



Entrepreneurship Development Foundation (EDF)
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DIVERSIFICATION PROBLEMS OF AZERBAIJANI ECONOMY: OBSTACLES AND SOLUTIONS

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LIST OF ABBREVIATIONS

ACG	Azeri-Chirag-Guneshli
ACB	Azerbaijan Central Bank
OJSC	Open Joint Stock Company
EBRD	European Bank for Reconstruction and Development
ADB	Asia Development Bank
SOFAZ	State Oil Fund of the Republic of Azerbaijan
SOCAR	State Oil Company of the Republic of Azerbaijan
IMF	International Monetary Fund
WB	World Bank
SSC	State Statistical Committee
PSA	Production Sharing Agreement
CPI	Consumer Price Index
MED	Ministry of Economic Development
IT	Information Technologies
NEER	Nominal Effective Exchange Rate
SEZ	Special Economic Zone
GDP	Gross Domestic Product
USSR	Union of Soviet Socialist Republics
NFES	National Fund on Entrepreneurial Support
REER	Real Effective Exchange Rate

INTRODUCTION

Building a sustainable economy capable of protecting itself from external shocks is one of the main goals of every state. Research evidence shows that high and even the highest economic growth rate observed in a number of countries cannot ensure sustainable development on a long-term basis. The sectorial structure of the economy is of great importance for high growth rate to ensure sustainable economic development. The concept of an optimal economic sector is fairly relative and depends on a number of factors that form the economic policy of every state, such as the availability of natural resources, geographical location of a country, history and etc.

Economic diversification, however, is not a panacea and has not resolved the fundamental economic problems of any country yet. Neither can diversification guarantee economic growth. There are grounds to say that countries implementing diversification do not experience economic growth in early stages and may even face a decline. Diversification is not a goal in itself. At best, it can be viewed as a means of saving an economy from a number of dependencies. And finally, there are very few examples of economic diversification policies that were actually implemented and facilitated sustainable development. In most cases, governments have declared economic diversification as a slogan in the interests of political populism, however this did not translate into any tangible changes for the economy. The concept of economic diversification is often associated with the fact that resource-rich countries do not have a long history of independence. And this makes sense. Mostly countries rich in natural resources face the problems of dependency. Although the vast majority of these countries have declared diversification their top priority and claim to achieve good results in this direction, due to current environment of low commodity price they are facing serious economic challenges.

Paradoxical as it may seem, instead of getting rid of dependencies, some countries end up becoming even more dependent.

This, of course, does not apply to all of the resource-rich countries. It is beyond doubt that the economic situation, structure of the economy, production of natural resources and dependence on their revenues vary. However, resource-rich countries tend to experience issues with diversification. Resource-rich countries have yet to develop their own model of economic diversification. Global financial institutions are mostly providing assistance in this. Research evidence on aids and reports prepared for different countries demonstrate the presence of great international potential in this area. The actual result, however, is only partly consistent with expectations. Under such circumstances, a legitimate question may arise: if the governments have sufficient financial resources, then why the issue of economic diversification of resource-rich countries has not been solved (the revenues of resource-rich countries registered a large surplus in the times of high prices)?

Why are there so few examples of successful economic diversification despite the extensive international technical and financial support? Why is diversification, which is supposed to lead to sustainable development, not yielding results? Does the eventual success of economic diversification require more economic or political support? Is the failure of economic diversification policies explained by technical drawbacks or is the issue more global and obstacles more fundamental?

It is not easy to answer these questions, but this document aims to shed a light at least on some of the key aspects.

SUMMARY OF LITERATURE

Although diversification studies and papers have a relatively short history, there is a wide range of them. In general, literature and theoretical approaches provide a positive assessment to economic diversification models of resource-rich countries. The literature mostly supports the hypothesis that by diversifying their economies,

countries dependent on natural resources can achieve the desired economic growth. At the same time diversification can protect the national economy from external shocks, reduce volatility and ensure stability of revenue from exports in the short term (Gelb and Grasmann, 2010).

The research shows particularly diversification of exports, leads to sustainable growth in the long term. (Hausmann et al., 2007, Hesse, 2008, Lederman and Maloney, 2007).

The need for economic diversification in the “resource curse” context is emphasized in the joint research by P. Collier and Venables (2007). The suggestion that trade plays an important part in economic diversification can also be found in other studies (Arezki and Van der Ploeg, 2007).

Several studies link diversification to a geographical location and the capacity to engage in trade relations (Rodrik et al., 2004). A number of studies suggest that the geographical factor actually plays the central role (Bloom et al., 1998; Diamond, 1997; Sachs, 2003). Finally, it is possible to trace a relationship between diversification and institutional factors. Some studies suggest that institutions play an important part in the success of diversification (Acemogly et al., 2001; Easterly and Levin, 2003; Rodrik et al., 2004). A number of studies in this direction are dedicated to issues of diversification in the institutional and political context (Cuberes and Jerzmanowski, 2009; Starosta de Valdemar, 2010).

Numerous reports have been published with technical and financial support of international financial institutions, especially the World Bank (WB), regarding the experience of several resource-rich countries. A study called “Diversified Development: Making the most of natural resources of Eurasia”, 2014, deserves special mention.

There have also been publications, reports and research on economic diversification opportunities in Azerbaijan. In particular, a report titled “Assessment of the Azerbaijani economy and diversification opportunities” was published jointly by the Public Associa-

tion for Assistance to Free Economy and the Public Association for Support of Economic Initiatives in 2013. The report touches upon the economic situation in the country, diversification priorities and etc. And what is its conclusion?

Another study of this nature is dedicated to oil dependence and challenges for economic diversification (Ismayil, 2015).

In general research by both foreign and local scholars and reports describe diversification as an important and necessary step for resource-rich countries. It is also indicated that economic factors alone are not sufficient to make economic diversification successful. Political factors also play a role.

SUCCESS STORIES

As mentioned above, there is only a handful of resource-rich countries that have successfully implemented economic diversification. This demonstrates yet again that it is extremely difficult to diversify the economy. At the same time, the presence even of a handful of successful countries shows that it is possible to build a diversified economy and reduce dependence on natural resources.

The examples of Malaysia, Chile and Indonesia are usually referred to as a positive experience. Malaysia is of particular importance among them. Oil fields were discovered in Malaysia in the 1970s. Prior to that, this country was known as a poor agricultural economy. In 1960, raw materials (natural rubber, lead) accounted for 80% of the country's exports. In 1990, raw materials already accounted for just 37% of exports, the bulk of which was made up of crude oil. Gradually the structure of exports changed from raw materials towards processed products, in particular those requiring sophisticated knowledge (Abidin, 2004). In parallel, the share of industrial products in the GDP started to increase. Namely, whereas in 1971 processing products accounted for 12.4% of the GDP, this figure reached 26% in 1995 and 30.6% in 2005. In addition, the

share of the service sector in the GDP has continuously increased as well.

Malaysia's success was conditioned to a large extent by the country's proximity to the ocean and the presence of a large port. However, the factor of access to a sea is not crucial. It plays more of a promotion role. The key contributor has been the aggressive long-term policy of the country's government to expand manufacturing and high-tech exports after the 1980s. This paved the way for immigration of knowledge and skills and facilitated continuous focus on the training of cheap workforce.

