

## The Role of Savings in the Economic Development of the Republic of Azerbaijan

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### Abstract

*This article aims to analyze the possibilities of the accumulation and mobilization of savings and their role in the economic development of the Republic of Azerbaijan. Currently, the national economic growth is mostly based on the resource components; crude oil, natural gas and oil products. For the development of the non-oil sector the mobilization of domestic savings into investments would prove very useful. Savings of people should be the most important investment resource for the development of the non-oil sector, as the foreign capital is mostly involved in production of natural resources like oil and gas. The mobilization of domestic savings is crucial for raising the economic growth and promoting development, as it is the private savings that affect the domestic investments significantly. The most of the savings are made when they are fully channeled into the productive investments. As a result, this will lead to the solution of problems of employment and economic growth.*

**Keywords:** economic growth and development, savings, investments, financial institutions

**JEL Classification:** O16, O11, E44

### 1. Introduction

Over the last three years the economy of Azerbaijan is being developed at an accelerated pace, so that its growth rate has become one of the highest in the world. The speedy growth of the economy is due to the existence of huge oil reserves and the increased production of oil. This increase has accelerated a rapid growth of GDP as the oil sector accounted for over 50% during 2007 and 2008 (Economy, 2009).

Azerbaijan's integration into the World Economy has been intensified in recent years. More than forty-nine billion USD were invested into economy over the period 1995-2007, 70% of which were foreign investments. Eighty percent of foreign

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investments are foreign direct investments (FDI). Most of the FDI (about 90%) pertain to the oil sector.

It is therefore obvious that incomes from production and sales of oil make up a very significant part of GDP. For example, in 2007, mining and hydrocarbon industries accounted for well over 95% of the Azerbaijani economy, and oil and its products made about 98% of total export in the first half of 2009. Main export products of Azerbaijan are oil and oil products and the economy is not yet well diversified into manufacturing industries.

According to the new report of the International Monetary Fund (IMF) the economic growth in Azerbaijan will decrease due to the year by year reduction in oil production (IMF on Economic Growth of Azerbaijan, 2009). Growth of investments in Azerbaijan is stipulated by availability of vast reserves of oil. As a result, along with a decrease of oil the inflow of investment resources will decrease and the economic growth rate will be affected negatively.

Thus, it is vitally important for Azerbaijan on this development stage if the country receives vast amounts of income to develop the non-oil sector of the economy and launch production of goods having potential to provide the country with additional incomes. To solve the problem of the development it is very important to stimulate the real sector (agriculture and manufacturing) of the national economy. The sustainability of development of Azerbaijan will depend on its ability to invest in productive enterprises. Entrepreneurs organizing the production of goods which could compete with imported goods should be supported by all means.

Steady and long lasting growth can also be ensured on account of production of competitive goods and extensive use of new technologies. This requires an increase of investments into the real sector of the economy. The state support of direct investments could create favorable investment climate for provision of development of production of goods and services.

For the development of the production of competitive goods it is necessary to attract investments from domestic sources. The development of these investments into the Republic of Azerbaijan will contribute to an increase of the production potential of the country's economy. In the literature there is wide support to the idea of the positive influence of attraction of domestic savings on the level of investments and on the economic growth. The realization of the objective of a steady economic growth and development is a very hard task without mobilization of savings and investments.

In this paper we consider the role of savings in the economic development of Azerbaijan and the possibility of a stimulation of savings and their subsequent use in the development of investment projects. The importance of this topic is determined by the need of creation of appropriate conditions for subsequent development of the economy on account of domestic sources of financing, and not only on account of foreign sources. The remainder of the paper is organized as follows. Next section describes the situation with domestic savings and their importance in the economic growth. Section 3 gives an analysis of the main determinants of savings in Azerbaijan. The fourth section



emphasizes the significance of transformation of savings into investments and the role of financial institutions. The paper's last section draws conclusions and suggests avenues for future work.

## 2. Situation of domestic savings in Azerbaijan

As it is known, in the long-run the level of investments in national economy closely correlates with the level of national savings. Population's savings are an integral part of the economic system and contribute to the future economic development. These savings can be the most important investment resource for the development of the real sector, because foreign capital is mostly invested in production of natural resources like oil and gas. It is of vital importance for the state to mobilize the savings of the people into the economy. The state will be less dependent on foreign investments and the domestic investments accumulated due to the savings will provide better stability of the country. This could contribute to the economic growth and development (Surina, 2007).

