Economic Diversification and Policy in Azerbaijan

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Abstract

The purpose of this paper is to develop an analysis of economic diversification of Azerbaijan and suggest some policy options for further diversification. More specifically, this paper aims to assess export diversification in Azerbaijan by analyzing diversification performances of two petroleum exporting countries namely Indonesia and Nigeria. The paper first discusses the merits of diversification by referring to existing literature on this topic then moves onto present an analyses of current economic situation and export potential of Azerbaijan. The paper also presents an econometric model in which measurement of diversification is proposed. Calculating diversification based on a model proceeded by using standard macro-economic ratios appears to develop our understanding of the level of diversification of the economy of Azerbaijan. In the final section concluding remarks and policy suggestions to achieve a more diversified economy is presented.

Keywords: *Economy of Azerbaijan, Petroleum Exporting Countries, Sectoral Diversification, Dutch Disease*

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1. Introduction

The purpose of this paper is to develop an analysis of economic diversification efforts of the Azerbaijani economy. These efforts, as it will be argued further down, can only become meaningful when diversification of the economy is derived from foreign trade and particularly from its exports. Studying export based economic diversification needs to focus on international experience. Nevertheless, drawing a solid policy recommendation for implementation needs to reconcile the current economic situation and the potential of the country.

Diversification of production is a simultaneous development. A variety of products produced in one enterprise occurs simultaneously. The firm expands and varies its production base to increase its competitiveness. Diversification is also desired to increase the effectiveness of production, to increase profitability and to prevent bankruptcy.

There exists arguments on pros and cons of diversification and these are referred to in this study. Especially the experience of Indonesia and Nigeria are highlighted. The article after giving a brief explanation on the merits of diversity continue with an overview of the current situation of Azerbaijani economy and her potentials. Then in the following section a calculation of the economic diversity is done by using a diversification index based on a variety of individual country experiences such as Nigeria and Indonesia and some of the measures required for industrial development through export diversification is presented. Finally article concludes with some policy suggestions for the purpose of further industrial development and to achieve export diversification.

2. Arguments On Pros And Cons Of Diversifications

An economy with economic diversity has more advantages than an economy without.

First of all let's treat this matter from the export viewpoint. As it is well known part of the commodities produced in one country is exported and ratio of total foreign trade to GDP may be considered as an indicator of openness of economy. In countries with low openness indicator, the matter of export diversification may not act as important problem, irrespective

of presence of risks that may lead to a reduction of prices for exported commodities in foreign markets. Even when such cases occur the economy of these countries may not be affected.

This problem is an essential one for Azerbaijan. She is in the process of openning up to the world particularly in the recent years, a process that accompanies the modern occurrence of globalization. In addition Azerbaijan is seeking membership with to the World Trade Organization (WTO). This would strengthen the trend of more integration to the global economy.

It is also a well known fact that its oil resources which is playing an important role for the country's economy will be exhausted one day. The total weight of this sector in 2011 with huge export incomes makes up 52.4% of the GDP and its share in exports is 94.4% (Ministry of Economic Development of Azerbaijan Republic and the National Bank) This is a clear indication that Azerbaijan depends heavily on "one commodity". It is not difficult to imagine what would happen if there was no oil. Export revenues would be very low which would have negative impact on the growth of the economy. The aim of this paper therefore is to create a theoretical framework regarding what will happen to the economy in case of a sharp decrease of oil and gas production and export.

Since no new oil and gas fields are found, it is estimated that oil and gas exports will be exhausted by the near future. Therefore Azerbaijan needs to set her policy priorities according to this reality. However up until the day of exhaustion of oil the economic conditions in Azerbaijan will be known as the period of oil boom. The main challenge that remains is development of the non-oil sectors, particularly trade sectors which would in turn avoid balance of payments crisis and any other disturbance that might occur as a result of a budget deficit. This would also develop Azerbaijan's international competitiveness. Development of the non-oil sectors would prevent Azerbaijan from facing some of the most severe economic complexities.