Macroeconomic policies were conducted in line with the declared open-door principles. Its key components were a soft currency policy, creation of free economic zones, state support for the production of competitive goods, research and development capacity building, etc. (Arezki, Gylfason, Sy, 2011).

Indonesia, the biggest Muslim nation of the Southeast Asia, faced more challenging context to pursue a policy of diversification. This largely agricultural economy had to channel its oil revenues into the exports of agricultural production (predominantly rice) and encourage the reduction of its cost value. In addition, a portion of oil revenues was invested in the gas industry. As a result, a portion of the gas was exported to Japan and another portion was provided as a subsidized product to enhance the competitiveness of the national economy.

In the 1980s, following Malaysia, Indonesia created favorable conditions for the production of high-tech goods. The availability of a cheap workforce made this sector even more competitive (Alan Gelb, 2011).

Another geographical location, Chile, can be viewed as a successful example of diversification. This Latin America country was mainly specialized in the production of copper and other nonferrous metals. The main objective of the government here was to increase competitiveness in a number of sectors by means of vertical governance.

And these efforts yielded good results. In particular, the production of highly popular fish (salmon) and wine became a good alternative to traditional raw material exports. The numerous ad hoc business and investment funds created a favorable environment for the accumulation of financial resources and promotion of private enterprise. And finally, as mentioned in the earlier examples, major investment was made in human capital, which gave an impetus to high technology and exports (Alan Gelb, 2011).

It is worth noting that the above-mentioned countries did not conduct their economic diversification policies according to one template. Their governments took into consideration the existing realities and the opportunities available (political, economic, geographical, etc.). It is also true that when implementing economic diversification, the government took the following sequence into consideration: creation of a legal framework, implementation of institutional reforms, improvement of the business environment, determination of the sources of investment, investment in human capital, investment in infrastructure, highlighting the role of the state as a catalyst at early stages, etc. As for the selection of a sector (sectors) as a national priority, experience shows that this depends on the cost effectiveness of the country's goods and products in world (regional) markets. These sectors can subsequently expand at the expense of investment in human capital. The development of the IT sector in Malaysia and Indonesia in the 1980s can be cited as an example.

DEPENDENCE ON NATURAL RESOURCES AND ECONOMIC DIVERSIFICATION

Economic diversification is an important stage towards reducing dependence for resource-rich countries. Precept 10 of the Natural Resource Charter touches upon issues of private sector development and diversification. This precept emphasizes that the governments of resource-rich countries should facilitate private sector investments to diversify the economy and to engage in the extractive industry. In other words, it is legitimately considered that the government should first establish an enabling environment for private sector investment, while prioritization of specific areas should be regarded as an issue of secondary importance. This requires reforms, and these reforms should make the capital, land and labor markets accessible, transparent and predictable. In addition, the government should also develop areas of public importance and infrastructure (roads, communications, etc.), enhance productivity and keep the social agenda in the spotlight.¹

Resource-rich countries are mainly producers of oil and gas and engaged in extractive industries. They are characterized by dependence on these resources, a large proportion of these products in the GDP and the structure of exports. According to the International Monetary Fund (IMF), if these products account for 25% of the GDP, 25% of budget revenues and 50% of exports, such an economy can be attributed to resource-rich countries. These criteria, however, have been as strict in recent times. Such countries demonstrate their resource dependence depending on the economic situation and the incumbent political regime. Even if they do not necessarily meet these criteria, the problem of dependence is quite relevant for them. It is largely believed that it is more difficult for oil and gas countries

¹Natural Resource Charter

http://www.resourcegovernance.org/sites/default/files/documents/nrcj1193_natural_resource_charter_19.6.14.pdf

to cope with resource dependence than for mining, which is why diversification is more challenging for them. This primarily stems from the windfall money in the petroleum industry. Another reason is the poor linkage of petroleum-based economies with other sectors.

Indeed, the products extracted offshore in particular practically bypass the country's economy, are mainly produced thanks to imported equipment and exported as crude oil and natural gas. In the mining industry there are quite a few examples when small association-type enterprises used domestic opportunities (human resources, local supplies, etc.) and engaged the surrounding socioeconomic environment in their activities. Due to its specific nature, it would be difficult to say the same about oil industry.

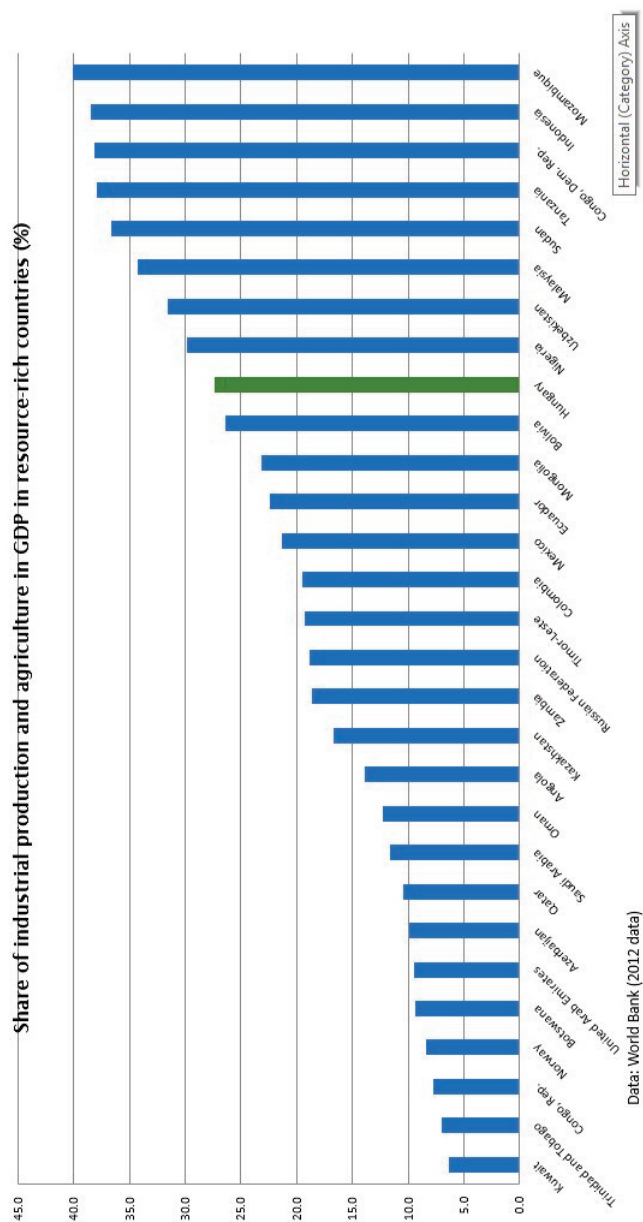
A distinction is usually drawn between economic and export diversification. In general, it is more difficult to diversify exports, i.e. to find an alternative to raw material exports, than to implement economic diversification (increase the share of processing or service sectors in the overall structure of the economy and reduce dependence on natural resources). This boils down to the difficulty of producing competitive goods for the world market. However, it is also worth mentioning that diversification is more important for small resource-rich economies. Since domestic market opportunities in these countries are fairly limited, they have to explore diversification possibilities in foreign markets.

