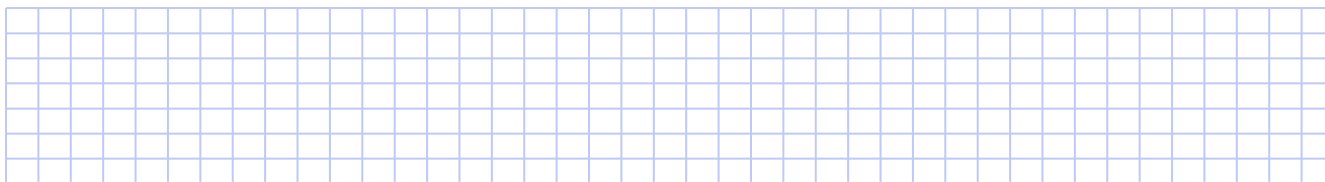


BENEFITS AND DOWNFALLS OF OIL AND IMPORTANCE OF DIVERSIFICATION: EVIDENCE FROM AZERBAIJAN



Rovshan MAHMUDOV

CAREC Institute

*Workshop on “Promoting Economic Diversification in the CAREC
region”, 16-17 May, 2019*

Content

- Overview of Azerbaijan Economy
 - Pre-independence period
 - Independence era
 - Regression stage (1991-1994)
 - Stage of initial reforms (1995-2003)
 - Rapid development stage (2004-2014)
- Factors hampering economic diversification
- Benefits of oil and gas extraction (2004-2017)
- Economic diversification challenges of resource-based economies
- Current assessment of economy: SWOT Analysis
- Post-oil stage: Deep reforms and period of low oil prices
- Recent progress
- 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.

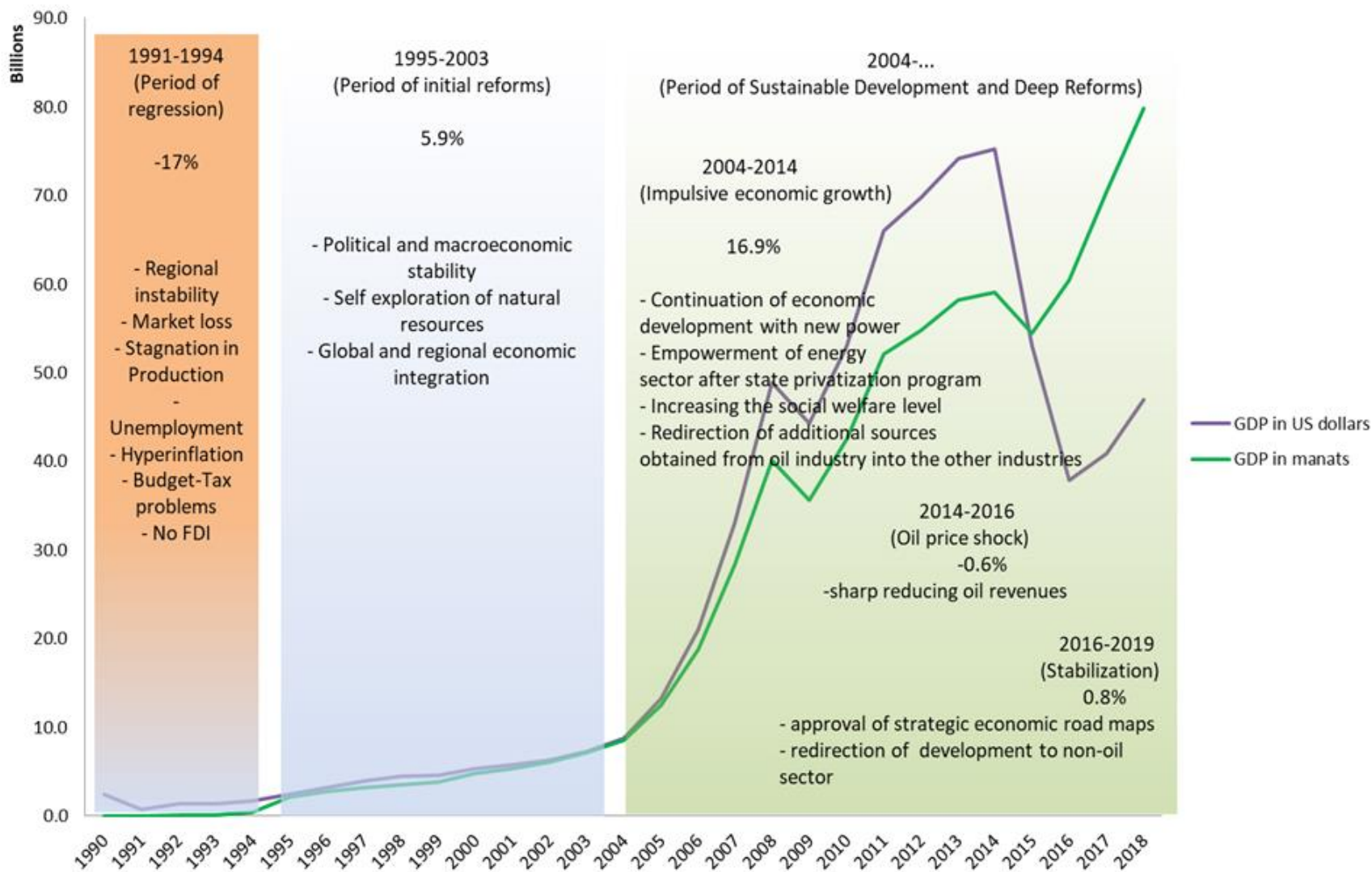
	1960-70	1970-80	1981-85	1986-1990
Economic Development, %	5.2	7.4	4.9	5-6

Source: Osman Nuri Aras, "Economy of Azerbaijan", Baku 2016

Overview of Azerbaijan Economy

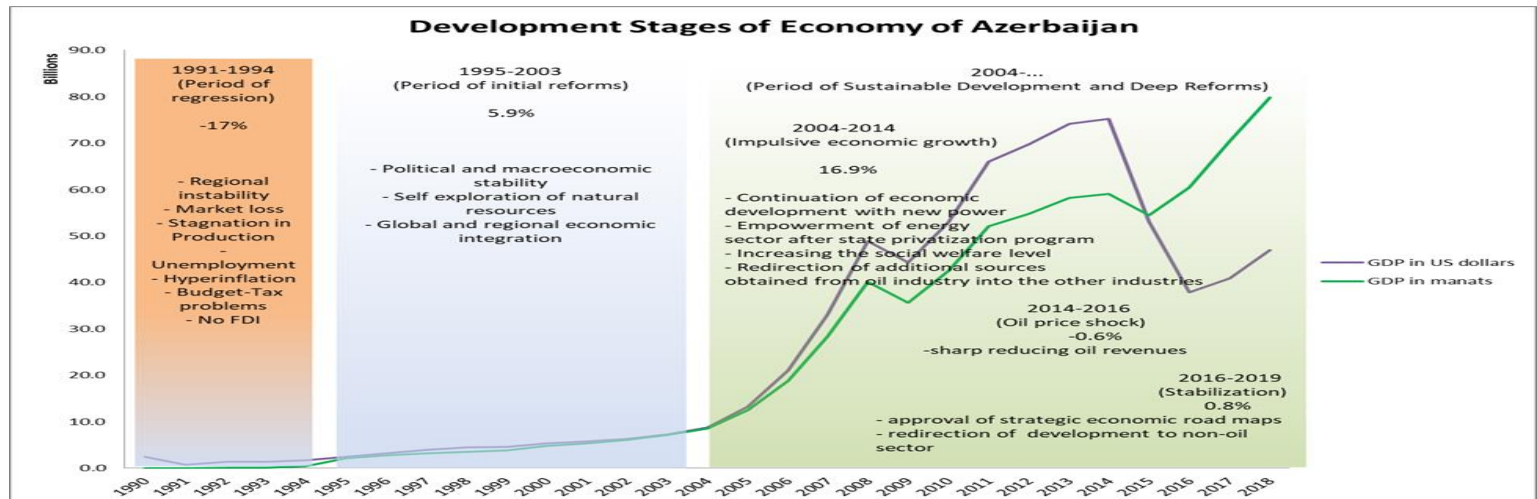
(Independence era: from stagnation to development)

