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The new issue of informational and analytical bulletin “Azerbaijan Economic Trends” has been published, where the dynamics, qualitative changes and tendencies that have taken place in the country’s economy during the year 2009 are analyzed. The publication has been issued in two languages (Azeri, English).

Official statistical data and ERC alternative calculation serves as the initial source of information.

The review consists of four thematical chapters. The first chapter considers the main macroeconomic indicators: economic growth, investments into the economy, as well as the situation in the foreign trade. The second chapter analyzes the revenue and expense in the government budget, monetary policy of the Central Bank, banking sector, insurance market, stock market and exchange rate policy. The third chapter describes the tendencies and issues in the development of industry and agricultural sector. The fourth chapter is devoted to the forecasts in state budget and inflation rate for 2010.

The publication is prepared for wide range of users: employees of government agencies, business, scientific research institutes and centers, public and international organizations, embassies’ staff, university professors and students, other interested individuals.

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CONTENTS

Foreward.....	6
1. MACROECONOMIC INDICATORS.....	9
1.1 GDP and output.....	10
1.2 Investment	13
1.3 Prices and inflation	16
1.4 Foreign trade	19
2. FINANCIAL SECTOR.....	22
2.1 Consolidated budget.....	23
2.2 Monetary Policy	26
2.3 Banking Sector	28
2.4 Exchange rate	30
2.5 Insurance Market	31
2.6 Stock and Bond Market	32
3. SECTORS AND INDUSTRIES OF ECONOMY	33
3.1. Industry	34
3.2. Agriculture	38
4. FORECASTING FOR 2010.....	41
4.1. 2010 Year State Budget.....	42
4.2. Determinants and forecasts of inflation in Azerbaijan.....	48
4.2.1. Determinants of inflation in Azerbaijan.....	48
4.2.2. Inflation Forecasting	49

TABLES AND DIAGRAMS

Table 1. Growth rate of oil and non -oil GDP in 2009	11
Table 2. Main socio-economic indicators for 2007-2009.....	12
Table 3. Trend of investment in fixed capital in 1995-2009.....	13
Table 4. The source of capital investments in 2009.....	14
Table 5. The share of capital investments in different economic spheres	14
Table 6. Indices of consumer prices	16
Table 7. Indices of price and tariffs on groups and total	17
Table 8. Change in Consumer Price Indices.....	18
Table 9. The dynamics of import-export operations within CIS and other countries	19
Table 10. Oil & Gas production in Azerbaijan.....	33
Table 11. The main indicators of industry.....	34-35
Table 12. Producer price index of industry.....	36
Table 13. Land resources of Azerbaijan	39
Table 14. State budget revenues	41
Table 15. Major sources of the 2010 state budget revenues.....	42
Table 16. The structure of the 2010 budget revenues.....	43
Table 17. Special share of expenditures in the state budget by expenditures lines	45
Table 18. the forecasting results of the CPI for 2010	48
Figure 1. Growth rate of Nominal and Real GDP (by years).....	10
Figure 2. Trend of growth rate of oil and non -oil GDP in 2009 (by months).....	10
Figure 3. Composition of GDP for 2009	11
Figure 4. Sources of investments in fixed capital	13
Figure 5. Distribution of investment on oil and non-oil fields.....	13
Figure 6. Breakdown of capital investments in 2009 by foreign countries and international organizations	15
Figure 7. The domestic and foreign capital investments.....	15
Figure 8. Comparison of the figures of monthly CPI in 2009 delivered by the SSC and ERC	17
Figure 9. Export diversification by regions.....	19
Figure 10. Structure of export in 2009	19
Figure 11. Import diversification by regions	20
Figure 12. Structure of import in 2009.....	20
Figure 13. Budget revenues & expenditures	22
Figure 14. Non-oil deficit and non oil GDP.....	22
Figure 15. Structure of budget revenue in 2009.....	23
Figure 16. Transfers from SOFAZ to state budget in 2009.....	23
Figure 17. Structure of budget expenditures	24
Figure 18. Trend of monetary base in 2009	25
Figure 19. Trend of monetary base from 2001 to 2009.....	25
Figure 20. Trends of M2 and M3 monetary base	26
Figure 21. Trend of monetary base from 2001 to 2009.....	27
Figure 22. Credits in 2009.....	27
Figure 23. Structure of credits in 2009.....	27
Figure 24. Currency structure of credits.....	27
Figure 25. The ratio credits and deposits	28
Figure 26. Nominal effective exchange rate	29
Figure 27. Real effective exchange rate	29
Figure 28. Structure of insurance claims.....	30
Figure 29. Structure of insurance premiums	30
Figure 30. Insurance market 2009.....	30
Figure 31. IPO and secondary markets	31
Figure 32. The volume of transactions, 2008.....	31
Figure 33. The volume of transactions, 2009.....	31
Figure 34. Industrial products in economic districts	33
Figure 35. Compared with the corresponding period of the previous year, in %.....	33
Figure 36. Agricultural production's composition	37
Figure 37. Production of husbandry crops in 2008	38

Figure 38. Productivity of crops (1000 s/ha).....	38
Figure 39. Fixed capital among economy's sectors	39
Figure 40. The structure and major sources of the 2010 state budget revenues	41
Figure 41. The structure and major spending priorities of 2010 state budget.....	44
Figure 42. The structure of the 2010 budget expenditures.....	45

Foreword

Challenged by these risks, the 2009 year was the hardest year for Azerbaijan economy; the risks of global crisis that started as of the second quarter of 2008 resulted in declining nominal GDP, per capita GDP, and widening gap between GNP and GDP, decreasing rate of non-oil GDP, cutting down the public expenditures, declining business competitiveness and income rates of population. Thus, the pre-crisis growth rate of 22% recorded in Azerbaijan economy went down thrice to 9.3% in 2009. At first sight, this growth, in times of global crisis, looks like quite a huge figure not only regionally but also on the global scale. Nevertheless, one fact should not be forgotten that Azerbaijan still remains a raw material country and GDP growth does not adequately represent the actual picture of reality in the country. The reliance of the state economy on the major export commodities, more specifically on oil prices became even more salient. The structural analysis shows that two thirds of GDP in Azerbaijan is exported and more than half of the national economic growth is attributable to the foreign demand. In this respect, the size of oil production in the country and world market price dynamics is very important for the national economy.

The previous year GDP growth of 9.3 per cent was caused by 14.3% GDP growth in the oil sector and 3.2% GDP growth in the non-oil sector. It must be noted that real GDP growth is the physical growth indicator of production and is therefore accepted as an indicator representing the activity of national economy. However, it is not a wrong approach to consider the growth in psychical size of production as an indicator of actual activity in the countries with the prevalent raw material component since the changing raw material prices are determined by the external factors, foreign demand and when the prices go down, there is a different reality. It means that there was recorded for the first time in the modern history of country a fall of 21.2% in nominal GDP despite the real GDP growth and the GDP deflator shrunk from 127.8% in 2008 to 78.8% in 2009. It means many more goods and services were produced but less incomes were generated. The more generalized indicator of per capita GDP went down from 4604 manats (\$5603) in 2008 to 3917

manats (\$4874) in 2009. The decline in nominal GDP is due to the falling oil prices and weak non-oil sector.

The total of 34 billion 579 million manats of GDP were generated in 2009 in terms of actual market prices unlike the previous year's 40 billion 137 million manats. So, if the financial-economic crisis had not occurred and average prices in 2009 had been the same as in 2008, the nominal GDP in the previous year would have been 43 billion 882 million manats. The gap between the base of nominal GDP and actual prices in 2009 (43 mlrd. 882. mln manat - 34 mlrd. 579 mln. manat) was 9 billion 303 million manats (\$11.6 billion). This is an amount that Azerbaijan lost as a result of the financial-economic crisis and failed to earn. These losses were reflected in the declining revenues of both State Oil Fund, state budget forecasts, and incomes of construction firms and other businesses.

The estimates show that a fall of \$10 in oil price per barrel would mean a loss of \$2 billion for the payment balance of Azerbaijan. In view of diminishing average oil prices per barrel from \$96.5 in 2008 to \$62 in 2009, the surplus in payment balance was \$5.8 billion less than the government's forecasts (the initial government forecasts were \$16 billion), and made up \$10.2 billion only. The real growth in industrial sector that formed half the GDP in 2009 was 8.6%. The major industrial commodities such as oil decreased by 13.5% to the final 50.4 million tons in production size, and marketable natural gas production amounted to 16.3 billion cubic meters. The mining production last year, which is a major part of industry, went ahead of the previous year by 12.5%. The industrial growth was mainly attributable to the growth in mining field since in the other fields of the industry – processing and electricity, gas, and water production and distribution – the production went down by 7.7% and 10.8% respectively. Nevertheless, the industrial GDP growth was 12.8%. In the other areas of material production, which are agriculture and construction, the recession was by 3.5% and 8.2% respectively. Overall, the 64.1% of GDP came from production (where GDP growth was 10%), 28.3% from services (the growth was 9.1%), 7.6% from net taxes for commodities and

imports (the growth was 1.8%).

The cheaper oil prices in the world market plunge the share of oil in GDP from 55.4% in 2008 to 47%, as a result of which non-oil sector went up by 7.5 percentage points in GDP to 45.4% compared to 2008. The growth of 3.2% in non-oil GDP was caused not by non-oil production, but by the increases in services, such as 13.1% in postal service and communication, 9.3% in transportation, 8.9% in trade, and 7.7% in social and other services. On the background of the negative trend in nominal GDP, the State Statistics Committee reports that people's incomes increased by 8.0% last year as compared to 2008 and made up 22.4 billion manats and per capita incomes raised by 6.7% finally adding up to 2 537,1 manats (211,4 manats in monthly terms). In the experience of different other countries and also theoretically, the contraction in nominal GDP would result in diminishing incomes of people and higher unemployment rate. Given the fact that the official statistics point that permanent employment places created last year declined by 35 thousand people as compared to 2008 and also the number of dismissals increased three times (from 3037 people in 2008 to 8747 people in 2009). In this case, the official statistics of increasing incomes of people are doubtful and the official statistics also point out that the sharer of incomes of people in actual GDP went up by 14 percentage points reaching 64.8% compared to 50.9% in 2008. It, in turn, indicates at the distorted parity between consumption and savings as a result of declining funds into the major funds, turnover funds and, at large, into the total savings. In fact, this change of increasing share of people's incomes in GDP is supposed to have seriously affected the consumption and bring about increasing average prices in the economy. However, the fact that wages, which is the major source of people's incomes, were increased by 8.6% and reached 298 manats last year did not cause expected price increases in commodities. People tended to spend their money in more economic manner.

The last year's deflation and inflation split the economic developments in the country; the first half of the year saw deflation and the second half inflation and monthly consumer prices index varied by 2,1 percentage points (between -0,8% and +1,3%) and was 1,5% annually. It is to note that the inflation in 2008 was 20.8% compared to 2007.

As a result of negative effects from the global financial crisis, the saving part of GDP and investments drastically contracted. As per the official statistics the capital investments contracted by 18.7% (it was 34.4% in 2008) to the final 7 billion 359 million manats.

Hence, the national economy lost one third of foreign investments and internal investments sank by 14.2%. State budget expenditures that are one of the major sources of internal investments contracted by 28% to 2 billion 678 million manats and comprised 36.4% of total investments. The reason behind lesser investment expenditures was that the state budget revenues were not carried out throughout the year.

In forecasts of consolidated budget revenues for 2009, the price level used by the government as a calculation base for oil (\$70) did not prove and the average oil price in the world market was 62 dollars, which distorted the 2009 year budget forecasts even more. It must be emphasized that despite the weaker implementation of 2009 year budget as compared to the 2008 budget, the Oil Fund transfers into the state budget were increased by 1 billion 115 million manats or from the previous 3 billion 800 million manats to 4 billion 915 million manats. However, the 2009 year state budget revenues and expenditures were realized at a lower level than in 2008. As per the initial data, state budhet revenues were 10 billion 326 million manats last year, 4.1% of 438 million manats less than in 2008, and the expenditures were 10 billion 504 million manats, 2.5% or 271.2 million manats less than in 2008.

The foreign trade statistics of Azerbaijan were not cheering either. According to statistics, the last year trade balance saw 2.5 times of contraction. The export-import transactions totaled to \$54 billion 920 million in 2008, whereas they declined by \$818 million to the final \$20 billion in 2009. The exports went down 3.2 times from \$47 billion 756 in 2008 to \$14 billion 698.5 million in 2009 and the imports declined by a total of 14.6% to \$6 billion 119 million. Despite the considerable contraction in exports, the trade balance was kept positive and the positive trade balance comprised \$8 billion 579 million in 2009, which was 4.7 times more and amounted to \$40 billion 593 million in 2008.

The unhappy situation was recorded in the non-oil exports too. The dramatic fall in oil prices combined with slumps in export volumes have significantly deteriorated the trade balances. Another side, the declining global demand and falling prices weakened the competitiveness of Azeri products, which are of a lower quality. The exports of aluminum and other products made of it declined ten times, chemical products three times, and ferrous metals and products made of them declined twice in exports and there was recorded a ten percent contraction in the exports of fruit and vegetables. Per-capita non-oil export declined from \$167 in 2008 to \$124 in 2009. According to the estimations, Azerbaijan underperforms in per-capita

exports compared to the average level of other post-soviet countries.

Foreign debts of Azerbaijan increased by \$420.7 million, 14%, and reached \$3421.8 million for January 1st, 2009. Its share in GDP increased also from 6.4% to 7.95%. per-capita foreign debts equaled to \$380.3. For January 1, 2010, the credits attracted for the purpose of carrying out economic reforms in Azerbaijan comprised \$326.91 million or 9.6% of overall debts (\$61.96 million to IMF and \$264.96 million to World Bank). The rest debts in the amount of \$3094.86 million (90.45% of foreign debts) are credits for investment projects including \$1359.8 million in energy systems, \$868.48 million in road construction and transportation, \$309,81 in water farming and amelioration, \$207.34 million in oil/gas and chemical industry, \$153.94 million in social sphere, \$124.78 million in agriculture and \$70.71 million in other spheres.

The last year economic indicators in the world showed that majority of developing world economies that are dependent on credits and capital flows for their economic growth were hit by the crisis. One of the reasons Azerbaijan was less hit by the crisis is that it is

less dependent on the credits and capital flows for its economic development, which can also be explained through the expanding oil and gas production in the country. Despite all this the studies show that global financial crisis affected Azerbaijan's economy both horizontally – impact on the markets (commodity, financial, currency, money-credit, bonds etc.) and vertically – impact on economic agents (government, businesses and households). That is why, global crisis re-uncovered the challenges faced by Azerbaijani government in adequate risk management associated with the sustainable economic growth and financial market stability. The challenge in the mid- and long-term is to significantly diversify the economy, employment, budget and export revenues, ensure the long-term sustainable macroeconomic development and increase the international competitiveness of the national economy. In view of this challenge, one of the core objectives is to strengthen the financial and macroeconomic stability that appear to be the major cornerstones of sustainable economic development and eradicate the negative impact on economy, business environment and households caused by the crisis.



MACROECONOMIC INDICATORS

Gross Domestic Product (GDP) and output

Challenged by these risks, the 2009 year was the hardest year for Azerbaijan economy; the risks of global crisis that started as of the second quarter of 2008 resulted in declining nominal GDP, per capita GDP, and widening gap between GNP and GDP, decreasing rate of non-oil GDP, cutting down the public expenditures, declining business competitiveness and

income rates of population. Thus, the pre-crisis growth rate of 22% recorded in Azerbaijan economy went down thrice to 9.3% in 2009. At first sight, this growth, in times of global crisis, looks like quite a huge figure not only regionally but also on the global scale. Nevertheless, one fact should not be forgotten that Azerbaijan still remains a raw material country and GDP

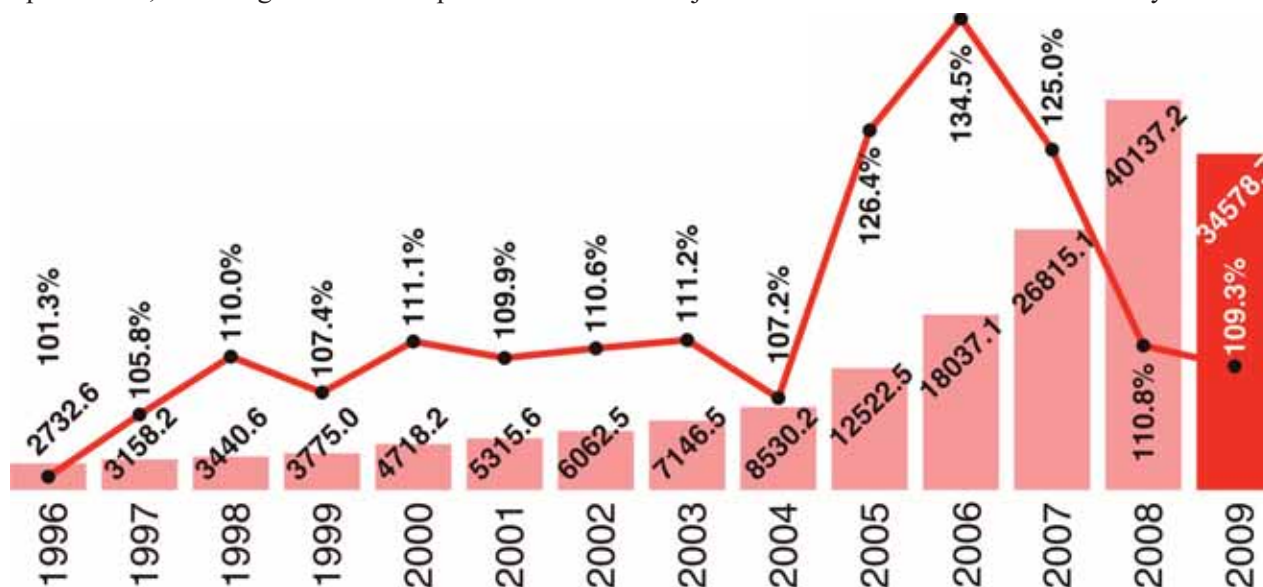


Figure 1. Growth rate of Nominal and Real GDP (by years).