It must be noted that during this period the government is committed to a "no debt" policy. Otherwise all the above mentioned problems will happen

as soon as the oil reserves are exhausted. If Azerbaijan waits until the final hour, the non-tradable sectors will be negatively affected which would lead to "Dutch Disease". The tradable sectors that are most likely to be affected by atrophy would still lead to a crisis and the solution to these problems will not be a case for economists. Major problems start when export revenues earned from a single commodity comes to a halt after the exhaustion of that commodity. This would lead to a severe balance of payments deficit. Other problems would follow suit. In the case of Azerbaijan funds at the State Oil Fund of Republic of Azerbaijan (SOFAR) will be drawn and eventually will be exhausted. Because the government now will be unable to reduce its expenses with the same proportion and will be unable to reduce budget deficit situation will become even more severe.

Azerbaijan is waiting for current inflow of petro-dollars for the last fifteen years. It is almost impossible not to get into euphoria as huge amounts of petrodollars finally began flowing into the country as a result of recent oil and gas extraction projects. The challenge here lies with how to use this money. The task is on the government which should make efforts to avoid longevity of the current indeterminate situation about where to invest and how to spend oil and gas generated funds. SOFAR is established to deal with such issues relating to spending and it acts according to the Regulations and economic logic of "Long-term strategy on management of oil and gas incomes".

The other risk the economy is facing with a single commodity generated incomes is the dependence on the price fluctuations of this product in the global markets. If our imagination is forced to reveal what would happen to say automobiles manufacturing as a result of an oil saving innovation the result would be a sharp decline of oil prices and oil revenues, besides other impacts. This would result in a contraction of the economy, a rise in bankruptcies and unemployment.

Another risk to the economy with no diversification would come from a rise in the global prices of imported and interim goods that are required for exports. If we continue with the previous example it would be easy to highlight the situation with rising prices of imported good that are used to produce export items. For instance, if the cost of imported steel used

in car manufacturing is increased up to the level whereby manufacturing and exporting of cars are now unprofitable this would still trigger crisis dynamics in the economy.

We should also note that Azerbaijan is currently going through a war period. The country is managed under the war conditions. If military engagement with Armenia is resumed, oil revenues might be put under risk. If that happens the oil sector will be useful only inside the country, losing its international markets as a result of possible embargoes. If the war situation resumes even when Azerbaijan is not subjected oil exports embargo, some hostile countries may impose restrictions on some of the Azerbaijani goods and if these goods are of strategic importance then the defence capability of the country.

In the same time, if we look at this matter from employment point of view, we will see that it would be very difficult to direct the labour force at one field. Particularly, when capabilities of the labour force vary. We have to note that in Azerbaijan oil and gas sector occupies more than half of GDP, but very small part of the labour force is engaged in this field. So, economic diversity would be more desirable if problems relating to employment needs to be prevented from turning into a crisis.

Some argument against the diversification may be also cited. The government targets to base country's economic specialization in one field and using Dynamic Theory of Comparative Costs[19].

From the other end of the spectrum it is not desirable to diversify the economy in Azerbaijan at present conditions at the cost of oil and gas sector (i.e. to withdraw capital, labour force and technology from this sector and to direct them to other fields), as this sector functions effectively and there is no such effective and profitable sphere in the country other than oil and gas.

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[19] *Dynamic Theory of Comparative Costs is not static compared to models of Ricardo and Hecksher-Ohlin, and it takes into account factors changing by time. This theory takes as basis comparative costs structure of plans in future. Developing country today may possess comparative advantage in labor-intensive fields, but may get comparative advantage in capital intensive fields at result of implemented economic policy [3].*

3. Experiences Of Oil Exporting Countries

Oil rich countries in Persian Gulf and Latin America consider oil as a mean to settle their development problems. In fact, despite positive interrelations between increases of oil exports and a rise of living standards in some of these countries, for the majority of them these relations are not set at the desired levels. Therefore a deeper study of the experience of these countries is very important for Azerbaijan. This would help avoiding some of the mistakes. The oil is to be accepted in Azerbaijan as a mean for creation of competitive production fields. In this study we will analyze the experiences of Indonesia and Nigeria and we will refer to the other experiences of some of the other countries, as similar cases are in abundance across the globe.

