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Assessment of the Effect of Declining Oil Prices on
Azerbaijan Economy



ASSESSMENT OF THE EFFECT OF DECLINING OIL PRICES ON AZERBAIJAN ECONOMY

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Introduction

The main goal of this study is to assess how the oil price decline in the world market will potentially impact the Azerbaijani Economy. The paper specifically looks at how last changes in the world market will affect both the revenue and expenditure sides of the state budget. The study also examines the “side impact” and “domino effects” of low oil prices.

As an oil exporting country, Azerbaijan might face the effects of a sharp fall in oil revenue after the oil price decline in the world market. Azerbaijan is heavily dependent on oil and natural gas export revenues. In 2013, Azerbaijan’s hydrocarbon export revenues accounted for 95% of the country's total export revenues and 64 % of total fiscal revenues.

In public finance section, the paper focusses on the impacts of the oil price decline on the 2015 State Budget of Azerbaijan Republic. The study calculates how a \$1 per barrel drop in the price of “Azerlight” results in annual revenue loss, including losses of GDP, normal export levels and country’s budget.

The study also assesses the potential intervention costs of the Central Bank of Azerbaijan Republic with the aim of preventing the depreciation of the local currency. Side effects of the oil price decline predominantly affect government and household savings, which in turn have an impact on services including the banking sector. Demand for bank loans and other services are expected to gradually decline.

The low price of oil in the world market has a negative domino effect on other sectors, including construction, housing and etcetera. The price decline leads to immediate cuts in energy companies’ investment budgets, both in the traditional sector and among promising alternative technologies.

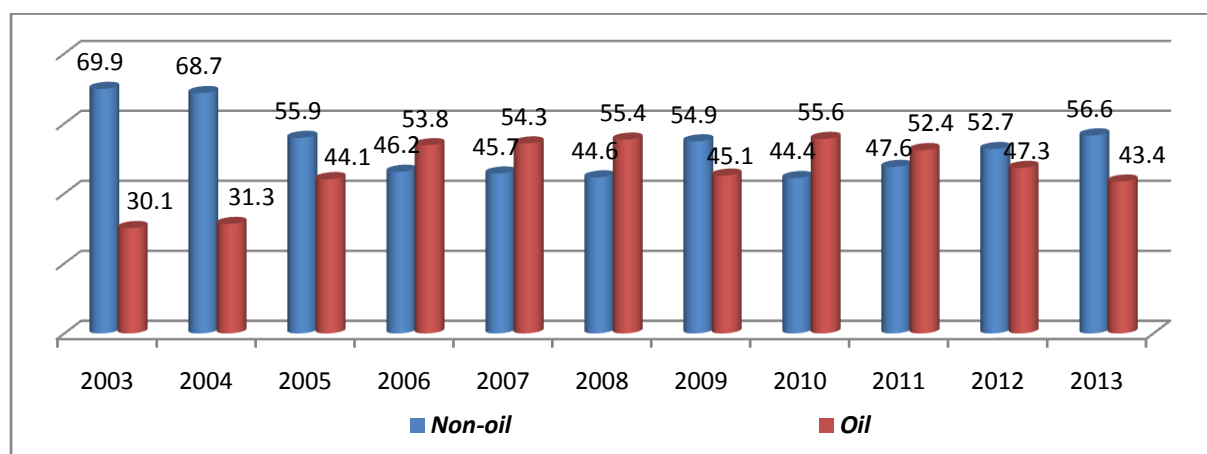
Obviously, the prices of energy-intensive goods and services are linked to energy prices; similarly the price of oil is linked, to some extent, to the price of other fuels. The assessment concludes that if low oil prices continue for a prolonged period of time, this could result in long-term reductions in the oil export revenue, and could force Azerbaijan to make difficult economic trade-off since short-term impacts are marginal.

Azerbaijan Economy: Brief Overview

The years immediately following Azerbaijan's independence were not only marked by political turmoil but also a period of severe economic turbulence. Preceding the politics of glasnost, the Soviet Union strived to keep its Soviet republics politically and economically dependent. Trade relations of all Soviet republics, including Azerbaijan, existed almost exclusively within the USSR.

The last decade has been a period of rapid growth, expansion of financial opportunities, and increasing domestic demand for the Azerbaijani economy.

Oil and Non-Oil GDP share in the total GDP in %



Source: State Statistics Committee of Azerbaijan Republic, 2014

According to the graph, there has been a significant increase in the share of the oil sector in the country's economy since 2005. The factor of growth was the launch of the BTC and the flow of crude oil to the world market produced from ACG field. The increasing share of the oil sector lasted until 2010 when the oil boom ended. Up to 2009, the country had been infected by oil euphoria, and within 5 years the non-oil share in total GDP decreased from 70% to 45%.

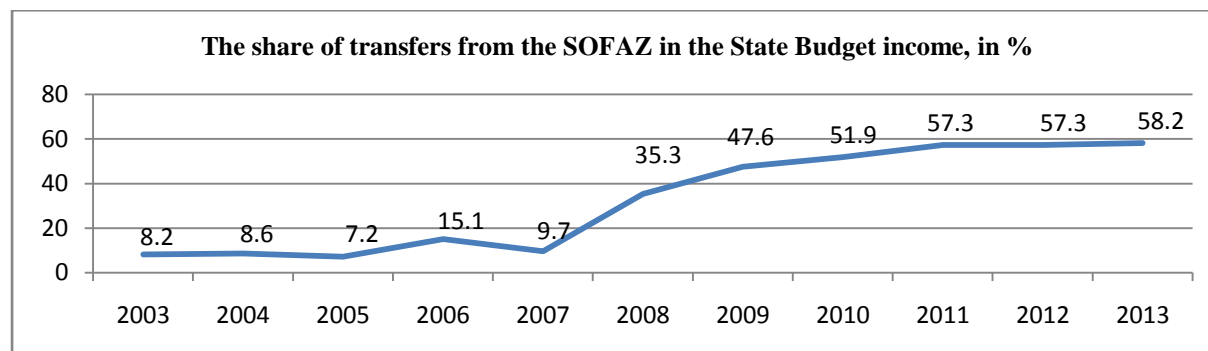
GDP growth rate, compared to the previous year, in %

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Total GDP	111,2	110,2	126,4	134,5	125,0	110,8	109,3	105,0	100,1	102,2	105,8
Shares:											
Oil and Gas sector:	103,9	103,0	166,3	163,2	136,8	106,8	114,0	101,8	90,7	95,0	101,0
Non-oil Sector	114,8	113,6	108,3	111,9	111,4	115,9	103,7	107,9	109,4	109,7	110,0
Net taxes on production and imports:	111,2	110,2	107,9	110,9	111,3	115,6	101,9	108,3	108,2	107	108,4

Source: State Statistics Committee of Azerbaijan Republic, 2014

Currently, 66% of the state budget's revenues are from oil income. This includes direct transfers from the State Oil Fund and tax revenues from the oil sector. In particular, transfers from the Oil Fund have increased rapidly in recent time, which has led to an irreversible situation. Although the volume of transfers to the state budget was reduced for the time in 2014, the transfers have been increased once again in the draft state budget for 2015. This is due to the government's commitment to international events for the next few years, which makes it difficult to reduce budget expenditures.

SOFAZ contributions to the state budget



Source: State Statistics Committee of Azerbaijan Republic, 2014

As we see in the graph above, the share of SOFAZ transfers in the state budget revenues has increased 7 times in the last 10 years. In the frame of these conditions, this rate of transfers will lead to a reduction in the Fund's resources. Thus, the decline in oil production and prices, as well as achievements in the structural diversification of energy resources in the world will lead to decline in oil revenues of Azerbaijan that will have a negative impact on the rate of state expenditures.

Although energy resources of Azerbaijan have been exploited over the last two centuries, the current capacity of oil and gas reserves is considered to be 2 billion tonnes and 2.55 billion cubic meters respectively. However, a decline in oil production has been observed since 2010.

