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**Challenges for Sustainable Economic Development:
Evidence from Azerbaijan**

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Abstract

The analysis of the observed trends in economic development motivates an extensive range of restrictions that Azerbaijan faces in making fiscally, socially, and environmentally sustainable progress. Economic progress will therefore necessitate dealing with these restrictions related to both sustainable growth as well as inclusive growth. Solutions to removing current constraints will facilitate the economy to move toward a new growth trajectory that will ultimately better enable Azerbaijan to achieve long-term sustainability and macroeconomic stability with a diversified economy.

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JEL classification: F42; H62; J24

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1. Introduction

Azerbaijan, as one of the fastest growing post-Soviet Turkic countries, has undergone significant economic transformation and development since the country's independence in 1991. Despite a collapsed economy followed with the breakup of the Soviet Union,¹ Azerbaijan has been able to quickly transform itself into an upper-middle income country with a gross domestic product (GDP) per capita of \$7,886 in 2014, and a poverty rate of only 6% in 2012. It has also become a “high human development” country since 2010 under the Human Development Index (HDI).²

The main role in achieving the rapid economic development played utilization of hydrocarbon resources, which attracted foreign oil companies and foreign direct investment into the country. Oil revenues facilitated the government to realize ambitious projects, as well as to increase its public investment into e.g., development of infrastructure, building human capital and others. Extensive economic and political reforms have also been implemented in order to maintain a market-based economy, which facilitated economic growth as a whole, as well as economic development in main industries, such as construction and transport. However, much of the private sector, even in leading industries, is reliant on government contracts from the public or budgetary investments, which itself is still heavily dependent on oil sector. For instance, approximately 80% of all budget revenue in 2010 was derived from the oil industry through the State Oil Fund of the Republic of Azerbaijan (SOFAZ) and taxes on the oil sector.³ In 2015, SOFAZ alone accounted for approximately half of the state budget revenues.⁴

Although abundance in natural resources does have potential to serve as an advantage for economic growth (Mehlum *et. al.*, 2006), the reliance only on petroleum revenues is dangerous in the long-run and places the country at risk of volatility and raises concerns about the long-term sustainability and macroeconomic stability. Indeed, slow growth rates observed in recent years and near zero growth in 2011, which was the lowest since 1995's GDP contraction due to a significant decline in oil production, demonstrate how dangerous the dependence on oil production and oil prices can be.

Thus, Azerbaijan needs to make greater progress in the non-oil sectors given the long time in which it takes to establish a diversified economy. The key economic challenge, then, is to develop a diversified economy that has new and sustainable sources of growth, and one that becomes more competitive in the global and regional markets.

The remainder of the article is organized as follows. The next section reviews evidence-based economic performance of Azerbaijan, which turns out to be challenging for the country, especially during last years after sharp reductions in oil prices, thus pushing the economist to develop new growth model in order to achieve sustainable development path. Section 3

¹ By 1995, the gross domestic product was below than 40% of what it had been in 1989. Source: *Asian Development Bank. 2014. Country Partnership Strategy: Azerbaijan, 2014-2018.*

² World Bank Group Data (online database) <http://databank.worldbank.org/data/>

³ European Commission, (2011), *Social Protection and Social Inclusion in Azerbaijan*, Brussels.

⁴ Ministry of Finance of the Republic of Azerbaijan: <http://malivyev.gov.az/en>

provides additional discussion on the main challenges and constraints to the existing growth model and Section 4 concludes by offering several policy advices.

2. Economic performance

Before 1991, Azerbaijan had a fairly broad economic base, with developed industrial, agriculture, and service sectors. Independence was followed with an economic collapse in Azerbaijan that was among the worst in the Commonwealth of Independent States (CIS), which led to GDP shrinking until 1996 due to a combination of trade disruptions and transition costs to a market economy, among other factors.

