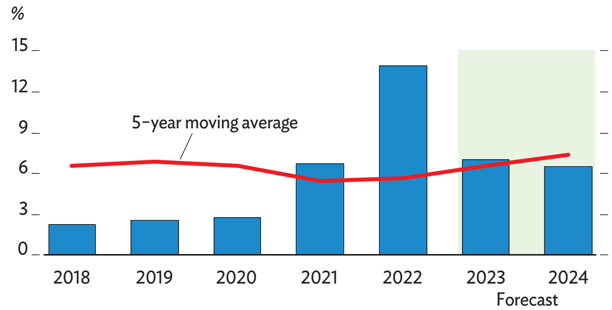
Growth is projected to slow in 2023 before rising in 2024.



Source: Asian Development Bank estimates.

Figure 2.2.8 Inflation Forecast

Inflation is projected to slow in 2023 and 2024.



Source: Asian Development Bank estimates.

Table 2.2.1 Selected Economic Indicators, %

Growth is projected to slow in 2023 before rising in 2024, with inflation declining in both years.

	2021	2022	2023	2024
GDP growth	5.6	4.6	3.5	3.8
Inflation	6.7	13.9	7.0	6.5

GDP = gross domestic product.
Source: Asian Development Bank estimates.

Net exports will be the main demand-side driver of growth. Private consumption is forecast to contract in real terms because of tightened monetary policy, while higher civil service wages will boost public consumption. The rise in construction, reflecting higher public and private investment, will be insufficient to boost total domestic demand. Net exports will rise in 2023 on higher hydrocarbon exports and lower imports before moderating in 2024 on cuts to hydrocarbon output and higher imports to meet improving domestic demand.

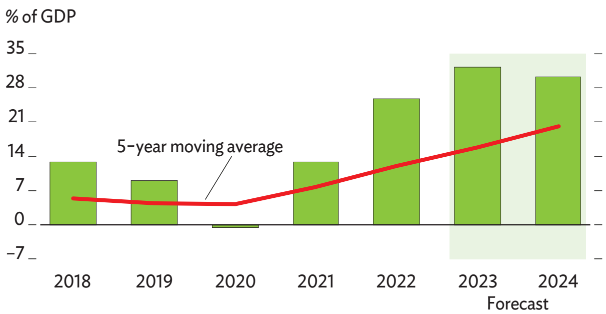
Inflation will ease. It is projected to diminish to 7.0% in 2023 and 6.5% in 2024, reflecting tight monetary policy, some decline in global commodity prices, and reduced bank lending (Figure 2.2.8). However, a rise in minimum wages and pensions in late 2022 could boost inflation. The central bank is expected to maintain its policy rate until at least mid-2023 while it observes price movements and consumer sentiment. The policy rate will be adjusted once inflation settles within the target band of 2%–6%. The exchange rate is forecast to remain stable as hard currency inflow rises.

Fiscal policy will become more expansionary. The state budget deficit is expected to double to the equivalent of 2.1% of GDP in 2023 and 2.2% in 2024. Hydrocarbon revenue will remain a key funding source. The non-hydrocarbon deficit will equal 7.0% of GDP in 2023 and widen further to 11.1%, with transfers from the sovereign wealth fund projected to increase in 2024. Total revenue is expected to decline to 22.2% of GDP in 2023 and further to 21.2% in 2024, while expenditure is forecast to equal 24.1% of GDP in 2023 and 23.2% in 2024, even as both revenue and spending rise in nominal terms. Public debt is forecast to remain moderate under the government's revised debt management strategy to keep public debt below 20% of GDP after 2025.

The current account surplus is projected to widen to the equivalent of 32.2% of GDP in 2023 and then narrow slightly to 30.2% in 2024 (Figure 2.2.9). With higher oil production and gas exports, the export total will rise by 0.2% in 2023 despite lower average oil prices. Exports will decline by 2.9% in 2024 with a forecast small decline in oil production. The overall trade surplus is expected to widen by 6.4% in 2023 and then narrow by 5.6% in 2024. Imports are seen diminishing in 2023 because of lower domestic demand but then rising in 2024 as growth accelerates and demand revives. Higher inflows from transport and tourism services will narrow the deficit in services by 5.8% in 2023 and 16.7% in 2024. However, rebuilding costs in the regained territories may widen the deficit. The income deficit may widen further in 2023 and 2024 because of rising income repatriation by foreign investors and interest payments on foreign securities and loans.

Figure 2.2.9 Current Account Forecast

The current account surplus will widen in 2023 before narrowing in 2024.



Source: Asian Development Bank estimates.

Policy Challenge—Strengthening Knowledge Management for Better Economic Policies

Azerbaijan continues to rely on revenue from hydrocarbon exports and is thus vulnerable to external shocks. Since 2016, the government has spent significant resources to accelerate diversification and boost the non-hydrocarbon economy. However, reform has been slow to take effect because of frequent policy changes, reversals of institutional decisions, and staff turnover. Underlying these problems is the difficulty of sharing knowledge within the government.

Knowledge is not disseminated across agencies, but is usually the preserve of individual employees. Moreover, inadequate coordination across government silos constrains knowledge sharing. A lack of proper infrastructure to collect, store, and use knowledge limits its dissemination. Moreover, a lack of regulations to protect knowledge and the absence of a dedicated government agency to act as the knowledge custodian further undermine knowledge sharing in the government.

Azerbaijan has significantly improved public service delivery by adopting digital technology and a one-stop shop. The system encompasses the E-government Development Center, which mobilizes all intergovernmental activities under a single platform used mainly for public services. The national socioeconomic strategy for 2022–2026 highlights the importance of achieving a knowledge society for further economic development. The government has started developing a digital strategy that will improve information technology infrastructure toward building a resilient knowledge- and evidence-based economy.

In addition, the government needs to adopt a program on knowledge management. A regulatory framework is needed to enable a smooth process for sharing knowledge and enhancing learning in and across government institutions. An efficient institutional setup with a dedicated government agency to serve as a knowledge custodian could optimize the use of knowledge products in the country. It is critical to institutionalize underlying knowledge management systems for agencies to benefit fully from knowledge enhancement. A supportive regulatory framework will promote intergovernmental collaboration to share knowledge. In addition, effective use of digital technologies that are fit for purpose can ensure easy and timely access to knowledge resources.

A key consideration in designing a knowledge management system is to ensure adequate resource allocation. The necessary resources include funding, staffing, technology, management commitment, and an organizational culture that motivates staff to tackle change management. Because knowledge derives from both education and practice, the capacity-building component of a knowledge management system is critical to ensure that all workers create and use knowledge products.

There is strong demand for knowledge and support technical assistance projects implemented by international organizations. As an upper middle-income country, Azerbaijan could co-finance such technical assistance programs it implements with international institutions.