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**Evaluation of macroeconomic
condition in Azerbaijan in 2010**

**ANALYTICAL
REVIEW**

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ABBREVIATIONS

CBA	Central Bank of Azerbaijan
EBRD	European Bank for Reconstruction and Development
SOCAR	State Oil Company of Azerbaijan Republic
SOFAZ	State Oil Fund of Azerbaijan Republic
IMF	International Monetary Fund
WB	World Bank
SC	State Company
SE	State Enterprise
WTO	World Trade Organization
SSC	State Statistical Committee
SCC	State Customs Committee
MoED	Ministry of Economic Development
ERC	Economic Research Center
NEC	Nominal Effective Currency
REC	Real Effective Currency
VAT	Value Added Tax
NBG	National Budget Group
GDP	Gross Domestic Product

SUMMARY

This analytical review had been prepared by the experts of the National Budget Group with the aim to evaluate macroeconomic activity in Azerbaijan in 2010. Basic macroeconomic indicators (GDP, employment, income of the population, foreign trade, foreign investments, poverty, etc.) of Azerbaijan in the recent 5 years (2006 – 2010 years) were analyzed in the presented review in the background of global economic processes observed in the world. Dependence of fiscal parameters on oil revenues, state investments and infrastructure expenditures, social policy (education, healthcare, social protection), taxation and administrative reforms, main parameters of monetary policy (money supply and inflation rates, real effective currency rate variations, credits, interest rates) and state of banking sector during the analyzed period were subjects of research in this paper.

It was revealed as a result of conducted research that the economy of Azerbaijan for recent years including 2010 demonstrates decline in dynamics of real economic growth rate; in addition, it was determined that there is a risk of deficiency in technological productivity of the current economic growth originators necessary to maintain sustainable economic growth rate. The research showed that the main impelling power of GDP in Azerbaijan economy is the actual final consumption, and there is no unique tendency in the role of export and saving. High dependence on raw oil, natural gas and oil products still remains in export operations which are the main components of the GDP. In addition, the research defined that "Deindustrialization symptom" of "Dutch disease" intensified in Azerbaijan 's economy with diminishing share of industrial and agrarian sector and relative expansion of share of the service sector in the GDP structure. Analyzes show that less share of nominal growth and nominal volume of GDP was provided by non-oil sector as compared to the oil sector; however, non-oil sector, particularly its construction segment, continues to hold the leading place in the investments made in economy; the poverty level is gradually decreasing, whereas employment level and nominal incomes of the population are increasing in Azerbaijan. Simultaneously, there is a problem of labour productivity in the economy, including serious salary differences between oil and non-oil sectors.

Key words: Azerbaijan, National Budget Group, Gross Domestic Product, fiscal expansion, investment budget, money supply, inflation

INTRODUCTION

Among all other independent research institutes in Azerbaijan the National Budget Group (NBG) is primarily known for its reviews on draft and implemented state budget. The "Analytical review – 2010" research paper is its first product from these series. The main aim of this research is to evaluate current condition of Azerbaijan's economy, evaluate recent established trends and observed new social – economic processes and their expected results from independent point of view through analytical approach and prepare recommendations in order to influence the policy decisions. Thus, this research is very important from the point of studying the current state of Azerbaijan's economy and estimating its future. One of the main factors behind the importance of this work is its elaboration with this approach for the first time by local experts. In addition, the fact that the research paper is prepared in a period when changes are launched in the macroeconomic policy of Azerbaijan is increasing its importance from the point of strategy development and targets selection for the new period. Thus, the analyzed period selected for this research was full of different changes such as "boom" and later decline of the economic growth rates. This, in turn stimulated expanded structure and dynamics of the research. The experts had evaluated macroeconomic conclusions of 2010 according to 3 main divisions:

Macroeconomic processes, established trends, sources of economic growth, macroeconomic balance and structure related issues observed during the recent 5 years including 2010 were analyzed in **the first chapter**. Evaluations of the role of basic factors behind sustainable economic growth in formation of GDP in Azerbaijan and their potential impact on economic growth were also presented this chapter. In this context evaluation of such issues as employment, variation of incomes of population, poverty and similar social indicators were included in the scope of research of the first chapter.

The second chapter focused on analyses of structure of the state budget, the dynamics of formation of its incomes and expenditures in the context of dependence of fiscal parameters on oil revenues. Impacts of fiscal expansion on state investment and infrastructure expenditures were evaluated in the macroeconomic background. Issues of management of budget deficit were included in the scope of research of this chapter.

Finally, **the third chapter** covers research on monetary, money – credit and, as well as currency and currency rate policy. Inflation rates, its sources, expectations and targets are also subject of the research.



With the aim to evaluate general economic activity of the government of Azerbaijan main findings and conclusions of the research, as well as derived recommendations are presented in the conclusion of the review.

Along with the official figures of the State Statistical Committee of the Republic of Azerbaijan, Central Bank and Ministry of Economic Development, alternative calculations were also used as main sources of information of the research. In addition, references were made to the NBG 's previous budget-related researches, the reports of the World Bank, International Monetary Fund and European Bank for Reconstruction and Development during the preparation of this analytical review.

Period of analyses of the research is 5 years. The research was conducted on the basis of actual figures of 2006 – 2010. However, the main emphasis of the review was put on the recent year – the macroeconomic evaluation of 2010.

The policy decision makers in the field of macroeconomic, fiscal and monetary policy, researchers conducting surveys in this direction, master and bachelor students can benefit from this analytical document.



1. Sources of economic growth, component changes in GDP and problems of macroeconomic structure in Azerbaijan

1.1. Dynamics and sources of economic growth in Azerbaijan

Gradual deceleration in real GDP growth rate had been observed in Azerbaijani economy for the recent years, including 2010. One of the important typical characteristics of the economies of the resource-rich states is the gradual decrease in the economic growth rates. This tendency is considered of main negative symptoms in the concept of the "resource curse". The issue in this case is not only the progressive increase of the economic growth rate in the resource economies with low production volume in the beginning stage, and its gradual stabilization in the later periods. The problem is also in the extreme dependence of the real and nominal GDP volume on the price fluctuation for the production and relevant raw material. Further decrease in the economic growth rates in 2010 paves the way for new macroeconomic conditions. Thus, several changes occur simultaneously in the economy with very high economic growth rates: (i) overheating of the economy; misbalance between the supply and demand causes negative outcomes with regard to the values of price balance (inflation, salaries, credit interest rates); (ii) nominal income of the population increases and poverty level decreases, however, the aggregate supply reacts later due to the time spent on the investment during the mentioned changes; (iii) rapid growth of the financial sector; due to the fast increase of the aggregate demand the impact of the government's macroeconomic policies on the economy is very limited (particularly in the direction of the monetary policy). Even though the complete opposite does not take place with regard to these tendencies in the period of downturn in economic growth, the opportunities for impact of government policies on the macroeconomic balance can increase. This is basically the main economic change of the new period started from 2010.

Table 1. Decrease in macroeconomic growth rates

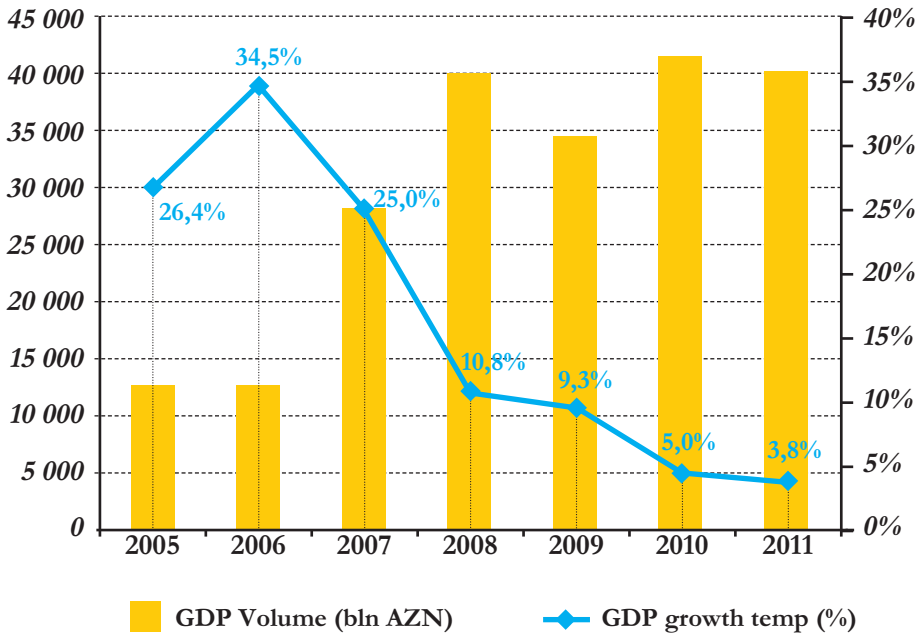
Average for the years, in %	2005-2008	2009-2010
Real growth of the GDP	24.2%	7.2%
Real growth of the oil sector	42.9%	8.3%
Real growth of the non-oil GDP	11.8%	5.6%
Inflation	13.9%	3.6%
Growth of the nominal income	31.8%	10.7%
Growth of the nominal salary	27.0%	8.9%
Nominal growth of the state budget expenditures	64.3%	6.8%
Nominal growth* of the bank assets	65%	14%

* calculated based on 2007-2008 years Source: Central Bank of the Azerbaijan Republic

Source: Central Bank of the Azerbaijan Republic

It is evident from the table that real growth rate of the GDP in Azerbaijan economy started to gradually decrease from 2007 and this downturn continued in 2010 (and this tendency will further be carried through 2011 according to the government forecast). The GDP volume produced in the country in 2010 increased by 5,0% as compared to the previous year and amounted to 41,6 billion AZN. Volume of the per-capita GDP increased by 3,7% and totaled to 4 653,3 AZN or 5 797,8 USD – the increasing trend of recent years is also preserved in this case¹.

Diagram 1. GDP nominal volume and percentage growth



Source: State Statistics Committee, Budget Budget contributions for 2011 (II Volume)

European Bank for Reconstruction and Development (EBRD) forecasts 3,5% economic growth rate for Azerbaijan in 2011, which is a relatively low indicator as compared to other countries in Eastern Europe, South Caucasus and Central Asia². In fact, increase and decrease of economic growth rates in a country depending on economic conjuncture can be treated normally at first sight. Nonetheless certain resource-rich states are subject to a macroeconomic risk when these rises and declines occur with extreme, rather than smooth paces. It should also be noted that the government committed itself to providing two-time growth of the economy in the upcoming decade and thus ensuring around 7-8% of annual economic growth³.

¹ <http://www.azstat.org/index.php?page=2&mstat=&topic=20>

² <http://www.ebrd.com>

³ <http://www.president.az>

It is significant to reveal factors standing behind this economic growth and its sources. Two methods are usually applied here: (i) "growth accounting" and "panel regression". The method of growth accounting assesses the role of capital, labor and general (technological) factor for productivity in economic growth (TFP). This fits the models of "Cobb-Douglas production function" and "Solow economic growth model" presented below; where K is accumulation of capital, L – labor factor, A – general (technological) factor for productivity.

$$Y_t = A_t \times (K_t)^a (L_t)^{1-a}$$

Economic growth in Azerbaijan, as in the previous years and especially through 2006–2008 was mostly provided by accumulation of capital⁴ (**according to IMF calculations, average for 1996–2006 is as follows: capital – 7,1%; labor – 0,2%; TFP – 4,1%**)⁵. It is impossible to calculate relevant indicators for 2009–2010 due to lack of statistical data. Irrespective of residual ratio, general decrease in the role of TFP proves that there is a weak transfer of technological innovations and capital-labor productivity into economy. This, in turn leads mainly to extensive, rather than intensive (based on technological progress), economic growth based on quantitative expansion of the existing capital (equipment, facilities, infrastructure, etc. per worker). Formerly world economists would criticize the South-East Asian countries for economic growth based on accumulation of capital rather than on TFP (increase of productivity based on the transfer of results of technological progress into economy), since such growth does not prove to be sustainable. This theory was further justified by cyclical and structural problems in the economies of the mentioned states.

Method of "analysis of panel regression system" considers formerly lost product output recovery, investment, stabilization and reforms, as well as foreign factors (trade regimes, world economic cycle, remittances – "external shocks"). IMF studies prove that changes in foreign trade regimes, macroeconomic stability and current investment flow have a large role in the economic growth of Azerbaijan⁶. Fiscal expansion, prevailing dependence of export on oil and gas resources, incompliance of level of tax savings from the private sector (around 5% of the GDP) with a share of private sector in GDP (higher than 80% on average) and rising role of state enterprises in the economy expands probability of government sector's dominance over the private sector in its share in the economic growth. GDP growth in 2010 was mainly influenced by the activity in the non-trade sector. Hence, nearly 40% of GDP is formed by the non-trade sector, which contributed additional 3,5% to the overall growth.

⁴ For more information see: Annex 1.

⁵ IMF Working Paper, "Rapid Growth in Transition Economies: Growth-Accounting Approach", July 2007

⁶ IMF Working Paper, "Rapid Growth in the CIS: Panel Regression Approach", July 2007.

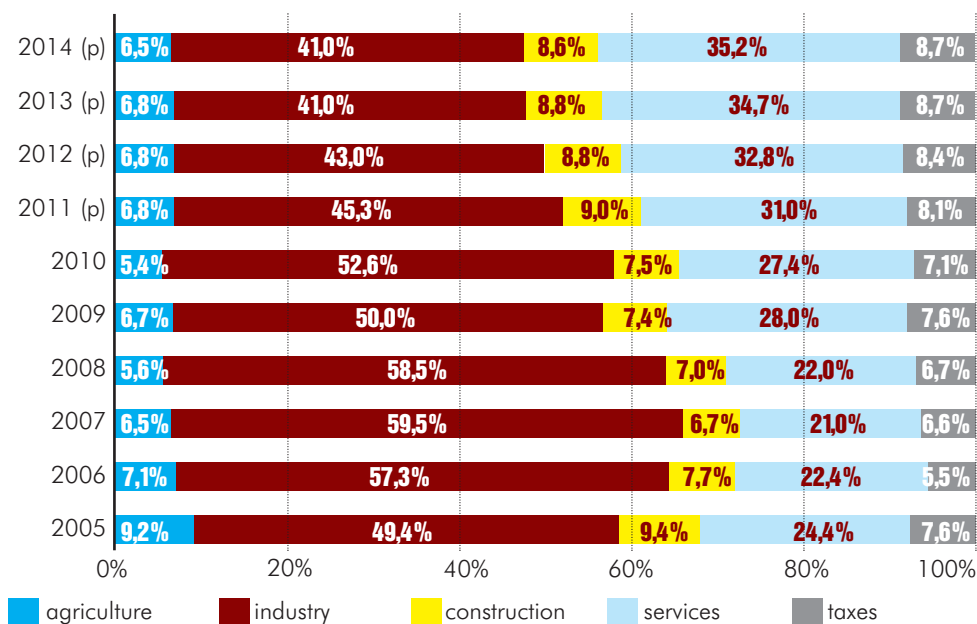
1.2. Alteration trend in GDP components and main structural problems

General output of any economy should be equal to a total aggregated amount of consumption, investments, government expenses and net import-export balance. Official statistical data in Azerbaijan does not allow reaching this balance.

It is difficult to trace any sustainable trend in GDP sectoral structure since the share of all sectors changes in a dynamic and chaotic way. Simultaneously limited statistic data does not provide for long-term economic observations. Nevertheless important indicators of the "Dutch disease" – tendency of decreasing share of industrial and agrarian sector (54% of work force was employed in construction and service sectors in 2010) and increasing share of construction and service sector in GDP is slightly observed during recent years (including official forecasts for 2014).

Specific weight of production sector in GDP increased from 62,4% to 65,5% in 2010 as compared to the previous year, whereas share of the service sector decreased from 29,7% to 27,4% accordingly. Net taxes on goods and import provided for 7.1% of GDP. However, further expansion of the service sector 's share in GDP is forecasted

Diagram 2. Deindustrilization tendency in GDP's sectoral content



Source: State Statistics Committee

for the upcoming 3 years. This is different from the deindustrialization tendency observed in developed countries. Relevant tendency in the mentioned states is based on the outsourcing of industrial production – transfer of the workforce into states with lower salaries.