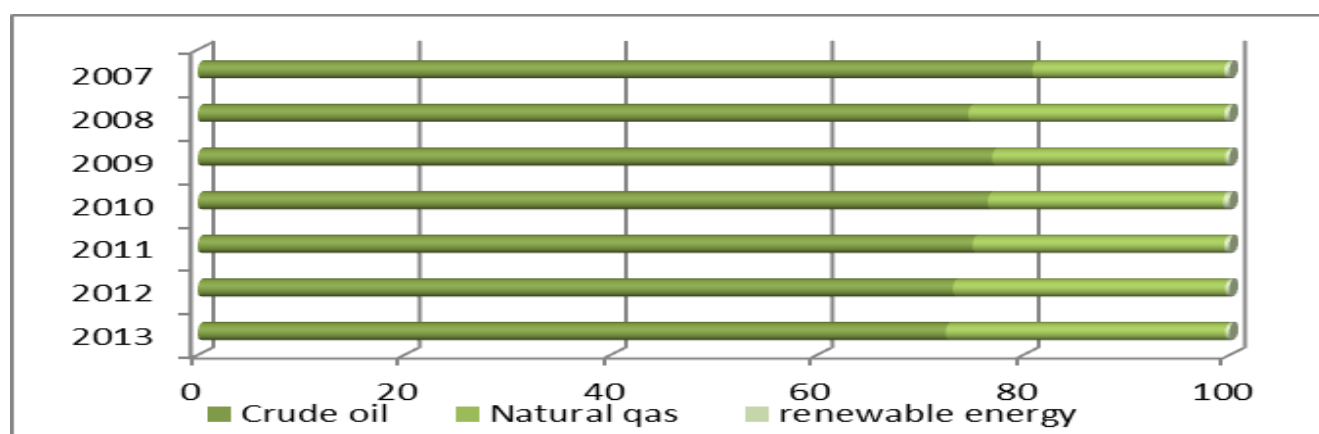
Oil and gas output in Azerbaijan

By year	2008	2009	2010	2011	2012	2013
Oil production (including gas condensates), 1000 tonnes	44 514	50 416	50 838	45 626	43 375	43 457
Commodity as well	44 395	50 364	50 693	45 375	42982	43163

Gas production, million cubic meters	23 399	23 598	26 312	25 728	26 796	29 245
Commodity as well	16 336	16 325	16 673	16 361	17242	17895

Source: State Oil Company of Azerbaijan Republic, 2014

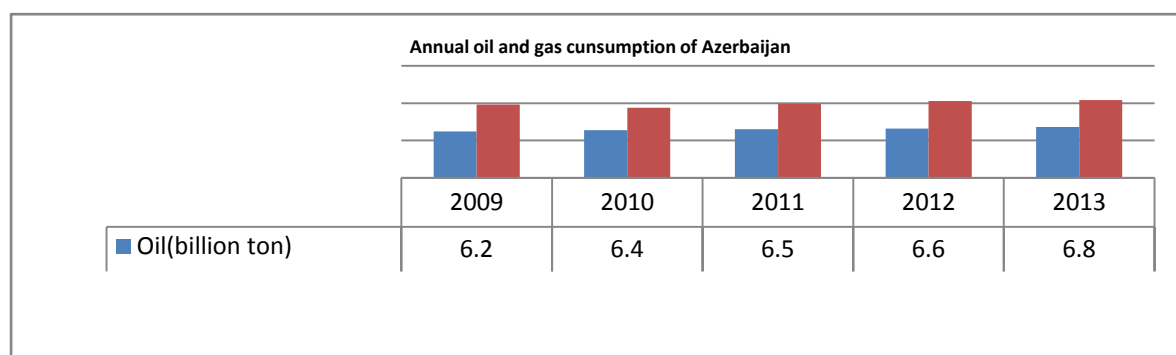
Oil production decreased 7.4 million tons or nearly 15% over past three years. It is expected that the decline of oil production will continue in the coming years. 40.6 million tons oil is forecasted to be produced in 2015, while annually less than 40.0 million tons of oil is forecasted to be produced between 2016 and 2018. However, serious problems may crop up in order to sustain the production of 40 million tons of oil. As soon as the depths of oil wells increase, additional expenses are bound to grow and in most cases the exploitation of new technologies will be required. Needless to say, all these aforementioned issues will lead to some difficulties during the phase of a sharp slump in prices. Additionally, the results of current discussions between the government of Azerbaijan and BP, the operator of AIOC, could influence the volume of oil production in the coming years. Hence, unless the agreement is reached, BP will not be curious about new investments, as a result production might decrease immediately. Thus, oil production might decline by up to 35 million tonnes by 2018.



Annual energy production, percentage

Source: State Oil Company of Azerbaijan Republic and State Statistics Committee of Azerbaijan Republic, 2014

Domestic demand is increasing year by year due to industrialization and the expansion of parking lots. Domestic consumption needs in 2010 were 6.4 million tonnes; by 2013 the figure for domestic consumption reached 6.8 million tonnes with 6% growth.



Annual oil and gas consumption of Azerbaijan

Source: State Oil Company of Azerbaijan Republic, 2014

32.7% of the income or 37.3 billion USD dollars are allocated and current reserves of the oil fund are established. The main expenses of the fund's income are transfers to the state budget; therefore the budget is heavily dependent on oil sector.

Azerbaijan Economy in the light of oil price decline

The observed oil price decline in the world market also affects the oil sector of Azerbaijan. The rentability of this sector plays an important role in the formation of the state's income as well as an important role in determining the volume of exports in value terms. Azerbaijan International Operating Company (AIOC) and State Oil Company of Azerbaijan (SOCAR) are trying to limit revenue losses by reducing the volume of production as well as the volume of exports so long as declining oil prices are observed in the world market. AIOC and SOCAR react to the declining oil prices by reducing the export volume as shown in the schedule.

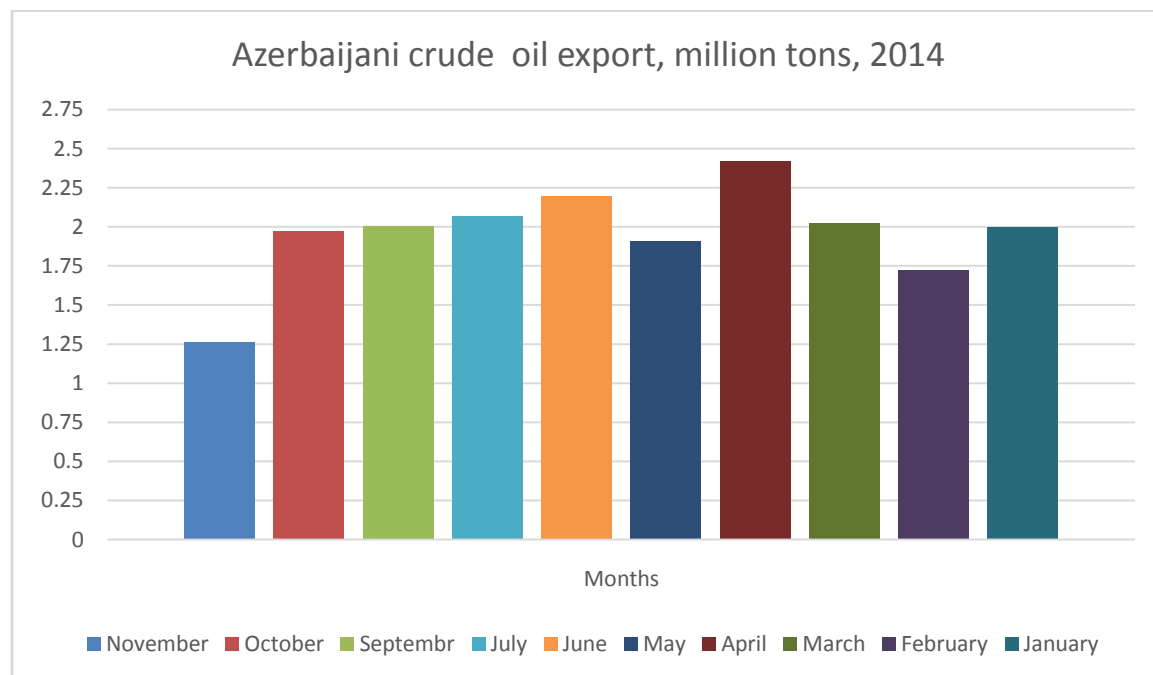
Azerbaijan crude oil export, million tons, 2014

Month	November	October	September	August	July	June	May	April	March	February	January
Oil Export	1.265	1.975	2.003	2.268	2.071	2.197	1.906	2.412	2.028	1.725	1.998

Source; State Oil Company of Azerbaijan Republic, December 2014

The table confirms that Azerbaijan achieved its minimum level of oil exports in November 2014: the country's oil exports amounted to 1.265 million tons, a 36 percent decrease compared to the previous month. In general, starting in August 2014, a decline in Azerbaijan's oil exports is recorded. Thus, in November 2014, oil exports dropped by approximately 80 percent compared to August. Azerbaijan's oil exports were at peak levels in April and August 2014. The price of oil in the world market will determine the volume of oil

