

Better Research, Better Policy, Better Reform



Azerbaijan's foreign trade; Comparative Analysis

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Introduction

Since independence, Azerbaijan has successfully improved both economic and trade relationships with its neighbors and other countries of the world. Above all, however, in the early years of independence, the fallout from the collapse of the U.S.S.R., including the loss of former Soviet economic connections, reverberated throughout Azerbaijan's economy and caused a crisis in all spheres of the economy, including foreign trade. The sudden and difficult transition from a planned economy to a market economy created many challenges for not only Azerbaijan but all former Soviet countries. One of the most difficult was the need to define what goods and services to trade with other countries and to answer decisively critical questions such as: In which direction should the economy move? In what industries should the country engage? What products should, and can, be produced? To answer these questions and overcome these challenges, countries had to reform and modernize their economic structures by re-writing the rules inherited from the former system, which were generally incompatible with the new system.

During this transitional period, levels of production declined due to the suspension of many plants and factories inherited from the former economic system, unemployment increased dramatically, and the inflation rate increased rapidly. All of this had a negative impact on not only foreign trade but also on macroeconomic

stability. Obviously, in this situation Azerbaijan's first objective was to stabilize the economy and endure the transition period with minimal losses. To this end, it was very important for Azerbaijan to find its niche in the international division of labor in the world economy.

All developed countries of the world like Germany, USA, Japan and others reached their currently powerful economic positions, in part, by specializing in certain fields in the international division of labor.

In this regard, international trade has a number of advantages that are crucial for the economic prosperity of any country. It enables a country to raise more revenue at a lower cost, to increase the inflow of foreign currency, and to contribute to world stability. With few exceptions, the world does not consist of countries that have closed economies. And the power of and contribution to the world's economy by countries that do have a closed economic system is minor. History has long since demonstrated that closed economic systems are unstable. Countries with closed systems not only lag behind in international trade but also struggle to realize their true economic potential. For example, compare and contrast the economies of South and North Korea.

The instability of closed economic systems hampers the transition from one economic system to another. However, the fact that official reports document that Azerbaijan maintained trade relations with over 160 countries in 2011 indicates the degree of openness of Azerbaijan's economy. Nevertheless, there are still weaknesses in Azerbaijan's foreign trade turnover.

For 70 years, Azerbaijan was an integral part of the Soviet economy, that has brought her to closed economic system. At present, according to official data, in 2011, more than 160 countries around the world, trade with Azerbaijan has relations. First, the oil factor's share in the trade turnover is considerable, and most of the oil is being exported as a raw material. This is due to the fact that besides exporting raw materials the Azerbaijani economy has not been able to find its place in the international division of labor so far. This may create negative long-term consequences not only for the country's foreign trade but also for Azerbaijan's economy in general. Solutions to the aforementioned problems are to enabling the economy of Azerbaijan to integrate into that of the world.

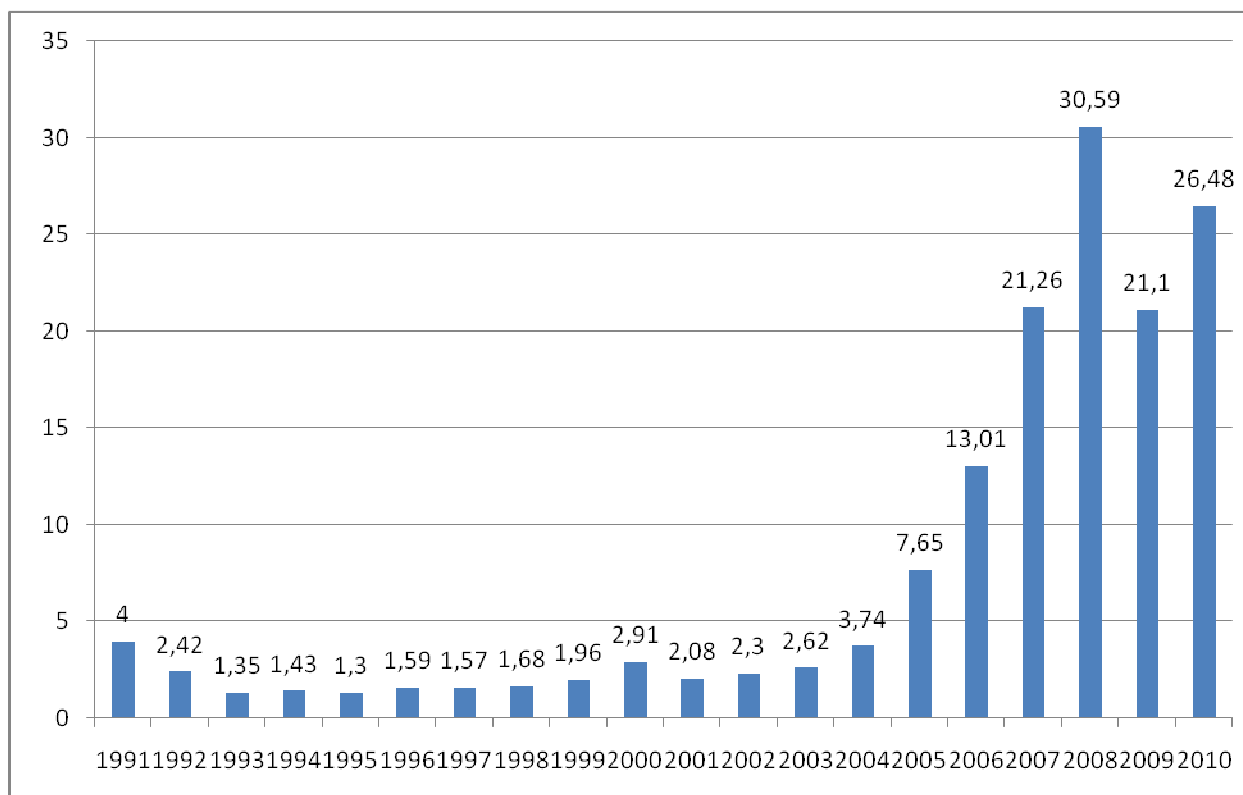
Considering the foregoing, in our research we address the following issues: the nature and magnitude of Azerbaijan's current problems in the foreign trade turnover, the structure of the trade turnover with Azerbaijan's partners in foreign trade, and recent developments in foreign trade.