3.1. Indonesia

In Indonesia rapid increase of foreign currency reserves, along with high domestic expenses had led to sharp increase of real currency exchange rates. This has reflected at the difficulties of some of the non-oil sectors such as the rubber production and processing. Under the unstable oil prices the government decided that the growth dependence on oil incomes was dangerous and future economic growth was based on producing labour-intensive exported goods. In 1978 the government had decided that devaluation of local currency would facilitate revival of economy, decrease dependence on oil and it would be support producers and exporters of non-oil goods. The currency was devalued 50% in 1979 which was accompanied with 22% inflation rate (Hobdari, at all., 2004).

In general, the impact of devaluation was estimated to be positive. Thus during 1978-79 exports of manufactured goods was doubled and foreign trade balance of non-oil goods has increased. As foreign currency reserves was enough for 4 months of imports, the devaluation was actually not aimed for settling some of the problems of balance of payments. The aim was to assist to relatively more labour-intensive non-oil commercial sectors.

During a second oil boom the government had decided to make second devaluation to stop outflow of capital from private sectors for a short term and develop foreign trade balance of non-oil goods sectors. In 1983 local currency was devalued 50% and for a second time during 5 years price

ratio of trade and non-trade goods was sharply changed. Fiscal policy was toughened and devaluation was supported. By mid of 1983 capital-intensive state project with 10 billion dollars (GDP in 12% ratio) was cancelled or postponed. This sharp reduction in state expenses allowed a government to transfer expenses from industrial field to infrastructure and social sectors.

In 1984 the government had changed a tax code and simplified form of simplified value added which allowed smooth management and monitoring of non-oil sector. Immediately after devaluation the government liberalized the fiscal system to increase competition, mobilize local collection on high level, and creation of incentives for loans. This devaluation was successful. During 1983-1985 exports of non-oil and manufacturing goods industry had increased, import of non-oil goods was reduced, foreign currency reserves got stronger and shoe-string-budget matched with balance.

While focusing on the use of large oil incomes, compared to other oil exporting countries Indonesian experience has been successful. There are three main factors for this success:

- oil was not a single source of export incomes and exports of other goods were also used to generate significant incomes;

- the government has not relied only on oil incomes and tried to diversify the economy: the country was a big exporter of non-oil goods during the oil boom;

- Indonesian government had applied macroeconomic policies to alter the negative impact of the changes in the foreign economic environment.

3.2. Nigeria
Before oil boom Nigeria had dominant agriculture sector in its economy, and country was the main producer of cacao and palm items. When 1st oil boom occurred the government faced a problem like how to use unplanned huge amount of oil incomes. Responsible and competent persons for fiscal policy did not pay any attention on possibility of turning current positive

conditions to be worse and decided to spend this money for large scale local investment projects. The state had increased basic expenses, incomes earned during 1970-1976 were mainly utilized, and at result a big budget deficit was formed. This deficit was covered thanks to funds accumulated during 1973-1974 period and monetary expansion. It led to inflation: prices went up 22% and in fact stable exchange rate and real exchange rate regimes were grown in value.

The government was not successful in diversifying the economy and such policies weakened the only strong agricultural sector. During 1964-1978 export of agricultural products was reduced twice and in 1975 Nigeria turned to be a net importer of agricultural products.

The second oil boom detained a government from taking unpopular steps. But as no lessons were learned from first oil boom and expenses for completion of incomplete buildings and construction of new ones were sharply increased.

As a result, all of the above was repeated and import limitations were applied, so manufacturing industry suffered from it, and government addressed to foreign creditors with request to prolong repayment time and even asked for new credits too.

Nigeria could not succeed to use its oil riches for the sake of poverty reduction. As there were some restrictions in application, so large scale investment projects were failed. Investments in industry were ineffective too. Ineffective tax, customs and currency policies had negative effects in 1980-ies and in 1990-ies on macroeconomic conditions of country (Hobdari, at all., 2004).

