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Higher Oil Price: Sustainable or Temporary Economic Growth?

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1. Introduction

The purpose of the research is to demonstrate the influence of oil price change on Azerbaijan as a whole in order to provide the explanation for the major developments of economic and social policies. Furthermore, the paper studies the impact of increasing and stabilizing oil prices on Azerbaijan Economy after the second half of 2016. It presents a macroeconomic analysis of the impact of stabilized oil price in Azerbaijan in 2017. Additionally, it assesses the overview of the economy with a holistic scene in macroeconomic analysis within 2017 with several comparisons to the previous years. The research mainly addresses the indirect effects of oil price increase on Azerbaijan after the recent recovery in the world oil price by building correlations to evaluate the changes.

It generally questions if higher oil prices are better for Azerbaijan's economy by shortly going back to historical data from 2014 to assess the local economy with a main focus on 2017 and 2018. Then it follows by investigating which factors play a crucial role in the economic development of the Azerbaijan Republic.

Additionally, it describes the probable scenarios with potential consequences for Azerbaijan's economy in 2018 if the oil price will remain stable, decrease and increase around \$60 with further recommendations including. Comparison of recent changes with relatively stable oil price in 2017 provides us with a general explanation about how the local economy can be developed with potential trends. The study, in the end, demonstrates the fragility of the Azerbaijani economy towards changes in world energy market due to the high dependency.

Since the end of 2016 the oil price has increased from 45 USD to approximately 69 USD at the end of February and the trend is still increasing. Following the changes in world energy market after the recessionary year of 2016, in 2017 the Azerbaijani economy grew by 0.1% and it is expected to grow by 1.5% in 2018. This is well correlated with the recovering oil price on the commodity exchange market. In 2017 the oil economy comprised 90.5% of Azerbaijani exports and the biggest share of production, which makes Azerbaijan vulnerable to even smaller changes in the price of oil. Therefore, for the Azerbaijani economy relatively stable oil price around 65 USD is estimated to be a favorable situation for a temporary stability period until the government enhances the diversification of the economy by working more on the long-term perspectives for strengthening the economy, however for the long term this is not the ideal situation.

2. Methodology

We have used statistical data to visualize the situation in order to understand it more in-depth. Then we assess and analyze current issues in Azerbaijan to build several correlations to explain the concern better. Moreover, the study is developed not on the theoretical basis, but rather macroeconomic analysis of statistical data.

The information in this form originates from official sources of the Central Bank of Azerbaijan, the National Statistical Committee, the State Oil Fund, the Ministry of Finance and the Customs Committee by empirical pricing of previous years. Additionally, the statistical bulletins of the state agencies were used to evaluate many factors at the same time.

The research is based on a quantitative method, but in some parts also includes qualitative analysis. Furthermore, we use graphs, pie charts and tables to demonstrate the visualization of data we have collected.

3. Overview of Azerbaijani Economy in 2017

2017 can be considered as a recovery year for the Azerbaijani economy due to the steady increasing oil price on world energy market. The Brent oil price on 29.03.2018 accounted for \$69.55 US with an annual 23.2% increase since the beginning of 2017.

In 2017 the Azerbaijani economy faced a growth trend because of rising oil price to a more favorable level. Compared to the previous year the GDP increased with 0.1% in 2017 and it is expected to grow around 1.5% in 2018. But the inflation rate remained around 13.2% as the government declared. The two-digit inflation occurred due to changes in the exchange rate of the Manat in the beginning and end of 2015.

Furthermore, during the given year the prices of consumer goods and services increased 12.9% in comparison with 2016 which remains two digits. The inflation rate for food products was 16.9%, for non-food goods 11.6% and for services 9.3% in 2017. The instability in the consumer product prices is also creating a reverse pressure for people by diminishing their purchasing power, as the inflation goes up with an unstable economic period at the given time.

Explained economic indicators represent the improving situation in Azerbaijan but only for the short-run period.

4. Influence of higher oil price on Azerbaijan

The effect of the oil price on the Azerbaijani Economy is crucial because Azerbaijan is an oil producing and exporting country with a huge share of oil in the economy. Since Azerbaijan experienced a recessionary year in 2016 with 3.1% decline in GDP after many years of rapid development since its independence.¹ The major reason for this economic slowdown is the sharp decline in the price of oil since the third quarter of 2014 which led to a severe domino effect by worsening the economic and social situation as a whole. Furthermore, there was a major devaluation of the national currency, cuts in government spending in the economy by 27.6% and a two-digit inflation rate.² These indicators exhibit the overall impact of negative oil price change on Azerbaijan. Government expenditures in Azerbaijan form a crucial part of the economy which fell after the oil price decline in 2014. However, it started already recovering with new projections, back to its previous level of spending.

According to the analysis of the macroeconomic indicators, during the study, we found a lagging period of six to eight months for the Azerbaijani economy after any given change in

¹ The State Statistical Committee of the Republic of Azerbaijan: The indices of main socio – economic indices (as percent to previous year)

https://www.stat.gov.az/source/system_nat_accounts/en/001en.xls

² Azerbaijan Economy in 2017; Brief Overview

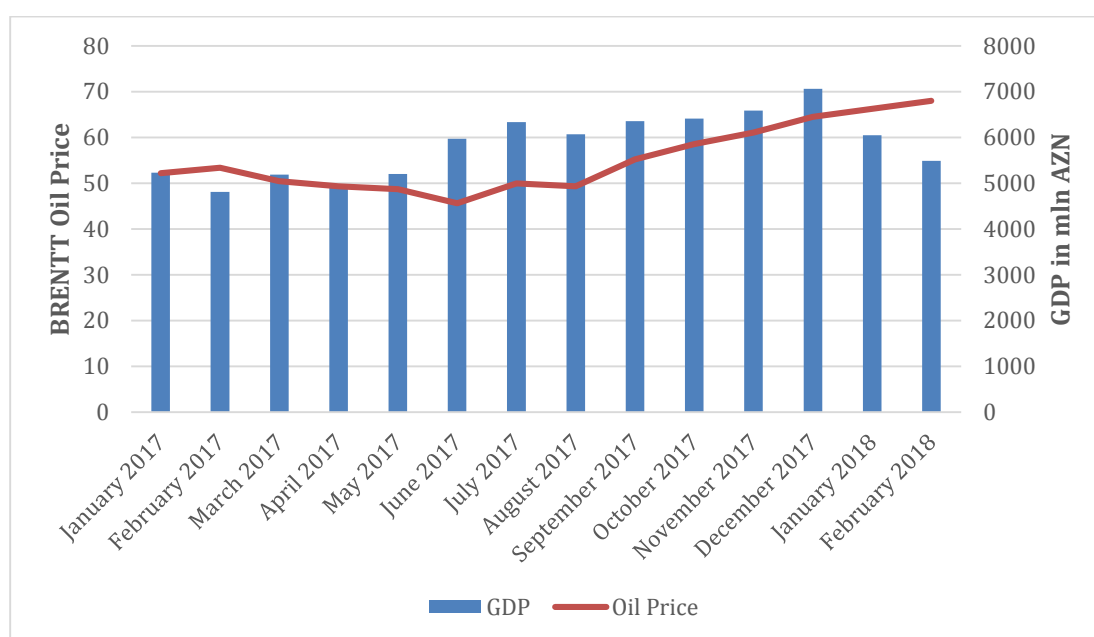
http://cesd.az/new/wp-content/uploads/2018/01/CESD_Research_Paper_Azerbaijan_Economy_2017.pdf