Development Stages of Economy of Azerbaijan

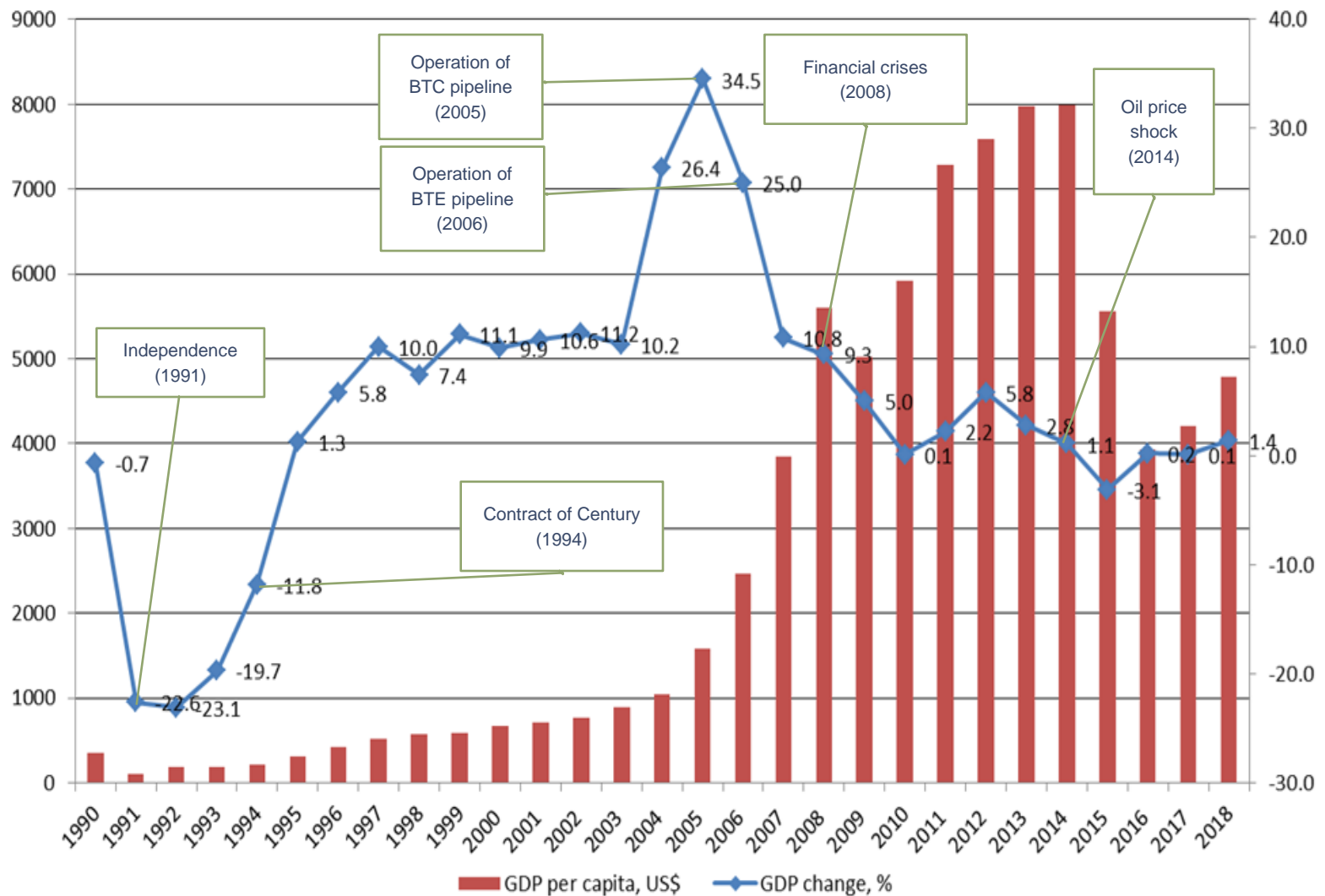


Regression Period (1991-1994)

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



Period of initial reforms (1995-2003)



Period of initial reforms (1995-2003) cont'd

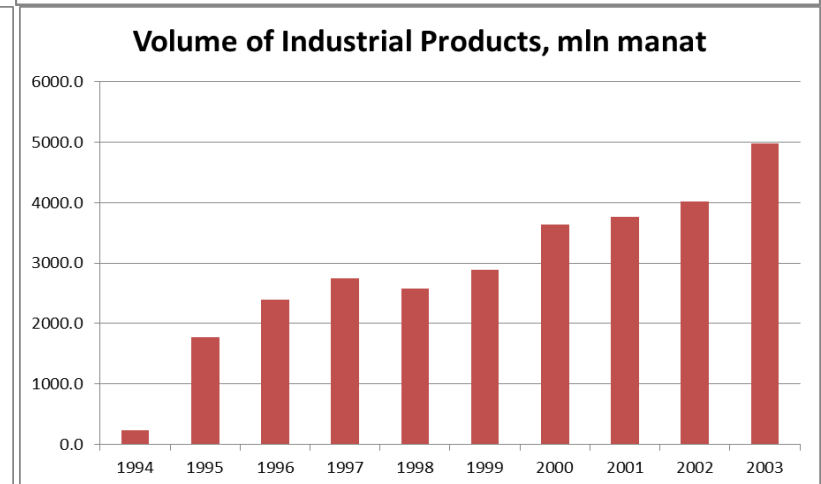
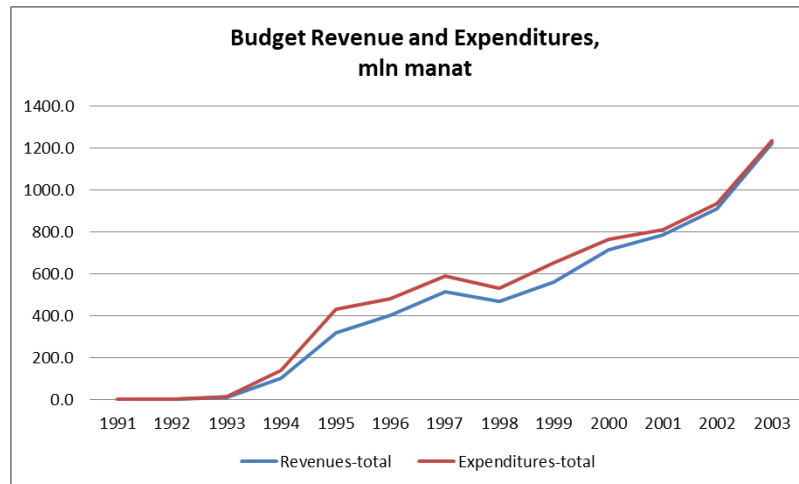
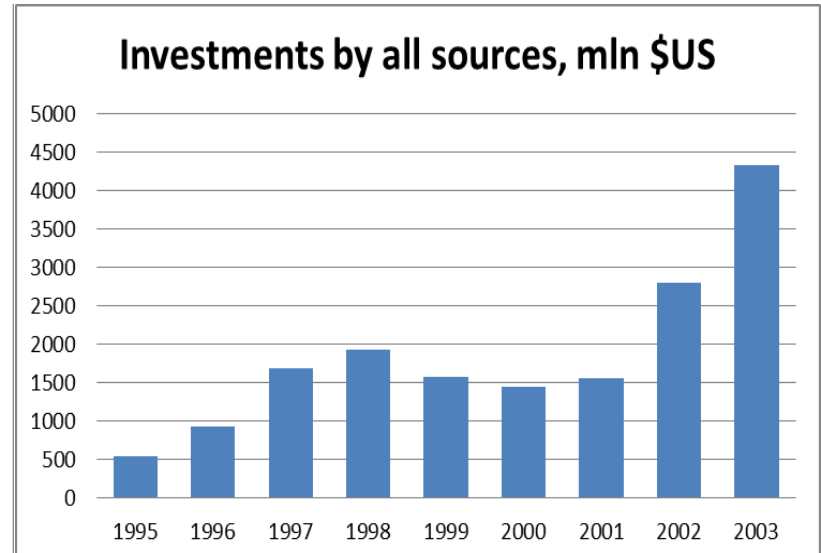
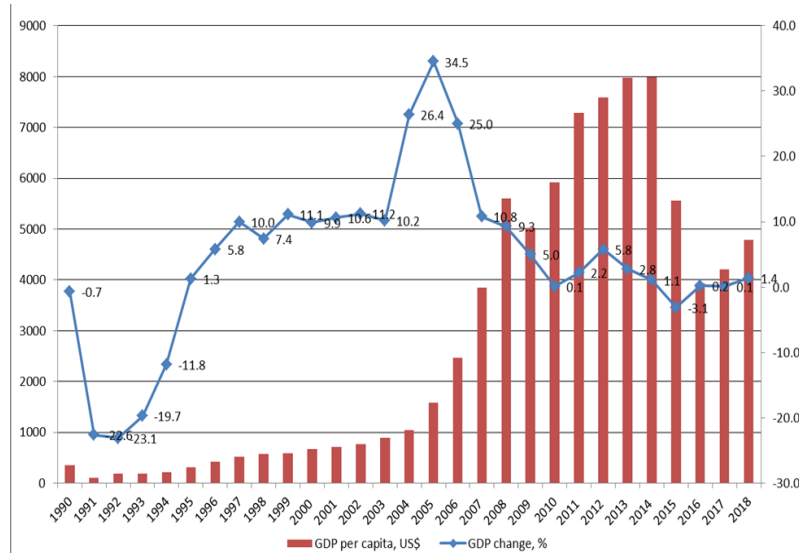
Important issues were intended to be realized in transition period

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)

