Growth declined in 2023 with lower oil production and transshipment, which dragged down transport services. Monetary tightening cut annual inflation to single digits. Growth will rise in 2024 and 2025 with higher public spending and transport gains from revived transshipments of Kazakh oil. Inflation should decline in 2024 in line with lower inflation of trade partners before rising in 2025 as fiscal expansion boosts demand. Strengthening public finance management is essential to address climate change and achieve decarbonization targets.

**Economic Performance**

**Growth slowed in 2023, reflecting lower oil production and deceleration in services.** Following a strong rebound from the pandemic, growth moderated from 4.6% in 2022 to 1.1% in 2023 because of weak performance in the hydrocarbon economy and a notable slowdown in transshipment services and total transport (Figure 2.2.1). Industry contracted by 1.1% following 1.6% decline in 2022 as technical problems constrained petroleum output. Mining stalled as a 4.2% rise in gas production only partly offset a 7.6% decline in oil output. However, industry aside from petroleum grew by 3.7% on higher production of machinery, furniture, and construction materials. Construction expanded by 13.3%, marginally below 13.4% in 2022, on higher public investment. Growth in services, representing nearly 38.0% of GDP, plunged from 9.7% in 2022 to 2.2% because of a sharp decline in transport. Credit-support programs and subsidies for inputs helped growth in agriculture reach 3.0%, slightly below 3.4% in 2022, with livestock and crop production rising by 3.2% and 2.7%, respectively.

**On the demand side, private consumption was a major driver of growth.** Expansion in private consumption accelerated from 4.4% in 2022 to 5.5% in 2023, reflecting a sharp rise of 12.8% in household incomes. Growth in investment rose from 8.2% in 2022 to about 11% due to increased spending in public infrastructure investment, while growth in private investment slowed. Declining oil output cut net exports.

**Inflation fell with monetary tightening, slower inflation in trade partners, lower global commodity prices, and a return to pre-pandemic prices for major services.** Average annual inflation slowed from 13.9% in 2022 to 8.8% in 2023 as price increases slowed from 19.5% to 9.6% for food, from 8.6% to 8.4% for other goods, and from 10.4% to 8.2% for services (Figure 2.2.2).
The continued peg between the Azerbaijan manat and the US dollar helped curb pressure from imported inflation. To May 2023, the Central Bank of Azerbaijan raised its policy rate in three steps from 8.25% to 9.00%, before lowering it to 8.00% in two steps from October to December, and then to 7.75% in February 2024 as inflation decreased.

Revenue rose from 22.9% of GDP in 2022 to 28.9% of GDP. This reflecting higher tax collections and increased transfers from the State Oil Fund of Azerbaijan, the sovereign wealth fund, which provided one-third of all revenue (Figure 2.2.3). Total expenditure grew by 13.7% to an estimated 29.6% of GDP in 2023, reflecting increased public investment. Converting part of the government’s contingent liabilities into public and publicly guaranteed debt caused total public debt to double, from 11.6% of GDP at the end of 2022 to 21.8% a year later.

The finance sector remained sound. Broad money growth plunged from 23.6% in 2022 to 5.3% in 2023 as net foreign assets expanded very little despite a rise in credit growth from a revised 14.0% in 2022 to 18.8%, driven by consumer lending (Figure 2.2.4). Strict prudential control and strengthened risk management practices at commercial banks helped reduce the share of impaired loans from 2.9% at the end of 2022 to 1.8% a year later. Banks’ profitability rose by 7.5% in 2023 on higher lending and timely repayments. Total bank deposits rose by 8.1%.