After the first major oil contract with international firms was signed in 1994, and the foreign direct investment started to surge, the economy quickly resumed growth in 1996 due to the onset of investment into oil exploration and production. Also, the country's stabilization and structural reform program began in 1995. The program brought about macroeconomic and financial stability in terms of GDP growth, better control of inflation, and reduced fiscal deficits. The 10% average annual economic growth between 1996 and 2005 contributed to a sharp decline in poverty from 68% in 1995 to 29% in 2005. Factors that led to the poverty reduction included (i) significant increases of the minimum wage; (ii) rapid increases in wages; (iii) substantial budget transfers to social programs; and (iv) higher remittances, especially from the Russian Federation.⁵ A significant development occurred in February 2005, when the government issued a decree to revalue the manat.⁶

Economic objectives were further developed by adopting three additional state programs: (i) *The State Program on Poverty Reduction and Sustainable Development (SPPRS)*, 2008–2015, which contains 9 strategic goals, including macroeconomic stability and balanced development of the non-oil sector, and increasing income-generating opportunities; (ii) *The State Program of Regional Development (SPRD) 2009-2013*, which highlights job creation in the regions among other priorities; (iii) *Azerbaijan 2020: Look into the Future* explains the aspirations of becoming a knowledge-based economy, increasing the country's competitiveness, and diversifying the economic structure.

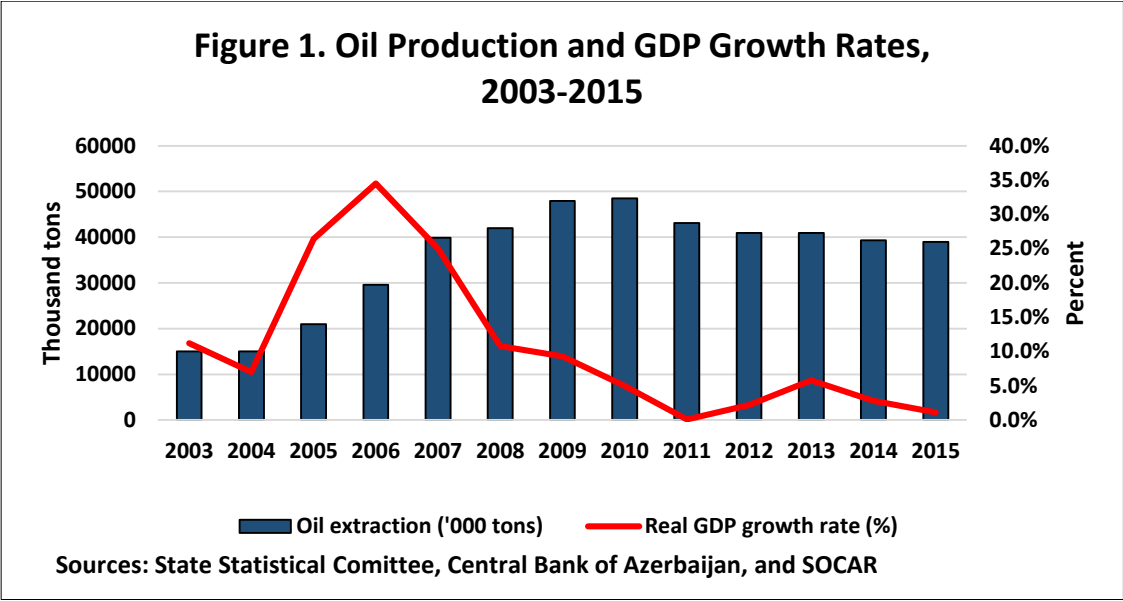
In summary, the various programs and strategies have been adopted to facilitate sustainable economic development, a diversified economy, global integration, and balanced development throughout the country, which affected economic performance of Azerbaijan throughout the period of interest.