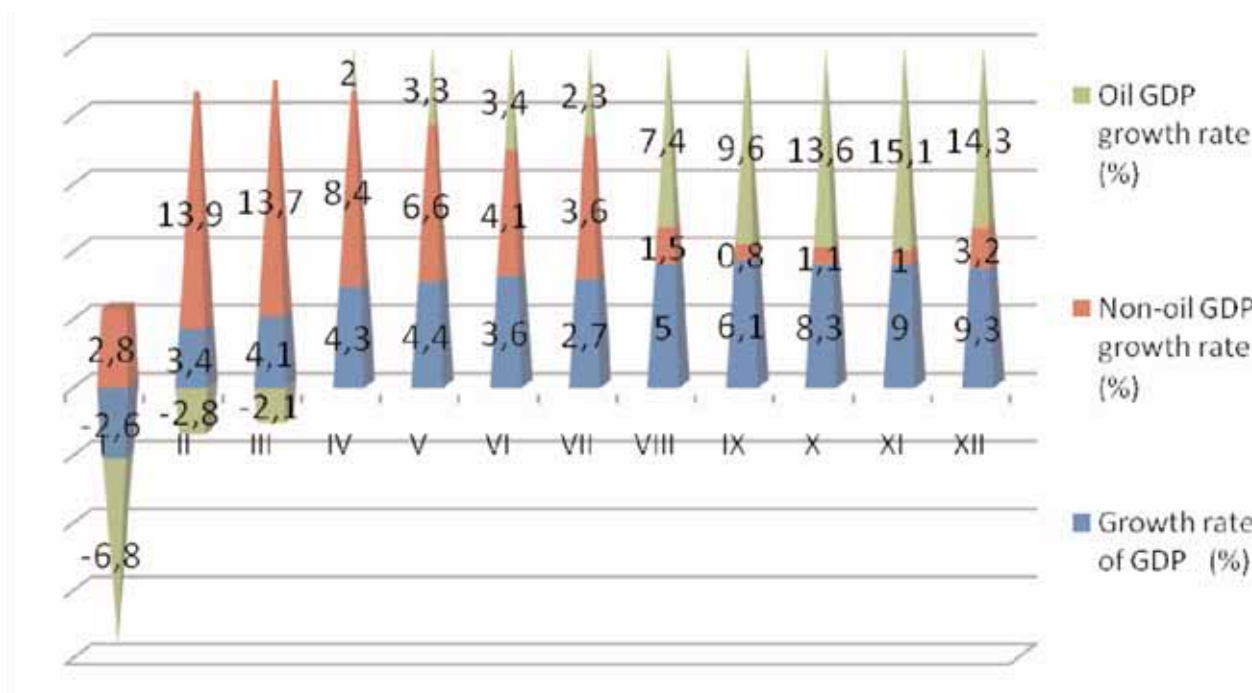


Figure 2. Trend of growth rate of oil and non -oil GDP in 2009 (by months).

2009	I	II	III	IV	V	VI	VII	VIII	IX	X	XI	XII
Growth rate of GDP (%)	-2.6	3.4	4.1	4.3	4.4	3.6	2.7	5.0	6.1	8.3	9.0	9.3
Non-oil GDP growth rate (%)	2.8	13.9	13.7	8.4	6.6	4.1	3.6	1.5	0.8	1.1	1.0	3.2
Oil GDP growth rate (%)	-6.8	-2.8	-2.1	2.0	3.3	3.4	2.3	7.4	9.6	13.6	15.1	14.3

Table 1. Growth rate of oil and non -oil GDP in 2009 (by months)

growth does not adequately represent the actual picture of reality in the country. The reliance of the state economy on the major export commodities, more specifically on oil prices became even more salient. The structural analysis shows that two thirds of GDP in Azerbaijan is exported and more than half of the national economic growth is attributable to the foreign demand. In this respect, the size of oil production in the country and world market price dynamics is very important for the national economy. The previous year

GDP growth of 9.3 per cent was caused by 14.3% GDP growth in the oil sector and 3.2% GDP growth in the non-oil sector. It must be noted that real GDP growth is the physical growth indicator of production and is therefore accepted as an indicator representing the activity of national economy. However, it is not a wrong approach to consider the growth in physical size of production as an indicator of actual activity in the countries with the prevalent raw material component since the changing raw material prices are determined by the external factors, foreign demand and when the prices go down, there is a different reality. It means that there was recorded for the first time in the modern history of country a fall of 21.2% in nominal GDP despite the real GDP growth and the GDP deflator shrunk from 127.8% in 2008 to 78.8% in 2009. It means many more goods and services were produced but less incomes were generated. The more generalized indicator of per capita GDP went down from 4604 manats (\$5603) in 2008 to 3917 manats (\$4874) in 2009. The decline in nominal GDP is due to the falling oil prices and weak non-oil sector

The average real economic growth of annual 22% recorded over the last 3 years in Azerbaijan fell down to 9,3% in 2009. For the first time in the independence

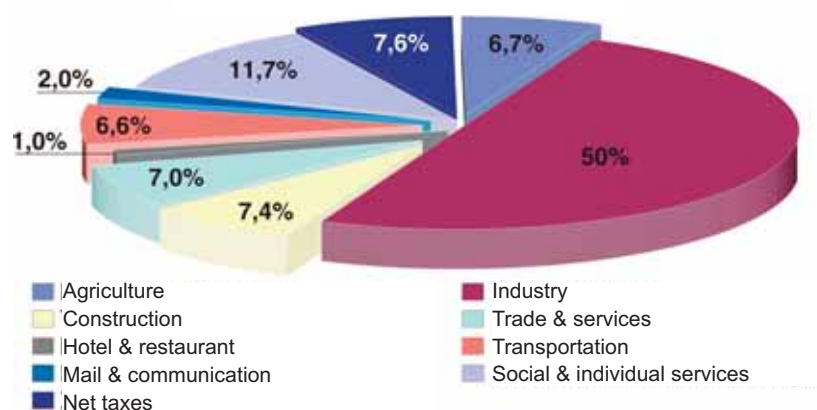


Figure 3. Composition of GDP for 2009

history of the country was the nominal GDP down by 21.2% unlike the real (physical) GDP growth. The reverse processes were experienced in the early 90-s of the previous century, when the high inflation and hyperinflation broke out. These processes in both directions are negative tendencies for any country's economy and a destabilizing macroeconomic factor. In this regard, the 2009 year is comparable with the hardest years of the early 90-s.

The GDP of 34,6 billion AZN was produced in 2009 as compared to 40,1 billion AZN in 2008. The standstill of real GDP growth at an annual 9,3% was caused by 14.3% GDP growth in oil sector and lesser non-oil GDP growth of 3,2%.

The per capita GDP dropped from 4604 manats (\$5603) in 2008 to 3917 manats (\$4874) in 2009. The decrease of GDP is due to global financial and economic crisis which resulted in decline of oil, main export of the country, and the poor development of non-oil sector.

The GDP of 15 billion 683 million manats was produced in the non-oil sector and of 16 billion 257 million manats in oil sector of Azerbaijan's economy in 2009. The net taxes for products and imports amounted to 2 billion 639 million manats in GDP.

Of all the GDP produced, 64.1% came from production field of economy, and 28.3% came from services of economy. The net taxes paid for products and imports made up 7.6% of GDP.

The GDP in industry was 50.0%, 6.7% in agriculture, hunting and forestry, 7.4% in construction, 6.6% in transport and storehouse, 2.0% in postal and communication services, 7.0% in the wholesale and retail trade,

and maintenance of automobiles, domestic wastes and things of private usage, 1.0% in hotels and restaurants, and 11.7% in social and other service fields.

Due to shrinking global market prices of oil, the share of non-oil sector value-addition in

GDP increased by 7,5 percent compared to 2008 making up 45,4%, whereas the share of oil sector value-addition amounted to 47%.

Years	2007	2008	2009
GDP, mln.AZN	28 360.5	40 137.2	34 578.7
<i>Growth rate, %</i>	25.0	10.8	9.3
GDP per capita, \$	3 474	5 603	4 874.1
Oil GDP, mln.AZN	15 411.7	22 251.3	16 527.3
<i>Growth rate, %</i>	36.8	6.8	14.3
Non-oil GDP, mln.AZN	9 533.9	15 197.2	15 683.2
<i>Growth rate, %</i>	11.4	15.9	3.2
Inflation, %			
Monthly, 12 monthly (Annual)	19.6	15.4	0.6
Average yearly	16.7	20.8	1.5
Income of population, growth rate, %	40.3	37.8	8.0
Average monthly wage, AZN	214.0	274.4	298.0
<i>Growth rate, %</i>	42.0	24.2	8.6

Table 2. Main socio-economic indicators for 2007-2009

As specified in the table, 10% increase in production is due to 12,8% increase in industry, because the regress of construction with a bigger share in GDP was more than the increase in agriculture with a less share. In turn, the rise of added value in industry was due to rise in mining, or increase in oil output, because last year a regression was recorded in other two fields of

industry (look at: in Industry Field). Despite of 3,5% increase in agriculture, overall the real GDP rise was not recorded in production of non-oil products. The rise in non-oil sector of economy was due to increases less crisis-hit service fields - 13,1% in post and communication, 9,3% in transport, 8,9% in trade, 7,7% in social and other service fields.

Investment

Capital investments shrank from the average annual 34% that was observed since the beginning of this century to 18.7% in 2009 as a result of the financial-economic crisis. The global crisis affected Azerbaijan's economy due to the declining global demand, which led to the decrease in the prices of export products, especially in those of oil and oil products, and global liquidity shortages, which limited the channels of Azerbaijan's financial sector to borrow from abroad.

Years	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Investment in fixed capital	82	212	139	123	98	103	121	184	174	135	117	115	124	132	81.3

Table 3. Trend of investment in fixed capital in 1995-2009 (as percentage of the previous year)

Along with the tightening global GDP in 2009, the GDP in Azerbaijan also squeezed by 9.3 billion manats, which resulted in lower domestic investments, including capital investments due to the decreasing revenues of enterprises and public investments due to the contracting budget inflows. Also, the restricted access to financial resources also squeezed foreign investments. The national economy lost one-third of foreign investments and domestic investments went down by 14.2 per cent.

Out of all financial sources, capital investments that were directed into the social and economic development in 2009 accounted for 7 billion 358.7 million manats. State-owned enterprises and organizations spent 4 billion 433,9 million manats on construction as opposed to 2 billion 924,8 million manats of non-state enterprises and institutions. The construction of production facilities received investments in the total amount of 5 billion 455,1 million manats as compared to 1 billion 903,6 million manats that were spent on building non-production facilities received.

Of all the capital investments, the domestic ones accounted for 79,9% compared to 20,1% of foreign investments. Of all the domestic investments, 70.4 per cent was absorbed by state-owned enterprises and institutions compared to 29.6% absorbed by non-state owned enterprises. Of the whole capital investments in 2009, 73 per cent or 5374,1 million manats were absorbed by the non-oil sector and 27 per cent of 1984,6 million manats by the oil sector.

Although 4 billion 718 million manats were expected to be allocated from the 2009 year state budget to finance the construction works in 2009, the investments from this source declined as a result of the incomplete realization of the budget throughout the year and therefore only 53 per cent of 2 billion 498 million manats were used in the end.

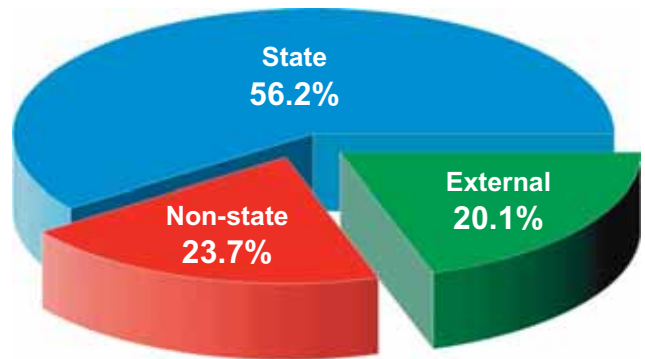


Figure 4. Sources of investments in fixed capital in 2009

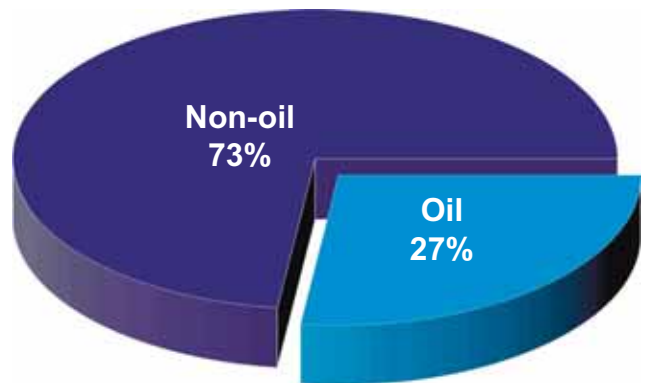


Figure 5. Distribution of investment on oil and non-oil fields in 2009

The capital investments were comprised of 3 billion 521,9 million manats of enterprise funds (47.9 per cent of all the capital investments), 384,7 million manats (or 5,2%) of bank credits, 2 billion 678,0 million manats (or 36,4%) of budget funds (including local

	In 2009, mln. manats	According to the previous year, per cent (comparative prices)	Special weight in common capacity, in %
Total	7 358.7	81.3	100.0
including: Assets of enterprises and organizations	3 521.9	86.7	47.9
Bank credits	384.7	110.5	5.2
Budget assets	2 678.0	72.1	36.4
Assets of non-budget funds	473.9	75.8	6.4
Personal assets of population	299.7	103.3	4.1
Other assets	0.5	10.1	0

Table 4. The source of capital investments in 2009

budget funds), 473,9 million manats (or 6,4%) of non-budget funds' resources, 299,7 million manats (or 4,1%) of people's personal money and 0,5 million manats of other funds. The capital investments were used in the following areas:

Of all the capital investments during the year in question, 40,9 per cent was spent for industrial development, 3,5 per cent for agriculture, 0,1 per cent for fishing, 0,4 per cent for construction, 2,9 per cent for trade and services, 0,7 per cent for hotels and restaurants, 23,8 per cent

Areas	In 2009, mln. manats	2009/2008, in % (comparative prices)	Special weight, in %
Total	7 358.7	81.3	100.0
Including: State sector	4 433.9	78.3	60.3
Non-state sector	2924.8	86.4	39.7
Agriculture	254.0	75.7	3.5
Industry	3 009.3	75.1	40.9
Including: I. Mining	2 013.6	73.0	27.4
II. Manufacturing	338.9	89.2	4.6
III. Electricity, gas and water supply and distribution	656.8	75.5	8.9
Repair of trade and personal goods	215.9	2.5	2.9
Transport	1 749.6	93.3	23.8
Communication	142.2	88.4	1.9
Real estate activities	802.2	98.6	10.9
Of which: Construction of dwellings	644.8	97.3	8.8
State management	525.5	67.6	4.1
Education	106.3	37.8	1.5
Health care and social services	155.8	61.0	2.1
Other public utilities, social and individual services	295.7	72.2	4.0

Table 5. The share of capital investments in different economic spheres

for transportation, 1,9 per cent for communication, 0,2 per cent for the financial sector development, 10,9 per cent for the real estate transactions (8,8 per cent of it for the housing construction), 7,1 per cent for the public administration, 1,5 per cent for the education, 2,1 per cent for health care, 4,0 per cent for other utilities, social and individual services.

As with the previous years, the major part of capital investments into Azerbaijan's economy in 2009 were concentrated in the capital city; from all funding sources in the previous year, Baku received 4 billion 443 million manats or 60.3 per cent of all the capital investments into different spheres of the economy for the development of capital city economy. In the light of contracted investments by 18.7 per cent into Azerbaijan's economy last year, the investments for the capital city declined even more, by 25.4 per cent, which is mainly explained through squeezed investments into the oil sector.

The breakdown of remaining capital investments by economic regions:

- Absheron economic region – 2.3 per cent;
- Ganja-Gazakh economic region - 4,6 per cent;
- Guba-Khachmaz – 4,1 per cent;
- Aran economic region – 5,4 per cent;
- Nakchivan economic region – 5,6 per cent.

The government was not able to divert 13.3 per cent of investments across economic regions and the rest 4.4 per cent of investment went to other 5 economic regions. (pie-chart)

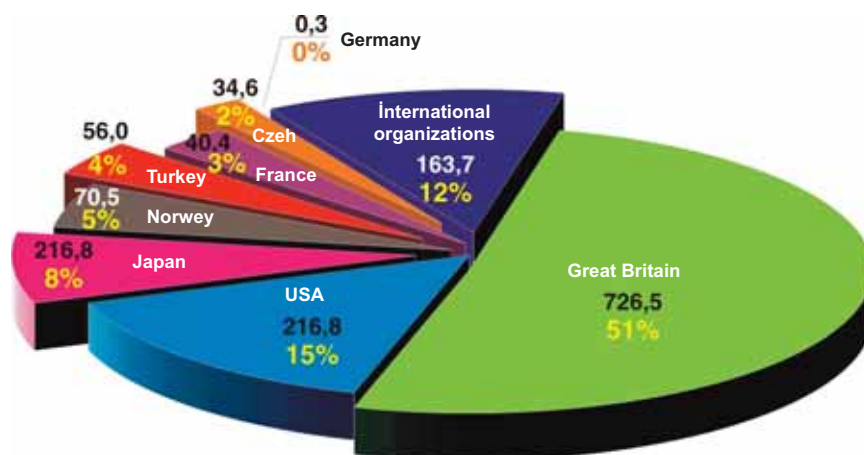


Figure 6. Breakdown of capital investments in 2009 by foreign countries and international organizations (in percentage terms)

In 2009, 525 MVt Power Station in Sumgayit city, Gadabay gold-copper processing and Hajigabul Brick plant, modular "Shahdag" Power Station in Guba district, "Azadliq avenue" metro station in Baku, International Bus Terminal Complex, Asphalt-Concrete plant in Sharur district, fridge storages for fruit and vegetables in Nakhchivan and Sharur district, fiber-optical main cable lines of 288.5 km-s in different parts of the country, new housing buildings with a total area of 1363,3 thousand square meters from all funding sources, secondary schools with the total capacity of 20 622 pupils, and Olympic Complexes in Shamkir, Ismayilli and Sharur districts were put in use.

The capital investments from foreign sources in 2009 went down to the lowest level in the last eight years, 1 billion 477,3 million manats. Compared to the previous year, Azerbaijan's economy lost its one-third of foreign investments, which, on the one hand, can be explained through the decreasing investments into the oil sector, whereas, on the other hand, through the direct effects of global financial-economic crisis.

