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Rupinder Singh – Juhani Laurila

Azerbaijan: Recent Economic Developments and Policy Issues in Sustainability of Growth

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Azerbaijan: Recent Economic Developments and Policy Issues in Sustainability of Growth[2]

Abstract

The macro economic stabilisation in Azerbaijan has been successful. Following cessation of conflict with Armenia, and decline of GDP by 60 per cent from 1990 to 1995, the government in effect implemented a big-bang reform process in 1995. The inflation rate has now declined to the lowest rate of any transition country and important reforms in the monetary-fiscal mix have been undertaken. The second plank of first generation reforms, liberalisation, has also been successfully implemented with liberalisation of prices, the trade and foreign exchange regimes and virtual completion of small-scale privatisation, although the onset of the Russian crisis in 1998 has impacted negatively both internal and external balances. The paper presents the current economic picture for Azerbaijan and then assesses economic policy issues facing the country.

Azerbaijan is well endowed with natural resources, particularly oil but also gas. The second part of the paper considers the question by focussing on policy issues related to the potential flow of oil-based monies into Azerbaijan. The possibility of the "Dutch Disease" syndrome impacting Azerbaijan through a rising real exchange rate on the non-oil sector is not considered to be a problem at present but is expected to become a policy concern in the medium- to long term. Structural reforms in public finance to deal with expected surpluses are lagging and are necessary in the next phase of the transition of Azerbaijan. Moreover, significant reforms are required in banking – privatisation, improvement in regulation and supervision and in the implementation of supporting legal rights, given the current lack of financial intermediation.

Keywords: Azerbaijan, economic development, oil, Dutch Disease, transition economies

JEL Classification Numbers: E6, P2, P3

ASSC	Azerbaijan State Statistics Committee
ANB	Azerbaijan National Bank
CMEA	Committee for Mutual Economic Assistance
EBRD	European Bank for Reconstruction and Development
IMF	International Monetary Fund

1 Introduction

Transition is sometimes referred to as a one-way path. Whatever the country-specific endogenous mix of policies undertaken to achieve the journey: big bang, slow reform or some intermediate approach, it presupposes a starting point and a destination. The historical context is even more relevant for an understanding of the starting point for Azerbaijan, with exogenous shocks through both the demise of the Soviet Union and related ruptures to the economy set within the context of regional ethnic troubles, civil unrest, armed conflict with neighbouring Armenia and geo-political machinations of regional and global powers. These issues are addressed in a complementary paper.[3]

A further paper examines issues in structural reform, where it is argued that the developments in the Southern Caucasus[4] in general, and in Azerbaijan in particular, bear interesting evidence of how attractive economic and commercial prospects and expectations can assist to overcome and bring closer otherwise countries which may be at conflict on the basis of ethnic or territorial claims. Economic and commercial co-operation becomes more attractive than the politics of isolation and the political compromises more expedient than the use of power.

At the time of writing, there is a lack of any literature on the Azeri economy *per se* and the present set of articles therefore attempts to fill the void. Azerbaijan receives attention from energy specialists, but the economic issues are typically addressed under pan-transition outlooks of the multilateral bodies such as the EBRD and the IMF. Aside from occasional Country Reports by the IMF or UNDP, there is a dearth of literature on Azerbaijan.[5] In relation to the Economics literature, the paper interlinks with separate works. The first is the literature that relates to countries heavily endowed with natural resources which can lead to macroeconomic instability, particularly through overvaluation of the real exchange rate (Buiter and Purvis, 1983 and Eastwood; Venebles, 1982 and Rosenberg and Saavalainen, 1998) and more recent analysis into the formation of power-clans (Tornell and Lane 1998). The second link is to the literature on equilibrium exchange rates for transition countries (Halpern and Wyplosz, 1996; Krajnyák and Zettelmeyer, 1997). The unifying theme for both in the context of Azerbaijan is the large endowment of oil and gas and the impact on the real sector through a possible rise in the real exchange rate.

Post-Soviet Azerbaijan has undergone a relatively fast reform process since 1995 and has successfully undertaken first-generation reforms towards a market setting. Following cessation of conflict with Armenia, and decline of GDP by 60 per cent from 1990 to 1995, the government in effect implemented a big-bang reform process. The paper presents the current economic picture for Azerbaijan and then assesses the policy issues for the pursuit of necessary second-generation reforms in the transition process. The second plank of first generation reforms, liberalisation, has also been successfully implemented with liberalisation of prices, the trade and foreign exchange regimes and virtual completion of small-scale privatisation. [6] However, the onset of the Russian crisis in 1998 has impacted negatively both internal and external balances.

The second plank of first generation reforms, liberalisation, has also been successfully implemented with liberalisation of prices, trade regime, foreign exchange regime as well as completion of small-scale privatisation.

The present paper is organised in two parts: section I sets out recent economic developments and section II assesses policy concerns for sustainable economic growth in the medium- to long-term.

The overall positive trends in economic reform since 1995 were perturbed by the impact of two external shocks in 1998, the decline of oil prices and the onset of the Russian crisis in H2 1998. Both shocks led to a worsening of both internal and external balances. The non-oil current account deficit was expected to worsen in H2 1998 as Azeri non-oil products came under competitive pressure from Russian goods, both in domestic and external markets, leading to a fall in exports and a rise in imports.

However, the basic macro-picture remains relatively sanguine. The spectre of inflation has been overcome and the country recorded the lowest annual inflation rates in transition countries in the years 1997 and 1998, of 4per cent and deflation of 8 per cent respectively. GDP is and expected to grow at above 6 per cent per annum for the next few years. The rapid expansion from 1996 has been on the back of significant inflows of FDI related to the oil-industry, and which has translated into high rates of investment. The decline in industrial production halted in 1996 following a cumulative recorded drop of 55.7 per cent from 1990. However, official statistics over-report the drop, as private sector activity is not adequately captured.[7] With sound monetary and fiscal stances and low inflation, real incomes have risen, leading to a rise in private consumption.

One question of policy concern is the exchange rate stance that Azerbaijan should adopt. Nominal stability during 1998 has been attained though use of central bank reserves – an unsustainable policy. A broader policy concern is for the long-term tendency of the real exchange rate. One conclusion of the paper is that for Azerbaijan, the possibility of the “Dutch Disease” syndrome through a rising real exchange rate on the non-oil sector is not a problem today but may became one in the medium- to long-term.

Secondly, state revenues are highly leveraged on oil exports. The decline in world oil prices during 1998 and strengthens the argument for faster structural reforms in public finance to improve transparency and improve both collection and management of state funds and that are necessary to ensure balanced growth over time, particularly as oil revenues rise beyond 2003.

One reason for the low inflation rate in Azerbaijan has been the low level of credit creation. The third conclusion of the paper is that the financial intermediation process is not operating efficiently due to both demand and supply-side constraints. An efficient financial intermediation process is necessary to direct excess savings to investible projects on market terms as well, in the case of Azerbaijan, to expand the provision of banking to areas outside the capital of Baku, currently at the expense of other regions and sectors, particularly agriculture. Significant reforms are required in banking – privatisation, improvement in regulation and supervision and in the implementation of supporting legal rights, particularly in order for the intermediation of credit to the real sector.

2 Recent Economic Developments

Introduction

Azerbaijan became an independent state on October 1991, following the dissolution of the USSR. The Azeri economy, geared to the demands of the Soviet GOSPLAN and part of CMEA, faced external shocks with the demise of these structures, and by the onset of regional conflict over Nagorno–Karabakh. The break-up of trading links and payment mechanisms within the CMEA *bloc*, and more particularly within the Soviet Union was exacerbated by deterioration in the terms of trade for Azerbaijan as formerly planned economies began to move towards transition at different speeds and with different rates of price adjustment.

Table 1: Key Economic Indicators

	1991	1992	1993	1994	1995	1996	1997	1998
GDP	-0,7	-22,6	-23,1	-19,7	-11,8	1,3	5,8	8,0
Industrial Gross Output	-8,9	-30,4	-19,7	-22,7	-17,2	-6,7	0,3	2
Agricultural Gross Output	-2,6	-25,0	-16,3	-13,0	-6,8	3,0	-6,9	5,6
Inflation (end of period)	126	1395,0	1294,0	1788,0	84,5	6,5	4,0	-0,8
General Government Balance[1]	..	..	-15,3	-12,1	-4,9	-2,8	-1,7	-4,0
External Current Account[1]	..	..	..	-9,2	-13,2	-25,5	-23,7	-29,5
Gross Official Reserves[2]	..	0,0	0,0	2,0	119,0	214,0	467,0	432,0
Exchange rate (end of period)	..	45,0	238,0	4330,0	4440,0	4098,0	3888,0	3860,0
Reserve Money Growth	..	..	..	..	..	17,7	35,1	-21,0
Broad Money Growth	..	..	821,0	1184,0	24,0	18,9	14,3	13,1
Labour Force[3]	..	..	0,5	-3,1	1,6	5,1	0,2	..
Unemployment Rate[3]		15,4	16,0	15,2	17,0	19,4	19,3	..

Source: ASSC, Azerbaijan Economic Trends, EBRD Transition Report 1998 and PlanEcon.
1. In per cent of GDP
2. USDm, year-end, excluding gold
3. Labour data are taken from EBRD and are significantly different from official data that gives the unemployment rate at under 2 per cent of the Labour Force. The EBRD Labour Force data here are corrected for the working age population outside the Labour force whilst unemployment figures are based on survey data.

The Azerbaijani authorities began a committed stabilisation programme in 1995, thus condensing the reform process, which had been smoother in some other transition countries. Prior to 1995, the contraction of the economy was accompanied by a reduction in real incomes, the latter due to hyperinflation.[8] High rates of domestic inflation in the period were due both to the release of the monetary overhang and to the pursuit of loose monetary and fiscal policies.

These changes led to significant shift in economic indicators from 1995, as shown in Table 1. During the years 1992–1994 economic activity as measured by GDP declined by more than 52 per cent (Table 1 and Figure 1).[9] In 1995 the decline slowed and in 1996 output increased by 1.3 per cent, the first recorded rise since 1990, and has since accelerated. GDP per capita started to decline year-by-year from 1991, bottomed at USD 173 in 1994 and has since risen annually to USD 599 in 1998 (see Figure 1).