4. Current Economic Situation In Azerbaijan And Export Potential

Azerbaijan's dependence on oil revenues has grown dramatically in the recent years. Based on the data from 2006 it can be said without any exaggeration that Azerbaijan is now an oil revenue dependent country. If we look at the parameters such as the share of oil sector in the GDP, the share of oil revenues in total exports and of the share of oil incomes in state budget which was 73.8% in 2011, then we will be able to establish solidly

the oil dependence state of the Azerbaijani economy.

The question then is what will happen after end of oil boom, how the government views current economic situation and what steps are taken towards diversifying of the economy. As it was mentioned in section 2, a policy of "long term strategy on management of oil and gas incomes" was adopted in Azerbaijan. But it would be hard to say that the fiscal policy currently is carried out is in conformity with the general principles of a stable and realistic expenses policy. For this purpose an annual expenditure calculation mechanism should be applied on institutional levels. But still no such mechanism is available and no real restriction is imposed against the ineffective use of means.

During past years a lot investments were made in Azerbaijani economy and the country began to spend part of its oil incomes. As a result the economy got intensified and it caused inflation, and from other side the national currency got overvalued. We think that these two issues are the main problems that the Azerbaijani economy faces. If these leads to a lower investment spree in the factors of production, the weight of non-oil tradable sectors will be also reduced in proportion to the GDP.

At the same time it is important to note that Azerbaijan cannot compete just by exporting its natural resources and raw materials. Global practices show that countries developing by using their raw material resources, cheap labour and geopolitical advantages, ends up with larger income distribution gap.

Azerbaijan has great agricultural resources, fertile lands, facilities to grow various kinds of fruits and vegetables. There is a potential to increase activity in fruit and vegetable processing for export, especially for Russian markets. Further non-organized and long-term export opportunities are connected with expanding international markets which have great demand in "green" products that were grown without using chemical fertilizers, harmful preparations against plants and parasites. As majority of agricultural lands of Azerbaijan remains useless or at least not a single chemical preparation was applied there for the last ten years, crops grown at these lands are classified as "green" products (Centre of Economic

Reforms, 2004). Presently local and foreign manufacturing companies operate to provide local and foreign markets with various kinds of (juices, dry fruits, wine, jams, etc.) products.

But some factors exist and negatively affect the utilization of this potential. It includes weak usage of modern marketing and advertisement methods in promoting new products in local and foreign markets; reluctant implementation of flexible policy tools in competitive pricing with foreigners who produce similar goods as well as other factors that originate from non-perfect local business environment, including problems in supplying raw materials and infrastructural restrictions.

It should be noted with certainty that local consumers still prefer to purchase imported goods. In fact this trend should be a warning sign for the producers in Azerbaijan and they should be more careful in designing their products. Furthermore shortages related to networks for harvesting crops, planting after harvest, ceras, inspection devices, lack of irrigation infrastructure; unfavourable micro-business climate – execution mechanism of contracts, fees on packing materials, robbing business practises, etc. have negative effect on the utilization of current potential.

A number of research findings concluded that, being an agricultural country, to a certain degree Azerbaijan has relative advantages in the fields like growing of tobacco, apple, nuts, sub tropic fruits, other fruits and berries, green tea, vegetables, natural honey, oil seeds, raw cotton, wool, leather, raw silk, medical herbs like liquorice and etc. Moreover there are haw, medlar, hips bushes, chestnut forests. Annually, Zagatala region produces about 40 thousand tons of dates, 11 thousand tons of cucumber, 40 thousand tons of maize seeds. There is a need to prepare a list for medical herb production in the territories and the definition of natural habitat of each medical herb. Azerbaijan has huge reserves of construction materials like sand and crushed stones.

Processing industries based on local agricultural products and raw materials have developed at a certain level. For instance, enterprises in Zagatala, inherited from the Soviet Union era has nut processing capability and these are presently privatized. More recently these companies assumed the nature

of a joint-stock companies (OJSC). Basic activities of these enterprises are production of fruit and vegetable cans and juices, processing of hazelnuts. These enterprises previously had a production capacity of 14-15 million conventional cans, 1000-1200 tons of hazelnut, at present can use only a part of their capacity because of lack of funds. Capital inadequacies, absence of sufficiently modern management practices etc., prevent these firms to adjust their business operations to the market conditions. Particularly the quality of technological equipment these enterprises utilize are outdated when compared to modern international standards. These companies are also subjected to moral and physical wearing-off. These conditions do not allow those enterprises to produce good quality and competitive products.