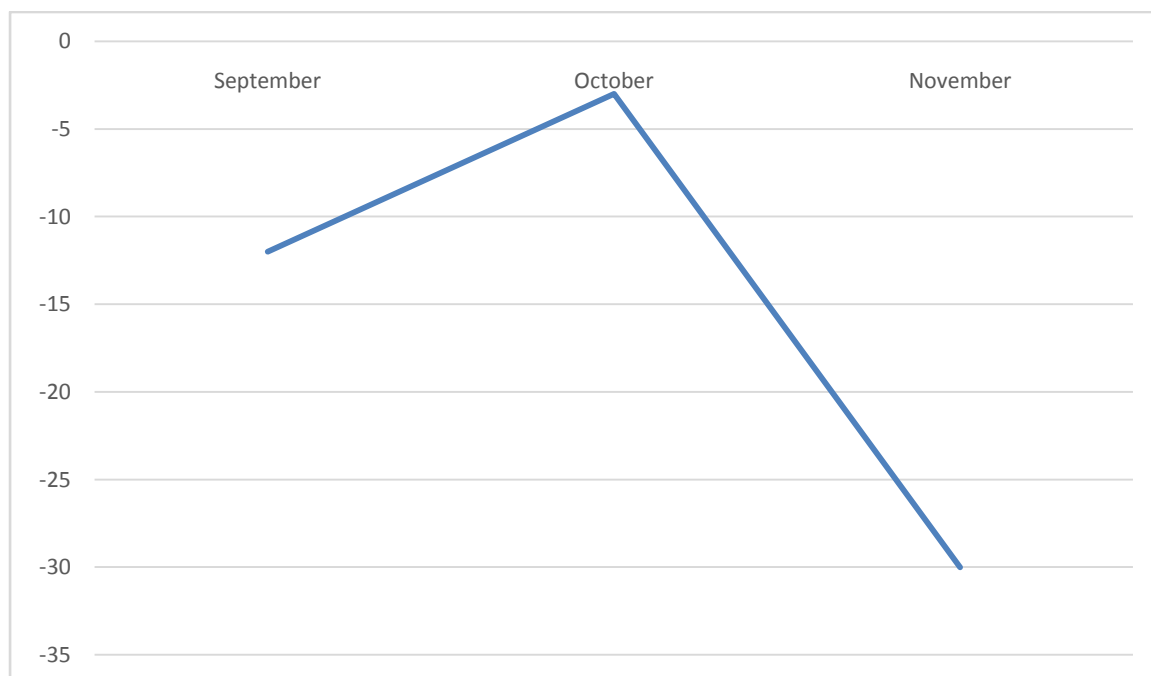
exports in the last months of 2014 and first few months of 2015. It is assumed that there will be a decline in the volume of exports in accordance with the price reduction.



Source; State Oil Company of Azerbaijan Republic, December 2014

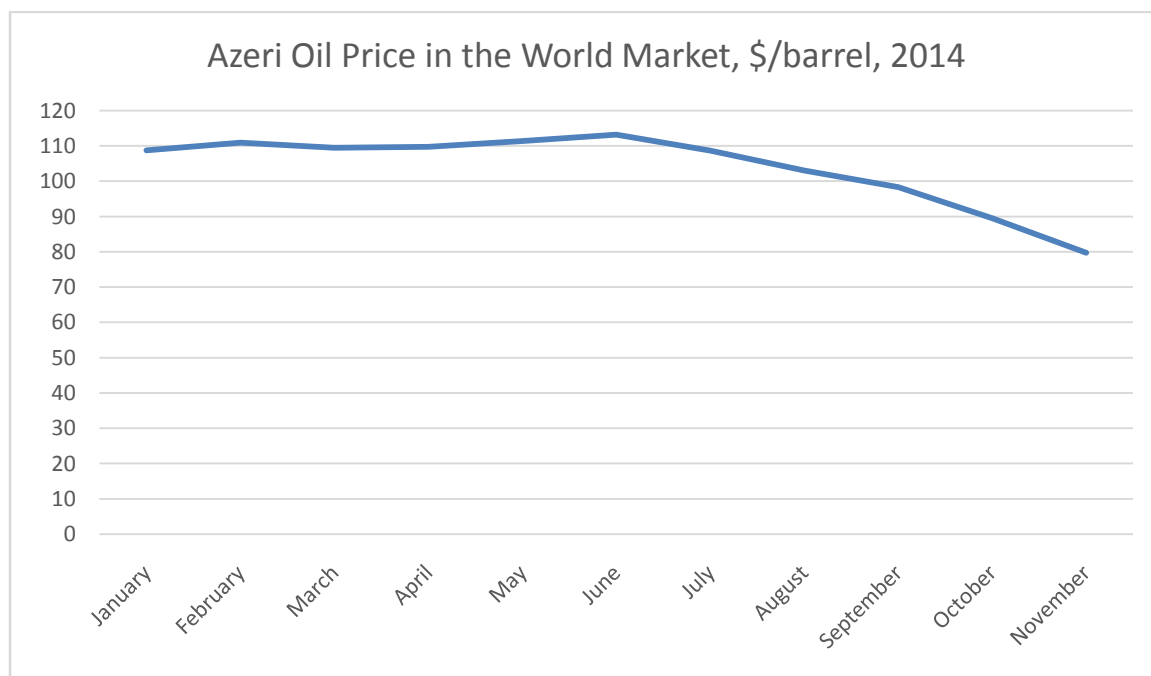
The tendency of a decrease in oil exports is clearly depicted in the diagram above. Oil exports fell below the 1.5 million ton psychological threshold in November 2014.

Oil export decline in September-November 2014, %



Source; State Oil Company of Azerbaijan Republic, December 2014

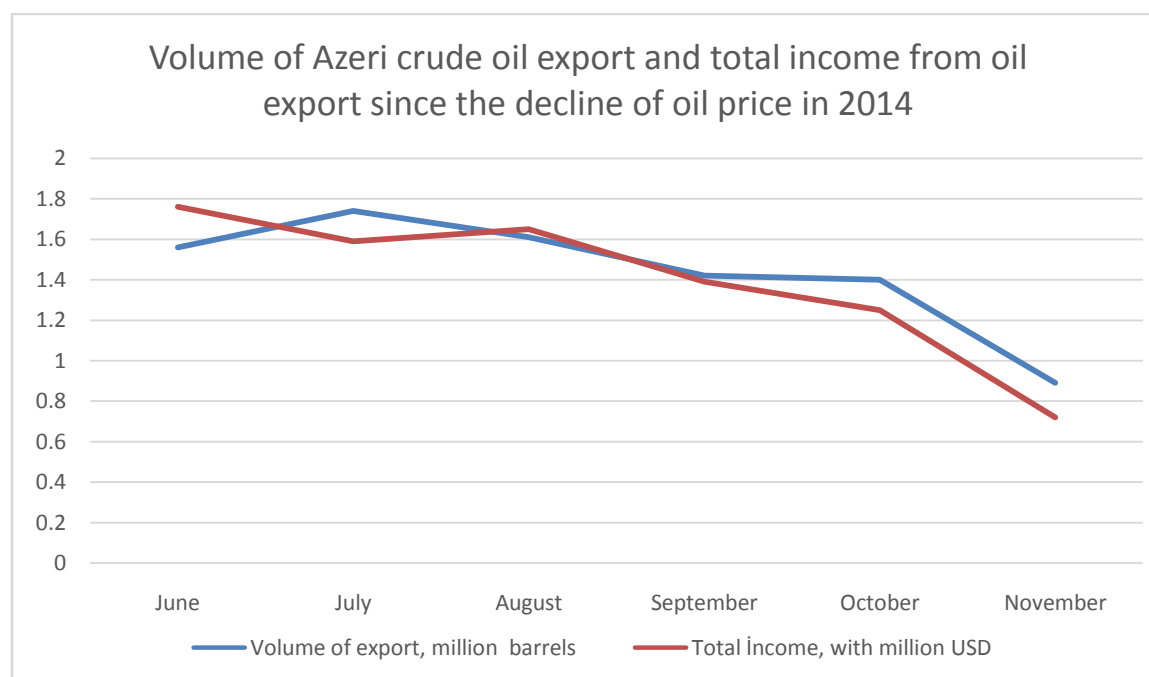
As shown in the chart, the decline in oil exports was 30 percent in November compared to the previous month, 3 percent in October and 12 percent in September. After observing a sharp drop in oil prices the reduction of oil exports has been recorded in the monthly trend. The main purpose of these declines is to sell less oil at the lowest price.



Source; State Oil Company of Azerbaijan Republic, December 2014

The decline in the price of Azerbaijani oil in the world market started in June 2014, followed by more significant price reductions in October and November. In June 2014 Azerbaijanoil

was worth \$113.21 per barrel, but by November it had fallen by more than 30 percent. This confirms that in the second half of 2014 the country's key strategic product has been offered at a lower price on a monthly basis.



Source; State Oil Company of Azerbaijan Republic, December 2014

The decline of the oil price in the world market and the reduction of oil exports impact the overall income of Azerbaijan. The graph shows that the rate of decline in oil revenues from sales exceeded the decreasing trend in the total volume of exports; therefore revenues fell more compared to the volume of exports. However, the falling oil prices on the world market has a negative impact on overall income. This difference is more visible since September 2014.

