BENEFITS AND DOWNFALLS OF OIL AND IMPORTANCE OF DIVERSIFICATION: EVIDENCE FROM AZERBAIJAN

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- Economic diversification challenges of resource-based economies
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- Key recommendations to economic diversification
Location: South-Eastern part of Europe continent
Borders: Russia, Iran, Turkey, Georgia and Armenia, and Caspian Sea
The distance from Baku: to North Pole is 5550 km, to equator is 4440 km
Total Area: 86,6 thsd km²; Population density (per sq km): 98.3
Language: Azerbaijan
Overview of Azerbaijan Economy (Pre-Independence period)

1. Central Planning and related production

2. No property rights on its own resources, so, the incomes came from the oil products, cotton, tobacco and winemaking industries

3. Only 50% of the consumption was met by the domestic production at the beginning of the 1990s in Azerbaijan.

4. Thus 55-60% of the export belonged to crude materials and intermediate products.

5. 45-50% of export and import to and from Russia

6. As a result of the irrelevant economic structure the export was more than the import about 30-40% at the end of the 1980s.

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Overview of Azerbaijan Economy
(Independence era: from stagnation to development)

Development Stages of Economy of Azerbaijan

1991-1994
(Period of regression)
-17%
- Regional instability
- Market loss
- Stagnation in Production
- Unemployment
- Hyperinflation
- Budget-Tax problems
- No FDI

1995-2003
(Period of initial reforms)
5.9%
- Political and macroeconomic stability
- Self exploration of natural resources
- Global and regional economic integration

2004-2014
(Period of Sustainable Development and Deep Reforms)
16.9%
- Continuation of economic development with new power
- Empowerment of energy sector after state privatization program
- Increasing the social welfare level
- Redirection of additional sources obtained from oil industry into the other industries

2014-2016
(Oil price shock)
-0.6%
- Sharp reducing oil revenues

2016-2019
(Stabilization)
0.8%
- Approval of strategic economic road maps
- Redirection of development to non-oil sector
Regression Period

- Regional instability
- Loss of Existing Market Share
- Stagnation in Manufacturing Sector
- Increasing Unemployment
- Hyper-inflation
- Budget-Tax problems
- Zero Foreign Direct Investment

- Independence (1991)
- Contract of Century (1994)
- Operation of BTC pipeline (2005)
- Operation of BTE pipeline (2006)
- Financial crises (2008)
- Oil price shock (2014)

GDP per capita, US$  GDP change, %
Important issues were intended to be realized in transition period

1. Using natural resources
2. Establishment of the relevant economic structure according to the liberal-democratic market principles
3. Integration with the world economy in global and regional level

Progress that was attained in that period as follows:

1. Stability in the economy
2. Significant improvements gained by the exploitation of the natural resources of the country
3. The new socio-economic situation after privatization policy
4. Free market economy, liberalization of foreign trade (simplified new customs tax), improvement of the foreign relations, and attraction of foreign investments
5. Reducing inflation rate and minimized budget deficits
6. Acceptance of IMF program in 1995
7. Improvement of legislative base
8. Establishment of the State Oil Fund (1999)
Period of initial reforms (1995-2003) cont’d
Rapid development period (2004-2014)

The main objectives of this period were:

1. To contribute economic growth and the strengthening of the economic policies;
2. The reconstruction of the energy sector via the programs in accordance with the second state privatization;
3. The strengthening of the social directions of the economic policies;
4. Enhancing the social welfare;
5. The diversification of the economy.
Rapid development period (2004-2014), cont’d

Government focused on following fields as a priority outside the oil sector for the purpose of achieving economic diversification:

i) agriculture (plant growing and cattle-breeding)
ii) fishery and fishing industry;
iii) food (agrarian), tobacco-growing and wine industry;
iv) consumer goods industry, including textile and silk-growing;
v) manufacture of construction materials;
vi) chemical industry;
vii) instrumentation manufacturing industry;
viii) tourism;
ix) electricity production;
x) communication and IT;
xi) education related to “human capital” development
Rapid development period (2004-2014), cont’d

Two “State Program on Poverty Reduction and Economic Development (2003-08; 2008-2015)” In 2001 IMF accepted this program
- According to the WB income of 40-50% of population is less than 1 $
  - Min standard of life was at 86 dollar
  - Average monthly salary was 64.4 $

- vitalization of non-oil sector
- increase level of employment
- increase household income and life standards
- increase GDP per capita from figure of 2008 to 2011 to 7000 $
- increase private sector in economy till 85%.