Few years ago some foodstuffs and cloths produced or packed in Azerbaijan were marketed locally. This problem is now partly eliminated. For the last few years due to the new investments by local and foreign investors, many enterprises are reconstructed. Application of modern technologies or inserting new ones using modern technologies are established. For example, vegetable oils, fruit and vegetable juice, beer, wine, tea, meat and dairy products, shoes and textiles are the case in point.

In the former Soviet Union Azerbaijani was very popular. This area had competitiveness with the similar products of the other Soviet republics. This opportunity may be gained again and we have to note that sufficient works were done in this direction recently. It is observed that more attention is paid on this field in the regions with favourable climatic conditions. According to the estimations of experts it is possible to get back expenses made in one hectare of vineyard just after five years in one season.

Based on the results from seveal research, we can safely assert that Azerbaijan export commodities and services rely on export revenues of fuel and mineral exports, and importing of capital and labour intensive commodities and services (machineries and equipment, mechanisms) (Centre of Economic Reforms, 2006). At the same time we can also assert that Azerbaijan's manufacturing is labour intensive. This is due to:

    1) the presence of unqualified and cheap labour, and;

2) excessive reliance on qualified and expensive foreign labour.

Absence of detailed indicators on fields of "Cost-Pass" in Azerbaijani statistics on professions and managerial positions is a main factor that hinders preferring any of these hypotheses.

The results of present study indicates that in Azerbaijan dominance of natural resources (fuel and minerals) and labour intensity in production is inevitably leads to a search for economic policies that would reduce oil export revenues and provide diversification of the economy. Moreover, this research clearly indicates that the services sectors particularly banking and finance has great potential to develop as these sectors already enjoy using available good quality infrastructure in Azerbaijan. Besides that forestry and fisheries are important natural resources and can help developing middle level productive sectors in the country. But level of supply of equipment, machinery and other mechanisms, which are urgently required for capital accumulation as the main production factors in the modern world, are not adequately available. Obviously it is a serious signal and is to be taken into account in defining of development strategy. Finally, economic progress can not be assured without a regulatory role given to the public sector.

5. Evaluating Diversification in an Economy

Diversification of exports is the increase in number of goods of exported goods and services. As a result of diversification of exported goods, the conditions are created for manoeuvre of economy, opportunities for elimination of negative effects of undesired economic conjectures on the economy. These also include elimination of bad "commercial condition". At the modern stage of diversification of exports, it is connected with rapid renewal of assortment of exported goods under influence of scientific–technical progress. Diversification of production is the shifting of production from one commodity to production with multi profiled, expanded nomenclature. Diversification of products is one of the forms of competition conditions of the modern market economy and expresses rise of products in significant numbers.

Diversification index is used to define diversity of economy or conditions of field structure (State Statistics Committee of Azerbaijan Republic, 2006).

$$D = \frac{C^2}{C_1^2 + C_2^2 + \cdots + C_{H}^2}, \quad 1 \le D \le H$$

here, *D* – diversification index of economy, *S* – volume of products created in all fields of economy.

$$S = S_1 + S_2 + ... + S_n$$

S_i ($u = \overline{1, H}$) – accordingly shows volume of value added of *i* – field.

D – index can vary between 1 and *n* (*n* – is a number of fields). Closeness of *D to 1* is undesired and closeness to *n* is desirable. D = 1 means that economy consists of just one field and product of that field comprises 100% of GDP. If *D = n,* it means equal volume of products are produced in all fields (in *n* quantity fields) of economy. Naturally, for all countries diversification index varies from 1 and *n*.