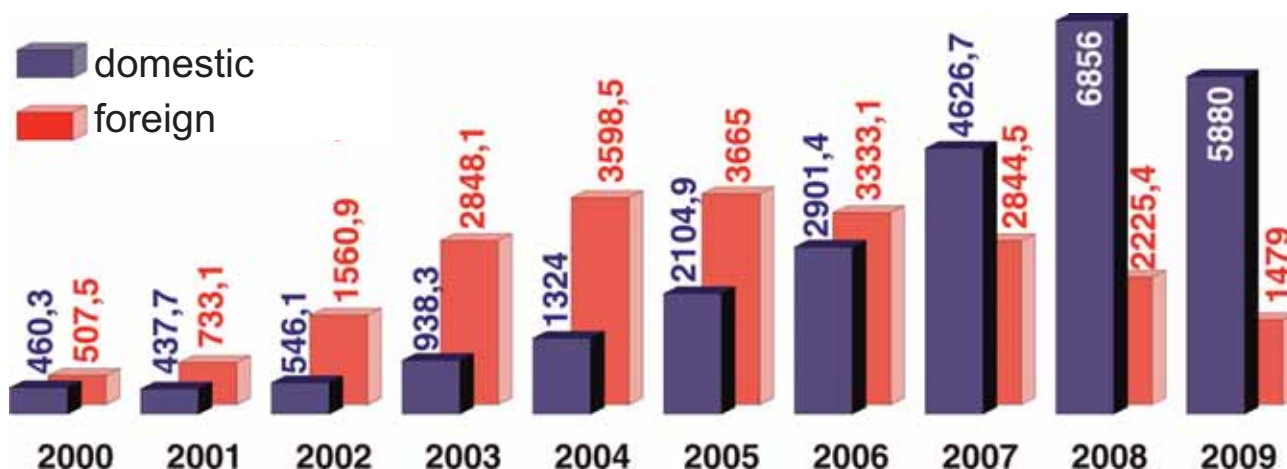


Figure 7. The domestic and foreign capital investments (in mln. manats)

Prices and inflation

According to the information released by State Statistics Committee (SSC), inflation for respective last three years were 16.7, 20.8 percent in 2007, 2008 and 1.5 percent in 2009. The 2008 trend for core CPI to be more or less equal to core inflation and the annualized level of consumer inflation continued in 2009 in both the year-on-year and monthly figures.

The core CPI index is calculated on the basis of a basket of consumer goods and services. The basket does not include services regulated by the government and goods with seasonal price fluctuations (fruit and vegetables).

Inflation peaked in November this year at 1.3% of the October figure, but fell away again in December to 0.8%.

Deflation was registered in the first months of 2009 with 0.6% deflation in January compared to December 2008, 0.8% in February, 0.7% in March, 0.2% in April and in May, and 0.6% in June. Inflation of 0.8% was registered in July, 0.1% in August, 0.4% in September and 0.4% in October.

The estimations on CPI conducted by the State Statistical Committee and Economic Research Center correspond to each other. Even price trends are similar.

According to ERC's calculations CPI was 0.56 %, while prices in Baku went up 2.67 % and in regions prices moved down 1.5 %. The most appreciation was in the service sector – 15.66%.

The International Monetary Fund has published World Economic Outlook 2009 and gave a more optimistic forecast of inflation processes in Azerbaijani economy unlike the country's government.

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The report said that in 2009 consumer prices in Azerbaijan are going to rise only by 4%. "In 2010 consumer inflation can reach 7%, but Azerbaijan will remain in a category of countries with the lowest inflation on the CIS area," the Outlook says.

The ERC research shows that according to the model the monetary policy has low effect on CPI, inflation expectation is the most influential factor on CPI, fixed exchange rate is the subject to be discussed. ERC forecasting shows that weighted average inflation forecast for the end of 2010 is 8.3%.

According to the factors model, CPI depends on previous CPI data and as deep as lag extend the dependence decreases. For example, 1 point growth in

Months	Compared to previous month, in %	Compared with the corresponding period of the previous year, in %
2008		
I	2.5	15.3
II	2.2	15.7
III	3.1	16.5
IV	3.1	17.8
V	2.3	19.2
VI	0.1	20.2
VII	-0.3	20.9
VIII	0.0	21.3
IX	0.9	21.5
X	0.8	21.6
XI	0.1	21.4
XII	-0.4	20.8
2009		
I	-0.6	11.9
II	-0.8	10.3
III	-0.7	8.4
IV	-0.2	6.6
V	-0.2	4.9
VI	-0.6	3.7
VII	0.8	3.1
VIII	0.1	2.6
IX	0.4	2.1
X	0.4	1.7
XI	1.3	1.5
XII	0.8	1.5

Table 6. Indices of consumer prices

CPI in a lag before causes 1.6 point growth in CPI. But exchange rate of AZN negatively impact on CPI and 1 percent growth in exchange rate in a lag before diminishes CPI 0.66 percent. As lag moves deeper dependence rate between CPI and exchange rate fluctuates. It is notable that relation between M2 and CPI embodies in our equation so lame. 1 unit increase in money supply accelerate the CPI 0.003 unit. The price of industrial products has certain influence on CPI. For instance, 1 unit growth of industrial index cause CPI to move up 0.03 unit.

The Azerbaijani government, that has tried to keep one-digit inflation for the last three years, originally forecasted for 2009 inflation at the level of 13% and

	December 2009 compared November 2009, per cent	January- December 2009 compared to January- April 2008, per cent
Products and services in total	100.8	101.5
Foodstuffs, beverage, tobacco	101.4	98.5
Non-foodstuffs	100.2	103.4
Services	100.0	107.1

Table 7. Indices of price and tariffs on groups and total

then cut the prediction to less than 10%.

Extinguishing inflation in Azerbaijan could not cause interest rate to be diminished in 2009. Growth of GDP and shrinking in Government purchase push down equilibrium between interest rate and investment, i.e. raises investment and saving, and forces interest rate moving down. On the other hand diminishing of tax collection impacts opposite direction, i.e. causes investment and saving moving down and interest rate going up. Thus diminishing government purchase and tax collection have adverse impact on endogenous variables such as consumption, investment and interest rate.

Simulation of national income turnover explains why interest rate so high in Azerbaijan and has not

changed sharply after crises as we observed in majority of countries. Of course it is not justification for the speculations of keeping interest rate high. In one hand Central Bank has to try to move down interest rate via monetary policy, but mainly government must take up the responsibility for adequate non-oil GDP growth which is base target.

First time after many years the GDP deflator and inflation moved apart from each others in a such scale. The GDP deflator forecast for 2009 was -0.7%, while it passed -20% in last year. Obviously it was due to the reduction of oil prices which amounts more than 50% of GDP. So that physically growth of GDP in 2009 was not envisaged nominally. CPI is only price index of 585 goods and services in Azerbaijan. GDP deflator is more

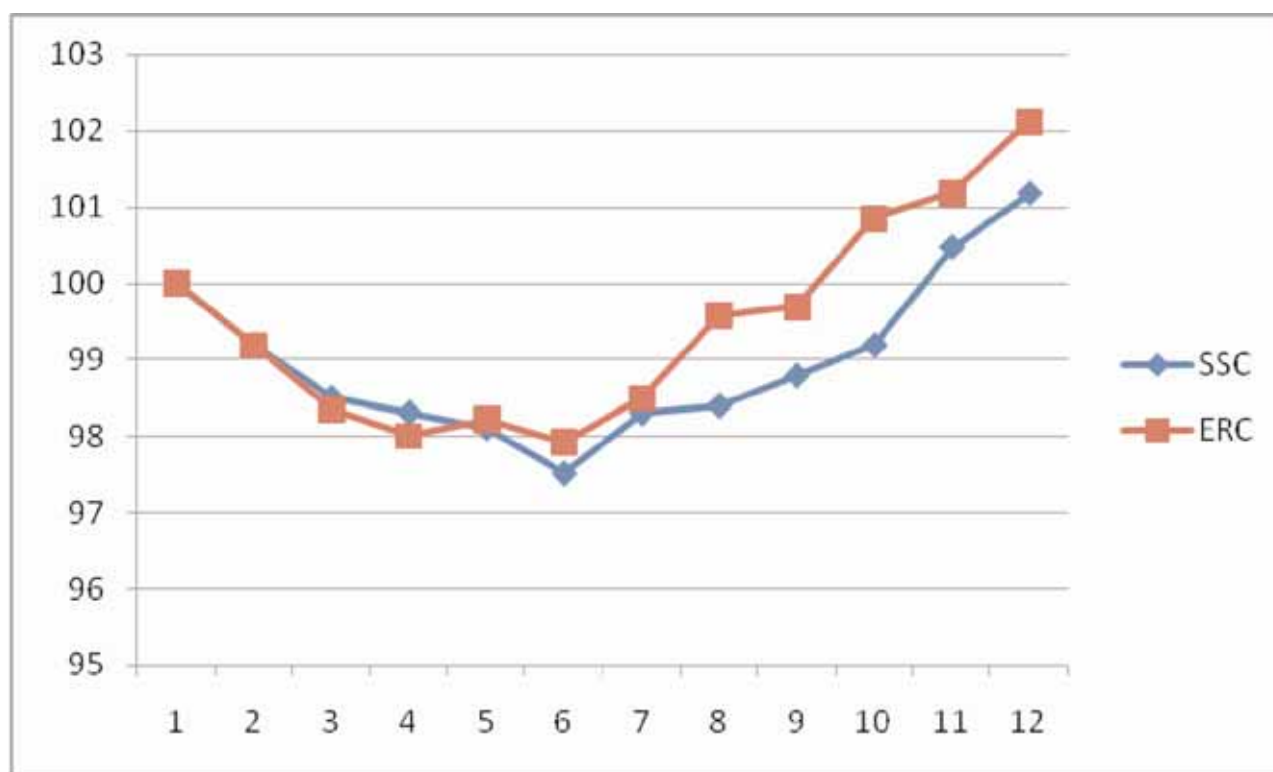


Figure 8. Comparison of the figures of monthly CPI in 2009 delivered by the SSC and ERC.

	Products and services in total	Foodstuffs, beverage, tobacco	Non-foodstuffs	Services
Baku city	103,4	99,7	103,1	111,1
Absheron	100,2	97,8	104,6	103,8
Gandja-Gazakh	101,7	98,8	103,6	107,3
Sheki-Zaqatala	100,4	99,1	101,3	103,9
Lenkoran	102,6	100,4	105,9	105,8
Guba-Khachmaz	101,3	97,1	107,4	107,1
Aran	100,6	97,5	103,5	105,1
Yuxarı Karabakh	99,6	96,5	104,9	104,9
Dağlıq Shirvan	99,5	97,7	97,9	106,4
Nakhchivan	97,3	95,0	98,1	102,4

Table 8. Change in Consumer Price Indices (compared with the corresponding period of the previous year of January December, 2009)

powerful and common while it covers the price change of all goods and services in the country within year. In 2009 GDP deflator was negative and CPI was positive.

Despite on reducing of important foreign financial flows in country, psychology valve of devaluation in neighbor countries, there was protected stability of rate of exchange of manat. To protect stability of manat Central Bank in time balanced on the currency market demand and supply, as a result there was prevented becoming keen cheaper of rate of exchange of manat. Stability of rate of exchange of manat prevented keen going up import and foreign origin commodities using in internal production. In condition of being important special import weight on internal consumption market was bringing rate of exchange policy for 11 months of 2009 played important role in being kept average annual inflation on the 1,5% level¹.

Low level of inflation and stability of rate of exchange gave a chance to protect social condition of population, over period the real growth of money profit of population increased by 6% in 2009. Low level of the inflation and being suitable of multilateral rate of exchange gave a chance to keep rivalry ability of the country, for 2009 the real multilateral rate of exchange of manat become 5,5% cheapen. Stability of manat also

prevented: 1) value lessness of investments of population 2) growth load of debt in foreign currency 3) reducing trust to manat and high dollarization in economy.

The Azerbaijani authorities successfully responded to the crisis. As fiscal revenues fell, the government appropriately cut non-priority spending and financed only ongoing capital investment projects. The Central Bank of Azerbaijan (CBA) successfully maintained financial stability by keeping the exchange rate stable and injecting liquidity into the banking system. The stability of the exchange rate reduced inflation, reversed the temporary increase in dollarization, and avoided a negative impact on households' and banks' balance sheets. CBA foreign exchange reserves declined, but remained comfortable at US\$5.5 billion at end-2009².

"Pressing caused by inflation will come back. It is currently low, but due to rising prices for fuel resources, the growth in consumption in the country will put pressure on inflation. Despite this, its level is much lower than 2008 (inflation was 22 percent)," said chief economist of the EBRD, Anita Tachi. Along with the recovery of the non-oil sector and the rise in international commodity prices, inflation in 2010 is expected to increase slight.

¹Statement of the National Bank of Azerbaijan on the Main Directions of Monetary Policy for 2009

²Statement by the IMF Staff Mission for the 2010 Article IV Consultation Discussions with the Republic of Azerbaijan

Foreign trade

Azerbaijan's foreign trade turnover declined by more than 2,5 times last year down to \$20 billion 818 million in 2009 from export-import trades of \$54 billion 920 million recorded in 2008. The exports in Azerbaijan shrank by more than 3,2 times – from \$47 billion 756 million in 2008 to \$14 billion 698,5 million in 2009. The imports comprised \$6 billion 119 million decreasing by 14,6%. Despite the significant decreases in exports, the trade balance of the country was maintained active. The positive balance in Azerbaijan's foreign trades amounted to \$8 billion 579 million in 2009, which was 4,7 times more in 2008 with a total of \$40 billion 593 millions.

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
export to CIS	104	102	130	61	91	111	95	109	136	185	147	103	119	147	101
export to other countries	93	97	118	93	192	210	139	92	117	133	115	158	91	931	29
Import from CIS	47	149	103	115	80	115	119	146	131	141	120	145	91	123	80
Import from other countries	150	141	71	152	106	112	124	103	175	130	119	115	120	127	88

Table 9. The dynamics of import-export operations within CIS and other countries

The legal and physical people registered in Azerbaijan carried out import-export trade transactions with 137 partner countries in the world in 2009. Trade relations were established for the exports in 70,6% of the cases, whereas 29,4% were based on imports. 89,6% of barter as well as 91,7% of exports and 84,5% of imports were implemented through floating currencies. Of the all export-import transactions, 53,3% was with Europe, 32,1% with Asia, 13,5% with America, 1,1% with Africa and Pacific countries.

Azerbaijan's exports with Italy made up 25,8%, 11,9% with USA, 9,0% with France, 8,4% with Israel, 5,1% with Russia, 4,6% with Taiwan (province of China), 4,5% with Indonesia, 4,0% with Canada, 2,7% with Georgia, 2,6% with Malaysia, 2,2% with Spain, 1,8% with India, and 17,4% with other countries.

Of all exported goods abroad, 92,8% was mineral products, including 91,7% of crude oil and oil processing products, 3,6% of foodstuffs, 1,2% of air, sea and vehicles, 0,8% of less valuable metals and products made of them, 0,4% of plastic mass, rubber, and products made of them, 0,3% of weaving materials and products, 0,2% of chemical industry products, 0,2% of machines and mechanisms, electro-technical equipment, and the rest 0,5% of other goods.

The fall in prices due to the decreasing global demand diminished the competitiveness of Azerbaijan products even further. The exports of aluminium and products made of aluminium fell 10 times, exports of chemical industry products 3 times, and exports of black metals and products made of black metals 2 times. The exports of fruits and vegetables decreased by 10%. The per capita non-oil exports dropped from \$167 in 2008 to \$124 in 2009. According to estimates of experts, Azerbaijan lags behind a number of poor African countries. The experts consider that the policy on development of non-oil economy turns out ineffective.

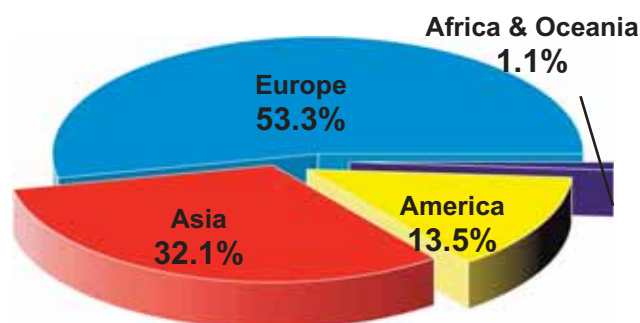


Figure 9. Export diversification by regions

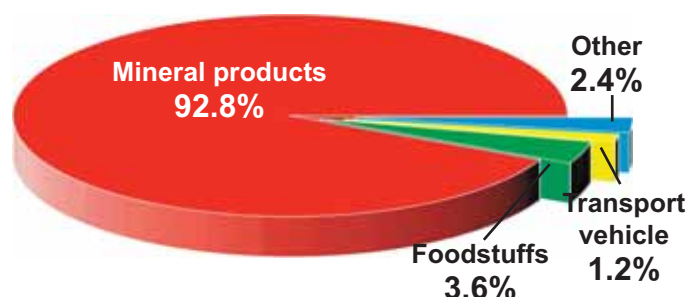


Figure 10. Structure of export in 2009

Last year, the exports of plant products decreased by 10,3%, mineral products by 70,6%, chemical products by 68,7%, plastic mass, rubber, and products made of them by 50,9%, less valuable metals and products made of them by 66,7%, machines and mechanisms, electro-technical equipment by 35,9%, while the exports of fats and oils of animal and plant origin increased by 4,4%, ready foodstuffs, alcoholic and soft drinks, vinegary and tobacco by 9,1%, weaving materials and products by 3,2% compared with 2008.

The exports with Russia were 17,5%, 14,8% with Turkey, 9,0% with Germany, 8,4% with Ukraine, 7,9% with China, 4,5% with Great Britain, 4,3% with USA, 2,4% with Japan, 2,3% with France, 2,2% with Belarus, 2,1% with Italy, 2,0%

with Republic of Korea, 1,9% with Sweden, 1,9% with Brazil, 1,5% with Switzerland, and 17,3% with other countries.