the world oil price, which is due to the adjustment of the economy with indirect effects from the oil revenue. Moreover, the changes in the macroeconomic factors are unlikely to be kept fully controlled as at the current moment the economy is not diversified yet. In accordance with official announcements, industry in Azerbaijan is still divided into oil and non-oil sector, which provides a general overview of the current situation.³

4.1. Gross Domestic Product

The GDP of Azerbaijan in 2017 increased by 0.1% and is expected to grow in 2018 further due to a recovery of the economy because of the increasing oil price.⁴

Diagram 1: Oil Price and GDP of Azerbaijan until 31.02.2018



Source: Central Bank of Azerbaijan, Statistical Bulletin 2018

Diagram 1 above explains the correlation between oil price and GDP per month in Azerbaijan. From the diagram, we can see that the GDP of Azerbaijan in 2017 has kept the same pace of change in oil price and increased as the oil price went up. Furthermore, until the end of 2017 the GDP kept a positive fluctuating trend. However since the beginning of 2018 it declined, although the oil price is increasing.

If we analyze the connection between GDP and Oil Price from Diagram 1 above, recent changes in oil price clearly demonstrate a correlation between Azerbaijan's GDP Growth and oil price. But the side effects of these indicators are even bigger because the dependency of

³ Development of industry in the Republic of Azerbaijan for January-September of 2017

<http://www.economy.gov.az/en/article/azerbaycan-respublikasinda-senayenin-inkishafi-haqqinda-2017-ci-ilin-1-ci-rubu-uzre/28197>

⁴ The Ministry of Finance of the Republic of Azerbaijan, "Presentation of projects on state and consolidated budget of the Republic of Azerbaijan for 2018", 26.12.2017, p.6

<http://www.maliyye.gov.az/sites/default/files/Budce-19.10.2017.pdf>

the non-oil sector on the oil sector is similar to the domino effect for the economy in the case of Azerbaijan. If the price of oil fluctuates, so too does the economy of Azerbaijan with a short lagging period.

Since the end of 2016, world oil prices started to recover and reached 65 USD by the end of 2017 with an increasing pace until the beginning of 2018. The relatively increasing oil price to 65 USD has allowed the Azerbaijani economy to improve by recovering revenues and reserves in the country which stimulated the whole economy by the end of 2017. The average oil price which was around 57 USD has provided the country with the possibility to balance the economy with increased revenues of oil and helped the economy to get out of the recessionary gap. Subsequently, government budget expenditures for 2018 have increased, mostly concerning substantial spending. Therefore, for 2018 slow economic expansion is expected, as Azerbaijan's economic wheel is turning faster with more financial injections into the economy as more government spending is created. This is because Azerbaijan is a consumption economy and other sectors depend on the inflow of spending to survive.

The stabilized exchange rate since the 1st February 2017 demonstrated itself in the GDP growth starting from the end of May 2017. The main factor for economic growth in 2017 was a strengthened exchange rate of the national currency. Moreover, until the first quarter of 2018, the oil price accounted for 67 USD which is 29% higher if compared with the same period of the last year.

In analyzing the structure of GDP in 2017 we can see the non-diversified structure of the economy. Economic sectors accounted for 30.7% in Oil and Mining, 10.5% in Construction, 5.6% in Agriculture and 4.9% Manufacturing.⁵ Furthermore, the structure of Azerbaijan's economy describes a consumption economy and the engine for economic growth is generated through spending both by the government and the citizens. The situation highlights the urge for diversification in Azerbaijan to lessen the vulnerability of the economy as a whole for better social development.

In 2018 projected budget expenditures will be 20.1 billion Manat and it is developed with the forecasted oil price around 50 USD in 2018. But if the oil price will increase higher, the consolidated spending can go up as well. In 2018 State Budget Expenditures are 23.7 % higher than 2017 budget spending. The higher budget spending will lead to GDP growth which can consequently strengthen the economy in the short-run due to the structure of the spending that might occur. Short-term perspectives induced by higher oil prices do not have a lasting effect on economy and the country, such as education, health, social welfare and diversification of non-oil sector.

4.2. Government Expenditures

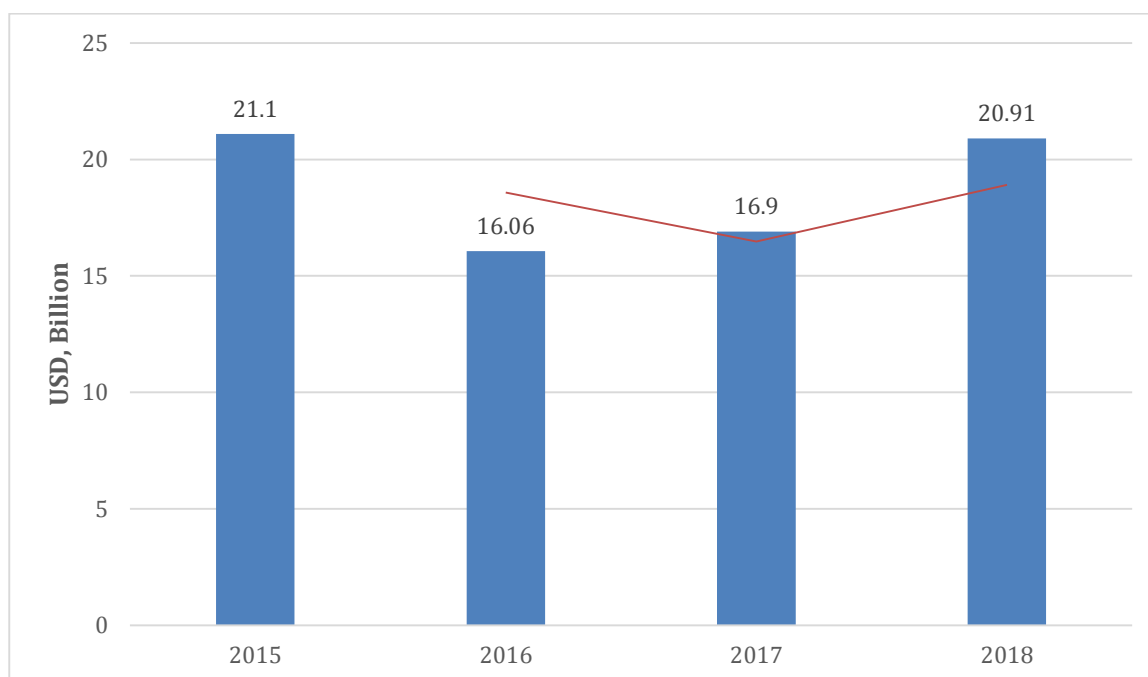
Oil price fluctuations indirectly influence State Budget Expenditures due to the changes in the GDP of Azerbaijan; it makes up the major part of the GDP. We can clearly analyze a