Among these factors, rapid increases in oil production was the main driver, which triggered GDP growth to surge in 2005-2007, averaging 28.6% annual growth rate before falling back to growth levels of around 10% observed in the first half of the decade. The vulnerability of the economy to oil production fluctuations was peaked in 2011, when annual GDP growth floored to 0.1%, due to lower oil production and despite some increase in 2013, recovery is

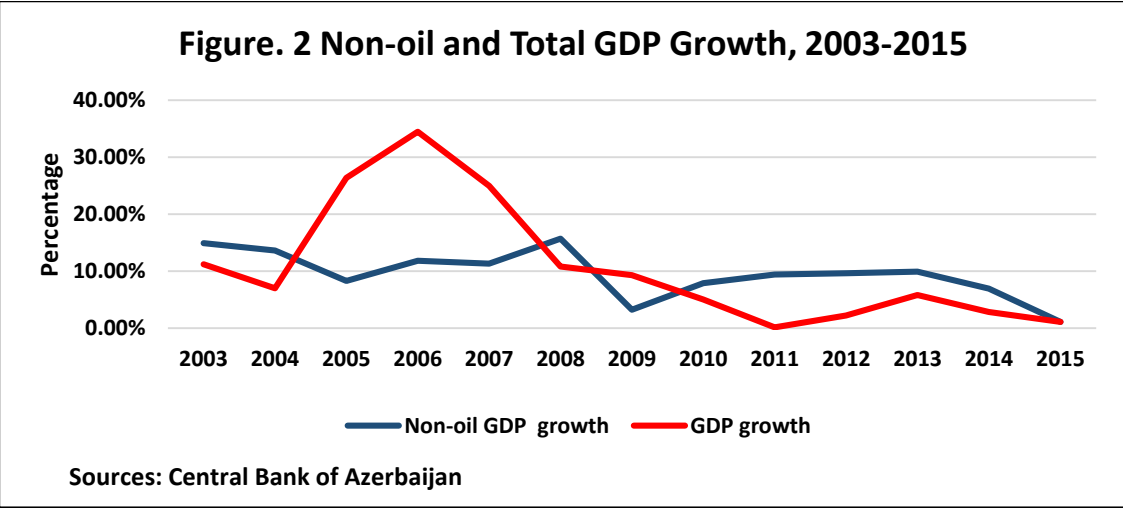
⁵ World Bank, 2009, Azerbaijan Country Economic Memorandum. Washington D.C.

⁶ The old manat was revalued at the rate of 5,000 to 1 new manat (AZN) and took effect on 1 January 2006. The nominal exchange rate for that year was AZN 0.8714 for one US dollar and strengthened to 0.784 in 2013.

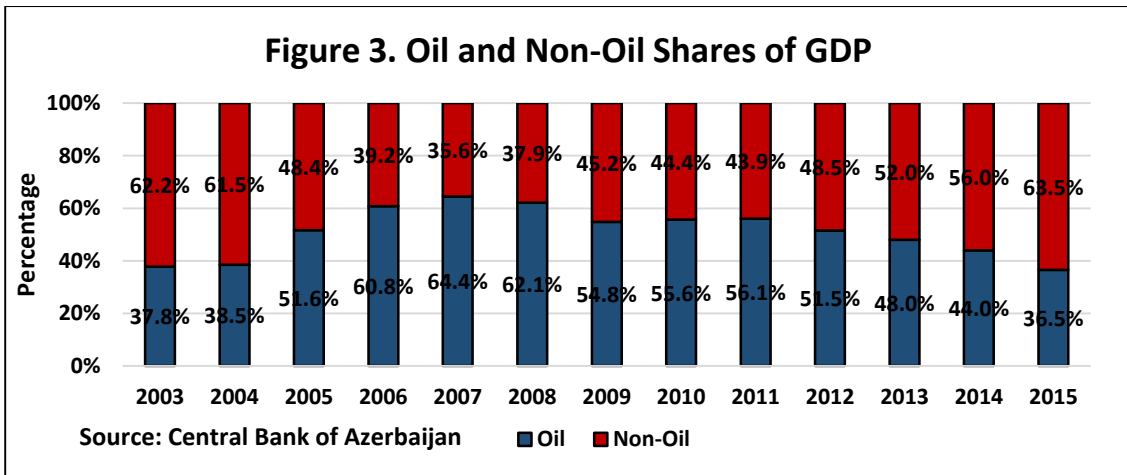
still not in the desirable region (1.1% in 2015), which is mainly driven by low oil prices (see, Figure 1).



