# Azerbaijan

GDP growth strengthened in 2018 as expansion in services and agriculture continued, and as industry contracted less. Exchange rate stability tamed inflation, and higher oil prices widened the current account surplus. Growth is forecast to inch higher in 2019 and 2020 on expanded public spending, gas production, and output aside from petroleum, with inflation rebounding slightly in both years and higher gas exports further widening the current account surplus. Improving infrastructure is a priority.

## Economic performance

Growth accelerated from a negligible 0.1% in 2017 to 1.4% on gains of 0.6% in the dominant petroleum sector and 1.8% in the rest of the economy (Figure 3.2.1).

On the supply side, industry contracted by 0.4%, improving considerably on 3.6% decline in 2017 with recovery in mining and 7.9% growth in manufacturing largely offsetting a steep drop in construction. Mining expanded by 0.4%, reversing 4.6% decline in 2017, as the beginning of supply from Shah Deniz 2 field boosted gas production by 7.1%. Lower capital outlays with the completion of major public investment projects deepened contraction in construction from 1.5% in 2017 to 9.0%. Agriculture expanded from 4.2% in 2017 to 4.6%, reflecting government support to farmers, particularly for crop production, which rose by 6.8%. Growth in services remained at 3.5% with gains in tourism and transportation.

On the demand side, 9 months' data show a 12.0% rise in consumption, including 13.0% expansion in private consumption as household incomes increased. Total investment contracted by 0.2%—though an estimate for the full year shows total investment rising. Net exports tripled as exports outgrew imports.

Average annual inflation plunged from 12.9% in 2017 to 2.3%, and core inflation to 1.8%, thanks to higher prices for oil exports and tightened control over the amount of currency in circulation to stabilize the exchange rate (Figure 3.2.2). With a decline in more expensive imported food, price rises for food slowed from 16.4% in 2017 to 1.7%, for other goods from 11.6% to 2.6%, and for services from 9.3% to 2.7% (Figure 3.2.3).

Expansionary fiscal policy saw expenditure increase from the equivalent of 25.1% of GDP in 2017 to 28.5%, mainly for investment (Figure 3.2.4). Revenue rose from 23.5% of GDP

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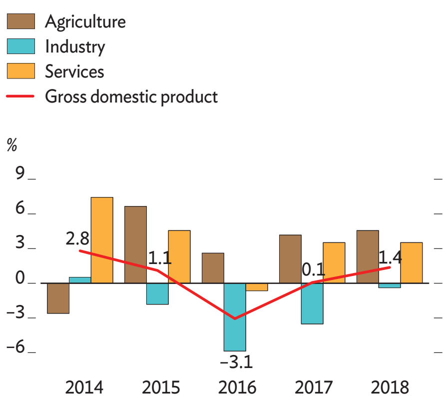
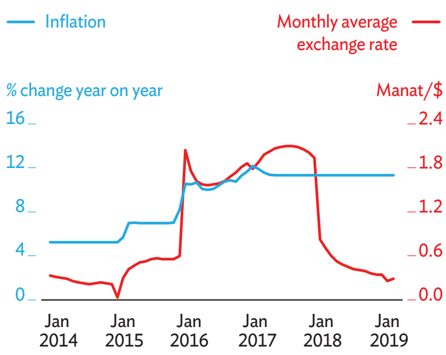
3.2.1 GDP growth by sector




Source: State Statistical Committee of the Republic of Azerbaijan.

3.2.2 Inflation and exchange rate



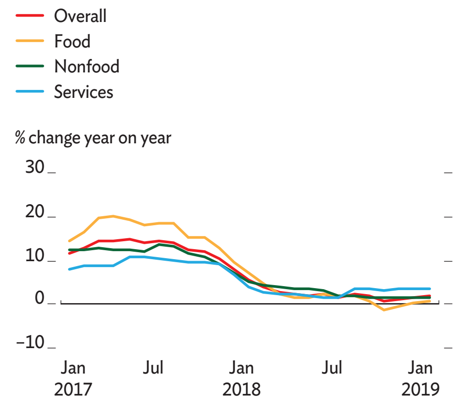

Source: State Statistical Committee of the Republic of Azerbaijan.

in 2017 to 28.1% on an 80% rise in transfers from the State Oil Fund of Azerbaijan (SOFAZ), the sovereign wealth fund, and on reform to tax and customs administration that improved tax revenue by 13.3%. Higher revenue trimmed the budget deficit almost to zero, from 1.6% of GDP in 2017 to 0.4%. However, the deficit excluding SOFAZ transfers remained substantial, rising from 10.3% of GDP in 2017 to 14.1%. Debt service payments of both interest and principal soared by 47.0% as the government opted to prepay a portion of more expensive external debt. External public and publicly guaranteed debt consequently fell from the equivalent of 22.8% of GDP at the end of 2017 to 19.0% a year later, partly reflecting a new strategy adopted in 2018 to rein in public debt.

