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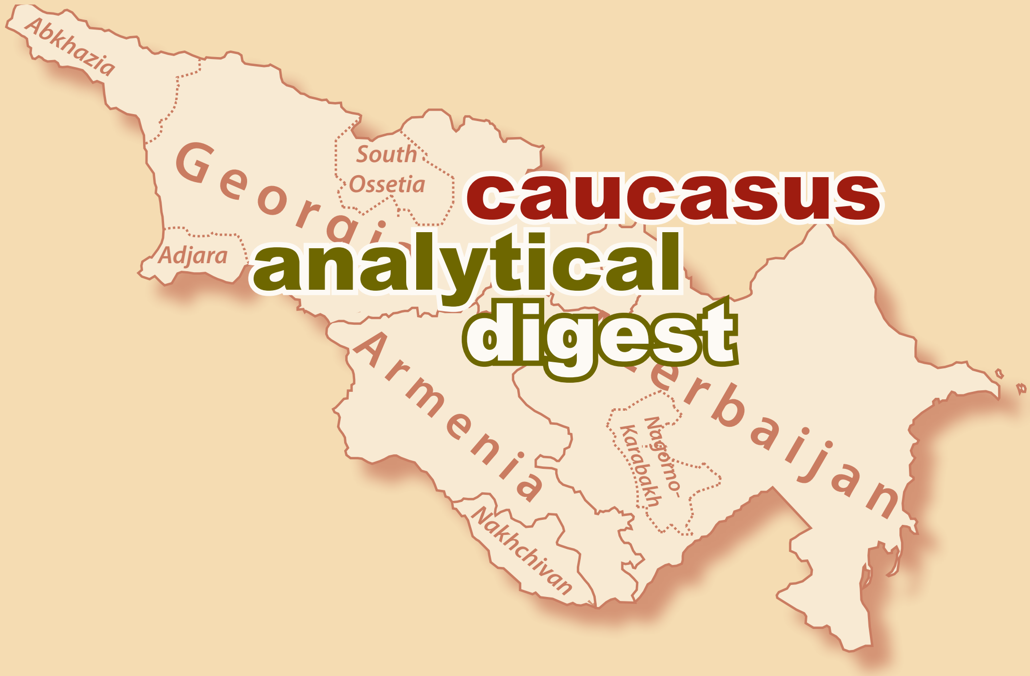

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LOW OIL PRICES: ECONOMIC AND SOCIAL IMPLICATIONS FOR AZERBAIJAN

Special Editors: Eurasia Extractive Industries Knowledge Hub (Khazar University) and Jeronim Perović

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Azerbaijan's New Macroeconomic Reality: How to Adapt to Low Oil Prices

By Ingilab Ahmadov, Baku

Abstract

Despite the accumulation of significant revenues from crude oil exports and remarkable economic growth over the past 15 years, Azerbaijan's economy has been hit hard by the recent drop in global oil prices and has experienced a period of painful economic adjustments. The government has attempted to change the traditional distributive approach that is based largely on oil revenue distribution in favor of a new earning-oriented model that is expected to benefit from a robust non-oil sector. It is clear that the oil price slump caught the government off guard and poorly prepared to cope with the new low price environment. Clearly, it will be difficult to build a new model of development quickly and thoroughly in a short period of time. While the availability of the state oil fund reserves mitigates the risk of financial and macroeconomic collapse in the near future, the effects of a large informal economy make it difficult to regulate the economy using only conventional instruments, such as money supply and credits. Thus, to be effective, authorities' anti-crisis measures should be accompanied by institutional and administrative reforms.

Oil Price Drop and National Currency Devaluation

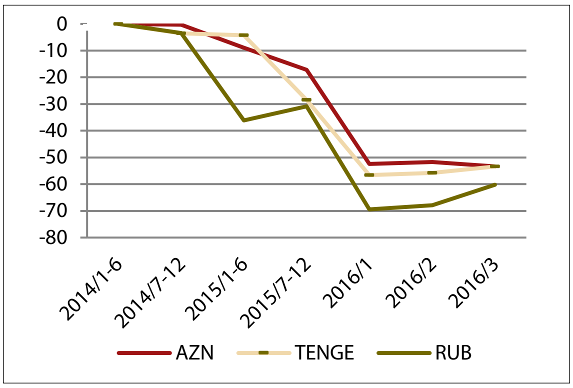
Azerbaijan is one of the most oil-dependent countries in the world. In 2015, the oil sector generated 31% of the country's GDP (compared with 52% in 2011), and oil revenues accounted for 63% of the state budget and amounted to 86% of total exports. Unsurprisingly, as in other oil-dependent economies, the drop in world oil prices has had a significant impact on Azerbaijan's economy. Moreover, the consequences turned out worse than expected. Last year, the Azerbaijani currency (manat) was devaluated twice and lost most of its value.

Similar to other oil-rich Caspian Basin states, namely Russia and Kazakhstan, Azerbaijan's national currency lost its value relative to the U.S. dollar and Euro. However, whereas Russia and Kazakhstan began to weaken their national currencies in 2014, Azerbaijan held its currency at a firmly stable rate in the hope of a return to favorable oil prices. Another peculiarity in this case is that both times that Azerbaijan devalued its currency, it did so sharply and not smoothly, which differs from the approach taken by Russia and Kazakhstan. Of course, in the Russian case, sanctions have had a significant impact on the ruble as well.

In terms of macroeconomic implications, currency devaluation was considered not only as a way to maintain monetary stability but also as a measure of fiscal and budget stabilization. As in Russia and Kazakhstan, the Azerbaijani state budget consists mainly of oil and gas revenues and therefore devaluation of the local currency allows the country to generate and transfer more earnings from the export of crude oil because the currency of the oil trade is the U.S. dollar.

The new socio-economic environment that emerged thereafter was painful for all social groups but particularly for the most vulnerable. Most investment programs, including public investment projects financed through the state budget and the State Oil Company (SOCAR), have been curtailed. SOCAR's capital-intensive investment projects were frozen, such as construction of a new oil refinery worth an estimated US$ 18 billion.

Figure 1: Devaluation of the National Currencies in Azerbaijan, Kazakhstan and Russia in Light of Low Oil Prices



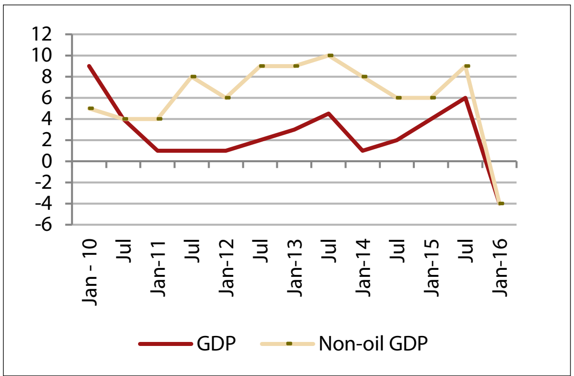
Source: Author's calculation based on statistical data from the central banks of the three countries

Following the manat's devaluation, the country's ranking in the world economy fell sharply: GDP per capita dropped 56%. By the end of 2015, annual GDP per capita in Azerbaijan stood at US$ 7,986; at present, that amount is only US$ 3,490.

Two other indicators are noteworthy as well. Before the national currency devaluation, Azerbaijan's public debt to GDP ratio was one of the lowest among oil-producing states, but today this is no longer the case. Public external debt to GDP (as of January 1, 2016) stands at 19.8%, whereas it was only 8.6% one year before (Ministry of Finance of Azerbaijan).

Fortunately for Azerbaijan, in the post-devaluation period the assets of the State Oil Fund (SOFAZ) are expected to rise to almost 100% of GDP this year (up from approximately 50% of GDP in 2014). This is the highest indicator among oil-rich countries in the region, where comparable figures for Russia and Kazakhstan are 10% and 35%, respectively.

Figure 2: Azerbaijan: GDP Growth Rate, 2010–2016 (% change, year-to-year, year-to-date, preliminary monthly estimate)



Source: The Economist Intelligence Unit

The State Oil Fund of Azerbaijan as an Airbag

Azerbaijan's oil revenue management system is based on combining SOFAZ and public budget mechanisms, whereby most oil revenues accumulate in the Fund and will be used for future spending on various investment projects directly and through the state budget.

As the biggest share of annual expenditures of the Fund are transfers to the state budget (in 2015, 88 % of SOFAZ expenditures were transfers to the public budget, amounting to 47% of the state budget revenues), in this current period of rapid change, this factor became a good benchmark at which to peg the exchange rate and prevent further devaluations of the manat.

From January to mid-March 2016, SOFAZ sold US dollars worth more than US$ 1 billion at a newly created auction marketplace, which is a significant opportunity for the domestic exchange market. It was a necessary step, as SOFAZ has to make regular transfers to the state budget in manat. In addition, this helps the Central Bank of Azerbaijan (CBA) to save its foreign reserves. Notably, the government has shown no intention of expanding the use of SOFAZ's assets to maintain the fiscal balance, as was the case with some other oil exporting states. Instead, the dramatic devaluation of the national currency gives the government an opportunity to save more of the Fund's assets for the future.

The Favorable Oil Climate of the 2000s

The last decade's commodities super cycle was quite beneficial for Azerbaijan's economic growth. Fortunately, this period coincided with an increase in Azerbaijani oil production following the signing of the "Contract of the Century" for the Azeri-Chirag-Guneshli deepwater fields, explored and developed in cooperation with global oil giants, including BP, ExxonMobil, and other multinationals.

Between 2004 and 2011, Azerbaijan's GDP growth was 15%, on average. In comparison, Russian GDP growth for this period was 4%, and Kazakhstan's growth was 7%.[1] Due to the enormous oil revenues generated during this favorable oil price super cycle, Azerbaijan's public budget grew by more than a factor of 25. All three countries established a sovereign wealth fund (in Russia, two funds), which have accumulated sizeable financial reserves.[2] These funds are expected to contribute to financial stability in the long run. By the end of 2014, the total amount accumulated in Russia's National Welfare Fund and Reserve Fund was estimated at US$180 billion (9% of GDP). Moreover, the National Fund of Kazakhstan had accumulated US$ 69 billion (30% of GDP), while the State Oil Fund of Azerbaijan (SOFAZ) had accumulated US$ 36 billion (47% of GDP).

The current financial turmoil calls the official opinion of the government into question. During the oil boom period, Azerbaijani authorities declared that the country had reached a sufficient level of socio-economic sustainability. Moreover, the chaotic decisions of the government indicate that it prepared poorly for low commodity prices. The government does not seem to have any clear strategy for adapting to the new reality.

Another essential problem is the disparity between official statistical information and the real picture, such as the volume of real cash flow (dollarization), traded goods in the domestic economy (some imported goods are not declared at the customs agency), tax avoidance, and other practices that constitute the informal economy. Ultimately, the cause of this disparity is the inefficiency in the existing institutional framework, including customs, tax collection, and antimonopoly agencies.

According to official statistics, the volume of the informal economy is 7% of GDP, which is likely to be a modest estimate. World Bank experts' calculations

1 UN, World Economic Situation and Prospects 2013, <http://www.un.org/en/development/desa/policy/wesp/wesp_current/2013annex_tables.pdf>

2 Ingilab Ahmadov, Stela Tsani, and Kenan Aslanli, "Sovereign Wealth Funds as the Emerging Players in the Global Financial Arena", Public Finance Monitoring Centre and Revenue Watch Institute (2009), <http://www.khazar.org/files/SWFs_new_book_RWI_PFMC.pdf>

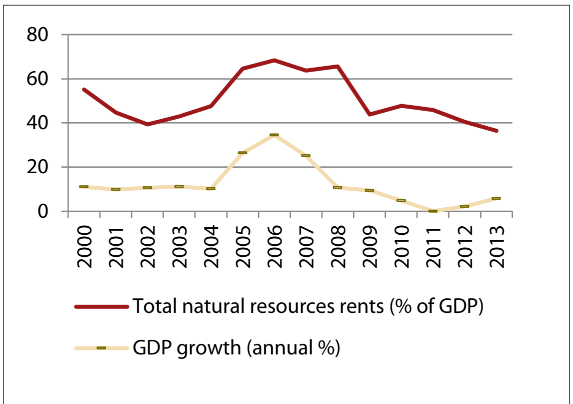
put the extent of informal economic activity at 32% of the country's GDP as of 2008.[3]

The negative consequence of the informal economy for the government, which needs to tackle exchange rate stability and predictability, is a lack of effective monetary and other economic instruments to influence the market. The sizeable informal economy implies there is an unaccounted amount of dollars in cash holdings, sales, services transactions, and household real income. It also points to widespread tax evasion. Informal transactions impede the implementation of an effective macroeconomic policy.