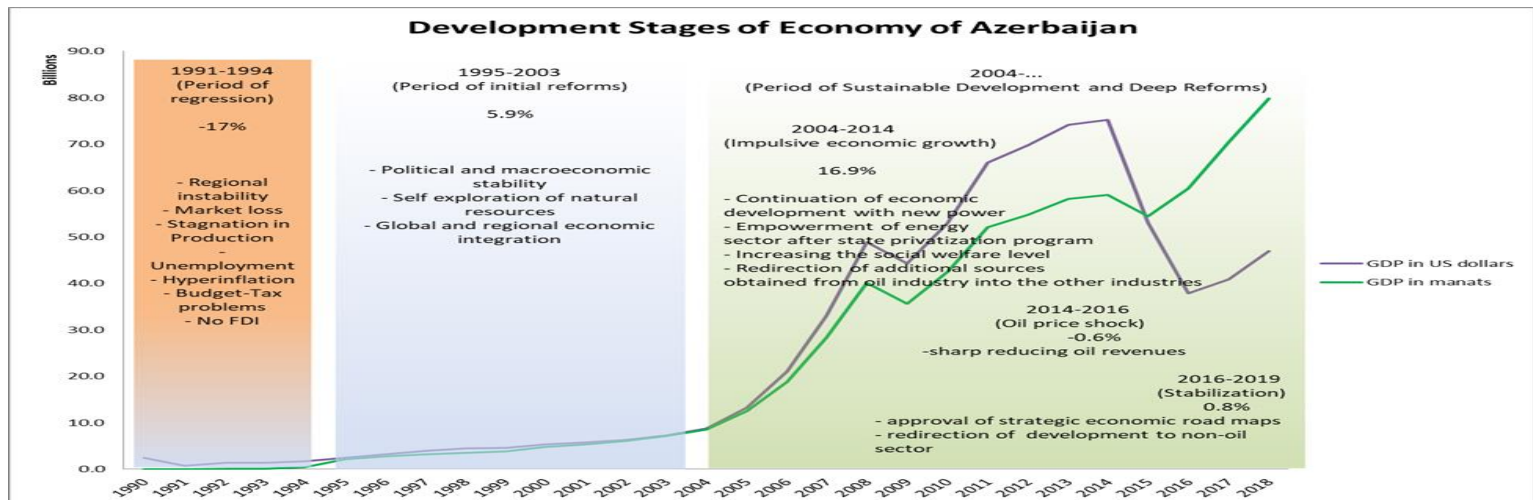
Period of initial reforms (1995-2003) cont'd



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 \$

Azerbaijan State Program on Regions Social and Economic Development 2004-2008 and 2009-2013

- 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

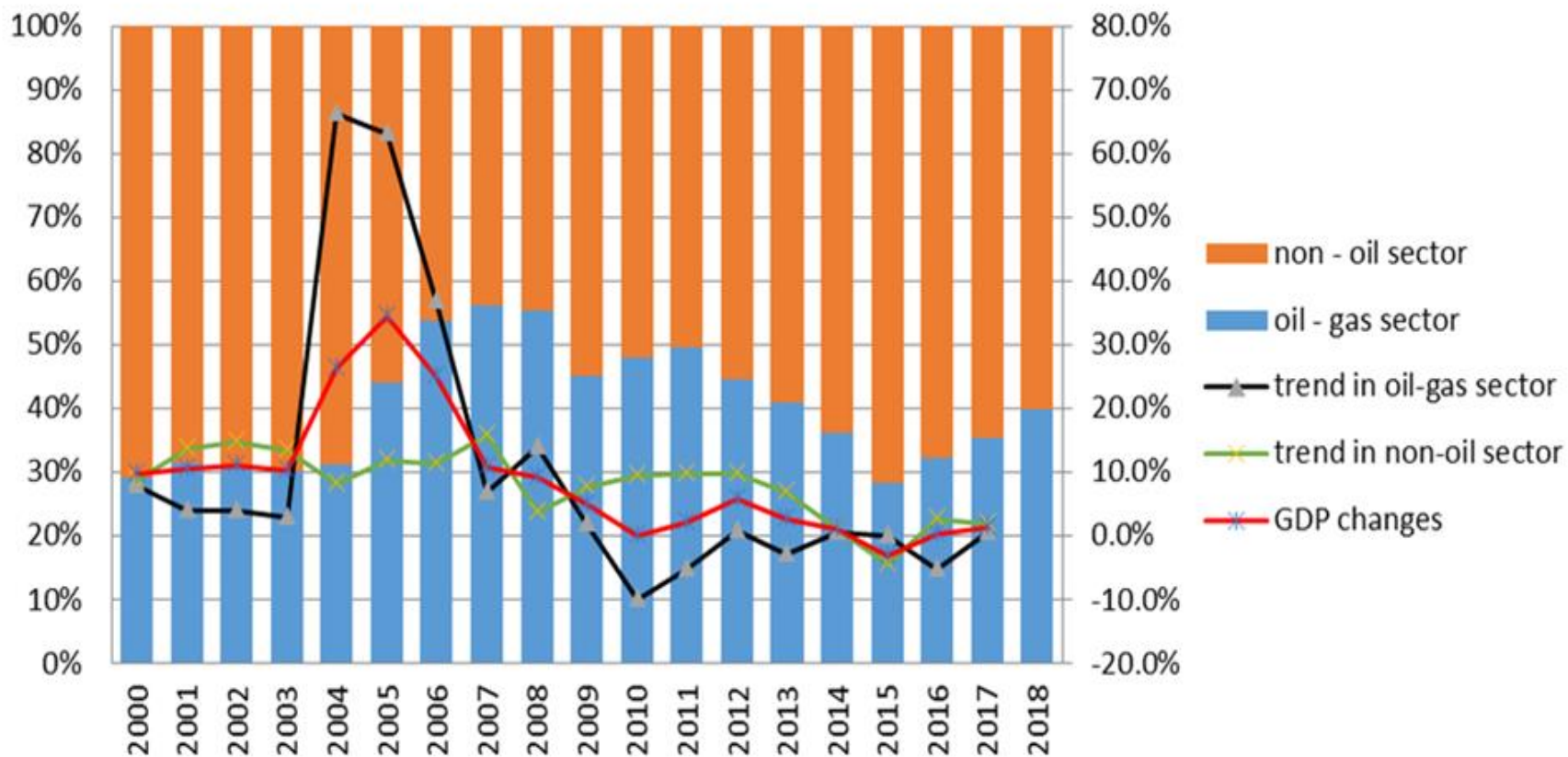
Rapid development period (2004-2014), cont'd

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

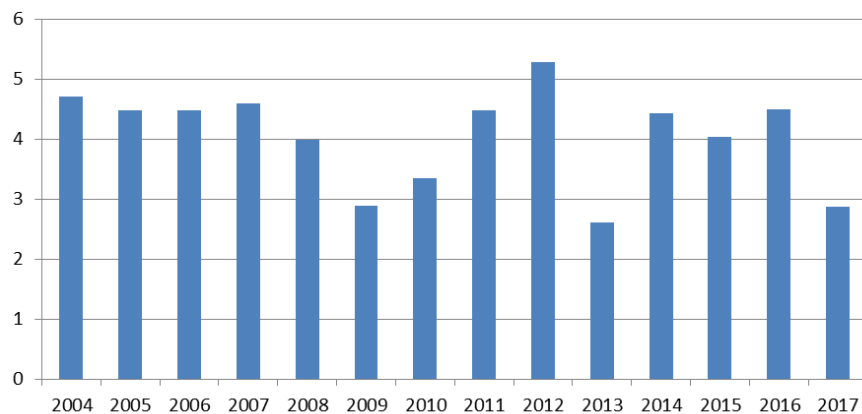
- i) expanding import substitution production in non-oil sector;
- ii) enhancing non-oil product exports and diversifying exports in non-oil sector;
- iii) ensuring regional development and balanced development across regions in the country;
- iv) manufacturing competitive and high-tech products through 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

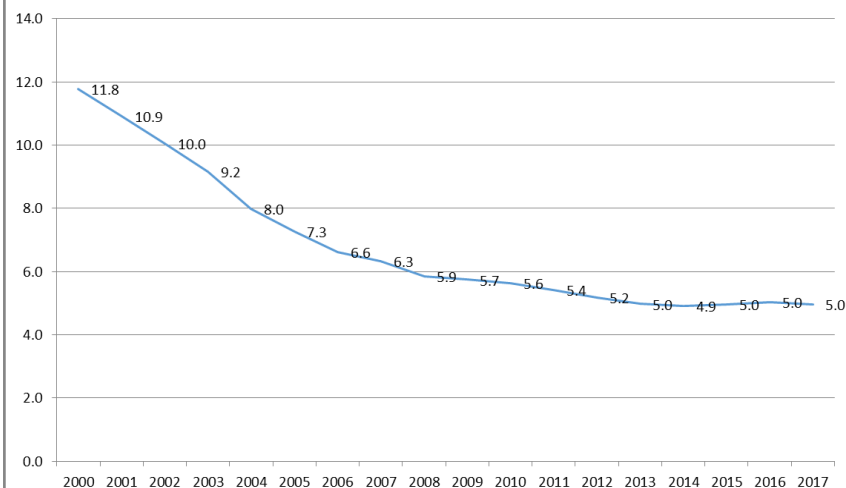
GDP Production in the section of oil and non-oil of economy