The volume and structure of Azerbaijan foreign trade turnover

According to the State Statistics Committee, the volume of Azerbaijan's trade turnover has increased seven-fold since 1991, when the volume of foreign trade turnover was 4 billion USD. In the early years of independence, Russia and CIS countries were Azerbaijan's only trade partners. Over time, the ratio of partnerships has changed in favor of EU countries. First, we will discuss Azerbaijan's volume of foreign trade turnover and then its foreign trade partners and structure.

Diagram 1. The volume of Azerbaijan's foreign trade from 1991- 2010.

(Billion. US dollars)

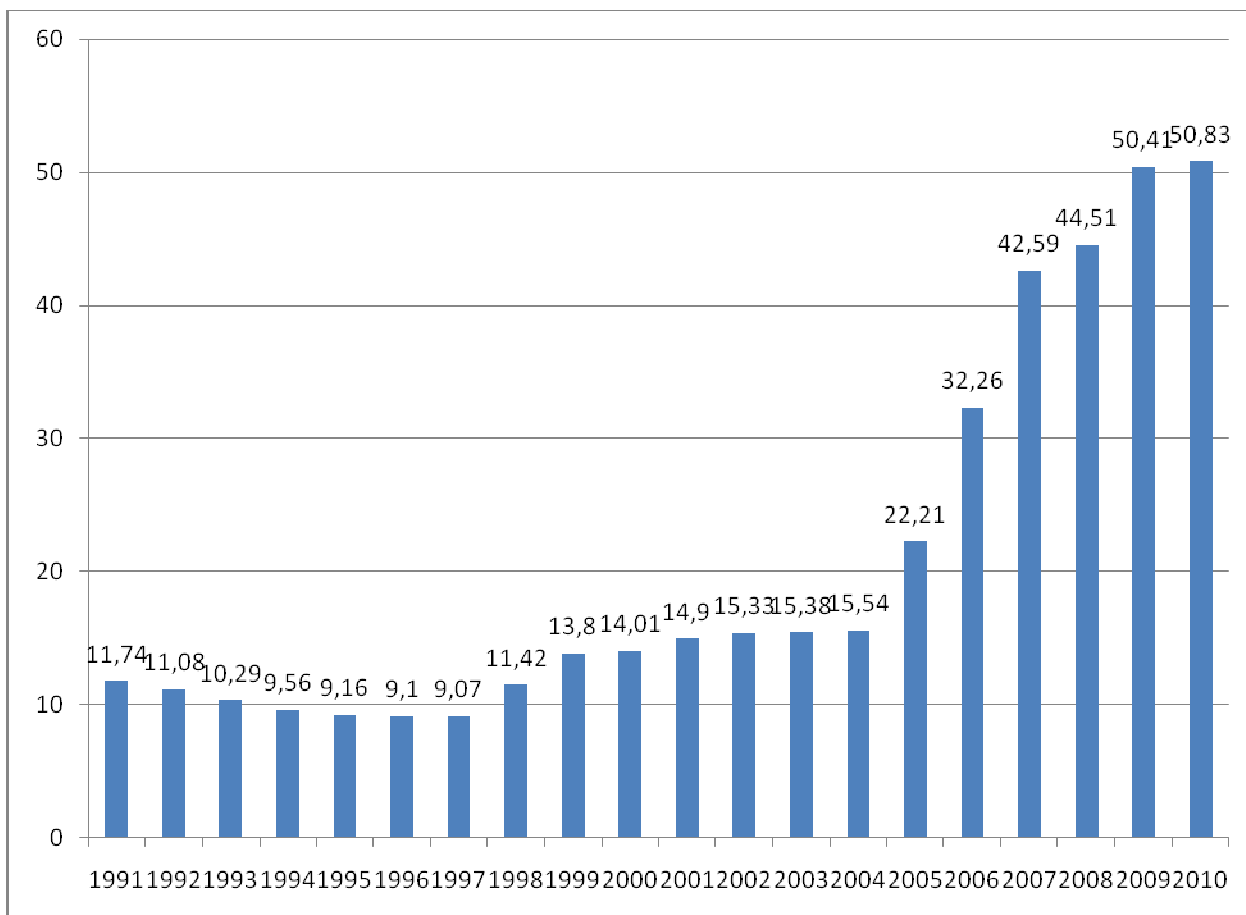


Source: State Statistics Committee, 2011 and the Central Bank Azerbaijan Republic, 2011

As seen from the chart, since 1992, trade turnover decreased sharply and remained low in the immediately following years, increasing by a significant amount (USD 3.6 billion) only in 2005. From 1993 to 1995 average GDP fell by 19%, which was an economic disaster for the newly independent country. As mentioned above, the main causes for this overall economic crisis signified by these figures were the collapse of the old economic system, the loss of existing economic ties with Soviet trading partners, and the decline in oil exports.