Note that gross income implies the currency entering the country from the sale of oil included within AIOC oil revenues. Profit after deducting costs from revenues defines the amount of oil in value terms. This is in accordance with production sharing offunds between the Government of Azerbaijan and AIOC.

Azeri oil export, total income and oil price

Months	June	July	August	September	October	November
Azeri oil export, with thousand barrels	15,598	14,704	16,102	14,221	14,025	8,981
Total income from crude oil export, million USD	1.766	1.598	1.659	1.398	1.255	0.716
Monthly price of Azeri oil \$/barrel	113.21	108.68	103.08	98.29	89.51	79.70

Source; State Oil Company of Azerbaijan Republic, December 2014

As shown in the table, the oil sector and as well as the country's state income depends on the price of oil in the world market and monthly oil production. In practice, although monthly production is important in determining the monthly revenue from the sale, the world market price dictates the proceeds from the sale of oil.

Losses in declining of world market price of oil

The entry of the world market price of oil into the Azerbaijani economy is determined through three scenarios.

1. Average scenario. The price of a barrel of oil in the state budget for 2014 is expected to be \$100. If the government of Azerbaijan considers this price as a target then the monthly average revenue target would be \$1.420 billion. If the price of oil for November 2014 is considered, the monthly potential income falls to \$1.132 billion. This means that when you consider the target price of state budget, then the potential loss would be \$288 million. In accordance with the Production Sharing, the potential monthly loss would be \$216 million for Azerbaijan.

So, the relevant formula should be as follows:

$$PL = (BPX NP \times AE) \times 0.75$$

Here:

PL-Potential Loss

BP- the price in the budget for the current fiscal year

AE-Average Export

NP- the price for November

Of course, the production sharing profits applies to oil. But applying the available sharing of revenues with the declining price of a barrel of oil to the net value practically leads to the same conclusion.

2. Saving scenario. Calculate by taking the price of the budget for 2014 into consideration and by accepting the lowest monthly figure of the monthly production. This calculation is based on the principle of reduced production and exports due to the decline of the oil price in the world market. In this case the monthly exports need to be calculated from 9.891 million barrels, and then the target amount for the budget is \$989.100 million. The revenue for the economy of Azerbaijan, if November 2014 price of oil considered, will be worth \$790.290. In this case the monthly potential loss is \$198.810 million. In accordance with the Production Sharing, the potential monthly loss would be \$149.107 million.

So, the relevant formula should be as follows:

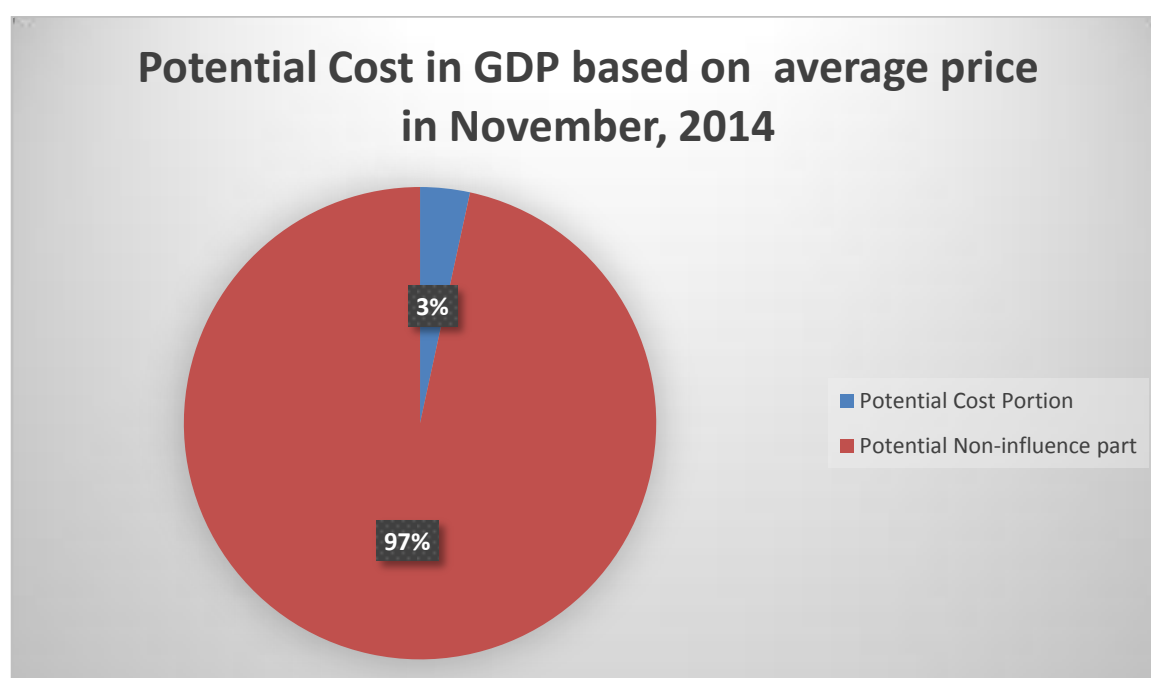
$$PL = (BP \times NE - NP \times NE) \times 0.75$$

Here:

NE- export for the month of November

In addition, the calculation uses the average price of oil, which was available before oil price decline in the world market. The world market price of Azerbaijani oil was \$110 US per barrel until the observed price reductions. But in November, one barrel of oil in the world

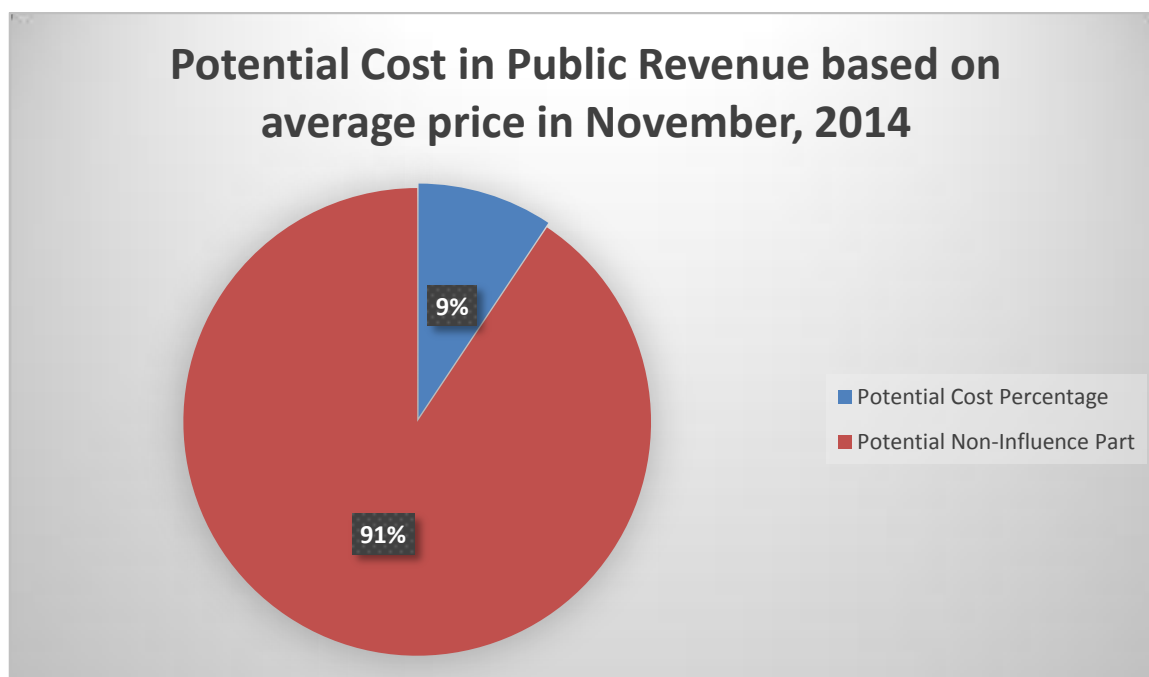
market sold for \$79.70. If we consider that oil exports were 14.2 million barrels, taking into account the average monthly price reductions, will give \$1.562 billion in revenue. This means that the price reductions create a \$430 million reduction in revenues per month. In this case, according to the production sharing, relative loss per share of Azerbaijan was \$322.5 US million.