Share of oil and gas industry in GDP structure increased to 47% in 2009 as compared to 44% in 2005. Share of net taxes (on product and import) in GDP decreased to 0,5% in 2010 as compared to 2009 figures. Furthermore, according to official government forecasts for 2011-2014 years period, gradual decline is expected in real growth rate of added value in agriculture and production industry, while two-digit growth rate is anticipated in the service sectors⁷. Particular long-term economic consequences (*gradual "deindustrialization" of the GDP structure, expansion of the construction and service sectors*) observed in the countries, fiscally and economically dependent on oil-gas sector, are likely to be "transmitted" into our economy. *In order to increase share of the industry in the GDP structure, it is vital to encourage private investment flow, particularly to the non-oil sector and establish industrial districts and innovation zones with tax and customs benefits.*

1.3. Consumption, saving and net export relationship in the economy of Azerbaijan

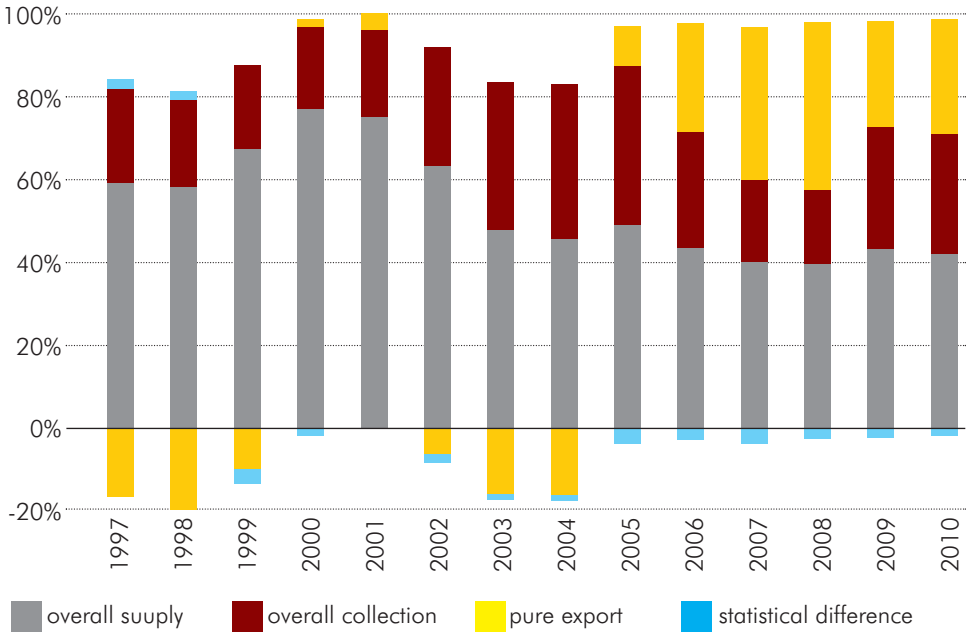
Ensuring "investment-saving" ($S = I$) balance is one of the priority measures in the economy of Azerbaijan due to the fact that sudden recession of global economy and rapid decrease in oil prices may abate foreign investment flows and export demands for the following years and may restrict fiscal oil revenues at least for the medium term. Provision of "investment-saving" balance also relies on improvement of internal saving potential through encouragement of efficient internal investment environment. "General saving" in Azerbaijan's economy (this economic category implies general saving of main capital funds and changes of main turnover funds) falls behind the actual final consumption during the recent years. Final consumption expenditures of population increased by 21% in nominal value in 2010 as compared to the relevant period of 2009 and equaled to 43% of GDP.

There is acute necessity to increase the level of real internal saving in order to achieve sustainable economic growth in Azerbaijan, which economy depends on natural resources in terms of export, fiscal profits and GDP. Liquid cash reserves produced by oil and gas export mostly appear like a foreign saving factor. Rapid increase of absorption (consumption and investment) in Azerbaijan economy during 2004-2008 years contributed to an average increase of 12,6% in non-trade sector (considered generally as services here) and 5,9% in the trade sector (considered generally as agricultural and industrial sectors; and partially construction and mining industry).

⁷ State budget for 2010 and 2011 (II Volume)



Diagram 3. A consumption share of gross domestic product in GDP (%)



Source: State Statistics Committee

Aggregate demand and aggregate supply ration in Azerbaijan economy is presented in the form of provision of "resources balance". It is obvious that overall demand is motivated mainly by two factors: the export (through the sale of oil and gas products) and growing actual final consumption. Consumption of state management bodies realized from the state budget also plays significant role here. Formula for the "resources balance" is as following:

Formula of resources balance applied in the official state statistics

$$AS = AD$$

$$AS = Y + M;$$

$$AD = X + C + S$$

$$Y + M = X + C + S$$

AS - overall supply; *AD* - overall demand; *Y* - GDP; *M* - import;
X - export; *C* - actual recent consumption; *S* - overall collection.

According to a model of "Domar-Harrod" macroeconomic balance is not an equation of overall demand and overall supply ($AD = AS$). It is rather deformation of these two components in the same manner ($\Delta AD = \Delta AS$). In general there is a balance between overall demand and overall supply in Azerbaijan economy⁸.

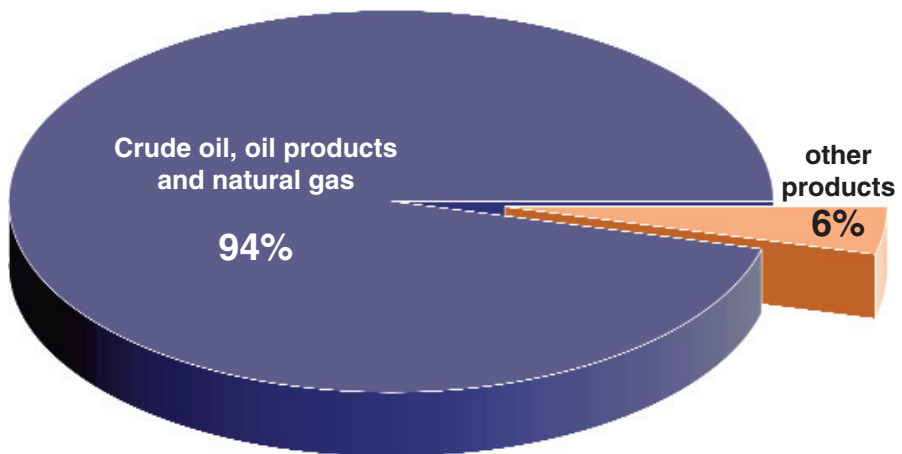
⁸For more details see: Annex 2

The level of oil dependence is still high in the export that plays significant role in resources balance. Positive saldo of the foreign trade of the country increased in 2010 as well. Commodity circulation in Azerbaijan in 2010 amounted to 27,9 billion USD, where 21,3 billion USD were made through export and 6.59 billion USD – through import. Export and import increased by 45% and 7,78% accordingly throughout the year. Oil, oil products and natural gas account for 93,9% of export in Azerbaijan. Share of the state sector in export still remains high (94,65%), while in import this indicator is 29%. Volume of officially stated oil export in Azerbaijan totals to 18 billion USD. Based on these figures, average annual export price per 1 barrel of Azerbaijani oil for the last year was 78,2 USD. It should be noted that share of the crude oil in 2010 amounted to 86,53% in the general export of Azerbaijan. Rapid growth of crude oil, caster sugar, tea and vegetable fats export was among the most obvious.

Predominance of the state sector in Azerbaijan's export continued also through 2010: its share in export operations in 2010 totaled to 94,65%. The private sector, which provided for 81,2% of the GDP in 2010, had only 4,71% share in export operations⁹. In other words, only 2,4% of products and services produced by the private sector in 2010 were directed to export. Azerbaijan ranked last among 22 Eastern European states and the CIS according to innovation expenses (Research&Development) of the companies involved in export operations. These facts reassert that export potential and competitiveness of the private sector is very weak.


In 2010 share of investment-related products and equipment decreased, whereas consumption products increased in import portfolio of Azerbaijan. Import of vehicles and equipment, electric appliances and spare parts dropped by 10,8% in price and con-

Diagram 4. Product Structure of Export for 2010



Source: State Statistics Committee

⁹ EBRD Transition Report 2010 (<http://www.ebrd.com>)



stituted 28,8% of import in 2010. Six thousand products with different names in the amount of 6,6 billion USD were imported throughout the previous year. Generally, the foreign trade structure of Azerbaijan is characterized with concentration in one or several range of goods in export and relative diversification of import. It is necessary to provide for wider diversification of export in mid-term and long-term periods.

1.4. Sustainability problem of oil and non-oil GDP and investments, entrepreneurship environment

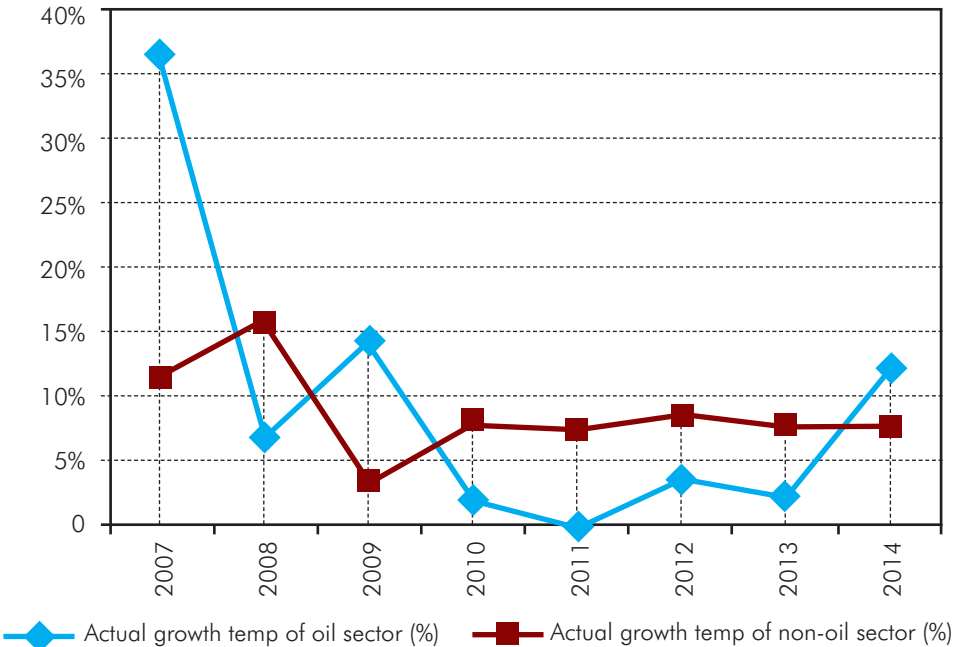
Growth dynamics of oil and non-oil GDP of Azerbaijan is vulnerable to problems of internal economic structure and external economic shocks. Affected by the global economic crisis, the growth rate of non-oil GDP dropped from 15,9% in 2008 to 3,2% in 2009. On the contrary, real growth rate of the oil GDP increased from 6,8% in 2008 to 14,3% in 2009. In 2010 1,8% growth of the oil sector was accompanied with the 7,9% increase of the added value in the non-oil sector. Only 39,4% (2 756 billion AZN) of the nominal growth of GDP (6 996 million AZN) in 2010 was provided by the non-oil sector. However, shares of the oil and non-oil sectors in GDP can be different in the real growth terms. The government forecasts for 2010 on prevalence of non-oil GDP over the added value in the oil GDP in terms of nominal added value were not realized. Non-oil GDP made up 44,2% of total GDP. Main sustainability problem occurs in terms of inadequacy between the non-oil industry development and the general development of the non-oil sector. Non-oil sector built on financial intermediation, ICT, trade, tourism and other services may confront challenges in creating added value and absorption of human resources for the long-term period.

In 2010 added value increased by 5,9% in the non-oil sector of the industry, by 20,3% in the construction sector, and by 7,2% in the service sector. Domination of the service sector over the non-oil sector is observed in this case as well. During the previous year 21,9 billion AZN (52,6% of GDP) of added value was created in the industry, 2,2 billion AZN (5,4% of GDP) – in agriculture, 3,1 billion AZN (7,5% of GDP) – in construction, and 11.3 billion AZN – in the services sector (27,4% of GDP).

Share of non-oil export in non-oil GDP grew 5% from 2001 and reached 10% in 2005. Nevertheless, this indicator dropped in 2008-2010. Initial increase was mainly stimulated by the export of agricultural and food products. Non-oil GDP of Azerbaijan in 2004-2008 performed 12,6% average annual growth mostly at the expense of fiscal expenditures.

Volume of foreign investment in the country's economy in 2010 increased by 41% and reached 2,4 billion AZN. Strategic currency reserves in 2010 grew 46% and reached 29,8 billion USD which satisfies the import of materials and services for the 3-years period. In general, volume of investments made in the oil sector of Azerbaijan's econ-

1.5. Labor productivity, poverty and employment problems in the Azerbaijan economy



Source: State Statistics Committee, Budget of 2011

omy in 2010 totals to 2,9 billion AZN. This equals to 30% of country 's investments and is 1 985 billion AZN more than the relevant indicators for 2009. 70% of investments directed at fixed (main) capital were supplied from the non-oil sector. Investments in the non-oil sector exceed the volume for the previous year by 15%. Investments in construction, machinery and equipment production, chemistry and agricultural sectors experienced particularly rapid growth. Intensification of foreign investment in the non-oil sector and elimination of the crowding-out effect – prevalence of the state investments over the private investments depend on the entrepreneurship environment in the state alongside with the factors of international economic conditions. Monopolization, artificial increase of prices and groundless audits held by the government officials need to be eliminated in order to improve business environment in the country. It is also important to sophisticate the legislative acts regulating entrepreneurship activity, establish industrial zones and business incubators, develop small and medium entrepreneurship, and involve youth in entrepreneurship activity. Adoption of Competition Code and further control over its implementation, tax relieves and their differentiation and simplification of customs procedures are of particular necessity. It



is crucial to ease access of entrepreneurs to medium and large credits; wide application of information technologies is important in order to diminish direct contact between state officials and entrepreneurs during the issuance of special licenses and authorizations (warranties) and conduct of the state monitoring activities.

In 2010 9,7 billion AZN was directed towards the fixed capital from all financial sources, which is (based on compared prices) 21.2% higher than in 2009; out of that amount 6,4 billion AZN was used in construction and installation activities. In other words, 66% of investments in the fixed capital were directed to the construction sector. Three fourth of funds allocated for the fixed capital, was supplied from domestic sources. 48.6% of used investments were utilized in goods production and 51,4% - in construction of service-related facilities. 23 service facilities, 9 infrastructure facilities and 14 production entities were established within the framework of the State Program on socio-economic development of regions in 2010. 50,8% of investments directed to the fixed capital were comprised of resources of enterprises and organizations, 32,8% - of budget funds, 4,2% - of specific funds of the population and 12,2% - of other resources. Limited share of the population in the investments to the fixed capital, domination of domestic investments and prevalence of service over production draws particular attention. Azerbaijan ranked first in the CIS according to the growth rate of investments in 2010. Growth rate of investments in the fixed capital in Moldova is 17%, in Belarus – 16,6%, in Turkmenistan – 14,5%, in Tajikistan – 11,5%, in Uzbekistan – 9,2%, in Russia – 6%. Relevant investments decreased by 0,5% in Kazakhstan, by 3,3% in Armenia, by 2% in Ukraine, by 9,8% in Kirgizstan and by 0,2% in the CIS in general¹⁰.

State support to entrepreneurship in Azerbaijan economy continued throughout 2010 as well. In 2010 National Fund on Support to Entrepreneurship allocated 115 million AZN in credits through its intermediary credit organizations. Special weight of large credits up to 5 million AZN was 70,8% in the Fund 's portfolio in 2010 (81,4 million AZN). In general, it is estimated that 5600 new work places will be opened within the projects financed by the Fund. Thus, the state spends 20 536 AZN (26 000 USD) to open one new work place.

