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Macroeconomic Forecasts for Azerbaijan in 2017: Independent View

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Contents

1. A brief overview of the economy of Azerbaijan in 2016	3
2. Forecasts on the macro indicators of the economy of Azerbaijan in 2017	3
2.1. Global economic environment – 2017	3
2.2. Domestic economic environment – 2017	4
2.3. Gross Domestic Product Forecast for 2017	6
2.4. Inflation forecast for 2017	7
2.5. 2017 forecast on exchange rate of national currency	8
2.6. Employment forecast for 2017	9
2.7. 2017 forecast for Population Income	9
3. Risks for 2017	10
4. References	11

1. A brief overview of the economy of Azerbaijan in 2016

Without a doubt, 2016 is considered as one of the painful years for the economy of the country. That is to say, the economy of the country encountered nearly 4.0 % decline [during January-November 2016 GDP fell by 3.9% compared with the previous year, SSCRA¹], the depreciation of national currency continued, as a result, manat lost its value by 12.5% during the year. The depreciation of national currency reached 57% from January, 2015 until December, 2016. Inflation rate increased to 12.1%, hitting a two-digit level first time since 2008 and consequently, real income of population shrank by 3.2%. The tight monetary and credit policies of the government led to weakening economic activity, lending level fell to the minimum, 11 banks were closed (one of them being systematically important). The state budget revenues and expenditures executed with respectively 16.1% and 10% decrease in 2016, compared with the January-November, 2015.

2. Forecasts on the macro indicators of the economy of Azerbaijan in 2017

2.1. *Global economic environment – 2017*

Firstly, it should be mentioned that, the World Bank projected global economic growth to be 2.8% in 2017, being 0.4 percentage points higher than the 2016 projection². USA is expected to grow by 2.2% and Eurozone by 1.6%. According to the International Monetary Fund, the world economic growth is predicted to be 3.4% in 2017. Based on the projections of the IMF, developed economies and developing economies are expected to record respectively 1.8% and 4.6%

¹ SSCRA, "Gross domestic production in January-November, 2016", 15.12.2016
<http://stat.gov.az/xeber/index.php?id=3434>

² World Bank, "Global Economic Prospects, Divergences and Risks", 06.01.2017
<http://beta.worldbank.org/en/publication/global-economic-prospects>

economic growth rate³. The declining growth rate in China [6.2%, IMF] may decrease its demand for raw materials and thereby, weakening the growth rate in the exporters of raw materials.

According to the CESD experts, the impacts of the Brexit and the victory of Donald Trump in the US presidential elections are likely to carry on in 2017. In parallel, the continuation of the tightening of monetary policy of the FED is to increase the volatility in global currency markets, and result in a depreciation of the currencies of many countries and declining prices in goods markets. Approaching to the targets of inflation and employment means that, FED is likely to pursue tight monetary policy.

By achieving an agreement on reducing the oil production in oil-exporting countries through the initiative of the OPEC may result in positive changes in this area. The rise in oil prices may positively affect the inflation rate in many countries, including the USA and EU and increase economic activity. Besides, purchasing power of oil-exporting countries characterised with a relatively more consumption level may rise, and as a result, global consumption environment may revive.

CESD experts consider that, major economies in the region are going to encounter a different situation in 2017. That is to say, in comparison with the previous two years, due to the impact of the rising oil prices, Russia is going to experience an increased economic activity and the appreciation of the Russian ruble will continue. Iran is going to be the country with the most rapid economic growth in the region, along with attracting the largest foreign investment. In 2017, economic risk level in Turkey may raise the highest level, which may accelerate the capital outflow from the country. In parallel, the decline in tourism sector of Turkey (1/3 decrease in 2016) may continue in 2017. In this case the depreciation of the Turkish lira will be inevitable.

2.2. Domestic economic environment – 2017

2017 in the country begins with the approval of the “Strategic Road Maps on the national economy and main sectors of the economy”⁴. The key objective of the approved document is to

³ International Monetary Fund, “World Economic Outlook October 2016”, 08.01.2017
<http://www.imf.org/external/pubs/ft/weo/2016/02/pdf/text.pdf>

⁴ President.az, the “Decree of the President of the Republic of Azerbaijan on the approval of the Strategic Roadmaps on the national economy and main sectors of the economy”, 06.12.2016
<http://www.president.az/articles/21953>