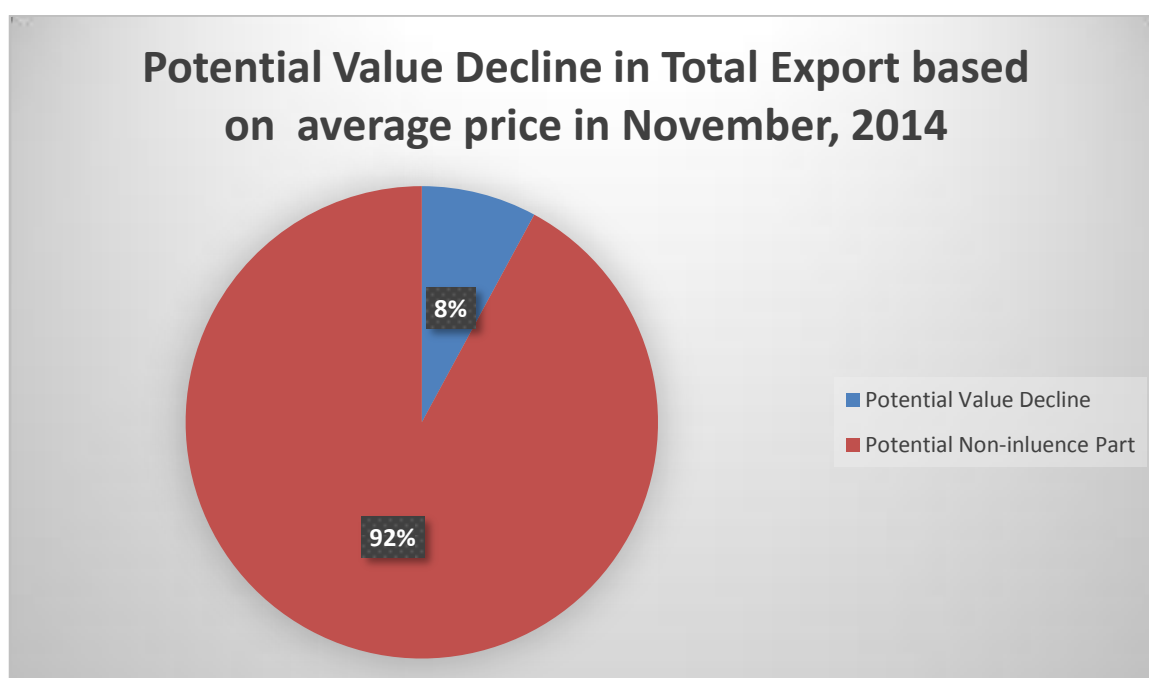
If taking into account the aforementioned calculations then the potential loss which may arise from the reduction in world oil market prices will be a maximum of \$216 million per month and at a minimum will be equal to \$149.1 million. Of course if price reduction continues, this difference can grow even more. As an oil exporting country, Azerbaijan understandably supports stabilized oil prices in order to achieve its economic and financial goals. Azerbaijan benefits from a lack of a drop in world oil prices, in this respect it is important to stabilize prices in order to achieve economic and financial goals.

Taking into account the aforementioned calculations, the annual potential loss to Azerbaijan is between \$1.789 billion and \$2.592 billion. At the same time, the savings method is not suitable for Azerbaijan's preservation of the GDP growth rate; calculations using the average monthly export method can be considered economically more favorable. This means that if oil

prices continue to decline in world markets in 2015, then the percentage ranges could potentially decrease by 3.4 percent of GDP, 10.3 percent of state revenues, and 7.9 percent of exports.

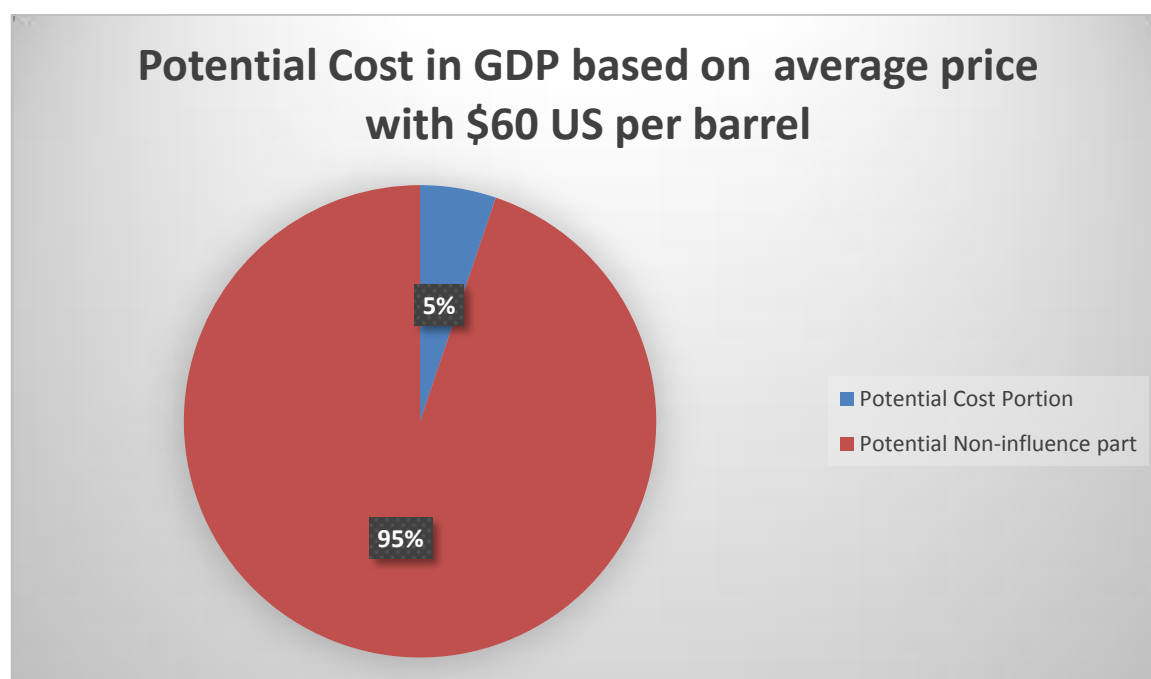


It is apparent that this may increase the potential impact on budget revenues. This is a high proportion of the budget revenues as compared to the oil sector, but also due to the amount of income.

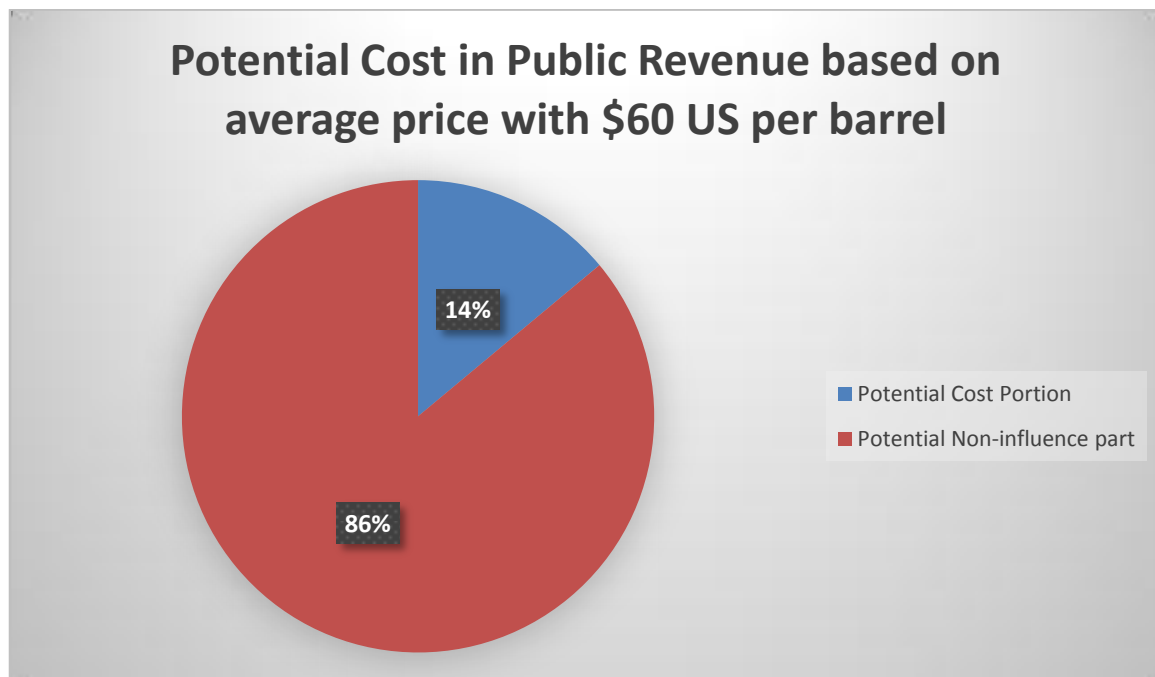


The decline of oil price in the world market leads to a reduction in value of exports since 94 percent of Azerbaijan's exports are oil and oil products. The decline in exports of crude oil has many potential impacts.

