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Greening and economic diversification in Azerbaijan's economy

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Abstract

According to forecasts, Azerbaijan's GDP will grow by 2.3 percent in 2024, thus, the average annual growth rate of Azerbaijan's GDP will be 2.4 percent in the period 2024 and 2026. However, if structural reforms are successfully to be accelerated, the country's GDP growth rate will most likely surpass these expectations. Economic growth in Azerbaijan slowed significantly in 2023, reaching only 1.1 percent, compared to 4.6 percent in 2022. According to sectoral data, this decline is due to a stagnation in the oil sector caused slowing production from existing fields. The growth rate in 2024 is expected to be higher than in 2023, thanks to a smaller decline in the oil industry, ongoing re-investments of oil revenues and progress in structural reforms aimed at diversifying the economy and reducing government involvement in business activities. Meanwhile, non-oil and gas production related GDP growth is expected to reach 4 percent in 2024, driven by government investments and growth in the construction sector. Industrial production in Azerbaijan will experience an average annual growth of just 0.2 percent from 2024 to 2026, while the agricultural sector is expected to grow by 3 percent and the services sector by 5.3 percent.

Keywords: Azerbaijan, energy, Europe

Introduction

Investment in the Azerbaijani economy saw a remarkable upswing in the first five months of 2024, characterized by a notable rise in fixed investment. A key factor in this increase is a significant growth in the oil and gas sector (annually 9.2 percent). This reflects the continued confidence and clear interest of investors in the Azerbaijani energy sector.

The country's strategic position as a major energy exporter has continued to attract investment in recent years. Both the oil and gas infrastructure and exploration activities have attracted a great deal of attention. The global rise in oil and gas prices significantly boosted Azerbaijan's economic growth in 2023.

Azerbaijan's importance in the global economy—as an energy exporter—has strengthened the country's role and prospects as a regional transportation hub. An agreement between Azerbaijan and the European Union aims to increase Azerbaijan's export potential in the field of renewable energy (such as offshore wind energy and green hydrogen). Efforts to diversify the country's economy and thus reduce dependence on fossil fuel revenues have also been intensified in recent years. Agriculture remains a key element of the country's development strategy, as it provides more jobs than any other sector in Azerbaijan.

Despite a slight decline, oil and gas still dominate with a share of around 90 percent of total exports, contributing to 50 percent of GDP and more than half of state budget revenues.

Economic trends

Azerbaijan's macroeconomy is influenced by various factors, including oil and gas production, trade relations, government policies and global economic trends.

- **Oil and gas sector:** Azerbaijan is a major oil and gas producer, and revenues from this sector play an important role in the country's economy. Fluctuations in global oil prices can have a direct impact on Azerbaijan's economic performance.
- **Diversification efforts:** In recent years, Azerbaijan has made efforts to diversify its economy away from oil and gas by promoting sectors such as agriculture, tourism and information technology. These efforts are aimed at reducing the country's dependence on oil revenues.
- **Foreign trade:** Azerbaijan's economy is closely linked to international trade. Its most important trading partners include countries in Europe, Russia, Turkey and China. Trade agreements and geopolitical developments can have an impact on Azerbaijan's trade balance and overall economic performance.
- **Government policies:** Government policies related to fiscal management, monetary policy and investment incentives can have a significant impact on Azerbaijan's macroeconomy. Measures to promote economic growth, control inflation and attract foreign investment are important factors to consider.
- **Infrastructure development:** Investment in infrastructure, including transportation, energy and telecommunications, is crucial for economic growth and competitiveness. Azerbaijan has focused on developing its infrastructure to support long-term economic development.
- **Inflation and exchange rates:** Inflation and exchange rate stability are important indicators of economic health. Monitoring these factors can provide insight into the overall health of Azerbaijan's macroeconomy.

Azerbaijan's GDP increased by 1.7 percent to USD 87.9 billion in 2023. An economic growth of 2.6 percent is expected for 2024 as a whole. Analysts explain subdued growth in Azerbaijan with a drastic decline in oil production and the stabilization of gas prices. In 2022, GDP growth was still 4.6 percent. Natural gas, construction and services sectors are the main drivers of the Azerbaijan economy. GDP is heavily dependent on the oil price's changes on the global markets, and the Azerbaijani economy is vulnerable to prices fluctuations. The oil industry is estimated to account for around 50 percent of GDP; oil and gas production alone accounts for almost 40 percent. Therefore, Azerbaijan's growth rates are strongly correlated with revenues from oil and gas exports. State coffers are flush with revenues from the rise in oil and gas prices leading to an increase in investment activity in the country.