Stabilisation

In 1995 the Azeri authorities undertook an IMF-backed stabilisation plan. Both monetary and fiscal policies were tightened. These led to a sharp reduction in domestic inflation to 84,5 per cent in 1995, to 4 per cent in 1997 and deflation of 0.8 per cent in 1998, down from 1788 per cent in 1994. Price stability has been achieved against a backdrop of upward adjustment in domestic utility prices, which were previously subsidised, and which for other transition countries have seen inflation inertia. Further structural reforms in the form of liberalisation of the exchange rate mechanism and of the trade regime have helped improve the position of the Azeri economy and correct the mis-allocation of prices and incentives.

The start of the stabilisation process was possible following the cessation of conflict with neighbouring Armenia. Whilst price liberalisation had in fact started in 1992, the necessary conditions of political stability and political consensus for successful stabilisation and liberalisation were lacking.[10]

To 1998, monetary policy has been geared toward reducing inflation and been moderately tight, with financing to the government eliminated. However, as highlighted later, the lack of structural reforms in banking and the creation of supporting reforms have led to an overly tight monetary stance, evidenced by the very low money-multiplier.

The manat, introduced as legal tender in 1994 has stabilised against the USD and in fact appreciated during 1997–98 in nominal and real terms against both the USD and on a trade-weighted basis. The stability and appreciation of the manat has been largely due to the inflow of FDI related to the oil-sector in Azerbaijan and spillovers into the non-tradable sectors such as construction and services. The country is endowed with significant oil and gas deposits and which policy-makers are hoping to develop and use as a platform for strong and sustainable economic growth.

The rise in both the nominal and real exchange rates against the USD have led to concerns about possible over-shooting, and is an issue that is addressed in Section II. The external current account deficit worsened from 9 per cent of GDP in 1994 to 24 per cent of GDP in 1997. However, oil-related imports of goods and services have been behind the evident deterioration. With inflows on the capital account, the overall Balance of Payments recorded a surplus of

USD 0.5bn in 1997, matched on the financing by a rise in reserve holdings of the central bank. The deficit grew to 29.5 per cent of GDP for 1998 because of a reduction in oil earnings following the decline in oil prices and a rise in imports following the significant the Russian crisis. Moreover, investment flows into the oil industry fell short of expectations, as oil companies pulled back investment plans following the decline in oil prices. The result was a small deficit on the Balance of Payments and a matching decline in reserves.

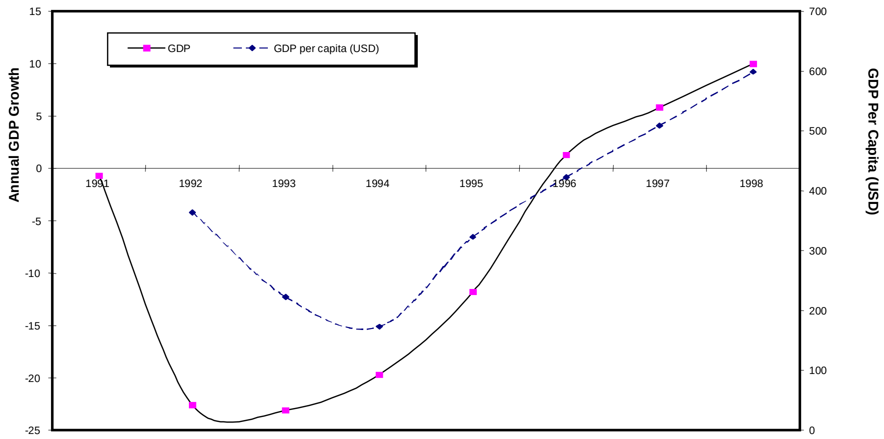
The contagion impacted money demand for the manat, and, with FDI inflows lower than expected during 1998, the central bank maintained a stable rate through intervention. This policy of depleting currency reserves is not sustainable, and a more flexible exchange rate stance is likely in 1999.

The decline in oil prices led to lower than planned revenues in 1998, expected at 17 percent of GDP in comparison to 19per cent in 1997. The fiscal position relaxed in H2 1998 as Expenditures accelerated before the Presidential election in October, and the deficit was 4per cent of GDP. Overall, the fiscal stance has in recent years tightened, especially on a cash-basis and a number of reforms are being introduced to improve both the revenue and expenditure sides, through introduction of a Tax Code, improved tax collection, greater transparency in expenditures through in particular the establishment of a Treasury function. However, revenue collection remains a problem, and particularly the imposition of a hard budget constraint for arrears and non-payment.

The privatisation process began in 1996. Small-scale privation of 16,331 enterprises was completed by April 1998. The private sector now accounts for 51 per cent of GDP, although as much as 60 per cent of GDP may not be accurately reported or reflected in economic statistics.

2.1 Growth in Azerbaijan, 1990 –1998

Figure 1: Azerbaijani GDP



Source: ASSC and author's calculations.

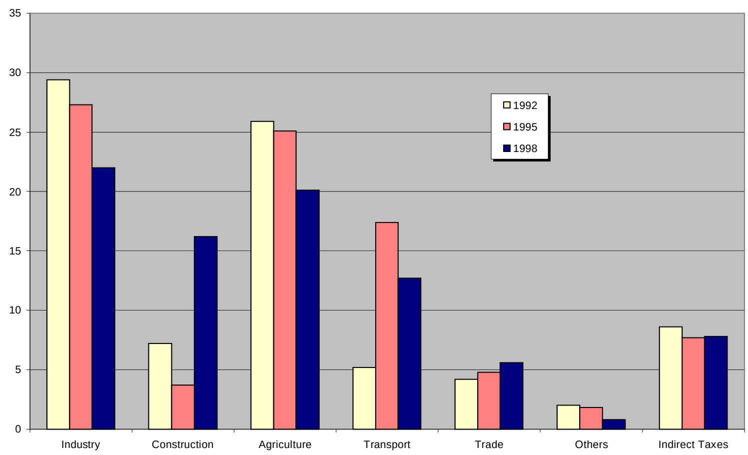
Real GDP rose 10 per cent in 1998, following the 5.8 per cent rise recorded in 1997. Nominal GDP in 1998 was almost trn 16 manat or USD4.1 bn, making it one of the biggest of the relatively small former Soviet successor states with the exception of Lithuania, which has an economy roughly double the size.

Since 1990 important structural changes have occurred (see Figure 2). The significant decline in output has meant that the "size of the economic cake" has declined. But within the reduced cake, the composition of sectoral output has too changed. At current prices, the share of total industry declined from 29 per cent in 1992 to 22 per cent in 1998. But at the same time, industrial production in volume terms decreased by about 72 per cent in comparison to 1990 and 55 per cent since 1992, i.e. by more than the decline in GDP, which declined by 42 per cent over the same period.

The share of agriculture fell from 26 per cent of GDP in 1992 to 20 per cent in 1997, following the high-point of 32 per cent share in 1994. However, gross agricultural output was 51 per cent below that in 1990 and 35 per cent below the level in 1992. The decline in agriculture has been due in part to deterioration in agricultural machinery, fertilisers, irrigation systems, lack of commercial marketing and wholesale structures to replace the Soviet planning norms as well as lack of financing for replacing equipment.[11] In 1998, Gross Agricultural Output declined by 6.9 per cent due also to the adverse weather conditions, but is expected to have rebounded by 5 per cent in 1998, though the share of agriculture in GDP remained constant at 20%.

The share of construction in GDP has risen from 7 per cent in 1992 to 16 per cent in 1998. In physical output, the level of construction fell dramatically during the first half of the 1990s, reaching the low-point in 1995 when it was only 10per cent of the 1990 level. However, construction activity has accelerated since 1995, related to the both oil-related construction and spillovers into building of hotels, offices and housing units and has become the fastest growing component of GDP, though from a low base, and is expected to continue at near double-digit annual growth rates during the next few years.

Figure 2: Change in the Composition of GDP



Source: ASSC.

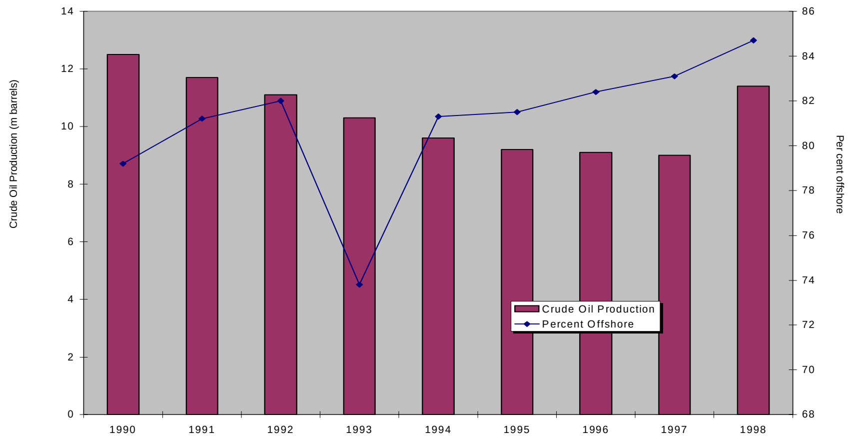
Transport and communications have increased their sectoral share since 1995. The volume of freight was up 14 per cent and is expected to show a further 6 per cent rise for 1998. At a crossroads between the East, the West, the CIS markets to the north and the Arab countries to the south, this sector is expected to show significant growth over the next decade. The EU funded TRACECA programme is seeking to open transport corridor along the former Silk Route for this very purpose, while Azerbaijan has an existing infrastructure for transport into Russia to the north. The rise in the sector will therefore be based on two factors: the transport of Caspian oil, either north to Russia or to the west, and; secondly, transit of traffic, inclusive of import-export operations undertaken by Azeri economic agents. The transport and communications sector is therefore expected to increase annually by double-digit rates for the next decade.

The trade sector has risen in importance although it is not evident from official statistics. The trade sector has grown since 1996, though from a low base, recording growth rates of 14 per cent and 17 per cent for 1996 and 1997 and expected 7 per cent for 1998, though the share of the sector in GDP has remained relatively constant at 6 per cent in 1998. However, the private sector and the trade sector in particular are very much outside official statistics and part of the shadow economy. This implies that the share of trade in GDP and its growth rate are under-represented.