The government's lack of a holistic approach to managing oil price downturns and its weakness in designing an anti-crisis program comprise another set of problems that became clear during the ongoing perturbations that began at the end of last year. The effective coordination of monetary, fiscal and social policies, based on a clear set of priorities in the post-oil period, which seems to have begun, is now the government's most important challenge.

However, Azerbaijan's predicament is not merely a consequence of low commodity prices. The country's economic problems were mounting before the crisis due to the poorly diversified structure of its economy and the absence of strict fiscal rules. Beginning in 2005, the enormous expenditures associated with ineffective and non-transparent spending show the economy in a negative light.

Figure 3: Azerbaijan: GDP Growth and Total Natural Resource Rents (%)



Source: The World Data Bank, World Development Indicators

Today, amidst macroeconomic deterioration, it is clear that something went wrong. As British economist Paul Collier put it, "And the supercycle of the last ten years has been the biggest opportunity that they've had in history. And for most of them, it's been a missed opportunity. And so it's really important, society by society, to discover what went wrong and what is needed to be understood in order for next time to go better."[4]

How Successfully Has the Government Reacted?

The government is taking active steps to tackle the challenges of macroeconomic balancing. Its policy actions so far may be divided into three groups:

1. Strengthening Financial Security and Predictability

Until now, the government has mostly concentrated on exchange rate stability. Immediately following the December 2015 devaluation, the financial sector endured chaos for some time, and the government did its best to prevent further instability of the national currency. As usual, the further decline of the manat led to speculations on the black market. The first steps were nervous, chaotic and unsystematic. The government decided to close exchange offices and concentrated all exchange operations only in the banks and their branches. It was clear that this reaction was associated with the flight of capital. Finally, the government successfully maintained the stability of the exchange market and tackled the foreign exchange rate. For this, it used additional interventions from the foreign currency reserves of the central bank (CBA).

Some administrative steps were also taken, such as the establishment of a new legal entity called the Financial Market Control Chamber. The mission of this entity is to ensure public control of the country's securities market, investment funds, banking and insurance sectors, as well as the flexibility and transparency of the activities of payment systems (www.president.az). Due to the changes to the Law on Banks, some functions of the CBA were delegated to the newly established Control Chamber. The changes also downgrade the CBA's powers of supervision over the banking sector.

2. Liberalization of the Economy and Improving its Entrepreneurship Space

It is clear that an essential reason for the painful ramifications of the commodity price decline in Azerbaijan is

3 Yasser Abdih and Leandro Medina, "Measuring the Informal Economy in the Caucasus and Central Asia", IMF Working Paper WP/13/137, May 2013, <http://www.imf.org/external/pubs/ft/wp/2013/wp13137.pdf>

4 Paul Collier, "The Decision Chain of Natural Resource Management (I)", Global Heritages, February 5, 2016, <https://globalherit.hypotheses.org/4710>.

the lack of a robust and competitive domestic business sector. The economic diversification policy, declared as a priority at the start of the oil boom, was not realized in practice. Barriers to stimulating domestic business development are mostly problems involving access to capital markets and monopolization of most segments of the markets. These distortions prevent the growth of local businesses. If the windfall of oil revenues compensated for the lack of an open business environment during the oil boom, the absence of a competitive environment today hampers the recovery of the economy over the long term.

Over the last two months, the President of Azerbaijan has issued more than a dozen decrees and other official documents aimed at encouraging local business development. This business support program includes the following measures: i) promotion of non-oil products for export, ii) reform of the customs agency, and iii) simplified procedures for issuing licenses and permits.

These decisions should give the business environment the necessary momentum to stimulate real economic diversification and eventually reduce the country's heavy dependence on petroleum.

3. Institutional Reforms to Support Development of the Non-Oil Sector

Institutional reform seems to be the most difficult task but is crucial if Azerbaijan is to adapt to the new low oil price era and build a desirable model of development that is sustainable in the long term.

Like many other oil dependent countries, the government of Azerbaijan is also considering privatization of state property as leverage and as an incremental source of budget income. Notably, the government did not pay adequate attention to privatization during the super-cycle oil boom of the 2000s, neither as leverage for business development nor as a source of revenue for the state budget. In the case of the budget, this was not necessary as oil revenues covered the budget needs with excess remaining.

Thus, most of the state property inherited from the Soviet legacy had little business potential and was essentially trash. In this regard, the Presidential decree on privatization of February 16, 2016 should be considered a continuation of the "State Program of Privatization of State Property" dated 10 August 2000.

All these efforts are necessary, but not sufficient. The government should recognize that the weak currency opens up enormous opportunities for local business, particularly farmers. However, in order to fully realize the potential of the emerging new environment the government should undertake fundamental liberalization reforms that would streamline the work of customs services and address the omnipotence of local authorities.

Conclusion

In sum, it is evident that the US$ 34 billion sovereign wealth fund (SOFAZ) diminishes the risks of financial and macroeconomic collapse in the near future. In practice, the rainy day oil fund operates as an airbag more or less successfully. Bolstered by significant foreign currency reserves, SOFAZ helps fix the fiscal deficit. The oil fund plays an active role in stabilizing the exchange rate by withdrawing the strategic currency reserves from the central bank and selling US dollars at currency auctions. In 2015, the central bank depleted US$ 9 billion of its strategic reserves to defend the national currency from sliding against the dollar.

However, the presence of a large informal economic sector makes it difficult to regulate the economy using only traditional instruments, such as money supply and credits. The official macroeconomic statistical accounts, particularly money indicators, may not accurately reflect the real picture. This is not only due to the imperfect work of the statistical agency. Typical institutional problems impede the gathering of information concerning customs- and tax-related transactions. Therefore, it is important to ensure that the government's anti-crisis steps are backed by institutional and administrative leverage. Without institutional reforms, it is unrealistic to expect that the anti-crisis policies will yield substantive and successful results.

About the Author

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Oil Price Shocks and Monetary Policy in Azerbaijan: Challenges and Opportunities

By Jeyhun Mammadov, Baku

Abstract
This article examines the transition from a fixed to a managed floating exchange regime in Azerbaijan and discusses the potentially stabilizing effects of monetary policy instruments on the Azerbaijani economy following oil price shocks. It argues that a proactive and credible fiscal policy and monetary expansion (albeit temporary) are indispensable measures to defend the domestic economy against external supply shocks. However, monetary expansion as a traditional approach to crisis management during recession has proven ineffective in the Azerbaijani case due to public panic over the possibility of further devaluation of the Azerbaijani currency (manat) and unofficial dollarization incentives. Faced with new challenges, the Central Bank of Azerbaijan adopted a tightening monetary policy to curb further devaluation of the manat, unofficial dollarization and inflation. However, establishing an effective monetary policy requires substantially enhancing credibility by creating a safer and sounder financial sector. In this regard, financial liberalization and greater ease of entry for foreign banks can lead to benefits connected with the development of the domestic financial system. The article also suggests that national currency devaluation has potential implications for the increase in exports and the inflow of import substituting foreign direct investment. However, a degree of uncertainty and turbulence surrounding the financial situation and weak institutional quality are barriers to external funding and can exacerbate the contraction of domestic credit for the time being.

Economic Conditions and Monetary Policy
As uncertainties and volatility in the global economy and financial markets increased in recent years, global risks have arisen and economic growth in transitioning and developing countries has slowed down considerably since 2015. In particular, the decline in oil prices since 2014 led to a sharp drop in the foreign currency income of oil- and gas-exporting states. This hurt the balance of payments and caused devaluation of the exporting states' national currencies against foreign currencies, especially the US dollar. Meanwhile, as imported goods and services became more costly, inflation, public panic and surging incentives for dollarization by private agents followed. In considering these issues, monetary policy makers in Azerbaijan have faced a number of challenges amid financial turmoil. The turmoil was mainly caused by the improper forecasting of the event and associated risks by the Central Bank of the Republic of Azerbaijan (CBA) and by the choice of an inefficient combination of monetary policy tools to respond to these events.

The first challenge facing the Central Bank of Azerbaijan was related to the economy's reaction to export price shocks starting in the 3rd quarter of 2014, followed by the devaluation of the Azerbaijani manat (AZN) by 34% against the US dollar in February 2015. The CBA set the manat at 1.05 against the US dollar (compared to 0.78 in previous years) until it announced a transition from the so-called fixed to a managed floating exchange rate regime in December 2015 and adopted a dollar-euro basket to manage the exchange rate.

The transition was officially linked to an attempt to stimulate the diversification of the national economy, improve the international competitiveness of the domestic non-oil sector, and ease tensions on fiscal and external balances. However, though decisive, it was a long-delayed decision. The Azerbaijani manat should have been devalued to some extent much earlier, i.e., before the negative oil price shocks hit the economy. Similarly, the exchange rate should have been fixed or managed around that depreciated level to promote international trade and investment, mitigate current speculative activities associated with exchange rate uncertainties and ensure international economic stabilization.

Notably, the fixed exchange rate regime does not imply that the rate will remain frozen forever, and it does not necessarily impede export diversification unless the national currency is overvalued. The exchange rate in a small nation with a fragile financial system like Azerbaijan's cannot be left completely floating; it must be managed (i.e., the central bank influences the exchange rates by buying and selling currencies). Therefore, the economy might also be intensely diversified under the so-called fixed exchange rate regime, although to a lesser extent. In the past decade prior to devaluation, the overvalued level of the manat, whereby 1 US dollar equaled 0.78 manat, was an obstacle to export diversification. As a more powerful tool in a fixed exchange rate regime, efficient government investment spending in non-oil production sector not only could have contributed to the progress of economic diversification but also could have alleviated social costs associated with the sudden devaluation of the manat in 2015. However, the turbulence in the financial and economic situation after the oil price shock demonstrated that "something went wrong" with appropriate spending during implementation of the economic diversification strategy aimed at improving the structure of the economy through "the development of the non-oil industry, the expansion of opportunities to use alternative and renewable energy sources, the development of the agrarian sector, the strengthening of food security, expansion and development of trade and types of services and the improvement of the foreign trade and investment structure".[1]

Resorting to economic theory, I would mention that because general government spending decreases national saving, thereby causing increases in interest rates or revaluation of national currency, the role of monetary policy is to maintain the fixed exchange rate by increasing money supply to prevent the crowding out effects of government expenditures on investment and export. Therefore, in designing an anti-crisis management strategy, proactive and credible fiscal policy and temporary monetary expansion are indispensable measures for filling the output gap in a recession period. However, the traditional approach was not effective in the given situation due to institutional problems and improper prediction of external monetary shocks and negative externalities.

Ineffectiveness of Loose (Expansionary) Monetary Policy

Taking a traditional approach to crisis management after the oil price shock, the Central Bank (CBA) confronted the challenge of increasing financial contributions and stimulating domestic investment by dropping the refinancing rate from 3.5% in 2014 to 3% in the 3rd quarter of 2015 (compared to 5% since 2011). Meanwhile, to enhance the availability of money and credit, the Central Bank dropped the reserve requirements from 2% to 0.5%, keeping the other parameters of the interest rate corridor unchanged: 0.1 % floor and 5% ceiling (see Table 2 on p. 10). Under these conditions, further devaluation of the manat and inflation were forecast in the 4th quarter of 2015.