The imported goods in 2009 consisted of machines and mechanisms, electro-technical equipment by 34,8%, foodstuffs by 15,7%, on-land, air and sea vehicles by 12,8%, less valuable metals and products made of them by 10,8%, products of chemical industry by 6,6%, optical, photographic, medical and other device and equipment by 3,5%, mineral products by 2,8%, plastic mass, rubber, and products made of them by 2,8%, and the other goods by 10,2%. The export of ready foodstuffs, alcoholic and soft drinks, vinegary and tobacco increased by 6,9%, live animals and products of animal origin by 27,6%, unprocessed leather, tanned leather, natural fur and products made of them by 16,0%, wood, cork and materials made of them by 2,6%, whereas the import of products of plant origin fell by 39,6%, mineral products by 48,9%, products of chemical industry by 8,2%, plastic mass, rubber, and products made of them by 29,4%, less valuable metals and products made of them by 13,2%, machines and mechanisms, electro-technical equipment by 3,6%, on-land, air and sea vehicles by 35,9% compared with 2008. The imported butter and other milk oils enhanced by 48,6%, fresh vegetables by 2,5 times, fresh fruits by 2,0 times, tea by 10,0%, crude sugar by 22,2%, mineral and aerated waters by 24,9%, cigarette by 3,0%, drugs by 12,8%, rods and armatures made from black metals by 8,2%, and tractors by 22,2%, whereas the imported poultry meat dropped by 28,8%, potatoes by 28,5%, wheat by 28,9%, rice by 20,0%, wheat flour by 69,0%, plant fats and oils by 13,1%, chocolate products by 3,6%, vodka by 50,3%, cement clinkers and cement by 16,6%, wood materials that are cut lengthwise by 8,5%, motor cars by 28,8%, lorries by 45,6%, and buses by 30,9% in 2009 compared with 2008. The total volume of trade turnover with the member countries of Commonwealth of Independent States (CIS) totalled \$3 billion, import \$1 billion 826 million and exports \$1 billion 136 million in 2009. The negative trade balance in the amount of \$690 millions emerged during the trade with CIS countries. \$17.9 billion or 85.8% of foreign trade turnover, including 92.3% of export and 70.2% of imports came from the countries that are not members of CIS. The trade relations with those countries consisted 76% of exports, 24% of imports and the positive foreign trade balance made up the total amount of \$9.3 billion. Due to decrease of import-export operations last year, the number of people engaged in foreign trade dropped. If the number of juridical and physical people involved in foreign trade amounted to 13 265 in 2008, this indicator fell to 9261 in 2009, 4087 of whom were legal people (4364 in 2008), while 5174 (8901 in 2008) were physical people and they decreased by 6,7% and 72% respectively as compared with 2008. The State Customs Committee informs that the share of public sector in export was 93,6% or \$13 billion 760 million, private sector 5,3% or \$779 million, and that of

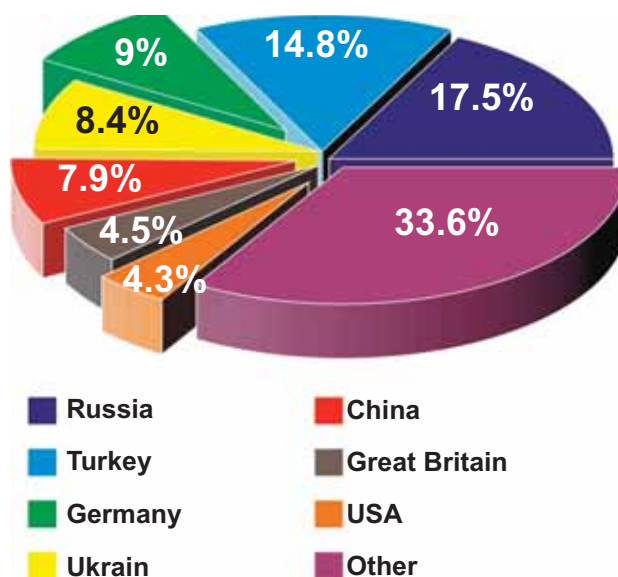


Figure 11. Import diversification by regions

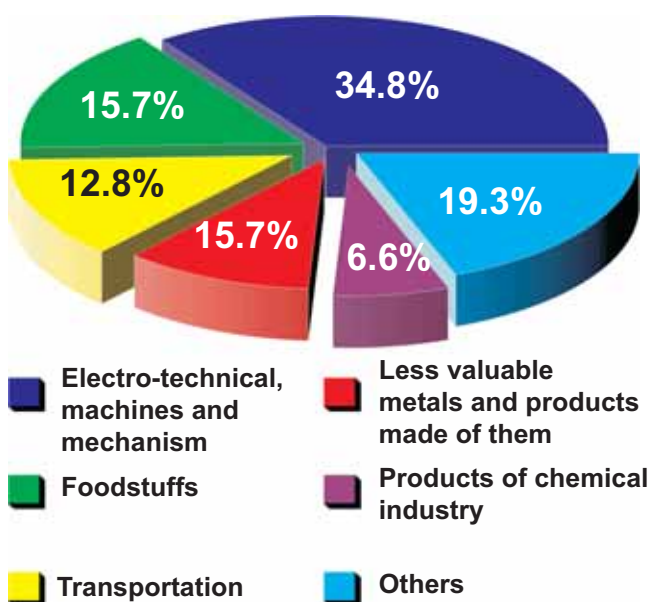


Figure 12. Structure of import in 2009

physical people was \$159 mln (1,1%). As is observable, the private sector which holds 85% of GDP was not adequately reflected in exports. The share of public sector in export was \$2 billion 25 million (33, 08%), private sector \$3 billion 793 million (62%), and physical people \$302 million (4,9%).

The 2010 state budget revenues are estimated to be at 10015,0 mln. manats comprising 31,5 percent of GDP. The estimated inflows from non-oil sector will be at 3570,0 mln. Manats, 2025,0 mln. manats or 16,8 percent lower than the approved forecasts for 2009 and 314,0 mln. manats or 3,2 percent more than the predicted inflows. It is to note that the share of state budget revenues in 2010 GDP is 3.9 per cent more than the share of state budget revenues in 2009 GDP.

95.4% of the 2010 state budget revenues will be centrally collected and 4,6 percent locally collected.



FINANCIAL SECTOR

Consolidated budget

As in recent years, the government ran an expansionary fiscal policy, induced by towering oil revenue. The budget expansion was enabled by a steep rise in direct transfers from the State Oil Fund (SOFAZ). As a result of a decrease in average oil prices in 2009, government sector revenues declined 24% in contrast to 19.4 bln AZN in 2008. However, the consolidated budget surplus remained sizeable and is estimated at 9% of GDP in 2009, compared to an exceptionally large 19% in 2008, when oil prices peaked above \$100 per barrel. The government adjusted for the fall in revenues by cutting non-priority spending and by financing only ongoing capital investment projects. As a result, the government managed to avoid a large increase in the non-oil fiscal deficit and was still able to increase social spending. Expenditures reached 43% of GDP in 2009 compared to 26% in 2007, which was matched by an even greater increase in revenues to 52% of GDP.

Non-oil deficit of consolidated budget remained high in 2009 at the level of 43% of non-oil GDP, compared to 46% in 2008. Government revenues and expenditures are expected to slow down after a period of very large fiscal expansion.

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2009 was the serious test year for the state budget of Azerbaijan. The acceptance of the state budget law of 2009 happened under a very contradicting condition.

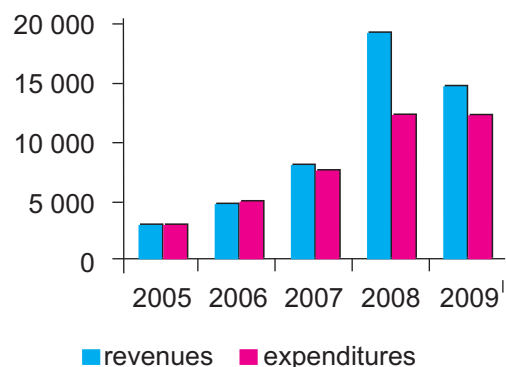


Figure 13. Budget revenues & expenditures

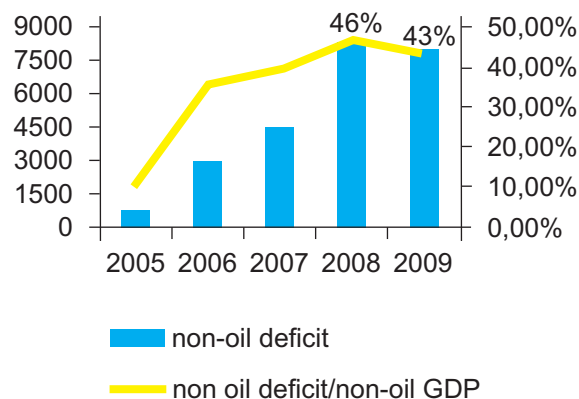


Figure 14. Non-oil deficit and non oil GDP

The impacts of the global crisis were clearly observable against the sharp decrease of crude oil price in the world market. Whereas the governments of most oil countries took serious and urgent measures considering lower prices of oil in the budget and thought of changes directed to the diversify caution in the economic structure, Azerbaijan was in a great tranquility mood. Having relied upon SOFAZ transfers, the government calculated the oil price as USD 70 in the budget for the next year. This figure was the highest among the countries the budgets of which depend primarily on oil.

The situation in 2009 turned out to be more tense than expected. Hence, the state budget incomes were 10325,9 million AZN against the forecasted 12177,0 million; in other words the implementation was 84,8% which was 436,8 million AZN or 4,1% less than 2008.

39,8% of 4113,5 million AZN of budget incomes is provided by the Ministry of Taxes of Azerbaijan Re-

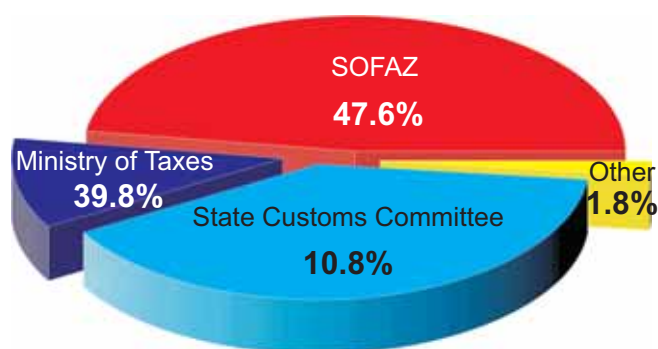


Figure 15. Structure of budget revenue in 2009

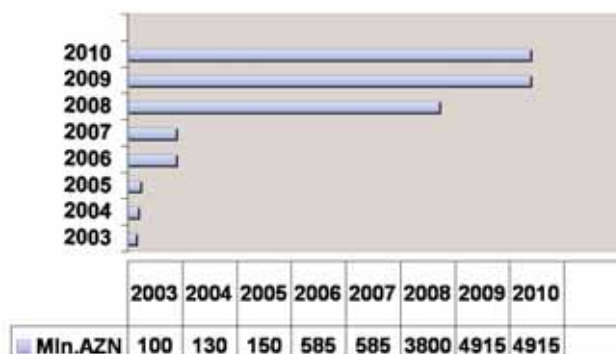


Figure 16. Transfers from SOFAZ to state budget

public, 10,8% or 1112,7 million AZN by the State Customs Committee, 47,6% or 4915,0 million AZN by the State Oil Fund and 1,8% or 184,7 million AZN by other sources. The Ministry of Taxes of Azerbaijan Republic managed to implement the income forecast by 71,5% having provided 4113,5 million AZN to the state budget which is 1636,5 million AZN less than the forecasted figure and 1581,9 million AZN or 27,8% less than the transfers in 2008.

The main reason of this reduction is the considerable decrease in oil price. Thus despite the increase of oil export by 23,4% in 2009, the average per barrel price went down to USD 61 from USD 96,5 in 2008. 30,9% or 1272,6 million AZN of the payments made to the state budget by tax bodies in 2009 falls to the share of profit tax of the State Oil Company and 12,5% or 513,2 million AZN to that of Azerbaijan International Operating Company. 56,6% or 2327,7 million AZN of the total funds collected by the Ministry of Taxes of Azerbaijan Republic in 2009 is made up by non-oil revenues which is 742,3 million AZN or 24,2% less than the forecasted figure and 70,0 million AZN or 3,1% more than the revenues for the corresponding period of 2008.

The revenues of the State Oil Fund of Azerbaijan Republic (SOFAZ) made up 8 176,7 million AZN and

its expenses 5 294,5 million AZN in 2009. The incomes of the Fund were fulfilled by 97,8% and expenses by 99,5%. The greatest part of the Fund's income (93,4%) was provided by the profitable sale of oil and gas. NBG mentioned its following opinion back then: "The unanimous opinion of group experts is that no problems are expected in state budget implementation even if the per barrel price of crude oil goes down to USD 40. It should be considered that 3/4 of oil incomes of the state budget are made up by SOFAZ transfers. If the price level of oil used as the calculation basis by the government when forecasting 2009 total budget incomes (though the per barrel price of crude oil was stated as USD 70 in the speeches of authoritative representatives of state bodies, this indicator was equal to USD 80 in 2009 budget documents) justify es itself, the SOFAZ revenues will make up 14 657 million AZN. In this case the forecasted budget allocations of the Fund will make up 34% of SOFAZ revenues for the next year. As mentioned above, even the worst price scenario (for instance, USD 40 per barrel) cannot decrease the forecasted SOFAZ revenues for more than twice. As is seen, even under such sharp reduction SOFAZ will not only be able to carry out its budget liabilities, but also cover its own expenditures. However, if that's the case, up to 60% of total SOFAZ revenues will transferred to the state budget. Consequently, the losses due to the decrease of oil price will be noticed in total budget, rather than in state budget."

SOCAR paid 1,47 billion AZN of taxes to the state budget in 2009. This is 117,1 million AZN more than the indicator of last year. It should be mentioned that this increase, though to a small degree, is due to the inclusion of Azerigaz into SOCAR balance. Just to note that Azerigaz paid 40 million of taxes in 2008. Also the company transferred 115,16 million AZN to State Social Defense Fund which was 7 million AZN more than the transfers in 2008.

As for the share of the company in state budget incomes, it made up 14,3%. As is seen, the market conditions that were not quite favorable in 2009 could not reduce the SOCAR payments to the budget. This also shows that the budget payments of SOCAR are due to the administrative methods of the government tested at hard times, rather than the company's economic means. Azerenerji JSC, another large tax payer, paid only AZN 130 million to the state budget in 2009. However, as the below table shows the payments made by such large tax payers as Caspian Sea Navigation Agency and Azerbaijan Railways JSC do not make up even 0,5% of budget incomes. In general, an interest-

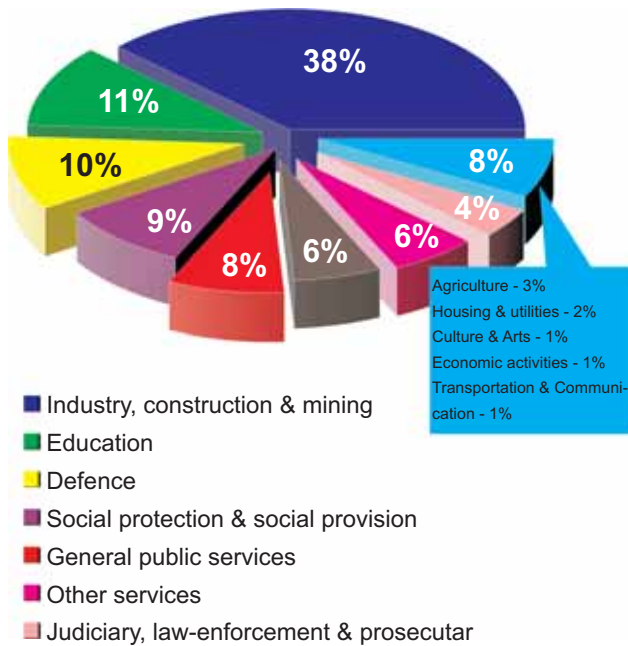


Figure 17. Structure of budget expenditures

ing point is that the share of other main large tax payers in budget payments, except for SOCAR, is incomparably small. For the sake of comparison, it's worth mentioning that the payments of Azercell LLC to the state budget in 2009 made up AZN 150 million (Source: "Trend", January 6, 2010).

Just as expected the crisis year caused some gross changes in the implementation of

budget expenses. Most expense items reduced were related to investments, having bypassed most social defense and provision fields.

The state budget expenses in 2009 made up 12355,0 million AZN versus the forecasted 10567,0 million AZN which means 85,5% implementation. This is 207,2 million AZN or 1,9% less than the implementation in 2008.

According to the information regarding the implementation of the state budget in 2009

provided by the Ministry of Finance, the total investment expenses made up 3567,3 million AZN which is 75,4% implementation of the forecast. Compared to 2008 the decrease was 724,7 million AZN or 16,9%. As is obvious, the investment expenses suffered most due to the shortage of funds. 140 million AZN was spent on the construction and renovation of education and health facilities out of the state budget allocations for state capital investment expenses in 2009. The construction of new school buildings, fundamental renovation and reconstruction of the existing schools, fundamental renovation of kindergartens, fundamental renovation and reconstruction of state universities were carried out with

these funds. The land and environmental protection expenses were 38,5%, housing and utilities expenses 24,9%, general state service expenses 14,7%, and expenses for the maintenance of judicial body, legal protection and prosecutor's office were 21,5% more in 2009 compared to 2008. Graph3 (2009 budget expenditures)

It's quite interesting that the social expenses did not reduce in 2009. Thus the state

budget allocated 26,2% or 2763,0 million AZN of its expenses to social measures (education, science, health, social provision and cultural expenses) which was 450,4 million AZN or 19,5% more than the same allocations in 2008. The share of social defense and social provision expenses in total budget expenses and GDP shows an increase of 2,04 point and 0,7 point accordingly. The growth of the social defense and social provision expenses of the government despite the crisis is a positive case.

The price policy applied given the importance of the special weight of imports in the home consumer market played a huge role in maintaining the average annual inflation rate at 1.5% level for the eleven months of the previous year. Low inflation and stable exchange rate made it possible to maintain the social condition of the population and the actual increase in the cash income of the population was 6% during the given period.

The 78.6 million AZN surplus back in 2006 that appeared as the result of 0.2% increase of budget incomes and implementation of budget expenses with 5.8% cut was said to be due to incomplete implementation of budget expenses, rather than the increase of revenues. Following the additions and amendments to the budget, the budget deficit increased by 43.5% compared to the initial draft of the state budget for 2007 and was forecasted as 0.5 billion AZN (the initial deficit was 379 million AZN, whereas the later one increased to 544 million AZN) with its expected special weight in annual GDP being about 2.5%. In fact the 2007 state budget had the curtailment of only 51.1 million AZN. The budget project of 2008 forecasted 1.126 billion AZN budget cut. The outcomes of 2008 showed 11.5 million AZN cut. The 2009 budget cut was expected to be AZN 178 million.

The 2010 budget includes the introduction of a number of tax changes and thus, providing fiscal stimulus, including a cut to the rate of tax on profit to 20% from 22%; a reduction of the maximum income tax rate to 30% from 35%; and a rise in the threshold at which small firms are subject to the simplified tax. The government's 2010 budget is based on a conservative oil price of \$45/barrel.

Monetary Policy

Inflation reduced substantially from the peak of 16.7% in 2008 to 1.5% in 2009 according to the official statistical figures. Favorable external circumstances (i.e., lower petrol and world food prices) as well as relaxation of domestic demand strains caused fair movements in prices throughout the year. During 2009, CBA put heavy emphasis on the stability of the manat/dollar peg regime which it introduced in January 2009 after the short-lived dollar/euro basket fixed exchange regime, and stood ready to buy and sell dollars to preserve the exchange rate. Under the pressure of appreciating dollar observed in the domestic market and the rest of the world, its international reserves fell to the \$4.9 billion in July 2009 from its level of \$6.5 billion at the end of 2008 which resulted in the reduction of the monetary base.

flating monetary base (Figure 12).