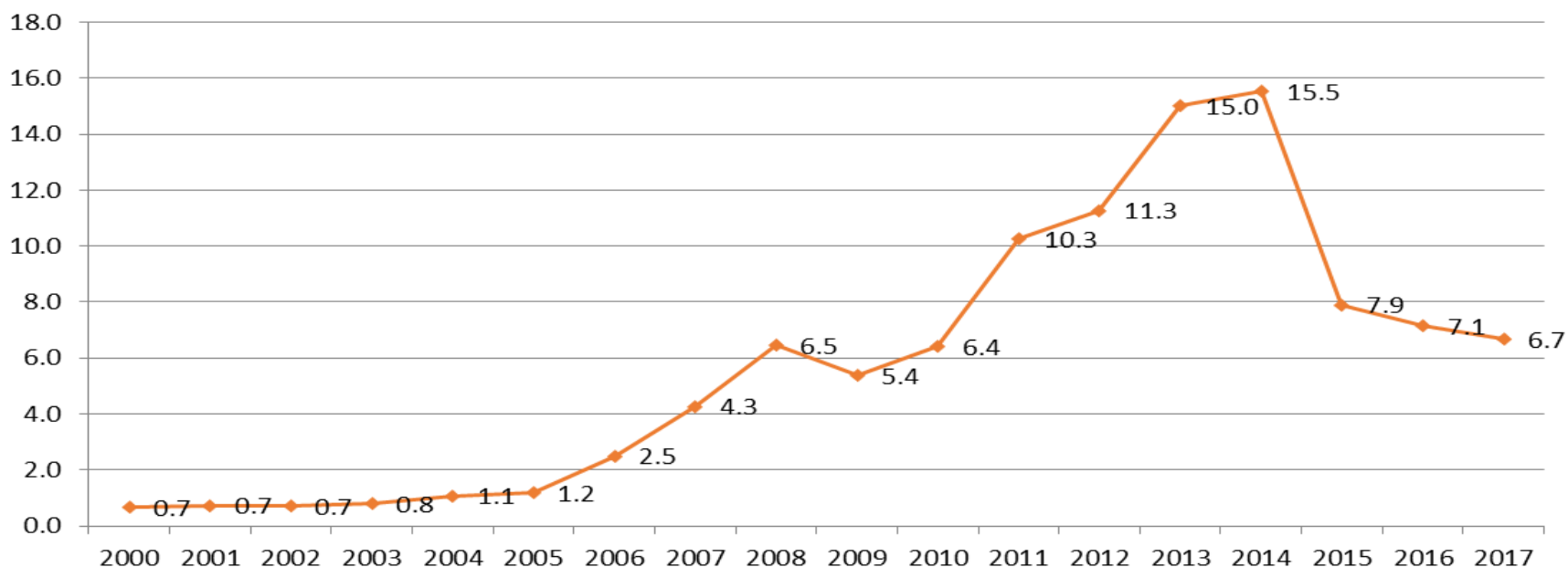
Foreign direct investment, net inflows (BoP, bln US\$)



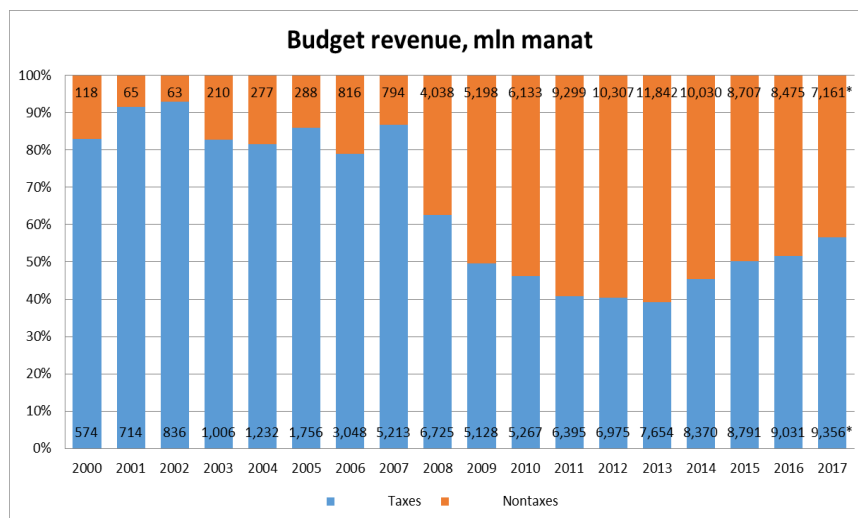
Unemployment rate (%)



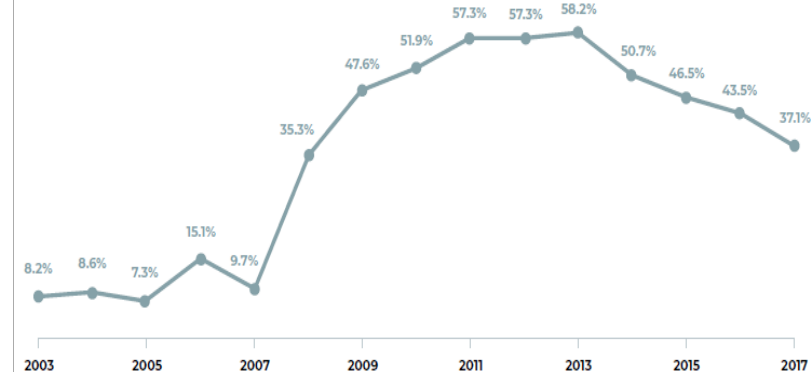
INTERNATIONAL RESERVES (Gold, Forex, SDRs) (\$bln)