⁵ State Statistical Committee of the Azerbaijan Republic, 2017 Gross Domestic Product
<https://www.stat.gov.az/news/index.php?id=3736>

correlation between the improved oil price, GDP growth, and State Budget Expenditures. The influence of higher oil price through domino effect on government expenditures gives us another perspective in assessing the importance of oil for Azerbaijan.

Government expenditures in Azerbaijan have also fluctuated with the oil price changes and there were cuts in budget expenditures in 2016 and 2017. In 2015 the overall amount of government expenditures in Azerbaijan was 21.1 billion USD which eventually declined by 24% in 2016 and increased only by 3% in 2017.

Diagram 2: State Budget Expenditures 2015-2018



Source: Ministry of Finance of the Republic of Azerbaijan, 2018

According to the graph, there is an oval U shaped trend line in the State Budget Expenditures from 2015 to 2018 which explains the lagging period for the Budget Expenditures and it is due to the fact that the Azerbaijani Government decided 1 year ahead with some expectations for future changes.

According to the Ministry of Finance for 2018, the projected amount of government spending is 20.91 billion USD. This increase in the level of government expenditures is a potential number for the economic development in 2018. The structure of the expenditures for 2018 shows where this money is allocated.⁶

If holding the fact that around 32% of government revenues are just generated from the oil sector without including taxation, payments from oil sector to back up another sector. According to the Ministry of Finance of the Republic of Azerbaijan, the structure of budget spending and the changes in the expenditures are clearly seen. The government is expected to

⁶ The projected budget of Azerbaijan Republic in 2018

<http://www.maliyye.gov.az/sites/default/files/Budce-19.10.2017.pdf>

spend on Substantial Expenditures 4.2 million USD in 2018 more than in 2017. This indicator explains the additional 4.2 million USD to the economy will be injected and it can stop the recession in the construction sector and boost it. It can additionally enhance the purchasing power in the economy and stimulate economic activity. However, this would only be a short-term solution.

Growing oil revenues do not contribute to the fiscal expansion in current expenditures probably due to the pattern of slowing oil prices and the mobilization of revenues towards maintaining the established exchange rates.

Expansionary governmental expenditures are mainly concerned with Substantial Expenditures, which mainly consist of investments into the construction and infrastructure sector. It does not have long-term economic stabilizing purpose; however it can create additional pressure on inflation. Therefore, it should be regulated by the government so that the two-digit inflation will not go to a higher level.

4.3. Hindered Government Reforms?

Since the second half of 2014, after two years of declining oil price the surging demand to search for new and alternative ways to develop the Azerbaijani economy. Therefore, it posed an urging need for the government to take further steps to improve the worsening situation in Azerbaijan. Thus, by the end of 2016, on December 6 the “Strategic Road Map for Major Sectors of the National Economy and Economy” was approved by the President of the Republic of Azerbaijan in order to enhance the economy’s performance as a whole through implementation of various reforms to address the current needs of the Azerbaijani economy.⁷

The Strategic Road Map includes systematic and effective development of public services, more transparent, resilient and flexible adaptation to the requirements of the competitive market economy to take the economy out of the recession. According to the Strategic Road Map, plans were sufficient if executed properly. However current trends after the oil prices started to recover by the beginning of 2017, it discouraged the government to stick to the adopted plans until 2020. Because the inflow of money into the economy was increasing and previous concerns were diminishing to stabilize the economy through diversification strategies.

Furthermore, increasing oil prices are diminishing the speed of reforms which was unquestionably observed during 2017. For instance, the established policy for floating exchange rate changed with regulated floating exchange rate and fixed to 1.7 USD/AZN in accordance with the trends seen by the beginning of 2017 towards the end of the year.

⁷ Strategic Road Map for Major Sectors of the National Economy and Economy, December 6, 2016
<http://static.president.az/pdf/38542.pdf>

Besides, SOFAZ is projected to transfer 9,2 billion AZN to the state budget in 2018, which is 3,12 billion AZN or 51.1% more in contrast with 2017 state budget transfer.⁸ Eventually, the increased transfer to the state budget and higher government spending will hinder the pace of reforms further as it did throughout 2017.

In the end, higher oil price and the speed of reforms are negatively correlated which hinder the sustainable economic development for Azerbaijan by creating a more comfortable situation for the government with short-term perspectives.

4.4. Oil Prices in Currency Market

Changes in the world price of oil have also influenced the currency market in Azerbaijan by facilitating the strengthening process of the Manat. In the table below we can see the stabilization and strengthening of the national currency during 2017. Since the second half of 2017, a stable national currency improved the balance of payments. This led to higher government expenditures, GDP growth and projected economic growth for 2018.

The oil price constitutes the living standards of the people in the country as well, due to the changes in economic stability. Firstly, the negative balance of payments led to a misbalanced economy and which eventually ended with the devaluation of the national currency. The negative balance of payments has led to a decline in government spending and reform which eventually led to a recession in the economy because around 30% of GDP consists of government expenditures in Azerbaijan's economy.