1.5. Labor productivity, poverty and unemployment problems in the Azerbaijan economy

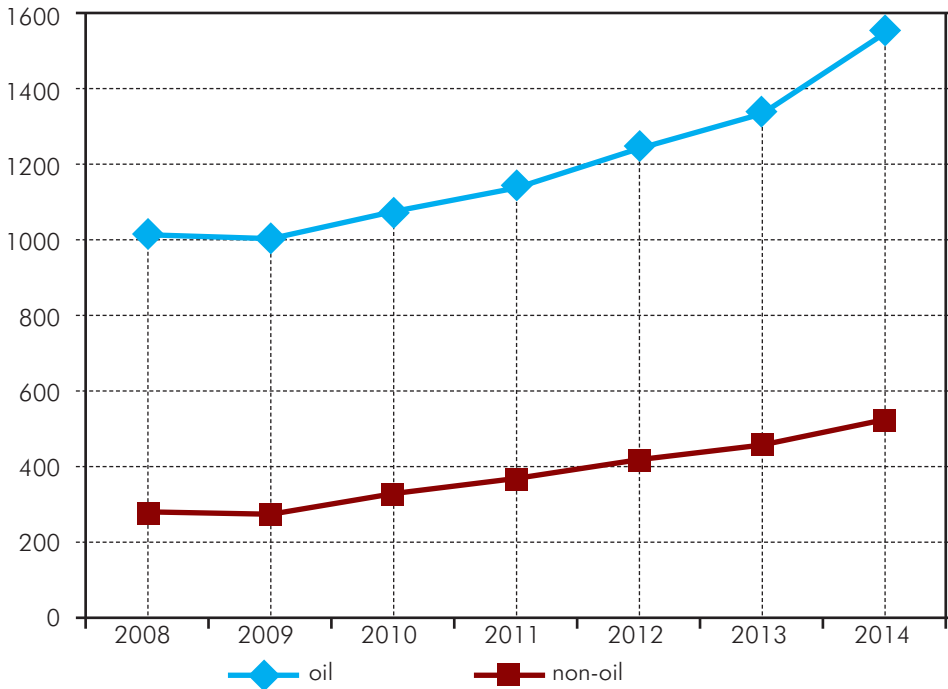
As seen from the analysis of the sources of the economic growth, contribution of labor productivity and labor factoring economy to economic growth is a very serious problem. It is noted in the last country memorandum of the World Bank that "... the existing problems have lead to more lowering of productivity in Azerbaijan in comparison with some neighboring countries"¹¹.

¹⁰<http://news.az/articles/economy/31112>

¹¹World Bank. Report No. 44365-AZ. "Azerbaijan – country economic memorandum – new silk way – diversification at the account of export", 23 December 2009

According to the same report, "... certain growth of the overall productivity of economy noted in the recent years is mostly explained by the growth of the oil sector. On the contrary, growth of productivity in agriculture is almost equal to zero. The agriculture suffered mainly from lack of investment and this is reflected in decrease of capital per person. However, it should be noted that despite the high growth in service sector in Azerbaijan, the overall productivity level of the country is sufficiently lower than in the neighboring countries Georgia and Kazakhstan..." **In 2010, added value produced by one employee in agriculture was 1 417 manats, 91 060 manats of added value were produced by one employee in industry and 7 641 manats were produced in the sector of construction and services. This shows significant inter-sectoral imbalance in labor productivity.** Average salary of the hired workers in the oil sector in 2010 amounted to **1 032 manats** and increased by 4,3% throughout the year, whereas in the non-oil sector the average salary totaled to **305 manats** and increased by 10% within the year. In addition, the average monthly salary of employees in the state sector of the economy amounted to 272 manats with 3,1% increase in 2010, whereas the same indicator in the non-oil sector totaled to 419 manats with 17,2% increase¹². Serious differences in the inter-sectoral distribution of several other economic parameters, including average monthly salary (particularly in the

Diagram 6. Average monthly salary in oil and non-oil sector (AZN)



Statistic source: envelop of state budget 2011 (2nd volume), Baku 2010

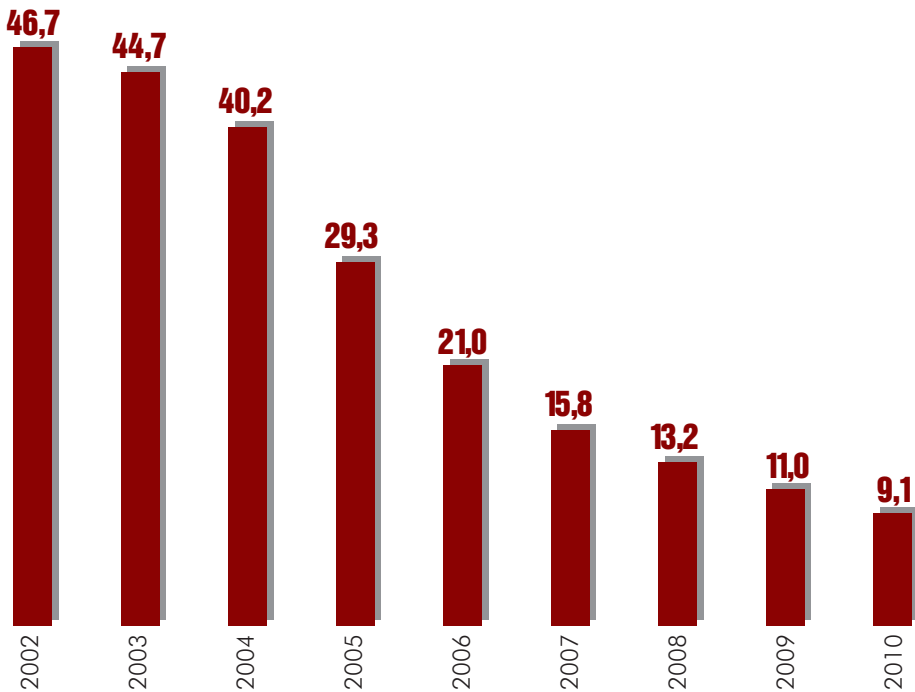
¹² Report on the activity of the Cabinet of Ministers of the Republic of Azerbaijan in 2010 (Baku 2011)

oil and non-oil sectors) will remain in the medium-term period.

Despite of problems with economic productivity, nominal money income of the population grew 13,3% in 2010 and reached **25,6 billion manats or 61.5 % of the GDP**¹³. Thus, the per capita nominal incomes in the country amounted to 2866 manats; the average monthly salary per employee was 325 manats. The share of salary factor in per capita incomes is 11,3 %. Revenues from business and property, as well as current transfers have large share in the income of the population. In 2010 the monthly income of one third (33,7%) of the population in Azerbaijan was below 100 manats.

Alongside with the increase in nominal incomes of the population, the level of poverty in Azerbaijan fell from 11% to 9,1% in 2010. Decrease in the number of poor occurred on the background of relatively high inflation as compared to the previous years. Thus, according to the official data, the consumer price index in Azerbaijan was 5,7% in 2010. However, independent sources calculated the average yearly inflation at level of 12,45%¹⁴. Simultaneously, the minimum salary and minimum pension in Azerbaijan increased only by 10 manats or from 75 manats to 85 manats in 2010. "State Program on Poverty Reduction and Sustainable Development in the Republic of Azerbaijan in 2008-2015" is implemented in the country with the aim to reduce the level of poverty.

Diagram 7. Official poverty level in Azerbaijan (%)



Source: State Statistics Committee

¹³ Central Bank of the Republic of Azerbaijan. "Money policy review 2010". Baku - 2010

¹⁴ Economic Research Center: <http://www.erc-az.org>

The methodology of poverty calculation and provision of statistical data for respective criteria are problematic issues not only in Azerbaijan, but also in a number of countries. Despite the highly disputable results, one of the poverty indices, the "Multidimensional Poverty Index (MPI)" presents interesting selection criteria and calculation technology. This index was developed by the Oxford Poverty and Human Development Initiative for the "UN Human Development Report 2010". This index is calculated based on 10 indicators, including education (school provision, children 's involvement in secondary education), health (children mortality, quality of nutritions) and minimum living standards (supply of electricity, sewage, potable water, apartment, provision with fuel that can be domestically utilized assets).

According to MPI percentage of poor in Azerbaijan is only 5.4%. This indicator, being even less than the official poverty level (which is calculated based on imperfect methodology) and allowing our country to leave behind the European Union member states like Estonia can rather be disputed. However, it should be considered that the calculations to identify the number of poor according to this index are conducted with the use of complex indicators.

Table 2. Table of MPI and related indicators for Azerbaijan (2010)

MPI ("Multidimensional poverty index") (H*A)	0.021
Percentage of poverty, based on MPI (H)	5.4%
Intensity of the poor's deprivation of (10) indicators (A)	38.6%
Number of the poor, based on MPI (million persons)	0.5
Poverty on incomes (1.25 \$ per day)	2%
Poverty on incomes (2 \$ per day)	2%
Official poverty level (2010)	9.1%
Number of population (million persons, 2010)	9.1
Human Development Index (HDI, 2010)	0.787
HDI ranking (among 104 countries)	66
HDI category	medium

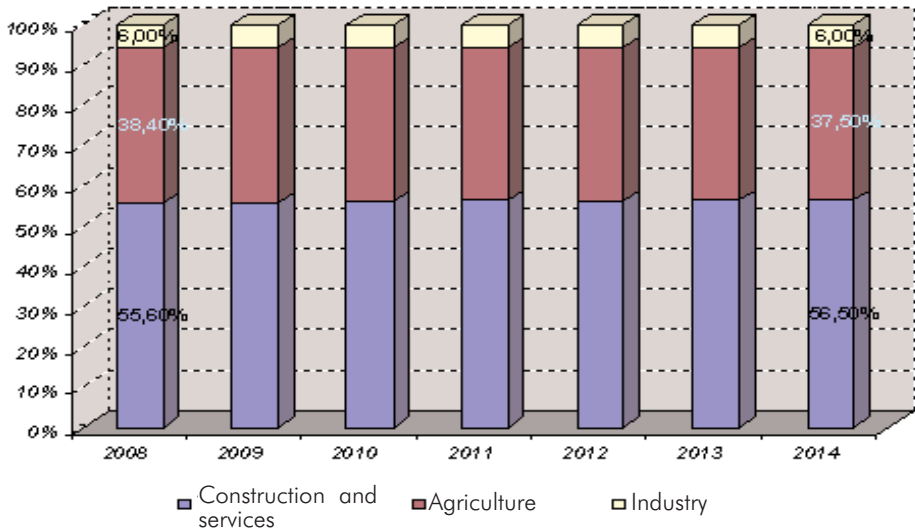
Source: www.ophi.org.uk/policy/multidimensional-poverty-index/mpi-country-briefings/

The employment level in the country in 2010 grew in parallel with reduction of poverty. Number of the employed population in overall economy increased by 0,4% throughout the year. In 2010, the number of economically active population in the country was 4 346 million persons, of which 4 088 million were employed in various fields of the economy and the social sector.

According to the official data, 73 thousand new jobs were opened (of which 52,7 thousand are permanent) and 4 296 new entities were established in the country in 2010. In 2009-2010, 146,6 thousand new jobs, including 107,2 thousand permanent jobs, were opened and 9 610 new entities were established in the country. The majority of the new

permanent work places were opened by the natural persons. Through the same period, new work places were mainly opened in the regions by the private sector. The fact that major part of the new job places were opened by the natural persons, less new jobs opened in the processing industry and generally in the real sector make the employment sustainability problematic. However, introduction of more new job places in the regions may be evaluated as a positive development. The sector-based structure of the employed population in Azerbaijan shows that the dynamics of human resource movement from real sector to the private sector is noticeably slow, which is usually not the case in the resource-rich states. Nevertheless, the leading position of occupation in the construction and service sector will remain and occupation in agriculture will continue to decrease.

Diagram 8. Sector structure of the employed population (%)



Statistic source: State budget envelop 2011 (2nd vol.), Baku 2010

According to the WB's last country memorandum, despite that the employment level increased in the Azerbaijan economy, the risk of incompliance of the current work experience and professional ability with the market requirements exists and this starts to become an obstacle to the growth of productivity. At the same time, significant disproportion exists in terms of the regional dimension of the labour market and the number of unregistered employees is growing. Currently, Azerbaijan faces the problem of inadequacy between the professional level of graduates and employees and the changing structure of the economy. With this consideration, appropriate investments may be the priority in order to meet the needs of the labour force and solid experience needed in the spheres of agriculture, production, processing and sales of agricultural products, oil production, oil related industries, tourism, communications and financial services sectors.

2. Assessment of the fiscal policy

2.1. Analysis of the budget revenues

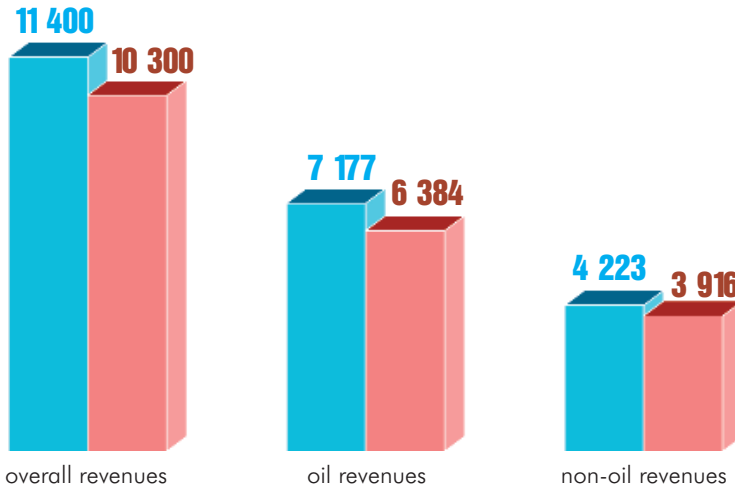
At present, growth in allocations of oil revenues plays special role in formation of the fiscal policy of the Azerbaijani government. Effective management of the increasing oil revenues is one of the major duties of the country's government in these circumstances. Experience of different countries, which face this problem, shows that no common approach and general recipe exist to solve it. Therefore, formation of the adequate fiscal policy in present conditions is a very complex and important issue. If on one hand necessity to renovate the country's old infrastructure serves the political and social purposes, it on the other hand reduces business costs and thus has vast economic importance. However, both political and social objectives, as well as economic-business effects require establishment of the framework that will optimize the state expenses. Formation of this framework is necessary to establish and strengthen additional effects.

The basis of fiscal expansion that had become widespread throughout the recent years in Azerbaijan is formed by the growth of the budget income at the expense of oil revenues. Calculations reveal that transfers from the State Oil Fund of Azerbaijan Republic (SOFAZ) to the state budget from 2003 to 2011 amount to 13 480 million AZN, 13 100 million manats of which were executed through 2006-2010. Total share of transfers in the budget revenues (42 366 million AZN) for the last 5 years is 31 percent.

In 2010 transfers from SOFAZ to the state budget amounted to 4 915 million manats and this income source constituted 51,8 % of the budget revenues. To compare, the share of transfers from the Oil Fund in the state budget income was 40.4 % in 2009.

Based on the initial data on implementation of 2010 state budget, it can be concluded that implementation of the budget income was 9,5% higher as compared to the previous year. Last year, 63 percent of the budget revenues were supplied from the oil sector and 37 percent from the non-oil sector. Though starting from 2008 significant decrease is observed in incomes from foreign and local oil companies on profit tax, the income from all sources of the oil sector was exposed to 1% increase as compared to the previous year particularly due to the growth of transfers. As the result, share of the non-oil sector in formation of the state budget reduced in 2010 in comparison with 2009.

Diagram 9. Implementation of the state budget revenues of the Republic of Azerbaijan in 2009-2010 (million AZN)

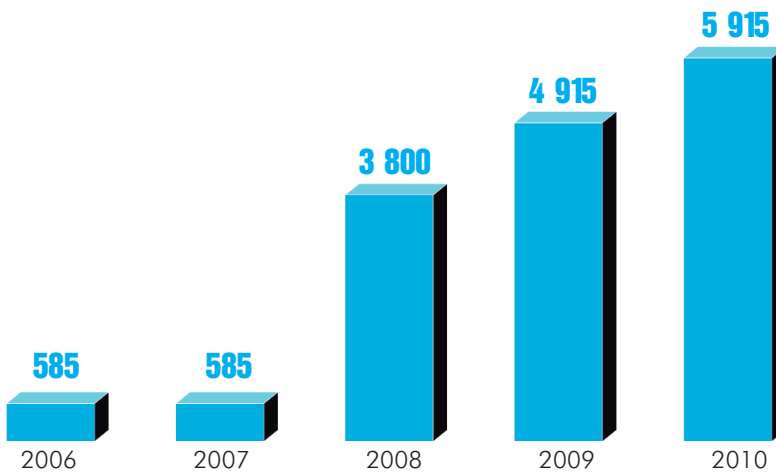


Source: Ministry of Finance

As can be derived from the columns, the income from the oil sector was 63 percent in 2010 as compared to 62 percent in 2009.

The transfers from SOFAZ in 2006-2010 are provided in the following diagram.