Azerbaijan 2020: Look into the Future
- a knowledge-based economy
- increasing the country’s competitiveness,
- diversifying the economic structure
Rapid development period (2004-2014), cont’d

The review shows that the government intended to achieve economic diversification through:

i) expanding import substitution production in non-oil sector;
ii) enhancing non-oil product exports and diversifying exports in non-oil sector;
iii) ensuring regional development and balanced development across regions in the country;
iv) manufacturing competitive and high-tech products through utilization of information and communication technologies and advanced production technologies;
v) establishing various institutions to implement dissimilar aspects of diversification policies;
vi) establishing an investment environment necessary for economic diversification, including legislative base required for competition or eradicated official and non-official obstacles.
Rapid development period (2004-2014) cont’d

GDP Production in the section of oil and non-oil of economy
Rapid development period (2004-2014) cont’d

Oil Revenue Allocation Choices

- Administrative Expenses
  - Civil servant salaries
  - Defense, Foreign Affairs
  - Other government direct and indirect costs

- Social / Economic Services and Infrastructure
  - Health
  - Education
  - Agriculture
  - Transport, Electricity
  - Others

- State Enterprises and Monopolies
  - SOCAR
  - AzChem
  - Azerceu
  - Azerigaz
  - AzeriStilik
  - Others

- Social Protection
  - Pensioners
  - IDPs, refugees
  - Handicapped
  - Marginalized poor

± $260 billion (2006-2024)

State Oil Fund

Source: SOFAZ, SSC of Azerbaijan
Total exports growth (58.7%), 2009-2013

- Decrease in traditional products to traditional markets: -25.0%
- Increase in traditional products to traditional markets: 83.0%
- Extinction of traditional products and traditional markets: -0.3%
  - Increase in traditional products to new markets: 0.0%
  - Increase in new products to traditional markets: 1.0%
  - Increase in new products to new markets: 0.0%

Source: ITC, calculations based on ITC’s Trade Competitiveness Map data.
Note: Graph shows decomposition of the country’s export growth in value terms by diversification pattern over the indicated period.

Major Non-Oil Goods Export (USD Million)

<table>
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<tr>
<th>Product</th>
<th>2015</th>
<th>2016</th>
<th>2017</th>
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<tbody>
<tr>
<td>Fruit and vegetables</td>
<td>371.9</td>
<td>377.2</td>
<td>502.8</td>
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<tr>
<td>Vegetables and animal oils</td>
<td>113.3</td>
<td>11.0</td>
<td>17.0</td>
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<tr>
<td>Sugar</td>
<td>62.0</td>
<td>39.5</td>
<td>112.5</td>
</tr>
<tr>
<td>Plastics and articles thereof</td>
<td>99.0</td>
<td>101.1</td>
<td>117.7</td>
</tr>
<tr>
<td>Aluminium and articles thereof</td>
<td>86.1</td>
<td>98.1</td>
<td>117.7</td>
</tr>
<tr>
<td>Base metals and articles thereof</td>
<td>34.9</td>
<td>96.1</td>
<td>82.9</td>
</tr>
<tr>
<td>Chemical products</td>
<td>55.9</td>
<td>79.6</td>
<td>60.0</td>
</tr>
<tr>
<td>Alcoholic and non-alcoholic beverages</td>
<td>25.8</td>
<td>18.7</td>
<td>21.9</td>
</tr>
<tr>
<td>Cotton (fibre and yarn)</td>
<td>14.6</td>
<td>18.0</td>
<td>49.7</td>
</tr>
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</table>
Factors hampering economic diversification

- National currency appreciation ("Dutch disease"),
- Poor governance and strategic approach
- Low efficiency of budgets
- Labor-intensity of many areas chosen as priorities
- Poor and inadequate export and import substitution
- Insufficient financial opportunities of enterprises
- Lack of qualitative human capital due to chronic problems in education and health
- Misuse of public funds, as well as inadequate government support

Reasons of failing economic diversification measures in agriculture sector:

a) lack of procurement system;

b) decreasing on supply of mineral fertilizers;

c) weak short-, mid-, and long-term developed strategy to mitigate loss of land quality;

d) inefficient of subsidies

Reasons of failing economic diversification measures in tourism sector:

a) lack of necessary coordination among public agencies;

b) still inadequate tourism infrastructure;

c) increased prices of goods and services
Benefits of oil and gas extraction

- GDP increased by 3.2 times, unemployment level decreased from 9.2% to 5.0%, poverty level decreased by 6.9 times from 43.7 percent and made 5.4 percent in 2017. Poverty line increased by 4.6 times and population income increased by 8.6 times, including average monthly wage by 6.8 times.
- State budget incomes increased by 13.5 times and expenditures increased by 14.2 times. Budget deficit to GDP made at average 0.6% against to 3% standard defined in international experience. Expenditures directed to social protection and social security of population increased by 11.0 times and funds directed to the development of economy – 18.1 times, including budget allocations to the development of education are increased by 7.4 times, to healthcare by 12.7 times.
- Number of entrepreneurship subjects increased by 4.3 times.
- Industrial product increased by 2.6 times, including non-oil sector by 2.2 times or at average annual by 5.7 percent: 72.9% of industrial products were produced by enterprises in mining, 22.0% - manufacturing industry, 4.4% - electricity, gas and steam production, distribution and supply, and the rest part - water supply, waste treatment and disposal field.
- Oil extraction increased by 2.5 times, natural gas production by 5.6 times.
- Investments directed to development of non-oil sector increased by 6.1 times.
- Agricultural production increased by 66.4 percent or at average annually by 3.7 percent,
- Transportation services increased by 2.8 times, Information and communication services by 11.2 times or at average 18.8% annually.
- Tourism sector, including the number of hotels increased by 5.9 times and made 563 units. The number of tourists accommodated in hotels increased by 9.6 times and number of foreign tourists – 12.6 times.
- The foreign trade turnover increased by 4.7 times including export – 6.0 times, import – 3.3 times, foreign trade partners increased by 1.5 times and reached from 124 to 187 countries.
Rapid development period (2004-2014) cont’d