Table 1: Exchange Rates of Manat

Date	USD	Euro	GBP	RUB
31.03.2018	1.7	2.0933	2.3855	0.0297
31.01.2017	1.9165	2.05	2.3975	0.032
% of Change	-14%	2%	-1%	-7%

Source: Central Bank of Azerbaijan, 2018

The predictability of the manat can enable the enhancement of trade relations and exports of the country due to the fact that Azerbaijan's products have gained relatively competitiveness in the world market due to the devaluations. The value of the national currency is forecasted to be higher than the actual one, but with intervention by the state the exchange rate is kept at 1.7. AZN/USD. A floating and stable exchange rate of AZN is crucial for balancing the economy, facilitating economic growth and lowering the inflation rate in the country in order to decrease it to a one-digit inflation rate.⁹

⁸ State Oil Fund of the Azerbaijan, 2018 budget approved
http://www.oilfund.az/en_US/hesabatlar-ve-statistika/buedce-melumatlari/azerbaycan-respublikasi-doevlet-neft-fondunun-2017-ci-il-buedcesi-tesdiq-edildi-29-12-2017.asp

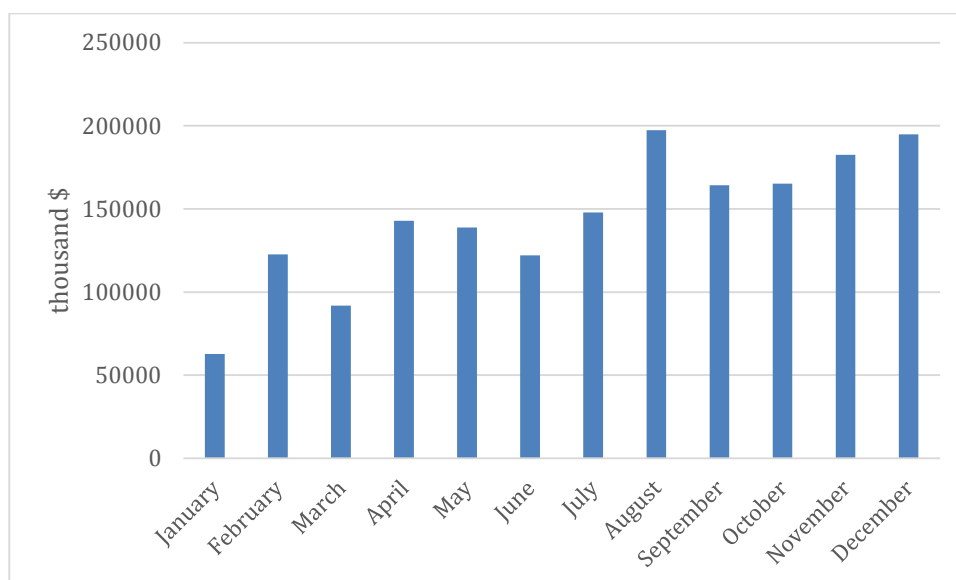
⁹ Central Bank of the Azerbaijan Republic: List of all AZN rates
<https://www.cbar.az/other/azn-rates>

The stable exchange rate catalyzed the financial balance in Azerbaijan and it was an important factor in influencing GDP growth. Consequently, the recovery period of the economy enhanced the trust in the national currency and people holding currency started to spend it. The correlation between GDP of Azerbaijan and both government and individual expenditures is quite high.

The secure exchange rate of the manat has provided economic stability to the economy as a whole. But the recent activities of the Central Bank show that Azerbaijan has recovered the fixed exchange rate and fixed it to AZN/USD to 1,7. However, it is supposed to hold an interval between two variable numbers which does demonstrate a promising situation for the future instability of the local economy.

This situation can cause problems for the Central Bank and it shows a possibility for a new devaluation of the currency if the pressure for USD will increase and outreach the capacity of the currency market.

Diagram 3: Demand for USD



Source: Central Bank of the Republic of Azerbaijan, 2018

In the graph above, which describe the demand for USD, we also observe an increasing trend which can put further pressure on the national currency if it will exceed the supply of AZN. In the analysis of Diagram 3, we can see a surging demand for USD in Azerbaijan which can offers an explanation regarding the currency market fluctuations and importance for the volatility interval for AZN. In 2017 the supply of AZN exceeded the demand for USD with a slight difference, but in case of outperforming, the new depreciation of AZN can be foreseen.

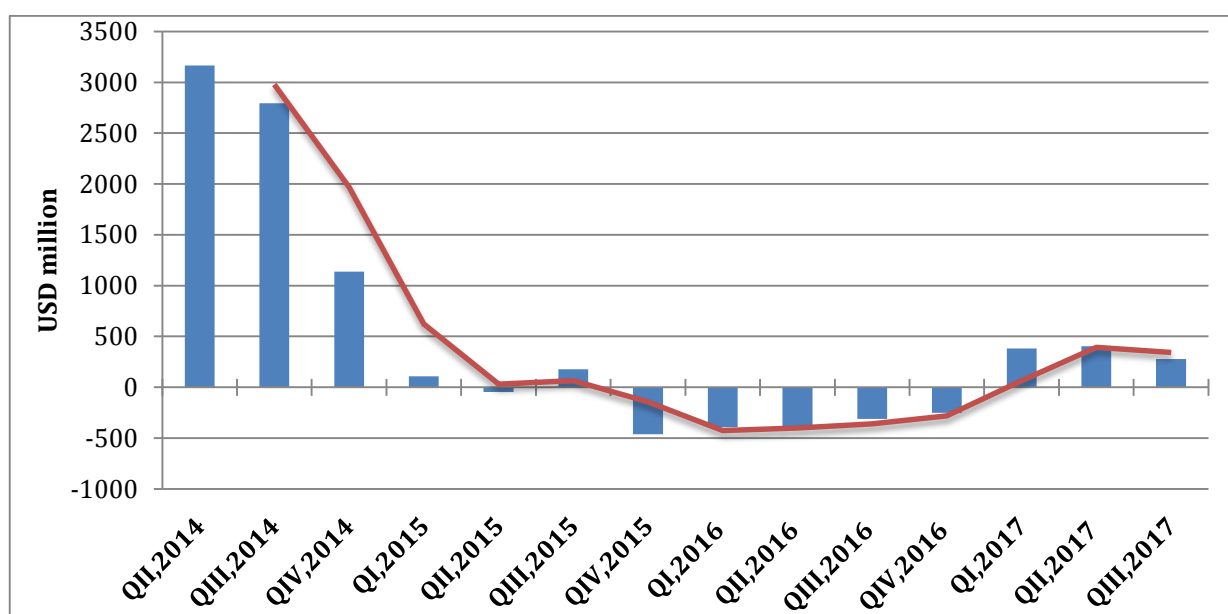
¹⁰

¹⁰ Central Bank of the Republic of Azerbaijan: Exchange operations with cash foreign currency
<https://www.cbar.az/assets/3595/3.6.pdf>

4.4.1. Balance of Payment

The primary effect of oil price increase is seen in the exchange rate of the national currency the Azerbaijani Manat which subsequently affected the balance of payments of the country as well. Diagram 4 with a bar graph below demonstrates the Current Account of the Balance of Payment of the Republic of Azerbaijan from 2011 until the third quarter of 2017. Since 2011 until 2014 we can see a gradual decline in the Current Accounts which is around 15% and the oil price was on average 103.9 USD between 2011 and 2014. Eventually, in 2014 September sharp decrease in oil price severely damaged the national accounts of the Azerbaijani economy up to 2016.