Another indicator that reflected the economic situation in those years was a general decline in Azerbaijani industry. Compared to the 1980s, the volume of industrial production decreased by 10% in 1991, 37% in 1992, and up to 50% in 1993. All this, of course, had to have a negative impact on the country's foreign trade. One of the main reasons for the decrease in industry was rapidly declining oil production.

Diagram 2 1991-2010- oil production (in million tonnes)

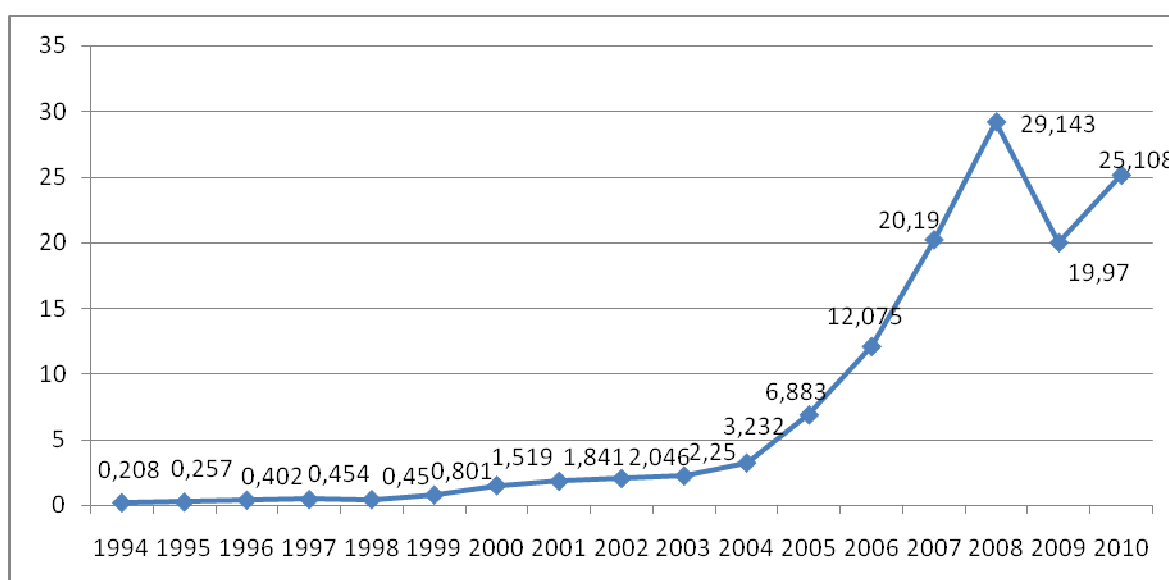


Source: State Statistics Committee of Azerbaijan Republic, 2011

Despite having rich hydrocarbon resources, Azerbaijan endured a troubled macroeconomic situation throughout most of the 1990s, which was reflected in its foreign trade turnover. Lacking the financial capacity to invest in either production or export, Azerbaijan saw its oil production, compared to 1991 levels, decline by 5.6% in 1992, 12.3% in 1993, and 18.5% in 1994. For the remainder of the decade, oil production continued to decrease and only in 1999 did production levels surpass those at the beginning of the decade.

Because there wasn't proper infrastructure available to export the oil produced pursuant to the Contract of the Century, only in 2006 did oil production exceed that of the previous year by more than 10 million tons. This increase was likely associated with the launching of the transportation of oil through the Baku-Tbilisi-Ceyhan pipeline. Next, we will examine the dynamics of oil exports from 1991-2010.

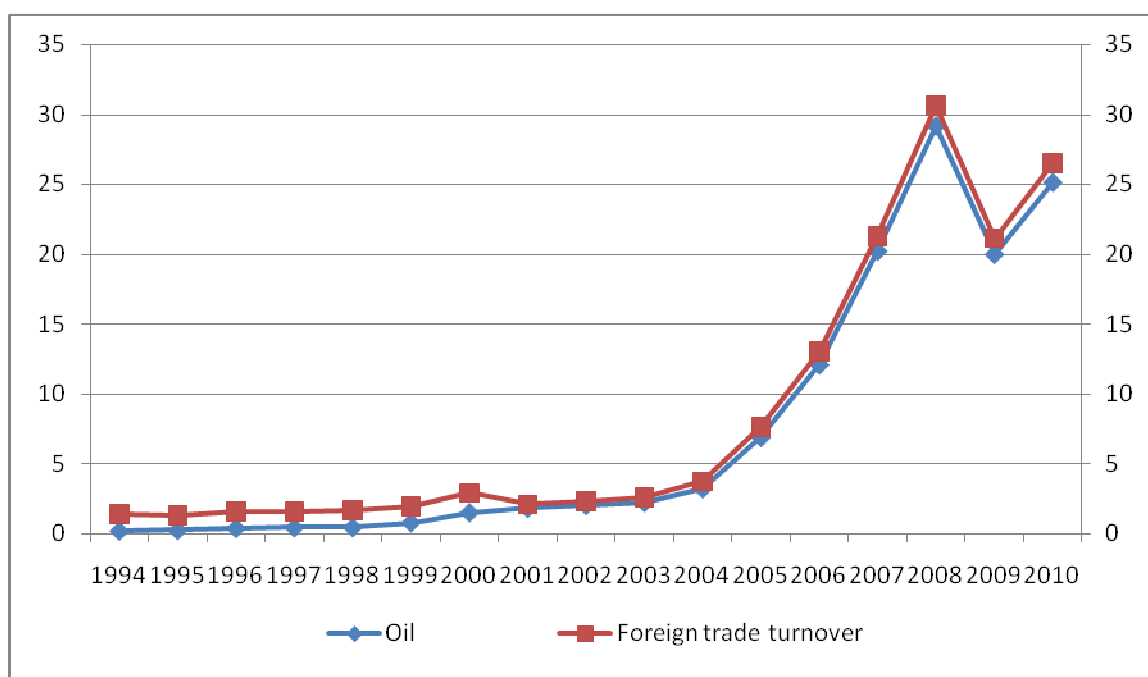
Diagram 3. 1994-2010- oil exports (in billion US dollars)