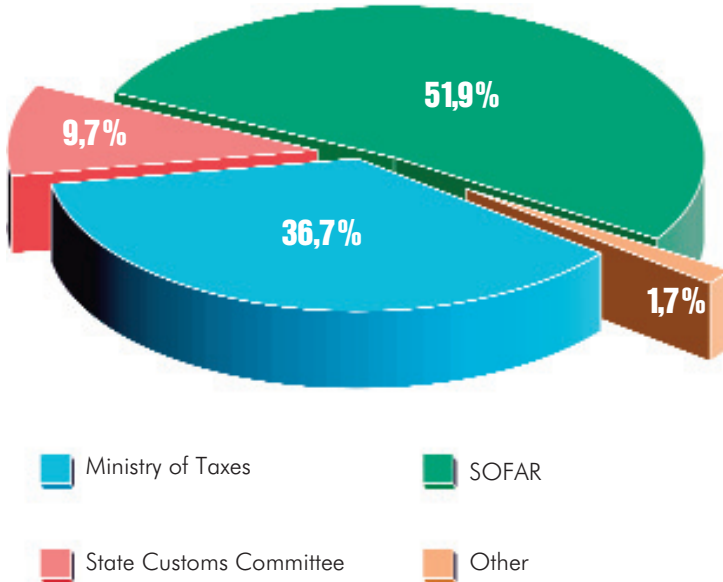
Diagram 10. Transfers from SOFAZ to the state budget (2006-2010)



Source: State Oil Fund

It is clear from the diagram that the amount of transfers from SOFAZ to the state budget had been increasing with each year. The transfers increased 20,3 percent in 2010, 29,3 percent in 2009 and 7,5 times in 2008 all compared with the preceding year. Thus, continuous increase from this source conditioned decrease in the special weight of the incomes from other sources. Formation of the 2010 state budget revenues based on the main income sources is shown in the following pie.

Diagram 11. Formation of the budget revenues from the main income agencies in 2010



Source: Ministry of Finance

Studies in this direction reveal that although the payments made through the Ministry of Taxes had the leading share in the state budget revenues until 2009, this ratio was distorted in favour of SOFAZ within the last 2 years, despite sustainable growth in incomes to the budget on some types of taxes (VAT, excise, land, simplified tax) and fees (state duties) since 2009, when the financial crisis started. This already established tendency is expected to continue through 2011. Transfers from SOFAZ in the current year will prevail over the budget payments through the Ministry of Taxes. In 2010, incomes from the Ministry of Taxes were implemented with 4% deficit.

The second factor conditioning such change was reduction in dynamics of the indicators on profit tax of the legal entities. This, in turn, may be explained by serious decreases particularly in the oil sector. Thus, whereas profit tax of the legal entities was 2862 million AZN in 2008 (76,8% of this amount was the profit tax of contracting

parties to the oil production sharing agreement on joint exploration of the deep area of Azeri, Chirag and Guneshli deposits in the Azerbaijan sector of the Caspian Sea and oil production), in 2009 it totalled to 1 329 million AZN and in 2010 this indicator amounted to 1 429 million AZN. In 2010 incomes from this source were equal to 27 percent of the implemented level in 2008 and 48 percent of the similar indicator of 2009.

It is obvious that decrease in income from the profit tax of the legal entities in the recent years, occurred as the result of drastic reduction in the amount of profit tax of the contracting parties to the oil production sharing agreement on joint exploration of the deep areas of Azeri, Chirag and Guneshli deposits in the Azerbaijan sector of the Caspian Sea. If on one hand this reduced special weight of the revenues from this source in the state budget income in recent years, it on the other hand, lowered direct effects of the fluctuating oil prices in the world market on the budget incomes. Thus, while 2,017 billion manats was received from this source against the forecasted 1,5 billion manats in 2007, 2 199 million manats – against forecasted 1,55 billion manats in 2008 and 587,9 million manats – against 1,23 billion manats in 2009, the forecasted amount in 2010 was 3,8 times less than the actual level in the peak year – 2008¹⁵. Persistence of this tendency, in its turn conditioned growth of the transfers from SOFAZ.

Analysis on tax types shows that VAT and profit tax still have the leading share in tax incomes to the state budget. The structure of tax incomes for the past 5 years is provided in the following table.

Table 3. Dynamics of state budget incomes on tax and other sources in 2006-2010 (thousand AZN)¹⁶

Tax and other payments	Entries				
	2006	2007	2008	2009	2010
VAT	400,54	669,65	1 169,89	1 180,28	1 271,46
Excise	164,05	330,59	395,81	417,37	452,03
Profit tax	1 375,56	2 459,18	2 863,95	1 329,19	1 429,82
Mining tax	100,20	123,23	147,75	121,90	130,07
Land tax	18,82	27,29	30,79	26,24	35,31
Property tax	56,25	72,76	113,23	66,17	101,81
Income tax of individuals	412,25	596,60	637,80	581,87	590,24
State duties	33,50	50,06	59,87	72,87	89,52
Road tax	10,34	17,14	27,37	16,46	15,17
Simplified tax	29,69	48,11	65,65	63,57	65,53
Other incomes	115,41	154,65	234,46	237,47	111,84
TOTAL	3 123,92	4 549,26	5 746,57	4 113,40	4 292,80

Source: Ministry of Taxes

¹⁵ Opinions of the Chamber of Accounts of the Republic of Azerbaijan on the draft law "on 2010 state budget of the Republic of Azerbaijan", Baku 2009 and 2010

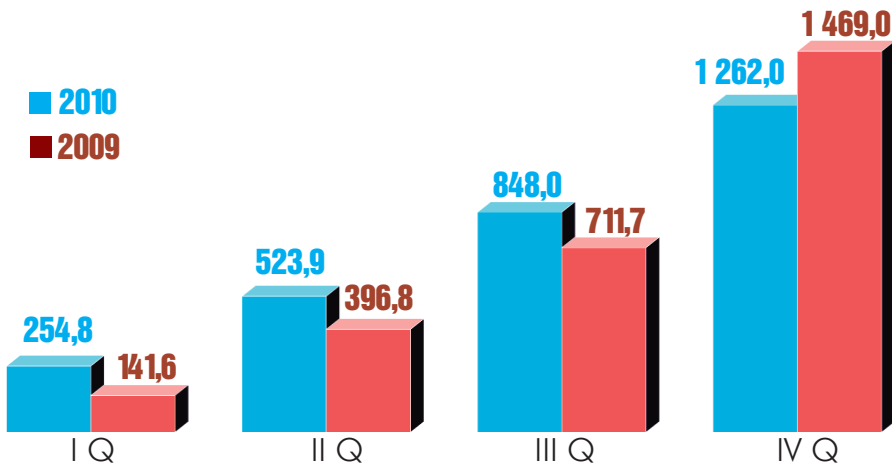
¹⁶ <http://www.taxes.gov.az/?name=statistika&lang=>

As is seen from the table, the most increase in the past period is traced on VAT and this allowed it to preserve the role of the second largest source of tax incomes of the budget for the last 5 years, after the profit tax which experienced noticeable tendency of decrease during the analyzed period. Coming to the income tax of individuals, considered the third important source in tax incomes of the budget, its highest indicator was noted in the pre-crisis period even though no serious deviations were observed on this source of income. The 2010 post-crisis year indicator was lower than the 2007 level. This, in turn can be explained by the increase of compulsory vacations, job closures and salary decreases during the crisis year alongside with changes in the direction of decrease in the level of the upper limit of the individuals' income tax. Stable growth in income on other taxes was observed throughout the analyzed period, except for mining, property and road taxes.

Growth in the dynamics of payments to the state budget from the State Oil Company of Azerbaijan Republic, the main taxpayer among other large payers, is observed for the last 5 years. Thus, the company payments to the state budget totalled to 734,7 million AZN in 2006, 1 080,7 million AZN in 2007, 1 351,7 million AZN in 2008, 1 469 million AZN in 2009 and 1 262 million AZN in 2010¹⁷. Obviously, incomes from SOCAR also decreased in the past year as compared to the preceding year. 14,1% less amount contributed to the state budget income in 2010 as compared to 2009. SOCAR's share in the total receipts of budget was 12,8 percent.

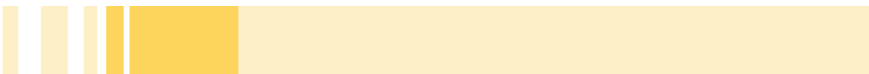
The following diagrams provide information on quarterly payments from SOCAR to the state budget within the last 2 years.

Diagram 12. Quarterly dynamics of funds entered from SOCAR



Source: State Oil Company

¹⁷ State Oil Company of Azerbaijan Republic, annual report 2008, 2009 and 2010



Coming to the quarterly dynamics of the amount received from SOCAR, as derived from the diagrams, in each of the past 2 years the major incomes are received during the last quarter.

The role of the State Customs Committee in formation of the budget income during the past 5 years is decreasing in relative terms, despite that in absolute terms it is expressed in stable amounts. Thus, although in 2006-2008 particular growth was observed in the state budget income provided from the State Customs Committee (SCC), it decreased in 2009. Incomes to the state budget through the SCC were implemented at the level of 67,9 % against the forecasted figures, which is 13,8 % less in comparison with 2008. This decrease in customs income is not surprising due to the diminished foreign trade circulation of the country during the crisis year. However, the crisis alone cannot be "blamed for" this decrease. It is the view of the authors that reduction in payments from customs agencies to the state budget may be explained by deterioration of business environment in the country, as well as with the incompliance of the foreign trade relations with the modern standards.

2.2. Analysis of the budget expenditures

Expenditures of the consolidated budget of Azerbaijan Republic in 2010 amounted to 13,5 billion manats and were implemented at the level of 94,7 percent, which is 1,3 billion manats (10,2 percent) more than the relevant figure in 2009. Despite the forecasted 1.2 billion manats budget surplus, the actual surplus of 2010 budget was 5.8 billion manats.

Expenditures of the 2010 state budget totalled to 11,8 billion manats or 95,9%, which is 1,3 billion manats or 12,0% more as compared to 2009. In 2010, almost all cost items were implemented with deficit against the forecast. About 11,6% more funds were allocated from 2010 state budget for public investment expenses and maintenance of state agencies on science, education, health, culture, social protection and social provision, defence, judiciary, law-enforcement and prosecutor offices.

Decreases were observed in the implemented state budget of 2010 as compared to the forecast indicators of the same year, whereas increases are traced in relation to the actual indicators of 2009. This is reflected in the following table data.

Table 4. Execution of the state budget costs in 2010

Cost section	Execu- tion 2009	2010				Comparison with 2009	
		prediction	execution	difference	percent	difference	percent
TOTAL COSTS	10 503,9	12 275,3	11 766,0	-509,3	95,9	1 262,1	112,0
<i>including:</i>							
General state services	825,2	967,0	794,3	-172,7	82,1	-30,9	96,3
Defense (current expenses)	1 183,9	1 205,8	1 185,2	-20,6	98,3	1,3	100,1
Judicial government, law-enforcement bodies and prosecutor' offices	648,9	712,5	668,51	-44,0	93,8	19,6	103,0
Education	1 147,9	1 240,7	181,4	-59,3	95,2	33,5	102,9
Health	402,4	485,6	429,4	-56,2	88,4	27,0	106,7
Social protection and social provisions	1 054,4	1 142,3	1 123,0	-19,3	98,3	68,6	106,5
Activity not referred to culture, art, information, physical education and other categories	158,3	172,6	168,4	-4,2	97,6	10,1	106,4
Housing and utilities	194,5	201,1	199,9	-1,2	99,4	5,4	102,8
Agriculture, forest industry, fishery, hunting and environmental protection	390,5	381,8	372,1	-9,7	97,5	-18,4	95,3
Industry, construction and minerals	3 567,3	4 172,5	4 147,0	-25,5	99,4	579,7	116,3
Transport and communication	75,3	74,6	55,1	-19,5	73,9	-20,2	73,2
Economic activity	146,3	125,0	115,9	-9,1	92,7	-30,4	79,2
Services not referred to the main sections	709,0	1 393,8	1 325,8	-68,0	95,1	616,8	187,0

Source: Ministry of Finance

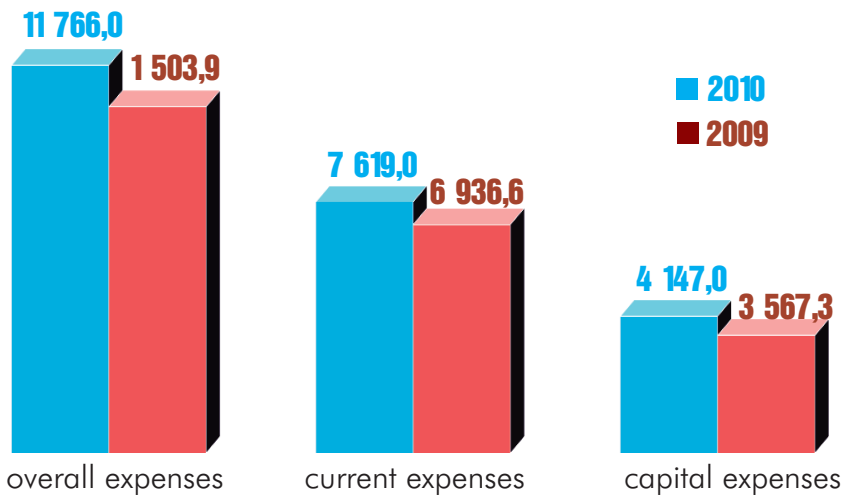
According to the operational information of the Ministry of Finance¹⁸, the highest actual implementation level in 2010 state budget was under the direction of investment (99,4%) and the lowest – under transport and communication (73,9%) expenses. Simultaneously, administration (82,1 %) and health related expenditures (88,4%) also differed by their low implementation level in the same term. Defence and social provision related expenditure items with high implementation level are among the leading

¹⁸<http://www.finance.gov.az/store/1/1.pdf>

expenditure directions. Both expenditure items were implemented at the level of 98,3 % each.

Coming to the expenditures on education, the sphere with considerable investments into the human capital, the implementation level on this expenditure item was 95,2 percent. 3,7 billion manats or 31,5 % of the current expenditures of last year's state budget constituted financial provision for social expenditures and this is 120,0 million manats or 3,3 percent more as compared to 2009. In 2010, 76,19 million AZN of the budget expenditures was directed to the current expenses and 4 147 million AZN – to the capital investments (see **Picture 2.2.1**). As is seen from the diagram columns, despite the increase in the absolute amount of funds directed to the current expenses as compared to 2009, the share of current expenses in the budget total fell from 66,1 percent to 64,8 percent in relative terms.

Diagram 13. Current and substantial expenditures of 2009 and 2010 state budgets



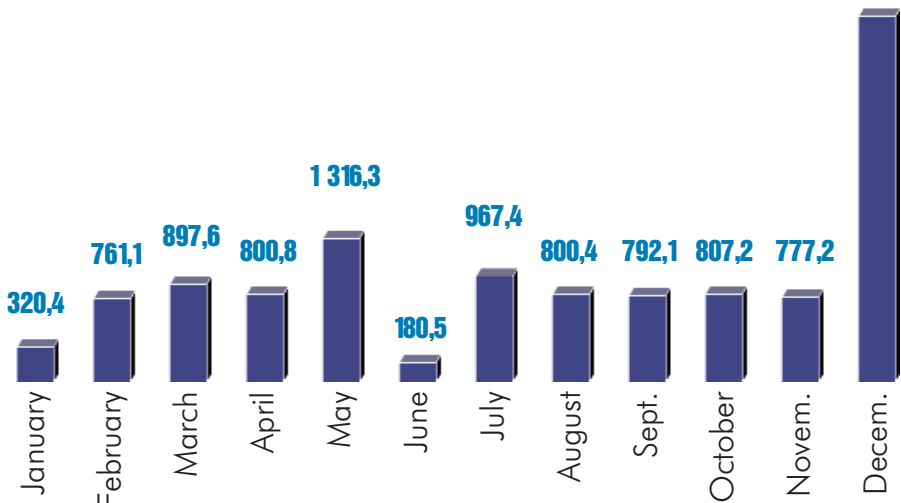
Source: Ministry of Finance

It is evident from the diagram that share of the current expenses in the structure of the state budget expenditures is high; this in turn may be explained by the fact that resources are mainly directed to consumption. In fact, the predominant special weight of the current expenses in the budget must be proportional in the dynamics of monthly implementation of 2010 state budget. As is obvious from the economic classification of the expenditure items of budgets (except for investment and defence budgets), the largest share of the allocated funds (for example, 79% in education, 58% in health, etc.) is allocated for salaries – the secured category and thus the mentioned expenditure items have stable monthly payment schedule and guarantee for execution. However,

disproportion revealed through the analysis of 2010 budget implementation (see **Picture 2.2.2**) shows that there is no balanced approach to the state budget spending. Thus, while the intended average monthly spending was 980,5 manats, expenditures in May and December were high and in other months, low. Especially, 3,5 times more than the average indicator was expended during the last month of the year, which constituted 28,5% of the total budget spending. This fact forms the assumption of "clearance" of budget resources, rather than their end-of-the-year spending and is considered an indicator of their ineffective spending. Among the causes of this condition can be absence of fiscal decentralization reforms in Azerbaijan and the procedure of obtaining the written consent from the financial agencies, applied by the budgetary institutions in cases of deviations from the approved norm during the item expenditure of their resources received through the equal distribution on the basis of the "Common Budget Classification of the Republic of Azerbaijan". Budgetary institutions which do not possess financial independence to manage and freely distribute their funds, receive reply to their requests sent to the Ministry of Finance in the beginning of the year at the end of the same year and thus conduct the large part of their operations in this direction in December or, simply already implemented activities are documented for that month, so that no remainder is left for the next financial year.