Diagram 4: Quarterly Current Account of Balance of Payment in 2014 – 2017



Source: Central Bank Statistical Bulletin December 2017

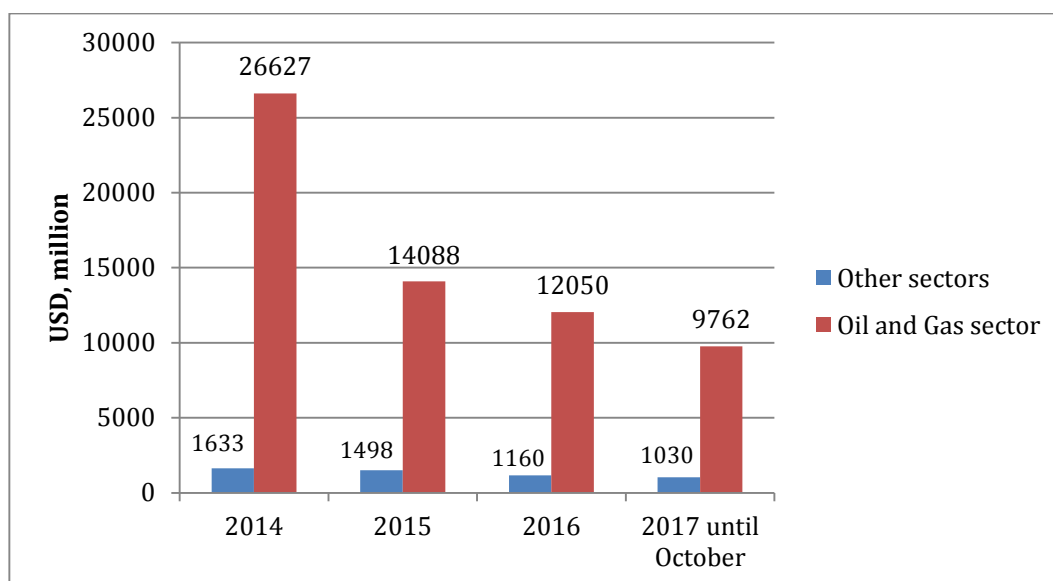
The Current Account of Balance of Payment in 2016 was in negative which follows the changes in the oil price as well. Until the end of 2016, the negative balance declined and turned into a positive one since the beginning of 2017 where the oil price was already at a satisfactory level for the Azerbaijani economy.

However, in 2017 the stabilizing and increasing oil price has shown its impact and the Current Accounts which turned into a positive account with the average annual oil price 52.1 USD in 2017. The improving trend in the overall economic activity of the country is expected to grow as the oil price will remain around 65-70 USD.

The Current Account of Balance Payment in Azerbaijan is very vulnerable to the changes in the world oil price as Azerbaijan's biggest share of export and economy relies on the oil sector. As figured out from the graph above, the red trend line fluctuates around positive balance since the first quarter of 2017, but if compared with the Current Account in 2014, it is

quite less in value which means that the Azerbaijani economy has much more to recover until it reaches the balance of 2014 once again.

Diagram 5: Exports of Azerbaijan from 2014 till 2017 October



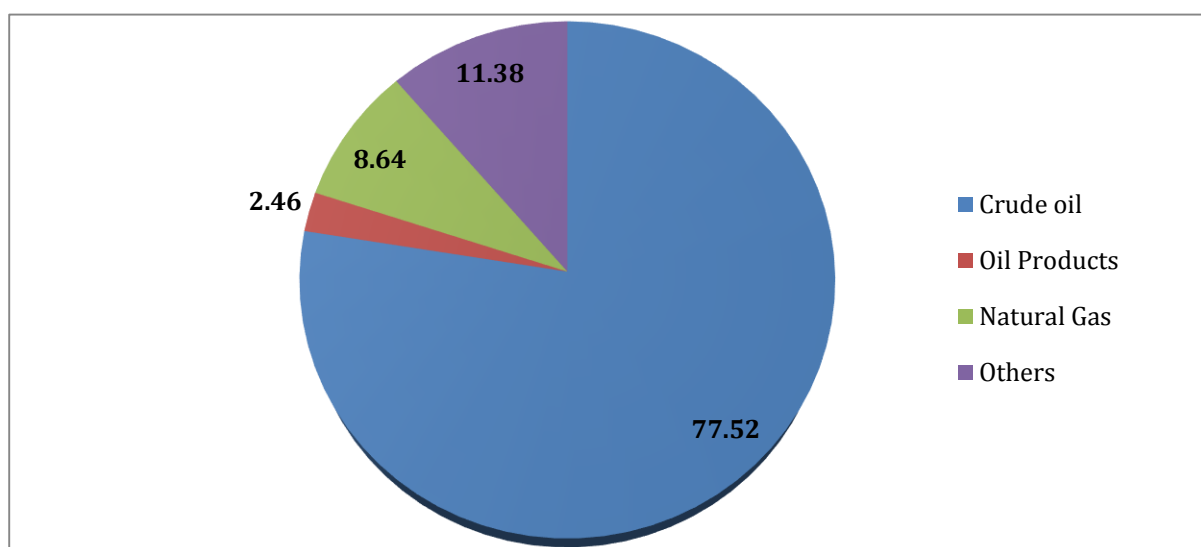
Source: Central Bank of Azerbaijan Republic, Statistical Bulletin 12/17

In diagram 5 above we can observe with an ease the influence of oil price on Azerbaijan's economic potential which describes the Exports of Azerbaijan since 2014. The decline of oil price has decreased approximately 121% from 26627 million USD in 2014 to 12050 million USD in 2016. Exports are the main indicators for the currency market to balance the economy, as it is the major foreign currency attractor to the country. That is why Azerbaijan should take more care for changes in exports and start an export-oriented policy to enhance the level of non-oil sector in exports.