2.2 Production: Oil and Gas

Figure 3 shows the output trends for oil production in Azerbaijan. Annual Crude oil production in Azerbaijan in 1998 at 11.4m barrels was the highest since 1991. The depletion of equipment and poor maintenance of existing fields, which constrained production, explain the decline in the interim. The arrival of foreign oil companies led to development of offshore oil and introduction of efficient technologies, and which accounted in 1998 for 85 per cent of total annual output. However, offshore production of oil has yet to take off at the levels earlier forecast.

Figure 3: Production of Oil



Source: ASSC.

Figure 4 shows trends for output of gas. Annual output of gas declined annually following the dissolution of the USSR, and in 1998 was 76 per cent lower than in 1990 at 5.3-m cubic metres. The decline has been due both due to both the inefficiencies of the distribution system and due to a decline in recorded reserves of gas. However, during 1998, new gas reserves were found offshore, and these reserves present a future source of earnings, although at present there is no infrastructure to produce and distribute this source. Nonetheless, gas production has begun to improve, due to the installation of a gas compressor station, located in the Guneshli field.

Figure 4: Production of Gas

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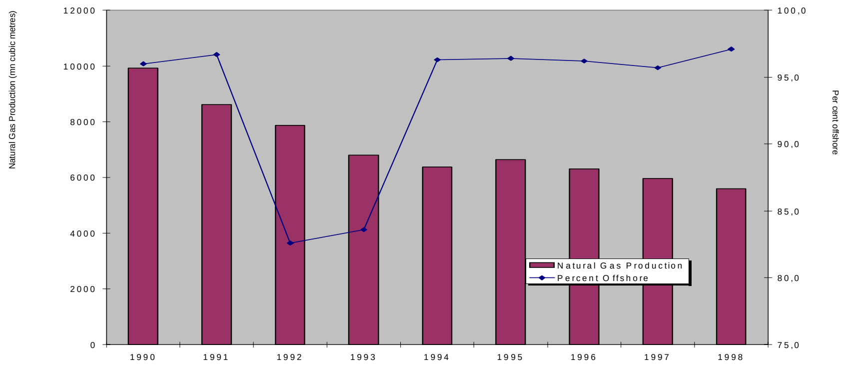


Source: ASSC.

2.3 The Non Oil Sector

Table 2 displays time series for real industrial production and annual real changes by sector. To 1997, total industrial production declined by 55.6 per cent from 1992. In 1996 the decline in real industrial production bottomed out, and in 1997 registered a small rise of 0.2 per cent.

Table 2: Industrial Decline (1992 = 100)

	1992	1993	1994	1995	1996	1997	1998
Total Industry	100	80,3	60,4	47,5	44,3	44,4	45,3
Energy	100	89,0	82,8	76,1	74,4	73,2	..
Metallurgy	100	61,3	16,2	8,6	2,1	9,7	4,9
Machine Building	100	85,6	46,1	25,0	20,5	20,4	14,3
Chemical and petro-chemical	100	72,3	43,8	37,2	46,5	33,4	29,7
Construction materials	100	65,8	45,9	17,0	16,3	15,6	13,7
Light Industry	100	85,3	61,2	54	32,1	26,8	15,5
Textiles	100	88	58,1	53,4	31,8	27,4	24,2
Agroprocessing	100	72,7	47	25,8	16,8	15,7	15,4
Agriculture	100	84,6	73,6	68,6	70,7	65,8	69,1

Source: ASSC.

Traditionally, the non Oil-Industry was dominated by heavy industries like metallurgy, machinery, and chemical industry and construction materials. Since 1990, by physical quantity the decline of theses industries has been spectacular. Physical production in 1998 was approximately 5 to 10 per cent of their 1990 level.

Electricity production declined by 43 per cent in physical terms from 1990 to 1997. However, the share of electricity production in total industrial production increased from 4 per cent in 1990 to 14.1 per cent in 1997.

The decline of light industry measures 83 per cent in physical quantity since 1990. The sharp decline in demand from former closed markets of the CMEA *bloc*, the rises in industry terms-of-trade following the upward adjustment of formerly repressed prices and faced against better quality goods from western producers are factors that explain the sharp decline. Industry rates of utilisation may be low in nominal terms, suggesting that in areas of comparative advantage, Azerbaijan may be able to restructure some enterprises and attract investment into these firms. However, to the extent that excess capacity includes redundant production lines, the full or part-time operation of these lines is a waste of economic resources. This has a cost to economic policy – higher excess capacity would suggest that the production possibility frontier for the economy is higher, or the output gap is larger. However, if excess capacity is over-valued then the output gap and the implied adjustment of the real sector may call for modified economic policies on the supply side.

The contraction in industry halted in 1997, when the sector grew marginally by 0.2 per cent, following the accumulated drop of 87 per cent to 1996. The bottoming-out in 1997 was on the back of 0.1 per cent rise in oil and gas and an extraordinary 362 per cent rise in metallurgy. All the main industrial sectors have declined per year to 1996, with the exception Chemicals and petrochemicals, which rose by 25 per cent before declining by 28 per cent in 1997.

2.4 Agriculture

The volume of agricultural output declined by 40 per cent between 1992 and 1995. Developments for individual crops are given in Table 3. One of the main factors explaining this decline was government pricing and procurement policies during this period, which have been reinforced by the break-up of the traditional links and partial loss of the captive markets in Russia because of deterioration of transport communication between Azerbaijan and Russia via the North Caucasus. The liberalisation of input prices and the system of compulsory deliveries to the state at low prices imposed too strong a pressure on profitability of the sector. Since 1995 reforms have been introduced. Domestic prices of wheat and cotton have been raised to near the world market levels in 1996. Privatisation has continued to progress slowly, the share of the private sector in the agricultural production rising from 39 per cent in 1990 to 67 per cent in 1995 and 74 per cent in 1997. The small recovery of the agricultural sector in 1996 may have been explained in part by changes in ownership structure, but also may have been influenced by other factors such as improved access to information about prices and distribution, although still very much nascent.

Table 3: Indices for Agricultural Production (1990 = 100)

	1990	1991	1992	1993	1994	1995	1996	1997	1998
cereals	100,0	95,2	94,6	81,2	73,5	65,2	72,0	79,7	67,0
cotton	100,0	99,4	61,9	52,4	52,3	50,5	50,5	23,0	20,7
tobacco	100,0	108,3	98,9	84,9	39,3	22,1	21,2	28,5	28,7
potatoes	100,0	97,1	84,2	82,2	81,2	84,0	115,9	120,6	167,4
vegetables	100,0	94,1	64,8	57,0	56,4	49,5	66,6	57,8	58,7
grapes	100,0	94,1	50,7	34,4	26,2	25,8	23,0	12,1	12,0
tea	100,0	87,0	74,0	78,0	63,0	31,0	9,8	5,2	2,9
meat	100,0	87,4	64,2	52,7	48,1	46,7	48,8	51,6	54,0
milk	100,0	97,7	87,6	82,3	80,8	85,2	86,9	90,8	95,2
eggs	100,0	97,2	82,4	59,3	50,1	46,3	48,4	49,9	51,5
wool	100,0	93,8	84,8	86,6	79,5	80,4	81,3	85,3	88,4
silk cocoons	100,0	120,4	106,9	65,3	30,6	22,4	16,3	8,2	2,0

Growth rates

	1990	1991	1992	1993	1994	1995	1996	1997	1998
cereals		-4,8	-0,6	-14,2	-9,5	-11,3	10,4	10,7	-15,9
cotton		-0,6	-37,7	-15,3	-0,2	-3,4	0,0	-54,5	-10,0
tobacco		8,3	-8,7	-14,2	-53,7	-43,8	-4,1	34,4	0,7
potatoes		-2,9	-13,3	-2,4	-1,2	3,4	38,0	4,1	38,8
vegetables		-5,9	-31,1	-12,0	-1,1	-12,2	34,5	-13,2	1,6
grapes		-5,9	-46,1	-32,1	-23,8	-1,5	-10,9	-47,4	-0,8
tea		-13,0	-14,9	5,4	-19,2	-50,8	-68,4	-46,9	-44,2
meat		-12,6	-26,5	-17,9	-8,7	-2,9	4,5	5,7	4,7
milk		-2,3	-10,3	-6,1	-1,8	5,4	2,0	4,5	4,8
eggs		-2,8	-15,2	-28,0	-15,5	-7,6	4,5	3,1	3,2
wool		-6,2	-9,6	2,1	-8,2	1,1	1,1	4,9	3,6
silk cocoons		20,4	-11,2	-38,9	-53,1	-26,8	-27,2	-49,7	-75,6

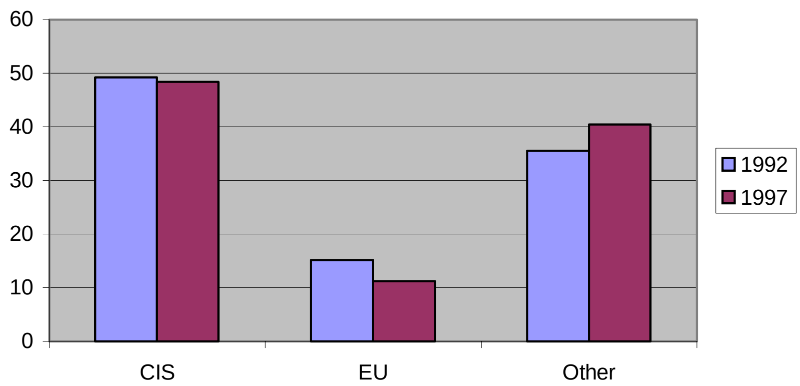
Source: ASSC.

Real agriculture rose by 3.1 per cent in 1996, following the 29.3 per cent decline from 1992 before declining by a further 6.9 per cent in 1997. The latter decline was on the back of a 55 per cent decline in cotton production in 1997.

2.5 External Trade

Figures 5 and 6 show the changing structure of trade in exports and imports. In 1992 exports to CIS represented 49.2 per cent of total exports, of which 23.4 per cent was to Russia and 9.2 per cent was to Ukraine. In 1997 Russia remained the main trading partner with 23.1 per cent of Azeri exports, but the second trading partner became Georgia with 17.1 per cent of total Azeri exports, whilst Turkey and Iran continue to be major trading partners. The decline in exports to the EU may simply be due to transit via third-countries, through "other" countries.