Declining oil prices and output slashed the current account surplus. The current account surplus fell by half from 25.7% of GDP in 2022 to an estimated 12.5% in 2023 as hydrocarbon export earnings declined. Lower oil earnings cut the trade surplus by more than half, from $178.6 billion in the first 3 quarters of 2022 to an estimated $76.1 billion in the same period of 2023. Hydrocarbons remained the main source of export earnings, though diversification efforts marginally increased the share of other exports. Higher domestic demand boosted merchandise imports by 24.3% in the first 9 months of 2023, slightly above the 23.7% rise a year earlier. In the same period, net secondary
income inflows fell from $2.3 billion to $1.9 billion as remittances fell by more than half, from $2.7 billion to $1.2 billion, with smaller inward money transfers from the Russian Federation. Net foreign direct investment in the period slowed by 4.3% to $4.4 billion, with 79.2% reflecting cuts in oil sector investment. Combined central bank and sovereign wealth fund reserves reached $67.6 billion, or 94% of GDP (Figure 2.2.5).

**Figure 2.2.5  International Reserves**

*Total international reserves grew in 2023 as sovereign wealth fund assets increased.*

<table>
<thead>
<tr>
<th>Year</th>
<th>State Oil Fund of Azerbaijan assets</th>
<th>Central Bank reserves</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>2019</td>
<td>10 billion</td>
<td>20 billion</td>
<td>30 billion</td>
</tr>
<tr>
<td>2020</td>
<td>12 billion</td>
<td>22 billion</td>
<td>34 billion</td>
</tr>
<tr>
<td>2021</td>
<td>14 billion</td>
<td>24 billion</td>
<td>38 billion</td>
</tr>
<tr>
<td>2022</td>
<td>16 billion</td>
<td>26 billion</td>
<td>42 billion</td>
</tr>
<tr>
<td>2023</td>
<td>18 billion</td>
<td>28 billion</td>
<td>46 billion</td>
</tr>
</tbody>
</table>


**Table 2.2.1  Selected Economic Indicators, %**

<table>
<thead>
<tr>
<th></th>
<th>2022</th>
<th>2023</th>
<th>2024</th>
<th>2025</th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP growth</td>
<td>4.6</td>
<td>1.1</td>
<td>1.2</td>
<td>1.6</td>
</tr>
<tr>
<td>Inflation</td>
<td>13.9</td>
<td>8.8</td>
<td>5.5</td>
<td>6.5</td>
</tr>
</tbody>
</table>

GDP = gross domestic product.

Sources: Bureau of National Statistics; Central Bank of Azerbaijan; Asian Development Bank estimates.

**Economic Prospects**

**Growth is projected to edge up to 1.2% in 2024 and 1.6% in 2025 with higher public spending and gains in services (Figure 2.2.6 and Table 2.2.1).** Led by expected increases in retail trade and transportation, expansion in services is projected to rise to 2.3% in 2024 and 3.0% in 2025. Gains in transport will come from an agreement between KazMunaiGas of Kazakhstan and the State Oil Company of Azerbaijan to increase the transit of Kazakh oil via Azerbaijan. Contraction in industry is forecast to ease to 1.6% in 2024 because of slowing performance at oil platforms and further to 1.0% in 2025 as gas production becomes more important. Food processing and the manufacturing of construction materials and petrochemical products will limit the decline in the broader industry sector. The next phase of agriculture support programs will help sustain growth in crop and livestock production.

**Private consumption and net exports will drive demand-side growth.** Growth in private consumption is forecast to accelerate as economic expansion and a further slowing of inflation boost real household incomes. Higher civil service wages will boost public consumption. Public investment will remain a driver of total investment in the forecast period, though declining oil production and weakening oil prices pose a risk to planned spending. Net exports will rise as export earnings outpace more slowly growing imports.

**Inflation should remain in check as the authorities monitor prices over the forecast period.** Declining inflation in trade partners is projected to slow inflation to 5.5% in 2024 before it rises to 6.5% in 2025 with faster economic growth (Figure 2.2.7). Continued exchange rate stability will moderate the impact of imported inflation. The central bank is expected to maintain its policy rate at least to mid-2024 and to observe price movements and consumer sentiment before making changes.