Azerbaijan's economic key figures				
	2022	2023	2024 (Forecast)	2025 (Forecast)
Nominal gross domestic product in billion USD	78.7	76.1	74.9	78.5
Gross domestic product/capita to purchasing power parity in USD	17.450	18.400	19.198	20.013
Population in million	10.4	10.4	10.5	10.5
Real economic growth in %	4.6	1.7	2.6	2.7
Inflation rate in % (year-end)	13.8	8.8	4.0	4.1
Unemployment rate in %	6.4	6.1	5.5	5.6
Exchange rate of local currency (manat) to Euro (avg)	1.81	1.88	1.90	1.96
The country's exports of goods in billion USD	42.2	38.9	25.4	21.8
The country's imports of goods in billion USD	13.5	14.7	11.6	9.1

Source: The State Statistical Committee of the Republic of Azerbaijan, <https://www.stat.gov.az/index.php?lang=az>

In 2023, 30.2 million tons of oil (-7.5 percent) and 36.4 billion m³ of gas (+4.2 percent) were produced, compared to 32.6 million tons of oil (-5.6 percent) and 35.0 billion m³ of gas (+7.3 percent) in 2022. The share of gas is gradually increasing. The Azerbaijani government focuses its efforts on establishing the southern gas corridor from Baku via Georgia to Türkiye, from there oil can be exported to Central Europe. USD 45 billion is being invested by the government in this project, with the first gas deliveries taking place in 2028. Caspian gas can be transported to the European market directly via the TANAP¹ and TAP² pipelines since the end of 2020. One of the most important strategic projects in the region is the construction of a Trans-Caspian Gas Pipeline from Turkmenistan to Azerbaijan.

Monetary and fiscal stability

Although the central bank already announced the transition from a fixed to a floating exchange rate in 2017, a truly floating system was not implemented yet. The exchange rate of the Azerbaijani

¹ The Trans-Anatolian Natural Gas Pipeline – is an important natural gas pipeline in Türkiye. It serves as a central segment of the Southern Gas Corridor. This corridor connects the huge Shah Deniz gas field in Azerbaijan with Europe. The connection is made via the South Caucasus Pipeline and the Trans Adriatic Pipeline. TANAP is of great strategic value to both Azerbaijan and Türkiye. (It not only enables the first Azerbaijani gas exports to Europe beyond Türkiye, but also strengthens Türkiye's position as a regional energy center. These factors underline the crucial role of TANAP in the region's energy landscape.

² The Trans Adriatic Pipeline –has been in operation since 2020. It transports natural gas from Greece via Albania and the Adriatic Sea to Italy. This pipeline is the last section of the Southern Gas Corridor, which begins in Azerbaijan. From 2022, its capacity will be 10 billion m³ per year. The gas comes from the second phase of the development of Shah Deniz, a large gas field in the Azerbaijani part of the Caspian Sea. The gas will be transported via the South Caucasus Pipeline and the Trans-Anatolian Pipeline. The TAP is supported by European institutions and is described as a "project of common interest" which aims to increase energy security and diversify gas supplies to European markets. The TAP is operated by a Swiss joint venture in which BP (20%), SOCAR (20%), Snam (20%), Fluxys (20%) and Enagás (20%) hold equal shares.

manat (AZN) is still pegged to the US dollar. therefore, the exchange rate remained constant at 1.70:1. The government sees a strong currency as a symbol of prestige and stability. However, the central bank lacks transparency and is heavily influenced by political decisions.

Azerbaijan is prone to inflation as the country is heavily dependent on imports and has significant institutional and structural economic problems. These problems include strict monopolies, government price intervention prices, constrained, uncompetitive markets-

During the period under review (2021-2022), an economic recovery driven by higher oil prices led to an increase in external buffers and a strengthening of international accounts. Public finances were in surplus and strengthened — particularly by the assets of the State Oil Fund (SOFAZ), which reached USD 45.386 billion as of October 1, 2022. In addition, the central bank's international reserves rose steadily to USD 8.995 billion by the end of 2022.

On January 1, 2022, government debt stood at 3.3 percent of GDP, with direct government obligations accounting for 2.7 percent while contingent liabilities a further 0.6 percent. Compared to the figures from the beginning of 2021, the domestic government debt to GDP ratio has only risen by around half a point (0.6 percentage points). This rise is due to efforts aimed at gradually replacing foreign borrowing with domestic sources and supporting the development of local markets for government securities in line with the guidelines of the approved medium and long-term strategy for effective public debt management.