If this policy were successful, it was expected that an increase in the quantity of domestic investment could decrease the supply of the manat to be exchanged into foreign currency (and into the US dollar, in particular) over the long term and that this fall in supply would appreciate the real exchange rate (by increasing the value of the manat).[2] However, private agents' incentives for unofficial dollarization seemed not to be considered, and this resulted in the ineffectiveness of expansionary monetary policy in further stimulating domestic investment.

Unofficial dollarization exerted a contractionary effect, i.e., it led to a reduction in official foreign exchange reserves and the money base in manat. Expectations of continuous devaluation and inflation frightened the population into converting their deposits from the manat into US dollars, which increased demand for US dollars and created the conditions for further devaluation of the manat.[3] This also led to a mismatch between deposits and bank loans. Consequently, in contrast to our hypothesis, a reduction in the money multiplier was observed (see Table 2 on p. 10). Over time, triggered by a fall in foreign exchange reserves, the broad money supply M3 (money in the hands of people, demand and time deposits in the manat and foreign currency) also decreased (see Table 2 on p. 10).

Adopting the Managed Floating Exchange Rate Regime

Meanwhile, the Central Bank attempted to preserve the value of the manat and defended it against the effect of falling oil prices by spending its foreign exchange reserves. Nevertheless, continuous declines in oil prices and foreign exchange reserves brought about the second major devaluation of national currency against the US dollar in the 4th quarter of 2015 (approximately 47%) and challenged the adoption of the managed floating exchange rate regime in Azerbaijan. Based on the fundamental factors determining supply and demand ratio in the currency market, the advantage of the floating exchange rate regime is that it allows the economy to neutralize the negative consequences of global shocks and stimulates the development of the local financial market.

1 For further information on the strategic view and government's main priorities, see the development concept "Azerbaijan 2020: Look into the future", http://www.president.az/files/future_en.pdf

2 As long as the ownership and internationalization advantages of domestic firms are not sufficient to invest abroad, it is irrelevant to consider the serious detrimental effect of exchange rate appreciation on exports.

3 In contrast to unofficial dollarization, "The main attraction of full dollarization is the elimination of the risk of a sudden, sharp devaluation of the country's exchange rate. This may allow the country to reduce the risk premium attached to its international borrowing. Dollarized economies could enjoy a higher level of confidence among international investors, lower interest rate spreads on their international borrowing, reduced fiscal costs, and more investment and growth." Berg A., and Borenzstein E., IMF Working Paper No. 00/50, 2000, <https://www.imf.org/external/pubs/cat/longres.aspx?sk=3486.0>

Tightening Monetary Policy and Addressing Novelty

As a fourth challenge, to prevent further devaluation of the manat and to keep inflation under control, the Central Bank cut its currency loose and began to pursue a tightening monetary policy. In this regard, increasing the refinancing rate from 3% to 5% and then to 7% in March 2016 is understandable (see Table 3 on p. 11). It was also one of the steps taken toward decreasing the dollarization incentives in the economy and increasing the population's confidence in the national currency because high refinancing rates can lead to increases in deposits. A high interest rate initially might discourage domestic investment, given that the turmoil in the financial sector has already decreased the confidence of the population and domestic investors (declining growth rates of loans in 2014 and 2015). On the other hand, it leads to increases in the opportunity costs of holding national currency and can also decrease the incentive for the population to convert the manat to the US dollar and stimulate them to increase their manat deposits. This activity can result in growing bank credits in the manat and push down the interest rate in the long term.

Financial Liberalization and Globalization

Due to the financial turmoil, unofficial dollarization, and reduction in the money base, the growth rate of loans contracted substantially in 2014 and 2015. The growth rate of loans by private banks contracted from 24% in 2013 to 22% in 2014 and 16 % in 2015. In the meantime, the growth rate of loans by private banks with foreign capital was 35% in 2013 followed by 21% and 15 % in 2014 and 2015, respectively. Although the growth rate of loans by state-owned banks contracted from 28% in 2013 to 16% in 2014, it showed 19% growth in 2015 due to government intervention (see Table 3 on p. 11). Furthermore, since early 2016, the CBA has revoked the licenses of 7 banks (out of 42 total banks) and aimed to consolidate the banking sector. According to the CBA, these banks could not fulfill their obligations to creditors or manage their activities prudentially.

The fifth challenge facing the CBA should be liberalizing the financial sector and creating favorable conditions for the entry of foreign banks. The share of foreign banks (with 100% foreign ownership) in total loans is approximately 7%. The share of private banks with foreign capital was approximately 29% in 2015 and 26% in 2016 (where private banks' share was approximately 60%). (See Table 3 on p. 11). This is a clear indication of the weak role of foreign-owned banks in Azerbaijan. To promote economic growth through external funding to local firms, there is an urgent need for financial liberalization, for creating favorable conditions for foreign bank entry, and for improving domestic banks' competitiveness.

The effects of a tightening monetary policy and the credit response of private banks depend on the ownership of individual banks. The role of foreign banks can be of crucial importance in monetary policy transmission, as they are less responsive to domestic monetary policy and also more reactive to changes in foreign financial conditions. In comparison to the refinancing rate of 7% in Azerbaijan, the rate in the Eurozone is approximately 0.05% (in 2015), which clearly indicates that the price of international funds is much cheaper abroad than in Azerbaijan. With the abundant presence of foreign-owned banks, the interest rate in Azerbaijan would not be expected to be so high. Therefore, an increased presence of foreign-owned banks in the banking system and the possibility of access to cheaper international funds can decrease the credit response of private banks to changes in domestic monetary policy. According to recent research conducted by the IMF (on the case of East Asian economies), state-owned banks responded more negatively to an increasing rate than private banks, and as expected, loans by foreign-owned banks increased.

Conclusion: Macroeconomic Prospects, Opportunities and Risks

The CBA has spent more than half of its foreign exchange reserves to maintain the level of the manat. Supported by the State Oil Fund of Azerbaijan (SOFAZ), the CBA continues holding foreign exchange auctions to help banks by selling dollars in exchange for manat (while simultaneously pursuing a tightening monetary policy). This is a short-term measure that offers little hope in the face of prevailing international and domestic economic pressures.

On the other hand, from an economic theory perspective on long-term sustainability, the devaluation of the national currency has created better economic prospects and opportunities, accompanied by exogenous and endogenous risk factors.

When the manat was devalued, its value declined relative to the value of other currencies such as the US Dollar and Euro. This exchange rate movement has potential implications for foreign direct investment (FDI). It reduces production costs in Azerbaijan relative to those in foreign investor countries, thereby enhancing Azerbaijan's location advantage for foreign investors contemplating investment projects in Azerbaijan. A depreciated exchange rate can attract FDI concentrated on import substitution (producing goods previously imported) and export promotion (seeking new sources of inputs). In turn, higher foreign capital inflow can compensate for weak domestic investment and eventually push down interest rates.

However, the deteriorating financial situation, the degree of uncertainty surrounding this situation and exchange rates, an expected tightening of monetary policy in the United States,[4] and weak institutional quality and government effectiveness[5] are not only barriers to foreign capital inflows to the non-oil sector but also obstacles that can aggravate the contraction of domestic credit and external funding and increase foreign investment repatriation.

In particular, creditworthiness has decreased and investor risks have increased since the negative oil shocks. The "Euromoney" country risk assessment survey highlights elevated investment risks since the 3rd quarter of 2014 (the risk score fell from 52.5 out of 100 in 2012 to 47 in the 4th quarter of 2015; a lower score indicates higher risk.)

Therefore, in an attempt to reduce fluctuations in the balance of payments under the floating exchange rate regime, the Azerbaijani government should accelerate the implementation of its adopted strategic economic development plan, reinforce financial stability to create a safer and sounder financial sector (to enhance credibility and monetary policy effectiveness), implement credible fiscal reform, stimulate domestic investment, and offer location advantages to foreign investors.

About the Author

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Further Readings

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- Berg A., and Borenzstein E. "The Pros and Cons of Full Dollarization", IMF Working Paper No. 00/50, 2000, <https://www.imf.org/external/pubs/cat/longres.aspx?sk=3486.0>

4 Expected tight monetary policy in the US may increase the cost of external financing and also lead to capital outflow from emerging and transitioning countries. This can cause further devaluation of these countries' currencies against the US dollar. Additionally, considering that the exchange rate of the manat depends on the dollar–euro basket, the impact of tight monetary policy in the US is inevitable.

5 For more information on the institutional quality in Azerbaijan, see Ahmadov I., Mammadov J., and Aslanli K., "Assessment of Institutional Quality in Resource Rich Caspian Basin Countries", 2013.

Table 1: Selected Economic Indicators for Azerbaijan (mln. USD)

	Q1 2013	Q2 013	Q3 2013	Q4 2013	Q1 2014	Q2 2014	Q3 2014	Q4 2014	Q1 2015	Q2 2015	Q3 2015	Q4 2015	Q1 2016
SOFAZ revenue % GDP				22.5				20.9				13.6	
Current account	428	2,320	2809	3,276	3,333	3,166	2,793	1,139	108	-45	177	na	na
Foreign trade balance	5,906	4,578	4,924	5,428	5,544	5584	5,080	2,720	1,758	2000	1,544	na	na
Export	8,289	7,571	7,950	7,947	7,504	8,090	7,338	5,328	4,250	4427	3,646	na	na
- Oil-gas sector	7,842	7,116	7,588	7,458	7,139	7,661	6,952	4,875	3,797	4,053	3,357	na	na
- Other sectors	447	455	362	489	365	429	386	453	453	374	289	na	na
Import	2,383	2993	3,026	2,520	1,960	2,506	2,258	2608	2,492	2,427	2102	na	na
- Oil-gas sector	281	237	292	356	272	409	326	431	344	590	571	na	na
- Other sectors	2,102	2,756	2,734	2,164	1,688	2,097	1,932	2,177	2,148	837	531	na	na
FDI	1,420	1,547	1,678	1,646	1,911	1,956	1,951	2,231	1,845	1,956	1,936	na	na
Repatriation of investments	-841	-871	-952	-998	-970	-826	-858	-982	-829	-830	-856	na	na
Official average exchange rates of the manat													
US dollar	0.78	0.78	0.78	0.78	0.78	0.78	0.78	0.78	1.05	1.05	1.05	1.23	1.58
EURO	1.02	1.04	1.05	1.07	1.09	1.07	1.01	0.97	1.14	1.18	1.18	1.34	1.72
Inflation (CPI)	1.2	2.0	2.3	2.4	2.0	1.6	1.5	1.4	2.8	3.5	3.7	4	13.6

Sources: The Central Bank of Azerbaijan (CBA), the State Statistical Committee and State Oil Fund of Azerbaijan (SOFAZ).

Table 2: Key Monetary Indicators: Money Aggregates, Monetary Base (mln. AZN)

	2010	2011	2012	2013	2014	2015	2016/01
Money aggregates							
M0	5,456	7,158	9,257	10,459	10,153	4,776	4,485
M1	6,839	8,796	11,122	12,737	12,830	6,897	6,273
M2	8,298	10,997	13,807	16,435	17,435	8,613	7,937
M3	10,528	13,903	16,775	19,290	21,566	21,319	19,965
- Net foreign assets	4,638	7,850	8,283	9,903	10,492	11,056	10,571
- Net domestic assets	5,889	6,054	8,492	9,387	11,076	10,263	9,393
Official FX reserves (mln. USD)	6,408	10,482	11,695	14,152	13,758	5,017	4,026
Money base (mln. Manat)	6,397	8,275	10,515	11,642	11,542	6,902	5,787
Money multiplier, M2/MB	1.30	1.33	1.31	1.41	1.51	1.25	1.37
Interest rates %							
- Corridor floor	1	1	na	na	0.5 (July) 0.1 (May)	0.1	2
- Corridor ceiling	7	7	na	na	5 (July) 6 (May)	5	17 (March) 10 (Feb)
- Refinancing rate	3	5.25 (May) 5 (Feb.)	5	4.75	3.5 (July) 4.25 (May)	3	7 (March) 5 (Feb.)