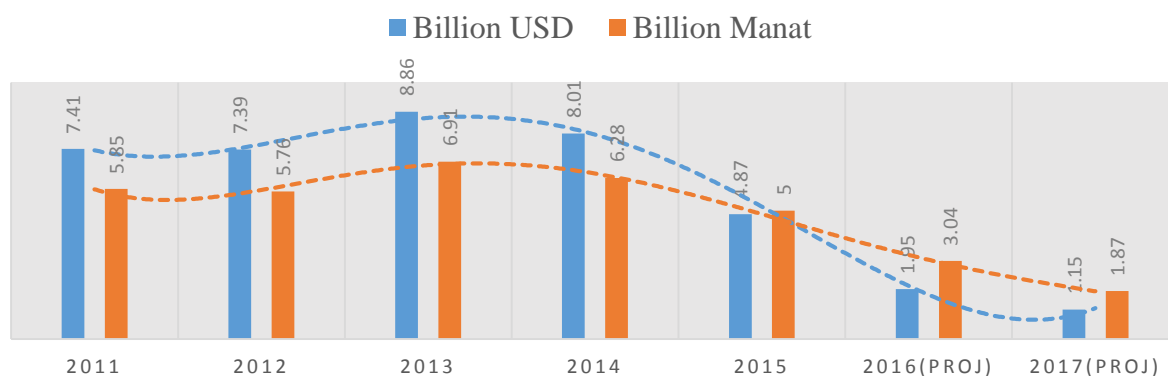
decrease the dependence on resources and to overcome the potential risks, through the sustainable and competitive development of non-oil sector in Azerbaijan. Currently, the actual and potential participants of the economy are trying to determine the motives of the promised future economic policy by conducting an evaluation of the document.

The government announced that the tight monetary policy is to be carried on in 2017. This is one of the factors affecting the domestic consumption level and will increase the pressure on the domestic production (calculated necessary to domestic consumption level). Thus, in 2017 consumer confidence is expected to remain low, which is going to decrease economic activity in the country.

The decision of the Tariff Council on increasing the price of utility services [electricity, natural gas, water] is expected to raise production costs for business, which may undermine the competitiveness of domestic production.

In order to decrease the reliance on oil and defend currency reserves, the government plans to lower the level of transfers from the SOFAZ. In other words, while the country relied highly on oil revenues to finance state budget expenditure during last decade, in 2017 the reliance on this source is expected to reach a minimum level.

Diagram 1: Investment expenditures in 2017



Source: The Ministry of Finance of the Republic of Azerbaijan, 2017

As can be observed, the state budget investments will decrease by 38.5% in 2017 (by 4.7 comparing with 2013) comparing with the 2016 projection.

All things considered, according to the CESD experts, the year 2017 can be a turning point for the economy. If there is no significant increase in oil prices and the government is committed to the implementation of the Strategic Roadmaps, the initiative in the non-oil sector may rise,

especially agriculture, tourism and light industry can develop. In general, it is expected that, the economic depression observed in 2016 will continue in 2017.

2.3. Gross Domestic Product Forecast for 2017

Strategic Roadmaps approved in December, 2016 and encompassing separate fields of the economy of the country specify some obligations posed to the government in 2017. Notwithstanding, it will not be attainable to accelerate the economic dynamics significantly. It is due to the fact that, a conservative approach will be preserved regarding the factors stipulating the economic growth based on the domestic demand throughout the year. Such that, 2017 state budget will be smaller by 8.6% in comparison with the current fiscal year projections. This, in turn, will adversely affect the GDP dynamics achieved owing to the long-term budget spending.

On the other hand, it is evident from the “Statement on main directions of monetary policy of the Central Bank of the Republic of Azerbaijan for 2017” that, tight monetary policy will be pursued in order to keep the exchange rate and inflation under the control as possible [*The Central Bank will significantly limit the channels of money supply via appropriate monetary program and a tight monetary policy will be implemented*⁵]. In other words, limited of loan provision will be observed in 2017.

Figure 1: GDP forecast for Azerbaijan in 2017, comparative representation



Source: World Bank, IMF, Ministry of Economy of RA, CESD, 2017

As seen from Figure 1, the most optimistic forecast for the economy of Azerbaijan is presented by IMF as 1.4% growth.⁶

Alongside with factors listed above, the shrinkage in construction sector will be ongoing in 2017, which will offset the overall economic impact of the expected growth in agriculture and

⁵ Central Bank of Azerbaijan, “STATEMENT on the main directions of monetary policy of the Central Bank of the Republic of Azerbaijan for 2017 year”, accessed on: 07.01.2017