Monetary policy continued to prioritize price stability. Success in reducing inflation nevertheless allowed the Central Bank of Azerbaijan to cut the policy rate from 15.00% to 9.75% in four rounds during 2018 and to 9.25% in January 2019. Broad money growth slowed from 9.0% in 2017 to 5.7% (Figure 3.2.5). Banks continued to face challenges as the percentage of nonperforming loans remained high at 12.2%, though efforts to address the problem brought a reduction from 13.8% a year earlier. Confidence in the Azerbaijan manat continued to firm, as indicated by the share of local currency deposits rising from 27.6% at the end of 2017 to 34.6% a year later, and the share of local currency loans rising from 59.1% to 62.0%. With greater exchange rate stability and more consumer confidence, the supply of credit grew by 10.7%, reversing 28.5% contraction in 2017.

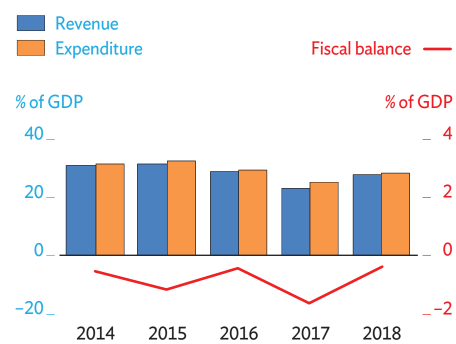
The current account surplus was estimated to have nearly doubled from the equivalent of 3.6% of GDP in the first 9 months of 2017 to 6.9% in the same period of 2018. Higher oil prices raised the full-year trade surplus to 16.0% of GDP and doubled export growth from 17.9% in 2017 to 35.9% as hydrocarbons continued to account for more than 90% of all exports, with other exports expanding as well. Import growth jumped from 1.6% in 2017 to 32.1%. With the completion of hydrocarbon construction projects, the deficit in services fell from $3.4 billion in 2017 to $1.3 billion, even as profit transfers by foreign petroleum investors widened the income deficit from $1.2 billion in 2017 to $1.5 billion. Growth in neighboring countries, particularly the Russian Federation, buoyed remittances by 10.7% to $600 million. Net foreign direct investment in the first 9 months of 2018 was $1.0 billion, up from $800 million in the same period of 2017. Foreign exchange reserves rose by $300 million to $5.6 billion at the end of 2018, which was cover for an estimated 3.8 months of imported goods and services. SOFAZ assets were $38.9 billion at the end of October 2018 (Figure 3.2.6).

**3.2.3 Monthly inflation**



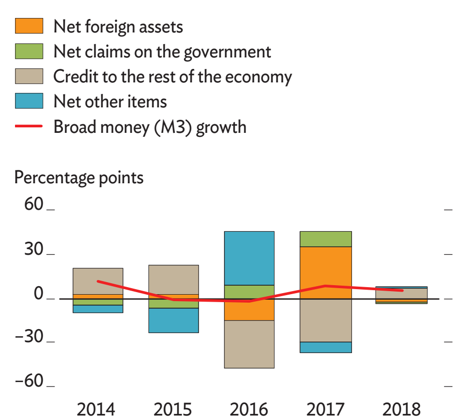

Sources: State Statistical Committee of the Republic of Azerbaijan; Haver Analytics (accessed 11 March 2019).

**3.2.4 Fiscal balance**




Source: Ministry of Finance of the Republic of Azerbaijan.

**3.2.5 Contributions to money supply growth**




Source: Central Bank of the Republic of Azerbaijan.

## Economic prospects

Growth is forecast to strengthen to 2.5% in 2019 on higher public investment and increased consumption, reaching 2.7% in 2020 as gas production at the Shah Deniz 2 field accelerates (Figure 3.2.7).

On the supply side, industry is forecast to grow by 1.0% each year, driven by manufacturing and gains in mining from higher gas production. Construction is expected to expand by 3.0% in 2019 to accommodate additional government programs for agriculture and housing and by 2.0% in 2020 with the implementation of regional development programs. Agriculture is projected to expand by 3.0% in 2019 and by 4.0% in 2020 as farmers' access to finance improves. Growth in services is projected at 3.0% in both 2019 and 2020 on gains in transportation, tourism, and retail trade.

