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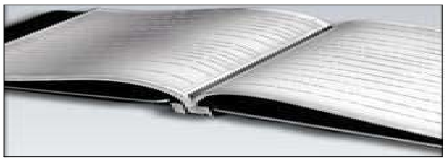

Economic Crises in History, the Characteristics of the Most Recent Crisis and its Effects on the Economy of Azerbaijan

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Executive Summary

The developed and the developing countries of era is experiencing the period of industrialization and information & technology simultaneously. Given this environment countries get closer and the financial markets cross the physical boundaries. Production and competition centered evolution brings up the term called "globalization" in the literature.

Globalization comes with both positive and negative effects. One of the most solid negative consequences of globalization is economic crises. Since the great depression of 1929, the crises have had different characteristics. In 1929 the system was based on trade of goods but over time, trade of goods changed into trade of money centered on the financial markets which indirectly affects the real economy. After the Second World War, direction was given by financial organizations such as IMF and the World Bank in the financial markets and WTO in trade. Current account deficits, extreme consumption, public income generation problems result in stand-by agreements with the IMF and triggered recessions or crises are felt not only be the developed countries but also most dramatically by the developing countries.

Keywords: Economic Crisis, Azerbaijan, Globalization Great Depression, Crisis Management

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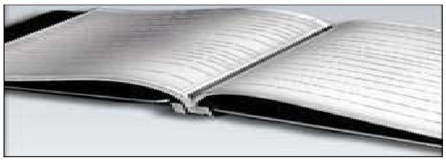


Economic Crises in History, the Characteristics of the most recent Crisis and its effects on the Economy of Azerbaijan

Introduction

In the history of economics, different terms have been used to describe what is known now as "crisis" after the great depression of 1929. After the Southern Asian crisis of 1997, both terminologies have been used respectively to describe the downturn. Economic crisis could be described as the slowing down of the production during recession. But after the Southeast Asian crisis reasons of the crisis has been varied. Today, the financial markets have become more sensitive to crises.

In recent times, the financial and economic crises occur more frequently and last for a short or a long period. The reasons are usually due to problems in the financial sector since both in developing and developed world, financial markets react rapidly to and developments. It is possible to soften the effects of crises by following a rational crisis management method. Strict financial and monetary policies will help ease the negative effects and shorten the overall process.

The Characteristics of Economic Crises

There are certain periods in time which brings groundbreaking changes to our daily lives. Alvin Toffler describes these periods as waves first of which was the agricultural revolution, second was industrial revolution and third one is the information revolution or commonly known as globalization (Durgut, 2000: 16).

The first wave is the society after the hunter-gatherers. Agricultural society begins almost at the same time with the history of humanity. The most important characteristic of this revolution is the non-differentiation of the producer and the consumer. In other words, human hunts for himself, produce for himself and build shelter. The main goal is to meet the needs of the individual and those who are under the protection of that individual. So there is no specialization since everyone does everything for themselves.

The second wave industrialization take place after the agricultural society which lasted hundreds of years. With the improvement in technology, use of machinery increases. Most of the work that was undertaken by human power can be done by machines in a standardized way. Labor in the factories made up the producing society. The most common feature of this era is the differentiation of producers and consumers which results in what we now as different classes in the society. There is no longer consumption for survival needs, there is consumption plainly to shop.

The third wave is the post-industrialization society. Following the 1950s many countries have begun their transition. Some of the terms used to describe this era is "Super-industrialized society, information era, space era, electronic era, global village, and techno-scientific era. Individualization and the growth of the services industry are important determinants of this period.

There are a number of factors that differentiates the second wave from the third wave. In the industrialization society, factors of production are land, labor and capital In the post industrialization society factors of production involve information (data, image, culture, ideology, values) and include non material segments. In reality different characteristics of these periods can give us the clues to point out the differences in the crises throughout history. In the agricultural society, we cannot talk about the modern day crisis affecting the financial markets, considering that consumer and producer is the same and there is no economic interaction across borders. The main problem in this period is famine.

The economic crises in the industrialization period usually follow the characteristics of the Great Depression of 1929. Unlike the agricultural period people consume not only for survival needs. People consume to shop and equilibrium is determined through supply and demand. The crises of this period are affected by the dramatic changes between supply and demand. The 1929 depression is caused by the fact that the supply has not been able to meet the demand of the people.

The post industrialized society puts strong emphasis on the value of information and use strategies such as sales, marketing to promote consumption helping develop the post modern society. Social, cultural, economic values are different than of 1950s and act in more global manner. Without taking into account the economic differences countries use similar financial tools and instruments with the contributions of globalization. Unlike the crisis based on the non-financial sectors, today's crises arise from the reactions of the financial sector. Now, the countries have to deal with the outflow of capital, current account deficits and artificial assets.