Rapid development period (2004-2014) cont'd

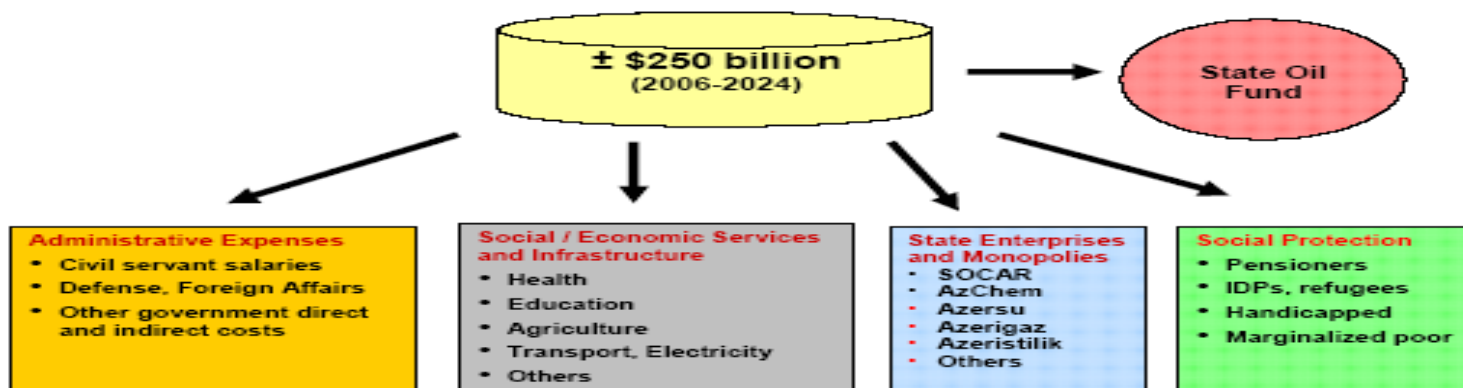


SHARE OF THE SOFAZ'S TRANSFERS IN THE STATE BUDGET REVENUES

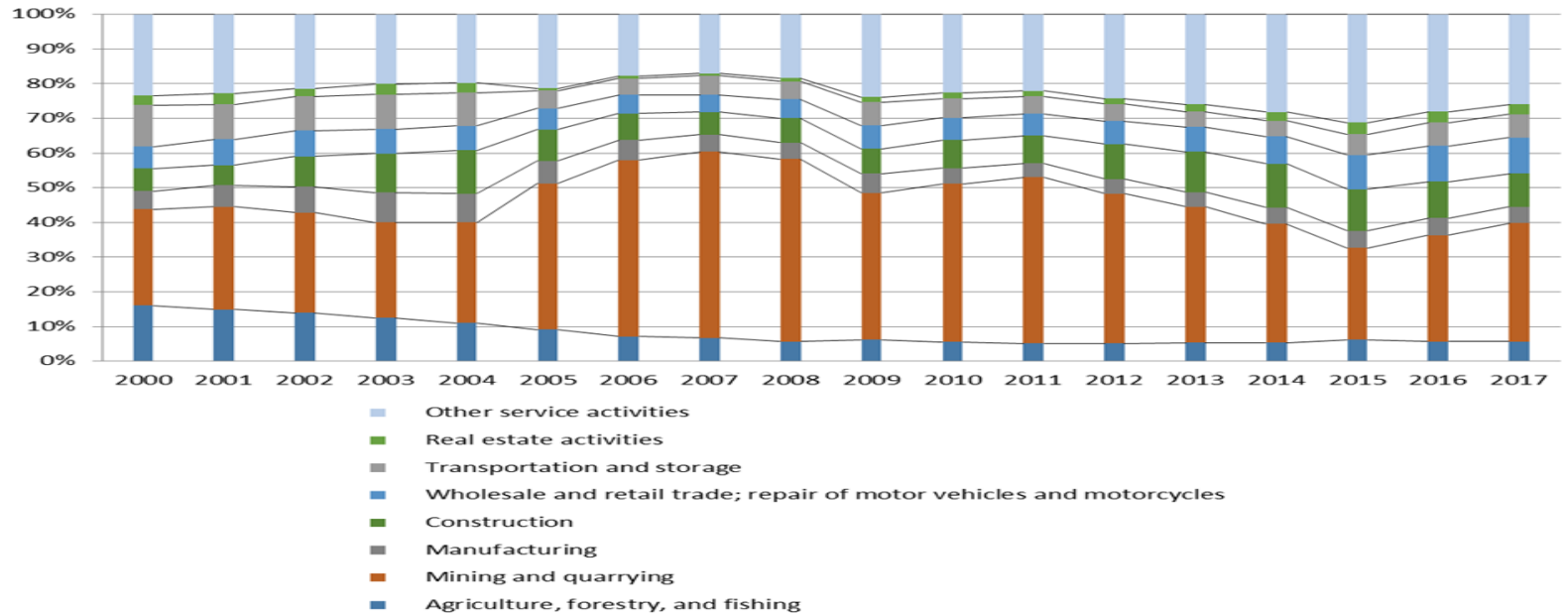


Source: SOFAZ, SSC of Azerbaijan

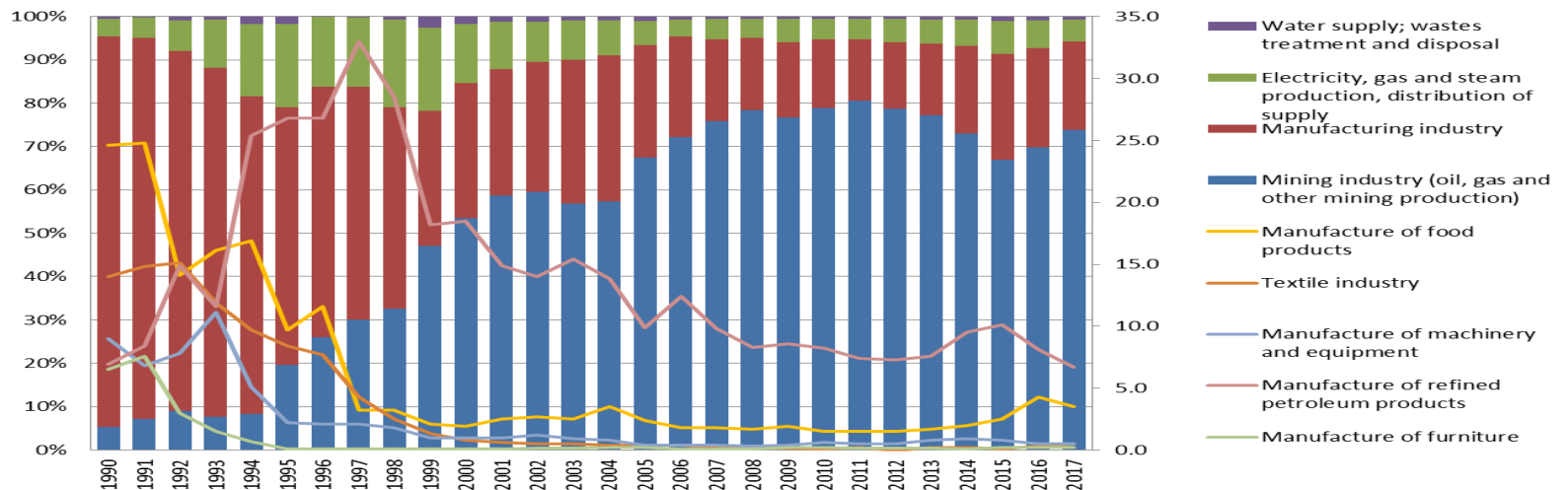
Oil Revenue Allocation Choices



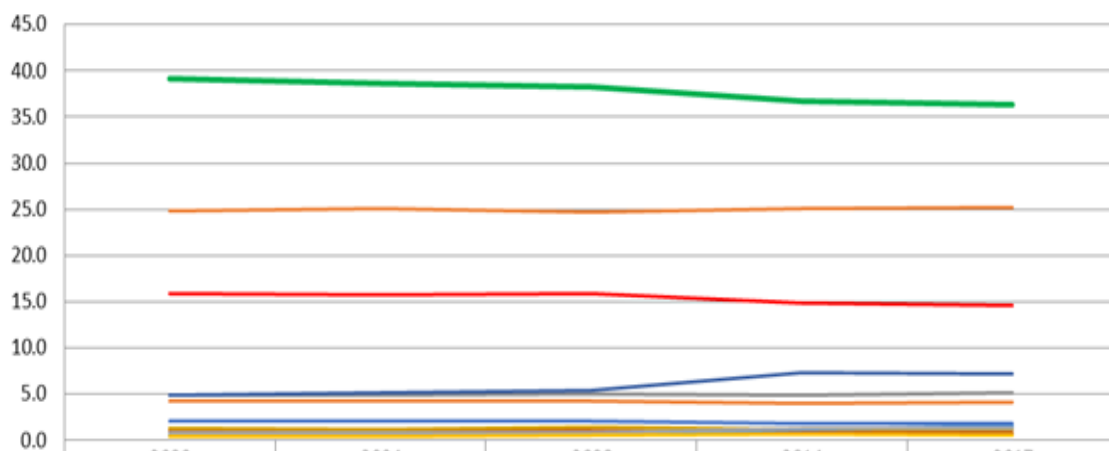
Structure of GDP by Industrial Origin, mln AZN



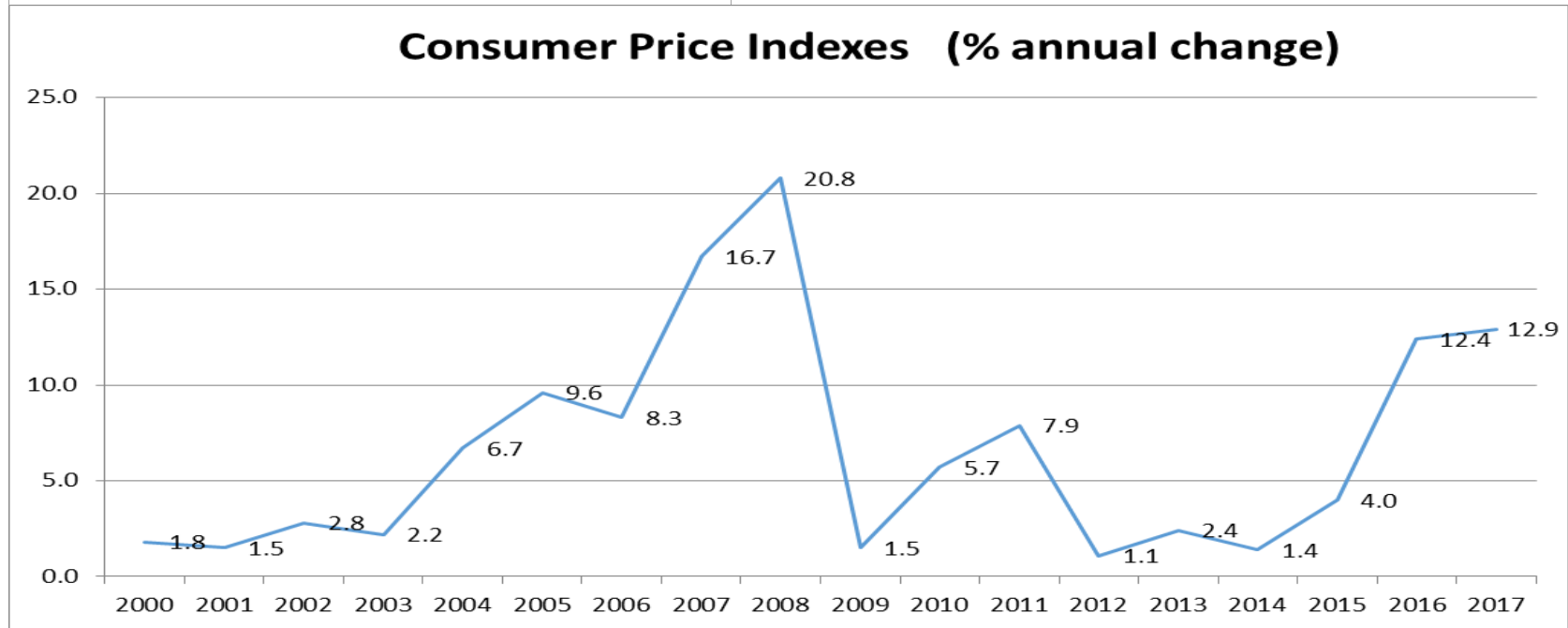
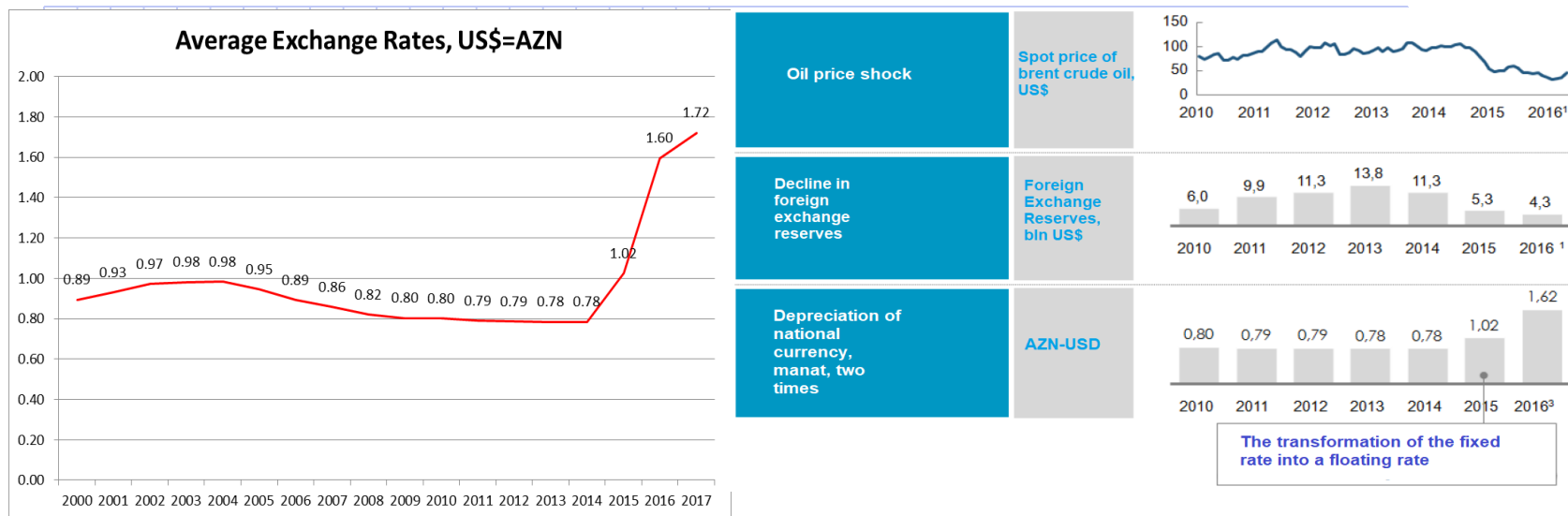
Sectoral Structure of Industry, total in %