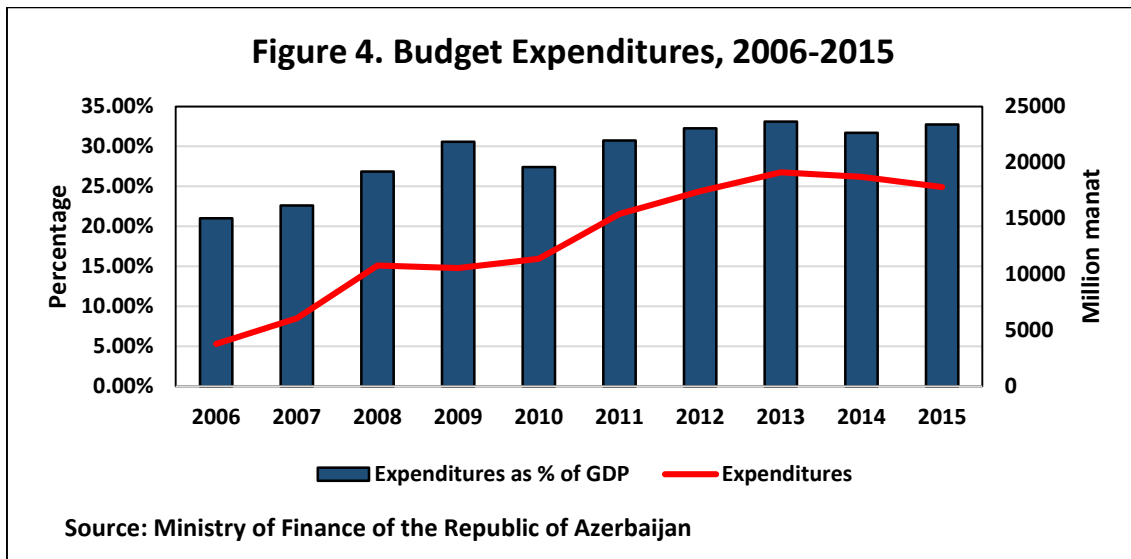
The non-oil sector growth rates, on the other hand, have been steadier and shifting less than overall GDP growth rates since 2005, oscillating around 10% until 2013 with the exception of 2009. From 2010, non-oil GDP growth was higher than overall GDP growth (and oil GDP growth, see IMF Article IV reports), although showing decline to 1.1% level in recent years (see, Figure 2).



Investigation also shows that oil revenues constitute more than half of Azerbaijan’s GDP between 2005 and 2013, demonstrating a decline trend afterwards, mainly because of sharp reductions in oil production and price levels (see, Figure 3). Aside from mining and quarrying, which includes oil, the composition of GDP by the next 4 largest sectors, namely construction (12.1% of GDP), transport, storage, and communication has demonstrated little progress in diversifying away from petroleum.

