THE FINANCIAL POLICY OF OIL-EXPORTING AZERBAIJAN

Abstract. This paper evaluates the financial policy of oil-exporting Azerbaijan in the recent oil boom and bust period. Analysis of fiscal policy evaluates the fiscal sustainability and efficiency of government spending to upgrade domestic economy. Monetary policy evaluation measures the effect of the exchange rate policy on competitiveness of non-oil economy and capacity of Azerbaijan government to sustain macroeconomic stability in the oil-shock period. The share of the oil revenue in government budget increased significantly, and budget spending is directed to physical investment while investment in human capital in the form of health, education and social spending lagged behind. Aside from currency crises in 2015, macroeconomic stability has been under control, but fixed exchange rate policy impeded the competitiveness of non-oil sector and caused Dutch disease.

Keywords: fiscal policy, financial policy,

Introduction

As an oil-dependent economy, the management of the oil windfalls has been one of the main challenges of financial policy of Azerbaijan. Lavish spending in oil boom period causes serious financial trouble to execute budget obligation in the course of commodity recession. Addition to problem of financing budget spending in rainy days, the injection of excess amount of oil revenue into domestic economy via fiscal channel keeps private sector underdeveloped and budget–dependent which can cause “Dutch disease” syndrome (Corden 1982). In the reality of oil-dependent budget, and budget-dependent private sector of Azerbaijan, procyclical fiscal policy causes deterioration of citizens’ living condition when oil revenues fall. From these considerations, the feasible financial policy is important for post-socialist Azerbaijan. Huge amount of investment in oil sector and launch of Baku-Tbilisi-
Ceyhan pipeline brought huge oil revenue for Azerbaijan in global commodity boom period. The suitable financial policy is important for mitigating negative effects of exogenous money on Azerbaijan economy and managing fiscal sustainability.

The challenges of provision intertemporal equity of benefiting from oil revenue has been main task need to be taken into consideration in oil-exporting developing countries. According to Permanent Income Hypothesis (PIH), government should save significant part of oil windfalls in the wealth form for future period rather than increasing current consumption (Mirzoev and Zhu 2019). The government should smooth consumption in the period of oil boom, fall in price and production and post-oil period. Azerbaijan also established sovereign wealth fund (SOFAZ) to effectively manage oil wealth, nevertheless, its success is debatable.

In this paper, I give descriptive analysis of the effectiveness of financial policy of oil-exporting Azerbaijan. In this consideration, I evaluate the effectiveness of fiscal and monetary policies with respective measurements. I investigate the efficacy of fiscal policy by consideration of fiscal sustainability and the effect of fiscal policy on efficiency of overall economy. For first consideration, I measure the dependency of state budget on oil revenue and the development of tax policy as a source of budget revenue of Azerbaijan. Economic justification of public investment and current budget spending will be examined to evaluate efficiency of budget spending. At the same time, the role of oil-source government supports to State Owned Enterprises (SOEs) via fiscal channel on their efficiency improvement will be evaluated. The level of economic restructuring of SOEs inherited from socialism has been one of the main drivers of economic success of post-socialist countries, therefore, this criteria is important in evaluating effect of fiscal policy on efficiency of economy. The suitability of monetary policy is analysed on the basis of effectiveness of exchange regime to support non-oil economy and overall macroeconomic stability. Alike majority of oil-exporting country pursued fixed-exchange rate regime for neutralizing negative effect of oil windfalls on non-oil economy and avoid currency volatility caused by fluctuating oil prices...

I will deploy the data from State Statistics Committee of Azerbaijan Republic (SSCAR) and Central Bank of Azerbaijan Republic (CBAR) for period 2002-2019.
The following section investigates the fiscal policy of Azerbaijan, followed by evaluation of monetary policy. The last section concludes.

**Fiscal Policy**

The involvement in devastating war in tandem with transition shock upset economic performance and macroeconomic stability in Azerbaijan in early years of transition period. The collapse of trade and financial links with soviet bloc caused dramatic fall in national output and price and trade liberalization engendered macroeconomic instability in the form of hyperinflation which was caused money printing to cover large budget deficit in the environment of the impossibility to finance budget deficit by borrowing (Kaynak and Nasirova 2005, Niftiyev 2021a). Achieved the political stability in mid-90s and promise of forthcoming oil revenue as a result of huge investments by FDIs convinced IMF to lend 240 million USD to Azerbaijan for macroeconomic stabilization and social assistance accompanying market reforms1. In one word, Azerbaijan government was able to achieve macroeconomic stability in mid-90s.