Source: The Central Bank of the Republic of Azerbaijan.

Table 3: The Structure of Loans to the Economy by Type of Credit Institution (mln. AZN)

	2010	2011	2012	2013	2014	2015	2016/01
Total loans	9,163	9,850	12,244	15,423	18,543	21,718	21,186
State-owned banks	3,902	3,300	4,137	5,300	6,144	7,289	7,707
Private banks	5,070	6,299	7,786	9,689	11,874	13,863	12,884
- with foreign capital	2,306	3,002	3,394	4,613	5,580	6,394	55,944
as % of total loans	25	30	28	30	30	29	26
- with 100% foreign capital	464	586	759	1,035	1,389	1,565	1,546
as % of total loans	5	6	6	7	8	7	7
Non-credit bank institutions	192	251	321	433	525	566	596

Source: The Central Bank of the Republic of Azerbaijan

Lower Oil Revenues, Higher Public Debt: The Fiscal Policy Implications of Low Oil Prices in Azerbaijan

By Kenan Aslanli, Baku

Abstract

This article examines fiscal policy and the main parameters of Azerbaijan's fiscal position in the context of the severe constraints (namely, reduced budget revenues and cuts in government spending) posed by the decline in crude oil prices. Azerbaijan's fiscal balances have deteriorated considerably as crude oil prices have tumbled. A worsening of Azerbaijan's fiscal balance could gradually contribute to an increase in the public debt burden and threaten fiscal sustainability in the long term. The sovereign wealth fund of Azerbaijan, SOFAZ, now has very limited profits from the sale of oil, and will contribute less to the fiscal revenues of the state as a consequence. The national state-owned oil-gas company, SOCAR, temporarily cancelled its plans for a new oil-gas refining and petrochemical complex because of the rapid fall in crude oil prices. However, at the same time, the new low oil price environment also offers an opportunity to boost a new wave of fiscal and public administration reforms in Azerbaijan.

Summary of the Fiscal Implications of Lower Crude Oil Prices

The drop in oil prices and resultant waves of devaluation hit Azerbaijan's economy and fiscal balance especially hard by diminishing oil revenue inflows to the fiscal system and decreasing budget incomes. Oil, gas and mineral revenues accounted for more than 77% of Azerbaijani budget revenue in 2014,[1] and low oil prices affected almost every aspect of the country's fiscal policy. Fiscal policy adjustments made in response to the new reality include changes in governmental budget revenues; changes in the structure of governmental budget spending, including cuts to capital and recurrent expenditures; new sources of financing for the budget deficit; changes in the State Oil Fund's (SOFAZ) assets; and changes in the State Oil Company's (SOCAR) operations. Both revenue and spending aspects of fiscal policy have encountered severe constraints due to low oil prices, namely the shortfall in budget revenues and cuts in government spending. Current fiscal balances have deteriorated amid plunging oil prices.

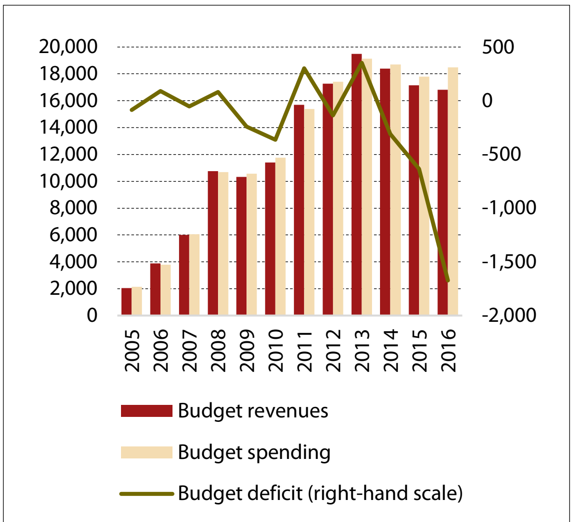
Decreased crude oil and natural gas production coupled with lower crude oil prices led to a contraction of

1 Azerbaijan EITI Report for 2014, <https://eiti.org/files/azerbaijan_eiti_report_2014.pdf>

the country's GDP in 2015 (which declined by 1.1% while it had still grown by 2.8% in 2014). Additionally, the poorly diversified Azerbaijani economy has been particularly vulnerable to the oil-price shock because of its higher fiscal dependence on revenues from hydrocarbon exports. The government has decided to reduce the budget for public investment by 40% from 2015 to 2016 and to halt the financing of new investment projects. Total revenues of the consolidated budget decreased 6% as a result of oil price readjustments (from $50 per barrel to $25 per barrel in the revised budget for 2016) and falling revenues from the national sovereign wealth fund (SOFAZ), which has traditionally played a central role in the country's fiscal policy.

The declining fiscal balance (Figure 1) will gradually contribute to an increase in the public debt burden, thus threatening the country's fiscal sustainability: Azerbaijan's debt-to-GDP ratio is 19.8% (as of January 2016). The government introduced new tax rates for simplified

Figure 1: Budget Revenues, Spending and Deficit (mln. AZN)



Sources: Author's calculations based on data from the Azerbaijan Republic Ministry of Finance, <http://www.maliyye.gov.az> *and Budget.az,* <http://www.budget.az>.

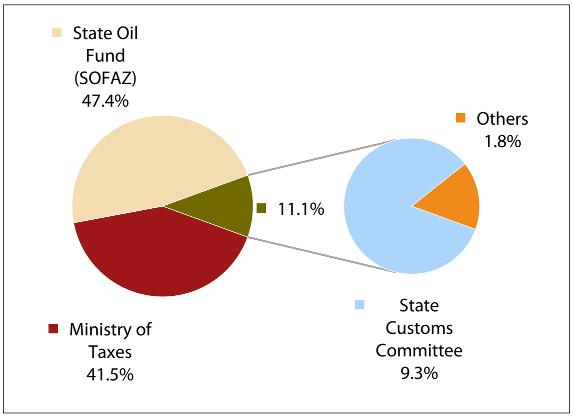
and income taxes as concessions to local entrepreneurs, without any serious changes in the rates of central taxes such as the VAT or the corporate profit tax. In addition to deepening our analysis of the above-mentioned "unexplored" fiscal trends, we need to investigate the fiscal consequences of restrictions on SOCAR's receipts from crude oil sales as well as subsidies to state-owned companies and natural monopolies. Beyond the immediate fiscal consequences, such as budget cuts on both the revenue and expenditure sides, public asset sales, and tax rate changes, the commodity price bust is influencing medium and long-term fiscal plans.

Contraction in State Budget Revenues

Low oil prices in international markets had an immediate adverse impact on national budget implementation: in 2015 budget revenues fell by 12% and state expenditures dropped by 16% compared to figures approved in the previous year's state budget. These figures indicate that actual total budget revenue figures are falling behind initial forecasts. First, SOFAZ was the primary source of budget revenues, contributing 48% to total revenues. These transfers were 21.7% lower than the original approved forecasts. Second, taxes and other mandatory payments collected and transferred to the Ministry of Taxes accounted for 42% of state budget revenues. Income from the non-oil sector constitutes 71% of that amount, which is 17% more than in 2014. Third, the State Customs Committee generated 9% of total revenues, which was 5% more than the previous year in absolute terms.

Finally, Figure 2 demonstrates that three institutions (SOFAZ, the Ministry of Taxes and the State Customs Committee) "carved out" the vast majority of fiscal revenues (98.2%), but the dominance of SOFAZ as a commodity-based extra-budgetary saving and stabilization fund jeopardizes fiscal sustainability in the long

Figure 2: Main Sources of State Budget Revenues in 2015



Source: Azerbaijan Republic Ministry of Finance, <http://www.maliyye.gov.az>*; Budget.az:* <http://www.budget.az>*; author's calculations*

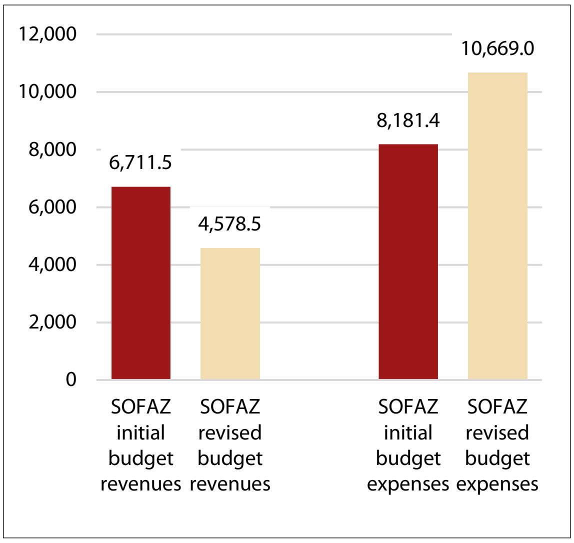
term. According to an independent budget review by a local think-tank, Support for Economic Initiatives, "the amount of transfers to the state budget from the State Oil Fund [has been] significantly reduced. The role of direct payments from the oil sector in the formation of state budget revenues has [been] considerably reduced in both absolute and relative terms".[2]

2 "Review of 2016 state budget (forecast) of Azerbaijan Republic", Support to Economic Initiatives Public Union, 2015, <http://budget.az/en/upload/files/SEI_Budget_Review_2016.pdf>

SOFAZ Will Contribute Less

In addition to making amendments to the state budget, the government has also revised the SOFAZ budget for 2016, decreasing revenues and increasing expenses as compared to the initial version of the SOFAZ budget for 2016 (Figure 3). The amended SOFAZ budget for 2016 envisions 4.6 billion manats in revenue and 10.7 billion manats in expenditures.[3] This is a significant decline in SOFAZ's earnings and a sharp increase in SOFAZ's expenditures compared to the budget implemented for 2015 or the initial version of the budget for 2016.

Figure 3: SOFAZ's Initial and Revised Budget for 2016 (mln. AZN)



Source: Azerbaijan Republic Ministry of Finance, <http://www.maliyye.gov.az>*; Budget.az:* <http://www.budget.az>*; author's calculations*

The lion's share of income for SOFAZ's 2016 budget will come from the sale of profit oil. Table 1 on p. 16 shows that while the main budget expenditure line of SOFAZ for 2016 denoted transfers to the state budget, it will contribute less than that amount to fiscal revenues (<http://www.oilfund.az>). Despite financial difficulties, SOFAZ will continue to finance national and regional infrastructure projects such as the Baku–Tbilisi–Kars railway project, Azerbaijan's share in the Southern Gas Corridor project, the reconstruction of the Samur-Absheron irrigation system and the construction of the "STAR" Oil Refinery in Turkey.

One of the implications of recent low oil prices and currency devaluation for fiscal policy was the appearance of SOFAZ as a seller at the foreign exchange auction of the Central Bank. SOFAZ has stated that it will continue selling currency through CBA auctions. There is no legal rule that regulates SOFAZ's presence at the foreign exchange auctions or its direct transfers to the state budget. It was evident that when oil production begins to decline or global oil prices drop, the government will either be forced to run a budget deficit or to draw more funds from SOFAZ. These options are unsustainable in the long term and could lead to a debt crisis, which would result in high costs and a lower standard of living for future generations; a debt crisis could also return Azerbaijan to levels of development and poverty that preceded the discovery of oil. In addition to borrowing and drawing money from SOFAZ, a third option would be to raise tax revenues from the non-oil sector. However, to this date, this has proven difficult because non-state non-oil growth remains weak and non-oil tax revenues linger steadily at approximately 20% of GDP, much lower than the 30–45% level in most developed countries.[4] But it is very unpopular to raise taxes and as a response people will seek to avoid them, hence the expected growth of the "shadow" economy.