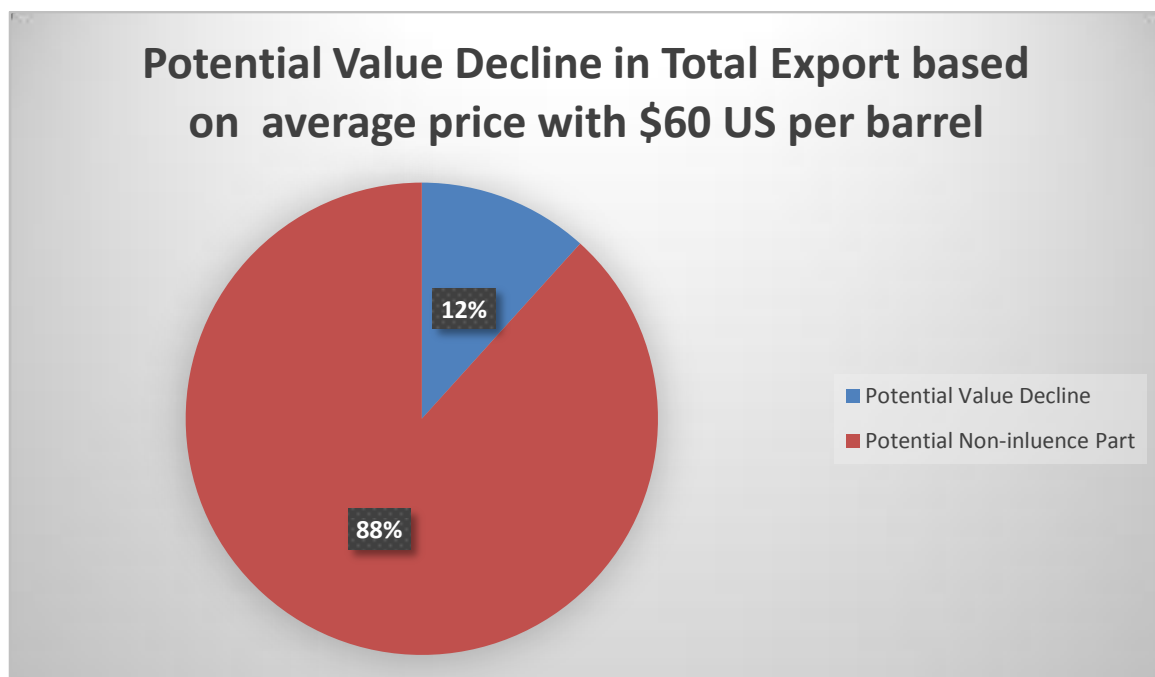
Considering the oil price in the world market for December 2014, the targeting price should be \$90 per barrel while the real price is \$60 US per barrel and the potential monthly loss would be \$320 million $[(\$1.278 \text{ million US} - \$852 \text{ thousand US}) \times 0.75]$. This means that if the average oil price in the world market is \$60 per barrel then annual potential loss would be \$3.840 billion. In this case the portion of the potential cost in GDP terms would be 5.12%, in terms of public revenue would be 15.36% and in the country's exports would be 11.7%.



The above-mentioned graph shows the portion of potential cost in terms of Azerbaijan's GDP if the average price was \$60 US per barrel.



The above-mentioned graph shows the portion of potential cost to the country's public revenue if average price would be \$60 US per barrel.



The above-mentioned graph shows portion of the potential cost to the country's total exports if average price would be \$60 US per barrel.

At the same time, due to intervention costs, the currency reserves of the Central Bank of Azerbaijan have decreased since the oil price dropped in the world market.

Total Reserves of Central Bank of Azerbaijan since the fall of oil prices in the world market in 2014

Reserves	August	September	October
Total Reserves	14782,9	14638,5	14630,8
Currency Reserves	14549,6	13351,0	13237,0

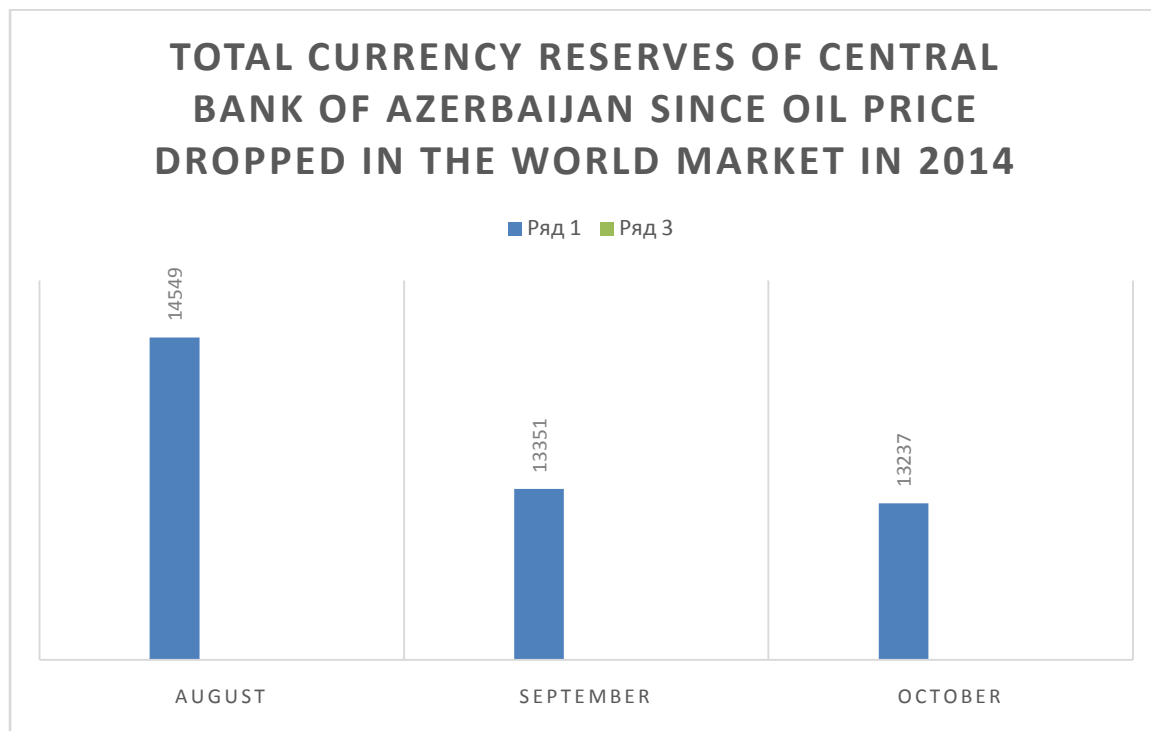
Source: Central Bank of Azerbaijan, December 2014

The table shows that there has been a decline of both the total and as well as currency reserves of Central Bank. This shows that the price of oil affects the Central Bank's intervention costs too.



Source: Central Bank of Azerbaijan, December 2014

This figure shows that there has been clear decline in the Central Bank's total reserves between August-October 2014.



Source: Central Bank of Azerbaijan, December 2014

The Central Bank's currency reserves have declined considerably since oil prices dropped in the world market in 2014.

State Budget for 2014: Brief Overview

Based on the law on the State Budget of Azerbaijan Republic for 2014, the income and expenditure of the state budget are more aligned to real economic conditions than recent years' budgets. The state budget's revenue is 18.384 billion manat and its expenditures are 20.063 billion manat. This means that the state budget will have 1679 million manat deficit, which is 2.87% of GDP calculated on from total GDP of 58.57 billion manat. In addition, the share of the state budget's income and expenditures in GDP has been calculated to be 31.40% and 34.30% respectively, by the forecast of Ministry of Finance. The state budget deficit will be financed by loans from the ministry.

2014 is the first time in the last decade that the State Budget will decrease by 4.05%. The transfers from State Oil Fund of Azerbaijan Republic will decrease by 17.74% or 2 013 million manat. The reduction of state budget's income is the result of this decrease in transfers from the State Oil Fund. Despite the negative effect of transfers from the fund, SOCAR's income is still the most important resource for the State Budget. Although the income of SOCAR will decrease by 1.6% or 191.2 million manat in comparison with the previous year's income, the expenditures of the company will not exceed their income; the forecasted income of SOCAR is 11.63 billion manat and its expenditures will be 11.3 billion manat.

It should be noted that in the current year's state budget the expenditures of the State Oil Fund have been forecasted to be 1.78 billion manat more than income of the fund. This trend has increased the dependence on oil revenues and is contrary to the principles of saving oil funds.