After the oil crisis of 1970 which carried most of the characteristics of the second wave, followed by the termination of the Bretton Woods Agreement, a new period has begun as money printing is no longer based on gold. IMF played an important role in the crises that broke out following the 1970s. Though it is an important player in the financial markets, it is frequently criticized for not being able to foresee the crises, creating the ground for debate to determine the real role of the IMF in the world (Göktaş, 2000:7).

As mentioned the crises in Mexico, Argentina, Brazil, Russia and Turkey (2001) is caused by the loans through the principal of conditionality. In other words, conditionality without taking into account the unique characteristics of the countries brings the debt crises of 1990s. The South East Asian crisis in the late 1990s has provided a new dimension by spreading the crisis around the globe caused by the outflow of capital.

Recent Global Financial Crisis

High-tech tools of our society enable a faster, lower cost and higher quality production in the economy. Thus, the only way for an entrepreneur to maximize its profit and increase production and that is promoting further sales, further consumption. Within this context, entrepreneurs developed sales and marketing strategies and new methods of payments (through monthly installments). Commercial banks provided the sector with "credit cards" and "consumer loans".

While the developments in the commercial sector satisfied the businesses and commercial banks, sudden increase in demand and financial tools to support the system, products (both financial and commercial) put on artificial values as described by Guillaune. This distorted the balance between the products and their monetary values.

In fact factors triggering the recent financial developments began in late 1990s and late 2000s. The slowdown in the Japanese and the American economies is caused by the increase in savings. In order to bring the money back in the markets and fasten up the economy, interest rates have been lowered. After 2001, policies such as lowered interest rates (2001-2004 period) Americans began to take out loans which increased the prices of the real estate. Higher prices resulted in more loans and the vicious cycle has been built. (Aktaş, 2008).

In order to fasten up the recovery, construction sector has been used by enabling the low income families own real estate. This tool is called the "subprime mortgage" which is a low quality real estate loan. The volume of this high risk loans has reached 1.5 trillion US dollars. Since for the past years the interest rates have been low, consumers chose to use the flexible interest rate option. But a sudden increase in the interest rates by the FED, immediately slowed down the construction sector. Banks who have allowed loans up to 110 percent of the value of the real estate and increase in interest rates have made it impossible for the low income families to pay back their loans. Commercial banks used the bonds provided by the investment banks to finance the real estate loans. And as the last chain of the cycle investment banks sold out the credit receivables to provide more money into the system. Eventually with the difficulties in the pay back of the loans, banks faced a significant threat in the United States.

The financial crisis that first grew in the mortgage sector turned into a severe liquidity problem in 2007 and caused four sectors, namely finance & insurance, real estate, construction and mining to slow down. A crisis in one of the most important economies in the world suddenly spread all around the world creating the most recent global financial crisis.

Following the outbreak of the crisis in the United States, countries followed different ways to deal with it. The priority was given to support the bankrupting companies by transferring public funds and by promoting consumption to increase the production. When realized that Keynesian policies only ease the troubles in the economy for the short term, a new search has begun in the global platform namely in G-20 meetings.

The exit strategy from the crisis has been prescribed in the IMF's G-20 meeting held in St. Andrews, Scotland on the 6th and 7th of November 2009. The resolution is as follows (IMF, 2009b: 1):

- The timing of exits should depend on the state of the economy and the financial system, and should err on the side of further supporting demand and financial repair.

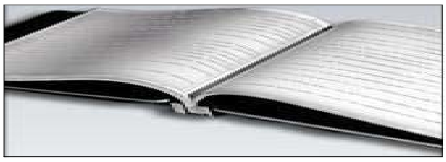
- With some exceptions, fiscal consolidation should be a top policy priority. Monetary policy can adjust more flexibly when normalization is needed.
- Fiscal exit strategies should be transparent, comprehensive, and communicated clearly now, with the goal of lowering public debt to prudent levels within a clearly-specified timeframe.
- Stronger primary balances should be the key driving force of fiscal adjustment, beginning with actions to ensure that crisis-related fiscal stimulus measures remain temporary.
- Unconventional monetary policy does not necessarily have to be unwound before conventional monetary policy is tightened.
- Economic conditions, the stability of financial markets, and market-based mechanisms should determine when and how financial policy support is removed.
- Making exit policies consistent will improve outcomes for all countries. Coordination does not necessarily imply synchronization, but lack of policy coordination could create adverse spillovers.

After looking at the general characteristics of the crises in history while giving particular attention to the most recent one, we can take a look at the effects of the crisis on the economy of Azerbaijan.