Source: International Monetary Fund, World Economic Outlook, 2011

As seen from the diagrams, the grow rate of oil exports largely tracks that of foreign trade turnover (Diagram 1). An increasing trend in both the volume of foreign trade turnover and oil exports was observed beginning in 2003.

Figure 4. The dynamics of oil exports and foreign trade turnover from 1994 to 2010. (In billions of U.S. dollars)

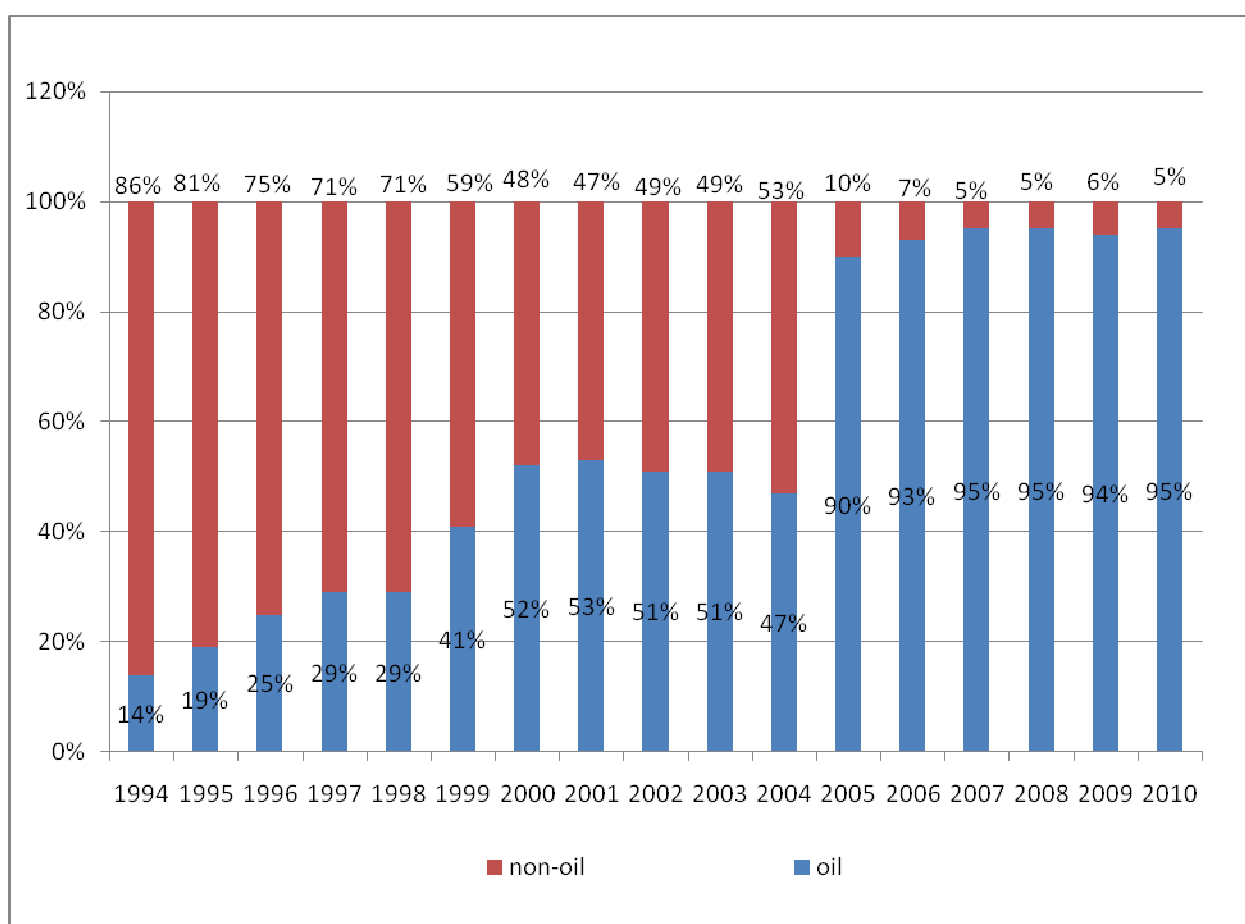


Source: Central Bank and the State Statistics Committee of Azerbaijan Republic, 2011

As seen from the diagram, even subtle fluctuations in the volume of oil exports are immediately reflected in the foreign trade turnover. Obviously, there is a direct correlation between the volume of oil export and the volume of the foreign trade turnover. According to our research, the correlation coefficient between oil export and foreign trade is 0.99. As our research mainly focuses on the two variables, correlations between foreign trade turnover and oil export, it is a simple correlation function. It means that, other factors which also have an effect on the foreign trade turnover were not considered. However, just the oil factor has a tremendous effect on the trade turnover.