**Fiscal policy will remain mildly expansionary, with the budget highly dependent on petroleum earnings.** The state budget deficit is expected to be around 2.0% of GDP in 2024 and expand to 2.3% in 2025 as...
The current account surplus will widen in 2024 and narrow somewhat in 2025.

The external position will remain robust but depend heavily on oil prices. The current account is projected to remain in surplus during the forecast period, despite a decline in oil prices, as gas exports increase and the share of non-oil exports rises (Figure 2.2.8). However, rising aggregate demand from higher growth will increase imports, narrowing the trade surplus. Higher earnings from transport and tourism will further narrow the deficit in services with a possibility of a wider deficit from reconstruction.

Policy Challenge—Strengthening Public Finance Management to Attain Climate Policy Objectives

Azerbaijan’s economy remains heavily dependent on hydrocarbons. During the past 2 decades, petroleum has accounted on average for 40% of GDP and 90% of total export earnings. Limited skilled labor, constraints on market competition, and a heavy presence of state-owned enterprises have constrained growth for the many private firms outside of the petroleum sector. Hydrocarbon revenue has funded expansion of the rest of the economy, making economic growth highly dependent on volatile energy prices. Fossil fuel production poses climate risks. Given COP29 in 2024, the government is taking certain measures on its decarbonization goals to reduce carbon emissions. During 2020–2040, average temperatures in Azerbaijan are expected to be 0.5°C–1.5°C above those during 1971–2000, while precipitation will be 10%–20% less mainly in the mountains and foothills and on the Absheron Peninsula.

Azerbaijan signed and ratified the Paris Agreement without committing to a net-zero target. The latest nationally determined contributions (NDCs) set decarbonization targets of 35% in 2030 and 40% in 2040, which will be hard to achieve under current policies. Transport emissions tripled from 2000 to 2019. Electricity generation is the second-largest source of emissions, with methane providing nearly 30% of total emissions. In 2024, the government has joined the Global Methane Pledge.

Strong fiscal policies are a key part of the government’s integrated strategies to combat climate change. These policies should be aligned with country’s NDCs, and climate dimensions of its sustainable development goals should be reflected in government strategies and budget allocations. The fiscal framework must be inclusive and climate-responsive. The green agenda and its concerns should be considered at an early stage of budget planning.
Medium-term macrofiscal analyses and forecasts and sector strategic plans should include green priorities and indicators. The strategic framework should reflect the government’s green plan, financing needs, source of financing, carbon goals and targets, and related items. Green priorities should also be included in fiscal sustainability analyses, along with assessments of the climate implications of budget practices. Reviewing climate concerns during impact assessment and cost and benefit analyses would be useful.

The government should assess the financing gap for green programs and develop a road map for green financing. Soon after strategic planning under the medium-term fiscal framework is completed, it should develop green finance instruments and frameworks for green loans, debt swaps, a carbon market, green bonds, and insurance products. Doing so will expand the scale of green projects and focus public finance more on green outlays. By raising funds with sovereign green bonds, for example, the government can ensure that public investment supports projects with environmental benefits and progress toward achieving carbon targets.

Climate budget tagging is an effective tool to highlight the climate dimension in resource allocation. It involves tagging expenditure items and monitoring their implementation during a reporting year to assess the efficiency of green objectives. The process should continue during budget execution. Moreover, this approach allows tagging other environmental objectives. The process should not be limited to the annual budget cycle but instead govern the whole medium-term expenditure framework, given the long-term vision of strategic planning.

Implementing a green fiscal policy will require a number of measures. These include adopting green fiscal risk management practices and green public procurement principles, implementing climate-sensitive public investment management and assessment, establishing practices for internal and external control, and promoting fiscal transparency. Clear institutional mechanisms should be established, since the process entails multiagency integration and collaboration. Harnessing the capacity of government institutions will be crucial to successfully implementing a green fiscal policy. The absence of a well-defined public finance management legal framework will be the main challenge to starting the process.