The Public Investment Program Has Attracted Less Public Money

Expenditures of the state budget in 2015 were implemented at the level of 17 billion manats instead of the forecasted 21 billion manats, representing a decrease of 16%. Current expenditures (58% of total expenses) were more than capital expenditures (38%) in 2015. Four percent of all expenditures were allocated to finance related costs for the maintenance of state debts and other commitments during 2015. The public investment program accounted for 28.1% of the expenditures of the state budget (33% in 2014). The state budget of Azerbaijan is socially oriented, and therefore, one-third of its total expenses were allocated to financing social expenses.

The Government Readjusted Its Fiscal Parameters

The government proposed new amendments to the state budget for 2016 and parliament approved these changes. The per-barrel crude oil price was set at $25 in forecasts of revised state budget revenues in 2016. This change increased the income of the state budget by 16% and expenditures of the state budget by 14% in comparison

3 SOFAZ 2016 budget approved, <http://www.oilfund.az/en_US/hesabatlar-ve-statistika/buedce-melumatlari/azerbaycan-respublikasi-doevlet-neft-fondunun-2015-ci-il-buedcesi-tesdiq-edildi-2.asp#sthash.MQcFQTPO.dpuf>

4 Kenan Aslanli, "Fiscal Sustainability and the State Oil Fund in Azerbaijan", *Journal of Eurasian Studies* 6: 2 (2015): 114–121.

with an initially adopted version of the budget (2% less than the implementation of the state budget for 2015).

There is a plan to secure additional revenues for the state budget through more transfers from SOFAZ (27% more in the revised budget than in the initial version) and more tax revenues from the non-oil sector of the economy. However, there is an alternative approach in which the significant increase in the special share of payments from the non-oil sector contributing to state budget revenues is mainly due to decreases in total budget income and in the absolute amount of oil revenues in the budget. Short of state oil fund transfers, state budget revenues will not be able to adequately finance current annual expenses. Substantial cuts to the public investment program for next year have applied also to socially oriented areas such as education and health. In other words, Azerbaijan government has adjusted fiscal policy to the falling oil prices and oil revenues. Public investments have been relatively lowered, but targeted social assistance expenditures have been raised.

The Budget Deficit Raised the Total Debt Burden

After the rapid decline of crude oil prices and after experiencing a relatively high budget deficit, the Ministry of Finance decided to hold regular auctions of state bonds by registered emission prospectus for an amount totaling US$ 500 million until the end of 2016.[5] For the year 2015, government indebtedness stands at just over 12% of GDP. During that period, the country accumulated substantial foreign currency reserves of approximately US$ 39 billion (73% of GDP, although these reserves then decreased to US$ 33.5 billion), which provided a sufficient guarantee against any possible adverse external and internal shocks. However, the situation deteriorated in 2016.

Public debt will increase in 2016, reaching 50.5% of budget revenues and 46% of budget expenditures. Furthermore, Azerbaijan's tax debt is estimated at AZN 2.4 billion. The budget burden for the payment of the national debt increased considerably in 2015 and 2016. "Ricardian equivalence" theory assumes that when the government attempts to stimulate demand by increasing debt-financed government spending, demand can remain unchanged; this is because the public will retain its savings to pay for possible future tax increases that will be applied to paying off the debt burden.[6] This has two implications: (a) debt burden increases make citizens more cautious about consumption; (b) public debt will be replaced by a tax burden on the population in the long run.

SOCAR Faces Financial Challenges

State-owned oil companies such as SOCAR find themselves with fewer financial resources to spend on costly upstream or downstream projects. SOCAR is the key player in Azerbaijan's energy sector, but it does not transfer its total oil revenues to the state budget. In 2015, SOCAR paid 1.48 billion manats to the state budget, which was 20% less than the previous year (SOCAR's total revenue figures for 2015 are not available to compare budget transfers with revenues). Moreover, the company directly finances some energy-related (and in some cases, even non-energy related) projects. Due to low oil prices, SOCAR decreased crude oil and natural gas production in 2015 and suspended some new projects. It announced the termination of its project to build a new oil-gas refining and petrochemical complex. National or state-owned oil-gas companies such as SOCAR seem insufficiently prepared to lower oil price conditions considering the importance of cost effectiveness, efficiency maximization, and their fiscal roles as taxpayers. As in the case of SOFAZ, there are no rules to regulate the portion of revenue that must be transferred or invested by SOCAR. After lower crude oil prices, SOCAR did not cancel any planned major projects including the modernization of an existing main refinery in Baku. However, the company had borrowed 1.86 billion manat from International Bank of Azerbaijan with a state guarantee provided by the ministry of finance.[7]

Some Fiscal Policy-Related Reforms Were Amplified During the Crisis

As part of a series of institutional changes, the Azerbaijani President established a new position and appointed the former deputy tax minister as the President's economic reforms assistant. Azerbaijan began to introduce a BOT (*Build-Operate-Transfer*) model for construction and infrastructure projects to attract alternative financing sources. The government also exempted investors (*investment certificate holders*) from some taxes and customs duties (by up to 50% for 7 years) and prepared anti-dumping duties to prevent import growth. Due to latest changes in the Tax Code, owners of retail service and catering service entities with annual turnover

5 The Ministry of Finance successfully issues state bonds, February 8, 2016, <http://www.maliyye.gov.az/en/node/1885>

6 Robert J. Barro, "The Ricardian Approach to Budget Deficits," *Journal of Economic Perspectives*, 3: 2 (1989): 37–54, <http://faculty.georgetown.edu/mh5/class/econ102/readings/budget_deficits.pdf>

7 "SOCAR в 2016 году привлечет от Межбанка Азербайджана еще 200 млн манатов" [In 2016, SOCAR will attract 200 million AZN more from IBA], Caspian Barrel, April 6, 2016, <http://caspianbarrel.org/?p=41181>

of up to 200.000 manats will pay a 6% and 8% simplified tax respectively.

The fiscal crises made fiscal discipline an unavoidable component of possible reforms. But unfortunately a separate law on state financial control and the Budget Code have not yet been prepared. Despite the fact that the government has already developed medium term expenditure planning, it has not yet transformed the budgeting to the Medium-Term Expenditure Framework that enables to track cyclical changes in main fiscal parameters. SOFAZ as an extra-budgetary sovereign wealth fund and main donor of the state budget needs new regulations or a law defining its saving and stabilization functions with clear deposit and withdrawal rules. The institutional capacity of the government should be improved in order to adopt a counter-cyclical fiscal policy and harmonize different components of the budget system (especially, interrelations between state budget and extra-budgetary funds).

Conclusion

Falling crude oil prices and consequent reductions in fiscal and budget revenues have amplified the government's budget deficit in Azerbaijan. The volatility of crude oil prices in the world market and the depletion of the country's foreign exchange reserves led to massive fluctuations in fiscal parameters. The government is not in the sustainable fiscal position of having a low level of public debt. This is a predictable consequence of Azerbaijan's high dependence on crude oil, which accounted for 78% of total exports and 60% of state budget revenues in 2015. Even if public debt is still relatively low as a percentage of GDP, lower oil revenues compared to previous years imply a less robust fiscal ability to pay down these debts in the future. Accordingly, there is a need to adopt a new fiscal policy and fiscal rules based on medium term budget expenditure planning and a sensitivity analysis to create larger fiscal surplus in order to meet long-term development commitments and to pay down public debt through SOFAZ, which accumulates fiscal surplus. However, at present, despite fiscal stabilization and the availability of SOFAZ as a savings instrument, the country still faces difficulties in fiscal policy. In Azerbaijan, there is no fiscal rule that limits annual spending of SOFAZ's oil revenues.

Despite the fact that crude oil prices remained low for 2015, the government did not adopt stricter fiscal decisions to cut spending or to raise tax rates. The government plans to reduce public investment spending by almost 40% in 2016 compared with the previous year's level, but it also plans to raise social spending. As a result, total budget spending in 2016 has been planned to be 4% more than in 2016, notwithstanding total budget revenues will be almost 2% lower in 2016 compared with 2015. Fiscal policy in Azerbaijan was expansionary and pro-cyclical during the previous years thanks to high crude oil prices. Currently, the government attempts to adjust its fiscal policy to new realities characterized by lower oil prices and revenue volatility without damaging its social obligations and adopting contractionary fiscal policy.

As in other natural resource-rich countries, Azerbaijan has faced all characteristic consequences of lower oil prices, including increased budget deficits and public borrowing, relatively lower capital investments from the budget, and cancellation of some projects by the national oil company. However, this new environment has also boosted a new wave of fiscal and public administration reforms. Azerbaijan scored 51 (on a 100-point scale) in budget transparency (*Open Budget Index 2015*) which is slightly higher than the global average indicator of 45.[8] There is room for improvement here to enhance access to budget data and improve the quality of the budget cycle, including budget forecasting and more efficient medium-term fiscal policy planning. The government can increase the comprehensiveness of the state executive's budget proposal by adding more details to fiscal policy narratives and fiscal performance indicators.

About the Author

Kenan Aslanli is a guest lecturer at the University of Applied Sciences BFI Vienna (Austria) and has been a regular trainer for the Eurasia Hub's training courses in natural resource management. He is also the local contractor of the International Budget Partnership's Open Budget Survey Initiative for Azerbaijan and a senior economist with the Public Finance Monitoring Center in Baku. His recent research article on "Fiscal Sustainability and the State Oil Fund in Azerbaijan" was published in the *Journal of Eurasian Studies* (July 2015), <http://www.sciencedirect.com/science/article/pii/S1879366515000056>

8 Open Budget Survey: Azerbaijan, 2015, <http://www.internationalbudget.org/wp-content/uploads/OBS2015-CS-Azerbaijan-English.pdf>

Table 1: SOFAZ's Budget Transfers (2003–2016, mln. AZN)

Years	Fiscal revenues from SOFAZ (transfers)	The share of SOFAZ's budget transfers in total budget revenues, %	The share of SOFAZ's budget transfers in GDP, %
2003	100	8.2	1.3
2004	130	8.8	1.5
2005	150	7.2	1.2
2006	585	15.1	3.2
2007	585	9.7	2.1
2008	3,800	35.3	9.5
2009	4,915	47.6	14.2
2010	5,915	51.9	14.2
2011	9,000	57.3	18.0
2012	9,905	57.3	18.3
2013	11,350	58.2	19.7
2014	9,337	50.7	15.8
2015	8,130	47.6	14.2
2016 (projected)	7,615	45.3	12.6

Source: Budget.az, <http://www.budget.az/main?content=526>

Azerbaijan: Low Oil Prices and their Social Impact

By Farid Guliyev, Baku

Abstract
This article looks at the impact of low oil prices and the resulting shortfall in oil rents on the Azerbaijani government's social-assistance policies and related expenditures and discusses its implications for social cohesion in the long run. It argues that the deployment of strategic fiscal reserves and citizens' continuing reliance on informal 'safety nets' have cushioned the negative social impacts of the oil plunge. However, there is a risk that the deepening of an economic crisis exacerbated by weak private sector development and missing major reforms in education and social sectors across the board might undermine the social contract. To mitigate the adverse social impacts of the ongoing crisis, the government must conduct a more comprehensive and wide-ranging reform of the labor market, of the access to and quality of education and of the private business sector to stimulate formal job creation, especially among youth and rural populations as well as in health care to provide quality and affordable health care, in education to improve human capacity and domestic labor skills, and in social policies to ensure inclusive and sustainable social welfare provision.