The huge investments in energy industry, construction of energy transportation and global rise in fuel prices brought colossal income for Azerbaijan. Considering the persistence of miserable social condition, backwardness of economic structure and reality of sharp decline in oil reserves of Azerbaijan in mid-20s, the management of oil revenue required careful approach from government (World Bank 2011). First issue should be taken into consideration is the effect of oil prices on fiscal sustainability. Will government be able to finance the level of spending in period of fall in oil revenue similar to oil boom period? Sovereign wealth fund was established for effective management of oil revenues. However, Azerbaijan government could not abstain from fiscal expansion. Figure 1 depicts that budget spending increased in tandem with rise in oil revenue in Azerbaijan. Nominal budget spending increased 9 within 2005-2014 which entails oil boom period.

Table 1 illustrates that share of oil revenue in government budget stood over 51 per cent which proves that the main source of fiscal expansion during oil boom

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INTERNATIONAL SCIENTIFIC DISCUSSION: PROBLEMS, TASKS AND PROSPECTS

period is oil revenue. The rate of dependence of government budget on oil revenue undermines the fiscal sustainability of Azerbaijan. The pursuing optimal budgetary strategy is difficult in oil exporting economies in the reality of rent seeking government (Auty 2001). Al-Sheikh and Erbas 2012 and Assaad 2014 conclude that oil exporting Arabian countries distributes oil revenue to powerful groups such as middle class and members of key tribes via over-subsidized public employment.

![Graph showing Budget expenditure and Oil revenue](image)

**Fig. 1. Annual Budget spending and Oil revenues (in million AZN)**

*Source: State Statistics Committee of Republic of Azerbaijan*

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</thead>
<tbody>
<tr>
<td>Revenues-total</td>
<td>1,509.5</td>
<td>2,055.2</td>
<td>3,868.8</td>
<td>6,006.6</td>
<td>10,762.7</td>
<td>10,323.9</td>
<td>11,400.0</td>
<td>15,700.7</td>
<td>17,281.5</td>
<td>19,496.3</td>
<td>18,400.0</td>
<td>17,498.0</td>
<td>17,505.7</td>
<td>16,516.7</td>
<td>15,108.3</td>
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<td>SOFAZ transfers</td>
<td>277.3</td>
<td>299.0</td>
<td>821.1</td>
<td>793.8</td>
<td>4,037.7</td>
<td>5,197.7</td>
<td>6,136.2</td>
<td>9,305.4</td>
<td>10,306.5</td>
<td>11,842.1</td>
<td>10,538.4</td>
<td>8,706.7</td>
<td>8,474.7</td>
<td>7,161.7</td>
<td>11,921.6</td>
</tr>
<tr>
<td>Share of oil transfer in budget</td>
<td>0.1837</td>
<td>0.1493</td>
<td>0.212236</td>
<td>0.1322</td>
<td>0.37516</td>
<td>0.50337</td>
<td>0.53812</td>
<td>0.952674</td>
<td>0.596889</td>
<td>0.637402</td>
<td>0.546513</td>
<td>0.497336</td>
<td>0.48411</td>
<td>0.6353</td>
<td>0.52964</td>
</tr>
</tbody>
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*Source: State Statistics Committee of Republic of Azerbaijan*

From this token, they claim that the suboptimal spending of oil revenues is embedded in institutional background of Arabian oil exporting countries. The transition shock and destructive war caused persistent poverty among more than half of population. Addition to this out-dated public infrastructure needed renovations. Regarding these issues, the voice for spending oil revenue has been immutable in
Azerbaijan. Nevertheless, the sharp fall in oil revenue as a result of decline in oil prices and production which went with currency crisis caused severe fiscal pressure on Azerbaijan to continue same level of spending as in oil boom period. In first three years of currency crisis, the transfers from SOFAZ to government budget were higher than its annual revenue\(^2\). Practically, Azerbaijan had to finance its budget spending from its accumulated oil wealth in SOFAZ. The rise in oil prices increased the revenue of SOFAZ; therefore, it is able to provide annual transfers to government budget with its annual revenues. Azeri and Ismail (2013) analyse 32 oil-exporting countries including Azerbaijan and concludes that governments tends to increase current expenditure when oil price rises but not to reverse when oil price falls. After currency crisis, it can be seen that there is significant fall in public expenditure while current expenditure such as social protection, health, education is stable (SSCAR). Despite, the budget expenditure in terms of USD halved after currency crisis but the fall was insignificant in domestic currency. Relying on budget in domestic currency, it is possible to say that Azerbaijan government did not followed strict procyclical fiscal policy by spending accumulated oil wealth. Global pandemic puts pressure on all countries including Azerbaijan. In order to overcome social economic burden of pandemic, Azerbaijan government refers to fiscal policy in the fall in economic activity due to lockdown measures. The oil transfers stand the main source of budget revenue. In the condition of low oil prices, the oil revenue is not enough to cover transfers to budget and oil wealth is used for financing budget.