Azerbaijani banks, which had long lived off oil revenues, began to recover after the government's restrictive [policies](#) in 2015. During this period, the price of crude oil, which is the largest contributor to the Azerbaijani state budget, plummeted on the world markets, leading to a drastic deterioration in Azerbaijan's budget revenues. In this situation, unlike in previous years, the government adopted a roadmap to ensure sustainable economic growth in the non-oil sector. The main approach of this roadmap was to reduce the budget's dependence on transfers from the State Oil Fund (SOFAZ) and to find mechanisms to use spending more effectively.

The budget mechanism should be considered as part of the Medium-Term Expenditure Framework (MTEF) and public financial resources should be allocated according to programs and strategic objectives rather than as separate items. The government expects the budget office to lay the foundations for the MTEF by the end of 2019 and move to performance-based budgeting (PBB) by the end of 2020.

The fiscal rule was first triggered by amendments to the [Budget Act](#) in June 2018. This rule only applied for one year in 2019. In 2020, the government decided to suspend the rule until 2022, citing the need for higher budget expenditure to combat the negative effects of the COVID-19 pandemic. The fiscal rule was reintroduced in 2022, but the previous rule that applied in 2018 was repealed and a new fiscal rule was introduced in accordance with the amendments to this law.

Fiscal [reforms](#) in Azerbaijan aim to improve the management of the country's public finances, increase transparency, improve efficiency and promote sustainable economic growth. These reforms are crucial for ensuring fiscal sustainability, reducing budget deficits, managing public debt and creating a favorable environment for investment and development. Here are some important aspects of fiscal reforms in Azerbaijan:

- 1. Improving tax collection.** Improving tax collection is a critical component of tax reforms. This includes measures to broaden the tax base, streamline tax administration, reduce tax evasion and enforce tax honesty to increase government revenues.
- 2. Public expenditure management.** Effective public expenditure management is essential to ensure that government spending is efficient, targeted and aligned with development priorities. Fiscal reforms can focus on rationalizing spending, optimizing budget allocations and improving public procurement.
- 3. Debt management.** Managing public debt is an important aspect of fiscal reforms to ensure debt sustainability and minimize risks to the country's financial stability. This includes strategies to monitor, assess and control government borrowing and debt levels.
- 4. Budget transparency and accountability.** Improving budget transparency and accountability is critical to building trust, improving governance and preventing corruption. Fiscal reforms often include measures to increase the transparency of budget processes, public financial reporting and monitoring mechanisms.
- 5. Reforms of pension and social security systems.** Reforms of pension and social security systems aim to ensure the sustainability of these programs, address demographic challenges and provide adequate support to the population, especially vulnerable groups.
- 6. Subsidy reforms.** Rationalizing energy subsidies and other forms of government subsidies is another focus of fiscal reforms. This includes targeting subsidies to the needy, eliminating inefficient subsidies and reallocating resources to more productive sectors.
- 7. Strengthening institutions.** Strengthening institutional capacity and governance framework is essential for the successful implementation of fiscal reforms. Strengthening the institutions responsible for tax policy, public finance management and oversight can help ensure the effectiveness and sustainability of reform efforts.

Fiscal reforms in Azerbaijan are an ongoing process that requires continuous monitoring, evaluation and adjustment to address new challenges and promote economic stability and growth. By implementing comprehensive fiscal reforms, Azerbaijan aims to create a sound fiscal framework that supports sustainable development, fiscal discipline and long-term prosperity.

Low wages and loss of purchasing power and interest rate turnaround

At the end of 2023, the unemployment rate 6.1 percent. The actual unemployment rate is one of the highest in the world, at 15 percent in rural areas. Due to insignificant unemployment benefits, many not even register as unemployed, so the official unemployment rate remains low.

The energy sector, which accounts for a large part of the country's economic growth, employs only a small part of the domestic labor force. More than one million Azerbaijanis work in Russia, who gradually leave Russia due to the war with Ukraine and its economic and political consequences. The currency remains strong, the manat - the national currency of Azerbaijan - is pegged to the dollar with a fixed USD exchange rate of 1.70. The euro stood at 1.83 AZN/EUR at the end of April 2024 and recovered by around 10 percent since its low in October 2022. The manat fell with the start of the war in Ukraine, but skyrocketing energy prices strengthened the local currency by around 20 percent.