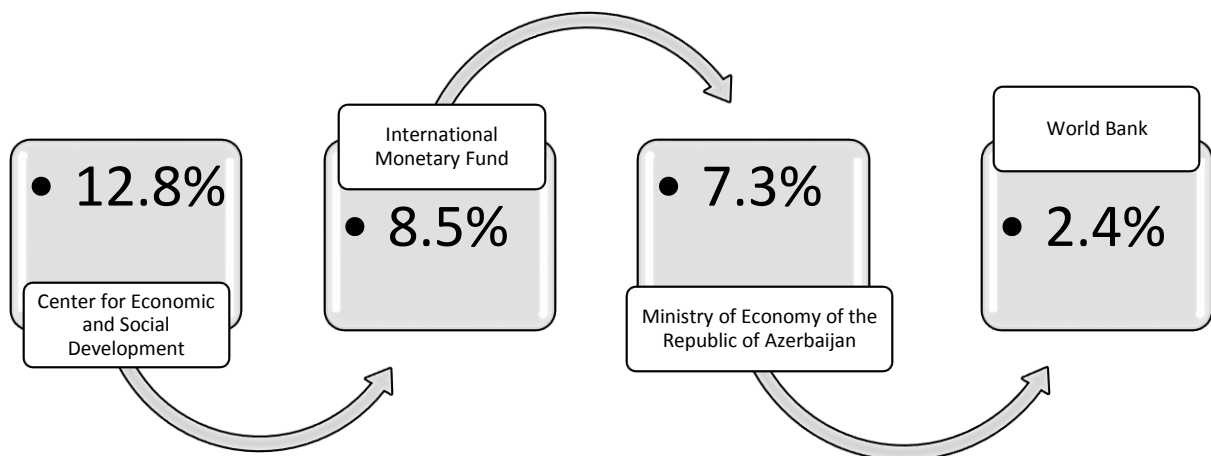
⁶ International Monetary Fund, “World Economic Outlook, October 2016”, accessed on: 06.01.2017, <http://www.imf.org/external/pubs/ft/weo/2016/02/pdf/text.pdf>

tourism sectors. Hence, CESD experts reckon that, 2017 year will be accompanied by “-0.8” percent dynamics for Azerbaijani economy at best scenario. In other words, the economic decline observed today will halt [See: Figure 1].

2.4. Inflation forecast for 2017

According to the forecast of World Bank, Azerbaijan will record 2.4% inflation in 2017⁷. It is to be noted that, the corresponding indicator was 12.1 % for 11 months of 2016⁸. At present, import inflation is on the rise due to the sharp devaluation of the national currency. Despite the fact that, factors such as unemployment, decline in profitability of business and the increase of foreign debt service costs have substantially reduced the consumption capacity of population, price index of imported goods and services shows an upward trend. In most cases, the price increase is compulsory and plays a substantial role for the sustainability of existing entrepreneurship activities.

Figure 2: Inflation Forecast, 2017



Source: World Bank, IMF, Ministry of Economy of RA, CESD, 2017

⁷ Trend.az, “World Bank: Inflation in Azerbaijan will decline significantly”, 04.01.2017 <http://az.trend.az/azerbaijan/society/2688779.html>

⁸ SSCRA, “Macroeconomic indicators of economic and social development of the country in January-November, 2016”, 14.12.2016. <http://www.stat.gov.az/xeber/index.php?id=3431>

CESD experts contemplate that, two-digit inflation will persist in 2017 as well. It is because, manat will depreciate approximately 20-30% as a result of the shift to purely floating exchange rate regime by the government, which will be inevitably increase the prices of imported goods and services. At the same time, it must be taken into consideration that, a sharp decline in aggregate demand has hindered the increment in prices of goods in various directions which would otherwise maintain the profitability of business activity. This may lead to the product shortage and an upward pressure on consumer prices may become critical. Considering the above-mentioned factors including the long-term effectiveness of measures on import dependence, CESD experts forecast high levels of inflation in 2017. It must be noted that, inflation level in the current year is expected to be at 7.3%⁹ according to the government projections.

2.5. 2017 forecast on exchange rate of national currency

National currency “manat” of the Republic of Azerbaijan has demonstrated a sensitive reaction to the changes observed in the country’s economy. Overall loss constituted 57% throughout the two years of sharp depreciation of “manat”. It must be mentioned that, the exchange rate of “manat” will be affected by following factors:

i) Shift to floating exchange rate regime¹⁰ – liberalization attempts of the currency regime during the year is considered to be one of the factors stipulating the depreciation of “manat”. It is because, the lack of administrative support to manat not able to achieve its real market value will decrease the reliance on it.

ii) State Oil Fund will limit currency purchase – In comparison with 2016 forecast, the transfers of State Oil Fund to the state budget has decreased by 20% [6.1 billion manat¹¹]. Alongside, the value of manat is lower than the average rate of 2016 [average rate for 2016 1USD= 1.5965, CB¹²] by 10%, which shrinks the prospects of currency conversion for the Oil Fund. It is assumed that, the Oil Fund will supply the currency volume equivalent of 3.5 billion US dollars in