Based on macroeconomic forecasts about economic and social development concepts of Azerbaijan Republic conducted by the Ministry of Economy and Industry, real economic growth will increase by 5.2% and Gross Domestic Product will be 58.6 billion manat, a projected 4.5% increase of GDP in 2014:

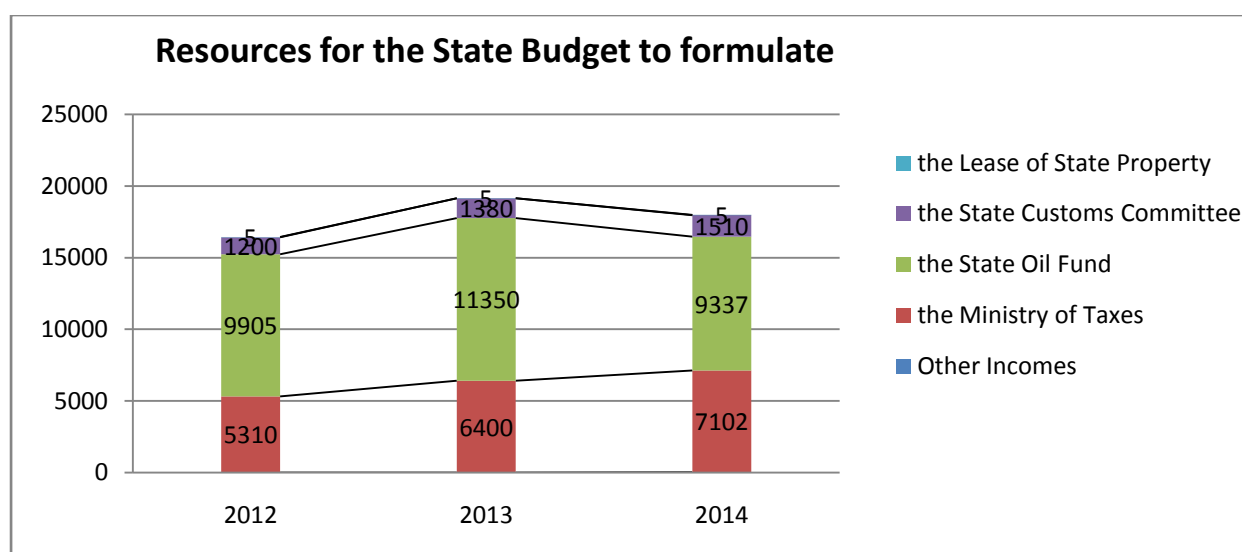
The indicators of the State Budget on Azerbaijan Republic					
	Forecasts of 2013		Forecasts of 2014		2014/2013 by %
	mlnmanat	Share in GDP	mlnmanat	Share in GDP	
Incomes	19 154.00	34.20%	18 384.00	31.40	-4.02
Expenditures	19 810.00	35.30%	20 063.00	34.30	1.23
Budget deficit	-656.00	1.10%	-1679.00	2.86	

Source: The Law on State Budget of Azerbaijan for 2014

As illustrated in the table, in 2014 the income of the state budget is facing a 4.02% decrease in comparison with 2013, but a 1.23% increase in expenditures is observed in the state budget. Taking into consideration the last eleven months' indicators in 2013, the GDP growth is 5.4%, but the state budget deficit has increased as well, which is not positive.

According to forecasts by the Ministry of Finance, the 2014 State Budget income will be 18 384 million manat or 775 million manat less than the current year's income. It is the first time in the last decade that the State Budget income will decrease by 4% after years of continuous increases. However the transfers from the State Oil Fund are budgeted to decrease in comparison with the current year's and that difference will be 2 013 million manat. This means that dependence on the oil sector is diminishing.

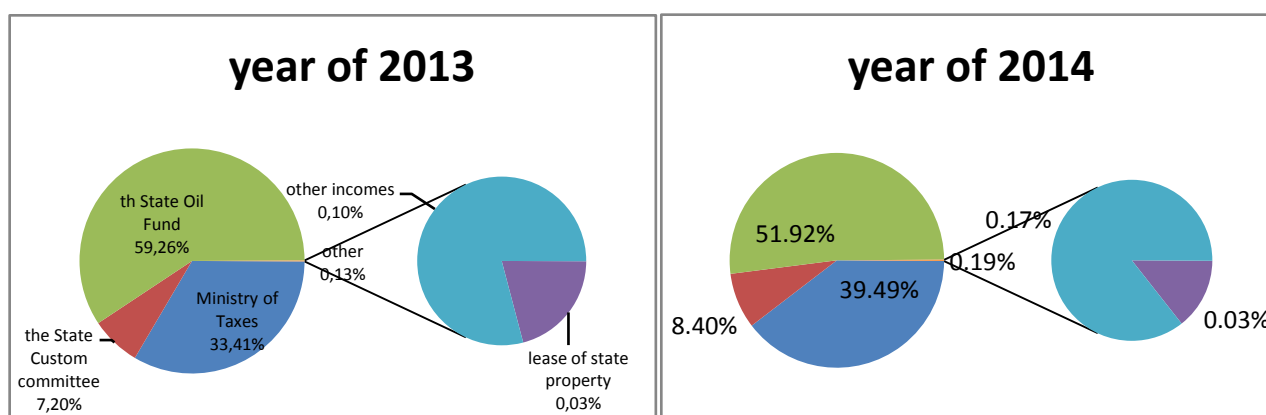
The resources to finance the State Budget of Azerbaijan Republic are given on graph below:



Source: The Law on State Budget of Azerbaijan for 2014

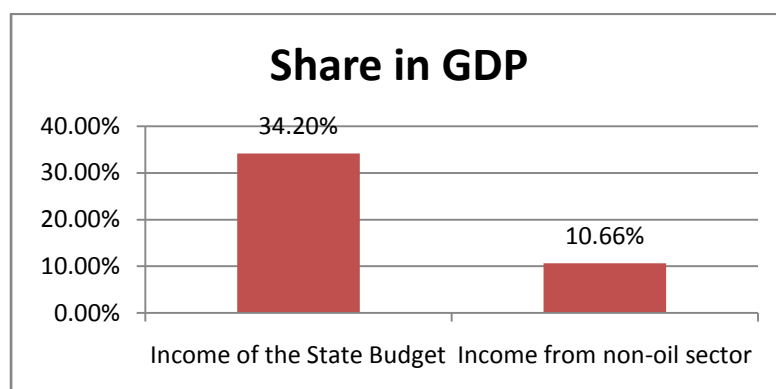
As illustrated in the graph the share of non-oil sector's revenue has been increasing in the state budget over the last three years. This means that tax revenues and income from the State Custom Committee will increase. The Ministry of Finance is optimistic about the revenues for the budget because the government plans to implement increases in tax rates; as a result, income from taxes as a percentage of the state budget will be increased. In order to achieve these increases in taxes, partnership with tax payers will play a significant role. Another interesting point about tax payments, based on statistics, is that normally the accumulation of taxes exceeds 100%; therefore, to increase tax rates is not preferable.

Fund's revenues contributions to the State Budget is illustrated in the graph below:



Source: The Law on State Budget of Azerbaijan for 2014

The share of non-oil revenues in the State Budget are given in the graph as well:



Source: The Law on State Budget of Azerbaijan for 2014

The graph shows that the share of the State Budget's income as a share of GDP is around 34.20%, in comparison with other countries' practices, this percentage is appropriate. But if we take into consideration the income from oil revenues, the reality of the budget does not seem so positive. Non-oil public revenues are predicted to be around 6 245 million manat and comprise only 10.66% of GDP.

In the last months of 2014 the decline in world market prices of oil and assessment

The oil price used in the state budget for 2014 is \$100 a barrel. During the first half of the financial year Azerbaijani oil, relative to the world market price, was higher than it was assumed in the budget. Comparable reductions in monthly payments to the state budget for 2014 have been observed more in the last 3 months. However, 2014 is not a problem in the formation of the state budget revenues. For each barrel of oil sold in the first 11 months of 2014, the median sales price was \$103.89, which was higher than budgeted. December 2014, excluding the results of the annual average prices, will fall below \$100, so is not difficult to predict that there will be a significant difference.

In this regard, the formation of the state budget revenues in 2014 is not a problem for the most of the government's financial plan. Revenues and expenditures of the state budget from the implementation of the results from the first 9 months of 2014 show that there was no observed problem in the formation of income and there has been substantial cost savings. In the first nine months of 2014 the state budget revenues were 14.070 billion while expenditures were only 12.693 billion manats, leading to a 1.377 billion budget surplus.

According to the Ministry of Finance, the state budget revenues in the first nine months of 2014 were 13903.7 million manats compared to the forecast of 14070.6 million, a 1.2% difference.