Therefore, it is both important and easy for countries with a large domestic market (such as Russia) to conduct diversification. For smaller economies (such as Azerbaijan), the diversification of exports is important but difficult to implement due to the presence of a limited market.

Economic diversification may also create conditions for mitigating price and revenue volatility and ensuring financial stability. Economic diversification can eventually serve as a good premise for minimizing negative outside shocks.

Another important advantage of economic diversification for pro-

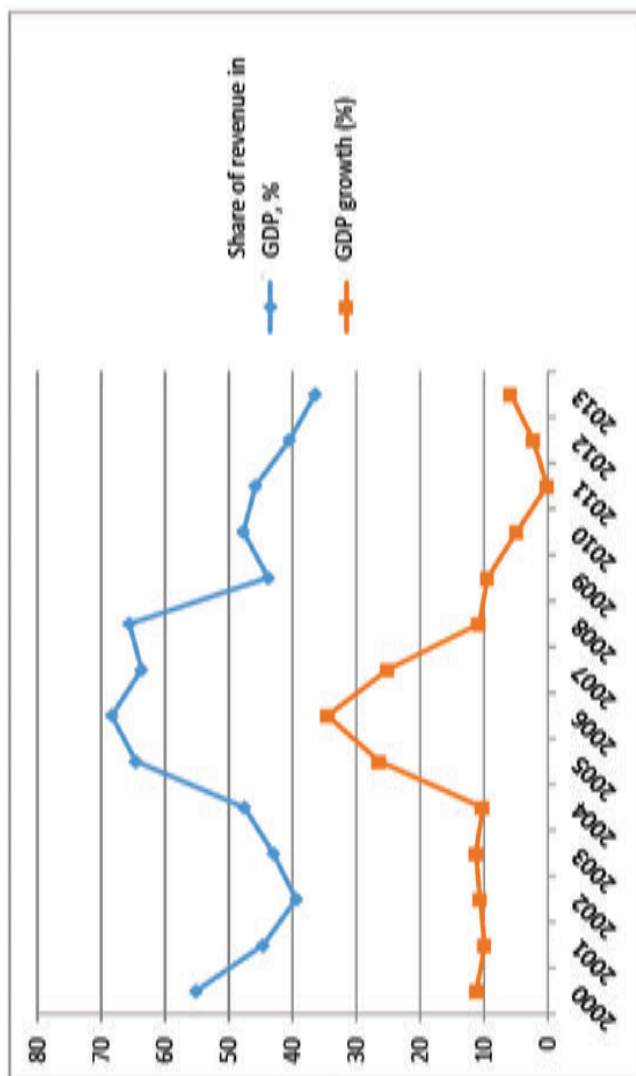
Economic Diversification



ducing countries is that it provides incentive for the establishment of a qualified government capable of identifying the market environment in these countries and maintaining competitiveness at the desired level. It is no secret that countries abundant in natural resources grow rich at the expense of the money made fairly easily. In return for that, they lose their competitiveness. The macroeconomic policies of such governments are either completely absent or are very weak. It does not seem realistic to develop a long-term program to maintain financial stability. As soon as the situation on global markets deteriorates, the volatile economies of producing countries experience serious problems. At best, the governments of producing countries apply to international financial institutions, the International Monetary Fund and the World Bank for help with the preparation of macroeconomic policies, but due to failure to follow their recommendations and this rarely brings efficient outcomes. Therefore, an indirect effect of diversification lies in the establishment of a competent government institutions and strengthening of expert capacity.

GROWTH AND RECESSION PERIODS OF AZERBAIJANI ECONOMY

Azerbaijan is a typical resource-dependent country. The oil and gas reserves and the rapid growth of their production in the last 20 years have put the country's economy in complete dependence on this sector. The role the oil factor has played in the economy and any other sphere of life in the country in this period can be divided into two parts. The 2005-2014 period can be regarded as one of growth for the economy particularly because of crude oil sales. This period is unequivocally regarded as being beneficial for the national economy. Since increased oil production was also accompanied by a high oil prices in global markets, the economic growth and export revenues reached record highs.



Source: World Data Bank

In 2015, the share of the oil sector in the GDP was 30.7% (as opposed to 52% in 2011), in budget revenues 63% and in exports 86%. The direct dependence of economic growth on the oil factor and the fact that this growth occurred specifically in the mid-2000s are illustrated by the following chart.

Of course, the impact of the oil on the economy, including the social and other spheres, was quite significant, and these impacts were accompanied by predictable contradictions.

On the one hand, a total of \$122 billion entered the state treasury from the State Oil Fund (from the sale of ACG profit oil in 2001-2016), of which only \$34 billion are its current assets. For comparison, the 2017 state budget is planned at \$8 billion.

The weakness of the macroeconomic framework, its inability to absorb a large volume of currency, the delaying institutional reforms and the rampant corruption did nothing to facilitate the development of non-oil sector. Investment in the national economy in this period was largely made by the state, which was partly inefficient.

The financial surplus and the high profitability of oil revenues in this period started to provide a distorted picture of the actual economic situation in the country. The seemingly positive economic environment actually delayed reforms and did not provide motivation for enhancing economic competitiveness in relation to trade partners.

There is no denying that some positive measures were taken to develop non-oil sectors. In fact, a number of processing enterprises were set up using both public and private funds. The establishment of processing enterprises in the districts is particularly commendable. These opportunities contributed a lot to the creation of jobs in Azerbaijan, a country with traditionally excessive manpower, and the solution of social problems.

In parallel, the boom observed in the construction sector facilitates a spillover of economic growth on different social categories.

In general, this period was characterized by macroeconomic stability,

high GDP growth, steady and rapid growth of the state budget, low inflation, and high surplus of the payment and foreign trade balance. The government declared economic diversification as its key objective and even identified 10 priority sectors for diversification.

These included agriculture, fishing, food industry, light industry, construction, chemical industry, mechanical engineering, tourism, power engineering and education.²

It is worth mentioning that the oil dependence in the overall GDP structure started to decline and the proportion of other spheres (construction, financial, services) to gradually increase in this period. However, subsequent developments showed that the steps taken were not based on a strong foundation and the newly-created business areas produced only a short-term effect. Service sectors managed to preserve their competitiveness to some extent, while production spheres failed to do so.

The reason for that was the difference between trade and non-trade products (services) stemming from the Dutch disease. The excessively strong national currency in countries experiencing the Dutch disease makes the sale of any imported goods on the domestic market much more profitable. Conversely, local production becomes completely unprofitable. This creates favorable opportunities for the goods and services for which there is no import substitution (construction, hotels, restaurants and other entertainment sectors). The sharp decline of prices on raw materials, crude oil in particular, observed on world markets since the start of 2014 has been a real test for the Azerbaijani economy. The oil price dropping more than in half in just one year had even greater impact on the Azerbaijani economy than it could have been expected. The depreciation of the national currency in relation to the world's leading currencies more

²Kanan Aslanli et al, Evaluation of economic and export diversification, 2014

than in half, the fiscal deficit, the serious problems with the payment balance, the closure of numerous jobs and the sharp reduction of public investments started to translate into social tension.