As a post-socialist economy, Azerbaijan government had to more build effective taxation system as a part of transition to market economy. In the first decade of transition, initial necessary steps were taken in this direction. Nonetheless, as oil revenue flood, Azerbaijan government lost incentive development of effective tax system as a source of budget revenue. Addition to non-improvement in enforceability of tax legislation, the fall in tax rate is observed in oil boom period (Aliyev 2018). According to Aslanli (2015), the non-oil tax revenues stands at 20 per cent of non-oil GDP in oil boom period. The table 2 indicates that this ratio stays the same in post-boom period. Aft-

Table 2

<table>
<thead>
<tr>
<th>Years</th>
<th>Non-oil tax revenue</th>
<th>Non-oil GDP</th>
<th>Share of non-oil tax revenue in non-oil GDP</th>
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<tbody>
<tr>
<td>2016</td>
<td>7200</td>
<td>35951</td>
<td>20.1 %</td>
</tr>
<tr>
<td>2017</td>
<td>7215</td>
<td>40328</td>
<td>17.9 %</td>
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<tr>
<td>2018</td>
<td>9440</td>
<td>41588</td>
<td>22.2 %</td>
</tr>
<tr>
<td>2019</td>
<td>8444</td>
<td>44471</td>
<td>19.1 %</td>
</tr>
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Source: Author’s own construction on the basis of data from State Statistics Office of Azerbaijan and CEIC Global Database

Double currency crisis of 2015 which openly revealed the dependence of Azerbaijan economy on fuel exports and vulnerability of government budget, Azerbaijan government accepted “Strategic Road Maps” to diversify domestic economy and shifting to tax-based budget has been among goals of plan. In this direction, “whiting” of informal economic activities is initiated. However, it was not impossible to fully enforce tax legislation and increase taxes on economy immediately after double currency crisis. As economy began to recover in 2018, the COVID-19 came to scene as priority to mitigate its negative social and economic effects and aims of shifting from oil-dependence economy to diversified economy and tax-based budgeting is postponed for post-pandemic period.

The effect of oil revenue on overall performance of national economy is immensely studied (Arezski and Ploeg 2007, Arezski and Ismail 2013; Aye et al 2014, Niftiyev 2020a, Niftiyev 2020b). Their main common result is that the injection of huge oil revenue into harms tradable sectors via Dutch disease syndrome. According this logic, petrodollars cause appreciation of domestic currency which leads fall demand for domestic tradable goods in global competition. In general, non-existence of competitive manufacturing industry in developing countries, and backwardness of industrial structure of post-socialist countries requires special approach for understanding the effects of oil revenues on Azerbaijan economy. The business activity in industry has distinctive features. The profit-making in such sectors depends on coexistence of couple of factors such as product

3 https://ereforms.org/store//media/ekspert_yazilari/islahat%20icmali/mart/strateji%20yol%20x%C9%99r%C9%99si%20-eng1.pdf
quality, price, marketing etc. Contrastingly, the profit making in domestic trade of imported goods, construction and non-tradable service sectors is simpler and less risky than industry. Considering limited absorption capacity of economy due to underdeveloped economic structure, injected oil money into domestic economy tends to end in less riskier sectors of economy. The value of imported goods increased more than 8 times in 2002-2019 (SSCAR). Rise in imports of machinery and equipment stands for considerable part of this increase which can be claimed as a contributor to improvement of technological capacity of economy. However, there is significant increase in imports of consumer products which is not accompanied by rise of exports of respective products. Secondly, the significant part of imported machinery has been utilized in oil and gas industry which does not have technological spill over to overall economy. The rise in the share of non-tradable sectors in overall GDP such as construction, trade, transportation in the background of fall in share of manufacturing in Azerbaijan in 2005-2019 periods supports this hypothesis (SSCAR).