Introduction
The oil price slide that began in June 2014 and continues to this day ended a decade-long oil boom in Azerbaijan. Boom turned to bust. The words "crisis" (*iqtisadi böhran*) and "post-oil era" (*post-neft dövrü*) entered the vocabulary of policy makers, shaping a new public discourse around Azerbaijan's petroleum wealth and apocalyptic predictions about a future without oil. Everyone, from

the average person on the street to high-ranking officials, seemed worried about the troubling times ahead. Rising food prices without an equivalent rise in wages worsened people's living standards. During the booming times, many citizens borrowed loans from banks to pay for mortgage (*ipoteka krediti*) or to purchase a car. However, as some loans were issued in foreign currency, the depreciation of the Manat relative to the U.S. dollar made it hard to pay back bank loans. A loss of faith in the Manat forced many borrowers to convert savings into U.S. dollars. Annual inflation in Azerbaijan is fast accelerating and will reach 12% this year, up from 4% in 2015. Fitch predicts a rise in inflation upwards of 14% by year end. All these developments fueled the sense of economic insecurity for many Azerbaijanis. More people today than in the oil-boom decade are questioning government effectiveness in managing the country's oil revenues and the quality of public spending in general. As everyone now realizes, times will never be the same again.

One area that has arguably been particularly vulnerable to the shortfall in resource revenues is the social sphere: (un)employment, poverty, and social welfare. While the oil price fall will have an incremental impact on the government's social assistance policy, there are some early warning signs that the problems of social welfare, unemployment (especially youth unemployment) and quality of education are becoming critical in a time of crisis.

Jobs and Wages

Official statistics reveal no drastic changes in the labor force participation, and the official unemployment rate remains unrealistically low at 5%. However, the true magnitude of crisis-induced unemployment may be higher than official figures suggest. According to media reports, several private and state-run enterprises announced job cuts in the wake of the latest currency devaluation in December 2015. Layoffs reportedly affected the state-run electric power producer Azerenerji, the gas-distribution network Azerigas, the state oil company SOCAR, and a major telecom operator, Azercell.[1] Radio Azadliq reported that, in January, perhaps as many as 250–300 employees lost their jobs in the energy and power supply network (Azerenerji, Azerishiq and Azenco) amid a faltering economy.[2]

Moreover, the licenses of seven of a total of 42 banks operating in Azerbaijan were revoked, and these allegedly insolvent or illiquid banks were merged. Several major energy companies, such as BP, announced layoffs, and Norwegian Statoil and U.S. oil giant Exxon-Mobil closed their representative offices in Baku. BP announced in January 2015 that it would cut 255 jobs (105 Azeri nationals and 150 foreigners) in Azerbaijan. Considering that oil and mining employs only 41,500 people (or only 1% of the workforce), the impact of the firm-level layoffs is not that big despite its collateral damage on the booming service and construction sectors linked to the oil industry. However, for a small but highly educated segment of the labor force—high skilled professionals and middle classes—this entails the loss of high-paid jobs. For more disadvantaged groups of the workforce—such as agricultural producers and local traders (employing 37% and 15% of the labor force, respectively)—the devalued national currency (together with cumbersome customs procedures) made it difficult for local businesses to sell profitably, as most intermediate goods are purchased from foreign suppliers and transactions are in foreign currency.

Youth will likely remain the most vulnerable group given Azerbaijan's large "youth bulge". Today, young people under 25 years constitute 40% of the total population. Having a relatively young population (the median age is 29 years), youth unemployment remains one of the biggest challenges for an economy that is highly undiversified and where the government lacked incentives, especially during high oil prices, to invest in human capital accumulation, namely investments in educated and skilled labor force. According to the International Labor Organization (ILO), the youth unemployment rate fell from 18% in 2003 to 11% in 2013 and stood at 10% in 2014. A major cause for young people having fewer jobs is that the skills they acquire while at school or university are not the ones demanded by the job market. As the government begins to slash public investments that generated jobs in services, construction and infrastructure in the previous decade (73% of all construction was financed with public money, which itself was 70% sourced from oil revenues),[3] there will be fewer jobs for young people, and this will likely drive youth unemployment up. Workers in rural areas have low-paying jobs. Unemployment is a serious problem, as too few jobs are being created outside of the capital city. Internally displaced persons (IDPs), who constitute more than 6% of the total population, are another vulnerable category;

1 Durna Safarova, "Azerbaijan: Unemployment Rises as Economy Teeters", *Eurasianet*, February 24, 2016, <http://www.eurasianet.org/node/77516>

2 "Enerji sektorunda kütləvi ixtisarlar" [Mass layoffs in the energy sector], *Radio Azadliq*, January 20, 2016, <http://www.azadliq.org/content/enerji-isiq-kutlevi-ixtisar/27499713.html>

3 "Azerbaijan Economy: Sailing Uncharted Waters", Galt & Taggart Research, February 26, 2016, <http://galtandtaggart.com/research/research-reports/all/all-all/2/>

IDPs' income level is below the poverty line, and they are employed largely in the agricultural sector. IDP labor force participation is very low given the lack of skills in this part of the population.

The public sector is likely to suffer, too. The president declared the need to downsize the state apparatus by abolishing governmental agencies with overlapping functions and merging them. This may lead to job losses for public sector workers who have traditionally constituted the social base of the regime.

In January, the president ordered the cabinet to prepare a broad privatization plan that will cover the International Bank of Azerbaijan (IBA), the only state-owned bank which holds 35% of banking assets in Azerbaijan. The finance minister urged the government to shift to a "four-year austerity" program to ensure, among other things, "the rational use of state funds, and prevention of squander and useless expenses".

The impact of the Manat collapse on wages has been very negative. As Azerbaijan decided to float its currency and de-peg it from the US dollar, salaries and social allowances paid in Manats lost in value. For example, while the monthly average salary for 2015 increased by some 5% to 462 Manats, it lost almost half of its value in US dollar terms— falling to US$ 296 (compared to US$ 597 in 2014)— due to the currency devaluation.[4] To mitigate this effect, president Aliyev signed a decree on January 18 increasing the minimum pension and salaries of state employees by 10%.

Social Expenditures

Social spending including expenditure on education, health, and social protection remained unchanged, and the government has emphasized its commitment to promoting social welfare. Officials speak of the state budget as socially oriented (*sosial yönümlü*).

There were no cuts in social assistance programs (see Table 1 on p. 21). Total social sector expenditures including salaries, pensions, medicine costs and other supplies are projected at 5.87 billion AZN, representing 36% of total budget expenses for 2016 (a 8.6% increase compared to previous year) and approximately 42 million Manat (or 0.7%) more compared to the previous year's budget.[5] All education and social assistance lines in the budget expenditure composition were kept at approximately the same level as in the previous year despite the fact that state revenues are heavily dependent on oil revenues and transfers from the state oil fund (SOFAZ) make up 43% of the overall budget revenues for 2016. In fact, in late February the parliament adopted revisions to the 2016 state budget based on an average oil price of $25 per barrel. In the revised budget, the share of socially oriented expenditures was increased by 1.7 % (i.e. an additional 1.29 billion AZN) and is now forecasted at 38% of total budget expenses.[6] Amendments were also made to the budget of the State Social Protection Fund (SSPF) with a projected 7% increase in expenditures totaling 3.3 billion AZN (US$ 2.12 billion).

However, in a cross-national comparison, Azerbaijan's welfare spending as a percentage of GDP is modest, social sectors are underfinanced, and human capital development is weak compared to other countries with similar economic growth levels or natural resource endowments.[7] Azerbaijan spends 5% of its GDP on healthcare and only approximately 2.5 % of GDP on education. According to World Bank estimates, Azerbaijan's public expenditure on education was less than 3% of its GDP on average between 2007 and 2011. This is less than that in comparable countries such as Malaysia and Poland, where education spending is 5% of GDP. The quality of education in Azerbaijan is also substandard. Azeri students show poor results on international education tests. Azerbaijan ranked 74 out of 75 countries on the 2009 PISA international education assessment survey (OECD, <https://www.oecd.org/pisa/46643496.pdf>).

Labor market specialists believe that Azerbaijan's unreformed education system as well as the outdated system of vocational training fail to provide job seekers with the necessary skills for the job market. For example, there were fewer than 500 graduates to match the specialty requirements for almost 15,000 jobs created in agriculture in the 2007–2011 period. Poor education quality and lack of skilled workers hurt the employment opportunities and life satisfaction for the current generation (and possibly their offspring). The lack of prospects drives many talented people to seek jobs (and better life chances) abroad, which impedes productivity and innovation in the private sector domestically. The economic crisis will likely reinforce this tendency for outmigration.

Over the past years, the government's social assistance projects—through the state budget and SSPF—

4 CESD, "The Economy of Azerbaijan in 2015: Independent View", January 2016, <http://cesd.az/new/wp-content/uploads/2016/01/CESD_Research_Paper_Azerbaijan_Economy_2015.pdf>

5 Ministry of Finance of The Republic of Azerbaijan, "Presentation on the Draft State and Consolidated Budgets for 2016", Baku 2015, <http://www.maliyye.gov.az/sites/default/files/presentation-2016.pdf>

6 "Azerbaijani Parliament Adopts Revised State Budget for 2016", *Trend.az*, February 23, 2016, <http://en.trend.az/azerbaijan/business/2498247.html>

7 Indermit S. Gill et al., "Diversified Development: Making the Most of Natural Resources in Eurasia", World Bank, 2014, <http://www.worldbank.org/content/dam/Worldbank/Feature%20Story/ECA/diversified-development-eurasia-full-report.pdf>

targeted the most vulnerable segments of the population and helped lift many people out of absolute poverty. The poverty rate dropped significantly from 47% in 2002 to the current 6%. Today, about 63% of households receive at least one type of social transfer benefit, such as pensions for elderly people, unemployment benefits, and social insurance payments. Among social transfers, pensions are the largest payment, accounting for 75% of all public spending on social protection.[8] The Targeted Social Assistance (TSA) Program, introduced in 2006, provides cash transfers to low-income households. In the absence of social transfers, the poverty rate would amount to approximately 25% (Onder 2013).

While the social transfers helped to reduce poverty, the oil price decline put the sustainability of public social expenditures under strain. During the booming times, the targeted social-assistance policies helped raise the basic living standards of citizens to a level just enough to quell social tensions and maintain a modicum of societal cohesion and political stability. This was important considering the rising expectations around the growing wealth and the public discourse around equity in revenue sharing. However, as the drop in oil prices shuttered the balance sheets of oil-producing countries, Azerbaijan's government has found itself in a difficult situation. Dwindling fiscal revenues weakened the government's ability to finance its social welfare programs and the heavy bureaucracy, and the depreciation of local currency has had a negative effect on citizens' perception of government performance. Nevertheless, the state authorities regard social spending as an "ultimate priority". Thus, according to Article 7 of the Law on Budget System (<http://www.e-qanun.az/framework/1126>), pensions, wages and social transfers belong to the so-called "protected" category of basic social costs and may not be subject to budget cuts (*sekvestr*) regardless of the level of state budget incomes.

However, citizens' notions and expectations of what is an acceptable level of social welfare are relative, and what ordinary Azerbaijani citizens perceive as a "normal" standard of living may not be the same as the one accepted in Western Europe. Throughout history, Azerbaijanis relied on informal kinship and personal friendship ties, rather than formal state institutions, to cope with poverty and economic distress. Many people still rely on reciprocity-based informal social "safety nets"—extended family, kinship networks and friends— for monetary assistance (cash transfers, remittances or soft loans), patronage and support. Patronage is widespread in hiring for jobs in both public and private sectors and is not uncommon among the domestically operating international donor community and NGOs. It is a culturally shared belief that wealthier heads of patronage networks who enjoy access to the spoils of the oil sector and other rents should provide for poorer members of the network. If the economic crisis worsens, people will likely tolerate loss of some social benefits and try to compensate by seeking recourse from their kinship group, personal connections and friends, rather than through organizing public demonstrations, given weak organized ties and social trust beyond immediate family and kin group.