After changes in oil price, non-oil sector exports have also faced a decline of about 40% which shows a clear correlation between the oil and non-oil sector in Azerbaijan. The oil economy is a major part of Azerbaijan's economy and in 2017 the oil sector comprised 37.2% of GDP and approximately 90% of exports in Azerbaijan which makes the economy vulnerable to changing oil prices with side effects of oil sector on non-oil sector. Since the oil price was around 60 USD it enabled the other sectors also to develop, as the economy of Azerbaijan is highly dependent on oil revenue. The small domestic market is also an issue which does not induce investors to be interested in doing export-oriented business in Azerbaijan which is eventually influencing the local economy negatively.

The pie chart below describes the structure of the exports in 2017 in detail which also demonstrates the dependency of Azerbaijan on Oil and Gas production. In 2017 crude oil and natural gas accounted for 86.16% of all exports of the country. Furthermore, it is an additional indication in examining the dependency of Balance of Payment Account on oil and gas sector, which also describes the foremost reason of economic vulnerability.

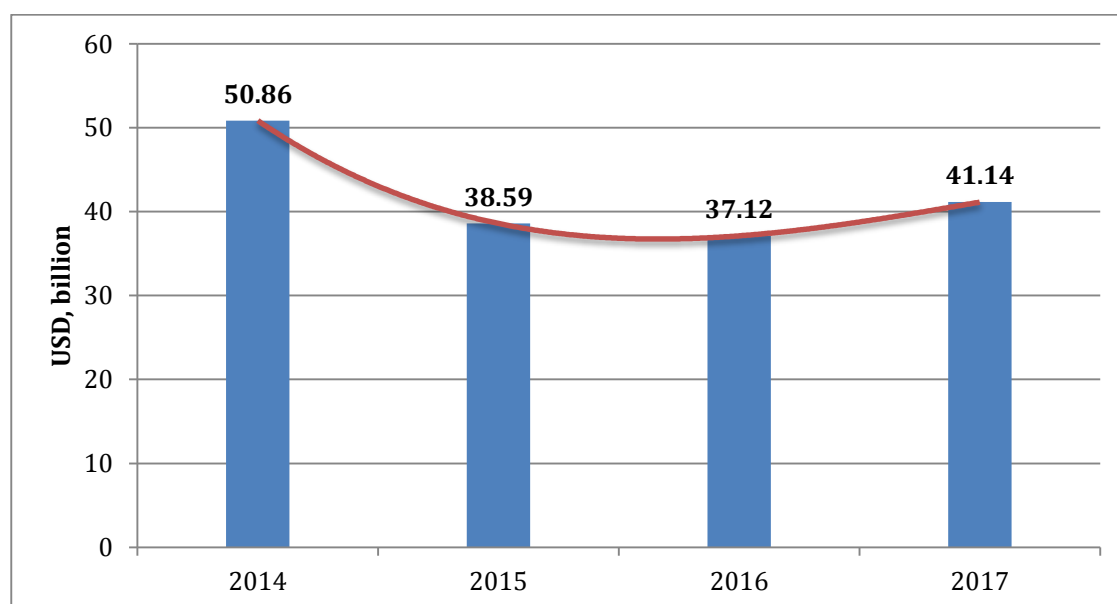
Diagram 6: Export Good Structure of Azerbaijan in 2017 (in %)



Source: State Customs Committee of Azerbaijan Republic, 2018

The structure of the exports of Azerbaijan poses an urging need, due to its non-diversified structure, for new initiatives to be developed to encourage the other sectors to flourish which comprised only 11.38% of the exports in 2017. Another difficulty is also monitored in the exports of oil products which is only 2.46% and explain the scarce value adding Azerbaijan receives from finished products of the oil sector.

Diagram 7: Strategic Currency Reserves of Azerbaijan Republic 2014-2017



Source: State Oil Fund of Azerbaijan Republic, 2018

In the graph above, diagram 7, we can see changes in the strategic currency reserves between 2014 and 2017. It declined in 2015 and 2016 but increased in 2017. It can be associated with changes in the balance of payment due to the relatively strengthened currency level. In the last quarter of 2016 we have observed the negative current account but in the first

quarter of 2017, it turned into a positive balance. Consequently, after the recovery stage in 2017, the positive influence of government expenditures can be analyzed on GDP growth, Exchange Rate stabilization and improvement of the Balance of Payment. But the Current Account of Balance of Payment could not have recovered to the level as it was in 2014. If the oil price will remain relatively unchanged, the economy can be strengthened through the governmental reforms. The changes in the balance of payment are also explored in the strategic currency reserves of the Azerbaijan Republic. The increased strategic currency reserves allowed the state to enlarge government expenditures.

The surplus of Current Accounts of Balance of Payment led to an increase in the strategic currency reserves of Azerbaijan. The strategic currency reserves at the end of November 2017 in comparison with the January 2017 have increased by 13.3% (5 billion USD) and totaled 42.6 billion USD. The currency reserves of the Central Bank have risen by 32% by the end of November 2017 and comprised 5.2 billion USD.¹¹

5. Stable Oil Price for Stable Economic Development?

The oil price fluctuations have influenced the Azerbaijani economy together with additional declining trend of production profoundly. There have been several types of research on oil producing economies with an assessment of the whole economy with its dependence on oil. Additionally, the International Monetary Fund has carried out breakeven analysis for oil producing economies. The breakeven analysis shows the price of oil required to balance the economy. According to IMF's 2017 analysis the Fiscal Breakeven is 55.1 USD and External Breakeven is 45.1 USD in Azerbaijan. This data has revealed how much Azerbaijan is dependent.¹² The breakeven points of the Economy of Azerbaijan explain if oil prices go below a level it can easily damage the whole economic system of the country. This given data by the IMF demonstrates the level at which the Fiscal and External balance of Azerbaijan is equal to zero. In short, oil price that is required to balance the Economy of Azerbaijan.¹³

The external breakeven point forecasted by the Azerbaijan state officials is 45 USD for 2018. This number demonstrates the expected price required by the State of Azerbaijan to balance the economy.¹⁴ If the price of oil goes below this level, the government cannot afford to meet the Budget Projection for 2018 and eventually can do enormous damage to the economy in the short run. However, experts assume the lower oil price below the breakeven point can induce the Azerbaijani Authority to take further actions with more consideration in

¹¹ Azerbaijan Republic Central Bank – Main directions for 2018 Monetary Policy, p.2
<https://www.cbar.az/assets/4472/NEW-beyanat-28.12.2017.pdf>

¹² Regional Economic Outlook: Middle East and Central Asia, October 2017, p.108
<https://www.imf.org/en/Publications/REO/MECA/Issues/2017/10/17/mreo1017>