On the demand side, a higher government salary bill will boost public consumption, while higher effective household income from growth should fuel private consumption, especially as inflation stays fairly moderate. A stable exchange rate and the implementation of economic reform to improve the business climate are projected to boost private investment, and more expansionary fiscal policy will raise public investment. Net exports will rise on higher hydrocarbon exports and lower imports, particularly in 2019 as higher customs duties suppress imports of machinery and automobiles, which together accounted for 36% of all imports in 2017.

Inflation is projected to accelerate to 4.0% in 2019 in line with higher salaries and, as faster growth boosts domestic demand, reach 5.0% in 2020 (Figure 3.2.8). A relatively stable exchange rate should prevent high inflation.

Over the next 2 years, the central bank is expected to focus on two objectives: maintaining exchange rate stability and limiting inflation to 5.0%. The authorities will therefore closely monitor import demand, foreign exchange movements, and capital flows. A stable exchange rate is expected to boost lending to the private sector. If the inflation target is attained, the central bank can be expected to ease the policy interest rate further.

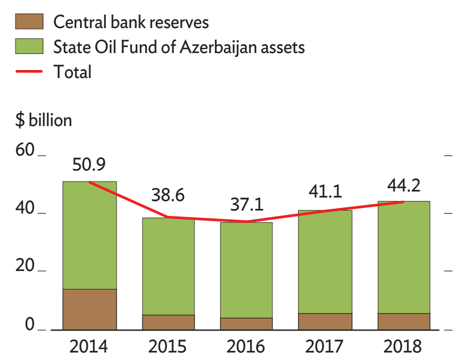
Fiscal policy is expected to become more expansionary, with the state budget deficit including SOFAZ transfers rising notably to 2.8% of GDP in 2019 before narrowing again to 2.0% in 2020. Deficit financing will come from privatization proceeds, domestic and external borrowing, and unused balances in Treasury accounts. The deficit excluding SOFAZ transfers will equal 18.6% of GDP in 2019 and 16.9% in 2020. Revenue is forecast to reach the equivalent of 32.2% of GDP in 2019 and 33.2% in 2020 as higher gas shipments boost hydrocarbon revenue and increased customs tariffs and other tax changes raise revenue from the rest of the economy.

**3.2.1 Selected economic indicators (%)**

| | 2019 | 2020 |
|---|---|---|
| GDP growth | 2.5 | 2.7 |
| Inflation | 4.0 | 5.0 |
| Current account balance (share of GDP) | 13.6 | 10.8 |

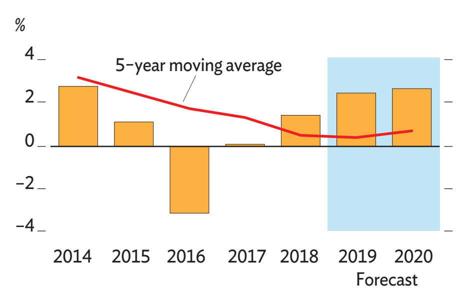
Source: ADB estimates.

**3.2.6 State oil fund assets and central bank reserves**




Sources: Central Bank of the Republic of Azerbaijan; State Oil Fund of Azerbaijan. http://www.oilfund.az (accessed 11 March 2019).

**3.2.7 GDP growth**

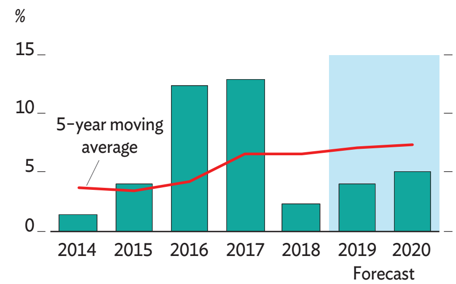



Sources: Central Bank of the Republic of Azerbaijan; ADB estimates.

Expenditure is forecast to equal 35.0% of GDP in 2019 and 35.2% in 2020, reflecting a 38% rise in the minimum wage and minimum pension, general pay increases in 2019, and a new regional development program in 2020 that will expand current and capital outlays alike. With higher growth and the debt management policy adopted in 2018, the government expects to hold public and publicly guaranteed external debt to less than 20% of GDP at the end of 2020.

The current account surplus is projected to double again to equal 13.6% of GDP in 2019 before falling back to 10.8% in 2020 (Figure 3.2.9). Despite higher gas exports, lower average oil prices will cut total exports in 2019 by 7.5%, then further increases in gas production at the Shah Deniz 2 field will boost exports by 1.0% in 2020. However, lower exports will be more than offset by an expected 19.9% decline in imports in 2019 owing to increased customs duties on machinery and cars. Imports are seen recovering by 11.1% in 2020 to meet rising domestic demand as the impact of these tariffs wanes. The deficit in services is projected to narrow further by 6.7% in 2019 and 7.1% in 2020 as construction on Shah Deniz 2 ends. However, the income deficit may widen further in 2019 and 2020 as foreign investors repatriate more of their hydrocarbon earnings.