It is clear from the above diagram that the dynamics of monthly implementation of 2010 budget is completely contradicting the proportionality of investments made in economy and the effectiveness of utilization of resources.

Diagram 14. Monthly budget expenditures in 2010, million AZN **3 345,0**



Source: Central Bank of the Republic of Azerbaijan

2.3. Evaluation of fiscal expansion

The state budget expenditures in 2006-2010 totalled to 43 408,4 million AZN and SOCAR's expenditures without transfers amounted to 2 213,5 mil. AZN¹⁹ which together constituted 28,4% of the GDP (161142,8 million AZN) for the same period. The trend analysis of the mentioned period reveals that the share of state budget expenditures in the GDP for the same term was the lowest (21,4 percent) in 2006 and the highest (32,4 percent) in 2010.

Utilities, energy and transport (investments are mainly directed to these sectors), state administration, education and defence sectors benefitted the most from the fiscal expansion carried out by the government during this period. The major part of the current expenses during the past term was directed to the state administration and education. The investment budget, taking the most advantage from the rapid expenditure growth increased by 5,4, 2,2 and 2,3 times in 2006, 2007 and 2008 respectively in comparison with the preceding years, and only in 2009 there was decrease in this expenditure item. Thus, tension in implementation of revenues as the result of impact of the global financial crisis in 2009 was partly balanced with compensation by reduction of the investment expenditures. Analysis of the internal structure of the investment expenses shows that transport, utilities and energy fields continuously benefitted from this increase. This, according to the nature of investments is the result of direction of budget resources mainly to the infrastructure projects. At the same time, public investment expenditures of the 2010 state budget were implemented at the level of 4,1 billion manats, which is 600,0 million manats or 16,3 percent more as compared to 2009. In the result, the growth level on this expenditure item was higher than the total growth of the budget expenditures (12 percent). Last year, 508,0 million manats were expended from this source on social projects, 1,9 billion manats on the infrastructure projects, and 1,7 billion manats on defence and other purposeful projects. The share of state budget resources in total investments to the Azerbaijan economy was 32,3 percent in 2009 and 36,4 percent in 2010.

In 2010, the share of investment expenses in the overall budget expenses and in the GDP was 34 percent and 11 percent accordingly. In the same year, 32,1 percent of the investment budget was directed to construction of transport, 4,52 percent – culture and tourism, 3,31 percent – the potable water supply, 2,36 percent – education and 1,13 percent – the health infrastructures.

Coming to 2011, according to the approved budget, large amount of funds had been allocated for the investment program. The investment program approved by the Order No. 21 dated 26 January 2011 of the Cabinet of Ministers envisages financing of 418 projects in total throughout the current year. The investment budget for this

¹⁹The State Oil Fund continues allocating direct funds to the investment and social projects. This prevents the budget to be a common source of the state expenditures and does not allow making full description of the budget.

year is 3 billion 380 million manats. The biggest expenditure directions in the program are the expenses for transport projects. 305 million manats less funding was allocated for this direction as compared to the previous year.

Trend analysis of the investment expenses reveals that during the past 5 years (2006-2010) 14 billion 820.1 million manats were allocated from the state budget only for the investment expenditures, which constitutes 34,5 percent (42 889,2 million AZN) of the total budget expenses through these years. As is evident from the following table, this expenditure item continues to exceed 10 percent of the GDP starting from 2008 and 30 percent in the total budget expenses starting from 2007.

Table 5. Investment expenditures from the state budget in 2005-2010

Years	Amount, mil. AZN	Share in the budget costs, oercent	Share in GDP, percent
2006	882,9	23,2	4,8
2007	1 930,9	31,9	7,2
2008	4 292,0	40,1	10,7
2009	3 567,3	33,3	10,0
2010	4 147,0	34,0	11,0

Source: Ministry of Finance, author calculations

"State Investments Management Index"²⁰ of the International Monetary Fund, that covered 71, mainly low and middle-income countries, shows that Azerbaijan which allocated 35% (about 5,1 billion dollars) of its state budget for state investments in 2010 was on the 43rd place with 1,53 points among 71 countries. Among the neighbouring states, Armenia is on the 8th, Kazakhstan – on the 9th and Turkey – on the 24th place according to the index listing. Weak position of Azerbaijan in comparison with the neighbouring states is related to existing problems in implementation of the state investment projects. Thus, the index analyzes the institutional environment and general efficiency of management of state investment projects based on 17 indicators that cover 4 general directions. The directions are as follows: (i) assessment of the state investment projects; (ii) selection of the state investment projects; (iii) implementation of the state investment projects; (iv) assessment and audit of execution of state investment projects. The directions deteriorating Azerbaijan's position were related to implementation of projects and assessment of their execution.

Stable growth had been observed in the sphere of social protection and social provision expenses within the last 5 years. Moreover, exclusively growth dynamics are traced within the analyzed period on this expenditure direction among the main expenditure items. The trend analysis of the last 5 years can be viewed from the following table:

²⁰<http://www.imf.org/external/pubs/ft/wp/2011/wp1137.pdf>

Table 6. Social protection and provision expenses from the state budget in 2005-2010

Years	Amount, mil. AZN	Share in the budget costs, oercent	Share in GDP, percent
2006	341,5	9,0	1,9
2007	594,8	9,8	2,2
2008	846,4	7,9	2,1
2009	1 054,4	10,0	3,0
2010	1 123,0	9,7	3,2

Source: Ministry of Finance, author calculations

As concluded from the table, 3 960,1 million AZN was expended from the state budget for social protection and social provision within the past 5 years, which constituted 9,3% of the total budget expenditures throughout the mentioned period.

Other expenditure items, selected as a source for comparative analysis are education, defence and general public service expenses, which excluding the latter in 2010 performed with high and stable growth. Yearly growth dynamics of the education expenses is presented in the table below:

Table 7. Educational expenditures from the state budget in 2005-2010

Years	Amount, mil. AZN	Share in the budget costs, oercent	Share in GDP, percent
2006	479,1	12,6	2,6
2007	723,0	11,9	2,7
2008	979,7	9,1	2,4
2009	1 147,9	10,9	3,3
2010	1 181,4	10,4	3,4

Source: Ministry of Finance, author calculations

As derived from the table data, 4 211,1 million AZN was expended on education from the state budget throughout 5 years, which constitute 10% of the general expenses. According to the forecast indicators for 2011, expenses on education will amount to 1 536,5 million manats. The share of these expenses in the GDP forecasted for the same year will be 3,3% and its special weight in the budget expenditures will total to 10,5%.

The practice of resource-rich states shows that during the period of revenue increase governments are interested in financing huge management apparatus and maintaining large public security and defence-oriented armed forces from the state budget. During the last 5 years the amount of funds allocated directly for the defence sector from the state budget was 5 142,2 million AZN, which had a 12% share in total state budget expenditures within the same period. Calculations reveal that the defence budget increased not only through direct allocations, but also at the expense of substantial expenses and

reserve funds directed at strengthening the defence capacity of the country. Thus, while the defence expenses directly financed from the state budget amounted to 1,18 billion AZN in 2010, 2,2 billion manats in total were directed to the defence sector from other sources, which is 562,0 million manats (35,5 percent) more as compared to 2009. The total amount of funds that are expected to be allocated to this direction in the current year is more than 2,5 billion AZN, which means that 1 manat of each 4 manats of the budget expenditures is directed at developing the country's defence capacity. This, on one hand limits the potential of allocations from the state budget for the real sectors of economy and on the other – the impacts of the effective budget expenditures on the real economy²¹. Despite the increase in the amount of funds allocated for the defence sector in the recent years, Azerbaijan is still behind the neighbouring Georgia and Armenia according to the indicator on special weight of the defence expenditures in the GDP²².

The sum of the total state service expenditures in the analyzed term was 3 151,7 million AZN and its share in the total expenditures of the state budget in that term was 7,4 percent. This fund is allocated only to keeping of the legislative and administrative and local self-governing bodies of the Republic of Azerbaijan. This fund is divided between different units of the government (ministries, committees, agencies, departments etc.) in proportion to their scopes. The said fund is distributed to the President Administration, Cabinet of Ministers, 14 ministries, 9 state committees, 4 commissions, 4 agencies, 2 departments, 3 services, 1 secretariat, 1 bureau, 1 administration, diplomatic missions abroad, city and region administrations²³.

Thus, summarizing the above trend and structural analysis, we may note that the dynamics of the main expenditures directed to fiscal expansion in the past 5 years is provided in the following table:

Table 8. Main expenditures of the state budget in 2005-2010

(in comparison with the preceding years)

Years/mil. AZN	2006	2007	2008	2009	2010
Expend. of the state budget	3 790,1	6 086,2	10 680,0	10 567,0	11 766,0
<i>Growth rate</i>	77,1	62,5	76,3	-1,9	12,0
Investment expenses	882,8	1 915,0	4 276,0	3 177,0	4 147,0
<i>Growth rate</i>	5,42 def	2,2 def	2,3 def	-25,7	16,3
Educational expenses	479,0	722,9	979,7	1 147,9	1 181,4
<i>Growth rate</i>	28,5	66,2	35,5	17,1	2,9
G. state service expenses	403,0	468,6	660,6	825,2	794,3
<i>Growth rate</i>	2,4 def	20,7	35,7	24,9	-3,7
Defence expenses	40,7	811,4	321,2	1 183,8	1 185,2
<i>Growth rate</i>	2,22 def	26,7	62,9	-10,4	0,5

Source: Ministry of Finance, author calculations

²¹In order to calculate the impacts of the effective budget expenditures to the real economy, the defence costs are deducted from the total expenditures and the remaining amounts are compared.

²²http://www.ng.ru/cis/2010-03-17/1_military.html

²³Note that the executive power of the government includes 6 ministries, 1 committee, 4 services and 1 departments. Their financing is effected under the defence, judicial power, law-enforcement and prosecutor's offices and other sections.



It is well-known that the gas and oil reserves of Azerbaijan are non-renewable and therefore, large-scale production will only continue through the limited period²⁴. The only inconsistency between the forecasts of local and foreign analysts with this regard is related to the fluctuation of oil prices in international markets. *This condition, leading to emergence of fiscal risks, requires more appropriate determination and regulation, otherwise, optimization of the implemented policy.* **The first of the main reasons** conditioning this situation is the preservation of oil revenues for the next generations and its equal distribution among generations. Overexpenditure today leads to reduced spending tomorrow, thus decreasing the share from oil dividends for the next generations. **Second**, the review of NBG experts²⁵ reveals that serious increase in oil revenue expenditure policy threatens macroeconomic stability. If on one hand, continuous growth of expenditures conditions the broad fiscal stimulus and monetary expansion, on the other it increases propensities for inflation. Simultaneously, oil revenues which are directed to internal market stipulate increase in the value of national currency AZN in relation to the USD, and thus, setting the frame for regulated currency regime, form undesirable conditions for exporters. Under these circumstances, higher productivity should be achieved to preserve the competitiveness of national economy. Transparent and effective management of state investments are necessary to achieve this. **The third reason**, necessitating optimization of state expenditures, is the need for protecting effectiveness of expenditures. Increased expenditures raise ineffectiveness, especially within the conditions of lack of transparency and weak public financial control. Decrease of ineffective spending, in its turn, is closely linked with the level of fiscal policy optimization. Finally, provision of constant growth and sustainable development in the economy is another reason for determining and following the optimal level of fiscal policy. Decreases currently observed in the economic growth rate in Azerbaijan are also the result of improper regulation of this policy during the past term. Thus, according to the calculations of experts of the International Monetary Fund²⁶, the deficit of the non-oil budget in the non-oil GDP was 35 percent in 2010. In the future, non-oil budget is expected to decrease through reduction of state needs in order to ensure fiscal security.

This problem is not of a serious concern of the government yet in the present situation as the oil production grows and oil prices increase. On the other hand, as the major part of revenues of the state budget is presently formed by the oil revenues, and the tax load of the population and companies reduces, the population is indifferent towards the budget issues²⁷ and simultaneously, it increases the non-oil budget deficit.

The average annual expenditures of the state budget of Azerbaijan Republic formed at the expense of oil revenues during the 3 recent years of the analyzed period were higher than the stable and permanent equivalent of 5,9 billion US Dollars proposed by the World Bank. Thus, the analysis shows that all sectors where the government was involved had benefitted from fiscal expansion. However the investment sector benefitted most from this expansion. The investments expenses totaled to 2,8 billion AZN in 2007, 4,2 billion

²⁴ See Budget Envelop 2010. Predictions of the Ministry of Economic Development and BP's calculations in Azerbaijan on oil production
²⁵ National Budget Group, study on the state budget 2011, Baku-2010

²⁶ <http://www.imf.org/external/pubs/ft/scr/2010/cr10113.pdf>

²⁷ C.Paul, A.Hoeffler and M.Soderbom, On the duration of civil war, Journal of Peace research, Oxford Economic Papers61: 1-27, 2004

AZN in 2008, 3,56 billion AZN in 2009, and 4,17 billion AZN in 2010. Calculations reveal that the amount allocated for public administration and education (the major part of current expenses for these sectors is expended) in 2007-2010 totaled to 43% of growth of total state expenditures. Utility services, energy and transportation (investments are mainly directed to these sectors) benefited from 24% of the expenditure increase. Share of expenditures for social sectors amounted to 25% of fiscal expansion (except for education). Despite the drastic increase in state expenditures on salaries, transfers, subsidies and particularly on goods and services in 2005-2008, the salaries, transfers, subsidies and goods/services in real expression stably at the level of 2008 and returns the investment budget again in the real expression to the level of 2007, the country can achieve the status of medium-size government (with non-oil sector reaching 37% of GDP) until 2024²⁸. According to other estimations, the expenditure of oil revenues at the level higher than the permanent income of 5.9 billion US Dollars can also allow to accumulate approximately 100 billion US Dollars (or 72 billion AZN on the basis of the 2007 prices) in the Oil Fund until 2030²⁹.

2.4. Analysis of budget deficit

Share of the state budget deficit in GDP fluctuated between 0,5 – 0,9 percent during the analyzed period. Thus, the corresponding indicator was 0,5% in 2006, 0,2% in 2007 and 2008, 0,7% in 2009³⁰. Despite the 770,3 million manats state budget deficit forecasted for the previous year, the actual deficit constituted 363,5 million manats, which was 0,9% of GDP. Thus, the income from privatization of state property, which was one of the important directions for coverage of state budget deficit, is decreasing during the recent years.

The NBG studies³¹ reveal that delay in incomes expected to flow in the state budget from the privatization of state objects and land, and year-by-year increase in the remainder on the income from the privatization in this field should be evaluated as a factor increasing the risk of corruption and preventing effective functioning of property. Thus the forecasted figure on the income from the privatization of state in 2010 is 31,2% lower than the 2009 indicator.

In addition, serious problems exist in the implementation of the income from the paid services of the institutions funded from the state budget, which are indicated in the budget documents as the source for financing the state budget deficit. Thus, the income from the paid services in 2010 was forecasted at the level of 145 million manats, and was implemented with 96 million manats against the 137 million of the private property.

Internal and external debts as well as incomes from the investment of securities abroad was forecasted at the level of 570.3 million manats in 2010, which is 5,8 times more than

²⁸ According to the World Bank estimates in order to correspond to permanent incomes approach the investment expenditures should gradually get back to 2.8 billion AZN (in AZN currency of 2007) in 2012.