Social Tensions

Azerbaijani protests in recent years reveal the tendency for small-scale, localized and uncoordinated actions largely concentrated in rural areas (with the exception of a handful of urban-based protests in Baku) where residents are economically less well-off and want to seek more wealth redistribution toward their rural areas and localities. Although the government allocated over $30 billion on its regional development program in the period 2004–2014, this has not translated into more jobs or inclusive social development due to poor implementation and rent-seeking at the local level.[9]

Rising unemployment rates and food prices spurred a series of pocket book protests across Azerbaijan's regions with people demanding redress in shrinking employment, income and welfare benefits. The protesters who were arguably apolitical in their demands raised the specter of rising social tensions in society. Demonstrations against price hikes, unemployment and the burden of paying off credits took place on January 10–12 in the provincial towns of Siyazan, Neftchala, Lenkaran, Quba and other regions. The number of protesters ranged from about 300–400 in Siyazan to more than 1,000 protesters in Quba. Scores of protesters and several local opposition activists were arrested after the authorities declared the rallies illegal and blamed the traditional opposition Popular Front (AXCP) and Musavat parties and "religious extremists" for instigating the protest.[10]

However, the protests dissipated quickly once there were neither organizational mechanisms nor resources to sustain collective action. The government used the "carrot and stick" approach: employing internal security forces to calm down protesters while at the same time

8 Harun Onder, "Azerbaijan: Inclusive Growth in a Resource-Rich Economy", World Bank, 2013, <https://openknowledge.worldbank.org/handle/10986/12228>

9 Zaur Shiriyev, "Protests in Azerbaijan: A Political and Economic Watershed", *Eurasia Daily Monitor*, February 1, 2016, <https://t.co/OrLnlxiiFw>

10 "Arrests as Azerbaijani Police Use Water Cannons, Tear Gas Against Protesters", *RFE/RL's Azerbaijani Service*, January 15, 2016, <http://www.rferl.mobi/a/27489831.html>

cutting bread prices and increasing the salaries of public sector employees by 10%.

Outlook

The government's ability to provide for welfare and basic living standards will depend on a number of variables, most importantly, the duration and intensity of the oil price and production level decline and its capacity to initiate and implement a strategy to overcome the oil-induced economic crisis. The fiscal buffers have enabled the government to maintain a passable level of social welfare since the beginning of the oil decline two years ago. However, the political leadership's weak steering capacity, which manifested itself in a haphazard reaction to economic recession, will put strains on its ability to navigate crises in the longer term if oil prices do not rebound to pre-crisis levels. Thus far, the sense is that the government has chosen to "wait and see" and hope the oil price returns to earlier peak levels, while contemplating a US $3 billion loan from the IMF and World Bank as a short-term solution.[11]

Azerbaijani officials also believe that there is a conspiracy to bring oil prices down. President Aliyev said that "reasons for such a difficult situation are outside our country and these reasons are rather political, than economic."[12]

It is clear that in the medium and long term, the crisis will drain state patronage resources. Whether the private sector can provide for jobs and welfare benefits without the usual injection of state money is not entirely clear. Small- and medium-sized enterprises were hard to develop under the Dutch disease. Oil cash inflows in U.S. dollars increased the value of the Manat relative to the U.S. dollar, which hurt local producers. The non-oil sector, which is dominated by nine large holdings (Pasha, Synergy, Ata, Gilan, Azersun, CRA, Garant, AF and Silkway), can hardly survive without crony links to the state. They are largely "subsidized" through state public investment programs and lack financial sustainability (see Table 2 overleaf). As the local economist Azer Mehtiyev put it, "The majority of these enterprises are not competitive and not export-oriented. Using close relations to powerful people, these companies drive out similar imported goods from the domestic market by unfair methods and mostly survive thanks to domestic consumers and state orders."[13]

With a lack of state funds and due to a poor diversification record, there will be more pressure on the government to deliver social benefits in the future while government resources will be further strained by dwindling fiscal revenues from the export of oil. Two aspects of government control will largely determine the outcome: 1) relinquishing control over independent business and 2) enforcing the rule of law over the grabbing hands of rent-seeking officials at all levels and over the informal reign of a handful of state-linked monopolies that dominate all sectors of the economy.

Open protest in the tightly controlled political space of Azerbaijan is an act of desperation. Protesters in Azerbaijan face three main challenges: the repressive state apparatus, the shortage of resources, and the difficulty of oppositional coordination. The outburst of social discontent in January was a series of typical pocketbook protests sprang from uncoordinated efforts by residents of some of the poorest *rayons* and towns beset by extreme levels of unemployment and income decline, and hit hard by the drop in remittances from Russia. (The total volume of remittances fell from US$ 1.7 billion in 2014 to US$ 1.18 billion in 2015, according to Central Bank data).[14] As one of the protesters in Quba noted, "Our protest was not organized… We did not have a leader, but about 5,000 people came and protested, because we could not tolerate it any more."[15]

Less oil revenues will significantly diminish extensive patronage opportunities in the hands of the incumbent elite and will widen the social gap. This, however, will not necessarily make the regime more vulnerable (relative to the existing political opposition forces) as the elite still enjoys access to oil wealth. True, cheap oil means less revenue, but there are other sources of rent (not just oil) that elites can tap into. While economic crises sometime create a critical juncture for a profound political change, much depends on whether societal actors will have the capacity and ingenuity to make use of this opportunity. Azerbaijani opposition groups, both old and new, are simply too feeble to threaten the status quo. This makes the prospects of political change even more dangerous as unmediated social discontent may result in social turmoil and permanent economic crisis.

See overleaf for information about the author.

11 Jack Farchy and Shawn Donnan, "IMF and World Bank Move to Forestall Oil-led Defaults", *Financial Times*, January 27, 2016, <https://next.ft.com/content/9759f42a-c51b-11e5-b3b1-7b2481276e45>

12 Reuters, January 10, 2016, <http://bit.ly/23m2sUx>

13 Quoted in: Mina Muradova, "Azerbaijan: The Pipe Dream of Economic Diversification," *Transitions Online*, April 7, 2015, <http://www.tol.org/client/article/24753-azerbaijan-the-pipe-dream-of-economic-diversification.html>

14 CBA Monetary Policy Review, December 2015, <http://en.cbar.az/assets/4059/MPR_-_2015_-_eng.pdf>

15 Reuters, January 18, 2016, <http://reut.rs/1PlJosR>

About the Author

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Table 1: Azerbaijan: Budget Expenses on Education, Health and Social Assistance, 2011–2016 (mln. AZN)

	2011	2012	2013	2014	2015	2016 (proj.)
Education	1,399.8	1,575.9	1,530.4	1,653.4	1,711.2	1,713.5
Healthcare	563.2	662.7	669.3	725.6	777.7	744.9
Social protection and social security	1,611.8	1,781.6	1,813.6	2,072.2	2,040.5	1,896.6

Source: Azerbaijan Ministry of Finance, Draft Budget Presentations, various years, <http://www.maliyye.gov.az/node/1128>

Table 2: Azerbaijan: Non-Oil Sector Holdings

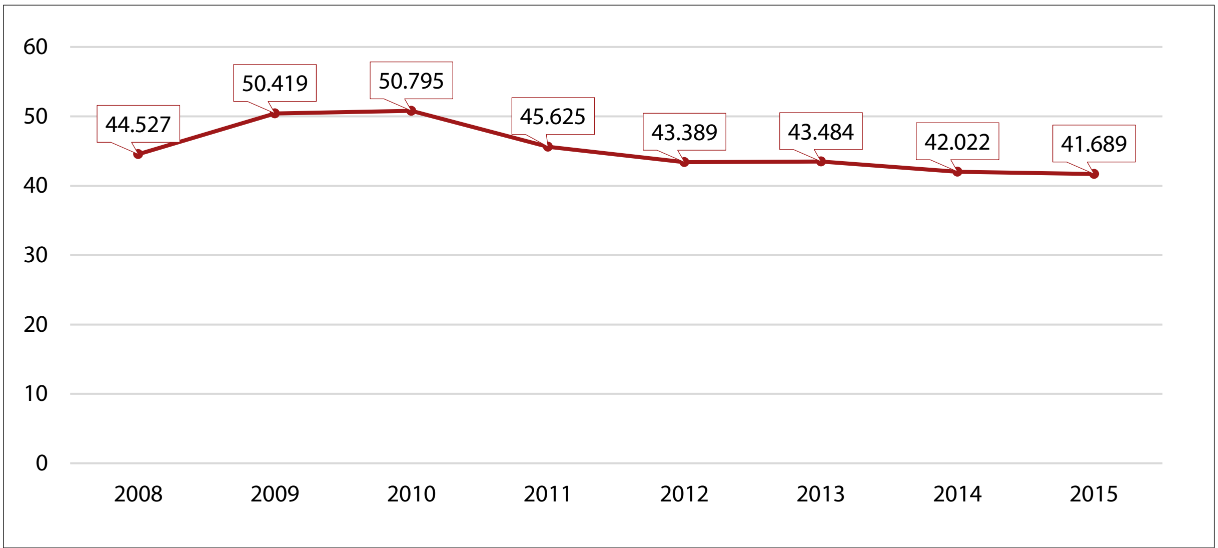
Name	Sector activities
Pasha	Banking, insurance, construction, travel, private equity
Synergy	Construction, construction materials, agriculture, hospitality, finance, tourism, IT services, industrial (food)
Ata	Finance, tourism, hospitality, industrial, IT services, insurance
Gilan	Construction, food, hotels/restaurants, diversified manufacturing
Azersun	Food processing, farming, trade, packaging and paper
CRA	Telecoms, oil services, cement, private equity
Garant	Finance, construction, hotels and real estate services, agriculture, logistics
AF	Construction products, property, retail
Silkway	Travel, airlines, travel-related retail and services

Source: "Doing Business and Investing in Azerbaijan", PWC, 2015 edition, p. 8. <http://www.pwc.com/az/en/publications/assets/dbg-2015.pdf>

STATISTICS

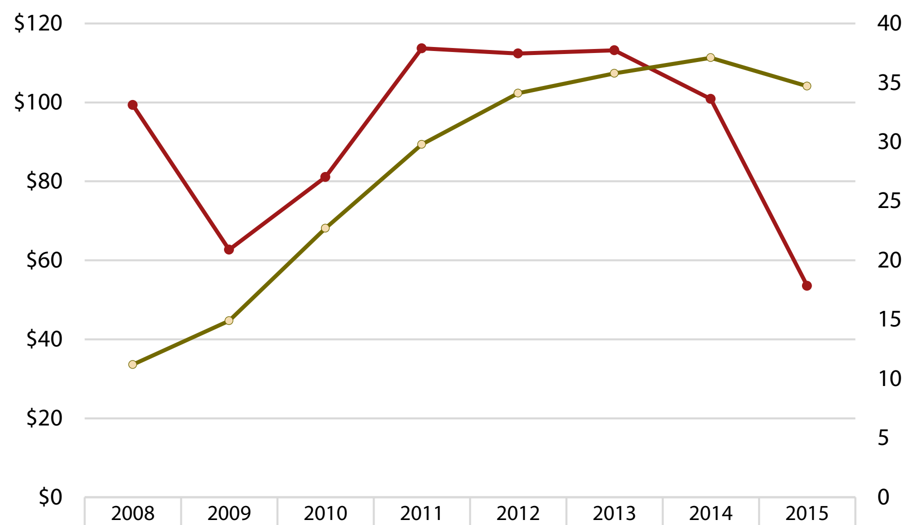
Oil Production and State Finances

Figure 1: Azerbaijan's Oil Production Volume (in million tonnes)