Figure 5: Direction of Exports

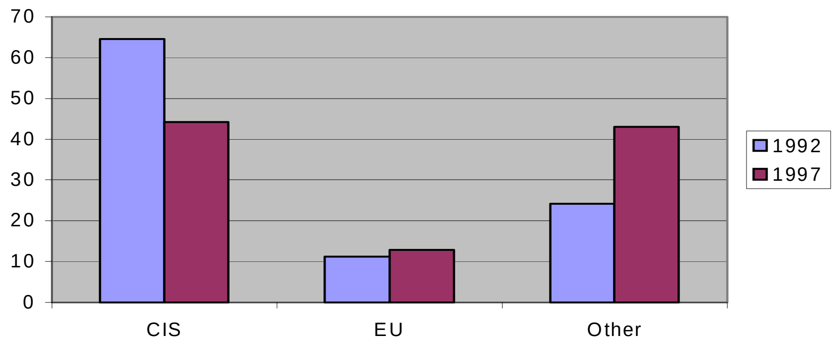


Source: Author's calculations on data provided by ASSC.

Medium-term trend in the trade-sector is likely to see greater commercial activity with neighbouring Caucus and regional economies at the expense of the rest of the CIS.[12] This trend will therefore see the decline of trade with

Russia and Ukraine but greater trade with Georgia, Turkey, and Iran and perhaps in the long-term even with Armenia. Two additional factors are likely to lead to a reduction in trade with Russia. Firstly, the development of oil exports with greater use of non-Russian delivery routes is likely to imply both larger export volumes and percentage of exports redirected toward the final destination of EU markets, and also of Kazakhstani oil transited. Secondly, the impact of the Russian crisis in 1998 is likely to speed up the export re-orientation away from Russia, particularly as the Azeri non-oil sector develops commercially and begins to shun barter solutions favoured by Russian entities.

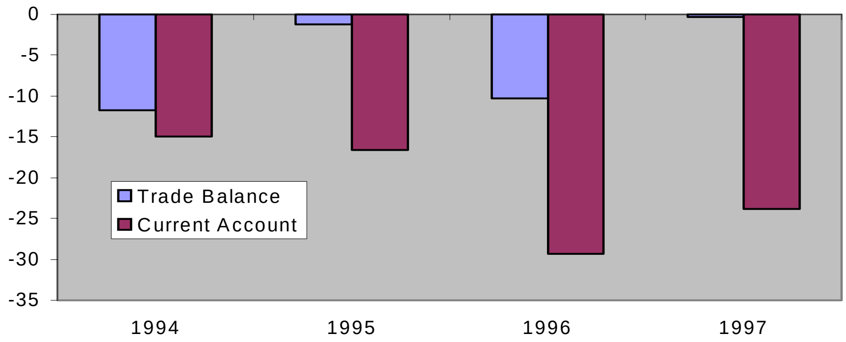
Figure 6: Direction of Imports



Source: Author's calculations on data provided by ASSC.

A noticeable shift in import structure has been observed since 1992 with the share of import to CIS countries reducing from 64.6 per cent in 1992 to 44.2 per cent in 1997. This is offset by an increase of imports from other countries such as Turkey, Iran and United Arab Emirates, from 24.1 per cent in 1992 to 42.9 per cent in 1997. Trade and import statistics in particular are not completely reliable due to problems of registering and governance at the Customs Office, something recognised by Azeri authorities. Azerbaijan has a dynamic import-export sector based on importing goods from Turkey, Pakistan and India, which are then re-exported in particular to the CIS markets. Including domestic consumption of goods, particularly tobacco, misspecification of imports is higher then for exports. This means that the true re-orientation of imports from the CIS and particularly Russia is in fact likely to be even more pronounced than indicated by Figure 6.

Figure 7: Trade and Current Account Balances (per cent of GDP)



Source: ASCC.

Figure 8 shows trends on the external account. Deficits on the current account have exceeded 15 per cent of GDP since 1994 and measured 23.8 per cent for 1997 and are expected to be of the same magnitude for 1998. However, oil consortiums have accounted for approximately half of the deficit through imports related to investments in the oil industry. Thus as shown in Figure 8, the headline deficit on the current account is indeed sustainable, since it has been financed through inflows on the capital account, particularly through FDI, the latter exhibited in Figure 9. Moreover, it is expected that with the completion of investment into the oil sector, oil-sector based deficit will decline along with compensating item on the capital account, but the onset of oil exports will lead to a balanced current account and then surpluses on the external account.

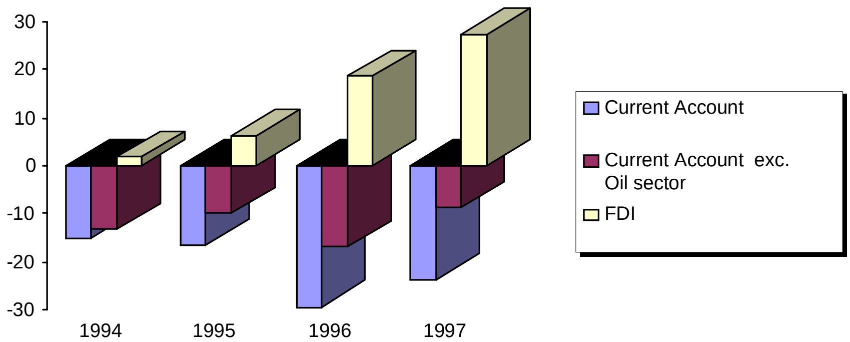
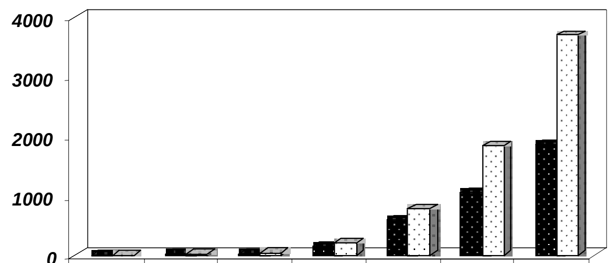


Figure 8: Current Account Balances (per cent of GDP)
Source: ASSC.

Figure 9: FDI into Azerbaijan



	1992	1993	1994	1995	1996	1997	1998
Flow	0	20	22	155	591	1051	1869
Stock	0	20	42	197	788	1839	3708

Source: EBRD (1998), EIU (1998), PlanEcon (1998).

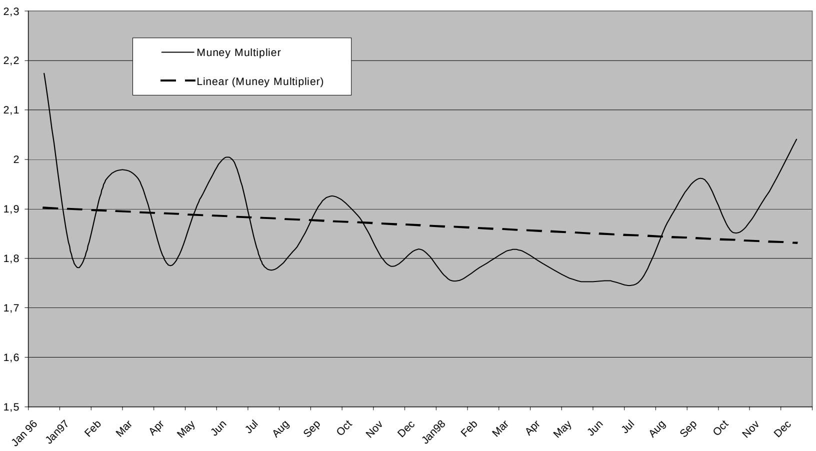
2.6 Monetary Stance

As part of the stabilisation package, monetary policy was tightened. However, in hindsight, monetary policy was excessively tight due to constraints on the intermediation function, which limited the money multiplier. Since 1996, real interest rates have remained relatively high at the level of 15–20 per cent. The manat strengthened and the pace of inflation slowed down in 1997. Therefore the NBA decided that it could afford the monetary aggregates grow more than it had planned, not offsetting the large capital and financial flows from abroad. Due to these heavy capital inflows net international reserves also grew rapidly and gross reserves reached to the level of four months' imports. Although the banking system still needed to improve its liquidity by resorting to borrowing from the NBA, lending by the NBA to the Government was less than expected. Subsequently, net domestic assets of the NBA also reduced from AZM 807 billion in the beginning of 1997 to AZM 648 billion at the end of 1997.

Monetary conditions tightened in the beginning of 1998. Due to the fall of oil prices the foreign exchange proceeds from oil-related activities diminished. The NBA intervened to support the manat and net international reserves declined. The resultant decline in Net Foreign Assets was not matched by a rise in Net Domestic Assets, and the result was a reduction in reserve money. Moreover, central government and commercial banks made lower than expected recourse to central bank financing. This implied that manat broad money fell as the manat multiplier declined reflecting the worsened financial situation of banks (see Figure 10). The refinance interest rates of the NBA have stayed since the mid-1996 fairly stable. The nominal rate came down from 34 to 13 per cent during 1997 but began to rise in 1998 once the monetary conditions tightened. Annual interest on bank loans was in mid-1998 about 20 per cent. Given the close zero rate inflation the real interest rate for potential borrowers were prohibitively high.

In principle, Azerbaijan maintains a flexible exchange regime. However, in practice, exchange rate stability has been a major policy goal to 1998 and the NBA has used substantial reserves to prop up the manat, particularly in H2 1998, when there was a move to dollarisation following the Russian Crisis. One policy issue is whether the exchange rate should be allowed to devalue and this issue is discussed in section 6. The official rate of exchange is determined by auctions in the Baku Interbank Currency Exchange (BICEX). Manat can be purchased and sold against major currencies (USD, DEM and RBL) freely in numerous local foreign exchange boots and banks.

Figure 10: Manat Money Multiplier and Linear Trend Line (1996–98)



Source: Author's calculations on data provided by NBA.