At classification of GDP structure of Azerbaijan, 15 fields diversification index for years 1995-2005 was calculated (Table on volume of value added set on activity kinds of economy   was given in Supplements) (State Statistics Committee of Azerbaijan Republic, 2006). As it can be seen from picture 1, best position of GDP structure in Azerbaijan was observed in 1998. Amount of diversification index had been rising regularly during 1995-1998. It means diversity of economy, i.e. field structure has improved. Diversification index began to go down since 1998, despite remaining relatively unchanged for a few years. In 2005, this index was 4.44 which mean that if it is not prevented, the economy would depend just on one area of production. As we have noted above, it is proved with clarity that the oil sector had 54.4% in a specific weight of GDP for 2006.

Decline in the diversification index in 2007 is linked with increase of value added in "mining industry and quarrying" field in specific weight of GDP from 10.7% in 1998 up to 39.4% in 2007. We have to note that 99.8% from 4682.5 million AZN value added created in 2010 in this field comes

from the share of oil and gas production. From the other side despite of slight increase of dynamic of volume of values added in majority of non-oil sectors the specific weight of these fields in GDP went down (e.g. "agriculture, hunting and forestry" – went down from 18% in 1998 to 9,1% in 2010, "construction" – from 13% to 7.5%, "transport, stores and communication – from 12% to 7.9%, "education" – from 6,9% to 3.3%, "other utilities, social and personal services" – from 7,8% to 1,1%). But, if we look carefully, we will see that a difference among percentages in fields with prevailing specific weight in value added is smaller in 1998 than 2010.
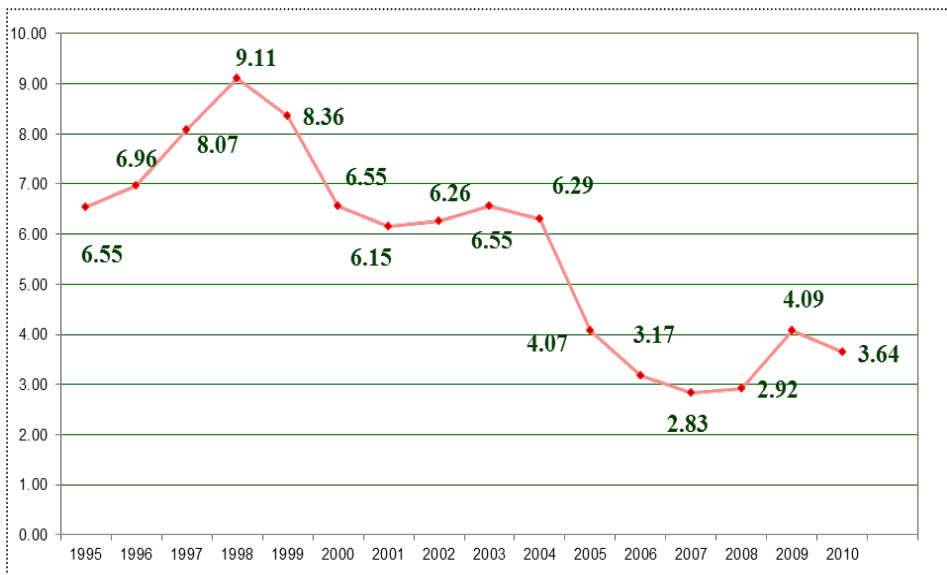

Figure 1. *Dynamics of diversification index.*

We think that for effective integration of Azerbaijani economy into global economic system Azerbaijan possesses real opportunities and using these opportunities logically will play important role in solving very urgent social and economic problems that challenge the country. This might also provide a perspective to achieve a place among developed countries of the world for Azerbaijan.

This study shows that once a scientifically grounded industrial policy is developed and implemented this would strengthen international

specialization of the economy and provides a promotion for national products produced by using high technologies in new markets. This would lead to export diversification based on traditional export. This would further modernize the economy in accordance with the economic potential of the country, its domestic demand and its advantages in the world division of labour.

To our mind at modern era industrial policy of a country should be developed by taking in view settlement of following issues:

1) *Segmentation of industry and global strategy*

Azerbaijan has capable but at the same time cheap labour force. Wide transport networks create grounds for Azerbaijan to develop its economic ties with foreign countries. Azerbaijan possesses a potential to develop oil refinery, oil chemistry, chemistry, electro-mechanics, machinery, ferrous and non-ferrous metallurgy, manufacture of construction materials, light and food industries.