- Independence (1991)
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- Operation of BTC pipeline (2005)
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Economic diversification challenges of resource-based economies

**Economic instability**, due to volatile commodity prices
Risk of **“Dutch disease”**: Exchange rate appreciation and rising inflation

**Weak linkages** with the rest of the economy

**Employment problem**: Energy sector accounts for 2% of total employment

Risk of **Institutional weakness**

**Over 50% of GDP, %58 of budget income, and 90% of export** is accounted by natural resources (oil, gas, coal etc.)

**%90 of FDI** go to the natural resource industry

Possibility of increase of **dependency** in future years

**Lack of oil reserves**, i.e. Azerbaijani oil reserves is less than S.Arabia’s in 45, Iran’s in 25, Kuwait’s in 17 times

**The end of oil production**: Azerbaijan (2025), S.Arabia (2095), United Arab Emirates (2125), Kuwait (2135)
## Current assessment of economy: SWOT Analysis

### Helpful (positive) to achieving the objective

**Strengths**
- Strategic geo-location
- Socio-political stability
- Social spheres are always in the spotlight of the government
- Increased efficiency and transparency in the provision of public services (ASAN public service)
- State support for entrepreneurship development, export promotion and economic diversification, creation of favorable investment environment
- Participation in global projects in the field of energy and transport corridors
- Self-sufficiency in energy and food security
- Satisfactory level of public debt, unemployment and inflation

### Harmful (negative) to achieving the objective

**Weaknesses**
- Procyclical macroeconomic policy (i.e., government spending increases in good times and falls in bad times)
- Weak economic and export diversification
- Dependence of economy from oil-gas revenues
- Unsatisfactory level of corporate management in public and private enterprises
- Redirection of FDI to oil-gas sectors
- Weak possibilities in absorbing of external shocks
- High weight of the state in investments, weak trend of private investment
- Raw material orientation of export
- Dependence of production on import
- High level of informal employment
- Weak global position on human capital development
- Weak Promotion on export of services

### Internal origin (attitudes of the system)

**Opportunities**
- Global supply chain integration, the possibility of economic diversification
- Availability of opportunities for the development of priority areas
- Creation of favorable business environment for non-resident entrepreneurs
- Attraction of private investments both foreign and domestic for privatization of State enterprises with low level of profitability

### External origin (attitudes of the environment)

**Threats**
- Growing geopolitical instability in the region
- Increased fiscal burden
- Investment to infrastructure projects more than the production sector
- Depletion of natural resources, new losses in compensation of low-developed industries
- Lowering the average income level

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“Post-Oil Period: Deep Reforms”

Strategic roadmaps for the national economy and main economic sectors with the aim of developing the non-oil sectors of the economy.

The roadmaps include:

(i) oil and gas (including chemical production);
(ii) manufacture and processing of agricultural products;
(iii) manufacture of consumer goods by small and medium enterprises (SMEs);
(iv) heavy industry and machinery;
(v) specialized tourism industry;
(vi) logistics and trade;
(vii) affordable housing;
(viii) vocational education and trainings;
(ix) financial services;
(x) communication and information technologies;
(xi) utilities (electricity and thermal energy, water and gas supply).

The outlook includes a detailed short term action plan for 2017-2020, a long-term strategy for the period covering years until 2025, and a vision for the post 2025 period.
Recent progress

- In 2018 GDP increased by 1.4%
- GDP per capital reached 4780 USD.
- Value added produced in non-oil sector of the economy increased by 1.8%, while in oil sector it increased by 0.6%
- Product output in non-oil sector of industry increased by 9.1%, while in oil sector it increased by 0.4%
- Foreign trade partners reached 185 countries, including 113 countries on export and 178 countries on import
- In 2018 non-oil export was 1.7 billion US dollars that is more in actual price for 9.8% and real terms for 1.0% relatively to 2017.
- Number of employees by 1.6%
- 25th position in the World Bank’s 2019 Doing Business report
- Number of licensed activities reduced from 59 to 37 and permits reduced from 330 to 86
- E-government services have been expanded significantly
- Moratorium on certain business inspections until 1 January 2021
Key recommendations to economic diversification (IMF)

Macroeconomic Pre-Conditions to Economic Diversification

Regulatory and Institutional Framework Conductive to Private Sector Growth

A Public Sector that Enables Private Sector Growth

The Road to a More Diverse Economy
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- [http://www.azerbaijan.az/portal/Economy/General/general_e.html]
- International Monetary Fund, 2016, "Economic Diversification in the oil-exporting Arab countries”, IMF Staff Paper
- Relevant legislative acts, state programs, reports etc.
THANK YOU!

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