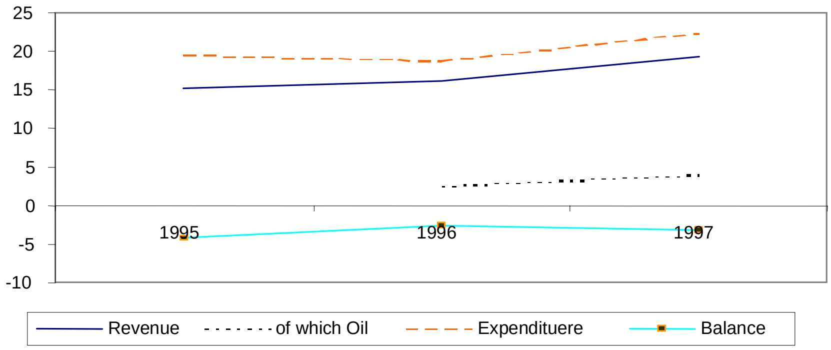
The manat is the only NIS currency for which the nominal exchange rate has strengthened against the US dollar monotonously from 1995 to 1998. The nominal exchange rate of the manat has been appreciating 8 per cent in 1996, 5 per cent in 1997 and about 1 per cent 1998. The monetary authorities continued their policy of limited intervention in the foreign exchange market.

The nominal appreciation of Manat has been supported by actual and expected inflow of foreign exchange through the FDI, proceeds from oil sector taxation, oil signature bonuses and production sharing mechanisms. This nominal appreciation has not been reflected by a corresponding decline of the domestic inflation because of the downward rigid prices of imported goods that presently dominate to consumer and also investment goods markets.

2.7 Fiscal Stance

Tight fiscal policy has been an essential part of macroeconomic stabilisation. In 1997 the fiscal deficit was 1.7 per cent of the GDP on a cash-basis, having been more than 15 per cent of the GDP in 1993. Total revenues amounted to 17 per cent of the GDP. Direct taxes have become the most important source of revenue: corporate profit tax, income tax for physical persons and social security contributions amount to 7.6 per cent of the GDP. The increase of revenues from these sources is related to the increased economic activity and higher average wages.

Figure 11: General Government (per cent of GDP)



Source: ASSC.

Revenues from indirect taxes (VAT, excises and customs duties) have increased to 7.2 per cent of the GDP. The increase is due to broadening the VAT tax base by removing exemptions and duty free threshold for imported goods for personal use. Royalties from the oil sector, item introduced at the end of 1995, amount to 2.2 per cent of the GDP in 1997. The revenues from property taxes and from other sources were 2.7 per cent of the GDP.

The two major expenditure items, 12.2 per cent in 1997, continue to be wages and salaries as well as purchases of goods and services. The public sector, including the central and local government as well as the state enterprises but excluding army, employs almost 1.5 million persons, while the total formal employment amounts to 2.9 million. Despite the regular annual salary increases of from 20 to 40 per cent the average public wage is only two thirds of the national average.

Figure 11 shows the position for the consolidated budget, including net lending. The fiscal balance declined from 4.3 per cent of GDP in 1995 to 1.7 per cent in 1997. At the time of writing, the drop in world oil prices impacted forecasts for revenues and the budget deficit was expected to exceed 2 per cent of GDP for 1998 and 4per cent of GDP on a consolidated basis.

In the fiscal area, a significant policy issue is based on the uncertainties on both the volume and timing of the future flow of oil revenues (front-end payments, royalties, and excises on existing oil production) because of the fluctuations of oil prices or that they often accrue as bullet payments. One implication of this is that this may lead to over optimistic budgeting, possibly to be financed through inflationary means in case of non-receipt of the expected oil revenues.[13]

As mentioned above, royalties and other bonuses financed the state budget deficit paid by oil companies on investment deals. The Azerbaijan government will receive about 25 per cent of the oil revenues, equivalent to 70–80 per cent of oil profits while foreign companies will get 20´–30 per cent depending on market fluctuations. Azerbaijan's receipts from the petroleum sector will derive mainly from royalties and excises on ongoing oil production. From the beginning of 2005 Azerbaijan expects to receive USD 5 billion a year hard currency revenues generated by the sales of oil from the Azeri–Chirag–Guneshli project[14]. Another source has been the receipts from sales of the Government Bonds ("Public Short-term obligations, PTSO's). The receipts from the 199 auctions in 1997 were 169 billion AZM.

3 Sustainable Economic Growth

Introduction

Having considered trends in recent economic developments, we now turn attention to economic policy issues facing Azerbaijan. In particular, the interest is on qualitative growth over the medium- to long-term. To this end, the discovery of oil presents additional complexities to reform for a country in the midst of transition from a planned to a market setting, creating specific challenges to macro-management.

Unsustainable economic growth over the medium- to long-term is typically due to a bad mix and design of policy and for commodity-endowed economies there is evidence of boom-and-bust economic growth.[15,16] Many features of the bad economic growth are currently visible in Azerbaijan, not yet as a result of growth, partly as a legacy of the collapse of the Soviet Union. Azerbaijan inherited a top-heavy industrial sector, geared to the demands of the Soviet Plan. Predominant industries – oil, chemical, iron, steel and agro-industries are highly capital-intensive and not sustainable in a market setting and in the main have been or will be closed. A significant policy concern therefore is to ensure that the growth translates into transition in the labour market, with excess labour moving from dying enterprises to new sectors. The potential cost of an inappropriate policy response would otherwise be a rise in the effective unemployment rate, increasing skewness of distributions of income and wealth between different social groups and regions and therefore be qualified as "bad".[17]

The Azeri government has addressed this issue through successfully privatising small-scale operations, in the main to existing managers. Moreover, the liberalisation of the trade regime has allowed a significant growth in private sector activity, in particular through import-export trade activity, itself not yet fully captured by official statistics. However, whilst these policy responses have been necessary in the first generation of reforms, they have not been sufficient to tackle the employment issue. Azerbaijan now finds itself in the throes of second-generation reforms and where difficult decisions are required to either close some of the existing large enterprises, or to privatise viable enterprises. The difficulties arise from the lack of either supporting institutional reforms to complement the move to market norms such as effective bankruptcy proceedings and existence of legal rights or from the lack of necessary political support because of vested interests.[18]

The seeds for the other type of the malign growth already exist in Azerbaijan. Income distribution has become highly skewed, with concentration in a narrow circle. This dualism exists also regionally and manifests itself as a growing gap of wealth and income between the metropolis of Baku and the rest of the country. The 850,000 internally displaced persons (IDPs), mainly farmers and their families from the occupied territory living in the camps, railway wagons and dog-holes, aggravate the situation. For political reasons the Azerbaijani government is not willing to support the IDPs to settle down where they currently live.

The very dynamic grey economy, corruption and underdeveloped social safety net also nourish the ruthless growth. Ultimately all this is based also on "voiceless growth" where the economy grows but a vast majority of population is without power, or democracy, to essentially resist the unequal economic and social developments. The well to do political power elite of Azerbaijan does not seem to be – for the time being – mature enough to reduce corruption and to introduce economic discipline necessary for civil society and enhanced social policy, and ultimately sustainable and equitable economic growth.

Outside political-economy considerations assessed in the complementary paper, purely economic policy issues arise from expectations of significant monies arising from the oil deposits in Azerbaijan. Economic forecasts about expected rapid growth rest on assumptions about the volume and price of the crude and gas excavated and transported from Caspian Sea to the world market. The substantial amounts of commitments serve as token of the seriousness or the intentions of the oil consortia. However, should exploration reveal oil reserves to be lower or contain more gas than oil, expected growth figures would have to be modified downward.

The implementation of the macro-economic stabilisation program launched in 1995 has been successful. GDP growth is strong and the rate of inflation low. With prospects for rapidly accruing oil revenues, the toughest challenge for Azerbaijan will be the acceleration of transition process in productive non-oil sectors so as to avoid narrow oil-based economy with virtually total absence of all domestic production and deepening the regionally and socially dualistic economy. Is Azerbaijan receiving too much and too fast external finance in order to be ready to develop a balanced and sustainable growth based on market principles and democracy?

We attempt to answer this question by considering the expected impact of the oil sector on non-oil sectors and on regional policy through the expected rise in the real exchange rate and the onset of the Dutch Disease syndrome, related policy issues in public finance arising from the oil premium, the interlinkages between the real and financial sectors through projections of the impact of the oil premium on investment and saving and supporting banking and structural reforms to improve the financial intermediating process.

3.1 The "Dutch Disease"

The "Dutch Disease" syndrome[19] is one where rapid economic growth of the oil and gas sector may potentially have adverse effects on the overall economic growth of Azerbaijan through impact on non-oil sectors, crowding out of financial and intellectual resources and impact regional policy outside the oil-rich Absheron peninsula.

The central focus of interest in the "Dutch Disease" approach is the expectation of an appreciating domestic currency, which favours imports and makes investments in export promoting and import substituting investments unattractive. Related macro-management issues relate to firstly monetary policy, which is geared at inflation-targets but may need to be accommodative to prevent overshooting of the exchange rate. On the other hand, if the credibility of the stabilisation program was weak and inflow of foreign currencies is particularly strong, sterilisation may be necessary to avoid excessive increases of money supply, itself a short-term solution.[20] Secondly, in the context of commodity-based financial flows, fiscal policy needs to be both managed and co-ordinated with the monetary stance to define an appropriate mix.

The monetary approach has a real sector variant. A real exchange rate that appreciates too rapidly may impede the development of the non-oil sector. An excessively tight monetary stance may lead to overshooting of the domestic currency and lead to investment in non-tradables. The rise in the relative price of non-tradables to tradables equates to a rise in the real exchange rate. The latter could thereby impact structural reform, particularly in a transition context – financial intermediation will be attracted to the non-tradable sector, and away from where there are both missing financial and commercial links, such as in agriculture. Moreover, given the concentration of recorded Azeri GDP in the Absheron peninsula and where Baku is sited of over 70per cent, the redirection of resources toward the non-tradable sector will be, as has been the trend since 1995, based in this area. This impacts regional policy, and the rising real exchange rate in Azerbaijan is therefore likely to have a relatively more severe impact the non-Azeri tradable sector.

Studies and models on the Dutch-disease in general assume firstly a market setting and secondly some notion of equilibrium real exchange rates (RER).[21] With respect to the first point, Azerbaijan is still very much a transition country, and lacks a fully functioning market system. With respect to the second point, Azerbaijan like a number of other former planned economies began transition with an undervalued real exchange rate. The latter is particularly so since, prior to the transition process, the RER was administratively set at an artificially high level through controls on domestic prices and access to foreign currency assets, including currency. Upon liberalisation, a sudden and sharp decline of the RER took place. Inflationary pressures combined with the flight to foreign assets led to a fall of the RER. The latter was in the context of sluggish adjustment of goods prices in relation to asset prices.