Budget Revenue and Expenditure Execution for the third quarter of 2014 by Ministry of

Finance

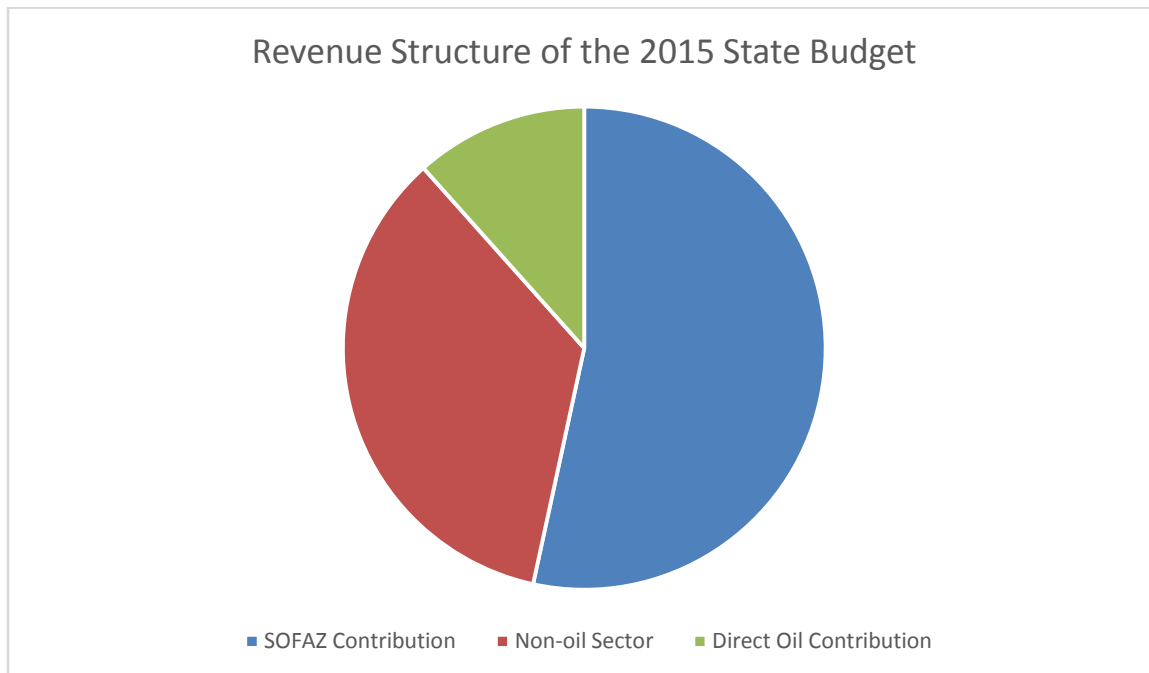
N	Expenditure Section	2014			
		Forecasted	Executed	Difference	%
	Total Expenditure	14,760.7	12,693.5	-2,067.2	86.0
	<i>including</i>				
1.	General State Services	1,469.8	969.7	-500.1	66.0
2.	Defense	1,204.8	1,073.5	-131.3	89.1
3.	Court, State Prosecutor and	912.6	743.8	-168.8	81.5
4.	Education	1,216.6	953.4	-263.2	78.4
5.	Health Care	533.9	450.1	-83.8	84.3
6.	Social Protection and Social Provision	1,524.7	1,462.8	-61.9	95.9
7.	Culture and Art, Information, Sport and other activities which is not included in other categories	229.1	215.9	-13.2	94.2
8.	Flat and Communal Services	336.4	258.0	-78.4	76.7
9	Energy and fuel	2.6	1.1	-1.5	42.3
10.	Agriculture, Forestry, Fishery, hunting and preservation of environment	414.2	370.8	-43.4	89.5
11.	Industry, Construction and Mining	4,622.3	4,554.7	-67.6	98.5
12.	Transportation and Communication	89.3	59.7	-29.6	66.9
13.	Economic Activity	241.4	234.1	-7.3	97.0
14.	Other expenditure not included in the main sections	1,963.0	1,345.9	-617.1	68.6

During the first nine months of 2014, 86.0 percent of the state budget's forecasted expenditures, or 12693.5 million manats, have been implemented. Even though the budget has surplus revenues, almost all the cost savings have been applied. The implementation of saving by Azerbaijani government is associated with the preparation for economic and psychological effects of the decline in world oil prices. With the current level of budgetary spending at the end of 2014, it is possible that instead of the projected state budget deficit there may be a surplus.

The state budget for 2015: Is there a concern?

The State Oil Fund is projected to fund 10.3 billion manat of the state budget in 2015. This means that 53.4% of the state budget, about half, will come from the State Oil Fund. The other half, including the non-oil sector, will be formed at the expense of other sectors of the economy. If we pay attention to the structure of revenues, almost all sources, including taxes, have increased. Predicting the growth of tax revenues is positive development. Given that value-added taxes and corporate income taxes are the largest shares after share of the State Oil Fund transfers. This is also important in terms of the amount of tax revenues.

In order to finance its budget deficit for 2015, which is expected to be 1.662 billion manat compared to the 17 million or less than 1 percent in 2014. Placement of securities to finance the budget deficit, privatization receipts, foreign grants and single treasury account balance will be funded through the state budget. In 2015 the state budget deficit to GDP ratio will be 2.8%. The most discussed issues are related to the budget price of a barrel of oil. 1 barrel of oil this on next year's state budget is expected to be \$90, 10 percent less compared to the price on the current year's budget. As we have noted, 53.4 percent of the state budget for the next year is to be funded by the state oil fund. This means that most of the state budget revenues are insured revenues. Regardless of what oil prices are on the world market, 53.4 percent will come from the oil fund, while the non-oil sector accounts for 35.0 percent of revenues. Sources of income from the State Oil Fund are now fully insured since the institution will carry out transfers regardless of the price of oil in the world market in the coming year. The other 35 percent of the budget will be affected by the world oil price, the volume of domestic investments to the economy, and by sectoral activity although these are indirect effects of the non-oil portion on the budget. In all cases, it is anticipated that there will be problems obtaining these budgetary funds. In this regard, 88.4 percent of the state budget revenues in 2015 are secured by revenues. Thus, the price of oil in the world market can directly affect the formation 11.6 percent of the budget.



Source: Ministry of Finance of Azerbaijan Republic, 2014

If the state budget for 2015 is considered the price of 1 barrel of oil to be \$90 and the world market price continues to decrease, then 11.6 percent of the formation of the state budget revenues may create some difficulties. This means that of the total state budget for 2015, 2.9 billion will be directly dependent on oil. Therefore a fall in world oil prices, first of all, may lead to difficulties in the formation of this part of the budget. Additionally, the state budget revenues from the non-oil sector are indirectly affected by oil money.

The decline of oil prices in the world market could have a negative impact on income from the non-oil sector. Calculations show that income from non-oil sector depends on 10 percentage points of the world market price of oil. Thus, the implementation of the budget will not be in serious trouble due to the impact of oil prices on next year's state budget. However, the price of oil for the next fiscal year will be the most important factor. If there is difficulty in forming the 11.6 per cent of the revenues directly affected by the price of oil, then it is possible to balance the budget revenues and expenditures by increasing the volume of transfers from the State Oil Fund or by cutting costs. If oil prices continue to

decline in 2015, the protected budget costs can not be reduced. According to the law on "Budget System" , if there is difficulty in the formation of budget revenues, protected (salary, pension costs and other social benefits.)excluding costs, other costs can be reduced. In this regard, infrastructure spending is expected to decrease in next year's state budget.

Conclusion and Policy Recommendations

The study shows that the world oil price is very crucial for the economy of Azerbaijan since the oil sector is still dominant in both the country's public revenues and GDP. An oil price drop will not have negative impact on the revenue side of the 2014 State Budget of Azerbaijan Republic since average price of Azeri oil for the first 11 months of 2014 was higher than the price that was specified in the financial year's state budget. However, the decline of oil price has had an impact on GDP growth in 2014. Although 5.2% growth has been forecasted for 2014 in Azerbaijan, real growth will be around 2.5%. The decline has also been observed in both the Central Bank's total and currency reserves since oil prices dropped in the world market.

The decline of the price of oil in the world market will have an impact on 11.6 % of the 2015 state budget revenues since SOFAZ contribution will make up 53.4 % of the total budget income and 35% is expected to be generated by the non-oil sector. However, the decline of the price of oil will have a very negative impact on SOFAZ's 2015 budget if the price is \$60 per barrel next year, this will result in a difference for the oil fund of around \$4.5 billion US. Meanwhile SOCAR's potential loss would be around \$520 million US in 2015. The Central Bank's intervention costs are also expected to be dramatically increased in 2015 due to monetary pressure on local currency. If the oil price in the world market remains at this level then a negative domino effect will be observed in other sectors too.

In light of decreasing oil revenues, Azerbaijan's economy strongly feels a need for diversification to prevent possible future economic turmoil, since momentum for one-engine growth based on oil revenues has passed. This economic diversification could be achieved via:

- Decreasing of infrastructure costs of the state budget starting 2015 in order to save financial resources for supplementary purposes;
- Review and develop a new oil revenue management strategy of SOFAZ;

- Boosting of liberalization and electronization of the Azerbaijani economy including export promotion of selected sectors and sub-sectors;
- Establishment of competition in all sectors. Currently the government's persistence in the economy is extremely high: more than 80%. This decreases motivation for development, competition and innovation in the sector. Private sector or competition is the only way of revealing true potential for all sectors in Azerbaijan;
- Decrease of Government participation in the economy. Economy shall be regulated only for social security purposes. The rest shall rely on the private sector.

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