²⁹ http://siteresources.worldbank.org/AZERBAIJANEXTN/Resources/Azerbaijan_CEM_FINAL.pdf

³⁰ <http://www.cbar.az/assets/87/1.3.pdf>

³¹ National Budget Group, survey on the State Budget of 2011, Baku 2010



the relevant figure for the preceding year. The drastic difference from the corresponding figure of 2009 can be explained with the impact of the global economic crisis.

In a conclusion, we can emphasize that there are problems in strategic approach to forecasting the budget deficit, as in all fiscal parameters of the state budget. This, in turn is related to the shortcomings in implementation of the budget and weak general forecast base in economic block of the government.

3. Evaluation of monetary policy

3.1. Main aims of monetary policy

Four basic directions will be considered in the evaluation of monetary conditions of economy of the country and monetary policy of the government:

- a. *Inflation and management of money supply*
- b. *Changes in effective currency rate of manat*
- c. *Changes in finance, credit and bank sectors*
- d. *Independence of the Central Bank*

The opportunities for influence of monetary policy were extremely limited on the background of observed growth rates in the years preceding 2010. Specifically, as this growth took place not as a direct result of particular economic policy, but in the background of drastic economic boom which was the outcome of exploitation of natural resources, the influence of the Central Bank of Azerbaijan (CBA) on macroeconomic balance with monetary tools was very restricted. Instead, the fiscal policy more actively conditioned stimulus for the aggregated demand, maintenance of high inflation rates³² and temporary demand shock for non – oil non – trade sectors (services). The slow-down of growth rates increase the opportunities for the Central Bank to more actively influence inflation, money supply and credit indicators. These also influence the objectives of the Central Bank. The basic target of the Central Bank during the high growth period was to control the inflation and maintain the macroeconomic balance. The main aim of the monetary policies in the new term is expected to be, along with preserving these two targets, support for the high-speed growth rate of the non-oil economy. The basic policy priorities of the Central Bank for 2010 were as following:

- a. *Maintenance of low level of inflation*
- b. *Protecting stability of manat currency*
- c. *Strengthening stability of bank-finance sector*
- d. *Provision of money demand of economy in the frame of inflation target*

The Central Bank is defining these objectives as qualitative indicators. It does not

³² Obviously the state expenditures are not the only source of inflation. However the cash flow entering to economy through the state budget in high temps is one of the important factors impacting to inflation. In the meaning of classic theory the total demand from this point is increased (impacting incomes of population, investment goods and services) however the total offer can provide such stimuli after certain period. Thus inflation is increased as a result.

relate them, for instance, to a quantitative indicator, such as the level at which the inflation should be maintained. Besides, these objectives are defined by the CBA in an autonomous manner (in some countries parliaments define inflation targets). The word most often observed among the targets of the Central Bank is stability. There are two types of connection between stability and development:

- *Macroeconomic stability (low inflation, stable currency rate, stable bank sector) which positively impacts development as investors and manufacturers can make more optimal decisions and evaluate risks more exhaustively and properly.*

- *Stability can lead to stagnation or low dynamic growth. For example, as stability in banking sector in fact is an outcome of low risk ambition, conservative approaches and tough regulations, the bank sector of Azerbaijan performs generally with low development indicators and cannot provide credit demand of the market with its full efficiency.*

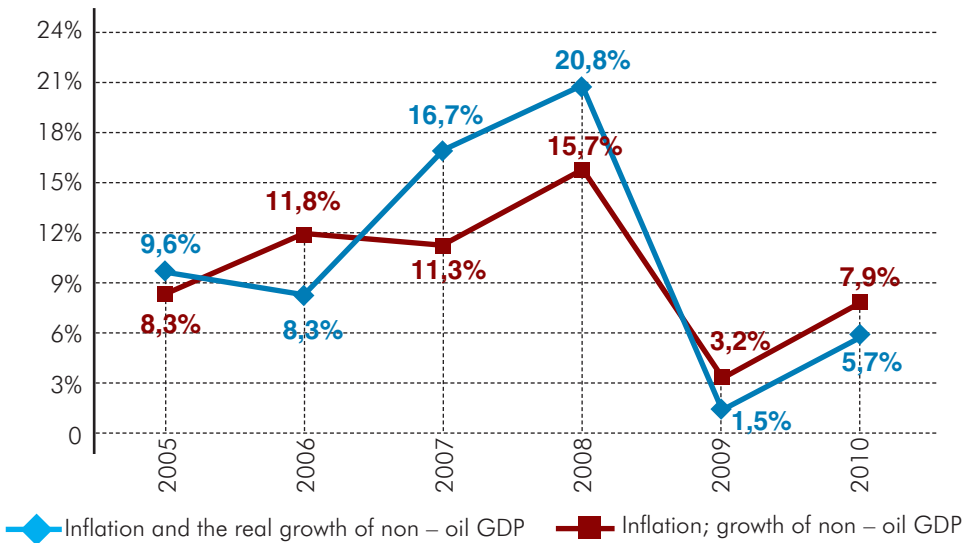
The fiscal policy of 2005-2009 was traced as a more effective policy tool in comparison to the monetary policy. The faster growth of fiscal expenditures than the absorption capacity of the non-oil economy restricted opportunities of monetary policy. That is why the discount rate and money supply remained insignificant tools that impacted macro-economic balance. The most important observation is that the new economic reality paves crucial ways of influence for monetary policy. The macroeconomic balance of the several recent years is changing. Deformation of economic growth model, as well as decrease in growth rates and expansion of the financial markets will form demand for new monetary policy.

3.2. Money supply and management of inflation

3.2.1. Inflation rate

In 2009-2010 inflation decreased to one-digit, a more manageable rate from the high two-digit level observed in preceding years. Usually it is more difficult to manage (both for the government and for the real sector of economy) high inflation rates (two-digit). It happens because the inflation expectations of economic agents (investors, depositors, borrowers, consumers, producers) increase, which in turn, stimulated high inflation in the current period. Besides, these economic agents are facing inflation distortion in investment and saving decisions and this is specifically observed in the bank sector. Inflation is negatively influencing saving and credits because it is neutralizing some part of incomes. State expenditures in these circumstances form more expectations of inflation and part of increasing expenditures is just inflation indexation (for example, 1/3 of increase in pensions, salaries and social payments compensate inflation rates). It is called "inflation spiral" in the economic literature – which means that state expenditures cause inflation and salaries are raised afterwards in order to compensate this inflation.

Diagram 15. Inflation dynamics in comparison with the real growth of non-oil GDP, 2005 – 2010



Source: the Central Bank of the Republic of Azerbaijan

Inflation rates and non-oil GDP growth are strongly correlated. While this correlation was 89% in 2005-2010, it was 16% between the inflation and GDP growth for that period. In addition, the inflation correlated with growth of budget expenditures at 79%, nominal income growth at 96%, nominal salary growth at 76% and M2 money supply growth at 22%. However, the correlation with M2 money supply growth was 77% with delay in one year (it is assumed that increase of money supply leads to inflation after some period).

3.2.2. Sources of inflation, expectations and targets

According to monetarist economic theories inflation in the long term interval is a monetary phenomenon. It means that the increase in prices can be explained with the increase of cash flow. Monetary factor is very important in explaining the inflation. According to econometric calculations of the Central Bank, if the monetary factor (change in money supply) was explaining 50,6% of inflation in 2008, this indicator was 12,5% in 2009 and 46,8% in 2010. Thus, the rest part is explained with the non-monetary factors. Non-monetary factors mainly include imported inflation and increase in administrative prices. Obviously, since free competition is not provided in all fields of the market, some monopoly factors can also influence inflation. Both state monopoly and the monopoly in the private sector can be referred to here.

Approximately slightly more than half of the inflation in 2006-2010 was formed at the expense of food products inflation. The food prices increased by 10,9% on average, prices

of non-food products – by 5.9% and prices of services – by 9,5% in 2005–2010. However, analysis of the inflation basket, reveal that the food prices had a bigger share. According to the State Statistical Committee (SSC), food prices grew by 7,2% in 2010, of non-food products – by 2,3%, of services – by 4,7%. Generally, 68% of 5,7% inflation for the same year is explained with the increase in food prices. Economic Research Center (ERC), an independent organization that conducts periodic calculations of inflation as an alternative to the SSC, indicated higher inflation rates for 2010 in its reports. According to ERC estimations, inflation rate was 11,45 percent in December of 2010 as compared to December 2009 and 6,82 percent in January-December, 2010 in comparison with the same period in the preceding year. The overlapping finding both in SSC and ERC inflation calculations is related to dominance in growth dynamics of inflation in food products over the general inflation level.

ERC expert forecast calculations reveal that 11,2% inflation is expected in 2011; the government analysis shows that the inflation rate will not exceed 5% throughout the year.

Inflation is usually the most important indicator of the monetary policy. Many countries provide large independence to their central banks and define the low inflation targets (for instance, the official target of the European Central Bank is defined at the level of 2%). However, the Central Bank of Azerbaijan usually defines different targets depending on macroeconomic condition of a certain year. At the same time, on the background of decrease in the macroeconomic pressure and economic growth rates of the crisis period, the Central Bank gains more opportunity to influence the inflation. This is reflected in targets for the next year. For instance, if targeted inflation level equaled to 12-13% for 2008, this indicator was targeted at 3%. According to the October 2010 World Economic Outlook forecasts of the International Monetary Fund (IMF), the inflation will remain at the level of one-digit figure of 6%.

Central Bank 's authorization of more moderate increase of money supply, increase of discount rate and nominal increase of manat makes maintenance of inflation at the level of one-digit figure more realistic. However, on the background of high energy prices and consequences of fast increase in global food prices, inflation can exceed the forecasted and targeted levels.

3.3. Currency rate variations

3.3.1. Nominal and Real effective currency rate variations

One of the main targets of the Central Bank is to protect stability of nominal currency rate of manat against the main currencies (US Dollar and Euro). The Diagram 16 shows that manat grew insignificantly more expensive by the end of 2010 as compared to 2000. Increase of manat currency is not one-sided; although it became stronger against some of the currencies (EUR, GBP, RUR, GEL) it turned cheaper in regards to other currencies (TYL, UKH, KZT, JPY).

General growth of the Nominal Effective Currency rate (NEC) was 6% in 2010 as compared to 2009. The main growth occurred against Euro and Pound. Only 4,2% growth is observed in comparison to 2000. Real Effective Currency rate (REC) continued to strengthen during 2010 and turned 10,6% and 48,8% stronger as compared to 2009 and 2005 accordingly. This, in turn, confirms the forecasts regarding the growth of manats at the expense of

Diagram 16. NEC and REC, 2000 = 100

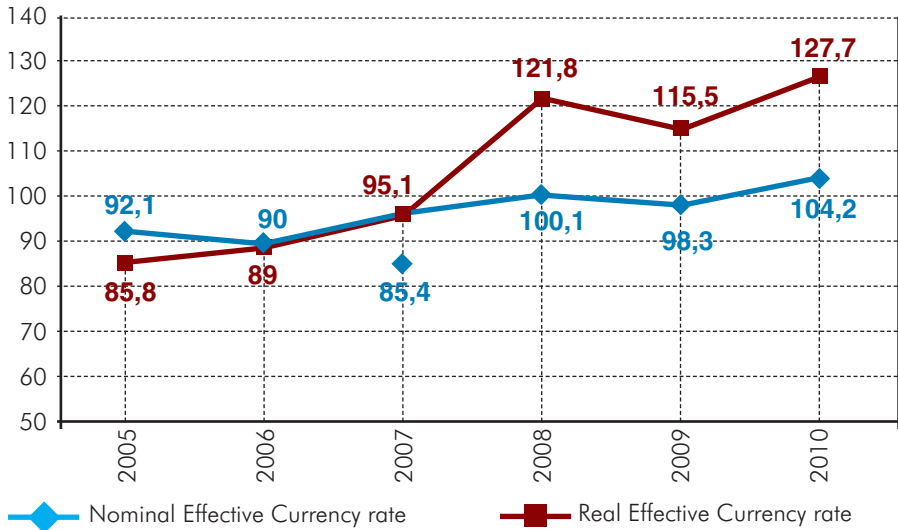
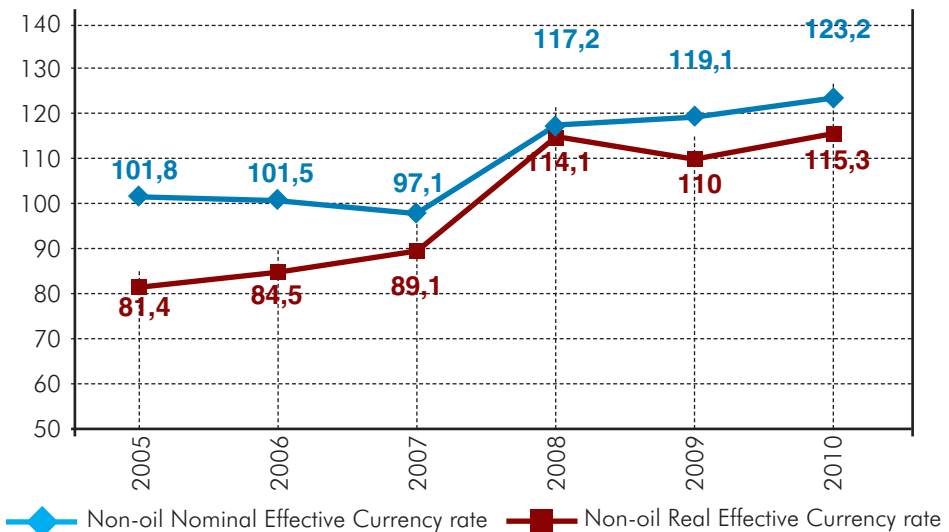


Diagram 17. Non – oil NEC and REC, 2000 - 100



Source: the Central Bank of the Republic of Azerbaijan

the oil dollars. The growth was 27,7% in comparison with 2000. Although non-oil NEC and REC (estimated with the consideration of non-oil trade) had shown similar trends, growth of REC was 4,8 % and 15,3% as compared to 2009 and 2000 accordingly.

Growth of REC depends on two factors: strengthening of NEC and inflation differences. Basic reason behind the growth in 2010 was strengthening of NEC as the inflation differences were insignificant. While share of non-oil growth of NEC was 73,6% in 2008, the same indicator was 23,8% in 2009 and 70,8% in 2010. If to consider the estimates that inflation forecasts will be close to the levels in trade partner states (as mentioned in the chapters above, general economic growth, deceleration of increase in cash flow on the background of decrease in growth dynamics of budget expenditures and income growth rates, decreased pressures on inflation), the variations in NEC will be mostly influenced by the fluctuations in REC.

3.3.2. Actual and balance indicators of REC

Although the above mentioned observations present generally negative description about changes in competitiveness of balance of payments, the comparison of REC with its balance value is an important factor here. This is because if the REC is below the balance value, its growth might not lead to decrease of competitiveness. According to various methodological calculations of IMF, in 2009 actual REC was below its balance value within the 4–10% intervals. This indicator shows that REC of manat can grow without damaging competitiveness. Moreover, even if REC is above its balance value, it may still not seriously influence the general structure of balance of payments since on one hand, the export is mainly oil based and on the other – the non-oil export does not have a broad base and consists of very specific goods, which makes dependence on currency rates insignificant.