Recent work has shown that as transition unfolds, the degree of undervaluation of the RER declines against some notional equilibrium (which too may of course vary).[22] This may be due to a number of factors:

1. Prices of public utilities (rents, transport, better financial discipline) are gradually adjusted to cost-pricing;

2. Possible high returns on capital investment attract capital inflow into sectors of comparative international advantage;

3. Pent-up demand pressures raises demand for non-oil sectors traded goods and bids up their relative prices.

In the case of Azerbaijan, the following additionally apply:

4. Productivity of the non-oil traded sectors is expected to rise as a result of a rise in capital investment

5. Productivity of the non-tradable sector is expected to rise through an expected rise in permanent income, already being evidenced in spillovers into sectors such as services and construction.[23]

6. A rise in the price of non-tradables relative to tradables.

The real effective exchange rate has appreciated by approximately 17 per cent since 1992 to 1997. Both the nominal and real values of the manat are expected to rise, particularly as the flow of oil-exports and associated revenues rise from 2001. It is assumed that this will raise the pressure on the manat, with a further upward pressure expected in 2005. The real effective value of the manat is expected to rise by 15 per cent to 2001 from 1997, by 55 per cent to 2005 and by 150 per cent in 2010. These estimations, although indicative and based on assumptions and expectations on future domestic and world inflation, do highlight the importance of the exchange rate on the competitiveness of the non-oil Azeri tradable sector beyond the short-run period of 2–4 years.

The Azeri authorities employed the nominal exchange rate since 1995 as an anchor to reduce inflation. The policy of how to manage rising demand for the nominal currency gave way in 1998 to the question of devaluing the current exchange rate. In particular, the dual external shocks of a decline in the price of oil and the onset of the Russian financial crisis and RUR devaluation worsened the position on the current account. The ANB used hard currency reserves to defend the manat parity during 1998, and with only partial rise in net domestic assets, the approximately 20per cent decline in reserve money was mirrored by a larger decline of almost 35per cent in net international reserves.

It is therefore likely that Azerbaijan will undergo an adjustment in the exchange rate regime with some devaluation in the short run. With a continued tight monetary stance, the adjustment will be credible and correct the current external sector disequlibria. Nonetheless, the medium- to long-term policy issue remains.

The rising real value of the manat is not expected to be a threat to the real sector and to competitiveness in the short-term given the following factors:

1. The starting point for a rise in the real rate for the manat is from a low base. In particular, dollar wages of approximately USD 35 per month according to official data and of USD 115 once ben efits such as free housing are incorporated, imply that labour costs will remain low by international standards even were there to be a rise of say 15 per cent.

2. Unit labour costs are distorted to the extent of over-employment. Discounting the excess labour hoarded by enterprises will lead to a rise in the value added per worker and thus a rise in productiv ity. Indeed, despite the nominal rise of the manat, relative unit labour costs in Azerbaijan are in 1998 only marginally higher than of trading partners.

3. Exports of both goods and factor services continue to rise, sug gesting that the current exchange rate strengthening and the im plied loss in competitiveness is not a major policy concern at present. A caveat is that the present volatility in financial markets and real sectors in emerging markets may result in considerable devaluation by countries which are competitors to Azerbaijan in

the tradable sector, and which would dampen projections for growth of non-oil exports and; as a consequence of a decline in world output, on oil revenues.

4. Barter trade, although declining annually accounted for 13 per cent of total exports and 11 per cent of total imports in 1997. Barter trade is prevalent in the CIS given the lack of liquidity amongst economic entities and the lack of well-functioning pay ment and settlement systems. Following the contagion of the re cent financial crisis in emerging markets that has also impacted transition countries, in particular Russia and Ukraine, the barter competent may in fact rise, given the decline in wealth of trade operators working through banking systems. The relevance here is that barter trade is invariant to standard economic interpreta tions of the real exchange rate and the impact on the trade-sector.

5. Official trade statistics do not fully reflect economic activity or trade. A substantial amount of trade is shuttle-trade, with import of consumer goods for CIS markets. This trade is in the main dollar-based, and is also invariant to possible appreciation of the manat.

The medium- to long-term position depends greatly on the extent to which the oil sector fulfils expectations and the timing of revenue flows. Current projections for the level of oil production and the related inflow of oil-based FDI and revenues to the state represent one optimistic case from a range of alternative scenarios. A lower inflow of monies will result in a reduced demand for the manat and a decrease in the real overvaluation.

It is argued by Azeri officials, that the inherited industrial structure, with a chain of industries of petrochemical, light and heavy industries all based on the oil industry implies that the real exchange-rate issue is in some sense overblown and not a policy-issue for the Azerbaijani economy.[24] However, even if the inherited industrial base is not subject to substantial restructuring and closure of non-competitive industries, a large inflow of oil-related revenue will impose pressures on the real sector, and the “Dutch disease” will take more pronounced policy impact.

The appreciation of the real exchange rate in the medium- to long-term suggested by forecasts indicates that the tradable-mix may change. In particular, productivity growth in the non-oil tradable sector will be lower than that in the oil sector. This therefore highlights the policy-implication that the non-oil tradable sector requires sustainable transformation in order to raise productivity sufficiently to compensate for the expected real exchange rate rise. If necessary reforms including institutional reforms are not carried out in the period before the expected rise in the rate of change in the appreciation of the real exchange rate, then there is a danger that the real non-oil sector will compress further.

An indirect impact will be the trend toward wage differentiation between the oil and oil-related sectors and the other sectors of the economy. Higher wages in the oil sector, coupled with the growth in the sectors of construction and services in the Baku region may lead to regional migration, with workers attracted from rural areas in search of higher wages. Strategic industrial policy will therefore need to take account of the regional mix in assessing the impact of the growth in oil-income on the non-oil sectors and upon investment.

A further indirect impact expected will be through a change in consumption. The strong manat and rising net wealth of the country will push up imports of consumer goods, further compressing the potential recovery of domestic light industry, unless the latter is sufficiently restructured within the next few years. The economic logic is that the rise in real wealth leads to a faster rise in consumption of tradables than in the production of tradables, thus leading to widening of the sectoral trade balance.

In sum, the RER for Azerbaijan is expected to rise over the medium- to long-term, although it may not be a perceived policy-concern at present because of existing under-valuation of the RER and evident lack of impact on other industrial sectors. The expected rising trend of RERs for all transition country is in the case of Azerbaijan reinforced by the impact of the above three resource-related factors specific to the country, particularly given the persistence of sticky goods prices and flexible asset prices.[25]

3.2 Issues in Public Finance

The Azeri government has agreed a medium term outlook for the external account with the IMF. The outlook is highly leveraged on expectations of an inflow of monies into Azerbaijan based either on development or production and sale of oil. Following signatures with consortia of oil-companies on production sharing, it is expected that oil exports will double between 1997 and 2000 and then rise by a factor of 5 in the following five years to 2005.

Simultaneously, the share of oil revenues accruing to foreign oil companies is expected to decline and the share for the state rise in 2003. The external current account deficit is expected therefore to worsen, from 22 per cent of GDP in 1997 to 35 per cent in 2000, but then recover to a balance in 2005.

The first question is the vulnerability of an economy depending on volumes and prices of only one or few strategically central products (oil and gas), particularly in cases they are small and open economies. The second elusive factor is the price the oil price. In summer 1997 the price of Caspian oil was around 20 US dollar per barrel, since then it has dropped to USD 10 dollar per barrel or less. This reduced the revenues of the Azerbaijan oil-company SOCAR and also the state budget revenues. These may in fact persuade the oil consortia to reduce or even suspend their plans.

Indeed, by end of 1998, none of the 12 foreign consortia conducting exploration in Azerbaijan had discovered oil in large quantities and 2 suspended activity in January 1999. Partners of the Caspian International Petroleum Company (CIPCO) have already drilled two exploratory wells in the offshore Karabakh field. SOCAR, the Azerbaijani State Oil Company is pressing the consortium to continue exploring a third field. Another consortium, the North Absheron Operation Company (NAOC) has too found little oil though greater gas reserves. Another 7-member consortium led by BP and Statoil of Norway are now drilling another field, Shah Deniz and results are expected in early 1999.[26]

Production of gas represents a partial solution in the future to lower oil findings, although current production-sharing agreements are at present only oil-based, and an infrastructure for export of gas would need to be created. SOCAR estimates oil reserves at 30bn barrels whilst independent analysts put the figure at 15–20bn barrels. Recoverable reserves of fields currently in production are some 2.6bn barrels.

The policy implications relate to the possible incorrect policy choice today based on a benign scenario of oil prices and development of new fields. A reduction in oil production would imply lower future oil-based earnings. A lower stream of oil earnings would impact plans for investment of oil-revenues into the non-oil sector.

Low oil prices in 1998 have led to lower export of crude oil and lower revenue to the budget. Since Azerbaijan produces only a small part of the world oil supply, it is a price-taker, and can not influence the price through changes in supply. Azeri officials now recognise this fact. One option which policy-makers might consider to insure themselves against deviations in the price of oil is the use of oil-derivatives. Mexico for instance, successfully insured against a drop in the price of oil in the early 1980s. Tatarstan has recently made use of these financial instruments.

At present, Azerbaijan has signed 12 agreements, representing USD 50bn in foreign investment. The stock of FDI totals USD 7bn to 1998 and the flow of FDI USD 1.2 bn in 1997 alone.

One key issue for good and sustainable economic policy is how to disseminate the inflow of oil revenues, particularly beyond 2000 when oil exports are expected to grow sharply and 2003 when the share of oil revenue accruing to foreign oil companies from the recovery of their investment costs is expected to decline.

From a fiscal stance, this implies that the overall state budget will be in surplus on the back of the expected inflow, although policy-makers would be advised to undertake sensitivity analysis to analyse the impact of alternative scenarios.

How will these surpluses be used? Possible options would include reducing state liabilities through repayment of debt, capital investment – particularly of infrastructure such the roads, railway, seaports and telecommunications. There is a lack of a clear strategy on this question, and which needs to be addressed now, in order to create the appropriate institutional structures to analyse the issue and to put in place by the time the budget surplus appears or to securitise cash-flows through mortgaging the future flow of oil revenue to the state. This would allow Azerbaijan to borrow money in order to begin investment in the short-run but mean debt-repayment in the longer run.