**3.2.8 Inflation**



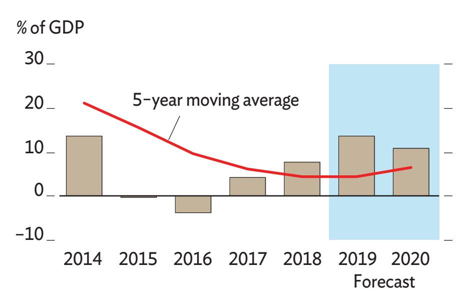

Sources: Central Bank of the Republic of Azerbaijan; ADB estimates.

## Policy challenge—improving infrastructure

Azerbaijan's oil wealth has fostered considerable social and economic development. While enabling rapid economic growth, hydrocarbon earnings have created an economy overly dependent on the petroleum industry. Toward diversifying the economy, the government has used much of the hydrocarbon earnings, including SOFAZ transfers, to rebuild and modernize Soviet-era infrastructure. From 2003 to 2017, investment in public infrastructure excluding oil and gas averaged the equivalent of 6.6% of non-hydrocarbon GDP. Maintaining and expanding this infrastructure is a continuing challenge.

Capital investments have so far focused on reconstructing and expanding road and railway networks, ports, and electric power plants. Most investment has gone into improving the country's east–west and north–south transport corridors toward fashioning Azerbaijan as a major transit and trade hub. Despite the creation of good transport and electric power networks, along with massive investments in other public utilities, critical gaps in infrastructure remain. Investment is still needed to replace and upgrade infrastructure for agriculture, rail transport, tourism, and information technology, among other needs. The government has estimated that investment of nearly $7 billion, equal to 4.7% of GDP, is required during 2017–2020 for these purposes.

**3.2.9 Current account balance**




Sources: Central Bank of the Republic of Azerbaijan; ADB estimates.

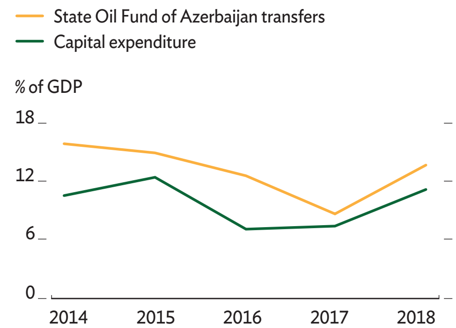
As state-owned enterprises have limited financial capacity, and as the private sector plays little role in financing and operating infrastructure, most of the costs will fall on the central government budget. However, public investment spending generally tracks hydrocarbon revenue. Capital outlays in the central budget declined from the equivalent of 12% of GDP in 2015 to 7% in 2016 as prices for hydrocarbons fell. They remained near 7% of GDP in 2017 but rose to 11% in 2018 with much higher SOFAZ transfers (Figure 3.2.10). The long-term sustainability of existing assets is a concern, and utility tariffs set by the government should be adjusted to cover operating costs.

The government needs to establish a robust system for managing public investment that will individually appraise the economic and financial viability of proposed projects, strengthen project implementation capacity, improve project monitoring and evaluation, and adopt a framework for comprehensively assessing project results. It has adopted a medium-term expenditure framework to ensure that adequate funds are allocated to maintain infrastructure once it is built. However, due attention will be needed to link the investment program with that framework to ensure that resources are provided in a timely fashion for infrastructure operation and maintenance.

To facilitate private investment in public infrastructure, The National Assembly adopted in 2016 a law on special financing for infrastructure investment projects that promotes the build–operate–transfer model, in which private firms construct infrastructure projects, operate them for a specified period to recoup their investment, and then hand them over to the government. An adequate legal framework is still needed, as is the acquisition of appropriate skills, to develop feasible projects for private financing and management. While state-financed infrastructure projects will remain dominant, private participation in selected areas can make service provision more efficient and competitive.

Enhanced skills will be important as well for maintaining infrastructure. Infrastructure expansion and the mastery of new technology will require better training facilities, curriculum, methods, and certification programs. Stakeholders, especially in agriculture and information technology, will need to adopt technology and comply with quality standards and certification requirements. Strengthened skills can help maintain existing infrastructure and promote investment in worthwhile new projects.

**3.2.10 Budget transfers and capital expenditure**




Sources: Ministry of Finance. *Annual Statements on Budget Execution, 2014–18*; Central Bank of the Republic of Azerbaijan.