For instance, in 2008 the foreign trade turnover reached its highest levels since independence, and it's not surprising that so did the levels of oil export, which totaled 29 billion U.S dollars. Moreover, oil exports consisted 94% of the foreign trade turnover that year. The following chart shows the proportion of oil export in the trade turnover for other years.

Figure 5. The share of oil exports in the foreign trade turnover in 1994-2010-
(percent)



Source: Central Bank of Azerbaijan Republic, 2011

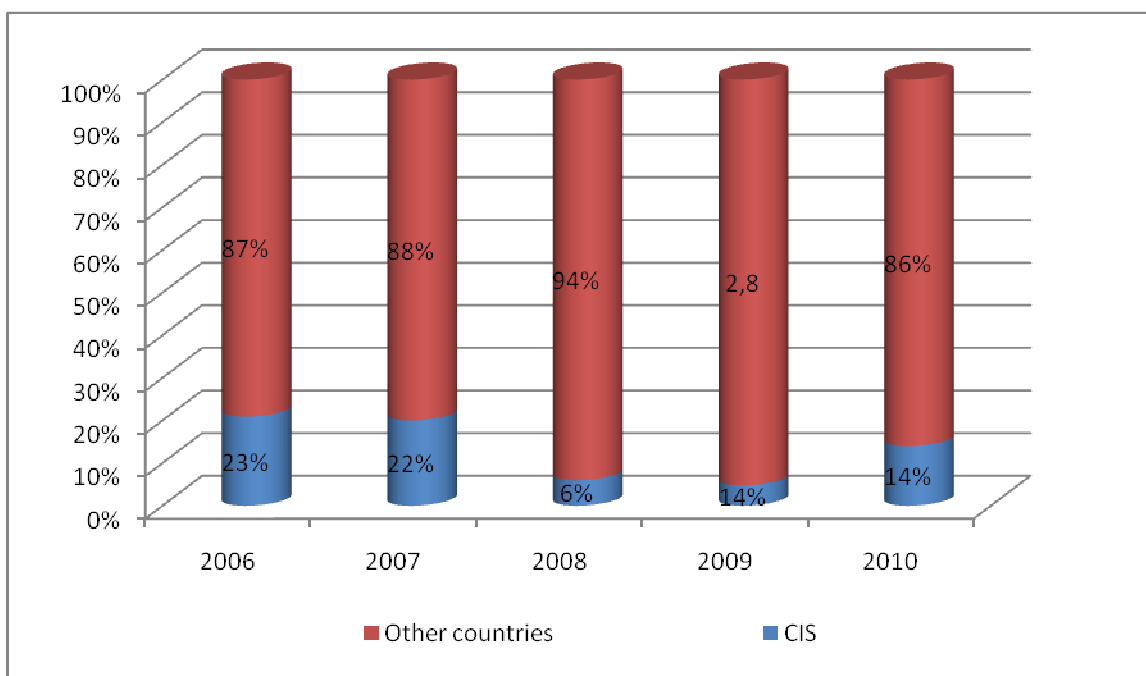
As seen from the diagram, the share of non-oil sectors in foreign trade has been shrinking. In the last five years, the share of the the non-oil sector has even

dropped into the single digits. This is a stark illustration of the Azerbaijani economy's complete reliance on the oil factor.

Foreign trade partners of Azerbaijan.

As the structure of Azerbaijan's foreign trade has changed, so have its trade partners. Although Azerbaijan's main trading partners were largely CIS countries in the early years of independence, this ratio has increasingly favored European Union countries.

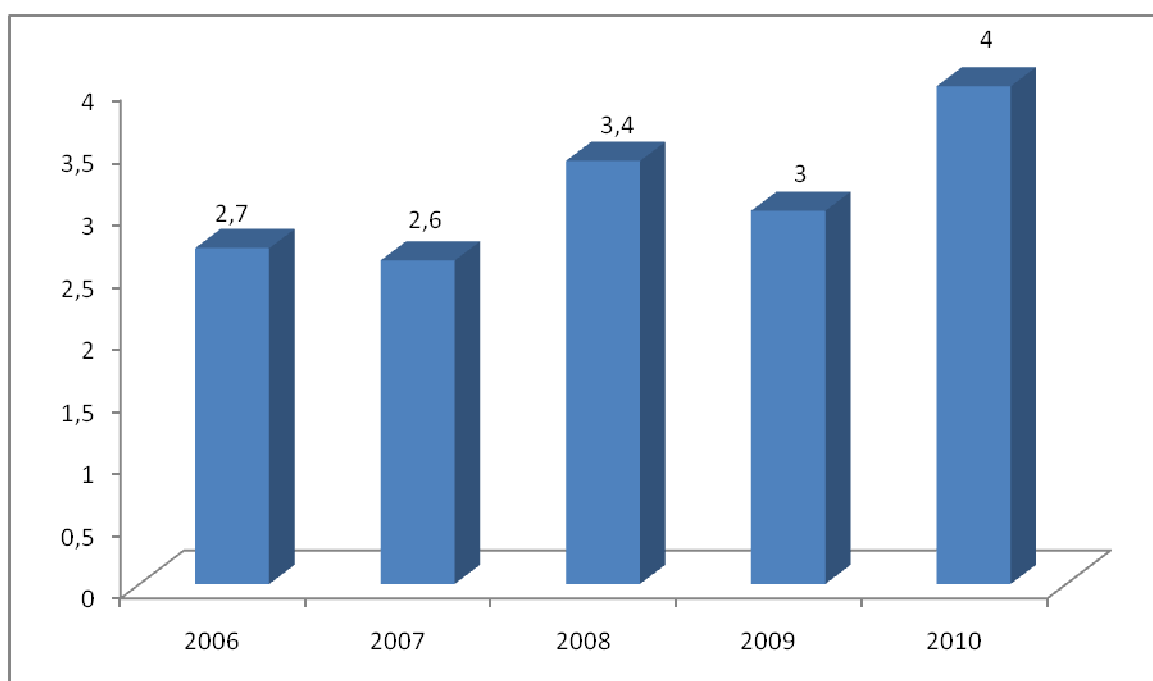
Figure 6. The share of CIS countries in the foreign trade turnover of Azerbaijan (in percentage)



