Oxford Analytica East Europe Daily Brief(c)
Monday, February 9, 2004

AZERBAIJAN: Strong GDP growth -- 11.2% in 2003 -- illustrates the benefits of a fossil fuel-driven development path. However, lingering political problems -- internal and external -- are jeopardising non-oil modernisation, and making Azerbaijan singularly unattractive to non-oil investors who require market scale, open borders and regional stability. See EEDB, February 9, 2004, I.

I AZERBAIJAN: Oil-fired economy

EVENT: The economy expanded by 11.2% in 2003, it was reported last week.

SIGNIFICANCE: Strong GDP growth illustrates the benefits of Azerbaijan's fossil fuel-driven development path. However, lingering political problems -- internal and external -- are jeopardising non-oil modernisation.

ANALYSIS: On December 30, the IMF released the third tranche of Azerbaijan's 100 million dollar Poverty Reduction and Growth Facility (PRGF), signalling the Fund's favourable assessment of the country's economic performance. The IMF forecasts a slowdown in real GDP growth, from 11.2% in 2003 to 8.1% in 2004, but a sharp rise to 14.0% in 2005 as the first proceeds from the Baku-Tbilisi-Ceyhan (BTC) oil pipeline arrive (see EEDB, December 2, 2003, II.).

Favourable indicators. Consumer price inflation is low (2.2% in 2003, with 2.5% predicted for 2004). The fiscal deficit fell from 2.6% of GDP in 2002 to 1.6% in 2003, the result of a surge in oil-related tax receipts. In accordance with the IMF programme, the authorities earmarked a portion as a cushion against reductions in world oil prices in future years. In line with IMF forecasts, broad money supply grew by 28% in 2003, reflecting a welcome increase in liquidity demand in a post-Soviet economy beset by low monetisation.

Meanwhile, the National Bank of Azerbaijan (NBA) has kept movement of the manat within the prescribed trading band, allowing a modest real depreciation that has helped preserve the country's export competitiveness. Azerbaijan has thus far eluded the 'Dutch disease' that plagues many oil-producing economies (see EEDB, January 3, 2003, I.).

External position. After three years of a positive trade balance, foreign trade edged into deficit in 2003. Exports rose by 19.6% to 2.59 billion dollars, but imports by 57.8% to 2.62 billion. However, this was due to the short-term requirements of BTC construction, which will reap benefits in the long term. The debt service ratio (5.8% of exports) is one of the lowest in the former Soviet Union. Foreign reserves grew by 11.3% to 757 million dollars, owing to the steady accumulation of oil revenues. At 38% of GDP, Azerbaijan's current account deficit is large for a transitional economy. However, oil-related foreign direct investment (FDI) suffices to cover this deficit, which the IMF expects to fall to 20% by 2005.

Economic structure. Even in structural reform -- where Azerbaijan has lagged behind Armenia, Kyrgyzstan and other Soviet successor states -- the IMF is surprisingly upbeat. Fund officials rebuked the government for permitting an increase in energy subsidies and quasi-fiscal subsidies in 2003 and voiced their displeasure with the NBA's issuance of a low-interest, collateral-free loan to private bank Most. However, they noted the government's assent to a provision in a draft NBA law prohibiting such loans in the future, and commended its progress

in commercial bank privatisation and restructuring. The January 26 announcement by Unibank of Azerbaijan's first manat-denominated corporate bond issue was a small but significant step towards forming a local capital market. Finally, the government's sale of its share of mobile phone operator Bakcell and its pending divestiture of Azercell illustrated movement in telecoms privatisation, a critical factor in the economy's technological modernisation.
Caspian oil. Progress in oil and gas projects in the Caspian creates further grounds for optimism:

BTC. Work on the pipeline continues apace, despite a strike in Georgia's section. Completion is due by end-2004, allowing the first deliveries to Turkey during April-June 2005. Principal operator BP-Azerbaijan put pressure on Turkey's Botas to accelerate work on its section.