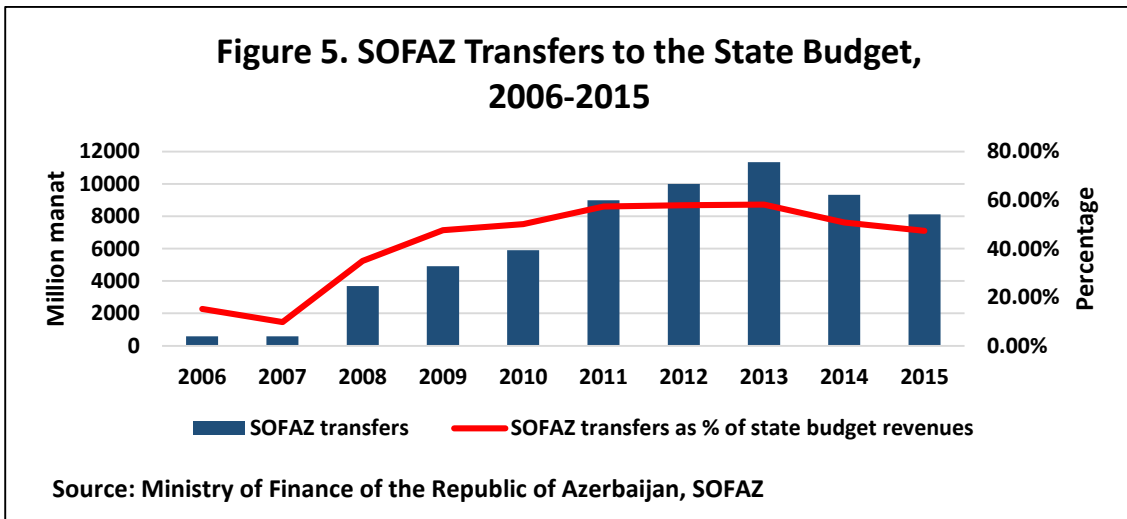


The oil boom has therefore clearly affected the structure of the economy, where much of the private sector's share of the economy is attributed to public expenditures and government contracts financed mainly by the country's petroleum export revenue.



For instance, the oil dividends facilitated to a significant increases in government spending, where the state's expansionary fiscal policy accelerated promptly in 2007 and 2008, with expenditures rising almost twice every year from 2006. Government spending have almost doubled since 2008 from AZN 10.77 billion to AZN 19.1 billion in 2013 (see, Figure 4). Although, surging oil revenues enabled the government to embark on ambitious public investment programs along with increasing wages and social transfers, low oil production and price levels led the government to gradually decrease its expenditures in 2014-2015 period.

It is worth emphasizing here that large annual increases in budget expenditures since 2005 have been facilitated by extensive transfers from SOFAZ, which made state budget become dependent on oil revenues (see, Figure 5). For instance, although SOFAZ transfers constituted only 9.7% of total state budget revenues in 2007 (AZN 585 million), between 2008 and 2013 this figure rose sharply from 35% to 58% amounting AZN 11.35 billion, which is nearly double of the amount transferred in 2010.



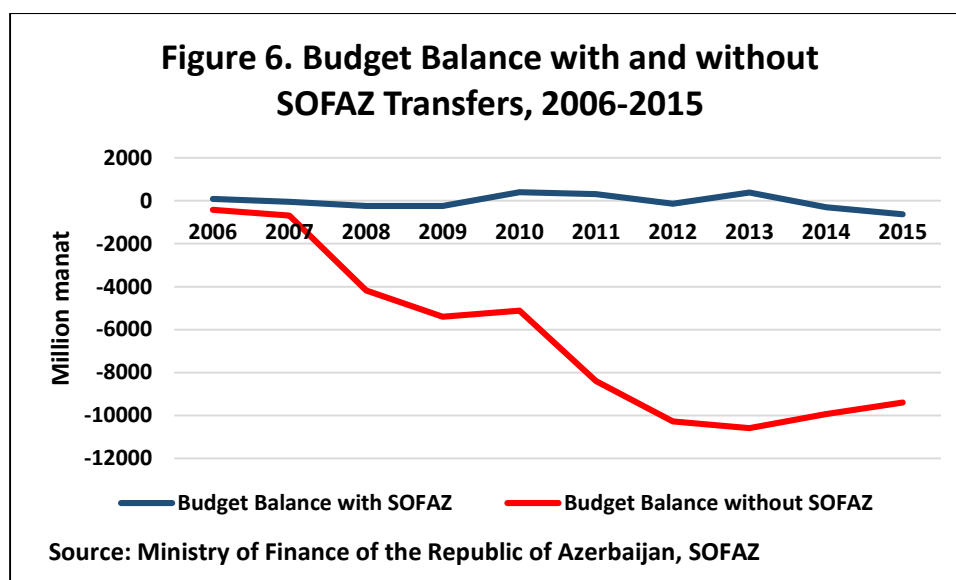
However, the rapid rise in SOFAZ transfers to the budget is a cause for concern due to fluctuations in oil industry, which country faces recent years, thus dragging the amount of these transfers down about one-third between 2013 and 2015.⁷ This constitutes that the government's expenditure was becoming increasingly dependent (at least in the short to medium term) on oil revenue as opposed to generating higher levels of other sources of revenue such as taxes. Additionally, by relating its fiscal policy to oil price cycle, the state places the economy under the risk of volatility.⁸

Overall government revenues have nearly imitated total expenditures as a percentage of GDP, which have gone from around 20% in 2006 to 33-35% in 2015. The state budget has experienced small surpluses or deficits of around 1% or less of GDP since 2001. However, without SOFAZ transfers, the budget deficit would be considerable larger and growing each year (see, Figure 6). For instance, the budget deficit would have been AZN 10.9 billion in 2013 without SOFAZ transfers compared to budget surplus of AZN 381 million.