⁹ Ministry of Finance of the Republic of Azerbaijan, “Representation of projects on 2017 state and consolidated budgets of the Republic of Azerbaijan”, accessed on: 07.01.2017

<http://www.maliyye.gov.az/sites/default/files/Budce-16-11-2016.pdf>

¹⁰ Central Bank of Azerbaijan, “STATEMENT on the main directions of monetary policy of the Central Bank of the Republic of Azerbaijan for 2017 year”, accessed on: 07.01.2017

<http://www.cbar.az/assets/4254/2017-BEYANAT - SON.pdf>

¹¹ Ministry of Finance of the Republic of Azerbaijan, “Law of the Republic of Azerbaijan on 2017 state budget of the Republic of Azerbaijan”, 28.12.2016

http://www.maliyye.gov.az/sites/default/files/Qanun_budce_2017_.pdf

¹² Central Bank of Azerbaijan, “STATEMENT on the main directions of monetary policy of the Central Bank of the Republic of Azerbaijan for 2017 year”, accessed on: 07.01.2017

<http://www.cbar.az/assets/4254/2017-BEYANAT - SON.pdf>

currency auctions, which is 28.5% lower in comparison with the current year [*the corresponding indicator was 4.9 billion USD in 2016*¹³].

Alongside with above mentioned, CESD experts forecast the USD/Manat ratio as 2.2-2.5 in 2017, given the high probability of FED to pursue tighter monetary policy, low growth of the share of non-oil economy in exports, current account deficit and the increase of costs of the foreign debt service.

2.6. Employment forecast for 2017

The development of strategic roadmaps on national economy and main economic sectors, adoption of several steps towards the liberalization of business environment including the elimination of licenses for various fields of activity or the facilitation of procedures (organization of the procedures by ASAN service), improvement of tax policy and adoption of the decision on the implementation of differential tax rates, as well as the establishment of “Asan Support for Family Business” center (ABAD) will facilitate the creation of new job positions during 2017.

However, according to the forecasts of CESD experts, the implementation of tight monetary policy by the government in current year will limit the access to capital and keep domestic consumption at low level; on the other hand, the lack of steps towards the establishment of independent judicial institutions considered as one of the main factors to accelerate the investment flow to the economy will lead to a low level of economic incentives, and the number of shutdown jobs will outweigh newly created job places. Thus, it is projected that, employment level will decline in 2017.

2.7. 2017 forecast for Population Income

CESD experts reckon that, population income in 2017 will be shaped with the impact of following main factors:

- i) *Unemployment will increase* – the shutdown of non-state enterprises in recession or the shrinkage of the activity of those will result in a rapid increase of cases of dismissal, which will reduce the income sources of population;

¹³ Central Bank of Azerbaijan, “STATEMENT on the main directions of monetary policy of the Central Bank of the Republic of Azerbaijan for 2017 year”, accessed on: 07.01.2017
http://www.cbar.az/assets/4254/2017-BEYANAT_-SON.pdf

- ii) *Excess supply in labor market* – the increase in the number of dismissals will increase the labor supply in the market. As a result, in parallel to the expansion of informal labor market, the level of suggested salaries will exhibit downward dynamics;
- iii) *Business profitability will decline* – the import dependence in final consumption market, as well as in production will lead to the increase in production costs. However, the purchasing power of population will shrink significantly. As a result, business entities will be forced to adopt lower level of profit margin. In other words, profitability will sharply decline, the latter adversely affecting the population income.
- iv) *Two-digit inflation is forecasted* – two-digit import inflation will lead to a real decline in population income;
- v) *Movement of economically active population to regions* – especially the observed shrinkage in construction sector will lead to a declining employment capacity and the movement of workers in this sector to regions (permanent residence places, places of birth), resulting in reduction of income flow from the capital to regions, as well as the forceful movement of labor force towards the low-income sectors.

Considering the impact of mentioned factors, CESD experts project that, the monetary income of population will experience a decline in 2017.

3. Risks for 2017

The price of oil in 2017 will remain as a major risk factor for the economy of Azerbaijan. Such that, if the agreement between OPEC and non-OPEC countries regarding the cut in production is violated, this will condition the sharp decline of oil prices in world market, and as a result, current account deficit may deteriorate, the pace of depreciation of the national currency and import inflation will accelerate.

Another threat for 2017 may be the weakening of the trust of interest groups including the country's publicity towards the newly approved Strategic Road Maps and commitment of the government in this regard. If the public opinion will be under impression that, the government or any of its bodies is not interested in the implementation of strategic road maps and economic reforms in general, it may aggravate the economic pessimism and deteriorate the economic activity. As a result, the incentives will weaken, local and foreign investments will decline.

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