In fact, a salient feature of the commodity (petrol) exporting countries is the observed high volatility of the exchange rate due to the swings in the commodity prices (trade shocks). In the case of Azerbaijan, because CBA fixed the value of manat, the effect of terms-of-trade shocks was fully translated into the fluctuations in the domestic economy. That is, when the financial crisis emerged (negative trade shocks) as an attempt to defend the peg regime CBA caused the money supply to contract at the time when the money supply should have been expanded (Figure 13). Or, when the petrol prices soared (positive terms-of-trade shocks) CBA induced money supply to expand while the reverse was expected to be conducted. However, the introduction of certain degree of flexibility to the

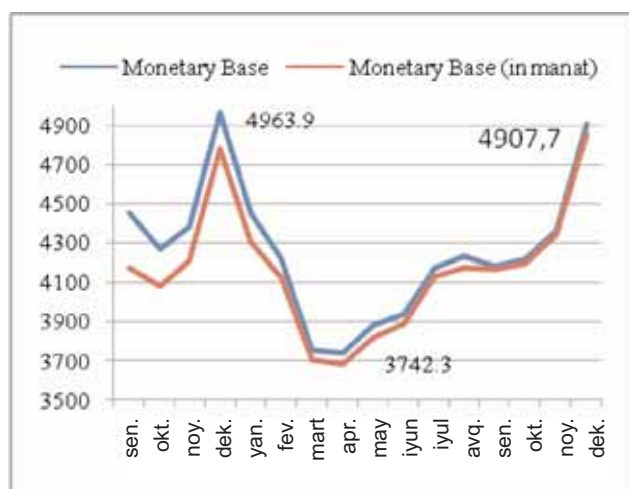


Figure 18. Trend of monetary base in 2009

As above figures show, monetary base contracted sharply (approximately 25%) over the period December 2008 – April 2009 as a result of enormous effort spent by CBA to halt the depreciation of manat. Given the limited availability of sterilization instruments, CBA encountered serious difficulties in overcoming the reduction of money supply. Similar problems also made themselves felt apparent in the recent past when the economy was exposed to the wind of appreciating manat. CBA avoided the appreciation at the cost of in-

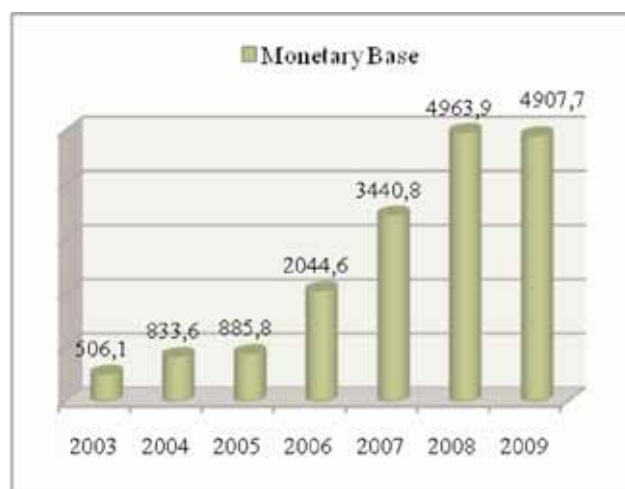


Figure 19. Trend of monetary base from 2001 to 2009

exchange rate will automatically dampen out the effect of those shocks and mitigate the unintended fluctuations of the money supply in the domestic economy.

By the end of 2009, CBA's anti-crisis measures led monetary base to almost restore its December 2008 level. This was mainly due to the use of indirect monetary tools (reserve requirements, refinancing rate, etc.) and the share of open market operations (OMOs) was small.

In the first half the year, CBA gradually cut dis-

count rate from 8% in December 2008 to 2% in May 2009 as well as maximum of the interest rate corridor from 13% to 7% which was targeted to meet the liquidity needs of the bank sector. Reserve requirement ratio also brought down from 6% to 0.5% during the same period. Furthermore, CBA extended last resort loans to a few banks which entangled in temporary liquidity problems. In November, CBA provided 50 million manat to UniBank (0.1% of GDP), as well as \$250 million to the commercial banks in the form of a short-term facility (0.7% of GDP).

Overall, through the use of both direct (credits) and indirect tools (required reserve ratio, CBA notes, etc.) in 2009 CBA injected 1672 million manat, which constituted 5% of the GDP to the economy. During the period, 22% of the credits supplied went to the banking sector whereas the strategic public sector enterprises received lion's share (SOCAR, "Azeraluminium", etc.). In order to ease the short-term liquidity constraints of the banking sector, CBA undertook 2020,4 million manat REPO transactions whereas no reverse REPO operations was conducted throughout 2009.

In 2009, with June decree of the President of Azerbaijan Republic new amendments to the law "On the National Bank of Azerbaijan Republic" were put into force. CBA was granted rights to provide credits in foreign currency, long-term credits and subordinated loans to the banks and to extend its credits to finance the projects of socio-economic importance or to supply liquidity to the real sector through banks. With this



Figure 20. Trends of M2 and M3 monetary base

amendment, CBA was also allowed to engage in the primary market of Treasury Bills.

In its statement on the main directions of monetary policy in 2010, CBA have declared to support the official target of 3% annual inflation rate. Monetary authority also leaves no room for further doubt that it will continue to commit to the announced peg regime.

However, as long as the role tailored to the monetary policy is to ensure the stability of the peg and given the fiscal dominance over it, the pursuit of the independent monetary policy is in conflict with the retained exchange regime.

Banking Sector

Despite the crisis, few operating banks (7 out of 46) reported loss in their balance sheet at the end of 2009. The satisfactory condition of the bank sector can also be tracked down by comparing the share of the profits in bank capital which went from 21.3% (317 mln AZN) to 23.2% (408 mln) over the year.

Bank assets grew by 13.5% from the beginning of the year reaching 11665 million manat at the end of 2009, 68.3% of which constituted net credits supplied to the customers. The credits lent out to households comprised the largest part of the credit stock, though its share decreased when compared to its level of September 2008. The credits supplied to the trade sector came in the second place in the credit portfolio. The share of agriculture credits stayed at its historical low levels over the period.

As it can easily read from the Figure 15 and 16, though the volume of credit stock hit the bottom in the first quarter of 2009, the largest decrease (22%) was observed in the foreign currency denominated credits.

On the other hand, interest rates on national and foreign currency denominated deposits demonstrated the reverse dynamics after the period of November 2008. The drop in the interest rate on manat credits was associated with modest decline in the volume of those credits. In contrast, the slump in the foreign currency denominated credits was accompanied by the steady increase in the interest rate.

The latter partly reflects the fact that the significant portion of the bank credits was made available through borrowing from overseas. This feature of the banking

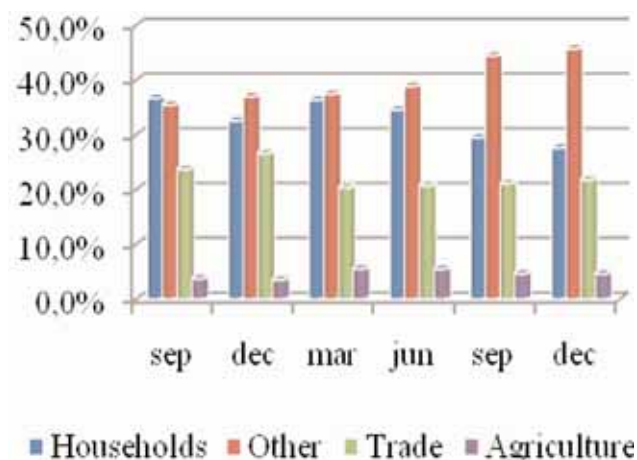


Figure 23. Structure of credits in 2009



Figure 21. Trend of monetary base from 2001 to 2009



Figure 22. Credits in 2009

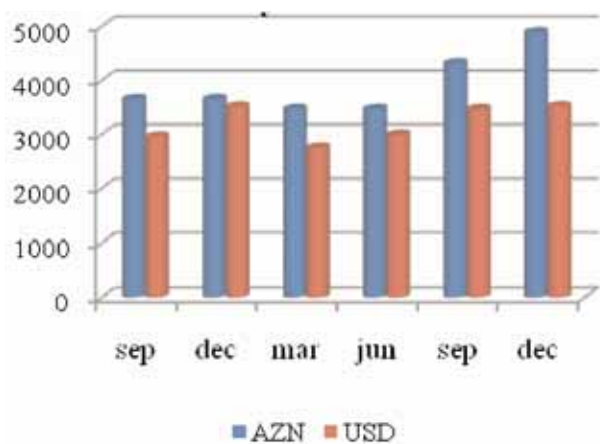


Figure 24. Currency structure of credits

sector can be easily pinpointed by examining the credit/deposit ratio over time. Though 100% ratio implies that every manat (or dollar) deposited in the banking sector is effectively converted into 1 manat (or dollar) credits, ratio higher than 100% , in general, indicates that some portion of the credits are financed by the borrowing from foreign financial markets³.

In 2009 as well, banks continued to cut off the share of their short-term loans in the structure of their credit portfolio. When currency structure of the credits, which is also one of the indicators of dollarization in the economy, are concerned, foreign currency denominated credits comprised more than 40% of the credits.

In 2009, to stimulate the domestic demand and to avoid stagnation in the real estate market, CBA took certain measures to give impetus to the effective working of Mortgage Fund. As a result, the volume of mortgage credits increased by 20% reaching 341.9 million manat.

The liability side of the balance sheet points out that the deposits have remained the main component of the financial resources of the banking sector. The deposit/assets (or bank balance) ratio constituted 40% which also reemphasize the importance of foreign borrowing. Though deposits of the juridical persons decreased by 18.8% reaching 2319.3 million manat, the volume of deposits lent by household to the bank sector increased by 22.5% reaching 2334.9 million manat over the course of the year.

Furthermore, the share of resources in the liabilities provided by CBA to the banking sector went up from 2.7% to 15.2% reaching 1466.2 million manat during 2009.

It is worth to note that over the years, the financial system consolidated its position in the domestic economy and started to play an important role in the mobilization of resources. This can be easily discerned by examining the M3 to non-oil GDP ratio (a measure of financial deepening) Figure 20. The ratio of credits and M3 during 2003-2009. Although M3/GDP (non-oil) ratio was around 23% in 2003, in three years it displayed a threefold increase.

Credit versus M3 comparison also reveals some important patterns (Figure 20). One implication might be possible presence of credit bubble in the domestic market. If it is the case, then CBA should shift emphasis from liability side of bank sector (deposits) to asset side (credits) by introducing new measures in ensuring the healthy expansion of bank credits. Secondly, the formulation of new measure of liquidity might be required instead of M3 as broad money.

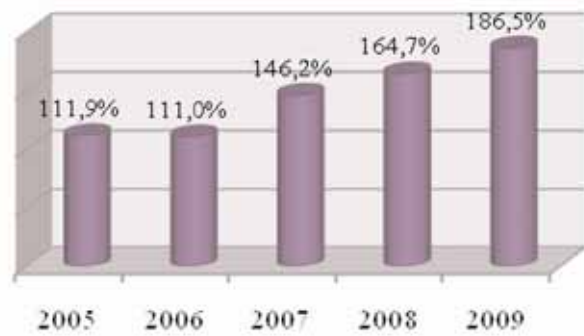


Figure 25. The ratio credits and deposits

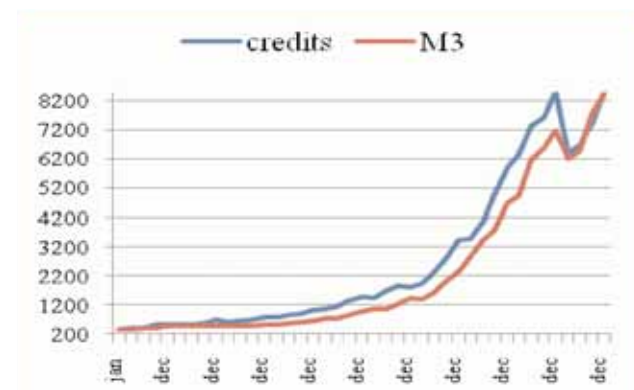


Figure 26. The ratio credit and M3

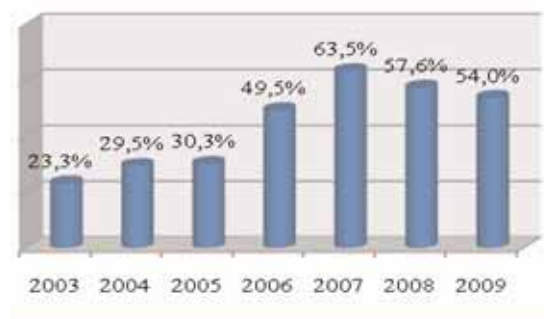


Figure 27. The ratio M3 and non-oil GDP

³High credit/deposit ratio is prevalent in the neighbor commodity rich countries such as Russia and Kazakhstan. In fact, heavy borrowing from financial markets overseas triggered the emergence of serious financial problems in Kazakh banking system in the recent financial crisis. [1].

Exchange rate

The central bank in March 2008 introduced a new exchange rate arrangement that pegs the manat to a dollar–euro currency basket. This was an important measure intended to limit imported inflation and, as a step toward greater exchange rate flexibility, introduced two-sided exchange risk to the market. Given the significant changes in the dollar–euro rate during the year, the basket arrangement would have led to a sizable depreciation of the manat against the dollar, and was therefore temporarily suspended. Azerbaijan repegged the manat to the U.S. dollar in January 2009 and the NBA intervened heavily to prevent its depreciation in the aftermath of declining terms of trade.

This policy is the direct result of the new peg regime adopted by the bank as a response to pressures on its balance of payments in late 2008, caused by the

decrease in both oil production and prices. As a result of the intervention, foreign reserves fell to a 14-month low of US\$4.9 billion in July 2009, down from \$6.5 billion at the end of 2008. However, international reserves have partially recovered to \$5.4 billion in December 2009. The return of stronger global growth in 2010 should result in a rise in foreign capital inflows into Azerbaijan, which will provide support to the reserves and the manat.

During 2009, the manat nominal effective exchange rate depreciated by 1.8%, but the real effective exchange rate depreciated by 6.1% because of Azerbaijan’s lower inflation in contrast with its trade partners. The inflation in Azerbaijan at the end of 2009 relative to the December of the previous year was 0.6%, whereas its trade partners had on average 5.9% inflation.

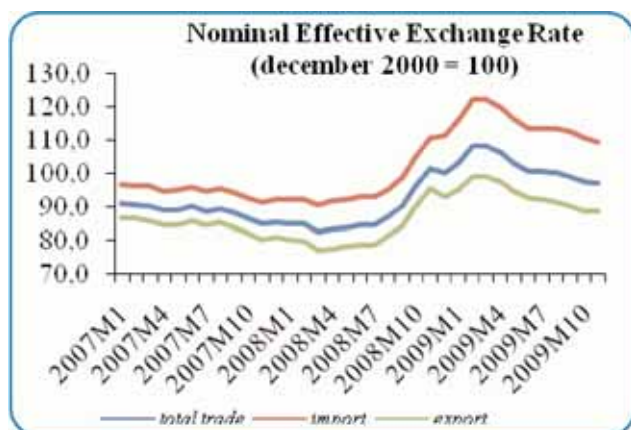


Figure 26. Nominal Effective Exchange Rate (december 2000-100)

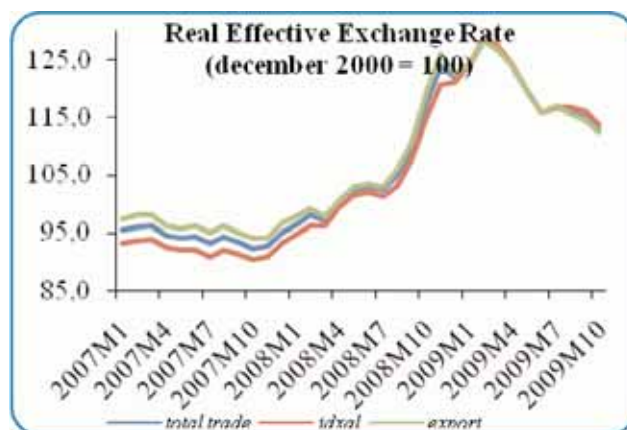


Figure 27. Real Effective Exchange Rate (december 2000-100)

Insurance Market

Since January 2009, the Ministry of Finance has started leaning on different capital evaluation criteria for insurance firms. For instance, the Ministry of Finance switched in its evaluation criteria from contributed capital to equity. In August 2008, the Ministry of Finance confirmed the program on the gradual rise of the minimum capital requirements of insurance and reinsurance firms. Until 1st of January 2009, insurance and reinsurance firms are required to hold, at minimum, 1 million and 2 million manat equity respectively. Beginning from 1st of January 2010, the minimum on the capital is lifted up to 2 million manat for insurance firms and 4 million for reinsurance firms. In January 2009, the aggregate contributed capital of the insurance firms was 79.8 million manat or on average, 2.85 million manat for each of the 28 operating insurance companies.

The interdependence among banks and insurance sector is of significant degree in the domestic economy. By the end of 2009, the founders of 12 out of 15 leading insurance companies were banks or holding companies incorporating banks into their structure. Also, the bank sector represents an important source of demand for the insurance services. For instance, it provided 42% of insurance premiums through direct or indirect channels in 2008.

When the structure of the insurance premiums is examined, it easily discerned that the non-life insurance formed substantial part of the premiums collected. The car insurance comprised 62%, real estate insurance 26% and personal accident and disease insurance 11% of the premium portfolio. The claims paid by insurance companies enjoy the similar structure with premiums. The life insurance represents miniscule segment of the insurance market which emphasizes the underdevelopment of this market. From the long-term perspective, the weak development of that segment is a serious barrier for the growth of the insurance market.

Starting from the third quarter of 2008, due to the financial crisis and problems in the domestic banking sector, insurance market faced contraction in the demand for the insurance services. In the first quarter of 2009, the premiums in the insurance market comprised 42.86 million manat which represented 16.9% decline with respect to the same figure of the previous year. On the contrary, the claims increased to 10.32 million manat or 14.8% increase compared to the previous year. However, over the course of the year the well-detected deterioration in the situation of the insurance market improved gradually and the market started to stabilize. In the end of 2009, the premiums collected cumulated to 163.31

million which was 9% less than the corresponding year end figure of 2008. The claims were recorded as 53.01 million which was 6.4% larger than that of 2008.

When ranked according to the premiums collected, the top five insurance companies received 49% of the overall portfolio in 2008 and 56% in 2009. However, the bottom ten picked up only 6% of the premiums in 2008 and 3.8% in 2009. As the financial crisis asymmetrically hit the operating companies and exacerbated the poor condition of the troubled ones, it seems that the crisis perked up the concentration in the market.

