

# Investment Policy of the Republic of Azerbaijan: Implications and Prospects

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**Summary:** The research analyzes existing conditions of investment activity and evaluates the role of state in the investment process. Notably, it looks into the role of state and private sector in the investment activity. Moreover, the research identifies that the state possesses enormous opportunities in financing investment activities, and provides further recommendations of utilizing these chances.

**Keywords:** investment policy, investment activity, government regulation.

**JEL:** E22, L52.

Maintenance of sustainable development and enhancing investments are significantly hinged upon state investment policy. State policy plays a crucial role in maintaining economic development. Government impacts on the division of resources by virtue of regulatory means, by actions taken to increase revenue and by decisions over expenditures (1). Government may stimulate private investments, may enhance expenditure on education and health, including on protection of environment for the development of human capital, or direct investments toward the development of infrastructure. Most often, government takes appropriate measures to maintain all these directions. However, shortage

in budget forces government to focus on separate directions. It is worth noting that government should not only invest on establishment of social institutions and infrastructure that bring about development of private sphere, but also on development of industry. It is mainly related to the fact that private sector is limited to invest on huge industrial projects. This is typical for Azerbaijan as well.

Azerbaijan encountered challenges in initial stages of the transition to market economy (from 1990 to 1996) and that led to a drastic decrease of economic activity. In the meantime, government made a strategic decision to direct foreign investment toward extraction of oil and gas. The "Agreement of the Century" signed in September 20, 1994 by leading oil companies on exploitation of Azeri, Chirag and the deep area of Gunashli oil fields strengthened confidence on economic development and political, economic, and social stability. In later stages, 24 new oil and gas contracts have been signed and Baku-Tbilisi-Ceyhan oil and Baku-Tbilisi-Erzurum gas pipelines were exploited. And these projects enabled Azerbaijan to export its oil and gas to world market.

Successful implementation of oil strategy in Azerbaijan brought about development of national economy. Thus, GDP increased 4.9 times compared to 1995 and 3.5 times compared to 2000 respectively. As it is indicated in figure 1, GDP has increased recently. In recent years, growth

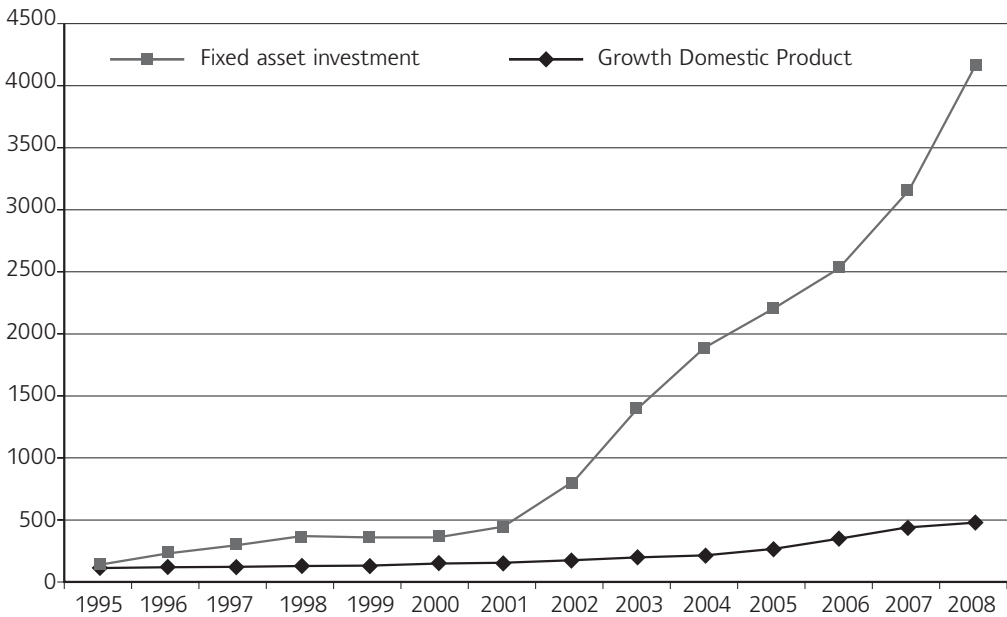


Figure 1. Growth dynamics of GDP and fixed asset investment in Azerbaijan (1995 = 100)