3.3.3. Currency rate and inflation targeting regime of the Central Bank

Central Bank puts stronger emphasis on absolute stability in its current currency rate and inflation targeting regime. Obvious evidence is 0,6% nominal growth against the main currency US Dollar in 2010. However more dynamic changes can be achieved for three reasons:

- 1. Import component in inflation is important;*
- 2. Pressure for overcoming balance value of REC is decreased (decrease of both multiplication of oil dollars and their inflow rate into economy);*
- 3. Inflation pressures had decreased in general;*

Under these circumstances, it is possible to set necessary conditions for faster nominal growth (increase of nominal currency rate) in order to decrease inflation (through import component)

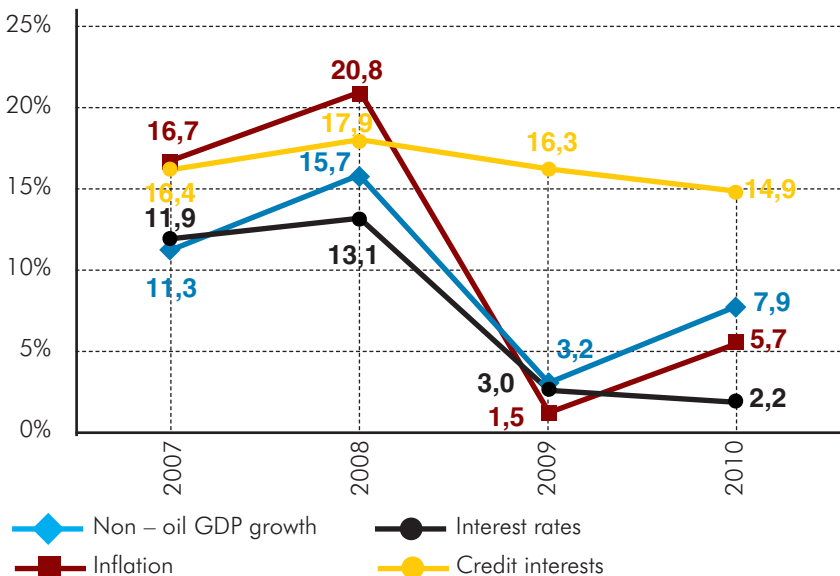
3.4. State of credit markets and bank sector development

3.4.1. Situation in credit market

Reasons for continuous ineffectiveness of changes in discount rate as a tool of monetary policy were analyzed above. The main reason for this is weak connection between the discount rate and credit interest rates in the market. This, in turn does not seriously affect the behavior of market participants due to high liquidity in credit markets and broad distribution of dollars. Thus, discount rate (bank rate) is not effective in market regulation through transmission mechanism. Despite these, the discount rate was of anti-cyclic character.

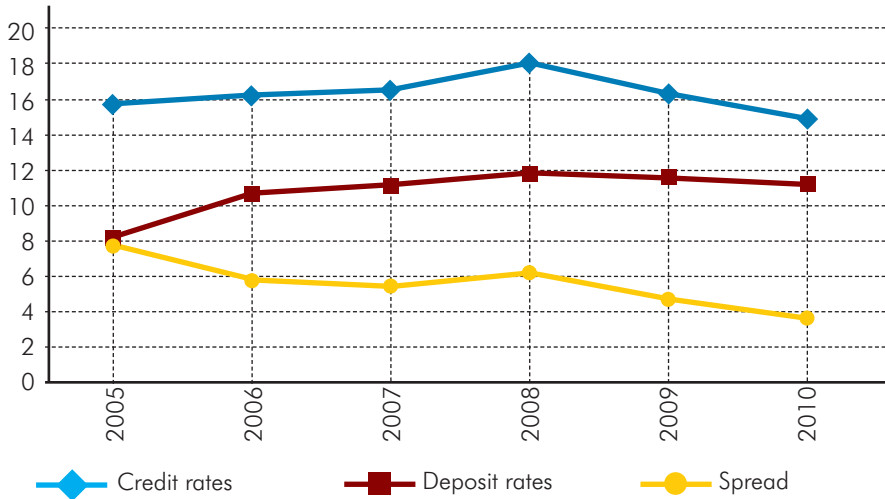
There are different trends in credit and deposit interest: (i) Although credit interest rates decreased on the credits issued in manats after 2008 (due to decrease in credit interest rates in global market and decrease of credit activity in local market), credit interest issued in foreign currency experienced increase; (ii) less decrease occurred in manat deposit interests, which conditioned less than 4% spread between credit and deposit interest in 2010. This seriously decreases the profitability of banks; (iii) absence of tendencies in the currency credit and deposit interest is related with the change of trust of population and business community to manat.

Diagram 18. Interest rate as an anti – cyclic monetary tool, %



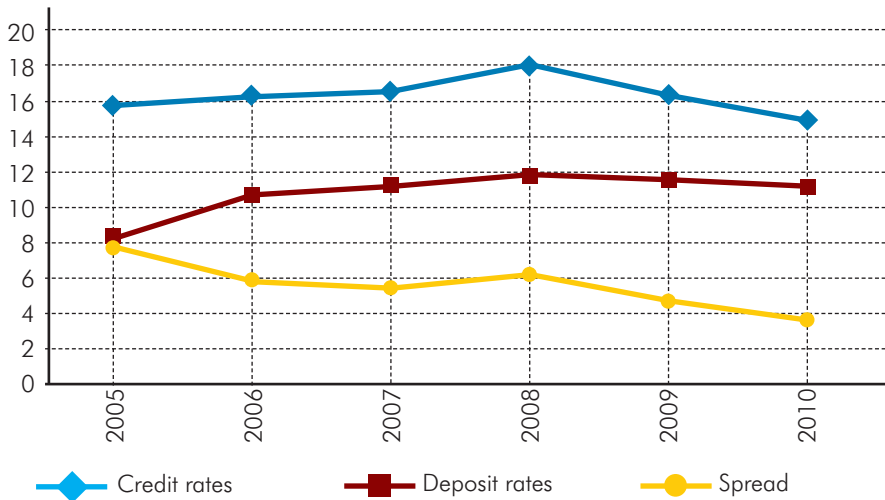
* Interest rate was estimated in medium size for years Source: the Central Bank of the Republic of Azerbaijan

Diagram 19. Credit and deposit rates in manats, %



Source: the Central Bank of the Republic of Azerbaijan

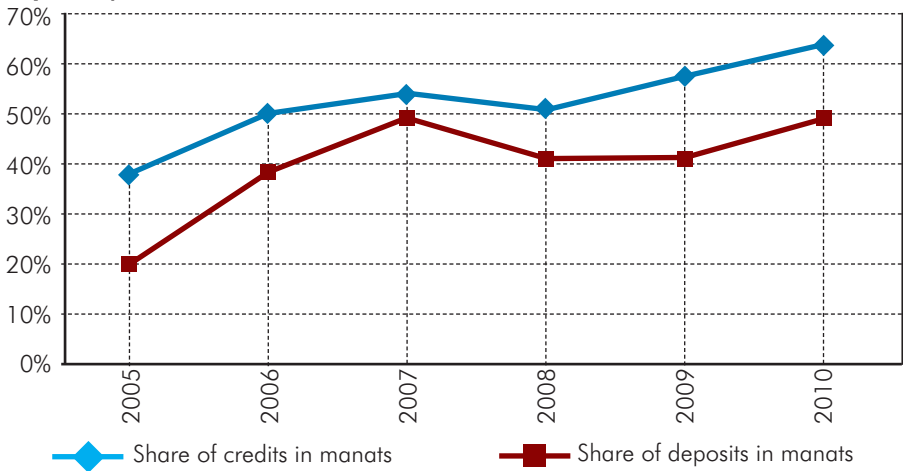
Diagram 20. Credit and deposit rates in foreign currency,



Source: the Central Bank of the Republic of Azerbaijan

Despite the improvements, the level of distribution of dollars is still high in credit markets. Although the 2008 global economic crisis had stimulated increase in expansion of dollar utilization (because of decreased trust for national currency), manat expansion trend continued in the post crisis period. Given the high interest rates on credits due to the currency risks with credits issued in currency, general market credit interest rates also remain high. Similar conclusion can be made about the deposits.

Diagram 21. Level of manat utilization (share of manats in general credits and deposits)



Source: the Central Bank of the Republic of Azerbaijan

3.4.2. Evolvement of bank system

The brief review of bank system can be derived from the following table. As is evident from the table, the bank system was able to increase all balance indicators by several times during the short period. Banks were able to emerge with minimal losses from the 2008-2009 financial crisis and continued to increase all their indicators.

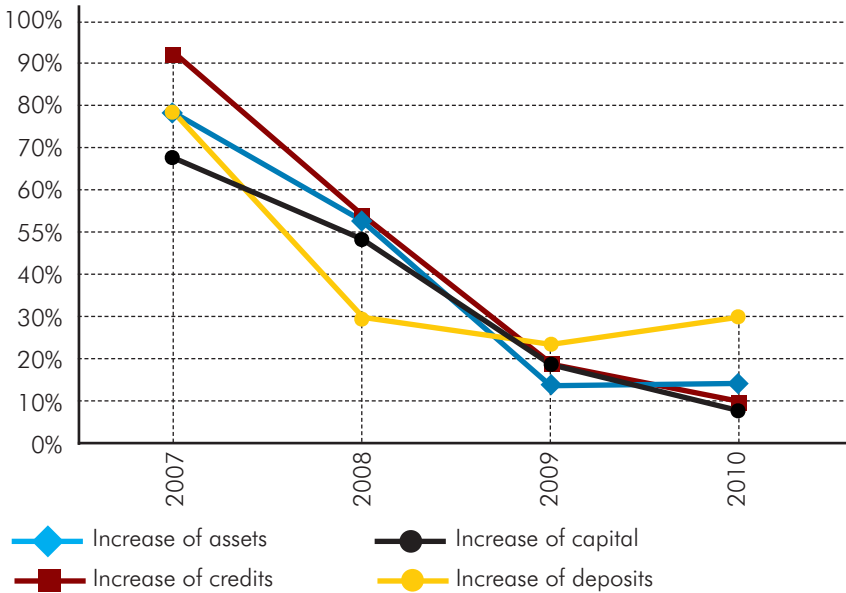
Table 9. Short review of the bank system, in thousand AZN

İl sonuna	2006	2007	2008	2009	2010
Assets	3 778	6 726	10 274	11 655	13 291
Credits	2 371	4 554	6 988	8 230	8 972
Deposits of population	826	1 468	1 904	2 335	3 030
Capital	603	1 009	1 492	1 759	1 897

Source: the Central Bank of the Republic of Azerbaijan

Despite the nominal increase, the growth rates in 2009-2010 decelerated as compared to previous years and dropped to the levels close to the GDP growth. Unlike low growth level on assets, credits and capital, 30% increase was observed in deposits of population. Although no broad research was conducted on the reasons of increase in deposits, it is possible to relate it with the fact that this was considered as less risky investment opportunity by the population. For example, the decrease in prices of real estate which started since October 2008 and continues currently is better explaining choice of investment in banks rather than in the real estate.

Diagram 22. Growth indicators of the bank system, in %



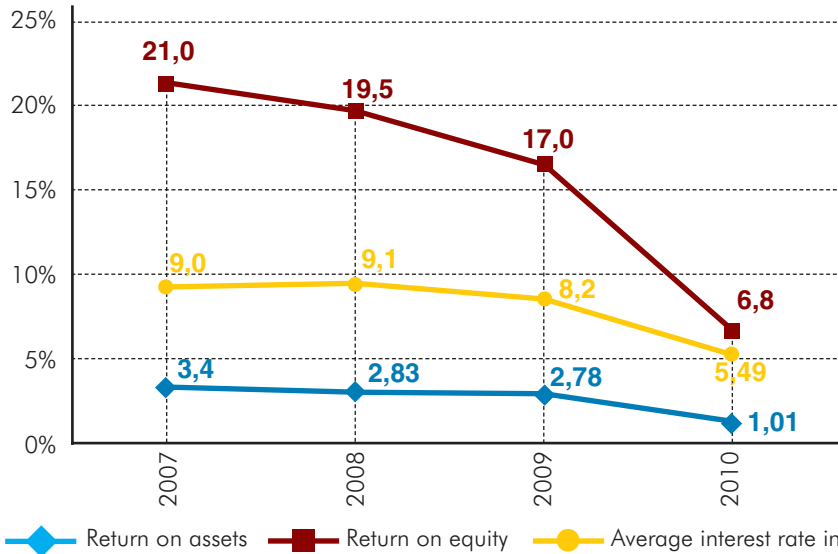
Source: the Central Bank of the Republic of Azerbaijan

Decrease also continues in profit indicators of banks. This can be explained by several reasons. First, decrease in difference between credit and deposit interest rates means less profitability of credits. Credit rates decrease depending on the level of activity and global market conditions, whereas deposit interest rates do not decline. The curve on average return on interest in the following diagram also proves this. Second, increase was observed in hopeless credits (these are directly decreasing net profit). For example, according to the World Bank this coefficient had increased from 4.5% in 2008 to 6.1% in 2009³³. Third, the slowdown in economic growth decreases profitability on non-interest incomes (for example, return capacity from other investments declines). Finally, administrative expenses (salaries, IT costs, consultation expenses, rent costs) rapidly increased during the analyzed period. As the majority of banks are small they cannot create the scope effect on these expenses. In the end, the total weight of these expenditures increases.

Such serious decrease in profitability is very important development because continuation of this trend will be the factor forming the base for crisis in bank sector. Thus, decrease of profitability is restricting the sources of self-financing (profit-making) of banks on one hand and reducing opportunities for receiving new credits from international finance markets and refinance existing commitments on the other hand.

³³The World Bank, The World Bank Group Country Partnership Strategy for Azerbaijan FY11-FY14, http://siteresources.worldbank.org/AZERBAIJANEXTN/Resources/301913-1240322367644/6043695-1286995766829/7474932-1287411211104/full_report.pdf

Diagram 23. Profitability indicators, %



* The average interest rate income is showing the ratio of interest rate incomes to credit portfolio
 Source: the Central Bank of the Republic of Azerbaijan

The banks are still financing a large share of their assets through foreign credits. In 2010 deposits comprised 23% of assets (22% in 2005), 14% of capital (16% in 2005) and 63% (62% in 2005) of other commitments. Dispositions for centralization are still strong in the banking system. Despite the relative decrease in market share of gross bank assets (80% at the end of 2008, 77% as for October 1, 2010) of 12 biggest banks their share in aggregate assets still remains high. It should be particularly mentioned that share of assets of the International Bank of Azerbaijan was 41,3% as for 01.10.2010. As for the growth of assets, the share of 12 biggest banks was 55% as for October 1, 2010 (63% in 2009).

We should additionally mention that the role of non-bank credit organizations in the finance market of the country remains insignificant and is gradually decreasing. Thus, the ratio of percentage of their credits to total credits was 2,1% in 2010 (2,7% in 2005). Despite 61% growth of money supply during 2005-2010, M2/GDP ratio by the end of 2010 was 20% and M2/non-oil GDP was at the level of 45%. This is one of the lowest indicators among the countries of the region. Low monetization level is one of the reasons delaying development of finance intermediation.

3.5. Independence of the Central Bank

Independence of the Central Bank (recognized by the parliament and government) provides positive contributions to economical stability. Independent central banks better control inflation and prevent the impact of government political aims on money supply. The Central Bank of Azerbaijan Republic is an independent institution according to the article 6 of the "Law of the Republic of Azerbaijan on the Central Bank of Azerbaijan Republic" and no other state structures can influence its activities. However, the main element of independence is the issue of who the bank reports to and who appoints and discharges its management. Independence of the Central Bank means total exception of full dependence on any governmental body. However, according to the Article 7 of the same Law, the Central Bank reports only to the President of the Republic of Azerbaijan and members of its Management Board are appointed by the President. To provide for its independence, the Central Bank must report to the parliament, which should approve the appointment or dismissal of the Management Board.

In fact, the Central Bank functions as a part of the government of the Republic of Azerbaijan and reports to the President. In addition, it sometimes executes decisions with political grounds. Examples of this fact are opening of direct credit lines to several state companies in large amounts (State Oil Company, Azeraluminium and AZAL). These credit lines consequence deterioration of financial discipline in companies working on commercial basis, as these are issued with low interest rates, for a long term and without specific provisions.

MAIN FINDINGS OF THE RESEARCH

On the 1st chapter

Economy of Azerbaijan, for recent years including 2010, demonstrates decline in dynamics of real economic growth; there is a risk of deficiency in technological productivity of the current economic growth originators necessary to maintain sustainable economic growth rate **(1.1)**. "Deindustrialization symptom" of "Dutch disease" intensified in Azerbaijan's economy with diminishing share of industrial and agrarian sector and relative expansion of share of the service sector in the GDP structure **(1.2)**. The main impelling source for the GDP in Azerbaijan economy is the actual final consumption, and there is no unique tendency in the role of export and saving. High dependence on crude oil, natural gas and oil products still remains in export operations which are the main components of the GDP **(1.3)**. Less share of nominal growth and nominal volume of GDP was provided by non-oil sector as compared to the oil sector; however, non-oil sector, particularly its construction segment, continues to hold the leading place in the investments made in economy; the poverty level is gradually decreasing, whereas employment level and nominal incomes of the population are increasing in Azerbaijan **(1.4)**. Simultaneously, there is a problem of labour productivity in the economy, including serious salary differences between oil and non-oil sectors **(1.5)**.