Inflation

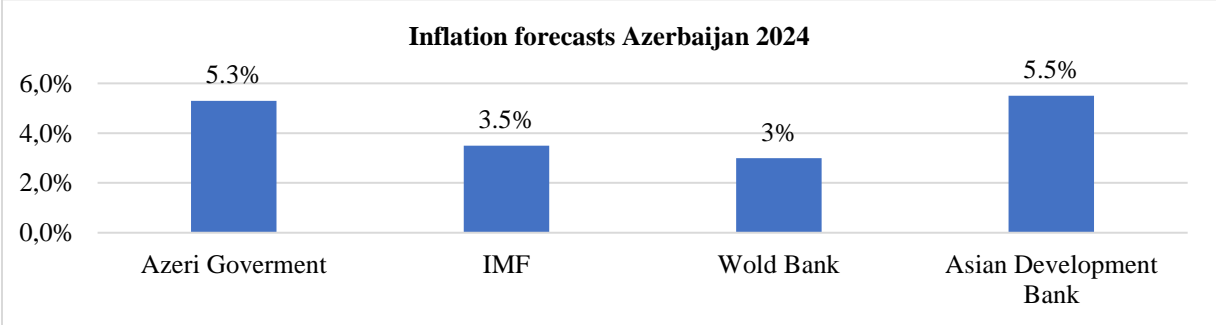
In 2023, annual average inflation was 8.8 percent in Azerbaijan. This was significantly lower than the year-end figure of 13.8 percent in 2022, which is attributable to cheaper commodity imports and government support for food.

According to the Azerbaijan’s State Statistics Committee, in January-April of this year the consumer price index amounted to 100.7 percent compared to the same period in 2023 being 100 percent, including for food products, drinks and tobacco products - 99.3 percent, for non-food products - 101.3 percent, paid services to the population - 102.4 percent.

The latest data from the State Committee for Statistics highlighted concerns about rising food prices in Azerbaijan. This information highlights the main factors contributing to this situation. In February 2024, Azerbaijan recorded an 0.7 percent increase in the consumer price index for food, beverages and tobacco products compared to the previous month. This trend continued in January and February with an increase of an 0.2 percent compared to the same period last year.

The continued rise in food prices can be attributed to two main factors: insufficient domestic agricultural production and the monopolization of the food market. In addition, Azerbaijan's inability to meet per capita consumption standards contributes to price volatility. This situation is exacerbated by the low purchasing power of the population.

But in June 2024, the international rating agency S&P Global Ratings lowered its forecast for average annual inflation in Azerbaijan to 3 percent in 2024 compared to the April forecast of 3.5 percent.



Source: IMF, World Bank, Asian Development Bank and Azeri government data

Improving foreign exchange reserves

At the end of 2023, foreign exchange reserves amounted to USD 11.6 billion. This is the result of low oil prices and their recovery since 2021. The country external debt³ remains low at 9 percent of GDP.

The commissioning of the Shahdenits-2 gas field [in 2018](#) and the higher oil price have contributed significantly to low budget deficits. Transfers from the [SOFAZ](#) oil fund to the Azerbaijani state budget will amount to around 6.9 billion in 2023. The budget deficit for 2023 amounts to around USD 1.6 billion (0.7 percent of GDP).

Top trading partners (export sources) of Azerbaijan in 2023 (in percent)		Top trading partners (import sources) of Azerbaijan in 2023 (in percent)	
Italy	44% (15.2 billion USD)	Russia	18.2% (3.16 billion USD)
Türkiye	15.8% (5.35 billion USD)	China	17.4% (3.02 billion USD)
Israel	4.13% (1.4 billion USD)	Türkiye	3.2% (2.28 billion USD)
Greece	4.02% (1.36 billion USD)	Germany	5.26% (910 million USD)
India	3.64% (1.23 billion USD)	United States	5.14% (889 million USD)

Source: Trendeconomy.com

Industrial production declines

Industrial production declined by 1.1 percent in 2023, while production in the non-oil sector increased by 3.7 percent. Agricultural production will increase by 3 percent. The retail and services sectors grew by 3.7 percent. The tourism sector recorded the highest growth, 21.8 percent. 7 million tons of transit goods were produced in 2023. FDI inflows play an important role for Azerbaijan and FDI amounted to USD 6.65 billion in 2023. The most important investor countries were the United Kingdom, Türkiye, Cyprus and Russia, but countries such as Japan and Iran has significant shares. In addition to the oil/gas sector, foreign direct investment targets mainly the construction, services, transportation, telecommunications and manufacturing sectors. Projects in the services sector and projects for photovoltaic and wind power plants have also benefited greatly from the investments.