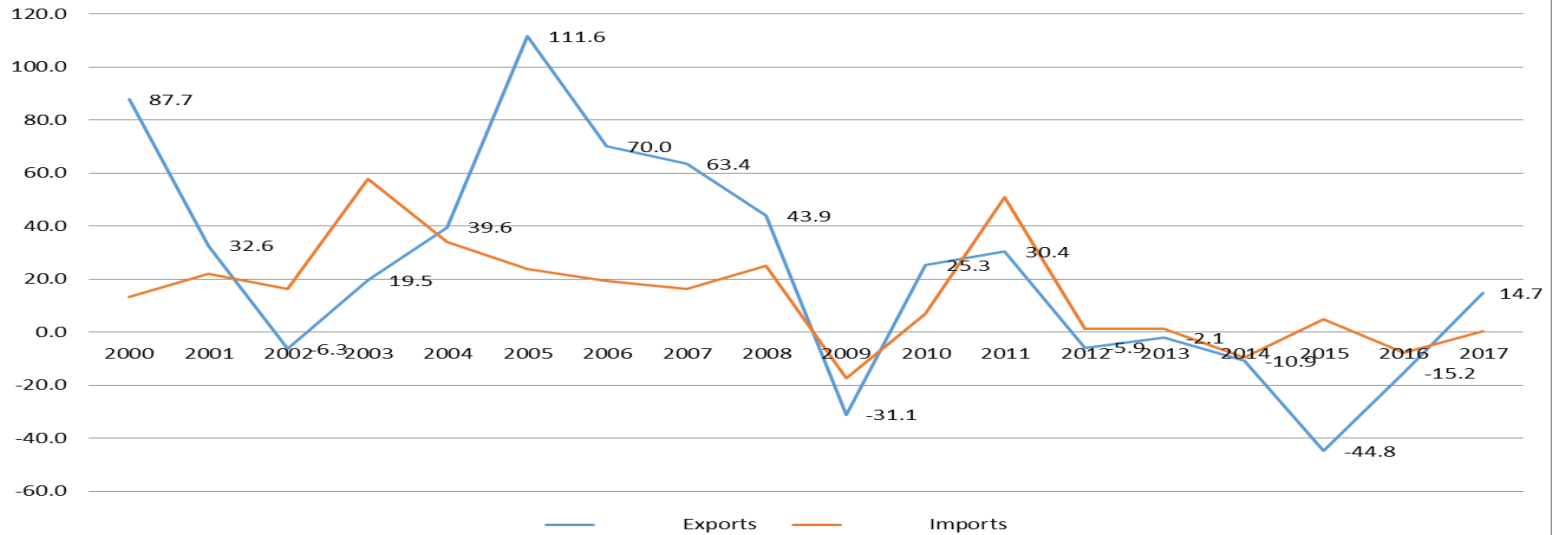
Employed by sectors, in %



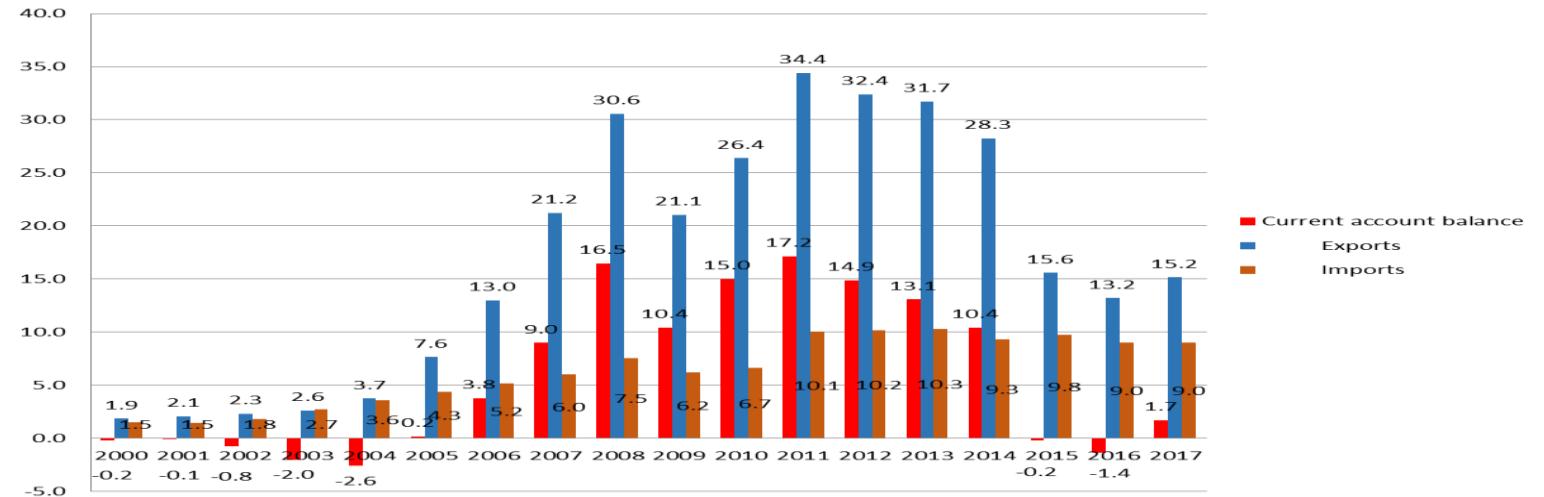
	2000	2004	2008	2014	2017
Agriculture, forestry, and fishing	39.1	38.6	38.2	36.8	36.4
Mining and quarrying	1.1	1.0	1.0	0.9	0.8
Manufacturing	4.9	4.9	5.0	4.9	5.2
Electricity, gas, steam, and air-conditioning supply; water supply; sewerage, waste management, and remediation activities	1.3	1.2	1.5	1.2	1.2
Construction	4.9	5.2	5.4	7.3	7.2
Wholesale and retail trade; repair of motor vehicles and motorcycles	15.9	15.7	15.9	14.8	14.6
Accommodation and food service activities	0.5	0.6	0.6	1.2	1.5
Transportation and storage	4.3	4.3	4.3	4.0	4.2
Information and communication	0.7	0.8	0.8	1.3	1.3
Financial and insurance activities	0.4	0.4	0.5	0.7	0.6
Real estate activities	2.0	2.1	2.0	1.9	1.8
Others	24.9	25.1	24.7	25.0	25.3