Source The Statistics Committee of Azerbaijan Republic, 2011

As seen from the diagram, the CIS countries' share in Azerbaijan's foreign trade has been shrinking. The main reason for this is that European Union countries are the major importers of Azeri oil, so as oil exports grow, the share of CIS countries in Azerbaijani foreign trade decreases. Even though trading with CIS countries has grown from year to year, its share in foreign trade is overshadowed by the growth in energy trade with European countries.

Figure 7. The trade turnover between Azerbaijan and other CIS countries in 2006-2010 . (in billions of U.S. dollars)

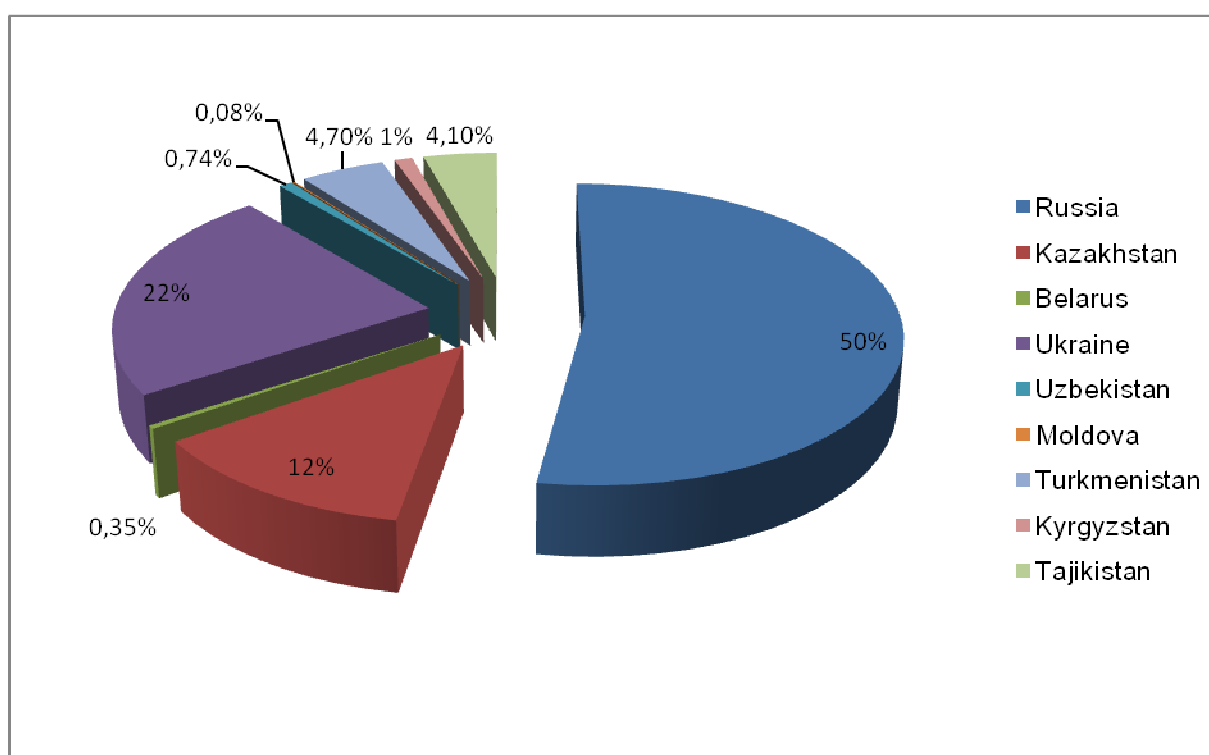


Source: The State Statistics Committee of Azerbaijan Republic, 2011

Compared to 2006, the volume of foreign trade turnover in 2010 increased 1.5 times or by 1.341 billion U.S dollars. However, the share of the CIS countries in the whole trade turnover decreased.