Global Financial Crisis and the Overview of the Economy of Azerbaijan

In order to understand the effects of the global financial crisis on the economy of Azerbaijan, we need to look at the brief economic history of Azerbaijan covering the last 18 years – since independence. We can analyze the developments in three categories. The first one is the 1991-1994 period, second one is 1995-2000 period and the final one is 2000-onwards period.

In the first period, Azerbaijan gave full attention to switch from a socialist economy to a capitalist system. Prices became flexible, trade became freer, privatization was undertaken and public spending was lowered. These attempts were unsuccessful mainly due to lack on systematic and institutional infrastructure and war with Armenia. With the collapse of the



Soviet Union, the transition period brought economic downturn and high inflation. Between 1991 and 1995, GDP of Azerbaijan fell by 60 percent (Musavev, 2007: 218).

The 1995-2000 period was period of relative stability. The shock policies during the transition were abandoned and the government pursued a step by step approach to deal with the transition. Main goal was to increase production and halt inflation to achieve some level of macroeconomic stability. Oil industry was promoted to sustain a cash flow, strict monetary policies were followed, privatization was undertaken and 1996 onwards, a sustainable growth level was achieved.

In the third period (2000-) similar policies of the second period were followed. But from 2003 on, with the rise of the oil prices, both Gross Domestic Product and public spending increased dramatically. With higher incomes, sectors such as construction, services and agriculture were supported. In this period GDP grew by 900 percent and public spending increased by 1500 percent (See Table 1 – 2).

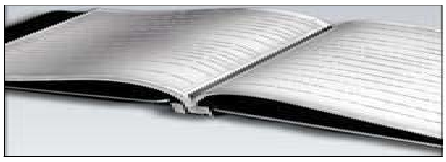
When looking at the 18 year period of the Azerbaijani economy, we can see two important determinants. The first one is relative conservatism and patience and second is awareness of the global developments and reaction through homogenous policies. For instance, heavy inflationist pressure was avoided (caused by higher oil prices), through conservative financial policies. Macroeconomic stability and sustainability have been prioritized by the government of Azerbaijan.

Table 1. Macroeconomic Indicators (2000-2008)

(mln. AZN)

	2000	2001	2002	2003	2004	2005	2006	2007	2008
GDP	4718,2	5315,6	6062,5	7146,5	8530,2	12522,5	18037,1	26815,1	38005,7
Growth (%)	11,1	9,9	10,6	11,2	107,0	26,4	34,5	25,0	110,8

Source:. The Central Bank of Azerbaijan, Annual Statistics, *www.nba.az* (15.11.2009)



Looking at the pre-crisis indicators of the Azerbaijani economy we can see that the GDP has been growing despite the two crises in Russia and South East Asia. Even though the public expenditure remained high, budgetary equilibrium has been achieved (Table 2). Foreign debt remained at 8-9 percent of the GDP. These indicators tell us that the economy of Azerbaijan will not be severely affected by short term crises.

Table 2. Government's Budgetary Expenditures (1995-2008)

(mln. AZN)

Years	Public Revenue	Percentage of GDP	Public Expenditure	Percentage of GDP	Budgetary Deficit	Percentage of GDP
1995	415,6	19,5	428,4	20,1	-12,8	0.6
1996	498,0	18,2	481,9	17,6	16,1	0,6
1997	513,0	16,2	588,7	18,6	-75,7	2,4
1998	465,5	13,5	528,3	15,4	-62,8	1,8
1999	549,7	14,6	641,5	17,0	-91,8	2,4
2000	715,5	15,2	763,8	16,2	-48,3	1,0
2001	783,8	14,7	806,6	15,2	-22,8	0,5
2002	910,2	15,0	931,7	15,4	-21,5	0,4
2003	1225,5	17,1	1234,0	17,3	-8,5	0,2
2004	1481,2	17,4	1501,0	17,6	-19,8	0,2
2005	2055,2	17,3	2140,7	18,0	-85,5	0,7
2006	3881,2	21,9	3789,7	21,4	91,5	0,5
2007	6006,6	23,8	6059,5	24,0	-52,9	0,2
2008	10762,0	28,3	10680,0	28,1	82,0	0,2

Source:. The Central Bank of Azerbaijan, Annual Statistics, *www.nba.az* (15.11.2009)

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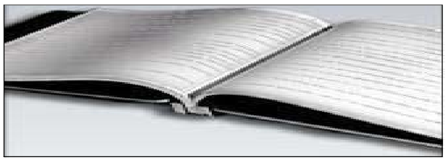

Even though the strong figures showed in the table are a result of the increased oil prices it is also the result of correctly directing the public incomes into the economy.

