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## Country Report

# Azerbaijan

### Azerbaijan at a glance: 2004-05

#### OVERVIEW

Ilham Aliyev, the son of the outgoing president, Heydar Aliyev, was elected president in a seemingly fraudulent election held on October 15th. So far the elite has rallied around the younger Mr Aliyev to ensure a reasonably smooth political transition. The Economist Intelligence Unit's baseline forecast assumes that Ilham Aliyev will consolidate his authority and remain in power over the forecast period. However, there is still a risk that his lack of political experience could result in members of the ruling elite challenging his authority, particularly now that his father is no longer on the scene. The economy is expected to continue to grow rapidly, owing to external investment in the energy sector and rising oil exports. Real GDP growth is forecast to decelerate to 8.5% in 2004 as oil prices decline sharply, before rising to 12% in 2005 as oil output increases substantially. Prudent monetary policy will help to keep inflation in check and to ensure nominal currency stability against the US dollar. The current-account deficit is forecast to increase rapidly, owing to substantial imports of capital goods and services for the hydrocarbons sector, but it will be easily financed by inflows of foreign direct investment (FDI).

#### Key changes from last month

##### Political outlook

- The former president, Heydar Aliyev, died in mid-December 2003, ushering in a new period in Azerbaijani politics. Nevertheless, at present we retain our view that the ruling elite will support his son, Ilham, especially since there does not appear to be a viable alternative to him at present.

##### Economic policy outlook

- Our expectation of higher oil prices in 2004 than the government anticipates bolsters our view that the state budget will meet its deficit target of 0.8% of GDP.

##### Economic forecast

- The release of multilateral funding for the construction of the Baku-Tbilisi-Ceyhan (BTC) oil pipeline reinforces our opinion that the BTC project will be completed on schedule in 2005, resulting in a sharp increase in oil exports.

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## Outlook for 2004-05

### Political outlook

#### Domestic politics

The political scene is experiencing a period of uncertainty following the October presidential election, in which the president, Heydar Aliyev, who had governed Azerbaijan since 1993, was succeeded by his son, Ilham Aliyev. Although the younger Mr Aliyev will inhabit the office of his father and wield the same constitutional powers, his success as president will depend on his personal political skills and network, neither of which at present seem a match for those of his father. However, Ilham Aliyev benefits from the fact the opposition is disorganised, fractious and lacks political credibility. In addition, the opposition's organisation of relatively poorly attended demonstrations, in protest against the result of the election, has given Ilham Aliyev the justification to launch a crackdown. This has the added advantage that it has sent a signal to potential rivals that he is willing, and has the ability, to deal ruthlessly with any dissent. Ilham Aliyev also benefits from some international support from countries that include the UK, the US and Russia.

The death of Heydar Aliyev in December 2003 heralds a new period in Azerbaijani politics. While Heydar Aliyev was still alive, even if in a serious condition in a US hospital, he still exerted some influence on the political scene. This deterred potential contenders for the presidency from making an open bid for power, with the elder Mr Aliyev's close associates publicly rallying around the former leader's son over the past few months (the main potential challenges to Ilham Aliyev's authority come from within the ruling elite). It will therefore take a few months before Ilham Aliyev can genuinely be considered to have consolidated his position, since any challenge to his rule is likely to come in the early stages of his presidency, when he is at his most politically inexperienced.

If Ilham Aliyev fails to convince the ruling elite that he has the ability to protect their interests, or suffers embarrassment as a result of an ongoing investigation into corruption in the US, then members of the elite might decide to move against him. It is as yet unclear if he can rely on the support of the security services and the military, in the event that his bid to remain in power is challenged by the elite. It is therefore quite possible that the succession will be disorderly and could also be violent, with a new strongman emerging to impose order. Ilham Aliyev may be tempted to allow lower-ranking, but still powerful, members of the elite considerable autonomy, so as to enrich themselves, as a means of curbing their political ambitions and retaining their support. At present, the Economist Intelligence Unit is assuming that the risk of political instability is low and we anticipate that Ilham Aliyev will establish his authority and remain in power over the forecast period. Despite the risk of upheaval, there is unlikely to be the sort of prolonged instability and violence that might disrupt the operations of Azerbaijan's main foreign investors—oil companies working offshore. Moreover, these oil companies are unlikely to pull out in the event of political instability, since they have already made considerable investment in the oil sector but have yet to receive a profit on their outlays.