In the last 2 years (2015-2017), budget revenues dropped more than three times in dollar terms. The reduction mainly occurred in state investment projects.

Currently, Azerbaijan experiences a recession, which started in 2015. The macroeconomic situation continues to be challenging and unstable. This is confirmed by the official statistics for 2016. In particular, the GDP reduced by 3.8% in 2016 compared to 2015, while inflation registered a record high figure of 12.4% against the backdrop of stable prices of recent years. The key areas prone to recession have been construction (27.6%), social and other services (2.5%), and others.

As mentioned above, the national currency, the manat, which has depreciated more than in half and has not regained stability to this day. This has turned into a major obstacle in the attraction of foreign investment. The government started seriously thinking and taking action towards economic diversification. Several activities were carried out to promote private enterprise. They can be divided in three categories: measures aimed at economic liberalization, regulatory measures and changes in the structure of governance.

The macroeconomic evaluation and the new economic policy are reflected in the Strategic Roadmap prepared for this purpose. This collection of documents covers 11 priority directions of the national economy and was approved by a presidential decree at the end of 2016. Of these directions, the “Strategic roadmap of national economy prospects of the Republic of Azerbaijan”³ and the “Strategic

³Yol Xeritesi

http://azertag.az/store/files/untitled%20folder/_STRATEJI%20YOL%20XERIT ESI.pdf

roadmap on the production of consumer goods at the level of small and medium-sized enterprises in the Republic of Azerbaijan”⁴ are of particular importance in understanding the government’s strategy in the area of diversification. The Roadmap was the first comprehensive approach towards reducing the dependence on the oil factor and implementing economic diversification. Whereas in the growth period of the 2000s economic diversification was a desirable issue for the government, in the years of economic recession it was already a vitally important matter that had no alternative.

It is also mentioning that international institutions also underline the importance of economic diversification for Azerbaijan and demonstrate their support for the government.

As UN Resident Coordinator in Azerbaijan Gulam Isakzai said regarding the UN-Azerbaijan Partnership Framework for 2016-2020, “The strategic priority objective of economic cooperation between the UN and Azerbaijan is to achieve inclusive development through enhancing economic diversification and employment”.⁵

The aforementioned demonstrate that, the conditions shaping up macroeconomic recession are different to those of a growth period. If new conditions necessitate economic diversification and compels it to resort to implementing fairly painful processes, this should be assessed quite positively. Despite all the difficulties, the government compelled to pursue diversification appears assertive in its efforts to implement this policy. On the other hand, the relative macroeconomic stability and abundant financial opportunities available in

⁴Strateji Yol Xeritesi

http://azertag.az/store/files/Strateji_yol_xeritesi/Ki%C3%A7ik_v%C9%99_orta_sahibkarl%C4%B1q_s%C9%99viyy%C9%99sind%C9%99_istehlak_mallar%C4%B1n%C4%B1n_istehsal%C4%B1na_dair.pdf

⁵Trend <http://www.trend.az/business/economy/2711049.html> Data not Found

the time of growth have been exhausted and from this standpoint there are no domestic financial opportunities required to implement diversification.

Therefore, both periods have advantages and difficulties associated with diversification. In addition, both periods have different obstacles in the way of diversification.

OBSTACLES TO DIVERSIFICATION IN THE TIME OF GROWTH

In the 2000s, especially the end of the decade, Azerbaijan experienced all syndromes of the Dutch disease. That period was characterized by the strengthening of the national currency in relation to foreign currencies, the development of non-trade sectors (construction, services and other products and services that cannot be substituted with imports), the formation of the domestic market mainly with imports, the fact that oil revenues play a crucial role in the economy and overall incomes, the drastic increase of corruption, the extremely large proportion of crude oil and natural gas in exports, the domination of the political elite in the economy, etc.

Economy monopolization reached maximum levels and access to all practically market segments was limited. Under such circumstances, investor motivation to create of a competitive non-oil business sphere and set up domestic production was brought to naught. For a country with financial and other resources managed within narrow frames, it seemed more affordable to manage imports than to create a new production sector. The strengthened manat made it more appropriate to exercise control over imports with different economic segments, thereby enabling relative easy revenue inflow. Although economic diversification was declared the government's top priority at the time, the government did not tangible steps in this direction. The unprofitability of economic factors (the strong manat hampered the competitiveness of local products in comparison with

imports) led to the resolution of this issue in the political plane. For this reason, in an effort to establish specific business spheres and construct enterprises in different regions, the government set up numerous processing enterprises the profitability of which was in serious question. These enterprises failed to introduce additional competition to the domestic market. In fact, they further strengthened the control of several holdings over the domestic market.

As in most post-Soviet republics, the tendency of government officials starting businesses intensified in Azerbaijan as well. The key function of governance, the separation between the state's regulation function and commercial activity, did not take place. On the contrary, these two functions thrived because of the businesses of government officials. Despite major investment projects, the activities carried out in the area of diversification in this period should be described as a missed opportunity. The major infrastructure projects financed from the state budget and the Oil Fund could to some extent be viewed as necessary and positive steps towards diversification. However, due to a lack of a favorable business landscape in the country, the dividends of major state projects financed with oil revenues were a far cry from expectation.

One may ask: despite the presence of extensive financial resources and the government's efforts in this direction, why did the steps towards diversifying the economy in general and exports in particular fail to achieve the desired goal? Are the reasons for that more economic or political?

The economic situation of the country at the indicated time should be assessed in the context of the "resource curse" typical of resource-rich countries. The "resource curse" is probably one of the biggest obstacles encountered by all resource-rich countries, especially those rich in oil and gas. If one component of this curse is the Dutch disease, another component is associated with negative implications related to overall governance. The biggest consequence of the "resource curse" is the fact that the revenue windfall from the sale of

raw materials has an adverse impact not only on the economy but also on other sectors. The worst affected in this sense are governance and decision-making institutions, which cannot perform their functions properly. Where the rule of law does not work (the executive bodies of countries experiencing the “resource curse” usually subdue the legislature and use it simply as a tool to legitimate its decisions) are faced with chaos. The market economy principles which are supposed to be based on public trust and confidence cannot effectively work in such conditions. The above-mentioned businesses of government officials may take advantage of these gaps to disrupt competition, thus making excessive incomes. In other words, the difference between the businesses of government officials and ordinary businesses is that the former take advantage of the exceptional market situation to derive incomes significantly exceeding market standards.

The realization of economic diversification poses a real threat to the above businesses. It is thanks to economic diversification that the principles of competitiveness may be restored and the practice of excessive income may lose its relevance. Economic diversification means elimination of monopolies in most market segments and restoration of competition. This prospect does not bode well for those in charge of the business sector now.

The vast majority of domestic investment in that period was channeled into infrastructure areas, and the processing enterprises established in parallel with that did nothing to contribute to the environment of competition. Interestingly, the raw material and semi-products stock of the new processing enterprises was also made up of imports. It is no wonder that most of them stopped operating as soon as recession set in.