For maintaining a stable growth rate of the economy of Azerbaijan it will be necessary to increase the investments by means of domestic resources. Currently the ratio of savings attracted from population and the GDP in Azerbaijan equals to 5%, which is not considered to be an optimal level. It can also be seen (Table 1) that the saving/GDP ratio over the last years does not exceed 5%.

**Table 1: Savings attracted from population (in thousands AZN)**

	2003	2004	2005	2006	2007	2008
Savings attracted from population	251935	403127.6	494500	819500	1468400	1903700
of which:						
national currency	18986.2	30130.2	55800	250300	676400	1035600
foreign currency	232948.8	372997.4	438700	569200	792000	868100
GDP	7146500	8530200	12522500	18746200	28360500	38005738
Savings/GDP ratio	3.53	4.73	3.95	4.37	5.17	5.01

Source: State statistical committee of the Republic of Azerbaijan

Note: (1 Euro = 1.14 AZN) - Manat (code: AZN) is the currency of Azerbaijan

According to the estimations of the Standard & Poor's Ratings Services the level of the per capita deposits in Azerbaijan equals to \$561. According to Table 2 per capita deposits in manats equals to 234 AZN and in foreign currency equals to 293 USD (numbers are calculated by dividing the total sums to the number of population which is equal to 8,238,672). This reflects to insufficiently strong market positions of the banking sector and to low level of well-being and savings (Standard & Poor's, 2008).

**Table 2: Deposits and savings by currencies (end of period)**

Year	Total deposits	of which:			
		in manat		in foreign currency	
		demand deposits	time deposits	demand deposits	time deposits
2001	393	43.7	13.6	179.4	156.3
2002	451.4	59.7	11.8	171.6	208.3
2003	610.6	91.6	18.6	173.2	327.2
2004	1025.3	179.5	26.3	244.1	575.4
2005	1294.4	200.4	48.9	324.1	721
2006	2129.2	542.3	284.1	540.1	762.7
2007	3183.7	939.2	748.9	270.7	1224.9
2008	4348.5	999.3	936	208.9	2204.3

Source: National Bank of the Republic of Azerbaijan

It is common knowledge that the savings of the population are closely connected to their well-being and are the main source of investment resources. There is a general consensus on the positive role of investments in the acceleration of the economic growth and that a high level of saving leads to high level of investments. The largest share of financing for development has to come from domestic resources. The majority of the countries are more likely to finance most part of their investment out of national savings instead of using international capital movements (Obstfeld and Rogoff, 2000). The level of financing of the economic growth in the republic should be largely determined by the level of savings of population.

‘The experience during a decade of economic transformation provides convincing evidence that the most successful transition economies have been those where the economic environment stimulated savings...’ (Financing Growth and Development in the Transition Economies: The Role of Domestic Savings. 2000).

Today’s savings are future investments. The situation with savings and investments in Azerbaijan is such that the ratio of investment to GDP is higher than the ratio of savings to GDP. Large investments in Azerbaijan are realized on account of the state financial resources, and not the private ones. The current role of savings of population in investment activities in Azerbaijan is not great. In developed countries savings of population attracted through the banking system and the capital markets are the most important sources of financing of economic growth. By conducting the necessary policies the government should create the required conditions for the growth of savings of population.

### **3. The determinants of savings**

The main determinants of savings analyzed in this section are fully relevant to the savings behaviour and derive from an extensive literature review, an indicative part of which is quoted below. The determinants included in the analysis are the income level and the expectations regarding future development, the taxation policy, the age structure of the population and the expected role of the financial institutions. The existence of some barriers is also discussed and taken into consideration.

The issue of the increase of savings is of great importance for maintaining the economic growth and development. Indeed, as Thirlwall argued:

‘The growth of output of any economy depends on capital accumulation, and capital accumulation requires investment and an equivalent amount of savings to match it. Two of the most important issues in development economics, and for developing countries, are how to stimulate investment and how to bring about an increase in the level of savings to fund increased investment.’ (Thirlwall, 2002)

Identifying the factors determining savings, as well as factors positively influencing attraction of investments is a major policy challenge for all countries (Xiaochuan, 2009). The main emphasis in the analysis below is given to the determinants of savings of people.

The income level is considered as the main determinant of savings, but this is not the only determinant affecting them. Other determinants are the level of interest rates and the age structure of population. As Metin states, there are several potential determinants of savings:

‘Both theoretical and empirical work on savings, have consistently outlined the major potential determinants of savings that can be grouped loosely under the headings of government policy variables, financial variables, income and growth variables, demographic variables, uncertainty measures, and external variables.’ (Metin et al., 2003, p. 1409).