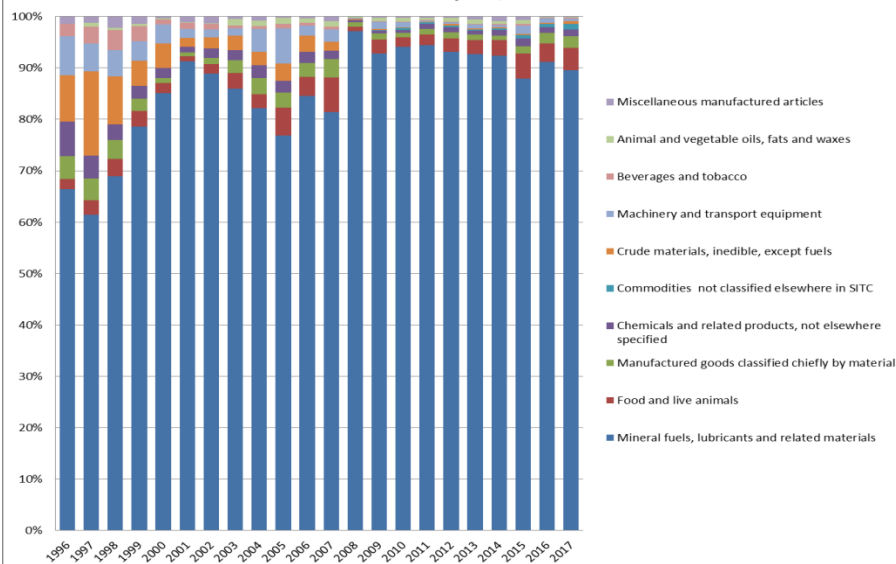
External trade, % change



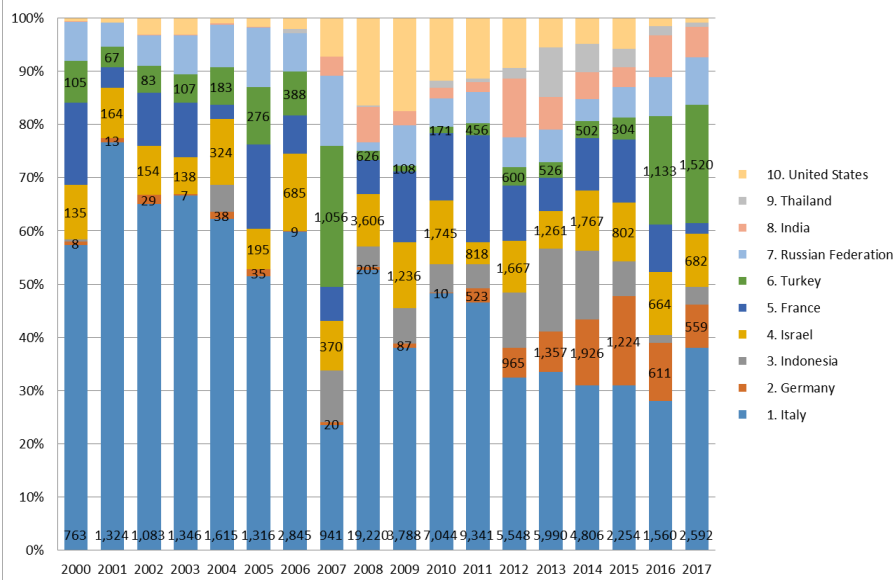
Balance of Payments, in US\$ bln



Structure of Export, % of total



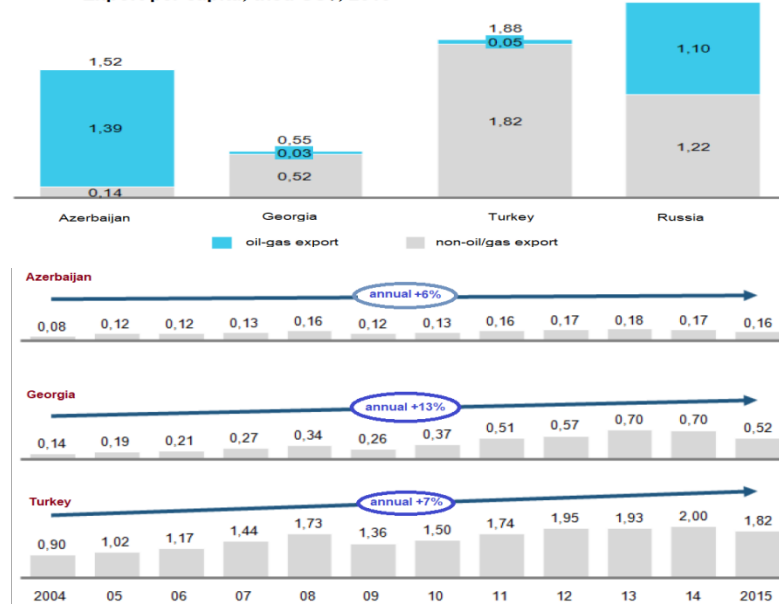
Main Export Partners, \$mln

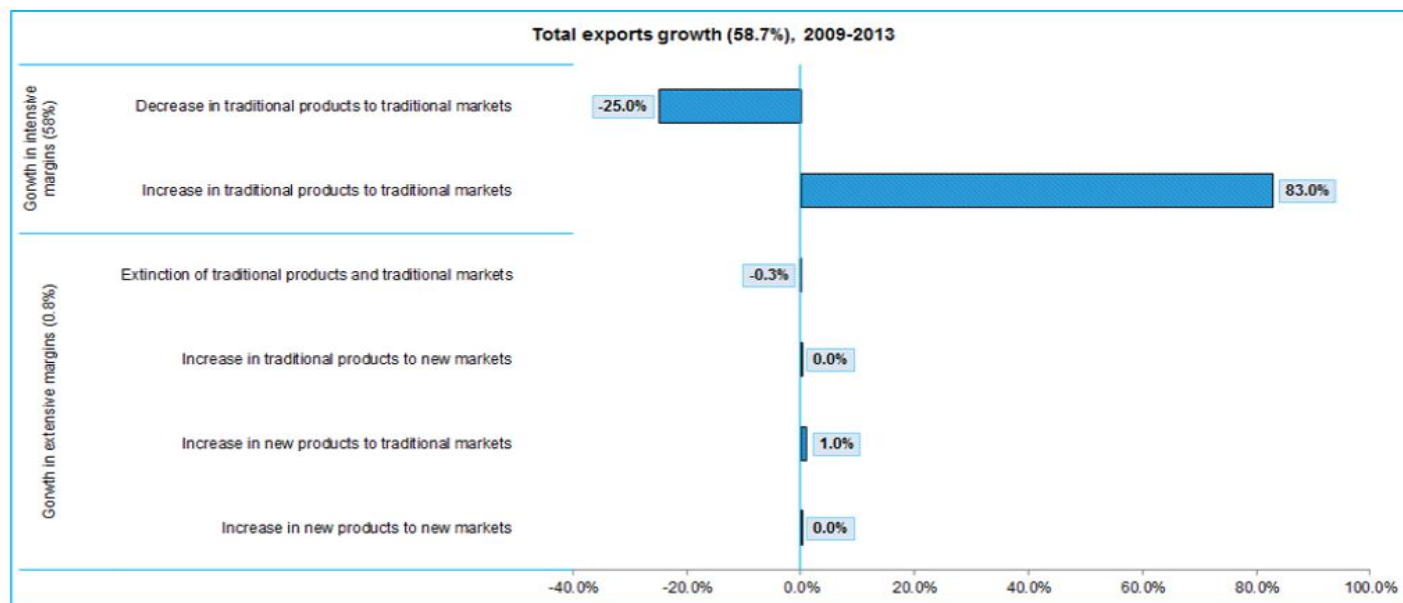


Sectoral diversification in products for Azerbaijan's exports (mirror)

Sector	Average share of sector in country's exports 2009-2013	Share of top 3 detailed products (HS6) in sector's exports		Sector's leading exported product HS6
		2009	2013	
Minerals	94.3 %	99.0 %	98.9 %	270900 Petroleum oils and oils obtained from bituminous minerals in primary forms
Processed food	1.5 %	49.3 %	46.8 %	220820 Spirits obtained by distilling grape wine or grape marc
Fresh food	1.2 %	58.8 %	60.6 %	081090 Fruits, fresh nes
Basic manufactures	0.8 %	81.7 %	63.8 %	760110 Aluminium unwrought, not alloyed
Chemicals	0.7 %	60.5 %	78.3 %	390110 Polyethylene having a specific gravity of less than 0.94
Transport equipment	0.4 %	88.7 %	78.8 %	890190 Cargo vessels nes&oth vessels for the transport of both persons&goods
Textiles	0.1 %	82.3 %	80.7 %	520512 Cotton yarn >=85%,single,uncombed,714.29 >tex>=232.56, not put up
Miscellaneous manufacturing	0.1 %	72.3 %	88.1 %	711319 Articles of jewellery&pt thereof of p rec met w/in plat/clad prec met
Non-electronic machinery	0.1 %	35.8 %	43.2 %	843143 Parts of boring or sinking machinery, whether or not self-propelled
Unclassified products	0.1 %	99.9 %	100.0 %	999999 Commodities not elsewhere specified
Wood products	0.0 %	77.3 %	70.1 %	480519 Fluting paper, uncoated, in rolls of a width > 36 cm or in square or r
IT & consumable electronics	0.0 %	74.4 %	62.9 %	851770 Parts of telephone sets, telephones for cellular networks other
Electronic components	0.0 %	33.8 %	60.6 %	853720 Boards,panels,includ numerical control panels,for a volt 1,000 V
Clothing	0.0 %	49.6 %	35.6 %	620349 Mens/boys trousers and shorts, of other textile materials knitted
Leather products	0.0 %	92.5 %	96.3 %	410411 Full grains, unsplit and grain splits, in the wet state "incl blu