It is expected that parallel to the improvement in the banking sector insurance market will continue to recover. However, for the sustainability of this process certain reforms should be undertaken to stimulate the life insurance segment as well as the law on compulsory insurance should be passed in the Parliament to contribute to the further growth of the market.

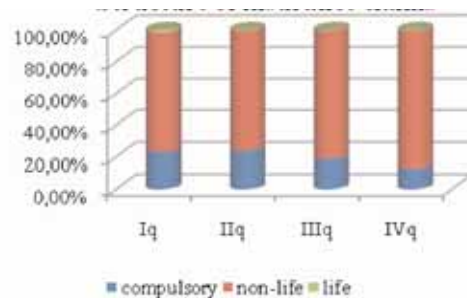


Figure 28. Structure of insurance claims

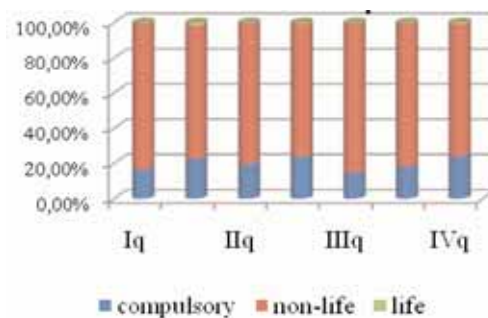


Figure 29. Structure of insurance premiums

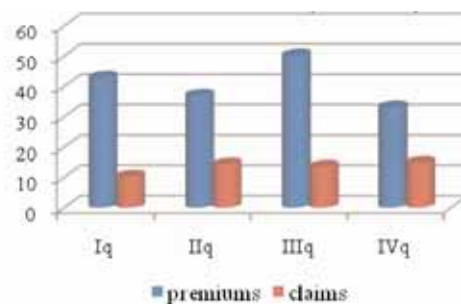


Figure 30. Insurance market 2009 (mln. manats)

Stock and Bond Market

In 2009 the volume of the securities market in Azerbaijan was impacted by macroeconomic policy decisions. In the early months of 2009 Azerbaijan experienced sharp decline in economic activity as a pervasive feedback loop between impaired financial institutions and real economy. The overall volume of transactions decreased in the market due to the decline in state securities segment of the market and the liquidity constraints of banks and other economic subjects affected the demand for securities. The Central Bank's decision to conduct easy monetary policy and to cut the issuance of short-term notes, which is the main sterilization instrument, by five times also played critical role. In line with this, the yields of the Central Bank notes also declined substantially. Therefore, low yield of issued securities and prevalence of security holders preferring "held-to-maturity" strategy caused low activity in financial markets.

Even though the volume of transactions in the market declined from 9,7 bln manats to 3.4 bln manats in 2009 compared to 2008, qualitatively major improvements in the securities market infrastructure and institutions were achieved and variety of instruments were expanded. In the current year Ministry of Finance has become more active in the securities market by issuing medium term securities and one year callable bonds, and those securities are being placed in the market successfully. As a result, the volume of government bond market increased by 55 percent during the year to 661 mln manats compared to 427 mln manats in 2008.

The State Committee for Securities continued developing corporate securities market by expanding the variety of instruments and bringing companies to the listing of the stock exchange during 2009. The corporate securities market expanded both in terms of volume and variety of instruments. Covered mortgage bonds were issued for the first time in 2009 by Azerbaijan Mortgage Fund and were placed successfully in the market.

The adoption of new listing rules by Baku Stock Exchange and a shift of trades from over-the-counter market to the stock exchange have led to the significant increase of both initial public offering and secondary market transactions. As a result, the volume of corporate stock and bond transactions at BSE increased by 2.3 and 28 times, respectively.

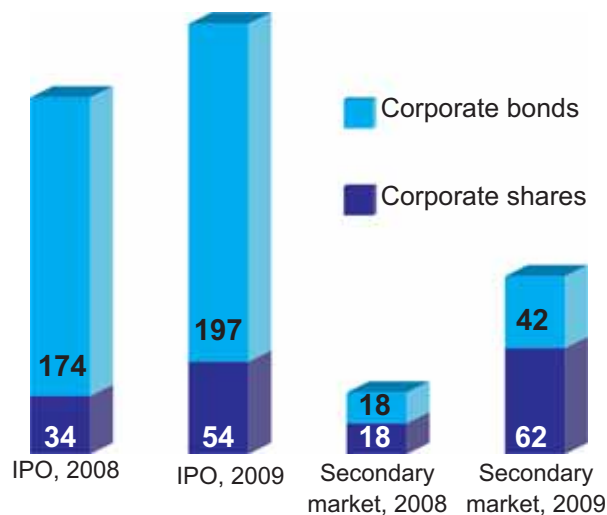


Figure 31. IPO and secondary markets. 2008-2009

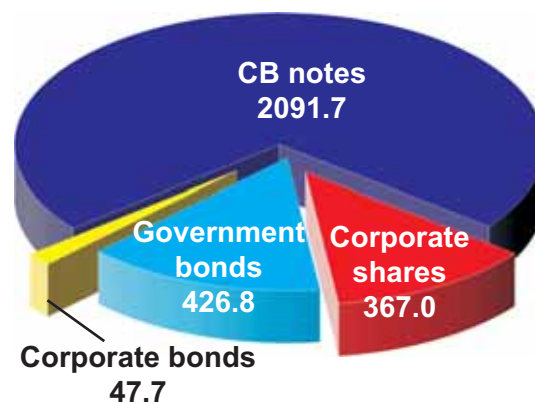


Figure 32. The volume of transactions, 2008

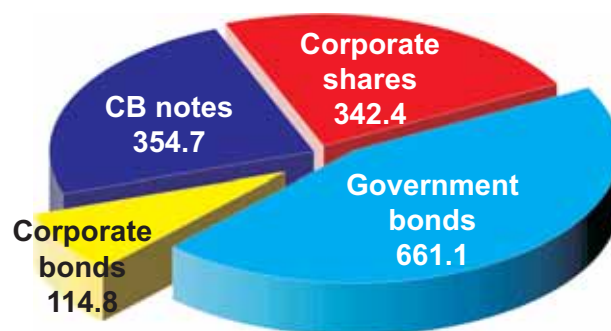


Figure 33. The volume of transactions, 2009



SECTORS AND INDUSTRIES OF ECONOMY

Industry

The industry has a biggest share in the Azerbaijan's economy. More than half of the Gross Domestic Product (GDP) produced in the country comes from the industry. Due to 2009 global financial and economic crisis, the oil price declined sharply hence causing the share of industry in GDP to drop to 50% from 59,5% in 2007 and 57,4% in 2008. The big share of industry in the Azerbaijan's economy can be explained with an oil sector. 81,5% of industrial production of 2009 comes from the oil sector, while only 18,5% from non-oil sector.

Last year industrial products in the amount of 22,2 billion manats were produced in industry 75.7% of which was produced in mining sector, 18.9% in processing sector, and 5.4% in production and distribution of electricity, gas and water. The industrial products of 90,7% or in the amount of 20,1 billion manats were produced in Baku. The rise in industrial production in the capital city was 8,9%, compared to 8,6% in the whole country. It means that the industrial production in the regions is lower than the average country benchmark. The big share of the capital in the production of industrial products is first of all the result of hydrocarbon production. The increase of production is related to the increase of physical volumes of production. The production of industrial products in other economic districts is recorded as follows:

- Absheron economic district - 225,2 million manats (including Sumgayit 133,2 million manats);
- Ganja-Gazakh economic district - 147 million manats (including Ganja 63,8 million manats);
- Aran 587,2 million manats;
- Nakhchivan 212,5 million manats;

The remaining production in the amount of 887 million manats comes from the other 6 economic districts.

The production trend in different sections of the industry is characterised by the following indicators:

The volume of crude oil which is the main industrial product amounted to 50.4 million tons increasing by 13.5%, whereas the marketable natural gas production totalled to 16.3 billion cubic metre in 2009 (total gas production was 23,6 billion cubic metre).

The mining sector of industry is of vital importance for the country's economy. The share of industry in this sector is 16.8 billion manats which exceeds 2008 year indicator by 12.5%.

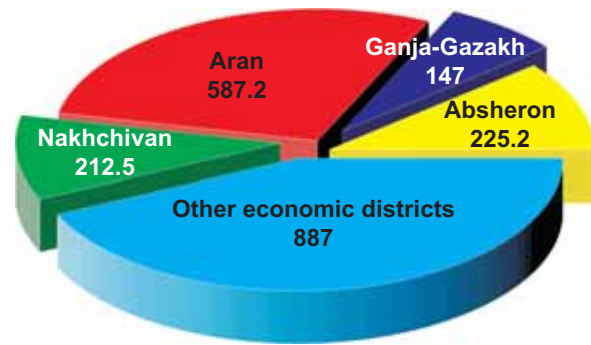


Figure 34. Industrial products in economic districts (in mln. manats)

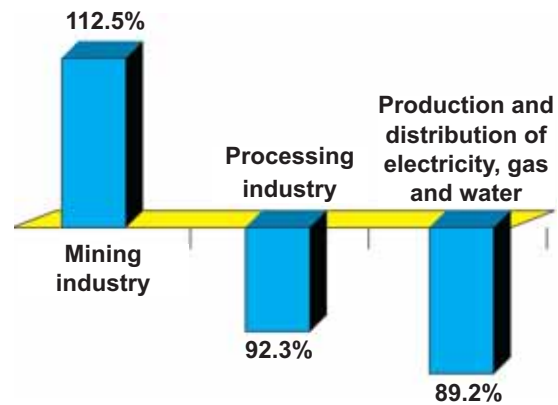


Figure 35. Compared with the corresponding period of the previous year, in %

Year	Oil, million ton	Gas, million cubmeter
1995	9,2	6 644
2000	14,0	5 642
2001	14,9	5 535
2002	15,3	5 144
2003	15,4	5 128
2004	15,5	4 995
2005	22,2	5 732
2006	33,2	9 080
2007	42,6	16 850
2008	44,5	22 800
2009	50,4	23 600

Table 10. Oil & Gas production in Azerbaijan

Azerbaijan International Operations Company (AIOC) produced 41,9 million tons or 16.8% more oil, and 10,1 billion cubic metre or 9,0% more marketable natural gas in 2009. Simultaneously, the joint enterprises working in this field increased the output of crude oil by 5,5%. The 64,7% of oil sold by the Consortium, which runs "Azeri-Cirag-Gunashli" block of fields, was the share of Azerbaijan.

The gold output which has been produced since summer of 2009 and is of great importance for the economy made up 333 kg.

A 7,7% decline was recorded in the processing sector which has the second biggest share in industry. The products in the amount of 4,2 billion manats were produced in this sector.

The major part of production (including beverages

Types of products	Produced in January-December of 2009	Compared with the corresponding period of the previous year, in %	Size of finished goods up to 01.01.2010
Crude oil and natural gas output			
Crude oil, 1000 tons	50 376.3	113.5	213.8
public sector	7 254.9	98.4	140.7
non-state sector	43 121.4	116.5	73.1
Natural gas (including surface gas), million m ³	23 584.0	100.8	-
<i>including marketable</i>	16 322.7	99.9	-
public sector	6 215.3	88.2	-
non-state sector	10 107.4	108.8	-
Beverage production (non-state sector, if not specified otherwise)			
Champagne wine, 1000 dkl	40.6	113.4	7.9
Vodka, 1000 dkl	841.8	112.4	38.3
Wine, 1000 dkl	407.5	49.9	111.1
Beer, 1000 dkl	3 627.6	112.3	193.9
Brendy (cognac), 1000 dkl	21.1	33.7	53.2
Soft drinks, 1000 dkl	16 667.3	81.2	525.7
Production of other foodstuffs (non-state sector, if not specified otherwise)			
Sugar and granulated sugar, 1000 tons	314.9	116.5	1.1
Bread and loaves, 1000 tons	728.8	98.0	-
Confectionery, tons	45 731.6	108.3	361.1
public sector	71.3	55.5	-
non-state sector	45 660.3	108.4	361.1
Packed natural tea, tons	7 731.0	108.4	366.6
Cigarettes, million units	2 339.2	87.9	93.0
Production of oil products (public sector, if not specified otherwise)			
Motor petrol, 1000 tons	1237.7	93.8	30.1
Petrol for usage in oil and chemical industry, 1000 tons	260.3	84.4	13.6
White oil, 1000 tons	609.6	79.1	10.5
Diesel fuel, 1000 tons	2 366.5	93.7	92.3
Lubricating oil, 1000 tons	44.9	67.9	12.3
Oil bitumen, 1000 tons	236.2	107.2	3.4

Types of products	Produced in January-December of 2009	Compared with the corresponding period of the previous year, in %	Size of finished goods up to 01.01.2010
Chemical industry (public sector, if not specified otherwise)			
Nitrogen, millioncubic metre	13.2	79.0	-
Propylene, thousand tons	22.2	63.4	0.5
Polythene, thousand tons	41.8	64.6	3.2
Isopropyl alcohol (absolute), thousand tons	10.0	45.8	6.7
Varnish and paint products, tons (non-state sector)	2 728.8	116.3	299.8
Production of cement, lime and plaster (non-state sector, if not specified otherwise)			
Cement, thousand tons	1 280.9	80.3	13.9
Construction plaster, tons	45 617.1	118.9	961.3
Construction lime, tons	248.7	56.2	1.5
public sector	10.0	-	1.5
non-state sector	238.7	54.0	-
Metallurgy (non-state sector, if not specified otherwise)			
Iron founder, tons	1 549.4	90.2	693.6
public sector	1 549.4	90.2	693.6
Steel works, thousand tons	49.5	66.2	1.4
public sector	39.2	59.9	-
non-state sector	10.3	109.6	1.4
Reinforcement, thousand tons	110.8	54.5	10.3
Production and distribution of electricity, gas and water			
Electricity, million Kw-hour	17 762.6	87.2	-
including:			
production of water power stations	2 228.4	100.2	-
production of heat-power stations	15 534.2	85.6	-

Table 11. The main indicators of industry

and tobacco) was for foodstuffs. Of the total foodstuff production, the production of sugar increased by 16.5% and made up 314.9 thousand tons, tea increased by 8.4% and made up 7.7 thousand tons, meat increased by 2.8% and made up 159.5 thousand tons, milk increased by 3.0% and made up 61.7 million dkl, butter increased by 0.9% making up 14.2 thousand tons, champagne wine increased by 13.4% making up 40.6 thousand dkl, beer production increased by 12.3% making up 3.6 million dkl, and vodka increased by 12.4% thus making up 841.8 thousand dkl.

The products in the amount of 1 billion 346 million manats were produced in the sphere of production of oil products with the second biggest share in process-

ing field. 1237.7 thousand ton of motor petrol, 609.6 thousand tons of white oil and 2366.5 thousand tons of diesel fuel were produced throughout the year. The production of oil bitumen which is of great importance for road building increased by 7,2% in January and December and made up 236.2 thousand tons.

The products in the amount of 163.1 million manats were produced in chemical industry by the enterprises involved in production of rubber and plastic mass products. Due to the launch of financial and economic crisis in the middle of 2008, the price of oil and chemical products fell sharply in the global markets which posed serious difficulties since the early 2009 for enterprises involved in chemical industry and

hence causing the enterprises to work with intervals.

Last year the production in chemical industry fell by 37.8% and production of rubber and plastic mass products by 15.0 % compared with 2008. Of the major chemical products, the production of nitrogen, propylene, polyethylene, isopropyl alcohol decreased. The production of varnish and paint increased by 16.3 %, washing materials by 31.4 % and covers of plastic windows and louvers by 77.8 %.

The share of production and services in the construction material industry declined by 15,1%. The production of cement and products made of cement declined due to sharp drop of construction share. Only the production of asphalt went up by two times. The production of ceramic layers and boards went up by 41.9 %, and flooring cement by 18.9 % compared with the previous year. The enterprises produced 1.3 million tons of cement, 18.9 thousand cubic metre cement-contained assembly construction materials and 5.5 thousand tons of construction blocks.

The products in the amount of 170 million manats were produced and services provided by the enterprises engaged in metallurgy industry and production of metal products. 1.5 thousand tons of iron founder, 312.5 tons of wire, and 1621 aluminium door and window blocks were produced in this field throughout the year.

The volume of production was 347 million manats in production of vehicles and equipment, electric and electron accessories, transport vehicles and equipment. Six “Kəpəz”-make truck cranes were produced for the first time in Ganja Automobile Plant in the country. TV sets in the number of 9227 units were produced and increased by 16,7% in 2009. The production of cash registers increased and made up 284 compared with the previous year.

The share of electricity, gas and water production and distribution sector in industry is 5.4%. Due to decrease of production of electricity, the volume of industrial products and services provided decreased by 10,8% and made up 1 billion 203 million manats. 17.8 billion Kw-hour electricity was produced in the country, 12.5 % of which was produced by water-power stations and the rest 87.5 % by heat-power stations.

The products made by the industrial joint-stock companies amounts to 839.3 million manats and comprises 3,8% of industrial output.

12.1% or 161.2 thousand hired labour working in 2009 in the enterprises and organizations in the country were involved in the industrial sector. Every three employees out of five were involved in public sector of industry, and every two employees out of five were involved in non-state sector. The employees working

in enterprises engaged in mining industry comprise 22.7%, those involved in production and distribution of electricity, gas and water make up 25.7%, and those working in processing industry comprise 51.6% of all industrialists.

Compared with 2008 the average monthly wage of industrial employees was 439 manats increasing by 3,1%. The wage of employees involved in private enterprises amounted to 524 manats which is by 1,4 times more than the wage of employees involved in public enterprises.

The wages enhanced by 7.6% in processing industry, by 4.4% in the field of production and distribution of electricity, gas and water and fell by 0,1% in mining sector.

The public sector enhanced salaries by 5,6%, whereas the non-state sector did not increase, but decreased salaries by 0,4% with regard to the crisis period. The average monthly nominal wage of employees engaged in oil sector fell by 0,9% and made up 990 manats. The wages of Azerbaijan citizens working in this sector increased by 6,5% and exceeded 752 manats.

The wages of employees involved in production of oil products went up by 10,9% and reached 506 manats. Though the economic theory cannot provide reasonable explanation for the increasing wages in oil sector on the background of decreasing oil prices in the world markets, it can be easily explained through the monopoly and old soviet-style management in this sector.

The higher level of wages was recorded in oil sector, and in production of vehicles, metallurgy and other non-metal minerals.

The producer prices of industrial products declined by 19,2 % in 2009 compared with 2008 and were as follows by the major sectors.