¹³ International Monetary Fund: Assessment of MENAP Countries 2017
<https://www.imf.org/~media/Files/Publications/REO/MCD-CCA/2017/October/MENAP/mcd-printer-without.ashx?la=en>

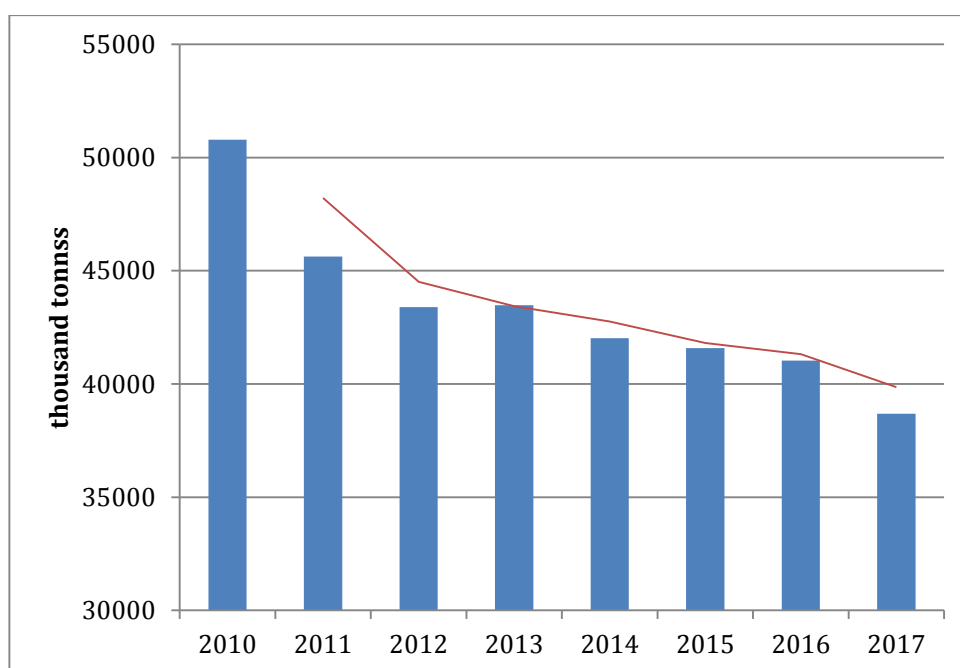
¹⁴ The Ministry of Finance of the Republic of Azerbaijan, "Presentation of projects on state and consolidated budget of the Republic of Azerbaijan for 2018", accessed: 26.12.2017, p.10
<http://www.maliyye.gov.az/sites/default/files/Budce-19.10.2017.pdf>

order to tackle the existing economic problems for long-term solutions rather than concentrating on short-term perspectives.

Strengthening the entrepreneurial activity and diversification are quite noticing factors for the sustainable development of Azerbaijan's economy. Although the oil price is increasing at the moment the scenario is different when analyzing the other elements, on the other hand, the oil production in Azerbaijan is declining. Oil production in Azerbaijan just in 2017 declined with 6% compared with 2016. But the trend has been ever declining since 2013. The decreasing oil price and not well predictable oil price demonstrates the urge for developing the non-oil sector in Azerbaijan to enhance the resilience of the economy.

A diversified economy in Azerbaijan can allow sustainable economic development for the country. The sustainability of economic growth and improvement cannot be achieved if the Economy of Azerbaijan has a large dependency on oil revenues to sustain the economic activity of the country as a whole, which means that other sectors do expect money inflow coming from the oil sector. Thus, the situation creates a “domino effect” inside of the Azerbaijani economy.

Diagram 8: Oil Production in Azerbaijan



Source: State Oil Company of the Azerbaijan Republic, 2018

Declining oil production is also creating an additional urge for the government to deliberately develop the non-oil sector. Oil production has declined 23% in Azerbaijan since 2010 up to 2017 which can be observed in Diagram 8 above.¹⁵ The major reason for the production decline is that the oil rigs of Azerbaijan from the surface level have finished. Thus for the further exploration of deep sea and drilling extra investment is required, but the

¹⁵ Economic and Statistic Indicators of the SOCAR

<http://socar.az/socar/az/economics-and-statistics/economics-and-statistics/oil-production>

investment is still lacking. Therefore, since 2010 oil production in Azerbaijan has had a negative trend up to 2017 and it can worsen in the upcoming years as well.

According to the analyses carried out in the paper, the likelihood of changing oil price is clearer to have a general forecast for the future state of the economy after analyzing past and current trends in the country. Hence, we have developed a qualitative research part for the possible future trends in accordance to the fluctuating oil price. Therefore, we have evaluated three potential scenarios with the relevant consequences of the historical experiences for the Azerbaijani economy regarding the oil price fluctuations.

If holding the oil price as the profound influencing factor to the economy as a whole, we can see two possible scenarios for the Azerbaijani economy:

5.1. Higher Oil Prices and Distorted Economic Growth

If oil prices will stay stable around 60 USD or higher than 70 USD in 2018 then the Stable Economic Development for the Azerbaijani economy could be attained in the short term period, but it does not have long-term perspectives if measures will not be taken by the government. Therefore, economists in Azerbaijan should implement some concrete policies to mitigate upcoming problems of the oil-dependent economy.

The economy will keep recovering at its current pace and government can slowly improve the macroeconomic outlook of the country. It will lead to economic growth with approximately 1-2 % annual GDP growth rate and enhance the purchasing power. This will improve the trust in the national currency and lead to a more sustainable path for the country as a whole.

Firstly, the stable oil price will impact the balance of payment positively where the Azerbaijani government will start to increase its expenditures and it will enable the national currency to get stronger. The expansionary fiscal policy and stronger national currency in the case of Azerbaijan will lead to steady GDP growth and assist in controlling the two-digit inflation rate. The positive and improved surplus of Azerbaijan's economy if the prices will be around 60 USD in 2018 will enable the government to continue steady economic development with a controllable level of macroeconomic indicators. It will reduce the risky environment of doing business, investing, working and concentrate on sustainable economic development in Azerbaijan.

However, higher oil price can only return the economy back to 2014 levels, but the Azerbaijani economy cannot be developed without implementation of new reforms and policies even though the oil revenues will increase. Therefore, even if the oil prices in 2018 will go higher than 70 USD, the government should stick to the Strategic Road Map to guide its future state.

