

# Boom and gloom

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## Azerbaijan's economy, drunk on oil, is suffering rapid inflation

Azerbaijan is the world's fastest growing economy, thanks to an oil boom, but it is already running into serious difficulty. A huge expansion in budgetary spending has pushed inflation close to double digits—in month-on-month terms—and there are early but ominous signs that the non-oil economy is losing competitiveness. The economy is already showing signs of Dutch Disease—and the maintenance of artificial monopolies throughout the economy will serve to exacerbate the problem.

Azerbaijan is in the midst of a dizzying period of economic expansion. Real GDP grew by 26.4% in 2005 and 34.5% in 2006, and is forecast to grow by around 21% this year. The main driver of this is the oil sector. The BP-led Azerbaijan International Operating Company (AIOC) has been steadily ramping up production from the Azeri-Chirag-Guneshli offshore complex and has now completed the Baku-Tbilisi-Ceyhan oil pipeline, which lays the foundations for yet higher output. Oil output grew by 41% in 2005 and 45% in 2006, and is set for a similar performance this year.

The oil boom has fuelled other sectors of the economy. The non-oil sector grew by 11% in 2006, propelled mainly by services. Baku, the capital, is in the midst of a construction boom that is impressive even by the standards of the transition region. Yet already distress signals are apparent. In 2006 the government increased budgetary spending by an astonishing 80%; a further 50% increase is anticipated this year. At the start of 2007, the impact of the huge fiscal stimulus began to tell on inflation. In annual average terms, inflation was 8.3% in 2006 and ended the year at 11.4% year on year. Doubt about the official number has spawned a number of alternative indices, some of which suggest the 2006 inflation rate could have been as high as 20%.

Even on the official measure, inflation is now surging. In January, the rate was 16.8% year on year and 6.4% month on month. Again, some private-sector economists grumble that the real rate is higher still. According to one USAID-funded NGO, January inflation was 14.3% month on month, which is more than double the official figure. Given that the government raised a host of regulated prices on January 8th—electricity tariffs trebled, water charges more than doubled, gasoline prices rose 50% and public transport costs increased by 30%—the unofficial estimate seems perhaps more credible than the official one.

## Oil's curse

One of the dangers for Azerbaijan of rampant inflation is that it will put pressure on the real effective exchange rate and thus undermine the competitiveness of the non-oil economy. In any case, the influx of petrodollars has in the past two years forced the strengthening of the manat in nominal terms against the dollar. In 2005 it appreciated by 8% against the dollar, and by a further 5% in 2006. According to the head of the central bank, Elman Rustamov, the 2006 figure would have been significantly higher but for central bank currency interventions to the tune of US\$1bn.

Ostensibly, the growth of the non-oil economy in 2006 suggests there is as yet little to worry about with regard to competitiveness. Yet that growth rate is primarily due to the

success of non-tradeables such as construction, which are barely affected by exchange rate appreciation. Azerbaijan's tradeables, by contrast, are already showing signs of strain. Agricultural output last year grew by just 1% and output of staples such as cotton, rice and potatoes actually contracted. In Baku's markets, local fruit is beginning to lose ground to Latin American competition; considering the cost of transport, this is a very worrying development. Agriculture is on some measures the most important part of the non-oil economy, as it is the largest source of non-oil exports. In addition to exchange-rate problems, agriculture is suffering from an outflow of labour, as the construction boom sucks labour from the countryside into Baku and other urban centres.

Elsewhere in the economy, there are clear signs of strain. In 2006, for instance, tax receipts from the non-oil sector actually fell in year-on-year terms—this despite a national headline growth rate of over 30%. Agriculture is not the only sector that is losing ground in the home market to importers. Also, now that power prices in Azerbaijan are sharply rising, following Russia's decision to hike gas prices for its CIS customers, it will be interesting to see how the energy-intensive metals sector, and particularly the country's aluminium enterprise, performs. Metals are the second largest source of non-oil related exports after agriculture, with 2.3% of total exports.

## **Wasting away**

Although Azerbaijan is at an early stage of its oil boom, the signs of Dutch Disease—in essence, a loss of competitiveness in the non-oil economy prompted by exchange-rate appreciation and other factors—are particularly ominous. At this point, it is possible that Azerbaijan will make the transition from a sizeable agricultural exporter to a major importer in less than the 15 years it took fellow Dutch Disease sufferer Nigeria.

In Azerbaijan's case, several factors conspire to deepen and accelerate the problems associated with Dutch Disease. First, its oil boom will be relatively short-lived on current forecasts: oil production will begin to decline in 2012. At least while oil receipts are gushing into the state budget, Azerbaijan will be able to throw money at some of the most obvious symptoms, as it is currently by hiking wages and offering to subsidise fuel purchases for farmers.

Second, the country's physical and financial infrastructure is underdeveloped and/or dilapidated, and this puts the non-oil economy at a huge disadvantage. The banking sector, for instance, scarcely exists beyond the major cities; this makes life harder for the country's farmers as they seek to modernise and expand. Electricity and water supplies outside the cities are also unreliable, and the road network is underdeveloped and in a very poor state of repair. The government's fiscal boom will alleviate some of these issues, particularly with regard to the physical infrastructure, although this will not improve utilities and the financial sector.

Third, the country's business environment is hazardous and getting worse and this makes life close to impossible for the private sector. The headline problems include: rampant corruption on the part of state officials, particularly in the tax and customs departments, as evidenced by Azerbaijan's very poor rating in Transparency International's Corruption Perceptions Index; a court system that is open to abuse, delivers verdicts at odds with the country's legal code and is often ignored by the authorities it relies upon for enforcement; the maintenance of a number of artificial monopolies in the country, including the import of basic commodities such as bananas, run for the benefit of well-connected individuals; and a high level of interference in the economy by government figures.

## **A self-serving elite**

This last problem is probably the most threatening, as in its scale it is excessive even by the standards of countries such as Russia, Ukraine and Kazakhstan, as well as neighbouring Georgia and Armenia. Within the last two years, a number of major enterprises have been subject to Yukos-style assaults by the authorities. Downstream oil company Azpetrol, which was widely considered to be the best-run company in the country, was taken over around the time of the 2005 parliamentary election and its major shareholders were jailed. Barmek, the Turkish-run power company, was forced out soon after. These are merely the highest-profile examples of a declining business environment. Although not reported in the international media, since the second half of 2006 a stream of Azerbaijani entrepreneurs have migrated to Georgia and Kazakhstan, because they find the business climate more attractive.

The phenomenon of well-connected Azerbaijanis muscling in on successful businesses has got noticeably worse since Ilham Aliyev succeeded his father, Heydar, as president in 2003. At the time, Western states hoped that Ilham would prove to be a modernising and liberalising force in the country. Instead, perhaps because he has been unable to fully control some senior members of the government, the country's political elite has encroached further into the private sector. This magnifies the corrosive effects of Dutch Disease, and at present it is more a matter of hope than expectation that the private sector will be allowed sufficient space to develop.

Mr Aliyev's government is quite aware of the phenomenon of Dutch Disease, and has taken some sensible preventative steps. A large part of the oil revenues are directed to a stabilisation fund, and institutions are in place to support the development of the non-oil economy. Yet the best chance for Azerbaijan to avoid the worst effects of Dutch Disease rests on Mr Aliyev implementing measures that he is politically unwilling or unable to take—namely to break up the artificial monopolies, rein in budgetary spending, curb the business empire-building of his inner circle, and promote anti-corruption and the rule of law.