tempo of GDP increased. Such growth was due to oil and gas production in the country. Oil production increased from 14 million tons in 2000, to 22.2 million tons in 2005 and to 44.5 million tons in 2008, gas production from 5.6 billion cubic meters to 5.7 billion cubic meters, and 23.4 billion cubic meters accordingly. As a result, the share of oil and natural gas production field in gross domestic product increased from 27.6 percent in 2008 to 52.5 percent. However, the involvement of foreign investments in oil and natural gas production led to the formation of an internal source, which was necessary for financing development of national economy. Thus, the nominal national saving volume increased from 1426.3 million AZN in 2000 to 20 528.5 million AZN in 2008. Also, the share of savings in income was 27.5 percent in 2000 and 55 percent in 2008 (2). Existing conditions in country's financial resources also increased investment activity. Thus, the fixed asset investment increased 41.6 times in 2008 compared to 1995 and 11.5 times in comparison with 2000 (Figure 1). In-

crease of national saving in the country resulted in increase of share of local source in financing investment. Thus, the entire investment directed toward the economy in 1995-1999 constitutes 27.1 percent, whereas in 2000-2004, 24 percent was carried out thanks to the local source. This indicator was 31.3 percent in 2005, while in 2008 it increased by 57.8 percent.

It should be noted that 11633.5 million AZN out of 20 528.5 million AZN of national saving formed in 2008 constituted funds from Azerbaijan State Oil Fund (3). Accumulation of a significant portion of state revenues in the hand of the state increased the role of the country in financing and implementing investments. Thus, in 2008 fixed asset investment increased 170 times compared to 2000 thanks to budgetary resources. As a result, the share of budgetary resources in financing fixed asset investment increased from 2.3 percent in 2000 to 38.8 percent in 2008. In 2008, however, 50.1 percent of local investment in fixed asset was carried out

with the help of budgetary recourses. Increase of oil revenues enhanced state budget as well.

In this period the state budget revenues increased from 714.6 million AZN to 10762.7 million AZN in 2008. In 2007, 58 percent and in 2008 64 percent of state budget revenues were formed due to oil revenues. Increase in budget revenues had a considerable impact on expansion

of internal market. Thus, share of the current budget expenditure (remaining part after subtracting capital expenditures from budget expenditure) in the country's total consumption expenditures increased from 20.4 percent in 2008, to 63,5 percent in 2000. As it is indicated, the state budget began to play a significant role in consumption expenditures, as well as in fixed asset investment.

Table 1. Fixed asset investment in economy (mln. AZN)

	2000	2001	2002	2003	2004	2005	2006	2007	2008
Total	967.8	1170.8	2107.0	3779.1	4922.8	5769.9	6234.5	7471.2	9944.2
Agriculture, hunting and forestry	6.5	8.3	17.2	35.1	35.0	40.6	58.3	243.3	336.5
Industry	659.6	825.9	1629.6	3004.7	3915.8	4169.7	4294.6	4539.9	4188.4
Including									
Crude oil va natural gas production, provision of services in this area	481.0	672.0	1438.2	2744.7	3679.3	3729.3	3385.0	3488.0	2878.5
Manufacturing industry	80.1	62.5	28.3	77.8	145.8	115.8	112.4	300.0	401.1
Electricity, gas and water production and distribution	83.0	91.3	162.5	182.2	63.3	323.6	796.5	742.3	904.7
Construction	3.4	13.0	40.0	12.2	20.7	46.1	10.1	4.2	66.1
Wholesale and retail trade, automobiles, consumer equipments an repair of personal belongings	32.3	51.3	52.6	29.9	56.6	83.2	100.1	96.0	278.2
Services in hotel and restaurants	3.6	0.2	0.6	1/7	0.4	2.7	13.6	16.2	20.5
Transportation, agricultural storage and communication	89.4	131.6	138.6	395.5	427.2	669.2	841.2	915.7	2153.4
Financial activity	0.1	0.0	0.0	2.2	0.1	1/5	0.1	4.1	15.7
Real estate operations, renting and services to consumers	114.4	109.8	189.1	227.3	71.1	591.9	514.7	504.7	1004.8
State administration and defence, social security obligations	6.5	9.1	12.7	25.0	37.6	61.4	127.8	628.7	870.0
Education	3.5	6.6	8.9	11.2	24.7	39.2	106.8	134.0	297.9
Provision of health and social services	29.2	9.3	4.1	3.7	10.2	15.5	82.6	144.7	299.2
Provision of other community, social and personal services	19.2	5.7	12.3	28.2	23.3	48.9	84.5	239.8	413.5