Source: Caspian Barrel and NRGI, 2016, <http://psaagreement.org/>. *Reproduced with permission.*

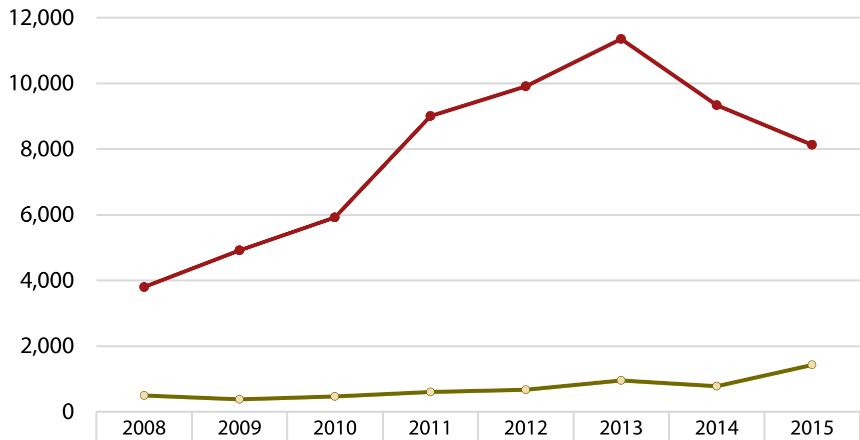
Figure 2: Assets of the State Oil Fund of Azerbaijan (SOFAZ, end of year, in billion USD)



	2008	2009	2010	2011	2012	2013	2014	2015
Average price of oil (in USD, left-hand scale)	$99.3	$62.7	$81.1	$113.7	$112.4	$113.2	$100.9	$53.6
Assets of SOFAZ (end of year, bln USD, right-hand scale)	11.2	14.9	22.7	29.8	34.1	35.8	37.1	34.7

Source: Caspian Barrel and NRGI, 2016, <http://psaagreement.org/>. *Reproduced with permission.*

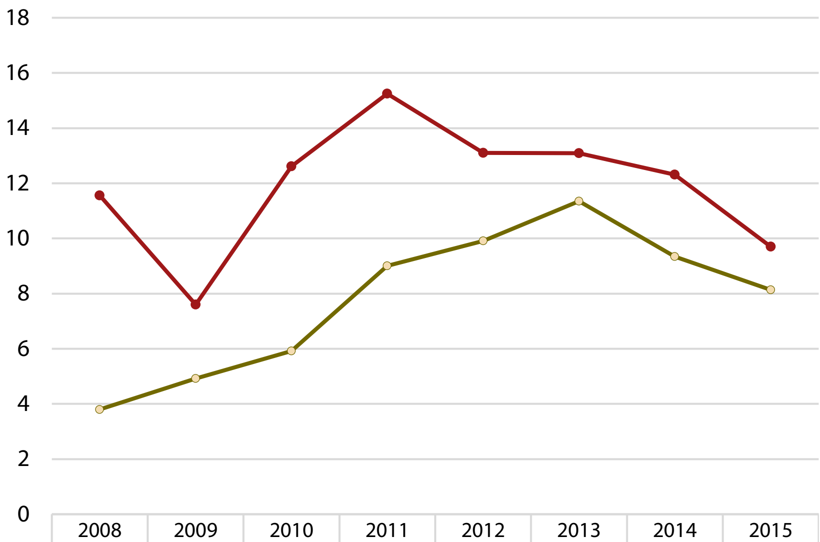
Figure 3: SOFAZ Transfers to the State Budget (in million AZN)



	2008	2009	2010	2011	2012	2013	2014	2015
Transfers to State Budget (mln AZN)	3,800	4,915	5,915	9,000	9,905	11,350	9,337	8,130
Other SOFAZ spending (mln AZN)	493	379	471	606	668	952	780	1,426

Source: Caspian Barrel and NRGI, 2016, <http://psaagreement.org/>*. Reproduced with permission.*

Figure 4: State Revenues from Production Sharing Agreements (PSAs) and Transfers to the State Budget (in billion AZN)

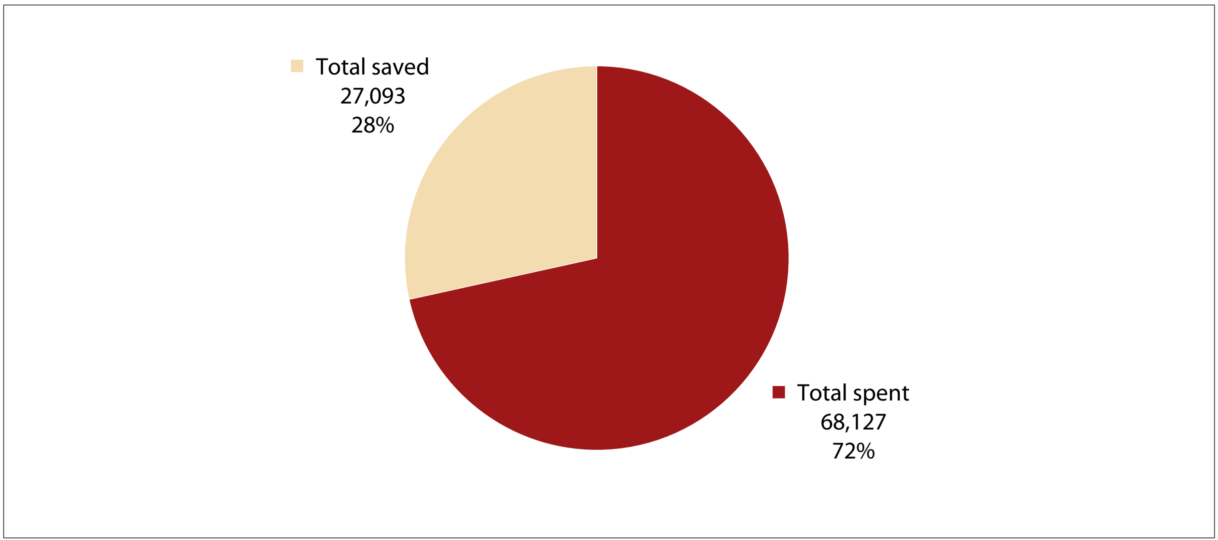


	2008	2009	2010	2011	2012	2013	2014	2015
Total government revenues from PSA agreements (bln AZN)	11.56	7.60	12.61	15.25	13.10	13.09	12.31	9.70
Transfers to State Budget (bln AZN)	3.80	4.92	5.92	9.00	9.91	11.35	9.34	8.13

Source: Caspian Barrel and NRGI, 2016, <http://psaagreement.org/>*. Reproduced with permission.*

**Note: The PSA Agreement (Production Sharing Agreement) is a special form of agreement on the establishment of an enterprise to carry out joint activities. Usually PSAs are signed between a foreign company(ies) (contractor) and the state or the company representing the state (customer) for the extraction of oil, gas and mineral resources. In the period 1991–2015, Azerbaijan signed more than 30 PSAs with foreign oil companies, attracting more than $55 billion in foreign direct investments. List of on-shore and off-shore PSAs is available here:* <http://psaagreement.org/psa-list/>*. For more on PSAs in Azerbaijan's energy sector, see: Nurlan Mustafayev, "Production-sharing agreements in the petroleum industry of Azerbaijan", Journal of World Energy Law & Business, 8:4 (2015): 362–384,* <http://jwelb.oxfordjournals.org/content/8/4/362>

Figure 5: Total Government Revenues from PSA Agreements: Savings vs. Spending, 2008–2015 (in million AZN)



Source: Caspian Barrel and NRGI, 2016, <http://psaagreement.org/>. *Reproduced with permission.*

CHRONICLE

22 March – 11 April 2016

22 March 2016	The Speaker of the Georgian Parliament Davit Usupashvili meets King Salman of Saudi Arabia in Riyadh, stating that it is important that an influential country like Saudi Arabia is interested in close ties with Georgia
22 March 2016	The Georgian authorities announce that security measures have been reinforced at airports in Georgia in the aftermath of the terrorist attacks in Brussels
25 March 2016	Armenian Foreign Minister Edward Nalbandian states after a meeting with his Georgian counterpart Mikheil Janelidze in Yerevan that there are "no problems" in the relationship between the two Caucasus countries
29 March 2016	The Deputy Head of the Georgian State Security Service, Levan Izoria, says that the outflow of Georgian citizens heading to join the Islamic State in Syria has sharply declined
31 March 2016	US Secretary of State John Kerry calls for an "ultimate resolution" of the Nagorno-Karabakh conflict during talks with Azerbaijani President Ilham Aliyev in Washington
31 March 2016	Georgian Prime Minister Giorgi Kvirikashvili announces that member parties of the Georgian Dream ruling coalition will participate separately in the upcoming parliamentary elections
2 April 2016	The EU Commissioner for Migration, Home Affairs and Citizenship, Dimitris Avramopoulos, visits Tbilisi and expresses hopes that a proposal on visa liberalization with Georgia will be adopted very soon
3 April 2016	Heavy fighting in the disputed region of Nagorno-Karabakh is reported with Armenian President Serzh Sarkisian saying that 18 ethnic Armenian soldiers were killed and 35 others wounded and the Azerbaijani Defense Ministry reporting the death of 12 Azerbaijani soldiers
3 April 2016	Georgian Prime Minister Giorgi Kvirikashvili expresses concern over heavy fighting in the Nagorno-Karabakh region and convenes a meeting of security, senior government and parliamentary officials to discuss the situation
4 April 2016	Georgian Defense Minister Tina Khidasheli has a telephone conversation with her Armenian and Azerbaijani counterparts to discuss heavy fighting in the Nagorno-Karabakh region. She expresses hopes that a ceasefire will be achieved
5 April 2016	A ceasefire is announced in the disputed region of Nagorno-Karabakh following heavy fighting and amid international calls for restraint
5 April 2016	Georgian President Giorgi Margvelashvili announces 8 October 2016 as the date for the next parliamentary elections in Georgia
6 April 2016	Iran's President Hassan Rohani offers to mediate between Azerbaijan and Armenia to help resolve the Nagorno-Karabakh conflict. He has telephone conversations with his Armenian and Azerbaijani counterparts, Serzh Sarkisian and Ilham Aliyev
6 April 2016	Kazakhstan's Prime Minister Karim Masimov proposes Moscow as an alternative venue for the summit of the Eurasian Economic Union (EES) scheduled to take place in Armenia's capital Yerevan on 8 April
7 April 2016	Russian Prime Minister Dmitry Medvedev says his country is ready to help resolve the Nagorno-Karabakh conflict between Armenia and Azerbaijan. He expresses hopes that the ceasefire agreement will hold during his visit to Armenia
7 April 2016	Russian Foreign Minister Sergei Lavrov praises the ceasefire in the Nagorno-Karabakh region amid claims of breaches by Armenian-backed and Azerbaijani-backed forces
7 April 2016	The Georgian Energy Ministry announces that Georgia and the Russian gas company Gazprom have signed a deal to extend an agreement on the transit of gas from Russia to Armenia via Georgia
8 April 2016	The former deputy head of the Constitutional Security Department (CSD) under the Interior Ministry and four other former security officers are arrested in Georgia on charges of recording sex videos of politicians in 2012 which were posted on YouTube in March 2016
9 April 2016	The Vatican press office says that Pope Francis will visit Armenia in June 2016 and Georgia and Azerbaijan in September and October 2016
11 April 2016	Thousands of people march in Yerevan in commemoration of the deaths of ethnic Armenians as a result of fighting in the Nagorno-Karabakh region

Compiled by Lili Di Puppo

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ABOUT THE CAUCASUS ANALYTICAL DIGEST

Editors
Tamara Brunner, Lili Di Puppo, Iris Kempe, Natia Mestvirishvili, Matthias Neumann, Jeronim Perović, Heiko Pleines

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