The major trading partner of Azerbaijan among the CIS countries is Russia. Its share of the trade turnover with CIS countries is approximately 50%. One of the main reasons for this is that Russia is the primary importer of Azerbaijani agricultural products. This high volume of trade between Russian and Azerbaijan is an outgrowth of the historical trade and economic relations between the two regions. Moreover, about two million Azerbaijani citizens currently live in Russia, which contributes to the growth of trade turnover volume. In this respect, Russia is a useful economic space for Azerbaijan.

Figure 8. The share of Russia and other CIS member-countries in the foreign trade turnover in 2006-2010 (percent)

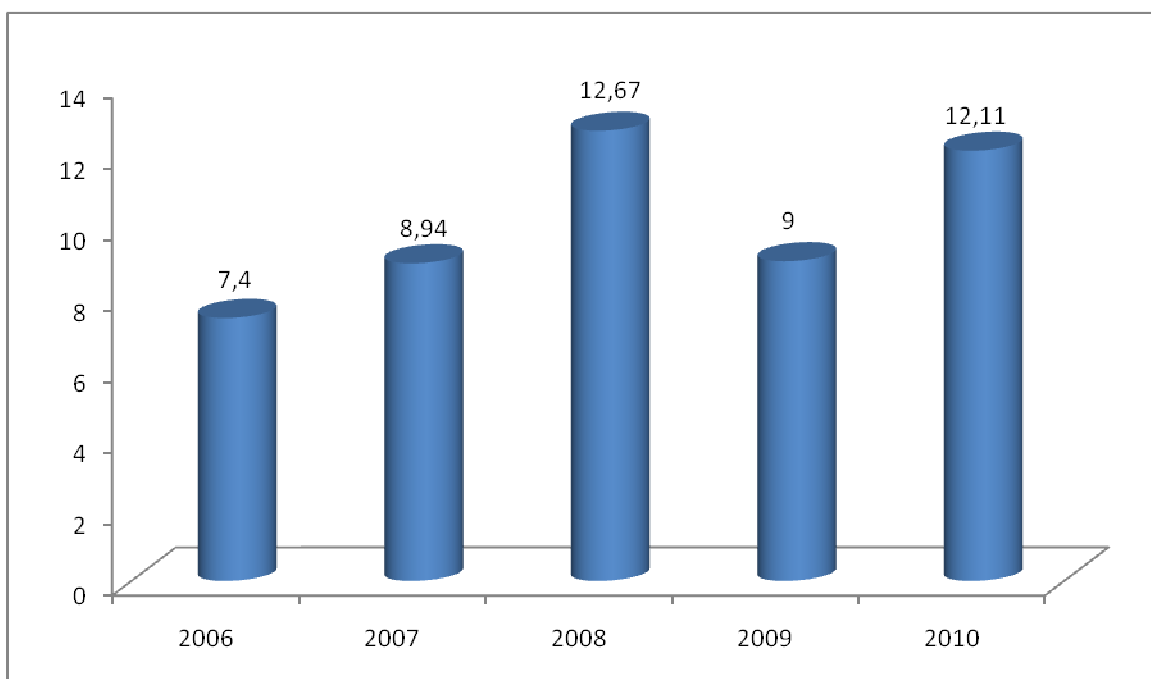


Source; The Statistics Committee of Azerbaijan Republic, 2011

To some extent, Russia's share of Azerbaijan's trade turnover is so high simply because Russia is the largest economic power in the CIS. Moreover, being one of the largest countries in the world in terms of area and population makes Russia a major market and economic space for not only Azerbaijan and other CIS countries but, indeed, the entire world. Thus, it is unsurprising that Russia plays an important role in the trade turnover of Azerbaijan and other CIS countries as well.

However, recent large-scale investments in the oil sector, especially involving foreign oil companies, has increased the share of European Union countries in Azerbaijan's foreign trade turnover, even doubling in recent years. This trend increased, especially after the Baku-Tbilisi-Ceyhan oil pipeline started.

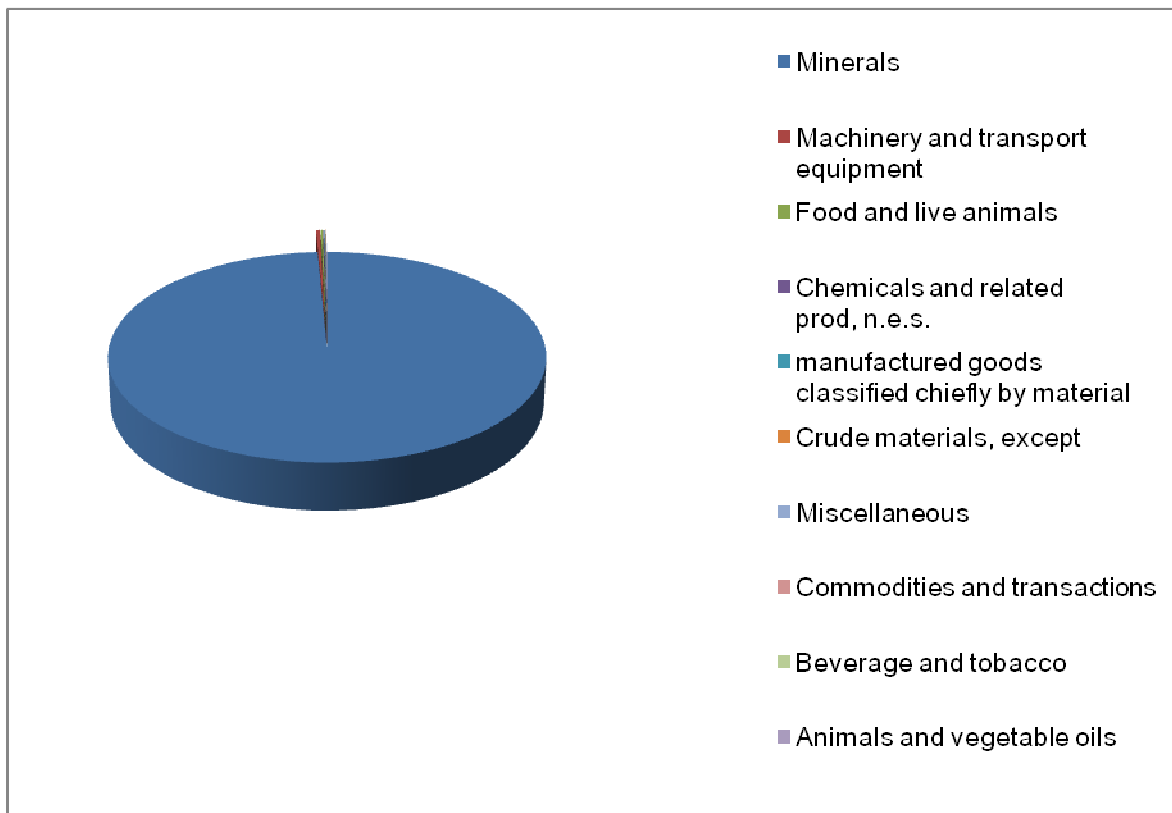
Figure 9. The foreign trade turnover with the European Union in 2006-2010(billion euro)