	2009/2008 in %
Producer price index of industrial products	80.8
Mining industry	66.9
including:	
Oil and gas output	66.6
other fields of mining industry	88.4
Processing industry	92.7
Production and distribution of electricity, gas and water	100.9

Table 12. Producer price index of industry

Agriculture

The agricultural sector is very important for food security and reduction of rural poverty. Agriculture is an important source of income and stability for rural areas where the benefits of Azerbaijan's petroleum wealth are much less evident. In Azerbaijan, the reliance on agriculture as a major source of income is associated with a lower risk of poverty. Further, the share of expenditures on food by Azerbaijani households is high and even higher for the rural poor. Of this, rural households produced half of the food they consumed, and for the poorest households the reliance on own consumption was even higher and grew over time.

Azerbaijan's agricultural sector grew 3.5 per cent in 2009. The husbandry consists of 63 % of agricultural production, while remain 37 % produced in the field of live-stock. According to Azerbaijani Agriculture Minister Ismat Abbasov, in 2009 Azerbaijan experienced record figures in volumes of harvest and it is planned to continue this trend in 2010. Abbasov also said that a three-percent growth was observed in agriculture in Azerbaijan in January to September, with a 2.2-percent achieved through livestock farming. Moreover, in this period some areas of agricultural production decreased, particularly cotton and melon production, which mainly occurred as a result of natural disasters. Expressing his attitude towards the partial reduction of the cotton plantations in the country, Abbasov noted that the demand for cotton on the world market grew in 2010 and prices on purified cotton are jumping up: "In this very case, the stock companies functioning in cotton growing in the country will start stimulating farmers for growing cotton this year. I think the shareholders will grant necessary financial support to farmers".

In January-August of 2009, Azerbaijan exported the agricultural products worth \$204.263 million, including crop production for \$93.4 million, livestock for \$10.575 million and agro products for \$100.231 million.

In this period Azerbaijan imported agricultural products worth \$449.691 million, including crop production for \$174.251 million, livestock for \$36.059 million and processing for \$239.367 million.

Azerbaijan held only 343 fairs for the sale of agricultural products, selling 77,000 tons of products, the minister said. (<http://en.trend.az/capital/agriculture/1569670.html>)

Since 1999 the producers of the agricultural products have been exempted from all taxes except for land tax. Agriculture received other exemptions from government, for example, the debts of the farmers in the

districts occupied and eliminated as a consequence of land reforms were cancelled. Moreover the government has started to pay the 50 percent of expenditures spent by the farmers on purchase of fuel, motor oil and fertilizer as well as provide subsidies for grain growing, the "Agroleasing" OJSC has been established to improve technical supply, and the producers are provided with equipments and fertilizers via leasing with concessional terms. Leasing plays a vital role in the renewal of major capital in the circumstances of investment and credit deficit. Works carried out with outdated facilities in the agriculture appear to be of poor quality and consequently cause a lot of losses. On the whole, products in the amount of 30-40 million manats on average are annually lost as a result of underdeveloped material and technical capacity. Therefore, establishment of a large network of service enterprises to meet current demands turns out to be very important. The "Agroleasing" OJSC was established with Decree 468 of October 23, 2004 of the President of Azerbaijan Republic on "Additional measures of expanding leasing in the agrarian sector" to accelerate the implementation of planned activities in the agrarian sector, facilitate entrepreneurs' works and timely provide them with necessary equipment with concessions. Agroleasing is operational in the regions with its 10 sale service enterprises and technical service enterprises in 57 districts of the country. «Agroleasing» Open Stock Company's main mission is to strengthen the material and technical capacity of agricultural producers and render them agro-technical services. The company provides agricultural producers mainly with agricultural technology, equipment, spare parts, agrochemical substances and anti-parasite drugs.

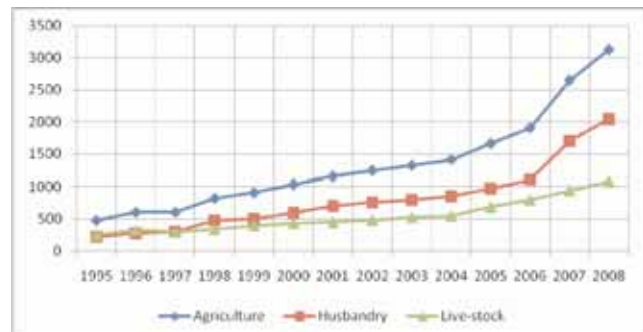


Figure 36. Agricultural production's composition (mln.AZN)

The important projects with a total amount of USD 158 million have been implemented in the agrarian sector of the country with the support of international organizations.

The volume and structure of plant-growing products have recently changed. Firstly, it affected the growing structure of the country enabling it to be formed at the level of domestic and foreign market requirements. The production of plant-growing products has increased since 1999. The grain production reached approximately 3000 thousand tons in 2009 as compared to 1098,3 thousand tons of 1999. Moreover dramatically growth could be observed in the production of potatoes, vegetables, and fruits. A switch to surplus is experienced with regard to the provision of some products in the country. The annual demand of population for potatoes, vegetables, market garden crops and fruits is already satisfied with domestic production and their export opportunities are expanding. Yet, the production indicators of market garden crops, including grain, are well below the potential opportunities of the sphere. Average productivity of grain and grain-bean crops that appear to be the main foodstuff adds up to 27,1 s/ha in Azerbaijan. However, it is possible to significantly increase the crop production just by applying up-to-date technologies without any expansion of sowing areas.

The good that is most imported to satisfy the domestic demand is vegetable oil. At the same time, the country has great potential to increase its production, particularly olive oil. Besides, it is possible to achieve increase in production of potatoes, vegetables, beet-sugar and other agricultural products by intensifying farm operations.

Seed-growing is of great importance in rise of productivity and quality of agricultural products, and improvement of food supply. More than 300 legal and physical farm persons, including 20 public agricultural production enterprises are engaged in production of seeds and saplings in 2009. The total amount of annually produced grain seeds in these farm holdings comprises only 7 to 10 % of the total demand in the country.

The processing, storage and sale of produced products are one of the important issues. Tens of new small and large enterprises have been built or rehabilitated recently towards processing of agricultural products. Yet, necessary market leverages and infrastructure corresponding new economic relations for the purchase and sale of products are slowly established. Because of deficient purveyance and sale bases, the delivery, storage and sale of fruits and vegetables are poorly organized. According to the calculations, 10-15 percent

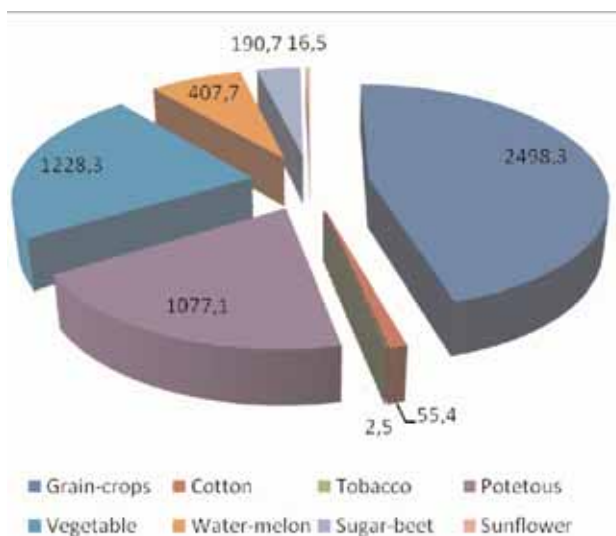


Figure 37. Production of husbandry crops (thsd. tons) in 2008

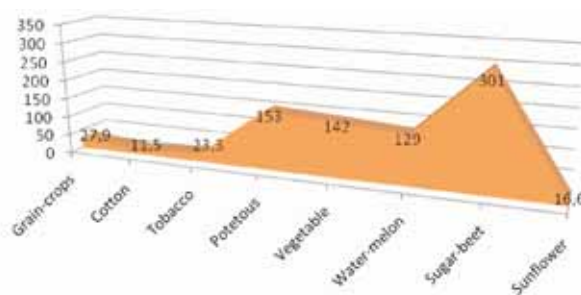


Figure 38. Productivity of crops (1000 s/ha)

of the grown vegetables are lost each year due to the mentioned reasons.

Since 1999 the producers of the agricultural products have been exempted from all taxes except for land tax. Agriculture received other exemptions from government, for example, the debts of the farmers in the districts occupied and eliminated as a consequence of land reforms were cancelled. Moreover the government has started to pay the 50 percent of expenditures spent by the farmers on purchase of fuel, motor oil and fertilizer as well as provide subsidies for grain growing, the “Agroleasing” OJSC has been established to improve technical supply, and the producers are provided with equipments and fertilizers via leasing with concessional terms. The important projects with a total amount of USD 158 million have been implemented in the agrarian sector of the country with the support of international organizations. The total amount of

state support to agriculture was approximately 700 million US dollars in 2009. By the way budget's expenditures on agriculture was 390 million AZN in 2009. The assistance from the republic budget has sharply increased during the recent years. However, the number of investments in the agriculture has been less than the average number of investments in economics. In 2009, for the government to pay 50% of fuel, motor oil and mineral fertilizer costs incurred by agricultural producers, 76.5 mln. manats were envisaged as per Decree 1907 of January 23, 2007 of the Azerbaijan President on "State support for agricultural producers", 60.0 mln. manats have been envisaged from 2009 state budget for the implementation of the "State Program on provision of people with foodstuffs in the Azerbaijan Republic during 2008-2015" approved by the Azerbaijan President Decree to stimulate rise of agricultural products and improve food supply of people on the basis of local production in the Azerbaijan Republic, and 220,0 thousand manats for funding of "State Program on Horse-Breeding Development".

The crediting and banking services sector also do not show active interest in investment projects of agricultural production, that led to situation of slow development of leasing.

The total land fund of the Azerbaijan Republic amounts to 8641.5 thousand hectares and 4756.5 thousand hectares or 55 % of it is good for agriculture. 1432.6 thousand hectares or 16.6 % of the total area are irrigated lands.

1808,4 thousand hectares out of the total land fund is arable for farming. 181,6 thousand hectares out of the land fund is under occupation and 224,7 thousand hectare land favorable for agriculture are multiyear sowings, 117,6 thousand hectare are hayfields, 2560 thousand hectares are pastures, and 45,7 thousand hectare are resting fields. There are 258,1 thousand hectares of courtyard fields (227,6 thousand hectares of it are favorable for agriculture) and 1038,8 thousand hectares of forest areas in the country.

The sowing area per capita is decreasing year by year as a result of land assignment to the non-agricultural premises and private constructions due to the population increase as well as land erosion, rising level of underground waters as a result of rising Caspian Sea level, improper implementation of ameliorative measures, violation of agricultural technology etc.

If sowing area per capita was 0,36 hectares in 1959, it went down to 0,23 hectares in 1970, 0,21 hectares in 1979 and 0,155 hectares in 2006.

40 percent of lands in the mountainous areas have eroded to some extent and approximately 47 percent

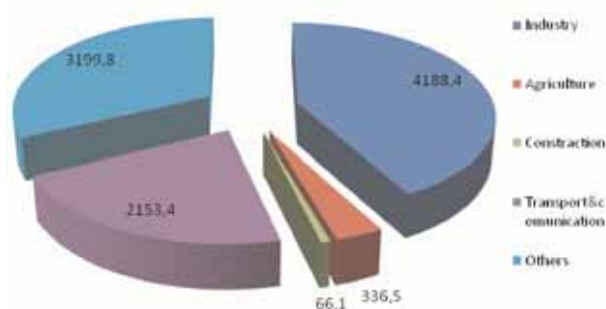


Figure 39. Fixed capital among economy's sectors (million AZN) in 2008

Land type	Area
Land area (1 000 ha)	8 260
Arable land (1 000 ha)	1 760
Permanent crops (1 000 ha)	71
Pastures (1 000 ha)	1 920
Irrigated land	1 455
Share in total water use by	
Agricultural:	67.5%
Industrial	27.7%
Domestic	4.8%
Forest area (1 000 ha)	936

Table 13. Land resources of Azerbaijan

of the irrigated sowing areas have become partially salty thus requiring ameliorative measures in 657 thousand hectares.

Water resources of the country are limited. Only 10 billion cubic meters or 30 percent of the land water resources form in the territory of the country, while the remaining 70 percent in neighbouring countries. The main discharge of water flow of inland rivers takes place in spring and autumn. In that the flow of most of them is not regulated, the accumulation and use of flood waters become difficult. Consequently, it becomes impossible to use 3,2 billion cubic meter quality irrigated water every year. The existing artificial water basins can contain only 21,5 billion cubic meter water resources. The majority of them are used for hydroenergetics and irrigation purposes. At present about one third of underground water resources are used. 7-9 billion cubic meter water is used every year in the country, 67% of which is used for agricultural needs.



FORECASTING FOR 2010

2010 YEAR STATE BUDGET

The 2010 state budget revenues are estimated to be at 10015,0 mln. manats comprising 31,5 percent of GDP. The estimated inflows from non-oil sector will be at 3570,0 mln. Manats, 2025,0 mln. manats or 16,8 percent lower than the approved forecasts for 2009 and 314,0 mln. manats or 3,2 percent more than the predicted inflows. It is to note that the share of state budget revenues in 2010 GDP is 3.9 per cent more than the share of state budget revenues in 2009 GDP.

95.4% of the 2010 state budget revenues will be centrally collected and 4,6 percent locally collected.

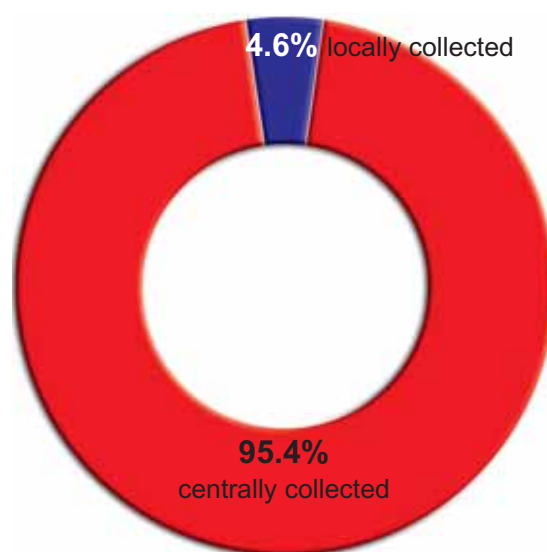


Figure 40. The structure and major sources of the 2010 state budget revenues

Year	2003	2007	2008	2009
Incomes of state budget (million manat)	1 220.9	6 007.3	10 763.0	10 325.9
Growth rate, %	34.1	55	79.2	-4.1
Oil incomes (million manat)	470	3 564	7 299.6	6 897
Growth rate, %	35.8	58	104.8	-5.5
Non-oil incomes (million manat)	751	2 443.3	3 463.4	3 429
Growth rate, %	32.9	51	41.8	-1.0
State budget expenditure (million manat)	1 235	6 058.7	10 680	10 503.9
Growth rate, %	32.5	6.0	76.3	-2.5
Including investment expenditure (million manat)	90	1 915	4 276	3 177.0
Growth rate, %		2.2	2.1	-25.7

Table 14. State budget revenues

Inflows	In million AZN	In, %
Ministry of Taxes of Azerbaijan Republic in total	3 980.0	49.07
State Customs Committee of the Azerbaijan Republic	1 100.0	10.98
Transfers from State Oil Fund of Azerbaijan Republic	4 915.0	39.70
Other inflows	20.0	0.25

Table 15. Major sources of the 2010 state budget revenues

This, the share of transfers from the State Oil Fund of the Azerbaijan Republic is expected to total to 49,07 percent, the inflows from the Ministry of Taxes of the Azerbaijan Republic to 39,7 percent, and inflows from the State Customs Committee of the Azerbaijan Republic to 10,98 percent in the 2010 state budget revenues.

The inflows from the Ministry of Taxes are expected to amount to 3980,0 mln. manats in 2010, which is 1770,0 mln. manats or 30,8 percent lower than the approved projections for the current year, and 354,0 mln. manats or 9,8 percent more than the expected inflows. 38,4 percent or 1530,0 mln. manats of estimated inflows comes from the oil sector, whereas 2450,0 mln. manats from the non-oil sector.

In general, the inflows from the Ministry of Taxes are estimated to make up 39,7 percent of the state budget revenues which is 2,3 more than the predicted inflows of the current year.

2450,0 mln. manats from the non-oil sector is expected to be included in the state budget through the tax agencies which is 620,0 mln. manats or 20,2 percent lower than the approved 2009 projection, and 134,0 mln. manats or 5,8 percent more than the predicted inflows. The share of inflows from the non-oil sector in GDP in 2010 makes up 7,7 percent which is 0,7 percent more than the approved projection of 2009.

The inflows provided by the Ministry of Taxes in 2010 under the local revenues of districts and cities (apart from Baku city) is expected to make up 347,1 mln. manats. Those revenues comprise 8,7 percent of inflows provided by the Ministry of Taxes which is 2,5 percent more than 2009.

The share of funds to be provided by the State Customs Committee is considered to amount to 11,0 percent, while the inflows from taxes and duties to be collected are considered to total 1100,0 mln. manats under the state budget which is 200,0 mln. manats or 15,4 percent lower than the approved 2009 year projection, and 1,8 percent or 20,0 mln. manats lower than the predicted projection. The share of the inflow projections through the State Customs Committee in GDP in 2010 amounts to 3,4 percent which is 0,4 percent more than the approved projection of 2009.

The forecasts of inflows from the non-oil sector and imports at USD 6373.1 mln for 2010 led to establishing the size of inflows through the State Customs Committee as it was in 2008.

The inflows estimated at 5,0 mln. manats is expected to be provided to the state budget by the State Committee on Property Issues from the rental of state property, which is 0,3 mln manats or 6,4 percent more than the approved 2009 year projections.

The direct transfers from the State Oil Fund, which is part of the consolidated budget, to the state budget in 2010 is estimated at 4915,0 mln. manats which is at the same level as in 2009.

15,0 mln. manats is expected to be included in the state budget from the other sources.

The inflows from different types of revenues are projected as follows:

The inflows from the income taxes of physical persons are estimated at 680,0 mln manats, which comprise 6,8 percent of total budget revenues. As per the major macroeconomic indicators of the country, Given the pay rise of 16.9 per cent in 2010, as well as the predicted loss of 23.0 million manats as a result of decreased tax rate from 35 per cent to 30 per cent for physical persons with a monthly salary of more than 2000 AZN that was caused by the recent changes and amendments made to the Tax Code, the inflow estimates from this revenue source have been predicted 38.0 million manats or 5.9 per cent more compared to the predicted level of current year revenues. The share of inflows from this revenue source in GDP comprises 2,1 percent, which is at the same level as the approved projections for 2009.