Hasanov et al (2018) analyse the effects of fiscal policy of Azerbaijan on non-oil economic growth and conclude that budget spending has positive effect on non-oil economy both in long and short-run. The dependence of government budget on oil revenue endangers the non-oil economy in the context of volatile oil revenues and possible depletion of oil reserves in near future. Increasing tax source of revenue as alternative to oil income via developed domestic economy can provide more sustainable budget which can ease volatility of budget dependent non-oil economy. At the same time, reducing of budget dependence of domestic economy should be among targets. Regarding import-intensity of government investment, Gurbanov et al (2017) question the determinacy of currency appreciation on weakening of manufacturing industry of Azerbaijan. They indicate the volatile and procyclical government capital investment in public infrastructure does not contribute to improvement of tradable non-oil products. According to their calculation, the 1 per cent rise in oil revenue increases government capital spending by 2 per cent. Consequently, government capital spending raises 0.38 per cent rise in real non-oil GDP but cause 0.23 per cent decrease in non-oil exports.
The economic efficiency of budget spending depends on destinations of spending and quality of spending. Regarding the destinations of spending, table 3 exhibits that nominal budget spending in the form of government investment and subsidies (national economy and other expenditure items in table) to SOEs increased by 18 times in 2005-2019 while overall government spending rose by 11 times. Addition to this, SOFAZ financed several investment projects which are not expressed in government budget. But, investment in nominal term in human capital in the form of educational and healthcare spending increased by 8 times. Devarajan et al (1993) analyse the relations between composition of government spending and economic growth for 70 countries for 1970-1990 and conclude that the economic growth has positive association with current government spending while negative with government capital spending. Mauro (1998) investigates composition of government spending and level of corruption. He claims that the capital spending by government is more prone corruption while current spending is less. Therefore, governments have tendency to increase capital spending while ignoring current spending such as investment in human capital. Nevertheless, the less chance of corruption cannot fully explain the overlook of current spending. The sharp cut in public investment is easier while reversal of education, healthcare and social protection spending is politically harsh after increasing them. Considering volatility of oil dependent fiscal revenue, Azerbaijan government thought twice on politically sensitive spending items. Aslanli (2015) states that transparency of spending of

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<tr>
<td>National economy</td>
<td>444.7</td>
<td>4 889.9</td>
<td>8 207.5</td>
<td>7 598.7</td>
<td>6 408.8</td>
<td>4 124.0</td>
<td>7 822.7</td>
<td>7 961.5</td>
</tr>
<tr>
<td>Education</td>
<td>372.5</td>
<td>1 180.8</td>
<td>1 437.7</td>
<td>1 553.9</td>
<td>1 605.1</td>
<td>1 754.4</td>
<td>1 966.6</td>
<td>2 195.7</td>
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<tr>
<td>Health care</td>
<td>115.3</td>
<td>429.2</td>
<td>618.9</td>
<td>665.3</td>
<td>708.2</td>
<td>702.5</td>
<td>709.9</td>
<td>873.6</td>
</tr>
<tr>
<td>administration</td>
<td>123.9</td>
<td>303.0</td>
<td>349.3</td>
<td>449.7</td>
<td>430.9</td>
<td>470.1</td>
<td>627.4</td>
<td>774.5</td>
</tr>
<tr>
<td>Social protection and security</td>
<td>304.9</td>
<td>1 123.0</td>
<td>1 750.3</td>
<td>1 971.2</td>
<td>1 857.2</td>
<td>2 645.2</td>
<td>2 150.7</td>
<td>2 281.0</td>
</tr>
<tr>
<td>Court authority, law enforcement</td>
<td>206.4</td>
<td>668.5</td>
<td>1 049.3</td>
<td>1 103.6</td>
<td>1 105.7</td>
<td>1 117.1</td>
<td>1 316.4</td>
<td>1 505.0</td>
</tr>
<tr>
<td>Other expenditures</td>
<td>468.1</td>
<td>2 818.5</td>
<td>4 610.2</td>
<td>4 569.5</td>
<td>4 578.6</td>
<td>4 371.3</td>
<td>5 485.0</td>
<td>8 376.2</td>
</tr>
<tr>
<td>Expenditure-total</td>
<td>2 140.7</td>
<td>11 765.9</td>
<td>19 143.5</td>
<td>18 709.0</td>
<td>17 784.5</td>
<td>17 751.3</td>
<td>22 731.6</td>
<td>24 425.6</td>
</tr>
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</table>

Source: State Statistics Committee of Azerbaijan Republic
Azerbaijan’s oil income is opaque.