The importance of identifying the determinants of savings is also emphasized in the Economic Survey of Europe:

‘Understanding the motivation for saving (at the level of individuals and for the community as a whole) is not only of academic interest but also important in terms of its policy implications. Identifying the key determinants of saving may help policy makers to design policies to stimulate domestic savings and thus domestic investment.’ (Economic Survey of Europe, 2001, p.177)

### 3.1 Income level

As it is stated above incomes of people are considered as the main determinant of savings. According to state statistical data population's income is increasing. The per capita income of population increased by over 3 times within the last 5 years: from \$641 USD to \$2,000 USD. The average monthly wage in the country increased by about 4 times in this period and reached \$252 USD. According to forecasts of the Ministry of Economic Development, these indicators will reach \$4,500 USD and \$657 USD in the next four years respectively.

According to these forecasts incomes of population made by government agencies in 2009 will increase by 22.5 % and will amount to 22.77 billion manats (Table 3). In 2009 the largest share of income of population will be formed due to entrepreneurial activities. Entrepreneurial income will amount to 11.3 billion manats which will make 49.6% of total incomes. The second largest share income will be due to wages and salaries. According to the forecasts wages and salaries will amount to 7.4 billion manats, which is 32.8% of all incomes. According to the same forecast, expenditures will be equal to 18.1 billion manats, which is lower than revenues by 20.3%. The amount of savings according to the same forecasting will be equal to 4628 million manats (Khankishiyeva, 2009).

**Table 3: Income and expenditures of population (million manat)**

	2003	2004	2005	2006	2007	2008	2009 (forecast)
Income	5018.6	5738.1	6595.1	8063.6	10198.5	14305.6	22773.3
Primary income including:	3948.8	4600.3	5345.4	6394.2	8299.6	11852.1	18872
Wages and salaries	1262.1	1620.4	2122.3	2954.8	3364.5	4564.9	7470
Income from entre- preneurial activities	2683.6	2976.3	3217.9	3432.6	4874.1	7215.1	11300
Property income	3.1	3.6	5.2	6.8	61	72.1	102
Transfers	1069.8	1137.8	1249.7	1669.4	1898.9	2453.5	3901.3
Expenditures	4171.2	4793.8	5549.9	6508.7	8208.1	10819.5	18145
Final consumer expenditures	3740.2	4230	4697.7	5532.6	6873.1	9374.6	15825
Transfers	431	563.8	852.2	976.1	1335	1444.9	2320
Savings	847.4	944.3	1045.2	1554.9	1990.4	3486.1	4628.3

Source: State statistical committee of Republic of Azerbaijan

Note: (1 Euro = 1.14 AZN)

Thus, it is forecasted that incomes of population will be higher in comparison with the previous year. The level of incomes directly influences the amount of savings, and also increases the propensity to save. Increase of incomes of households will lead to an increase of the investment potential of the Republic of Azerbaijan. Increase of the size of the income will be accompanied by even higher increase of savings. Savings of people as one of the indicators of living standard depend on the well-being of the population.

The expectations of people regarding the future economic situation are also an important factor because they can affect the current expenditures and savings. The study and the analysis of the determinants of savings will enable to forecast the tendencies in accumulation of financial resources by the population and will also help to develop an efficient mechanism of the transformation of savings into investments.

### **3.2 Taxation policy**

Encouragement of the interest of population for the increase of savings can be realized also through the taxation. Several studies have shown that tax policy has a positive influence on the real sector and is an important tool not only for stabilization but also for promoting savings and capital (Peter and Peter, 2006, p. 36). As the most developed countries practise, tax stimulation of savings and relevant incentives for domestic investors should be actively used. It is well-advised to introduce the appropriate model of taxation based on benefits on incomes that people receive from investments. Indicative types of benefits are tax discount on installments of investment funds and special non-taxed savings accounts. Introduction of special banking accounts which would allow people to deposit some amounts of money without taxation of accrued interests within the first few years is one of methods of tax stimulation of increase of savings.