The inflows from the profit taxes of physical persons are estimated at 1096,0 mln. Manats, which comprise 10,9 percent of state budget revenues. This is 1118,0 mln manats or 50,5 percent lower than the approved projection of the current year. 330,0 mln. manats of inflows from the profit tax consists of profit tax amounts of contractors working under the agreement of production share volume on joint processing of Azeri, Chirag oilfields and the deep part of Gunashli oilfield in the Azerbaijan sector of the Caspian Sea. It

Tax and other inflows	Amount in 1000 AZN	In %
Income taxes of physical persons	680 000,0	6,78
Profit (income) taxes of judicial persons	1 096 000,0	10,94
Value added tax	1 876 000,0	18,73
Excise tax	552 000,0	5,51
Property taxes of judicial persons	101 000,0	1,0
Land tax of judicial persons	35 000,0	0,34
Road tax	40 500,0	0,40
Mining tax	130 000,0	1,29
Simplified tax	90 000,0	0,89
Customs fees	213 500,0	2,13
State fees	73 000,0	0,72
Inflows from rental of state-owned land properties	4 000,0	0,03
Inflows from rental of state property, privatized state ventures and enterprises	5 000,0	0,04
Inflows based on disparity between domestic wholesale price and manufactured and regulated output contract (sale) value (import expenses excluded) in Azerbaijan Republic	164 000,0	1,63
Credits granted to the governments of foreign countries	468,0	0,00
Dividends obtained from banks and other credit organizations having state share on their stocks	80,0	0,00
Inflows on credits granted from credit organizations under state guarantee of Azerbaijan Republic	1 780,0	0,01
Dividends granted from non-financial state enterprises	1 200,0	0,01
Inflows from State Oil Fund	4 915 000,0	49,07
Inflows on credits allocated from budget	5 850,0	0,05
Repeated agreements signed between main and recurred debted judicial persons with relevant executive power and inflows into state budget based on signed agreements with mediator (agent) banks regarding utilization of credits	2 900,0	0,02
Inflows from sale of excise stamps	2 722,0	0,02
Other revenues	25 000,0	0,24

Table 16. The structure of the 2010 budget revenues

is to note that the anticipated loss estimated at 90,2 mln. manats due to the drop of profit tax from 22 per cent to 20 per cent since January 1, 2010 was considered during the projection of this type of tax.

The inflows in the amount of 1876,0 mln manats are considered under the value added tax. 1078,0 mln manats of this amount comes from the tax agencies and 798,0 mln manats from the customs agencies. The proportion of inflows from the value added tax to the budget revenues will make up 18,7 per cent. It is to note that the share of value added tax in GDP in 2010 will comprise 5,9 per cent, which is 0.6 per cent more than the forecast approved for 2009, including 0.2 per cent more than the one established to come from Ministry of Taxes and 0.4 per cent from State Customs Committee.

The inflows in the amount of 552,0 mln. manats are forecasted under the excise tax which will comprise 5,5 per cent of 2010 year state budget revenues. 470,0 mln manats of this amount is expected to be provided by the Ministry of Taxes and 82,0 mln. manats by the State Customs Committee. This is 67,0 mln. manats or 13,8 per cent more compared with the approved forecast of 2009. The share of inflows in GDP in 2010 comprises 1,8 per cent, which is 0,7 per cent more than the approved forecasts for 2009, including 0,6 per cent for the Ministry of Taxes and 0,1 per cent for the State Customs Committee.

The inflows in the amount of 130,0 million manats are considered to be provided from the mining tax during the next year. The mining tax from non-oil sector is considered to comprise 33,3 per cent or 1,0 mln manats more than the expected inflows of the current year.

The growth in the amount of 101,0 mln manats or 6,3 per cent is considered to be generated from the property taxes of judicial persons. It is to note that compared with the amount of taxes to be generated from non-oil sector until the end of this year, this growth will be more by 15,6 per cent.

The inflows from the road taxes in the amount of 34,0 mln manats is considered to be produced by the tax agencies, while 6,5 mln manats by the State Customs Committee, 4,2 mln manats or 11,6 per cent more compared to the approved forecasts for 2009. The expected revenues from this source for the current year are estimated to be of 13 per cent or 3.9 million manat increase from the Ministry of Taxes and 8.3 per cent or 0.5 million manat from the State Customs Committee.

The inflows from the land tax of judicial persons are expected to be at the same amount (35,0 mln manat) for the next year as for the current year.

90,0 mln manats is predicted from the simplified taxes, 12,0 mln manats or 15,4 per cent more than the approved forecasts for 2009. As per the amendments and changes to the Tax Code expected to come in force

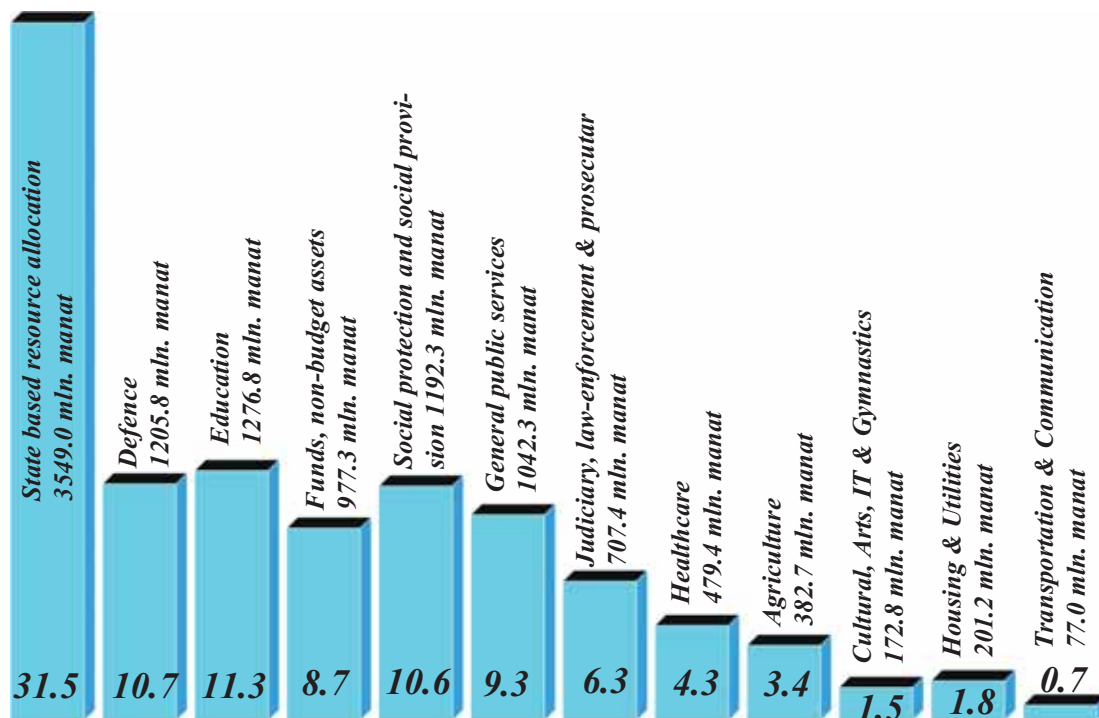


Figure 41. The structure and major spending priorities of 2010 state budget

from January 1st 2010, legal entities the transactions that are eligible to the simplified taxation will be raised from the current 90.0 thousand manats to 150,0 thousand manats and the potential additional contributions that are expected to come have also been incorporated into the forecasts.

The inflows in the amount of 73,0 mln manats is projected under the state fees for 2010 which is a growth in the amount of 13,0 mln manats or 21,7 per cent as compared to the approved forecast of the current year.

The inflows in the amount of 189,0 mln manats is projected under the other inflows during the next year. 157,0 mln manats of this amount comes from the oil sector. The inflows from non-oil sector are 12,0 mln manats or 50,1 per cent more than the approved forecasts for 2009.

The contributions from the rental of state-owned land properties for the next year are estimated in the same amount as for the current year (4,0 million manats).

213,5 mln manats is forecasted to be included in the state budget from the customs fees in 2010.

The 2010 state budget expenditures will be a financial guarantee for the implementation of the economic policy including both middle and long-term priorities of the government, as well as maintenance of social and economic development, regulation and stimulation of the economy, rise of the economic power of the country, ensurance of national interests on a global scale, balanced development of regions, development of non-oil

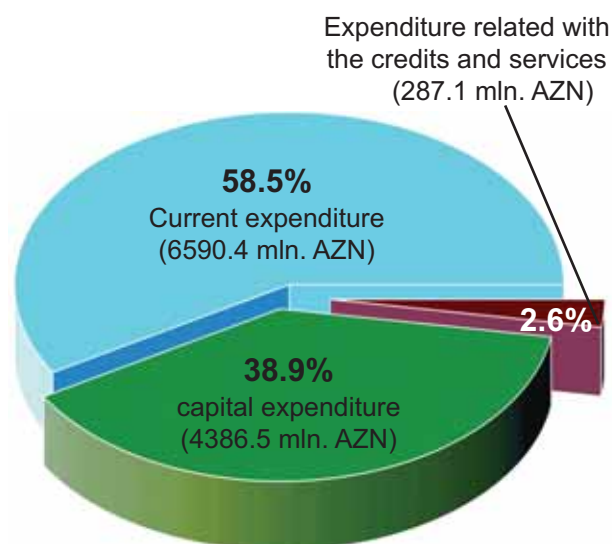


Figure 42. The structure of the 2010 budget expenditures

sector and entrepreneurship, construction of the production and social infrastructure in line with the modern requirements, and improvement of social welfare.

The improvement of the structure and execution of the state budget spending, and ensurance of transparency and targetedness in this sphere will still be carried on in 2010.

The state budget expenditures for 2010 are estimated to be equal to 35.4 per cent of GDP or 2.8 per

	Budget expenditures	Amount in thousand AZN	In %
1	State based resource allocation	3 549.0	31.50
2	Defence	1 205.8	10.70
3	Education	1 276.8	11.33
4	Other (Funds , non-budget assets.etc)	977.3	8.67
5	Social protection and social provision	1 192.3	10.58
6	General public services	1 042.3	9.25
7	Judiciary, law-enforcement and prosecutor	707.4	6.28
8	Health care	479.4	4.25
9	Agriculture	382.7	3.39
10	Cultural, Arts, IT and Gymnastics	172.8	1.53
11	Housing and Utilities	201.2	1.78
12	Transportation and Communication	77.0	0.68

Table 17. Special share of expenditures in the state budget by expenditures lines (in percentage)

cent more than the actual expenditures of 2009.

The 2010 state budget expenditures are forecasted in the amount of 11264,0 mln manats in view of the deficit-financing sources and transfer in the amount of 4915,0 mln manat allocated by the State Oil Fund, 1091,0 mln manats or 8,8 percent lower than the approved forecast for 2009 and 1248,0 mln manats or 12,5 percent more than the actual.

In the current expenditure structure of 2010 year state budget, 6590,4 million mantas mln mantas are meant for capital costs, 4386,5 million mantas for credit debts and interest payments and 287,1 million mantas for services.

In the 2010 year state budget, the allocations to the capital funds for capital investment expenditures (government's capital investments, purchase of major assets, capital construction and renovation etc.) are 4386,5 million mantas or 21,2 per cent of the total expenditures,

1162,2 million mantas or 10,3 per cent of the total expenditures for the pensions and social allowances, 328,5 million mantas or 2.9 per cent of the total expenditures for the purchase of drugs, bandages and food stuff, 172,4 million manats or 1,5 per cent of the total expenditures for the purchase of inventories and equipment, 155,6 million manats or 1,4 per cent of the total expenditures for transportation, utilities, and communication services, 178,0 million manats or 1,6 per cent of the total expenditures for the maintenance of the office and current expenses, 40,1 million manats or 11,0 per cent of the total expenditures for business trips, and 866,9 million manats or 7.7 per cent of the total expenditures for the rest other expenditures (e.g. rental and employments, financial transactions for the financial liabilities, subsidies, interest rate payments, membership fees, grants and other payments, bank fees).

DETERMINANTS AND FORECASTS OF INFLATION IN AZERBAIJAN

Determinants of inflation in Azerbaijan

This research is an attempt to develop a simple theoretical framework of inflation determination appropriate for Azerbaijan and then test it empirically by Economic Research Center within the framework of "Calculation of alternative inflations level and development of models" funded by SECO. Taking into account the data availability and reliability problems, we choose to concentrate on the simple theoretical and empirical set-up. The inflation is usually driven by demand-side and supply-side, internal and external factors, the theoretical and empirical problem is how to differentiate between these factors and at the same time take them into account simultaneously.

To sum up, four major blocks of factors determining inflation may be pointed out: demand-side (i.e., persistent increases due to the continued excess demand); real or supply shocks (or cost-push inflation; primarily, the negative productivity shocks, domestic currency depreciation, rising wages, interest rates, taxes, price shocks from inputs markets); inertial (expectations, sticky wages and prices) and institutional factors. In reality, it is a mixture of all factors that seems to cause the inflationary or disinflationary processes.

The slight impact of the monetary policy upon the inflation from the monetary aggregates as implied by the lagged money supply term directly and by the insignificance of the money market disequilibrium term, on the one hand, and the existence of the long-run relationship between money, prices, exchange rate and real output, on the other hand, raises the question about the possible implications for the use of the monetary aggregates as a good intermediate target to achieve price stability. To derive some more precise conclusions about the link between money and prices, one may want to try to incorporate the money velocity changes into the model. At present, there seems to be no independent monetary policy in Azerbaijan as the money supply depends on the foreign currency inflow, which creates the danger of the monetary overhang and leads to the very limited control over the inflation.

The major drawbacks of the applied cointegration technique are that, first of all, it has been applied in the presence of the rather short time span, data reliability problem and possible instability in the long-run relationships. The small sample does not allow con-

sidering a larger number of variables and lags

in the short-run model. The major challenge was to model inflation dynamics in the midst of the structural changes in the economy and high administrative interference into the prices. The cointegration technique may be quite difficult to apply in the economies that undergo structural changes (also dedollarization, demonetization, etc.) and in some years there could be some completely different long-run equilibrium. The break-down into the sub-samples is not quite appropriate for the meaningful analysis, since afterwards one ends up with the small sub-samples.

Second, each sector was estimated separately, thus, the biased estimators could be obtained. The potential alternatives could be estimating the long-run relationships based on a complete VAR model and the multi-equation short-run model afterwards, if the variables turn out to be endogenous, or focusing on one particular source of inflation. At the same time, the estimated macroeconomic model has been a step away from a-theoretical VAR models.

The structural approach to time series modeling uses economic theory to model the relationship among the variables of interest. Unfortunately, economic theory is often not rich enough to provide a dynamic specification that identifies all of these relationships. Furthermore, estimation and inference are complicated by the fact that endogenous variables may appear on both the left and right sides of equations.

These problems lead to alternative, non-structural approaches to modeling the relationship among several variables.

The vector autoregression (VAR) is commonly used for forecasting systems of interrelated time series and for analyzing the dynamic impact of random disturbances on the system of variables. The VAR approach sidesteps the need for structural modeling by treating every endogenous variable in the system as a function of the lagged values of all of the endogenous variables in the system. Since only lagged values of the endogenous variables appear on the right-hand side of the equations, simultaneity is not an issue and OLS yields consistent estimates. Moreover, even though the innovations may be contemporaneously correlated, OLS is efficient and equivalent to GLS since all equations have identical regressors.

Inflation forecasting

In our research, we invoke to different techniques to forecast inflation in Azerbaijan. We estimate ARIMA, VAR and Phillips curve for this end.

As known, one of frequently appealed methods of inflation forecasting is to use Phillips curve. We estimate traditional, forward-looking new Keynesian and hybrid Phillips curve for the country. We use both monthly and quarterly data in our estimation and report the results for both unemployment rate and output gap measure for the traditional Phillips curve. Lagged inflation term appears to be statistically significant. On contrary, both unemployment rate and output gap measure appear to be insignificant independent of the number of lags incorporated to the model. The preliminary estimation results hint that backward-looking behavior might be an important factor in the determination of the inflation rate. Besides, we also estimate forward-looking new Keynesian and hybrid Phillips curve. The New Keynesian approach provides a framework that combines the theoretical rigor of Real Business Cycle (RBC) theory with Keynesian ingredients like monopolistic competition and nominal rigidities. As model assumes rational expectations we employ one period ahead inflation rate as the proper measure of future inflation expectations. We estimate forward-looking Phillips curve using unemployment gap, output gap and the share of labor cost as the respective measure of marginal cost. Both least squares and GMM estimation techniques are appealed to in our estimation. When least squares are used in the estimation, output gap turns out to be insignificant similar to the outcomes of the traditional case. However, when labor share is used as the marginal cost measure, it appears to be important factor though its coefficient is small in size. In addition, GMM technique is also utilized for the same end. Rational expectations assumption allows us to impose the condition that the forecast error is orthogonal to information set. As a subset of information set we use four lags of inflation rate, labor share, gap, wage and commodity (oil) price inflation. Though forward-looking behavior seems to be significant as an underlying factor of current inflation, the share of labor cost is estimated to be insignificant. At last, we run regression of hybrid Phillips curve. Least squares estimation shows that both forward and backward-looking behaviors enjoy similar powers in the formation of current inflation though once more, the marginal cost fails to be statistically significant. Therefore, it seems that output gap and marginal cost measures are not driving forces behind inflation, i.e. they are

Time	forecast (%)	forecast (subset model%)
2010, January	1.91	1.72 (0.5)
2010, February	0.74	1.06 (1.1)
2010, March	1.11	1.19 (1.3)
2010, April	0.64	1.26 (0)
2010, May	0.07	0.5
2010, June	-0.87	-0.56
2010, July	-0.62	-0.41
2010, August	-0.17	0.55
2010, September	0.75	0.99
2010, October	1.46	1.18
2010, November	1.46	1.25
2010, December	1.42	1.29

Table 18. the forecasting results of the CPI for 2010

not as important as backward and forward-looking inflation expectations. Therefore, though Phillips curve are frequently used forecasting technique, it is not practicable in our case as the estimation output provides evidence against the existence of significant Phillips Curve relation.

Other forecasting methodologies we employ are ARIMA and VAR models. In the ARIMA case, we invoke to Box-Jenkins methodology. In this literature, the appropriate data generating process (DGP) of the variable of interest is determined. That is, we find out whether the variable of interest is either AR or MA or ARMA. When DGP of the variable of interest is examined during 2005-2009, the most appropriate form is AR (1) process for inflation. The estimation results are provided in the appendix for ARIMA model.

In the VAR model, we use consumer price index (cpi), money supply (M2), nominal effective exchange rate (neer) and non-oil real gdp (rngdp) in our VAR model. We estimate both restricted and unrestricted models. In the restricted model, we use sequential elimination of regressors (SER) strategy which sequentially deletes those regressors which lead to the largest reduction of the given criterion until no further reduction is possible.