As it is provided in the data, the amount of crude oil and natural gas production and provision of services in the total fixed asset investments decreased from 64,6 percent in 2005 to 28.9 percent in 2008. Moreover, the share of infrastructure increased significantly. Thus, production and distribution of electricity, gas and water increased from 5.6 percent in 2005 to 9.1 percent in 2008, and transportation, storehouse and communication increased from 11,6 percent to 21,7 percent. Furthermore, during this period investment to agriculture, education, health, state administration, defense and social security areas increased tremendously. For example, investment to agriculture in 2000 increased 42.1 times more than that of 2007, and 57.7 times more than that of 2008. Estimates indicate that total investment to agriculture in 2007 and 2008 was 2,6 times more than 1992- 2006 years combined. This growth was namely implemented thanks to state investment activity. Growth in state financial resources entailed increase of investment in development of society - both in physical (infrastructure) and in creation of human capital. It should be noted that expenditure on development of these areas increases demand within the country, and eventually it leads to a short term positive development in a number of areas, for example, construction and consumer products and so forth, but impact on increase of demand does not happen in a short-term. Hence, the capital created as a result of infrastructure investments yields a result in a long run. Immediate impact on increase of demand in other fields through investment in infrastructure is possible while maintaining balanced economic growth. That is, once infrastructure is set up parallel to other services, investments enormously serve to economic growth in a short run. Conversely, development of infrastructure affects economic growth after certain period of time. Hence, it is of paramount importance to take appropriate measures to upgrade efficiency of investment in infrastructure and maintain balanced development of national

economy in the country. Namely, preference should be given to industrial area and agriculture while defining investment policy of the state. In my opinion, the state should play a key role in financing private sector in Azerbaijan. Estimates indicate that private sector possesses limited resources in this regard. Moreover, investment on production of sophisticated products is long-term and risky. Thus, commercial banks do not necessarily play a crucial role in financing such huge projects. In 2008, 7163,2 million AZN credit was granted to the state economy, whereas 400,8 million AZN of fixed asset investment constitute bank credits. Shortage of resources in financing production of sophisticated products and difficulty of involving debts require the state to play a considerable role in developing these areas. Taken all the aforementioned facts into account several development institutions have been set up recently to finance private sectors by the state. With the decree of the President of the Republic of Azerbaijan dated to August 27 2002 "Adoption of Regulations on National Foundation for Entrepreneurship Support of the Republic of Azerbaijan" was set up to improve financial assistance system to entrepreneurs.

As to the decree of the President of the Republic of Azerbaijan "On additional measures in expansion of leasing in agriculture" in October 23, 2004, "Agroleasing" Open Stock Company and its regional branches were set up. "Agroleasing" OSC leases agriculture equipments to individuals and legal persons with favorable conditions. Based on the decree of the President of the Republic of Azerbaijan "On additional measures on propogating investment activity" dated to May 30, 2006, "Azerbaijan Investment Company" OSC was established. The company aims at establishing periodical investments from share of authorized capital of stockholders and other commercial institutions in non-oil sector. Furthermore, Azerbaijani state has been implementing a set of measures to decrease tax load of non-oil sector. Thus, income tax declined

from 27 percent in 2000 to 20 percent in 2010, social insurance rate decreased from 33 percent to 22 percent. Moreover, simplified tax system has been applied to small entrepreneurs, and excluding land tax, all taxes with regard to agriculture were removed.

The main target in implementing the above mentioned measures was both to finance investment with cheap financial resources and to improve efficiency of production. Apart from that, in my opinion, it is of paramount importance to develop investment activity of the state, increase financial resources of private sector and expand investment cooperation between state and private sector. Thus, 87,8 million AZN was granted as a credit in 2008 by the National Foundation for Entrepreneurship Support, and authorized capital of Azerbaijan Investment Company constituted 90 million AZN. The combined resources of these institutions constituted 1,8 percent of fixed asset capital in the country in 2008.

It should be noted that there are different opinions on impacts of state investment and private investment to economy in economic

literature. Some economists indicate that private investment affects economic development more sufficiently rather than state investment (4). In addition, American economist D.A. Aschauer writes that although state investment replaces private investment, it positively affects enhancement of efficiency of private sector (5). Another research also shows that increase of state investment positively affects economic growth (6). Generally, in my opinion, determination of ratio between state and private investment can be different in separate states. So, state investment may be needed for improving government management, developing infrastructural fields, as well as developing human capital in order to achieve development of private sector. The volume of such kind of investment can be determined with the value of needs to resources from the perspectives of economic development. In any case, the issue on correlation between state and private investment depends on in which field efficiency of investment is high. Currently, one of the main problems in the acquisition of national saving is comparatively low development of private sector. Thus, formulation of investment ideas, application of investment projects are based on