2) *Strengthening of specialized fields*

The export similarity of Azerbaijan with 84 countries of the world was calculated using Finger and Krein index (Centre of Economic Reform, 2004) to define the products that may be exported compared with the other countries. According to results of this work, finding similarities in exports of Azerbaijan with export structure of any other country is possible by making an assumption about similarity of goods produced and exported from Azerbaijan. Here basic support comes from the similarity of production factors, technology, productivity and production.

Some countries that have similar export structures with Azerbaijan exist. These countries export oil products too, but they do not export crude oil but oil refinery products (engine oils, white oil, primary refined benzene, gasoil, lubricants etc.). Study of export structure of such countries and definition of exportable goods from Azerbaijan are useful for our purpose.

Researching into similar countries and providing detailed list of goods that are not exported by Azerbaijan should be available. It would be better for Azerbaijan to export to the global markets end products by developing oil industry, instead of merely exporting crude oil. At the same time oil chemistry should be developed based on development of oil industry and Azerbaijan can turn into a big exporter of products like lactam, laccin, tyres for trucks and buses, polyvinyl chloride and etc.

Almost all similar countries are exporters of liquefied propane. In future this field has to be developed in view of gas resources of Azerbaijan.

The research shows that similar countries have dominating position in products of chemical industry. Production of sulfur (except purified), nitrogen fertilizers (there is a great need in country in this product) etc may be developed in Azerbaijan in the near future. Azerbaijan has great opportunities to develop these fields.

Detailed analysis of export structure of similar countries shows that Azerbaijan in future can export flour made of oily seeds, oats, fine animal hair, salted, frozen, canned and dried fish liver, fresh Crustaceas, flour of cereals (except grain), foods and breakfasts made of cereals, juices, sugar, grain grass, flour from grain grass, natural honey, combed and cleaned wool. Azerbaijan exports agricultural products, though in small amount.

3) *Import substitution (possibility to replace imports in certain areas that has much suffered from balance of payments deficit);*

It would be easy enough to demonstrate the areas and products that have suffered from trade deficit. But some failures of import substituting policies in developing countries show how selection of sectors need government help to deal with problems. We think that three main criteria should be taken into account at such selection:

- Influence on the country's economy;
- Potential competition position of Azerbaijan in this sector;
- Possibility of fast realization of relevant measures within framework of industrial policy;

Influence on the country's economy: first of all influence of import substitution may be estimated on the volume of trade deficit. This is the mostclear criteria. In fact, support for building of broad economy and reduction of risks related to shortages of de-centralization efforts of production should be directed to expanded fields in significantly restricted number and fields corresponding to this aim are those which have big trade deficit. But Azerbaijan has to face significant changes in its market structure for being a transit country. All current trends of this market is to be analysed. For example, let's imagine that it was decided to restore or reconstruct some fields in Azerbaijan, which suffered in during 1990s from shortages of investments, e.g. in heating system. Therefore it is expected that import of such equipment in the future will grow.

Current or future account deficits, their volume and scope, relations with the relevant areas of the economy should be studied. For example, import of polymer plastic may not be important entirely but its influence on competitiveness of fields is certain. Therefore choice among import components having significant share in value of commodities or its local production will be more dependable on availability of cheapest local producers (as transportation expenses are high). In such a case state support on construction of enterprises in country will be important. Hence while private investors estimate ratio of risk and profitability, will not take at all into account how this enterprise is valuable for whole fields.

Potential competitiveness: The second criterion is competitiveness of Azerbaijan. At the first stage, potential competitiveness may be divided into following elements after elimination of main obstacles for its achievement:

- Cost factors;
- Economy with wide coverage;
- Technical know-how;
- Experience in organizational and marketing fields.

Fast execution and expressing monitoring practices: This practice shows that correct selection of fields and regulation methods are not important to get success of state interference, skill of definition of mistakes and correcting them are sufficient grounds. Therefore effectiveness of industrial

policy direct at development of import substituting, most likely would be high, if results would be obtained sooner and estimated then. As result of it would be better to give priority on short term investments fields but not on excessive capital intensive ones.