Moreover, start of a large expansion in the money supply (broad money M2) and appreciation of manat every year since the 2006 revaluation also played its role in restructuring the economic situation, which has been mainly caused by the large influx of foreign currencies during the oil boom years. Following the global economic crisis of 2008 and 2009, the real effective exchange rate appreciated due to oil-related pressures, which affected Azerbaijan's competitiveness and its ability to export goods besides hydrocarbons.

⁷ The government has also adopted policy measures to reduce budget dependency on oil incomes. Despite an increase in budget expenditures, transfers from SOFAZ in 2014 (2015) were reduced by AZN 2.0 (AZN 1.2) billion compared to 2013.

⁸ IMF. 2012. Republic of Azerbaijan 2011 Article IV Consultation. *IMF Country Report 12/5*. Washington D.C.



The exchange rate appreciation thus made it more difficult for Azerbaijan to diversify into agriculture and manufacturing exports. In order to increase competitiveness in light of the currency appreciation, Azerbaijan will need to boost productivity. Public investment can help in this regard but only in the short-run.

Overall, Azerbaijan has been pursuing a strategy that involved short-term maximization of oil revenues in order to obtain the necessary revenue for state expenditures. This strategy of present consumption of oil funds has clearly benefited the country's current population in the short run, with a remarkable reduction in poverty, higher living standards, and higher wages since the mid-1990s. Yet this resource dependence has a finite life span, and therefore Azerbaijan must make greater strides toward a non-oil economy.⁹ Hence, Azerbaijan faces a demanding challenge in managing its oil resources and revenues for future generations, while simultaneously spending on the infrastructure needed to support diversification of the economy that would enable long-term, sustainable economic development.

3. Challenges and constraints to growth

Recent macroeconomic and geo-political developments suggest that new sources of shared growth will have to be generated for going forward. The impact of the oil price shocks and the economic situation in Russia has led to reductions in growth projections for many countries in the region, including Azerbaijan. The policy framework in Azerbaijan had been defined by a de facto exchange rate peg to the US dollar since 2009, and was supported by Central Bank interventions that led reserves to a draw down from \$15.2 billion to \$5 billion and almost 100 percent devaluation of the manat in 2015. This needed adjustment has aligned the exchange rate better with new economic fundamentals including falling oil prices and depreciation in trading partners' currencies. While fiscal dominance, a high share of cash in circulation, dollarization, limited capital market development and the absence of an interbank

⁹ Azerbaijan has an estimated 7 billion barrels (or 1 billion tons) of oil reserves. Its reserve-production ratio is only 21.9 years, which is considerably lower than the world average of 52.9 years. Source: British Petroleum. 2013. *BP Statistical Review of World Energy*. <http://www.bp.com/statisticalreview>

money market all challenge the monetary policy transmission mechanism, maintaining pressure on the state budget and on transfers out of accumulated savings in the Oil Fund, the manat depreciation will provide some mitigation.¹⁰ As noted by the World Bank (2015), fiscal consolidation and a more competitive exchange regime are both needed to complement the deep structural reforms that are essential for developing new and resilient sources of growth and revenues.