Table 3. Balance of Payments Indicators (2005-2009)

(mln. US Dollars)

	2005	2006	2007	2008 1st Quarter	2008 2nd Quarter	2008 End of Year	2009 1st Quarter	2009 2nd Quarter
Current Account	167	3707	9019	3683	6029	16453	1795	2686
Balance of Trade	3299	7745	15224	5816	8202	23012	2110	3805
Export	7649	13014	21269	7237	9996	30586	3587	5256
Import	-4350	-5269	-6045	-1421	-1794	-7574	-1477	-1451
Balance of Services	-1970	-1923	-2131	-508	-591	-2343	-268	-332
Capital Account	567	-1737	-5760	-1895	-1283	-3557	-2979	-978
Reserve Movements	-608	-1717	-2898	-1761	-4289	-12050	2043	-1560
Net error and ommissions item	-126	-256	-361	-27	-457	-846	-859	-148
Balance	0	0	0	0	0	0	0	0

Source:. The Central Bank of Azerbaijan, Annual Statistics, *www.nba.az* (15.11.2009)

Azerbaijan has been implementing a development model based on the oil incomes and to successfully manage this income “State Oil Fund” was established separately established from the regular budget of the state. By doing so, the use of the fund for regular public expenditure as avoided. Instead transfers were done according the needs of the country. In 2003, the transferred funds reached only 150 millions of dollars whereas this number reached 5 billion dollars today. It is the largest segment after the taxes in the budget. This fund is used for the financing of public investment acting in a way to prevent lavish expenditure in the economy.

When we look at the expenditure items in the economy in 2009, we can see that current expenditure makes up 60 percent and investment spending makes up 40 percent of the public expenditure (Budget Law, 2009; m.8). This, in a way proves the support of the government for the growth of the economy. Azerbaijan is one of the leading countries that managed to attract foreign direct investment during the short transition period based on the oil industry. This not only solved the foreign exchange problem in the economy but also supported the growth of production.

One of the most important factors that contributed to success of the economy of the Azerbaijan during the crisis period is "conservatism". While integrating into the international financial markets, Azerbaijan has been acting rather slow and careful. The fact that there is a foreign exchange flow into the economy due to oil income makes easier to be conservative in the financial markets.

The second factor can be described as the slow and controlled privatization despite the heavy pressure in the post Soviet period. Especially non-privatization of companies such as State Oil Company and Azerbaijan Airlines was a correct step. Although these companies are seen as inefficient, they are more resistant to the negative effects of the financial crises in the world.

It was previously mentioned that Azerbaijan's economy can easily avoid a short term financial crisis but if faced a longer term more persistent crisis, the foreign exchange reserves may not be helpful enough to support the economy. An impact of a crisis on oil prices can severely damage the economy.

Recommendations to avoid a drastic damage in the Azerbaijani economy considering the global environment can be summarized as follows:

- Continuation of the stability of the value of Manat (Currency of Azerbaijan). Since it followed a relatively stable path for the past ten years, and fluctuation can risk the trustworthiness of the economy.

- Prevention of unnecessary public expenditure. If not achieved, there may exist an inflationist pressure in the economy.

- Support to the non-oil industries of the economy. Currently the industrial sector makes up 60 percent of the GDP and approximately 90-95 percent of the industrial sector is made up of oil industry. This is the inevitable result of the high oil prices but if the oil prices fall in the future, the economy may be severely harmed. Thus, other industries must be also supported by the government.

- Supporting the tourism and other services industries. Although Azerbaijan holds a strong potential in tourism, it remained relatively underdeveloped in the country. There are infrastructural as well as skilled labor problems in this sector. Research should be done to analyze the best cases in the world to promote tourism. It can act as an alternative to the oil industry to bring in foreign exchange.

- Supporting the agricultural industry. Agricultural sector makes up only 5-7 percent of GDP. High production costs, lack of research and development and transportation problems undermine the growth of the agricultural sector in the economy.

Conclusion

Regardless of the dimensions a crisis, whether local or global, the only way to overcome the negative impacts of it is by following rationale political and economic policies. Within this context economic stability as well as political stability, controlled budget expenditures, certain level of conservatism are helpful factors to deal with crises.

Fiscal policy tools, strict controls over public expenditure and foreign debt, prevention of shadow economy together with rationale monetary policies implemented by an independent central bank are the ultimate tools to be used in the economy. Each and every country can follow different methods to overcome the adverse effects of a crisis. Regardless of the development level of the country, each of them rely on different industries, different resources. .

Azerbaijan is one of the least affected countries from the global financial crisis since she follows and implement most of the policies prescribed below. Her economy relies on oil and natural gas. In the pre-crisis period, the government did not count on the highest price level but a more moderate one, established "State Oil Fund", took out lesser loans and carefully controlled the public expenditure. If Azerbaijan managed to establish a health tax income and lesser shadow economy, she can not only stand stronger against a crisis but also secures its place among the developed countries.

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