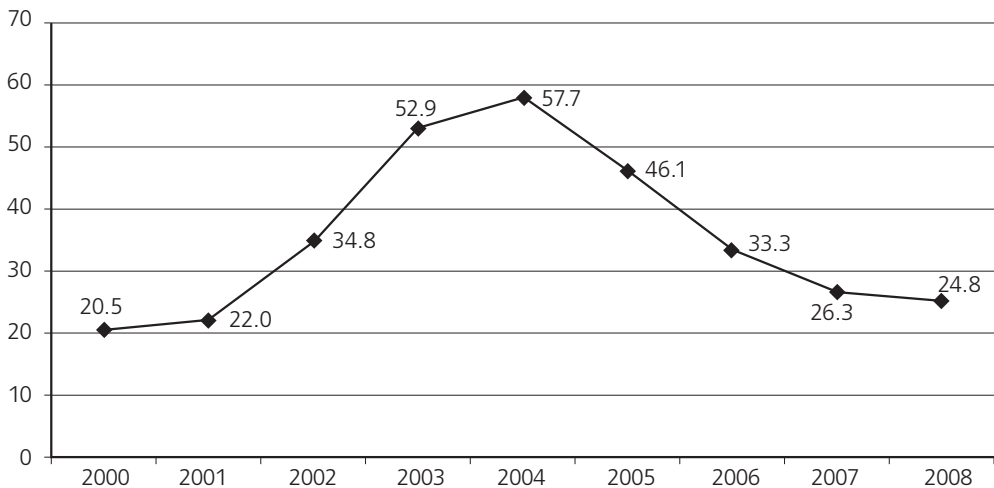


Figure 2. Ratio of fixed asset investment to GDP in Azerbaijan (with percentage)

these ideas, and shortcoming of experience in implementing these projects, as well as limitation of knowledge in implementation of investment projects in production, technology and market spheres put some restriction to usage of national saving as acquisition of investment in a country. Most often the impact of this factor on investment activity becomes higher in comparison to limitation of a capital. In 2008, 7503.1 million AZN was assembled as a part of 20 528.5 national saving. This entailed decrease of fixed asset investment in GDP in the period of decline of investment on oil sector (figure 1).

As it is indicated, relatively small part of resources had been acquired as investment. Transparency of a country economy makes foreign investment involved to a country by private sector as well. Because of higher rate of economic growths of Azerbaijan economy and increased foreign currency value in recent years brought about decrease of risks of foreign investment involved in the country. Moreover, the rate of credits in international financial markets directly influence credit rates in small countries. Changing of credit rates in a country is influenced by changes of exchange rate (7). Forecasting of relative stability of exchange rate positively affects rate of credits to maintain stable in a country for midterm period.

In 2008, average 3 months London Inter Bank Offer Rate (in dollars) constituted 3,18 percent, while annual interest rate of long-term credits was higher than 20 percent. In addition, inflation rate was 8.3 in 2006, 16.7 in 2007, 20.8 in 2008 and 1.5 in 2009 respectively. It is predicted that the inflation rate will constitute 6 percent in 2010. It is also predicted that inflation rate will be 5 percent in midterm period and exchange rate will be stable, in this case, it is efficient to involve foreign credits. The aforementioned indicates that the key factor in implementing investment on private sector is not financial shortage, but lack of private sectors that possess

necessary knowledge, experience, relevant experts and technology.

Thus, presently there is a need for increasing role of government in developing national economy. While designing the state investment policy fields, which were not developed sufficiently by private investment, have to be defined precisely and state investments have to be directed to these fields. But in that case measures have to be realized in order to eliminate disproportionateness that put a hurdle to economic development. Thus, balanced development of national economy is related to the existence of competitive fields. It should be noted that an efficiency of decrees of a state on production-economic activity is lower rather than private sector. For example, American economist Nicolas Stern writes that private sector possesses larger opportunity on market features and meets their demands rather than the state. The likelihood of making mistakes in state prognostication process is bigger compared to market mechanism. Promptness in taking decision is higher in private sector rather than in state organizations. Necessary stimuli to work and innovation, level of control on expenditures and economic efficiency are lower in state organizations rather than in private organizations. Because of all these factors the efficiency of intervention of a state into economy becomes low (8). However, from the perspectives of existing possibilities the participation of a state in economy is necessary. The formation of development institutions in a state, and cooperation between state and private sector in a model of realizing state investment, financing private investment with low interest rates and using different other methods are likely to lead to decrease of negative factors.

Thus, one of the beneficial ways of using revenues coming from exportation of oil and gas is the development not only of infrastructure, education and health but also establishment of private sector and its development.

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