Therefore, the government pursuing the policy of diversification in the seemingly favorable conditions could not be interested in truly diversifying the economy, which would mean a loss of the existing source of excessive incomes. From this standpoint, when looking

for answers to the above questions, it is worth looking for reasons behind diversification failures in institutional factors.

CURRENT OBSTACLES TO DIVERSIFICATION

Azerbaijan is currently experiencing a fairly difficult period. The recession which started in 2015 compelled the government to embark on serious reforms. In contrast to the period of surplus, the shortage in the balance-sheet together with other implications made the government look for more fundamental steps in addition to the conventional search for funds.

From this standpoint, the current stage sharply differs from the previous one. These differences are as follows:

1. The fact that the manat lost more than half of its value in relation to the dollar in the last two years created fairly favorable conditions for developing domestic production in comparison with the period of growth. While in the growth period the strong manat was a serious obstacle in this direction, the depreciated national currency has made domestic analogues of foreign trade partners more competitive both on domestic and foreign markets. It is true that the national currencies of our key trading partners (Russia, Turkey) have also dropped, but the depreciation of the manat occurred faster, which puts it in a more favorable position in terms of gaining new markets.
2. It was rather difficult for businesses to find cheap workforce as Azerbaijan had high salaries in the period of growth. This led to increased value of products and enhanced competition. The significant decrease in the average wage (2.2-fold in dollar terms) has made it possible to reduce the value of goods and take cheaper products onto the market.
3. Drastic reduction of cash holdings (as mentioned above, budget revenues reduced more than threefold (in dollar terms) and loan investment dropped by 24.3% in 20 alone). On the

one hand, cash shortage is an obstacle in the way of investment, while on the other, in contrast to the previous period, it is an opportunity to treat investment more rationally and increasing its efficiency in comparison with previous years.

This means that the current economic landscape is more favorable for diversification and there should be more tangible results in this direction at this stage.

This is what the President of the Republic of Azerbaijan said about economic diversification prior to the 2017 Davos forum:

“We will continue to implement efficient economic reforms. At the same time we will increase spending for socially-oriented initiatives. The diversification of our economy is almost complete. Now almost 70% of our GDP comes from outside of the oil industry. Our main target today is to diversify our exports. Measures taken in 2016 will lead to implementation of this goal. Azerbaijan is already ranked number 37 in the World Economic Forum’s Global Competitive Index (Number 1 in the Commonwealth of Independent States) and we are determined to strengthen this progress.”⁶

Of course, it may seem from first sight that there are no favorable conditions for economic diversification at the present time due to the shortage of cash and disrupted macroeconomic balance, but the implementation of diversification is vitally important for the government. Mobilization of economic opportunities to implement it in a more focused and systemic manner should not be too difficult. However, as mentioned earlier, the economic situation is not the only prerequisite of diversification and other factors should also be taken into consideration.

It is evident from the government’s conduct that it is necessary to conduct drastic reforms, including diversification. Otherwise, there is no alternative for the future of the economy.

⁶President.az <http://president.az/articles/22480>

It is also important to note that the path to diversification lies through rule of law, institutional reforms and complete restoration of competition in the country. These are the areas where the government still seems rather hesitant. There is no time no waste.

SEQUENCE OF ECONOMIC DIVERSIFICATION MEASURES

Although the government still does not have a specific document related to economic diversification (the 10 priority areas determined earlier should be revisited), the Strategic Roadmap may play the role of a compass for the near- and mid-term future.

However, the Roadmap does not explicitly state what policies the government plans to pursue (economic diversification of the diversification of exports), whether the government prefers to promote non-oil exports or create import-substituting businesses, and, finally, whether the goal is vertical or horizontal diversification. If there is no clarify on these issues, it will be difficult to achieve tangible and systemic results.

As mentioned earlier, it seems more difficult for a small economy like Azerbaijan to diversify its economy than exports. First of all, it is necessary to identify the country's non-oil export potential and priority areas. From this standpoint, Azerbaijan is in a more difficult situation. In the last few years, the country has not only failed to increase its non-oil exports, but has not made major strides in establishing new import-substituting production spheres either. It therefore appears that even the domestic market of a small economy is determined more by imports than domestic production. With the exception of a few segments (poultry meat, dairy products), it is impossible to meet the market demand for all other products without imports. In fact, even the raw material, semi-products and other components of domestic production rely on imports from foreign markets.

This situation is the consequence of the growth period. It was in those years that the strong manat and the unfavorable business environment preconditioned the preference of imports even in consumption areas. The country's traditional agricultural and investment opportunities, as well as the abundant workforce, could have met the demand for these products by local production.

It is worth mentioning that Azerbaijan's non-oil export opportunities seem quite favorable in terms of finding external markets. In particular, Russia continues to be a traditional trading partner with a prospect of expanding exports to such a large market. The fact that Azerbaijan has not disrupted its relations with Russia as several other post-Soviet republics and the presence of a large business community from Azerbaijan in this country are further evidence of such opportunities.

All this suggests that it would be wrong to give unequivocal preference to economic or export diversification. While the establishment of new companies manufacturing import-substituting products could represent economic diversification, it would also create the groundwork for diversifying exports.

As earlier theory shows, since diversification of exports is more difficult to implement than economic diversification, this approach is more likely to succeed. However, the establishment of import-substituting companies is also fraught with some difficulties. The fact that domestic production is at a low level suggests that the macro-economic, financial and the overall business environment is not ideal. Otherwise, there would have been tangible changes in this area and a serious growth in the number of import-substituting companies given the period of almost two years of the cheap manat in the aftermath of devaluation. The table below shows that this is not the case.

Table

Main commodities exported in 2016				
Description	Million USD		Difference, %	Difference, million USD
	2015	2016		
Energy and oil products				
Crude oil	8 866.16	6 504.52	-26.64	-2 361.64
Natural gas	1 505.02	970.68	-35.50	-534.34
Oil products and other fuel	776.42	430.97	-44.49	-345.45
Electricity	17.23	28.34	64.48	11.11
Industrial goods				
Plastic	112.45	98.98	-11.98	-13.47
Aluminum and products from it	86.15	98.06	13.82	11.91
Ferrous metals and products from them	34.71	96.08	176.81	61.37
Products from previous metals, imitation jewelry, coins	83.22	77.21	-7.22	-6.01
Chemical industry products	79.99	55.89	-30.13	-24.10
Water-borne vehicles	0.13	44.05	33 784.62	43.92
Equipment, mechanical facilities and spare parts	36.13	27.34	-24.33	-8.79
Coal-based tar oils and products	22.31	21.33	-4.39	-0.98
Copper and products from it	9.89	19.45	96.66	9.56