### **3.3 Age structure**

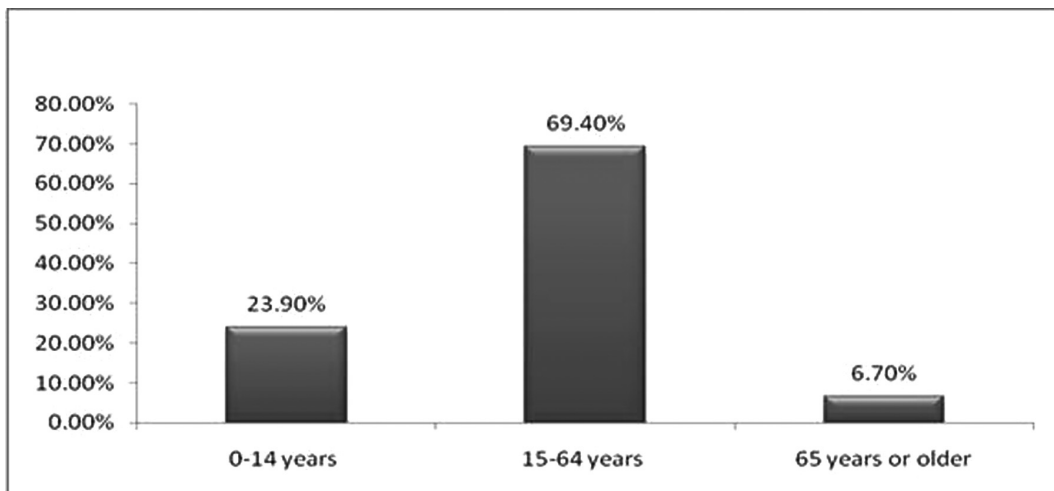
Demographic variables are considered as important determinants of household savings. The population structure affects saving behavior of people.

‘In the basic life-cycle model, the age distribution of households has an effect on the aggregate personal savings rate because the savings rates of individuals are assumed to vary with their age. An increase in the proportion of elderly households in the population is expected to reduce the aggregate savings rate because retired households are assumed to dissave, or at least save less than those of working age. Similarly, an increase in the proportion of the population that is of pre-working age is also expected to reduce the aggregate personal savings rate as parents spend a

large proportion of their income on taking care of their children.’ (Bérubé and Côté, 2000, p. 5).

According to the age structure of the population of Azerbaijan (see figure 1) 23.9% of population is 0-14 years old, 69.4% is 15-64 years old and 6.7% is 65 years or older. The median age of population equals to 27.7 years. According to the State Statistical Committee of Azerbaijan out of 8.6 million of people 5.8 million are at working age. 2.9 millions are in the category of 1-19 years old and 0.6 millions in the category of 65 and over.

**Figure 1: Age structure of population**



Source: State statistical committee of the Republic of Azerbaijan

The population factor for the development of the savings is favorable as the population is young and the majority of it is in working age and the number of the younger generation prevails the older one. Young, energetic and growing population predetermines the long-run economic growth. This factor increases the potential of the economy for growth and contributes to an increase of aggregate saving in the country.

### **3.4 The importance of financial institutions**

The problem of transformation of savings into investments has a special significance for the development of the Republic of Azerbaijan. Redistribution of financial resources from those who own to those who need is essential for the economy. In order to transform savings into investments, savings should be attracted by financial institutions. The process of transformation of savings into investments can be carried out by financial markets and by financial intermediaries. Mobilization of savings of



population by financial intermediaries is the most important type of relevant banking operations. Commercial banks play a key role in transformation of savings into investments. They attract savings of people and ensure the economic growth of the country.

Mobilization of savings of the population into the economy can be realized with the help of the banking system and other institutions of the financial sector. For the people, in order to deposit their savings in bank accounts, it is well-advised to apply more widely such mechanisms, as payment through banks for various kinds of services and goods and transfer of wages and salaries to current accounts of individuals. It is also necessary to use mechanisms of commercial banks for the realization of programs of stimulation of a consumer demand and acceleration of activity of non-bank organizations working with the savings of the people (Lopintsev, 2008).

The encouragement of transformation of savings of people into the investment should be carried out by the development of the system of insurances of individual investments. The use of insurance mechanisms for the transformation of savings into investments is of great practical importance. The amount of deposits insured by the state in Azerbaijan was equal to 8,000 AZN (\$9,900 USD) until recently, but since May 2009 the amount equals to 30,000 AZN (\$37,000 USD). The measures taken for the protection of the rights and legitimate interests of insured people increase the financial stability of the insurance organizations and confidence of people to the financial institutions.