On the 2nd chapter

The studies show that provision of the growth rate of the state budget income mainly at the expense of transfer from SOFAZ during the last 5 years, extends the risk of the fiscal sustainability. Thus, the amount of transfers to the state budget from SOFAZ in 2006-2010 totalled to 13 100 million AZN, which comprised 30,9 percent of the budget incomes formed during the same years. In 2010, the share of SOFAZ transfers in the budget incomes was 51.8 percent, which caused increase of the share of transfers in budget revenues and loss of significant position of payments on profit tax of the legal persons in formation of general tax revenues of the state budget **(2.1)**. The dynamics of monthly implementation of the 2010 budget is in conflict with the proportionality and productivity of utilization of public resources, and describes the state of "clearance" of the budget funds mainly at the end of the year **(2.2)**. 73,3 percent of total budget expenditures were allocated for 5 directions – 34,5% for investments, 12% for defense, 10% for education, 9,3% for social protection and insurance, 7,4% for state administration (excluding the costs for maintenance of law enforcement bodies) during the analyzed period. However, the majority of sectors of economy had benefited from the fiscal expansion at the expense of increased oil revenues. Thus, during the recent 5 years the sectors that benefitted most from the fiscal expansion were public transportation, energy, utility, defense, social protection and social insurance, education and public administration. Although increased expenditures caused rise in value added tax with the effect during the particular pe-

riod, it cannot play the role of the source of serious increase in economy anymore. This occurred due to the drastic growth of economy during the recent years, which does not allow maintain its growth rate at the previous level (2.3). It is concluded that the government of Azerbaijan does not have a policy on medium-term management of budget deficit, its balancing in accordance with the annual or economic cycles (2.4).

On the 3rd chapter

Slowdown in growth of non-oil GDP, state expenditures (depend on non-oil GDP and oil revenues), income of population (depend on first two indicators) and money supply (depend on the previous indicators) decreased the pressure on inflation. The Central Bank did not have opportunity to maneuver using two tools – the cash flow or interest rates on the background of such growth rates. It is possible to conduct more effective monetary policy with the decrease in growth rates, impacting discount rate as well as cash flow (3.1). Based on observations for 2005-2008 and 2009-2010, we may come to important conclusions. The rapid increase in cash flow in initial period had overcome absorption capacity of economy, which caused high inflation, especially in 2007-2008. In modern economic terms it is called "overheating of the economy". Decrease in cash flow rates had decreased inflation pressure. More moderate growth rates of economy and state expenditures in the upcoming years will become one of the basic factors of low inflation level (3.2).

Decrease of credit and deposit interest rates given in manats is a positive development for deepening the credit market. However competition of banks for deposits is still an obstacle for decreasing deposit interest rates. Besides, high inflation rates also negatively influence the decrease in deposit rates. High level of dollars distribution still shows incomplete trust to manat and real potential for devaluation danger of economy. Decrease of credit interest rates is important for restoration of credit activity. At the same time, this becomes more relevant as the levels of profitability in economy decelerate. Decrease in deposit rates, positively influencing the dependence of banks on the foreign debts, will set the conditions for decrease of such dependence (3.3). The bank system can be characterized with one large state bank, several relatively large banks and many small banks. In this case it is impossible to depict highly competitive environment. In order to strengthen competitiveness, it is necessary to privatize the state bank and improve conditions for foreign banks to enter the local markets. During the privatization of the state bank special attention should be paid to its privatization not by existing large banks but by independent competitor. Otherwise such transaction will even more negatively impact competitiveness. Growth indicators and competitiveness of bank system seriously decelerated with the decrease in growth of non-oil GDP. Considering the forecasted low GDP growth rates in the near future, growth opportunities of banks seem limited. In this case, it will be important to decrease credit interest rates, present new products (especially private mortgage) and launch new types of services in order to ensure growth. The most real way of reducing credit interest rates is to increase capital requirements and consolidation in bank sector. It is complicated to form economies of scale in small banks (3.4).

CONCLUSIONS AND RECOMMENDATIONS

Economy of Azerbaijan, for recent years (including 2010), demonstrates decline in dynamics of real economic growth; the role of technological productivity indicator, which should become an important source of the economic growth decreased as compared to capital accumulation. The share of industrial and agrarian sectors in the GDP decreases, whereas the share of the service sector is relatively expanding, which gradually conditions the deindustrialization symptoms of "Dutch disease" in the economy in Azerbaijan. The statistical balance on the main expenditure components of the GDP which is an internationally accepted practice is not provided in the Azerbaijan economy. The main impelling force for the GDP in Azerbaijan economy is the actual final consumption, and there is no unique tendency in the role of export and saving. Despite the increase in scope of import-export operations, dependence on crude oil, natural gas and oil products still remains high. Less share of nominal growth and nominal volume of GDP was provided by non-oil sector (compared to the oil sector); the construction segment, alongside with the non-oil sector, continues to hold the leading place in the investments made in economy; the poverty level in Azerbaijan, but there is a problem of labour productivity in the economy, including serious salary differences between oil and non-oil sectors. Despite the increase in employment levels, the problem of its sustainability and lack of professional force in labour market is still a problem.

There are three reasons that stimulated decrease in growth rates: slowdown in the growth of the oil sector on the background of deceleration of the oil production and reduction of price increase rates; negative impact caused by the effects of the world financial crisis on aggregate demand and credit markets; base effect (since the GDP grows on a larger base every year, increases in similar amounts condition less growth percentage). According to the forecasts, low economic growth rate will be observed in the country throughout 2011-2015. Based on the report of the International Monetary Fund in May 2010, average economic growth level will approximate to 3% during the mentioned period, whereas growth in the non-oil sector will total to 4.9%. It is assumed that such growth rates will result in low-speed increase of investments, budget spending and income of population. This in turn, forms new settings for the fiscal and monetary policy.

The fiscal analysis reveals that since the gas and oil reserves of Azerbaijan are non-renewable, large-scale production will only continue through the limited period³⁴. The only inconsistency between the forecasts of local and foreign analysts with this regard is related to the fluctuation of oil prices in international markets. These conditions, leading to emergence of fiscal risks, require more appropriate determination and regulation, otherwise, optimization of the implemented policy. The first of the main reasons conditioning this situation is the preservation of oil revenues for the next

³⁴ See: 2010 state budget package. Forecasts of the Ministry of Economic Development and BP's calculations on oil production in Azerbaijan


generations and its equal distribution among generations. Overexpenditure today leads to reduced spending tomorrow, thus decreasing the share from oil dividends for the next generations. Second, serious increase in oil revenue expenditure policy threatens macroeconomic stability. If on one hand, continuous growth of expenditures conditions the broad fiscal stimulus and monetary expansion, on the other it increases propensities for inflation. Simultaneously, oil revenues which are directed to internal market stipulate increase in the value of national currency AZN in relation to the USD, and thus, setting the frame for regulated currency regime, form undesirable conditions for exporters. Under these circumstances, higher productivity should be achieved to preserve the competitiveness of national economy. Transparent and effective management of state investments are necessary to achieve this. The third reason, necessitating optimization of state expenditures, is the need for protecting effectiveness of expenditures. Increased expenditures raise ineffectiveness, especially within the conditions of lack of transparency and weak public financial control. Decrease of ineffective spending, in its turn, is closely linked with the level of fiscal policy optimization. Thus, there seems no other alternative to the optimization of the fiscal policy in order to resolve or mitigate current problems.

On the background of significant slow-down of Azerbaijan 's economy (lag of economic growth indicators), the growth decelerated in financial markets and banking sector. This opens new opportunities for the Central Bank of Azerbaijan (CBA) to stronger impact the financial markets. The following main tendencies are observed in the monetary sector:

a. The decrease in growth of non-oil GDP, state expenditures, income of population and money supply paralleled with the decelerated monetary impact on inflation, whereas the effect of non-monetary factors is still high. Imported inflation, administratively regulated prices and lack of free competition in trade can be mentioned here as well. The constant and rapid increase in food prices in the world markets is characterized as the most important factor impeding the fight against inflation (base inflation, in particular). In result, inflation pressures are still high.

b. Real effective currency of AZN has constantly increased. However, this currency is still lower than the balance value according to the CBA and IMF reports. In this case, this growth in value of manat does not seriously influence the current saldo deficit and non-oil competition. Reaching the peak level in oil production will assist to reduce the growth pressures. Unexpected increase in oil prices will stimulate counter-impact. In addition, high inflation pressures will also lead to REC acceleration.

c. General decrease had continued in credit and deposit rates and the disparities between these interest rates decelerated as well. The growth rates continued to fall in the banking sector and the decrease had also been observed in profitability indicators. Increase in number of banks operating with decline, decrease of activity in credit markets and reduction of general profitability forms systematic risks for banking sector.



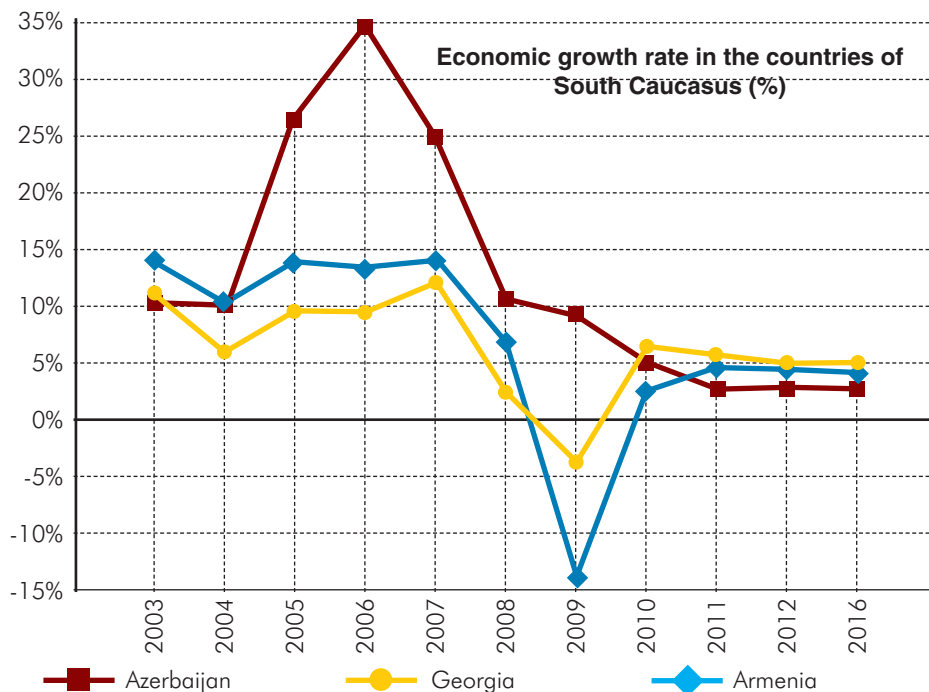
Based on the results and findings of the research and assessment of established tendencies and observed trends, the NBG presents following recommendations for the government of Azerbaijan:

1. *Considering the risk of continuing growth rate of the economy after 2011, the pro-cyclic macroeconomic policy should be replaced with the sustainable economic development-based macro-economic policy; in addition, dependence of the economic growth rate on crude oil prices should be gradually neutralized;*
2. *Problems in GDP structure and particularly the risks of determining the role of consumption and capital accumulation should be considered in macroeconomic policy;*
3. *Particular strategy should be developed for the development of the agricultural sector and non-oil industry and the control over the implementation of state programs should be accelerated;*
4. *Business and investment climate should be developed in order to further increase the share of non-oil sector in investments and the GDP;*
5. *New phase of government assistance to entrepreneurship should be launched to expand the non-oil export potential and taxation base;*
6. *Monopolization, artificial increase of prices and groundless audits held by the government officials need to be eliminated in order to improve business environment in the country.*
7. *Adoption of Business Competition Code and further control over its implementation, tax relieves and their differentiation and simplification of customs procedures are of particular necessity*
8. *It is also important to sophisticate the legislative acts regulating entrepreneurship activity, establish industrial zones and business incubators, develop small and medium entrepreneurship, and involve youth in entrepreneurship activity*
9. *It is crucial to ease access of entrepreneurs to medium and large credits; wide application of information technologies is important in order to diminish direct contact between state officials and entrepreneurs during the issuance of special licences and authorizations (warranties) and conduct of the state monitoring activities.*
10. *Addressed "agitation" policy should be realized to decrease the salaries difference between the economic sectors (for example, application of alleviated tax and social payment rates for the entities in the non-oil sector where salaries are lower than in the oil sector);*
11. *Improvement of the national accounting system and statistics on macroeconomic indicators and poverty;*

12. *Permanent and unchangable incomes approach should be applied to the oil revenue expenditures, as envisaged in the "Long-term strategy on oil and gas revenue management";*
13. *Financial policy directive, based on solid foundations, should be adopted on "Fund-budget" relations and transfers from SOFAZ should be limited to particular amount of its assets;*
14. *Azerbaijani government should add a stronger strategic composition to the budget and align the fiscal policy with the strategy and programs related to the medium and long-term development of the country;*
15. *Structural reforms should be undertaken in the state management, decentralization policy should be expanded and financial independence given to the health and educational institutions in the first place in the frame of fiscal decentralization reforms in Azerbaijan;*
16. *Classification of expenditures according to paragraphs, articles and items which are subject to ammendments according to the decision of the Cabinet of Ministers on approval of the "Unified budget classification of Azerbaijan Republic", should be complied with the real needs;*
17. *Tax administration should be improved to increase the coefficient of direct tax incomes saving in provision of state budget incomes; regulative and stimulating, aside from fiscal functions of the taxes, should be strengthened and the sources of tax debts appearance investigated.*
18. *The budget deficit, along with the other fiscal parameters, should also be forecasted for the medium term period at the level, not harmful for the macroeconomic stability and the sources of its coverage be complied with the general fiscal policy;*
19. *Considering that the increase of state expenditures is among the factors seriously affecting the inflation, it is important that they grow in tact with absorption capacity of the economy. Thus, the absorption capacity of the economy should be considered in budget increases, alongside with the principle of stability;*
20. *Competitiveness in the bank sektor should be increased, power concentration decreased and administrative distortion eliminated in the credit market to manage the growing risks in the bank sector and prevent the possible crisis.*

ANNEXES

Annex 1. Economic growth rate in the countries of South Caucasus (%)



Source: IMF World Economic Outlook 2011

Annex 2. Application of “growth accounting” methodology in Azerbaijan

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Real economic growth rate (%)	11,1	9,9	10,6	11,2	10,1	26,4	34,5	25,0	10,8	9,3	5,0
Percentage of capital factor	1,8	1,9	3,3	6,5	7,1	6,9	6,6	6,2	5,4	-	-
Percentage of labor factor	0,0	0,1	0,1	0,2	0,7	0,4	0,9	0,3	0,3	-	-
Percentage of productivity factor (TFP)	9,3	8,0	7,2	4,5	2,3	19,2	27,0	18,6	5,2	-	-
Gross economic productivity growth (%)	10,9	21,1	12,9	14,4	15,4	35,1	54,8	36,1	32,1	-	-

*Source: "Macroeconomic Study of Azerbaijan – The Way to National Economic Diversification".
EU Project: "Support to the Ministry of Economic Development in Azerbaijan". Contract No. 2007/ 147- 594. October, 2009*

Annex 3. Resource balance

	Million manats			Percentage		
	2005	2008	2009	2005	2008	2009
OFFER						
Gross Domestic Product	12 522,5	40 137,2	34 578,7	100,0	100,0	100,0
Import	6 624,5	9 418,9	8 123,2	52,9	23,5	23,5
Total, offer	19 147,0	49 701,9	42 701,9	152,9	123,5	123,5
DEMAND						
Export	7 881,8	26 400,7	17 127,6	62,9	65,8	49,8
Actual final production	6 579,7	16 829,8	19 390,5	52,6	41,9	56,1
<i>Including:</i>						
<i>Individual consumption of domestic households</i>	5 274,6	13 420,1	14 946,1	42,1	33,4	43,2
<i>Consumption be the public management bodies</i>	1 305,1	3 409,7	4 444,4	10,5	8,5	12,9
Total collection	5 201,2	7 503,1	6 827,8	41,5	18,7	19,7
<i>Including:</i>						
<i>Total collection of basic funds</i>	5 172,9	7 457,0	6 786,8	41,3	18,6	19,6
<i>Variation of basic turnover funds</i>	28,3	46,1	41,0	0,2	0,1	0,1
Statistical difference	-515,7	-1 177,5	-734,0	-4,1	-2,9	-2,1
Total, demand	19 147,0	49 701,9	42 701,9	152,9	123,5	123,5
Internal demand	11 265,2	23 155,4	25 484,3	90,0	57,7	73,7

Source: State Statistical Committee

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