Land transportation vehicles and spare parts	2.22	16.34	636.04	14.12
Ore, slag and ash	6.43	15.91	147.43	9.48
Salt, sulfur, sand and stone, masonry materials, lime and cement	9.88	15.15	53.34	5.27
Electrical machinery and equipment, spare parts	23.10	11.75	-49.13	-11.35
Textile products	10.63	10.77	1.32	0.14
Optic, photographic, control and measuring equipment	17.40	6.94	-60.11	-10.46
Lead and products from it	1.38	6.49	370.29	5.11
Paper and cardboard products	4.63	4.39	-5.18	-0.24
Products from nonprecious metals	1.33	3.04	128.57	1.71
Airborne vehicles	150.30	0.00	-100.00	-150.30
Agricultural and processing products				
Fruits	220.25	243.76	10.67	23.51
Vegetables	91.68	129.03	40.74	37.35
Sugar	212.09	62.03	-70.75	-150.06
Alcoholic and nonalcoholic beverages	25.83	18.73	-27.49	-7.10
Cotton yarn	14.39	18.01	25.16	3.62
Vegetable and animal oils	153.34	17.11	-88.84	-136.23

Unprocessed skin and tanned leather	12.18	15.09	23.89	2.91
Vegetables, fruits, hazelnuts and walnuts	10.86	11.41	5.06	0.55
Tobacco products	9.41	8.90	-5.42	-0.51
Food residue and waste	3.94	7.91	100.76	3.97
Tea	19.50	6.18	-68.31	-13.32
Cocoa and products from it	7.65	4.94	-35.42	-2.71
Oilseed crops	1.36	2.88	111.76	1.52
Grain crops	0.06	2.62	4 266.67	2.56
Other	89.49	31.00	-65.36	-58.49
Total	12 729.14	9 143.28	-28.17	-3 585.86

Main commodities imported in 2016				
Description	Million USD		Difference, %	Difference, million USD
	2015	2016		
Food products	979.49	1 322.08	34.98	342.59
<i>Including:</i>				
<i>Wheat</i>	296.83	295.02	-0.61	-1.81
<i>Sugar</i>	124.49	152.76	22.71	28.27
<i>Vegetable and animals oils</i>	83.83	144.14	71.94	60.31
<i>Fruits and vegetables</i>	58.05	135.00	132.56	76.95
<i>Alcoholic and nonalcoholic beverages</i>	63.30	58.43	-7.69	-4.87
<i>Butter and milk-based oils</i>	22.39	48.38	116.08	25.99
<i>Tea</i>	16.32	44.73	174.08	28.41

<i>Meat</i>	19.86	38.62	94.46	18.76
<i>Milk</i>	5.76	8.03	39.41	2.27
Machinery, facilities, electrical equipment	2 460.70	2 013.38	-18.18	-447.32
Ferrous metals and products from them	1 586.75	1 118.50	-29.51	-468.25
Transport vehicles and spare parts	1 217.12	813.92	-33.13	-403.20
Other chemical industry products	434.32	515.58	18.71	81.26
Plastic	204.77	281.70	37.57	76.93
Oil, oil products and energy carriers	152.21	273.72	79.83	121.51
Clothes and garments	45.48	211.53	365.11	166.05
Pharmaceuticals	270.68	196.38	-27.45	-74.30
Firewood and timber	229.78	189.42	-17.56	-40.36
Optical, photographic, measurement, medical and surgical equipment	238.87	183.24	-23.29	-55.63
Tobacco and cigarettes	297.61	153.12	-48.55	-144.49
Furniture and parts	100.75	111.48	10.65	10.73

Paper, cardboard and products from them	62.80	105.63	68.20	42.83
Rubber and products from it	54.98	95.77	74.19	40.79
Tools and other products from nonprecious metals	71.54	86.17	20.45	14.63
Glass and products from it	77.33	74.80	-3.27	-2.53
Footwear, socks and similar products	8.00	67.76	747.00	59.76
Ceramic products	48.57	63.75	31.25	15.18
Products from stone, gypsum, cement, asbestos and similar materials	87.71	53.05	-39.52	-34.66
Livestock	51.67	28.70	-44.46	-22.97
Cement	29.48	17.92	-39.21	-11.56
Other	744.94	738.09	-0.92	-6.85
Total:	9 216.68	8 532.45	-7.42	-684.23

Source: State Statistical Committee of the Republic of Azerbaijan

This shows again that the promotion of the national economy is not limited to the favorability of the exchange rate, financial stability and even the overall improvement of the macroeconomic situation. The problem is deeper and more comprehensive.

The identification of import-substituting or leading export sectors usually involves setting the goal of vertical and horizontal diversification. In particular, when we talk of vertical diversification, the winning processing spheres are selected (for example, petrochemicals), relevant state preferences are provided for this area (lower tax rates, subsidies, lower customs duties, direct state investment, etc.), and this turns this sphere into a leading “player” of business exports. Despite being relatively easy and simple, this approach may not produce the desired result. In particular, such preferences may lead to unlimited state support of a given area, not to its competitiveness. Horizontal diversification is not about identifying an area and supporting it. It is about improving the overall business environment. In particular, it may include increasing the profit ratio, systemic and tangible steps to ensure inviolability of property rights, investment in human capital, which eventually contributes to the development of domestic production and service sectors.

As is evident, this approach will not produce result quickly. The creation of a better business environment will take time. There is even the risk of reforms not being implemented in full or not producing the desired result. However, correct and consistent goals may help implement diversification and, most importantly, facilitate the country’s sustainable development.

FACTORS PRECONDITIONING DIVERSIFICATION

Classical theory says that a successful economic diversification involves a number of preconditions. First of all, it is important to have relevant institutions in place. These institutions should protect the rule of law, the inviolability of property rights and competitive en-

vironment. Of course, the said factors are usually not very established in resource-rich developing countries. They are observed in developed OECD countries more, and the issue of diversification for them is not as relevant. For instance, the diversification experience of Malaysia and Indonesia shows that such institutions were very under-developed there. However, the experience of these countries also showed that institutional reforms should be held in parallel to diversification. It is an axiom that investment security and the presence of a predictable environment are crucial in the conditions of weak institutions.

Studies suggest that a country's democracy ratings do not necessarily have to be high for the quality of institutions to improve. Of course, it would be a welcome phenomenon, but the key indicator of quality of such institutions is the presence of a check and balances system (Collier (2007), Arezki, p 66).

Unfortunately, Azerbaijan's biggest diversification problems are associated with that. The restrictions with access to markets and financial resources, the lack of a complete competitive environment and very serious problems with the protection of property rights require prior institutional reforms. The weakest point of the Strategic Roadmap is the halfhearted nature of institutional reforms.

Another precondition for diversification is the proper level of infrastructure. This factor is very important for promoting investment in processing and other industrial sectors. Investment in economies based on natural resources is usually of local nature and is mainly channeled into raw materials, while the overall infrastructure (roads, electricity, water, communications, etc.) are in a deplorable state. This applies especially to oil countries. The areas of oil production are usually not very large and are sometimes located offshore. Under such circumstances, the country's other infrastructure (usually apart from the capital city) is usually unprepared for accommodating major business investment.

The major overhaul of infrastructure which started in Azerbaijan in

the years of growth significantly changed the situation for the better. Of course, the major investment made in infrastructure in comparison with neighboring countries should be considered a huge plus not only in terms of socioeconomic development but also from the standpoint of attraction of new investment. For comparison, it is worth noting that even Malaysia and especially Indonesia, which can boast of a successful diversification experience, did not succeed in revamping their infrastructure.