4) New export destinations;

From short-term to long-term: We think that industrial policy directed at achieving new and high diversified exports is to be defined with three term categories:
- <u>short-term:</u> the aim should be giving a push to already available production fields (Today there are many Azerbaijani goods which can not find itself export markets due to various reasons);
- <u>mid-term:</u> the aim is to assist to the areas, which have its markets but requires investment for development in creation of production;
- <u>long-term:</u> the aim is to achieve effective utilization of potentials of Azerbaijan in technologies and markets with high development perspectives, which are absent now;

We think that basing on above-said, working out and implementation of scientifically grounded industrial policy by taking into view potentials of country at modern period will help in development of non-oil sector and manufacturing industry, including obtaining of diversification of economy, in other words increase of diversification index.

6. Conclusion and Suggestions
International experience, current economic situation of country and export potential were studied in research work and some conclusions were made in this regard.

From macroeconomic point of view as it was mentioned above there are two main problems: inflation and growth of real currency rate. We think that the second problem is more serious as at result of continuation of such tendency non-oil trade sectors may collapse entirely and it would be more difficult to revive these fields after cease of oil export. In long-term a growth of real currency rate should be slowed as much as possible.

If government would accept control of non-oil deficit as a base of long term fiscal policy, we believe that steady development of Azerbaijani economy will be provided. According to various estimations ratio of non-oil fiscal deficit to non-oil economy had grown from 16-19% in 2002 to 60-66% in 2011. And this growth fluctuates.

Ratio of non-oil deficit to non-oil GDP will have to be reduced up to such level by 2025 that since that time this deficit might be financed on account of incomes that will be received from management of funds accumulated in SOFAR (Sabiroglu at all., 2011). At the same time from one side all infrastructural projects that would develop non-oil economy should be completed by 2015, and from other side fiscal burden of non-oil economy should be lessened. During this period non-oil economy may get stronger due to infrastructural provision and low rated tax policy and may step to qualitatively new development stage.

Between 2016-2025 years the shoestring-budget expenses of state and non-oil deficit should be reduced thanks to reduction of state investment expenses, fiscal burden of non-oil economy is to be optimized gradually. That is large scale oil incomes provides us unprecedented chance to reduce fiscal burden of non-oil economy thanks to non-oil deficit. We should certainly avail this opportunity effectively.

As it was noted very scanty investments are directed at non-oil trade sectors. Preference is to be given to these fields in respect of sector-wise policy. As it is known agricultural sector is exempted from profit tax for the period of 5 years. Continuation of this policy is not sufficient, as agriculture and rural infrastructure is to be seriously developed. Agriculture is to be set a priority in economic policy of country and support on this field should be of total an expansionist nature so to change the situation in deep. Granting of credits, especially investment credits is to be increased as a part of implemented measures.

The second priority is to be a processing industry of agricultural products so to increase a demand in farmers' products. As third priority field we suggest other processing industries. This prioritization should be reflected in tax and credit policy in addition to state investment policy. Differentiation

is to be applied regarding taxes, and as far as credit concerned a preference of credit taking person is to be defined according to this prioritization in credits granted by state.

Another priority field is an expansion of transit facilities of Azerbaijan Republic, creation of competitive transport-transit system meeting international standards and at the same time conduction of works in direction of maximum effective use of current potential.

Conclusions of performed research show that Azerbaijan first of all has abundance of factors in agricultural production and low skilled labour. Thus we face shortage of mid and high qualified labour. From other side according to results of performed research Azerbaijan has not comparative dominance in fields using mid and high qualified agriculture labour. State policy is to be directed mainly on support of development of fields which uses this kind of labour and that would be competitive in future.

At classification of GDP structure of Azerbaijan on 15 fields, diversification index for years 1995-2010 was calculated. In 2010 this index was 3.64, which means that if it is not prevented, the country economy would depend just on one field.. All it means that in modern period scientifically grounded industrial policy should be developed and realized for achieving strengthening of international specialization of country economy and provision of promotion of national products produced using high technologies in new markets basing on traditional export positions, in accordance with economic potential of country, local demand and domination position in international labour distribution.

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