³ With the inclusion of the oil fund SOFAZ (around USD 56 billion) with strategic reserves of around USD 67.6 billion at the end of 2023.

Declining oil production puts pressure on growth

The low economic growth of 1.7 percent in the current year is primarily due to the 7.5 decline in oil production compared to the previous year, persistently high inflation and the weakening of domestic demand. In contrast, production in the non-oil sector grew by 3.7 percent in real terms, the higher salaries in the public sector and real wage increases supported consumer demand. In the medium term, the measures described below will. The current account shows high surpluses, which are supported by the strong demand for oil and oil products. This is likely to remain the case in the coming years.

In terms of foreign trade and investments, Azerbaijan is closely linked to Türkiye, which makes the manat vulnerable to the depreciation of the lira. Azerbaijani foreign policy continues to strive for a balance between Russia, the EU, the USA and the states of the Islamic world.

Beacuse of high oil price and gas reserves, Azerbaijan will continue to benefit from high revenues and achieve a current account surplus next year. This is despite the fact that oil production from aging fields is continuously declining and no significant new oil reserves are in sight. In contrast, BP announced the discovery of new gas deposits under the existing Chirag-Guneshli field in July. Production could start as early as 2024, which would accelerate the shift from oil to gas production.

Outlook for 2024

In the first five months of 2024, the Azerbaijani economy showed remarkable resilience and rapid growth, which was reflected in a remarkable increase in gross domestic product. From January to May, GDP grew by 4.2 percent.

An important reason for this growth is the performance of the non-oil and gas sector. Reports from the Statistics Commission demonstrate that value added in this sector increased by 7.3 percent compared to the previous year. This shows that Azerbaijan has managed to [diversify](#) its economy and reduce its dependence on revenues from the oil and gas sector.

While the non-oil and gas sector flourished, the oil and gas sector remained stable. Despite global fluctuations in oil prices and geopolitical tensions, the Azerbaijani oil and gas industry continues to make an important contribution to overall GDP and provides a stable foundation for economic stability.

An analysis of the composition of Azerbaijan's GDP sheds light on the sectors driving this growth. The industrial sector is at the top with 39.7 percent of GDP. It is followed by trade and repair of vehicles (9.6 percent), transportation and storage (7 percent), construction (6 percent), agriculture, forestry and fishing (3.8 percent), tourism and hospitality (2.4 percent) and information and communication (1.8 percent). Various other sectors account for the remaining 20.1 percent. Net taxes on products and imports also make a significant contribution to GDP (9.6 percent).

One notable aspect of this economic growth is its positive impact on per capita income. With a GDP per capita of 4,713.3 manat (USD 2772.53), this upswing will increase the standard of living and strengthen the purchasing power of the population.

Factors potentially contributing to Azerbaijan's robust economic growth include the government's efforts to diversify the economy, attract foreign investment and encourage entrepreneurship. Ongoing infrastructure projects and initiatives to improve the business environment have likely boosted economic activity in various sectors.

GDP growth in early 2024 underlines Azerbaijan's economic resilience and potential for sustainable development. The significant expansion in the non-oil and gas sector combined with a stable performance in the oil and gas sector are promising indicators for diversification and sustainable development goals in the coming years.

However, several risks could affect this positive outlook, even if most of them are offset by external uncertainties, which remain high. An escalation of conflicts, such as in Ukraine or between Israel and the Gaza Strip, poses upside risks due to higher hydrocarbon prices and increased demand boosting exports and tax revenues, but also downside risks in terms of food security and inflation due to higher food prices. Domestically, risks arise from a pro-cyclical⁴ financial policy and fiscal problems in state-owned companies.

In addition, commodity price volatility poses similar mixed risks. A global economic slowdown could have a negative impact on Azerbaijan's terms of trade. Reinforced by the weak economies of its trading partners, this will affect the overall outlook. Increasing geo-economic fragmentation could also drive up input costs and disrupt payment systems, leading to a detour of trade flows to Azerbaijan. Extreme climatic events could affect agricultural production and food security and further exacerbate inflation. On the one hand, a peace agreement with Armenia could significantly boost regional trade

⁴ In the case of Azerbaijan, a procyclical fiscal policy can be summarised simply as governments choosing to increase government spending and reduce taxes during an economic expansion, but reduce spending and increase taxes during a recession.