Therefore, infrastructure development, which is regarded as an important precondition of diversification, is at a good level in Azerbaijan.

Another precondition, the macroeconomic situation, is of great importance for the success of diversification. This, first of all, requires macroeconomic equilibrium and financial stability.

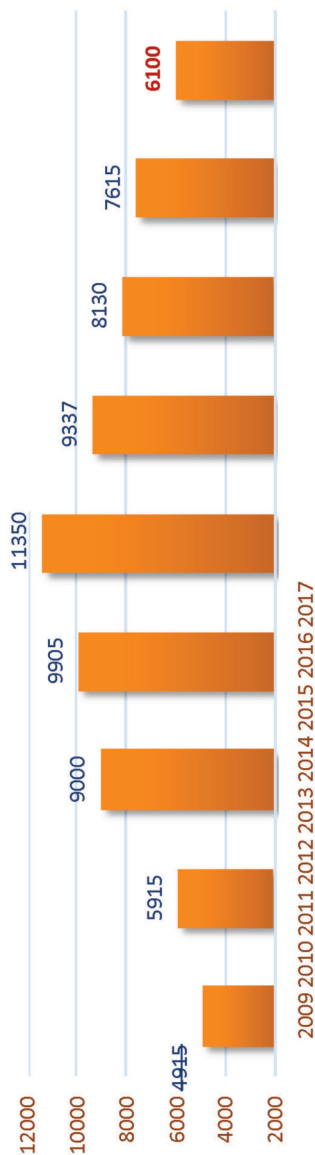
The developments unfolding in Azerbaijan now suggest that macroeconomic equilibrium has been disrupted and there is no financial stability. Under such circumstances, it is extremely difficult to implement economic diversification.

Economic diversification in itself requires sizable resources from the government. These resources are needed for reforms, structural changes, investment in human capital, implementation of the required preferences, etc. In other words, economic diversification involves major spending. The government should be financially prepared to implement that in a consistent and sustainable manner and build its macroeconomic policies in accordance with that.

Fiscal and monetary policies are integral parts of the overall diversification strategy. The tax policies and budget revenues should be conducive to the development of non-oil processing and other industrial spheres. The tendency towards attracting funds into the state budget at a time of fiscal problems may bring the economic diversification effort to naught.

The unprecedented shortage of the fiscal and payment balance compels the government to take drastic steps. The government sees the

Transfers into the state budget of the Republic of Azerbaijan by State Oil Fund (in million manats)



Source: Ministry of Finance of the Republic of Azerbaijan

increase of the tax burden as a way of eliminating the budget deficit, which makes the business environment even worse. The government replenished the state budget mainly with Oil Fund transfers in the years of growth, while now it prefers to dramatically reduce their share in budget revenues.

The theory of revenue management in resource-rich countries actually suggests completely the opposite. Therefore, in order to prevent cyclical dynamics of the budget (when revenues increase, so do expenses, and the other way round) and achieve sustainable management of revenues, it is possible to achieve the desired stability by accumulating some revenues in the growth period and aim to increase spending when revenues decline. From this standpoint, the government should now increase transfers from the Oil Fund and try to reduce the tax burden in return. Only in this case will it possible to revitalize the economy. It does not seem logical to accumulate the Oil Fund money at this stage for another reason as well. While the accumulation of large revenues by way of sterilization looked logical in terms of dealing with the Dutch disease at the time of the revenue windfall, there is no such threat now, which is why the channeling of the Fund's resources into the domestic economy will not have macroeconomic implications.

Therefore, the reduction of the tax burden could lay the groundwork for expanding entrepreneurial activity and achieving more tangible diversification.

The anxiety over the sharp increase customs revenues in recent years has been another issue of concern.

In 2017, customs bodies contributed 13.7% to budget revenues. This includes customs duties, the excise tax for importation into the Republic of Azerbaijan, and the value added tax. It is worth noting that this is the third biggest source of income after transfers from the Oil Fund and the value added tax. The drastic increase of such revenues in the last two years is explained by greater transparency in this area. Although this is a positive phenomenon, it does not fa-

cilitate the improvement of the business environment. Also, such a major role of customs bodies in the economy in the context of economic liberalization is not a welcome sign. For comparison, customs and tax bodies in the neighboring Georgia have been joined within the framework of institutional reforms and operate as a revenue division of the Finance Ministry.

The monetary policy should also be consistent with diversification goals. Experience shows that countries implementing economic diversification achieve greater success if they pursue liberal monetary and credit policies. Restricting measures such as the increase of the interest rate, the unpredictable nature of the national currency exchange rate, the difficulties with the accessibility of credit resources and expensive loans are considered to be obstacles.

Unfortunately, the financial and exchange rate problems currently experienced in the country are compelling the government to take restriction measures, which hampers the diversification of the monetary environment.

The financial instability caused by the second wave of devaluation (21 December 2015), the undermined confidence in the manat and the sharp increase in inflation expectations prompted the Central Bank to take drastic restriction steps. "Whereas in 2012-2014 the cash provision of the economy was at 26-30%, it dropped to 16-17% in 2015-2016. This led to both dollar and manat shortages in the country. The shortage of manats also affected the crediting process. The low level of cash provision created problems in meeting budget expenses throughout the year".⁷

The drastic decline of currency in circulation was clearly aimed at reducing speculative transactions and preventing inflation in general. This also indirectly indicates that a reliable investment environment has not emerged in the wake of the devaluation. By conducting

⁷Samir Aliyev. "State policy to reduce the adverse impact of the manat devaluation on the business environment". Baku. 2017

a drastic monetary and crediting policy, the Central Bank manages to keep financial markets under control on a short-term basis. At the same time, however, such restraining measures represent an obstacle in the way of reviving the economy, especially the real sector at the expense of new investment opportunities in the mid- and long-term prospect.

As a possible way out, the government should resort to gradual financial liberalization, give preference to “linking” the excessive currency being released into circulation to the real sector and develop a relevant plan.

Another important factor for the implementation of economic diversification is human capital. This is confirmed by the experience of Malaysia, Indonesia and several other relatively successful countries. Another common feature for resource-rich countries is that economic growth in them, in particular the GDP growth, occurs not due to added value but due to revenues. The added value per capita in these countries is usually very low.

Azerbaijan is no exception to this rule. In fact, as a country with high oil revenues it experiences a distinct disproportion of workforce between economic sectors.

Table (2016)

	Share in GDP	% of workers in total hired workers
Oil and gas sector	34.3 %	2.3%
Non-oil sector	65.7 %	97.7 %

The key problem in this area is not the disproportion of workforce between sectors of the economy, but the quality of it. The main factors of human capital, such as education, research and development,

are much lower than in developed countries.