**International relations** The Economist Intelligence Unit does not expect the ongoing territorial dispute with Armenia over Nagorny Karabakh—a region that is formally part of Azerbaijan, but which has an ethnic Armenian majority and is under Armenian military control—to be resolved over the forecast period. Domestic hostility towards any concessions on crucial issues in both Armenia and Azerbaijan is expected to prevent a settlement. However, the impasse is unlikely to bring significant political instability. Good relations with Russia are vital, as Russian support for Ilham Aliyev could be a key factor in determining whether he is able to survive domestic political challenges and consolidate his authority. Azerbaijan will therefore try to maintain its improved relationship with Russia by staying sensitive to Russian concerns (for example, by co-operating with Russia in what Russia sees as a war against terrorism in Chechnya). At the same time, Azerbaijan has ensured good relations with the US by becoming part of the coalition that backed “Operation Iraqi Freedom”, and by sending a token number of peacekeeping forces to Iraq. However, an ongoing investigation in the US into corruption surrounding the Azerbaijani privatisation process could prove embarrassing, as high-ranking Azerbaijani officials are allegedly involved.

## Economic policy outlook

**Policy trends** Ilham Aliyev stressed his commitment to following the same policy direction as his father in both his electoral campaign and his inaugural address. This implies that the government will retain its favourable legal and regulatory environment for foreign investment in the hydrocarbons sector, especially since the country lacks the funds to develop its main asset on its own. Increasing production in the oil and gas sector and high foreign investment—which in the hydrocarbons sector is relatively insensitive to the overall investment climate and operating environment—will ensure continued macroeconomic stability and high real GDP growth rates over the next few years. However, structural reforms will continue to lag, particularly in areas such as corporate governance, judicial reform, large-scale privatisation and restructuring. The government will use part of its gradually accumulating oil wealth to implement social welfare programmes, in order to mitigate popular discontent over widening income differentials between the ruling class and the public. Oil revenue will also be used to subsidise some uncompetitive sectors, rather than reforming them, since restructuring would entail mass lay-offs.

In the event that the presidential succession process were to result in a bout of instability, reforms, limited though they are, would be put on hold. However, every effort would be made to ensure that the operating environment for oil companies remains favourable. There is a possibility that if Ilham Aliyev consolidates his authority and obtains the support of the elites associated with the police, armed forces and security services, he may be willing, and have the ability, to implement the more painful reforms needed to boost the performance of the non-oil sector. However, this is unlikely to occur in the short term, since Ilham Aliyev is probably unsure of his support base and is as yet an untested politician.

**Fiscal policy** The state budget for 2004 (which differs from the consolidated budget, which is reported in our forecast tables) targets a deficit of Manat315bn (US\$63m; 0.8% of GDP), based on real GDP growth of 9% and an oil price assumption of US\$20/barrel. Budget revenue is expected to rise by 13.8% year on year, to Manat6,934trn, and expenditure is targeted to increase by 12.9%, to Manat7,249trn. We currently expect oil prices to average US\$22.4/b for dated Brent Blend, higher than the government's assumption. Since over 40% of budget revenue comes from the oil sector, we expect the government to meet its target. The budget is forecast to record a surplus in 2005, as we anticipate that a rapid rise in oil production will outweigh a slight decline in oil prices.

There is a risk that, if oil prices fall below the government's estimate, the deficit could overshoot its target. The overdependence of budget revenue on the oil sector means that even a small change in oil price expectations will have a significant knock-on effect on revenue from corporate income tax and customs and excise taxes relating to the hydrocarbons sector. Moreover, the authorities will be reluctant to reduce expenditure in order to meet the budget target, for fear of stoking public unrest by reducing spending on social welfare.