The use of the oil-premium to invest in infrastructure development would do much to improve the efficiency of the Azeri economy and create the conditions for higher endogenous growth, which depends on supply side policies to improve efficiency generally. The policy would therefore allow for development of the non-oil sector by improving its ability to compete internationally, and also attract new sources of FDI into non-traditional sectors.

Such a policy choice and the dynamic contexts would require further assessment. “Spillovers” or externalities from such a policy stance would include the further development of the service sector, thus creating the potential for growth in private sector employment, the development of high-tech firms utilising the new technologies – particularly if harnessed together with incentives to attract foreign firms by highlighting the advantages of investing in Azerbaijan.

Any fiscal assessment would need to consider the impact on the tax base. A rise in public expenditure on investment would, if associated industrial policy is carefully executed, see a rise in revenue to the state from the associated rise in the private sector. This assumes that the appropriate structural reforms in the fiscal and financial sphere are carried out.

The tight fiscal stance in Azerbaijan in recent years has been achieved through a compression in expenditures as well as recent moves to raise the flow of revenues. The consolidated deficit in 1997 measured 1.7 per cent of GDP. Arrears in wage and pension payments were eliminated in 1997, although arrears for utilities – water and energy remain, while the stock of inter-enterprise arrears remains at 200 per cent of GDP. The latter is effectively a contingent fiscal liability, as the enterprises are state-owned.

A fundamental reform effort is needed to tackle inter-enterprise debt and to introduce appropriate tools to tackle both the "flow" aspect of the problem, which has proven in transition countries a far bigger structural issue to resolve, than the more immediate "stock" problem evidenced by the raw nominal figure. Resolution of the debt-overhang is necessary as part of Azerbaijan's structural adjustment programme of the industrial structure, to raise transparency and improve incentives, as well as to reduce the potential inflationary impact of the problem.

Medium- to long-term economic planning should in addition focus on a direction for utilising comparative advantages in Azerbaijan in the form of a well-trained work-force and high level of engineering and research capabilities, as well as the natural geographic advantages of lying between Europe, Asia and the Slavic republics. Fiscal measures could be developed to assist in the longer-term aim of creating industrial parks or "green-field sites" where the scientific potential could be harnessed, through future tax benefits for investors for instance. Countries as diverse as Ireland, Israel and India have successfully employed such policies in recent years.

3.3 Issues in Credit and Banking

Under a planned model, the function of a central bank is to act as an accounting centre – to print and allocate the necessary money to fulfil the plan; it is dependent on the government. Prices are fixed so the link between money and price is less visible than in a market system.

In a market system, prices are not exogenous, but fully linked to monetary growth. Expansion of money supply beyond money demand leads to inflationary pressure. Domestically, this impacts the goods markets through either higher prices, or in the event of price controls, in the form of shortages and export of goods to higher priced neighbouring markets. Externally, the excessive monetary creation impacts the price of the domestic currency, by making it cheaper for a given unit of a foreign currency, such as the USD.

To curb inflationary pressure, an appropriately tight monetary stance is required. Azerbaijan has successfully stabilised its inflation rate through following an IMF-designed stabilisation plan. A tighter monetary policy does however reveal the problems in the real sector. Enterprises previously able to service debt through inflation no longer have the option – in an inflationary environment, debtors gain at the expense of creditors since inflation wipes away the real value of the debt; the reverse is true during a period of price-stability. Without enforceable contracts and hard budget constraints, rises in inter-enterprise debt, or arrears in taxes or wages are a rational real sector response.

Moreover, a tight monetary stance implies a reduction in the emission of money and credit. This creates liquidity problems for the real sector previously reliant on cheap and directed credit. Enterprises have reacted through falling-back on inter-enterprise credit, through use of barter activity and arrears on wages and taxes. Without functioning market-based legal mechanisms in place, Azerbaijan has allowed a number of enterprises to reduce or halt production, but not close outright.

A Looser Stance?

The reduction in the Azeri inflation rate was faster than planned. In particular, a reduction in the issuance of reserve money by the central bank led to a faster decline in the growth of broad money than anticipated. The higher than anticipated decline in money creation highlights both the cause and reaction of an underdeveloped financial and banking sector.

Proponents outside the NBA, including the Ministry of Economy, argue that the Azeri industrial sector is facing an excessively restrictive monetary stance. In particular, it is argued, that the lack of long term credit to the economy is a constraint to the long-term development of the non-oil industrial sector and that the central bank should therefore do more to issue such credits.

The NBA increasingly issues credits on commercial terms through auctions, as part of its monetary policy. The maturity of these credits ranges from 7 days to 180 days. The latter is in line with standard international practice. Moreover, the central bank is seeking to move towards the use of indirect instruments of monetary policy in order to manage liquidity and set the monetary and exchange rate stance.

The lack of long-term credit in the economy is due, not to the monetary stance pursued by the central bank, but more due to lack of money creation or lending by commercial banks. Money creation was lower than the IMF-agreed programme, witnessed in the low broad money to narrow money ratio. In the absence of directed credit, banks have refused to intermediate credit to expected levels. It is therefore the financial intermediation function that is inefficient. Deposit-taking banks are financial intermediaries – they collect deposits and transfer them into loans, loans of differing maturities. In Azerbaijan, the lack of long-term credit is due to a number of factors that impedes the banking sector from carrying out maturity transformation of short-term credit into long term loans.

The banking sector in Azerbaijan is small in terms of GDP with Total Banking Assets at 11per cent of GDP, in comparison to mature economies where the relative size is typically greater than 100per cent of GDP, or even in countries advanced in transition such as Poland where it is over 60per cent of GDP. The majority of loans originate from the four large banks: Agroprombank, Prominvestbank, International Bank and the Savings Bank. With a decline in directed credit and increasing commercialisation of the banks through auditing, regulation and supervision along international best practice, why are banks not successfully intermediating savings into investment?

Supply Side Factors

Three factors explain. On the supply side, banks are risk-averse. Lending rates in real terms were above 20 per cent to 1998, which are extremely high. This suggests that banks are using margins to build balance sheets, that there are greater risk-based incentives for short-term lending for import-export operations say, or for investment in financial securities than in lending for long-term loans, a situation not unique to Azerbaijan among transition banking systems. High rates of lending suggest that bankers see lending as highly risky. Preference for short-term lending is therefore a consequent response. The policy impact is therefore to determine how to focus on the supply side structural changes in the financial sector which can reduce the risk assessment by banks, to make it more attractive for them to lend, and for longer-term projects.

The possibility of large loans is of course limited simply because of the low capitalisation of the banks. Currently, banks are now to raise capital to USD 1m and to USD 5 m by 2000. The small capital base restricts banks' ability to increase their loan books. This point highlights the fact that existing banking structure is too large in the number of banks in existence and that there will need to be mergers or closures, in order to leave a domestic banking sector with a stronger capital base. Secondly, the high lending rates may also indicate a degree of cartel among the main banks in Azerbaijan and a lack of real competition. Opening the banking sector to foreign banks and allowing greater ownership of domestic banks will raise both the level of sophistication of lending teams through transfer of operational skills and also lead to downward pressure on interest rates for viable projects that meet standard lending criteria.[27] At present foreign banks face obstacles in the form of approval required to raise statutory capital, where a ceiling of 30 per cent on foreign capital applies and in the make-up of senior bank personnel required.

A further factor that reduces the ability of banks to extend their loan books is the low level of existing deposits in the banking sector. This is partly a function of the transition in the economy and the banking problems since 1991, both in Azerbaijan and those in Russia, which has reduced confidence in the banking system.[28] Economic stabilisation coupled with the strong performance of the Manat is improving the incentives for savings into the banking sector. A related problem is the level of dollarisation in the economy, both officially measured – the percentage of foreign exchange deposits in the banking sector and the unmeasured amount held outside the banking sector. Improvements in payment and settlement systems and a reduction in barter trade, improvement in the taxation of income and in the collection of in particular customs, are structural reforms which will help to reduce the incentive to hide undeclared or illegal earnings and internalise transactions through new financial channels that reduce transaction costs for participants, as well as making compliance more forthcoming. One factor specific to Azerbaijan is access by tax inspectors to information on bank accounts. In an environment where the tax Inspectorate is recognised as being prominent in rent-seeking activity, there is an incentive for economic agents to work outside the official banking system in a form of "shadow banking".

Thirdly, the risk premium attached to lending is made high due to the lack of fully functioning legal and property rights. A law on bankruptcy was passed in 1997. However, it is not effective because it is not being implemented. There has not been a single bankruptcy registered in Azerbaijan. Without rights to foreclose debtors, a bank would be taking a huge risk in providing long-term credit. In part, the passage of other reforms such as land privatisation and registration of titles to property may allow banks to lend against security.

Accounting procedures remain to be reformed. Whilst all the major banks are now audited by internationally reputable accounting firms, reforms to improve the accounting for borrowers lags. Improvement in presenting a full set of accounts showing the full balance sheets with all assets and liabilities as well as Profit and Loss Accounts would improve the ability of loan officers at banks to better assess the quality of loan proposals and the value of collateral.

Demand Factors

When real loan rates are high, the quality of proposals put forward by borrowers declines. In economic parlance, there is “adverse selection” – only high-risk proposals are put forward.

Who are borrowers at present? Demand for long-term loans comes from the existing or reformed enterprises in the public sector, from the privatised SME and from new start-ups. All other things equal, the larger enterprises should expect to pay lower rates of interest for loans because of their existing history, larger scale production and the larger security they possess.

The implementation of legal and property rights has already been covered in the supply side factors and applies equally here.

For improving the financial flow for the real economy, what can the government do? The use of government guarantees is a tool that may be utilised, both complete or partial. In developed economies, the use of partial guarantees for small-sector and start-up ventures are used and could be utilised in Azerbaijan. The strategy may be amended with time as transition unfolds and firms are able to self-finance without need of extra guarantees.

A major policy issue is how to direct lending to the agricultural sector and to rural areas in general. Here the relevance is that a holistic long-term industrial strategy needs to consider how to channel finance to the agricultural sector. Agroprombank represents the existing channel for provision of finance to farmers and the existence of both its branch network and that of Industrial bank may provide an avenue for providing credit. However, given the development stage of banking in Azerbaijan and the problems highlighted already, it is unlikely that more than a trickle of commercial bank credit will flow to agriculture in the short-run.