To a certain extent, the factor slightly improving this unfavorable picture in the area of human capital is that a large component of cheap workforce without specialized education is now in the neighboring Russia and other CIS states. This factor lays the groundwork for reducing the social tension and softening the impact of unemployment. On the other hand, this significantly detracts from the capacity for the national economy to create added value. This factor should be taken into consideration during economic diversification. The attraction of a part of the exported workforce to work within the country should also be viewed as the opportunity to diversify exports. To do this, it is necessary to enhance the quality of human capital and significantly improve the business environment.

POLITICAL AND ECONOMIC DECISIONS

The success of economic diversification first of all requires the right conceptual approach. In addition to studying the overall requirements and successful experiences, the diversification concept should also be based on the political and economic realities of the country, the code of conduct in society, decision-making procedures and the existing situation. Only in this case can policies be based on realities and succeed.

However, the development of the right diversification concept alone is not sufficient. The biggest problems are associated with its implementation. Experience shows that it is in this area that most countries are faced with serious obstacles and can't succeed.

The key problem in Azerbaijan at the moment is not the lack of a

⁵⁴Ibid

⁵⁵Ricardo Hausmann, Dani Rodrik, and Andrés Velasco. "Getting the Diagnosis Right". *Finance and Development*, 43 (2006).
<http://www.imf.org/external/pubs/ft/fandd/2006/03/hausmann.htm>

conceptual approach but the implementation of policies. The pre-conditions of economic diversification are fairly clear and it should not be too difficult to develop a short-, medium- and long-term action plan based on that. The government's main goal is to create a decision-making mechanism and to ensure consistent and systemic execution of these decisions.

Government decisions in this area can be conditionally divided into two parts: political and economic decisions. Paradoxical as it may seem, the importance political decisions is greater than others. Political decisions first of all imply the capacity of institutions to follow best governance practices to operate effectively. The IMF's "Code of Good Practices on Fiscal Transparency" published in 2007 deserves special mention. The 1st principle of this Code is Clarity of Roles and Responsibilities. It covers the following:

- i) there should be a distinct differentiation between the public sector and commercial activities;
- ii) there should be a distinct differentiation between legislative and institutional governance;
- iii) there should be a distinct differentiation between public sector policies and governance.⁸

As mentioned above, the biggest obstacle in the way of economic diversification in Azerbaijan is the current situation with governance, which is not fully consistent with the mentioned IMF Code. This is why the business environment is faced with serious drawbacks, which causes doubts among potential investors regarding reliability and credibility.

The biggest problem in this area is the inviolability of property rights. It should be taken into consideration that the success of diversification

⁸IMF (2007) <http://www.imf.org/external/np/pp/2007/eng/051507m.pdf>

requires creation of new production sites, which, in its turn, requires guarantees that investor's property rights are guaranteed.

The Strategic Roadmap and the numerous decrees and resolutions signed to promote and liberalize the business sector, as well as the changes to existing laws, have reduced the need for the adoption of special decrees and resolutions related to diversification. The measures taken to liberalize the economy and promote the business sector eventually actually serve the interests of economic diversification.

However, due to the presence of tradition of politicizing national goals to conduct reforms in the country and the fact that this mostly yields fruit, there is a need for a special decision on diversification. Otherwise, there is a risk of diversification “getting lost” among other goals.

Such a decision (decree) should be very comprehensive. It should reflect short- and medium-term goals for economic diversification and a plan of relevant political, economic and social actions to achieve them. Of course, it should also be aligned with all other decrees and resolutions on diversification signed earlier, as well as the adopted Strategy.

The future decree or resolution should also envisage comprehensive reforms in the governance system. As mentioned above, reforms are an important condition for building a diversified and competitive economic system for a long-term future. Otherwise, there may be an appearance that the goal is to increase the share of the non-oil sector in the economy and exports in a specific period of time and that a result has been achieved. This may only be of illusory nature and will not lead to sustainability.

Therefore, the implementation of economic diversification and the achievement of tangible results in Azerbaijan require political will, competence of the government and, most importantly, systemic and sustainable reforms.

CONCLUSION

Azerbaijan is currently experiencing a watershed period in its economic reforms. The government is adopting important decisions to develop the non-oil sector, taking relevant steps to liberalize the economy, improve the business environment and modernize the governance system.

The effectiveness of reforms and the accomplishment of tangible results require economic diversification.

In order to analyze the conditions for economic diversification and obstacles in the way of it, the country's development can be conditionally divided into two stages. The Azerbaijani economy experience a period of growth in 2004-2014, while the crisis that began in 2015 is still ongoing and putting the economy to a serious test.

Even though the government had the intention of implementing economic diversification in the period of growth, the government failed to achieve a positive result.

Since the country is experiencing recession now, economic diversification is vitally important. The consistent steps taken by the government in recent years are evidence of that.

At the same time, the current macroeconomic policy, especially the strict monetary and credit policies, are hampering the success of economic diversification. The government is giving preference to restraining measures to maintain financial stability. However, the success of economic diversification implies soft and liberal monetary policies, not restraining measures.

Economic factors alone are not sufficient for economic diversification to succeed. Experience shows that there are several preconditions, of which political ones are of particular importance. It is political will that eventually makes diversification irreversible. Of key importance are the rule of law, institutional reforms and investments in human capital.

Despite all the existing economic difficulties, there is a favorable en-

vironment for economic diversification in the country now. It includes the revamped infrastructure, the drastic devaluation of the manat, the dramatic reduction of the average monthly wage as expressed in dollars, the reappearance of cheap workforce, and the presence of such a regional market as Russia.

All these, however, are only potential opportunities. The main functional factors of diversification are the establishment of ownership rights in the country and a favorable business environment. The selection of several sectors of the economy as a priority and the implementation of diversification at their expense does not produce the desired result. The experience of the 2000s proved that. The success of diversification first of all requires a favorable public, political and socioeconomic situation, as well as a reliable and predictable business environment for investors.

While the Strategic Roadmap does play the role of a compass in the area of diversification, it should also be emphasized that a special government decision is equally important for the success of diversification.

RECOMMENDATIONS

1. The government should make serious changes to its tough monetary policies and gradually replace them with a soft and liberal approach. To do this, it is necessary to alter macroeconomic goals and increase the relative and absolute shares of Oil Fund transfers into the state budget.
2. The government should prepare a program document that would be consistent with the comprehensive economic diversification strategy and would then be approved by a presidential decision.
3. The institutional obstacles hampering economic diversification should be clearly identified and the measures to be taken to eliminate them should be outlined in this decision.
4. In order to ensure the success of economic diversification and avoid previous mistakes, all the obstacles hampering the development of small and medium-sized businesses should be discussed and eliminated.
5. The good examples already existing in the business sector should be identified with the participation of business people and disclosed to the public.
6. Prior to the approval of the program of economic cooperation and support for reforms between international financial institutions such as the IMF, the World Bank, the European Bank for Reconstruction and Development, the Asia Development Bank and the Government of Azerbaijan, it should be discussed with the participation of the public and experts and a decision should be adopted after recommendations have been taken into consideration. International institutions should put this forward as a mandatory condition.

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Note

**DIVERSIFICATION PROBLEMS OF AZERBAIJANI
ECONOMY:
OBSTACLES AND SOLUTIONS**

Prof. İngilab Ahmadov

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