Additionally, higher oil price can result in increasing inflation rate created due to higher spending levels in Azerbaijan's consumption economy. Because Azerbaijan, as could be seen from the analyses of the research, government responds to the increased inflow of foreign exchange with an expansionary fiscal policy by increased government spending and budget

expenses. This practice can accelerate the two-digit inflation rate further by governmental intervention to the market. The higher government spending will benefit the country only for the short term if the government will follow the same spending patterns as in the past, such as on infrastructure.¹⁶

Furthermore, this scenario should be well-managed, otherwise it can worsen the economic situation as it will not induce the government to take important steps in strengthening the economy for long-term solutions. Therefore, this scenario is not favorable in case it will not be effectively tackled as we can see from past experiences.

5.2. Lower Oil Prices and Encouraged Development

Lower oil prices, if we analyze the time-span between 2014 and 2016, would encourage the government to take alternative measures in improving the economy as a whole with well-established plans and reforms.

Looking at the experience of 2015 until 2016 when the economy was unable to balance itself and severe economic recessions occurred. It can get even worse in the short-run because the economy has not recovered itself to the previous stage with a more stable inflation rate, exchange rate, GDP growth rate and other macroeconomic factors. If accounting the assessment of the IMF and the State Budget Project of the Azerbaijan Republic, the economy will face a reconstruction period until the government carries out proper policies and reforms to mitigate the short-term recessionary gap of the economy.

Additionally, this scenario can cause a recession for several years, but oil prices lower than 45 USD can induce the government to reconsider new reforms and policies to improve the economy by implementing alternative measures for development. Furthermore, this situation can lessen Azerbaijan's dependency on oil in the long-term, in case it will be managed through effective allocation of the country's resources. The financial resistance of the country will improve in the long-term period which also leads to increase the probability of attracting more investments due to a strengthened economy. The financial resistance also provides ground for economic development. The diversification of the country's economy is one of the major issues to tackle with precise attention for the next upcoming years in order to achieve a stronger economic situation to enhance the living standards of the citizens.

Facilitation of the implementation of the Strategic Road Map can be an achievable solution to deal with the difficulties brought by lower oil price for the development of Azerbaijan Economy. It can consequently lead to sustainable growth and strengthening the structure of the economy within the country as better reforms are crucial in enhancing the resilience of the Azerbaijani economy to the challenges of economic recessions.¹⁷

¹⁶ Oil Becomes More Expensive. Should We Be Happy about That?
<http://cesd.az/new/?p=11295>

¹⁷ Azerbaijan reveals volume of soft loans provided to entrepreneurs
<https://en.trend.az/business/economy/2865089.html>

Conclusion and Recommendations

After the analyses of this study, the past and current economic situations demonstrate the acute situation in Azerbaijan with an urging need to implement better policies and reforms by the government with long-term perspectives. Additionally, oil dependency in Azerbaijan should be examined in details to develop the non-oil sector and abolishing the division of the economy into two parts: oil and non-oil sector. Thus the Azerbaijani authorities should recognize the importance of sticking to the plans of the Strategic Road Map in 2018 to withstand the economic downturn in 2017. But the higher oil prices have distorted the speed of the reforms and created additional concerns. High oil prices will not entice the government to push for reforms, but in a low oil price environment there could be stronger need for reforms.

The economic situation can be further developed and solved if the liberalization in the governance system could be improved and enhancement of the promotion of SMEs by providing a space for diversification and lowering the focus given to state owned companies. Hence it can lead to a structural well-backed development within the country.

Additionally, the focus could be drawn into expansionary governmental policy with higher spending in other sectors rather than infrastructure. Consequently, more investors will be willing to invest in Azerbaijan. But the usage of the government expenditures is not very promising for the future trend if the previous ones are analyzed. The Azerbaijani Government should consider more long-term perspectives which can strengthen and diversify the economic stability of the country through effective economic and social reforms, which eventually can lead to a more prosperous economic situation for everyone within the country rather than just the upper-class. Furthermore, achieving the long-term plans for Azerbaijan can offer many advantages for a bottom-up development.

The small domestic market is also an issue which does not allow non-oil products to be produced in Azerbaijan. As a result, we have found the diversification of non-oil sector and promoting small and Medium-sized Enterprises as the possible solutions to the vulnerability of the Azerbaijani economy. Additionally, the development of SMEs can also add value to the economy, as local production will be improved.

The SMEs' role in the development of an economy for a sustainable growth and strengthening the structure of the economy in a country is crucial. After the 2008 crisis, it was more obvious that SMEs are more resilient to the challenges of economic recessions throughout the world, which can be a similar case for Azerbaijan.

Moreover, Azerbaijan should heavily invest in education and academics to mitigate future consequences to allocate its real economic resources through bottom-up development. Higher revenues from the oil industry should be allocated to human capital development in order to attain an effective economic situation, which is unlikely to happen until the structural reforms take place for the betterment of economic sectors with the main focus in education, as it is the common base and a real value of an economy without an intrinsic and monetary value. It will

enable the economy to grow sustainably because the most important asset for a country's economy is its skilled human capital. This can build up the long-term perspectives for social development in the country.

We propose the following recommendations in order to improve the economic situation in Azerbaijan and solve the aforementioned problems.

Recommendations:

- Following to plans of the Strategic Road Map until 2020 fully in order to improve the self-sufficiency of the Azerbaijani Economy by complying with the projected plans.
- Enhancing the development of the legislative system in Azerbaijan which will attract more Foreign Direct Investments (FDIs). Because FDIs are done for long-term perspectives and the investors are not willing to invest in the high-risk environment.
- Facilitating the development of Small and Medium-sized Enterprises, by strengthening the rule of law and establishing new attractive policies. So that, the diversification of the economy could be developed with a bottom-up approach, as SMEs are bringing innovations to the market which will create a favorable situation for Azerbaijan in the long-run. Consequently, innovations brought by the SMEs' can enrich local production by encouraging value adding to the economy.
- Establishing a "Diversification Fund" which will deal with developing and implementing plans for improving the non-oil sector in Azerbaijan by providing pioneering suggestions and policy measures to the government in order to build alternative approaches for economic development in Azerbaijan. The fund should be involved with analysis of grassroots of the current economic difficulties in Azerbaijan to be able to simplify the development process for diversification of the Azerbaijani economy, which is an urging need for the future of Azerbaijan. Moreover, through the Diversification Fund local production, businesses and start-ups will be supported, thus the export potential of Azerbaijan could be enhanced further.
- Creating a Currency Market Balance to assess the demand for foreign currencies and volume of currency entering the Currency Market. Thus it will improve the predictability of the AZN exchange rate and lower the risks in order to be able to mitigate upcoming changes in the market. Additionally, establish a volatility interval for the exchange rate of the Azerbaijani Manat should be determined, to make the national currency resistible to any small change in the Exchange Rate Market.

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