**Monetary policy** The Azerbaijan National Bank (ANB, the central bank) in recent years has followed a policy of informal exchange-rate targeting, allowing for a modest depreciation against the US dollar within a narrow band. Over the forecast period, however, the ANB will find it increasingly difficult to ensure the nominal depreciation of the currency against the US dollar, in view of the anticipated rise in inflows of foreign direct investment (FDI). In order to achieve the desired depreciation, the ANB might therefore be forced to accept a more rapid rise in the money supply, as it will be forced to intervene even more actively on foreign-exchange markets. This is unlikely to have serious inflationary effects, in view of the extent to which the economy is demonetised. However, it still raises the risk of inflation, and thus the risk that the ANB will decide to make use of other policy instruments as well—such as raising interest rates—in order to keep inflation in check. The ANB has already committed itself to raising its benchmark rate, the refinancing rate, if year-on-year consumer price inflation reaches 4%.

## Economic forecast

### International assumptions

### International assumptions summary

(% unless otherwise indicated)

	2002	2003	2004	2005
<b>Real GDP growth</b>				
World	2.9	3.5	4.2	4.1
EU	1.0	0.7	2.0	2.2
Turkey	7.8	4.6	-4.0	4.5
<b>Exchange rates</b>				
¥:US\$	125.3	116.0	104.5	106.5
US\$:€	0.945	1.132	1.273	1.245
SDR:US\$	0.772	0.714	0.668	0.676
<b>Financial indicators</b>				
€ 3-month interbank rate	3.33	2.35	2.20	2.75
US\$ 3-month commercial paper rate	1.70	1.10	1.43	3.56
<b>Commodity prices</b>				
Oil (Brent; US\$/b)	25.0	28.7	22.4	20.1
Gold (US\$/troy oz)	310.3	357.8	350.0	320.0
Food, feedstuffs & beverages (% change in US\$ terms)	12.7	6.1	1.7	6.8
Industrial raw materials (% change in US\$ terms)	2.2	11.8	11.1	0.3

Note. Regional GDP growth rates weighted using purchasing power parity exchange rates.

The global economy is accelerating, and we forecast that world GDP growth (on a purchasing power parity basis) will average 4.2% in 2004, slowing fractionally to 4.1% in 2005, after expanding by an estimated 3.5% in 2003. Latest data in many of the world's largest economies suggest that growth has picked up significantly, with output in the third quarter of 2003 rising at its fastest pace since early 2000. The euro zone also seems to be recovering, with third-quarter GDP data showing that the recession seen in some countries in the first half of 2003 has come to an end. However, we remain concerned about the weakness of domestic demand—the recent upturn seems to have been driven by exports (despite the strong euro), rather than stronger consumption or investment. We expect growth in the euro zone to accelerate more significantly from mid-2004 onwards, as capital expenditure starts to rise in the sectors that were least affected by the investment boom of the late 1990s, but performance will remain disappointing compared with the rates seen in the late 1990s.

Oil prices—which are currently inflated by the lack of Iraqi oil and the perception that the market is undersupplied—look set to fall as the market returns to oversupply. Oil prices are expected to fall by over 20% year on year in 2004 to an annual average of US\$22.4/b, with a smaller decline in 2005. A possible alternative scenario is that supply disruptions of the kind seen in Iraq, Venezuela or, to a lesser extent, Nigeria, will continue to affect the market for at least another year. In particular, instability in Iraq, which has held back oil production, could continue to disrupt Iraqi oil supplies for many years to come, certainly throughout much of 2004 and 2005.

### Economic growth

Year-on-year real GDP growth was 10.5% in the first nine months of 2003 and was fuelled by a rapid rise in fixed investment, which almost doubled in year-on-year terms. The bulk of this investment is from foreign firms and is related

to four large hydrocarbons projects currently under way. FDI will therefore be the main factor driving economic growth over the forecast period. However, the concentration of growth and investment in the hydrocarbons sector means that the rest of the economy only benefits indirectly from the high degree of foreign investment. Oil- and gasfield development will have important spillover effects on sectors such as pipeline construction and some related services (for example, transport and communications, and hotels and catering). We expect economic growth to decelerate to 8.5% year on year in 2004, since oil prices are anticipated to decline sharply and will not be counterbalanced by only gradually rising oil production. Economic growth is forecast to accelerate to 12% year on year in 2005, when oil production will almost double with the completion of the Baku-Tbilisi-Ceyhan (BTC) oil pipeline, which will have a capacity of 1m barrels/day.