Azeri-Chirag-Gunashli. US firm McDermott has begun laying an underwater gas pipeline for this offshore project, which will enlarge Azerbaijan's capacity to produce natural gas now imported from Russia. The Azerbaijan International Operating Company estimates that the first phase will yield 375,000 barrels per day (b/d) of oil, and the second phase (to be dr
illed in 2006-07) 420,000 b/d.

Shah Deniz. Probes in this large offshore gasfield indicate recoverable reserves exceeding 400 billion cubic metres. Shah Deniz gas will be transported from Baku to Turkey via a pipeline, construction of which is scheduled to begin in 2004.

Legal claims. On January 15, an Iranian delegation arrived in Baku for negotiations on remaining differences over the division of the Caspian seabed. Together with Azerbaijan's 2003 bilateral agreements with Russia and Kazakhstan recognising the 'median line' principle, the Baku-Tehran talks raise hopes for a break in the long impasse between the littoral states a development that would revitalize exploration projects stalled by jurisdictional uncertainties. Azerbaijan's growing role as an oil and gas producer is boosting ts leverage in foreign economic relations. Reflecting the istributional flexibility afforded by BTC, in early January the tate Oil Company of Azerbaijan announced that it had rejected Russia's proposal to extend the bilateral agreement on transporting oil through the Baku-Novorossiisk line. Baku has also dismissed Kazakh President Nursultan Nazarbayev's suggestion for creating an OPEC-type cartel of Caspian states.

Economic diversification. The looming question is whether Azerbaijan can convert its fossil fuel wealth into broader economic development. The IMF has made oil revenue management the centrepiece of the next phase of its PRGF, emphasising the urgencyof a sustainable development strategy that will insulate the economy from oil price fluctuations and dedicate resources for diversification into non-oil sectors. To that end, Fund conomists are recommending modest increases in Azerbaijan's non fiscal deficits to boost investments in infrastructure and human capital and permit reductions in the non-oil enterprise profit tax.

However, stimulating the required FDI in manufacturing, agriculture, tourism and other non-oil sectors economic diversification depends on transforming the country's domestic political system and regional relations:

1. Authoritarianism. Since the disputed presidential election in October, the new government of Ilham Aliyev has arrested about a thousand opposition leaders ad pro-democracy activists, provoking a sharp rebuke from Human Rights Watch and inviting invidious comparisons with developments in neighbouring Georgia. Meanwhile, the Deutsche Bank Eurasia Group's newly released index of political stability rated

Azerbaijan next to last (ahead of only Nigeria) among 25 emerging markets.

Aliyev's political crackdown has prompted a muted response from the Bush administration, which waived sanctions under the US Freedom Support Act to release bilateral assistance to reward Azerbaijan for its support of the 'war on terror'. Washington's apparent reluctance to bring pressure to bear on the younger Aliyev to initiate serious political reform calls into question the country's ability to attract investors demanding transparency, regulatory uniformity and rule of law.

2. Karabakh. In late December, parliamentary representatives from Azerbaijan and Armenia convened in Scotland for talks on disputed Nagorno-Karabakh. The result of these discussions was a bland communique declaring the countries' agreement that a peaceful resolution was the only acceptable outcome and establishing a rotating presidency (initially held by Georgia,which also dispatched a delegation) to govern continuing negotiations. The Scotland talks were clearly a welcome development to the extent that they initiated a formal, regular process to guide direct contacts between Armenia and Azerbaijan, previously limited to ad hoc meetings between President Robert Kocharian and now-deceased Heydar Aliyev. However, the intractability of the territorial and political issues surrounding the Karabakh dispute together with the profound animosity and distrust between the two countries -- provide scant grounds for optimism that these new discussions will reach a settlement that has been elusive for nearly a decade.

CONCLUSION: While Azerbaijan is certain to attract heavy amounts of oil-related investment, the bleak prospects for a break through on the Karabakh conflict make the country singularly unattractive to non-oil investors who require market scale, open borders and regional stability.