Thus, sustainable and inclusive economic growth model faces a variety of challenges and constraints that Azerbaijan has to overcome in order to attain its goal of becoming a diversified, knowledge-based country in the near future. On this regard, Azerbaijan has already started drawing up “Strategic road map” on the national economy and its priorities in accordance with the tasks set forth by the head of state to ensure sustainable economic growth in the country.¹¹

One of the major directions prioritized in strategic roadmap, which plays crucial role for sustainable and inclusive growth model and therefore has to be brought to the center of public policy agenda, is development of SME sector. Government has already adopted several promotional policy packages to encourage performance of business enterprises in this direction such as (i) reducing the number of required licenses and easing getting license procedures, (ii) promoting allowances on export and investment performance, (iii) temporary ceasing of tax inspections and others. However, SMEs in Azerbaijan still have a small share of GDP – less than 10% – which is below the 30-45% found in other Central Asian countries,¹² and therefore do not possess desirable level of economics of scale effect in playing a significant role for growth or aiding the economy to diversify. Although the government additionally also offers some assistance to promote SMEs such as the Entrepreneurship Support Fund, these efforts are still not in a sufficient level to enable expanding SME sector to a desirable level, unless level playing field conditions are not fully satisfied. Further eliminating artificial barriers will also enable to foster competition, innovation, price stability and improved service quality.

Institutional capacities and regulatory reforms is another field of development area, where there is a room for improvement in planning and implementation capacities with well-coordinated administration among ministries and state agencies. Setting priorities and sequencing reforms have to improve in order for diversification of the economy to occur.

Huge investments in the country’s infrastructure have also significantly advanced the quality of infrastructure over the past decades, which has to be utilized as an advantage for developing the economy further in following years. Specifically, electricity and highway

¹⁰ World Bank Group, 2015, *Azerbaijan Systematic Country Diagnostic*.

¹¹ Roadmap includes economic development strategy and action plan for 2016-2020, long-term vision for period up to 2025 and vision to post-2025 targets. Source: <http://en.apa.az/azerbaijan-economy/finance-news/main-directions-of-strategic-road-map-on-national-economy-and-major-sectors-of-economy-approved-working-group-created.html>

¹² Figures derived from IMF. 2012. Republic of Azerbaijan: Selected Issues. IMF Country Report No. 12/6. Washington D.C., and Gloria Pasadilla. 2010. Financial Crisis, Trade Finance, and SMEs: Case of Central Asia. ADBI Working Paper 187. Tokyo.

infrastructure improved greatly in recent years. However water and railway infrastructure is in a relatively limited condition in regions, which creates unnecessary costs to the economy. Thus, developing these areas of concern would bring significant value added for economic development in the long-term.

Another area of concern is related with employment growth, which has been mainly observed in lower paying, less productive sectors. Limited quality in the education system is making it more difficult to improve the modern skills and knowledge required for a competitive and innovative non-oil economy. Despite the skill insufficiencies of labor, the minimum wage, wages and salaries have increased significantly during recent years. Youth unemployment could become challenging taking into account that one-third of the unemployed are in the 16-24 age group, which is higher compared to other countries.¹³ Also gains are geographically uneven across territories and urban/rural areas.

4. Conclusion

The analysis of the observed trends in economic development motivates an extensive range of restrictions that Azerbaijan faces in making fiscally, socially, and environmentally sustainable progress. From the top-down perspective, overall economic growth is unbalanced and slowing down alongside troubling fiscal imbalances and limited employment creation.¹⁴ Thus, in order to achieve *sustainable growth* in the following years, Azerbaijan needs to more efficiently employ the strategic use of oil rents and apply more effective public expenditures policy to promote the accumulation of a diversified asset-base in the economy. Moreover, promoting productivity growth to foster long-term private sector growth and economic competitiveness, consolidating the intensity of use and returns to assets is crucial for further economic development and for reaching a new level of the steady state level. From the bottom-up perspective, participation of households in this new economic environment has to be maximized in order to ensure *inclusive growth*. Fostering the accumulation of diversified assets for all households in the country (in particular those in the bottom 40) and enhancing opportunities for households to use their assets more intensively will be efficient way of achieving this goal.

Economic progress will therefore necessitate dealing with aforementioned restrictions related to both sustainable *growth* as well as *inclusive growth*. Solutions to removing current constraints will facilitate the economy to move toward a new growth trajectory that will ultimately better enable Azerbaijan to achieve its goals.

¹³ IMF. Republic of Azerbaijan: Selected Issues. IMF Country Report No. 12/6, January 2012.

¹⁴ World Bank Group, 2015, *Azerbaijan Systematic Country Diagnostic*.

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