The poor investment climate and bureaucratic obstacles outside the hydrocarbons sector mean that non-oil-related sectors receive barely any foreign or domestic investment. The dichotomy between the two sectors will be accentuated over the forecast period. This implies that the non-oil sector's contribution to exports—which is already less than 10% of export revenue—is likely to fall further. Azerbaijan will therefore become even more reliant on oil and gas production and exports, increasing its sensitivity to external shocks, with negative implications for long-term growth.

**Inflation** One of the greatest concerns of policymakers is that the enormous inflows of FDI, which began to pour in at the beginning of 2002, will push up consumer price inflation. The creation of the overseas State Oil Fund of the Republic of Azerbaijan (SOFAZ) as a mechanism for keeping the oil windfall offshore is one means of avoiding both an inflationary surge and a real appreciation of the exchange rate. Consumer price inflation over the forecast period will therefore be driven by a booming services sector related to hydrocarbons development, which will result in job creation and fuel nominal wage increases. At present, we expect annual inflation to remain below 4% in 2004-05, since the economy is substantially demonetised. Nevertheless, there is a risk that, in the event of higher oil prices than we currently expect, Azerbaijan's limited sterilisation instruments could be insufficient to contain the impact of capital inflows, leading to a steeper rise in inflation.

**Exchange rates** Despite massive hard-currency inflows since the beginning of 2002, the ANB has managed to prevent the real appreciation of the manat against the US dollar. However, even higher inflows of FDI over the forecast period will make it more difficult for the ANB to ensure that the currency continues to depreciate nominally. In addition, revenue from SOFAZ is to be used to fund social welfare schemes, which will put further pressure on the exchange rate. Relatively stagnant export revenue in 2004 will ensure that the manat will depreciate by about 1% in nominal terms, but the depreciation will be reversed in 2005, owing to a surge in oil export volumes. The extent of a real appreciation in 2005 will nevertheless be contained by moderate inflation.

**External sector** Hydrocarbons development will lead to a marked deterioration in the trade and services balances, which will result in burgeoning current-account deficits over the forecast period. Capital imports and services related to construction, transport, drilling and consulting will increase sharply in 2004-05, since Azerbaijan has an insufficiently developed industrial base and the domestic market is ill-equipped to service oil and gas investors. The current-account deficit is expected to surge to an estimated 36.5% of GDP in 2004, as export revenue will barely rise in year-on-year terms—oil prices are forecast to decline by 22% in that year, more than offsetting a slight increase in oil export volumes. However, the current-account deficit will fall in 2005, when oil production is set almost to double. These large deficits are unlikely to threaten macroeconomic stability, since they will largely be covered by FDI and multilateral financing—foreign investment in the hydrocarbons sector tends to ebb and flow according to the project cycles of specific ventures.

#### Forecast summary

(% unless otherwise indicated)

	2002 <sup>a</sup>	2003 <sup>b</sup>	2004 <sup>c</sup>	2005 <sup>c</sup>
Real GDP growth	10.6	10.0	8.5	12.0
Industrial production growth	3.6 <sup>b</sup>	5.0	7.0	12.0
Gross fixed investment growth	30.0 <sup>b</sup>	34.0	39.0	30.0
Unemployment rate (av)	1.0	1.2	1.2	1.4
Consumer price inflation (av)	2.8	3.0	3.3	3.6
Consumer price inflation (year-end)	3.2	3.5	3.5	3.3
Short-term interbank rate	17.4	15.4	14.6	14.1
Consolidated government balance (% of GDP)	-0.4	-1.2	-1.5	0.3
Exports of goods fob (US\$ bn)	2.3	2.6	2.7	3.9
Imports of goods fob (US\$ bn)	1.8	2.5	3.4	3.9
Current-account balance (US\$ bn)	-0.8	-1.7	-2.8	-2.4
Current-account balance (% of GDP)	-12.6	-25.0	-36.5	-26.0
External debt (year-end; US\$ bn)	1.3 <sup>b</sup>	1.5	1.7	1.9
Exchange rate Manat:US\$ (av)	4,861	4,918	4,958	4,802
Exchange rate Manat:Rb (av)	134	136	137	133
Exchange rate TL:Manat (av)	310	306	321	530

<sup>a</sup> Actual. <sup>b</sup> Economist Intelligence Unit estimates. <sup>c</sup> Economist Intelligence Unit forecasts.

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