The current position of agriculture is in flux. Privatisation of farms is under way. The implementation of land law will allow farmers to borrow on secured terms, and there will then be a commercial basis for banks to open credit lines to farmers, both for purchase of seeds and inputs and for working capital. The state could in addition assist by assisting in the development of leasing facilities for agriculture, ideally with the participation of the private sector and/or international bodies. The strategy could be complemented by a shorter-run solution of the set-up of a micro-lending unit or bank typically found in developing countries, in order to provide small loans that are outside the scope of existing domestic commercial banks.

4 Conclusions

The first part of the paper outlines current economic developments in Azerbaijan. Data on the real economy and industry are analysed and discussed. The decline in real GDP and production was 50 per cent of the level in 1991 to 1995 but that the rise in the nascent private sector is not fully reflected in official statistics, and may represent as much as 60 per cent of GDP, thus over-representing the recorded decline.

The Azeri government has pursued, almost to the letter, the IMF-led stabilisation package since 1995. This has led to a rapid decline in inflation to single digit annual inflation and resumption of economic growth, measuring 6 per cent in 1997 and expected 8 per cent for 1998. The Azeri economic structure within the USSR was based around the utilisation of energy resources located in Azerbaijan, with heavy industry such as electro-energy, chemicals and metallurgy and light industry such as textiles and food-processing representing downstream industrial use. Other sectors such as Agriculture, although outside the oil-based complex, benefited from subsidised energy inputs. Although the oil sector remains the main engine of economic growth, there were signs of a broadening of the recovery, with increases in output in agriculture, services and industry, though recently non-oil activity appears to be slowing again. In the oil sector, exports of crude oil from the new fields began in November 1997 and have risen more rapidly than expected, and seven new oil exploration contracts with foreign consortia were concluded during 1998. Foreign direct investment has amounted to US$1.8 billion in 1998 (nearly USD150 per capita), about one quarter of which went to the non-oil sector and the stock of total FDI to 1998 is approxately USD 4bn.

The next stage of reforms represents structural adjustment beyond stabilisation. Significant steps have been achieved in the liberalisation of the liberalisation of prices and of the trade regime. Privatisation of the small-scale sector is complete. However, while reforms of the banking structure and supporting laws on bankruptcy have been pursued, progress has been slow. Moreover, public finance reform is still on the agenda – a new Tax Code is earmarked for passage in 1999, while the expenditure function is being made more accountable and transparent through the introduction of a treasury system. On the Revenue side, a properly trained and accountable Tax Inspectorate is lacking, whilst the lack of independence of the judiciary is proving to be a source of rent-seeking activities.

The relative abundance of oil and, in future, of gas represent natural advantages for achieving sustainable and equitable economic growth for Azerbaijan into the 21st century. However, as discussed in the second part of the paper, this abundance needs to be managed with care. Nigeria and Norway represent two alternatives to where oil-intensity can lead for an economy. In particular, the issues raised include the problems related to the "Dutch disease" syndrome, which can lead to problems of competitiveness for the non-oil tradable sector, and to crowding out of resources in favour of non-tradables. Related issues include how to manage the increase in expected wealth from the oil-premium to attain fiscal smoothing, and structural reforms in the banking sphere to kick-start the thus-far lacking intermediating process.

The expected in-flow of oil revenues will lead to both internal and external surpluses, particularly after 2005. This is expected to lead to a strengthening of the manat and a worsening position of the tradable sector. Whilst not a policy concern at present, the real exchange rate is expected to rise from 2003 and so will represent a medium-term policy issue. Possible policy responses include maintaining offshore oil earnings as in the Kuwaiti case or in the form of an Investment Trust as undertaken by Norway. Supporting second generation reforms in the fiscal area in addition to better fiscal governance and improved tax collection, as well as preparations to manage surpluses from the "oil premium", and which need to be developed in advance. The non-oil industry employs the majority of the labour force. Intermediating savings into investment potential, outside direct FDI requires banking sector reforms, and has regional policy implications. The development of microcredit facilities for Agriculture represents a possible low-cost solutions to providing credit to rural farms, where commercial banks may not otherwise venture for many years.

Azerbaijan has successfully steered through the first generation of reforms. The focus is now upon second generation reforms.

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Notes

[1] The authors have acted as advisors to governments in Azerbaijan and other CIS republics. Mr Singh is a member of CETRAN, Centre for Economies in Transition at Independente Universidade, Lisbon, Portugal and was a visiting researcher at the Bank of Finland. Mr Laurila is a senior advisor at BOFIT.

[2] The present article is the second of two articles focussing upon Azerbaijan. A complementary first paper by Juhani Laurila at BOFIT presents the reader with a historical background to the geo-political background adjunct to the economic issues. This article has come out in series entitled BOFIT Online.

[3] Laurila (1999, forthcoming), BOFIT, *Power Politics and Oil as Determinants of Transition: the case of Azerbaijan*. The paper concludes that co-operation and partnership created through liberalised and free markets and commercialisation pushing aside the ethnical and religious conflicts, isolation and territorial demands, can be seen as a part of transitional process. Moreover, it is argued in that the oil-driven transition, if successfully implemented in Azerbaijan, is likely to increase the political stability in the Caspian region and Caucasus, through internationalising commercial activity related to the energy sector.

[4] As a counterpart for "Northern Caucasus" containing Dagestan, Chechnya, Northern-Ossetiya, Gabardino–Balkariya and Karabayevo–Chercessya, "Southern Caucasus herein refers to Armenia, Azerbaijan, Georgia and to the Russian notion "Transcaucasia" ("Zakavkazye") which refers to land mass south of Caucasus mountain ridge as seen from northern (from Russian) perspective.

[5] Recent work on Azerbaijan includes Altstadt (1992), *The Azerbaijani Turks* and Dawisha K and B Parrott (1997), *Conflict, Cleavage and Change in Central Asia and the Caucasus* and which focus in general on geopolitical analysis.

[6] de Melo (1996) defines three aspects of liberalization: (i) internal liberalization, or price liberalization an abolition of state monopolies (ii) external liberalization, or liberalization of the foreign trade regime; and, (iii) private sector entry, small and large scale privatization. See Singh, (1999, forthcoming) BOFIT, *Transition and Transit to a Market Setting: A Model Guide*, for development of this definition where liberalization as defined here and stabilisation together define first generation reforms and where structural reforms represent second generation reforms in the transition process.

[7] Up to 60per cent of GDP is estimated (e.g. EBRD Transition Reports) to be not recorded.

[8] Based on 1990, recorded real wages declined by 86 per cent in 1995. By 1997 the decline was 75 per cent, following the onset of growth. The recorded statistics do not capture the large shadow economy and therefore over-report the decline by as much as 35 – 40 per cent.

[9] The period was marked by the Nagorno–Karabakh war, which led to the loss of 20 per cent of the Azerbaijani territory. However, according to the Azeri government, the region was responsible for a very small share of pre-conflict GDP and the loss thereof did not therefore deprive Azerbaijan of significant GDP. Nevertheless, the agricultural potential of the lost territory and the cost of providing housing and supporting displaced persons has undoubtedly (i) raised both the level and composition of expenditures, (ii) reduced the potential growth of the holiday service sector since the majority of these buildings are used to house displaced persons and (iii) reduced potential GDP.

[10] Singh (1999), *op.cit.*

[11] The possibility of deploying micro-credit structures is an option, and briefly discussed in Section II, (iii).

[12] This echoes the argument made in Laurila (1999), *op cit.* about economic and commercial interests overcoming non-economic hostilities and providing a bridge toward solutions in non-economic areas.

[13] Tornell A and Lane P (1998) blame the “voracity effect” for boom and bust fiscal responses in resource-rich economies, particularly against the background of a fragmented society and competing power blocs.

[14] Natik Aliyev, President of SOCAR, in Daily Monitor, 18 August 1998, p. 6.

[15] Singh (1999), op cit. argues that sustainable economic growth beyond first generation reforms requires institutional reform, which can be regarded as a catalyst for move toward “good” or sustainable and equitable economic growth. See also Barro (1994) where the link with growth and democracy are found, and Valdivieso (1998) who links the success of sustainable reform and therefore growth on the starting conditions of a country.

[16] For instance, The UNDP Human Development Report on Azerbaijan (1997)**.**

[17] The unemployment rate in Azerbaijan is artificially low as firms closed nominally continue to have labour on their books in order to qualify for present or future social benefits, whilst the labour force itself has shrunk due to the low level of minimum benefits though on the other hand a significant minority of women, also not registered, are working in the informal trade and service sector.

[18] These issues are addressed more completely in Laurila J (1999, ii).

[19] The Dutch Disease syndrome relates to a situation in which fast growth of a resource-based economic sector impacts negatively other real sectors through a rise in the real exchange rate and crowding out of resources.

[20] Controls on the Capital account á la Chile and China represent possible medium-term policy instruments as part of a sequenced reform agenda.

[21] See for instance Eastwood, RK and AJ Venebles, 1982 and Buiter W and DD Purvis (1983) for models.

[22] Halpern L and C Wyplosz (1996) and Krajnyák K and J Zettelmeyer (1997).

[23] A rise in the equilibrium real exchange rate corresponds to a situation of productivity in the tradable sector is greater than that in the non-tradable sector, viz. the Balassa/Samuelson condition.

[24] See footnote 1.

[25] The same factors are likely to apply to other resource-endowed transition countries, such as Kazakhstan, Uzbekistan and Turkmenistan.

[26] See Laurila (1999), *op cit* for further description on the oil consortia.

[27] The experience from other transition countries, such as Estonia, where foreign entry has been forthcoming is that there are other positive spillovers. Foreign banks bring more conservatism to operations and better governance, and reduce regulatory risk for bank regulators with limited supervisory capacity by being responsible also to home country regulators in mature market economies. For universal banks and proliferation of financial subsidiaries in other financial markets such as for securities and insurance, greater prudence and better governance has extended to these markets where regulation and supervision in transition countries lags bank regulation.

[28] TV media in particular is very much Moscow-based, particularly for news. Thus confidence in banking in Azerbaijan is very much affected by the coverage of financial and banking crises in Russia.

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