Source: DG Trade Statistics, 2011

In 2010 the volume of the trade turnover between Azerbaijan and European Union countries increased by 4.7 billion euro, or by 63%, compared to that of 2006. The main reason of increase on trade turnover with EU is a large share of oil export. However, Azerbaijan also saw a decrease in the volume of the trade turnover in 2009, which correlates with the dependence of the volume of trade turnover on the oil factor, as seen above in Figure 4.

Diagramm 10. The structure of Azerbaijan's trade turnover with the European Union, in 2010 (percent)



Source: DG Trade Statistics, 2011

As seen from the diagram, petroleum products are the lion's share of Azerbaijan's trade turnover with European Union countries.

The low share of non-oil sector products in the trade turnover with EU countries is related to the low quality of Azerbaijani products and their inability to satisfy EU product standards. This, in turn, negatively affects the country's export potential. Likewise, not being a member of the WTO impedes Azerbaijan's access to the European market and its nearly 500 million consumers. Since more than 95% of

world trade is conducted by WTO members, Azerbaijan's entrance to the WTO means its access to the world market.

Many post-Soviet countries long ago joined the WTO. If Azerbaijan further delays its own membership, the volume of the trade turnover with CIS countries may also suffer as a result because after CIS countries join the WTO, they may apply the WTO's standards for imports, which would likely exclude products of Azerbaijan's non-oil sector. Therefore, membership in the WTO is very important for Azerbaijan, and this process needs to be accelerated and well-prepared in advance. In the initial stages, this will require the development of competitive, quality products in the non-oil sector and full support of the membership process. Azerbaijan must identify prospective fields and products and further develop them in order to be a part of the world market.

Conclusion

In recent years, growing oil production has driven continued growth in the volume of Azerbaijani trade turnover. However, the depletion of oil resources in the future is inevitable and may set the stage for a number of economic risks. One of the major problems might be a sudden stop of currency inflows into the country that, in turn, may lead to the decline of the manat's exchange rate, the acceleration of inflation, and general macroeconomic instability. In order to promote more successful integration to the world's economy and develop its reputation for high-quality goods, Azerbaijan must both increase the volume and diversify the structure of its foreign trade turnover by facilitating the production of competitive products that can satisfy world standards.

Diversification of foreign trade is a crucial part of the industrialization and economic progress of a country that primarily exports raw materials. Delaying this process may have negative net effects, which later will be difficult to resolve. For Azerbaijan, this means decreasing reliance on the oil sector for economic growth and gradually developing non-oil sectors in all spheres of the economy. At the same time, it is necessary to implement certain corollary measures, such as strengthening the fight against monopoly and corruption, improving the business environment, and supporting the development of small and mid-sized enterprises.

In particular, the growth of the agricultural sector in the country's economy should be promoted by introducing new technologies to increase productivity. Certain Azerbaijani agricultural products have the quality to be competitive in the world

market but must be produced with greater efficiency. Accordingly, Azerbaijan should cooperate with countries that are experienced in agriculture and apply those models that best match Azerbaijani agriculture's current reality to improve productivity.

At the same time, economic liberalization and development of the service sector is necessary to attract greater foreign investment and increase productivity. In particular, new products in the banking and financial sectors are needed to improve this sector's financial condition and subsequently to expand small and mid-sized enterprises' access to financial resources.

Currently, the majority of banks in Azerbaijan provide only traditional services, which limits start-up and growth opportunities for local entrepreneurs. For example, the banking sector in Azerbaijan supports few international banking services and products relevant to export. This, in turn, reduce the export potential of Azerbaijani entrepreneurs.

Ultimately, inadequate development of market-economy infrastructure will eventually impede the growth of the whole economy. Thus, economic reforms must be implemented throughout the country with greater speed to increase foreign trade turnover and diversify its structure as a whole.

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