The development of an institution of nonbanking financial intermediaries in Azerbaijan could also be a positive factor for the accumulation and the mobilization of savings of population. These institutions are indispensable suppliers of loan capital. Specialized nonbanking institutions unlike banks accumulate financial savings for sufficiently long periods and therefore can make long-term investments. The main forms of activities of these institutions are accumulation of savings of people, granting credits by means of issuing bonds, mobilization of capital and granting mortgage and consumer loans. Expansion of the nonbanking segment of the financial market by way of introducing new financial instruments will stir up investment activities of people. As we know, strong financial system promotes the transformation of savings into investments.

‘Azerbaijan's financial system is not fully developed but is growing rapidly. Availability of long-term financial instruments remains limited, providing virtually no viable domestic savings options other than bank accounts. The market for state and corporate bonds remains small and illiquid.’ (Index of Economic Freedom 2009).

‘The private savings ratio tends to increase along with the development of the financial system.’ (Koskela and Viren, 1983, page 117).

The development of securities markets in Azerbaijan can be useful for the transformation of savings into investments, as these markets are indispensable for the

stability of financial markets. The development of stock exchanges is also conducive to an efficient transformation of savings into investments due to the fact that by trading securities stock exchanges large amounts of capitals can be accumulated which are also used for the development of productions. Weaknesses in the regulatory and supervisory framework, deficiencies in market architecture and infrastructure, insufficient development of equity markets are the main impediments of the development of capital markets in Azerbaijan (Project Information Document, 2008). The lack of investment interest of people in investment institutions is caused by the lack of development of the infrastructure of the securities market, its informational non-transparency, illiquidity of most securities, and lack of knowledge in investments issues. The regulation policy about the securities should first of all focus on the development of its investment potential, on the system of attraction of investment resources and on the attraction of private investments. Companies and enterprises in Azerbaijan should also work hard for the improvement of their corporate governance practices. Good corporate governance is pivotal for the integrity of corporations, financial institutions and markets, and essential to the health of economies and their stability (OECD Principles of Corporate Governance).

‘Corporate governance has become an important topic in transition economies in recent years. Good corporate governance helps to increase share price and makes it easier to obtain capital. International investors are hesitant to lend money or buy shares in a corporation that does not subscribe to good corporate governance principles.’ (McGee and Bose, 2008, p. 1).

However, the positive effects of the above important determinants to domestic savings will be active only if some side obstacles can be overcome. Barriers such as the current global unfavorable investment climate, the existing monopolism in some sectors, the emigration, as well as the corruption, a phenomenon noticed in most new countries formerly belonging to the Soviet Union have to be seriously considered and tackled. In our opinion, these barriers can be confronted only by a decisive intervention of the state. The most efficient tool would be a carefully prepared, protective legislative framework. It would be better if the voting of this framework was unanimous and the republic of Azerbaijan took every concern for its catholic application.

#### **4. Conclusion**

The objective of this article was to determine that the savings of population, if properly used, could be a significant factor in stimulating economic growth in Azerbaijan. Sustaining economic growth is important to ensure macroeconomic stability, develop strong financial institutions and fund the market in order to provide accumulation and transformation of savings into investments. Strong financial institutions facilitate the flow

of funds from savings to investments. Even if savings are high in the country without developed capital markets and financial intermediaries there will be no use as they could not be channeled into investments. On the other hand, insufficient development of the system of financial intermediaries lowers the rate of growth of the economy and can render the mobilization of savings inexpedient. The success of transformation of savings of people is determined by the degree of the development of financial intermediaries and the presence of attractive financial instruments.

Policy makers should focus on increasing the level of domestic private savings because the crucial problem for developing countries is the lack of investments which restricts economic growth. The savings of people serve as the basis of investment resources of the country and are essential for development and growth. Increase of the savings will lead to the capital accumulation which will eventually lead to the economic growth. High level of domestic savings will serve to the solution of the problems of unemployment, contribute to the development of entrepreneurship, and can therefore positively influence the rate of the economic development. Under a strong financial system the level of savings can be a reliable gauge of the economic development of the country. Besides, the saving rate along with inflation and unemployment can be considered as an indicator of the country's economic situation.

The estimation of volume of savings of population, the search for the ways of its use and the stimulation of investment activities of people should be the priority task for the government. The efficiency of measures will be productive only if the involvement of savings will favorably affect the well-being of people. In this case not only investment activities will be boosted but also the population's entrepreneurial potential, which will contribute to the increase of incomes and employment, as well as to the improvement of quality of life.

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