Export per capita, thsd US\$, 2015

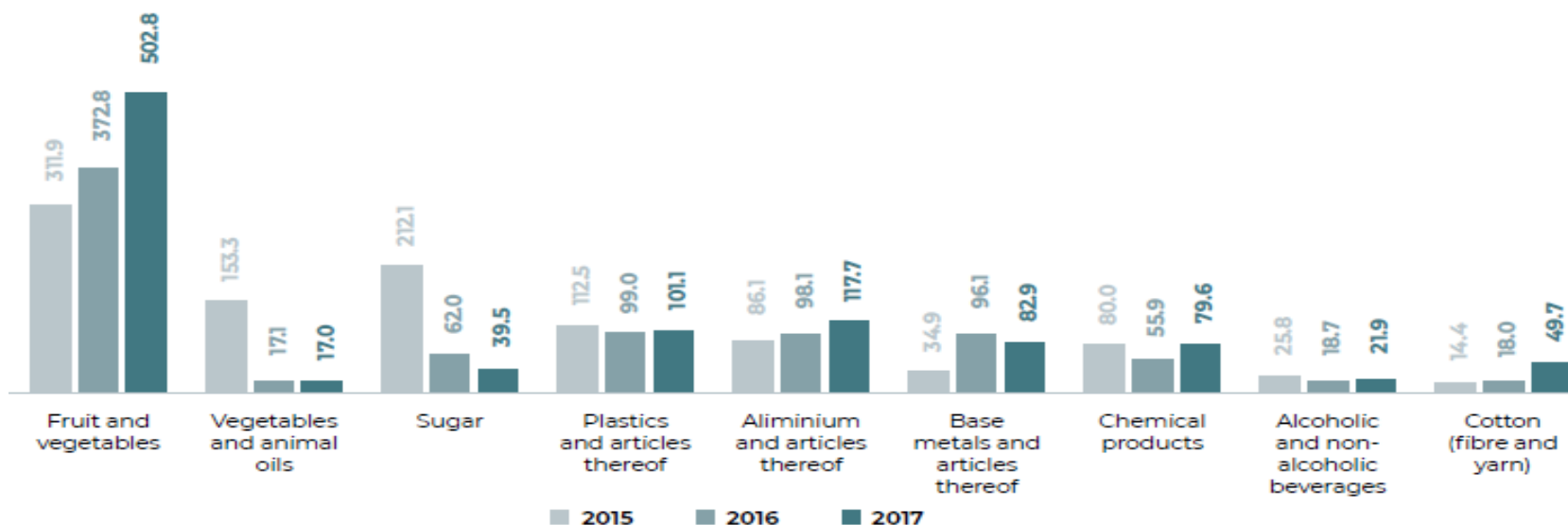




Source: ITC, calculations based on ITC's Trade Competitiveness Map data.

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)



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

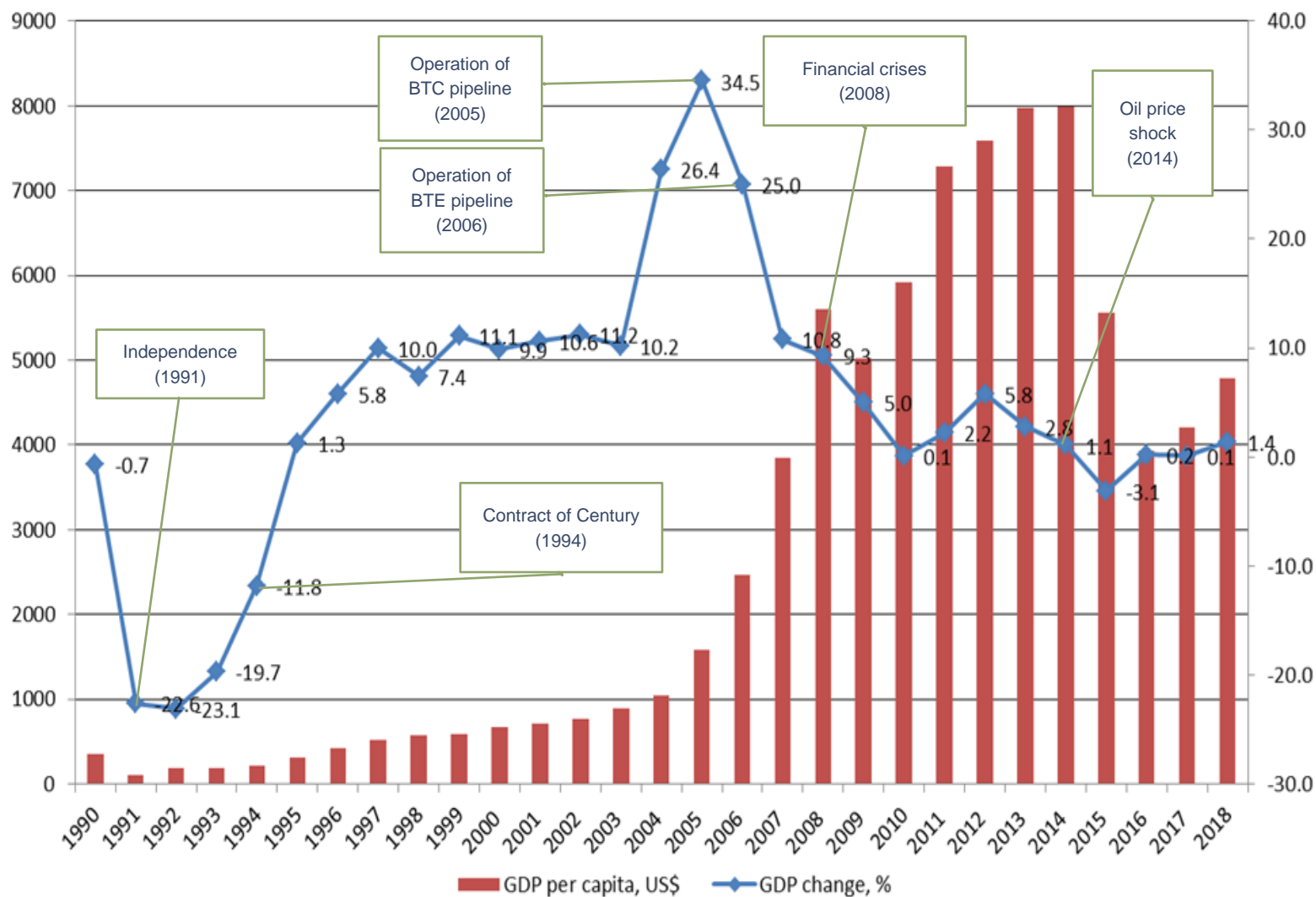
Reasons of failing economic diversification measures in tourism sector:

- 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 (2004-2017)

- 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



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	Harmful (negative) to achieving the objective
Internal origin (attitudes of the system)	<u>Strengths</u> <ul style="list-style-type: none"> - 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 	<u>Weaknesses</u> <ul style="list-style-type: none"> - 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
External origin (attitudes of the environment)	<u>Opportunities</u> <ul style="list-style-type: none"> - 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 	<u>Threats</u> <ul style="list-style-type: none"> - 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

Post-Oil Period: Deep Reforms

12 “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 Conducive to Private Sector Growth

A Public Sector that Enables Private Sector Growth

The Road to a More Diverse Economy

References

- “Azerbaijan 2020: look into the future” Development Concept. http://www.president.az/files/future_az.pdf
- Decree No 1897 of the President of the Republic of Azerbaijan, "Primary Directions of Strategic Roadmaps for National Economy and Main Sectors of Economy", 16 March 2016
- Decree No 1138 of the President of the Republic of Azerbaijan, "Approval of strategic road maps on national economy and the main sectors of economy", 6 December, 2016
<http://www.president.az/articles/21953>
- State Programs on the socio-economic development of the regions of the Republic of Azerbaijan in 2004-2008, 2009-2013 and 2014-2018
- K. Aslanli and et al, "ASSESSMENT OF ECONOMIC AND EXPORT DIVERSIFICATION" AZERBAIJAN, 2013
- State Statistics Committee of Azerbaijan, "From Salvation to Progress", Baku 2018
- Report of ADB: Country Partnership Strategy: Azerbaijan, 2014–2018
- The State Oil Fund of Azerbaijan: Annual Report 2017
- R. Rahmanov, "Permanent and Temporary Oil Price Shocks, Macroeconomic Policy, and Tradable Non-oil Sector: Case of Azerbaijan, Kazakhstan, and Russia"
- N. Guliyev, "THE EFFECTS OF EXTERNAL SHOCKS ON AZERBAIJAN ECONOMY"
- Osman Nuri Aras and et al, "Economy of Azerbaijan", Baku 2016
- AZERBAIJAN - 2030: FROM THE MILLENNIUM DEVELOPMENT GOALS TOWARDS THE SUSTAINABLE DEVELOPMENT GOALS, Volantury National Review, Baku 2017
- OECD (2019), Azerbaijan: Driving Diversification through Strengthened Entrepreneurship, OECD Publishing, Paris
- World Bank (2017), World Development Indicators, <https://data.worldbank.org/products/wdi>
- V. Bayramov, L. Orujova (2017), "Volatility, Diversification and Oil Shock in Resource-Rich Turkic Countries: Avenues for Recovery", Bilig
- 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!

rovshanm@carecinstitute.org