Hashimova and Kadyrov (2017) investigate the performance of SOEs in Azerbaijan after currency crisis. They indicate the high indebtedness of these companies after currency crisis as a main problem. At the same time, poor governance and out-dated technology are considered as main backwardness of those companies. Before and after crisis, significant amount of money has been transferred to unprofitable SOEs. Kornai (1979) coins “Soft Budget Constraints” (SBC) to describe continuous government support to firms which cannot cover its costs. In this regard, persistence of SBC financed from government budget undermines the efficiency of budget spending which is transferred to chronic loss-making SOEs. Existence of SBC reduces the motives of managers of SOEs to improve productivity of their companies.

**Monetary Policy**

The majority of oil-exporting countries choose the fixed exchange regime for neutralising the effect of injected petrodollars into domestic economy via fiscal channel. Influx of huge amount of foreign currency into economy would appreciate the domestic currency which undermines the price competitiveness of the tradable non-oil products against foreign goods (Corden 1984). For protecting competitiveness of domestic currency, Central Banks purchase foreign currency and prevent appreciation of domestic currency. Addition to prevention of “Dutch disease”, stabilization of currency rate and overall of macroeconomic environment is another aim of fixed exchange regime in the condition of volatile oil revenues. Azerbaijan also pursued fixed exchange rate policy in 2004 until currency crisis in 2015. Nonetheless, fixed exchange regime tied hands of CBAR to overcome inflationary pressure. Rapid fiscal expansion caused inflation and CBAR could not reduce money supply because of priority of taming currency appreciation. Fiscal expansion caused double-digit inflation in 2005-2008 in Azerbaijan (WB). Hasanov (2013) claims that rapid inflation and rise in wages caused appreciation of real exchange rate. According to him, the “spending effect” of oil revenue via fiscal channel caused relative de-industrialization in Azerbaijan. Niftiyev (2020c) also confirms that overvaluation of national currency through real appreciation of wages
is one of the reasons for decline of manufacturing. Addition to this, he indicates non-targeting of rebuilding of industrial heritage as a main cause of de-industrialization in Azerbaijan. Considering this findings, it can be claimed that exchange rate regime is not enough itself to overcome Dutch-disease without well-targeted fiscal policy. By implying multivariate OLS, Niftiyev (2021b) finds the existence of oil-sourced Dutch disease in Azerbaijan.

![Fig. 2. Azerbaijan: Foreign exchange reserves including gold, billion USD](source: The Global Economy)

Under fixed exchange rate regime, CBAR collected petrodollars from economy and prevented overvaluation of nominal exchange rate. In this regard, CBAR increased currency reserves up 15 billion USD until 2014 (Figure 2) and used its reserves for avoiding devaluation of domestic currency in the period of falling oil revenue. Despite efforts, double currency crisis occurred in Azerbaijan in 2015. The cost of crisis has been higher in the form inflation due to rise of cost of imported products after crisis, doubling of the debt of whose indexed in dollars, closure of several banks. However, it is hard to achieve without prudent fiscal policy, occurrence of currency crisis undermines the success of monetary policy to provide macroeconomic stability. Despite shift to floating exchange rate regime is declared, they intervene to prevent devaluation.

In short, occurrence of symptoms of „Dutch disease” and currency crisis can be enough to claim that monetary policy has not been successful to achieve goal of preventing decline of manufacturing and providing macroeconomic stability. But,
achievement of these goals requires viable fiscal policy too. Considering macroeconomic stability, the volatility of domestic currency might be harsher without intervention to currency market.

**Conclusion**

Huge influx of oil revenue since mid-2000s necessitated effective management of this revenue for achieving fiscal sustainability and mitigating its negative effect on overall economy of Azerbaijan. In this regard, sovereign wealth fund was established for management of oil revenue. However, Azerbaijan government followed oil-sourced fiscal expansion during oil boom and oil dependence of government spending undermined its sustainability. It can be justified that rise in budget spending was necessary due to persistent social problems after transition shocks. But the main channel of fiscal expansion has been public investment and social spending and investment in human capital in the form of educational and healthcare spending lagged behind overall budget expansion. Several studies found out that overall economy tended to be dependent of budget spending and manufacturing and tradable sectors suffered as a result of rise in real wages and high inflation. Despite fixed-exchange rate regime, the Dutch disease and currency devaluation has been inevitable. After currency crisis, government initiated to reduce dependence on oil revenue and diversify economic activity. However, post-currency crisis situation of overall fiscal policy and economy of Azerbaijan shows that there is more to do to achieve these aims.

**References:**


