

A Brief Macroeconomic Analysis of the Impact of Investment Activity on Economic Growth

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The Government's Investment Policy Has a Weak Impact on Economic Growth

It can now be stated with confidence that the government will be unable to achieve the target it set for economic growth in the “Socio-Economic Development [Strategy](#) of the Republic of Azerbaijan for 2022–2026.” The Strategy targeted economic growth in 2026 at 120% of its 2021 level. According to [data from the State Statistical Committee \(SSC\)](#), in 2025 economic growth stood at 112,2% of its 2021 level. This means that, to achieve the target, real economic growth this year must be at least 7,5–8% relative to 2025. However, according to [data from the SSC](#), real economic growth in the country was only 0,8% in the first half of the year. In fact, the slowdown in the economic growth rate began last year: Whereas real growth was 4,2% in 2024, it fell to 1,4% in 2025. During the first five months of this year, there was no economic growth at all. In an [interview with the press](#), Minister of Economy Mikayil Jabbarov cited changes in the implementation schedules of certain public investment projects as the principal reason for the slowdown in economic growth rates. The minister specifically emphasized that the slowdown was not related to private investment. Large-scale infrastructure projects implemented in Azerbaijan in recent years, projects carried out for the reconstruction of territories liberated from occupation, the establishment of industrial parks, and public investment programs create the impression that investment activity in the country is high. In reality, however, the

statistical analyses recently presented to readers by the Baku Research Institute on the [dynamics of foreign direct investment \(FDI\)](#) in the Azerbaijani economy over the past 10 years and on the [dynamics and structure of investment activity](#) as a whole reveal a different picture. The problem is not the low absolute volume of investment in fixed capital. The central issues are: i) the weakening of investment activity in the country; ii) the continued inability of the private sector to become the leading investment force; and iii) the insufficient strengthening of productivity-enhancing components within the investment structure.

One of the most common errors in evaluating investment policy is to draw conclusions solely on the basis of the annual amount of investment. In fact, two countries investing the same amount may achieve different rates of economic growth. The difference is determined by the direction of investment, its technological content, its impact on productivity, and the level of private-sector initiative. Therefore, the question "In which sectors has investment been made?" is just as important as the question "How much has been invested?", and sometimes even more important. This is because economic development is determined by investment's share of GDP, its sectoral distribution, and the extent to which it increases future production capacity.

[Statistical analysis of investment activity](#) in the country shows that, although the annual absolute amount of investment in fixed capital increased from year to year over the past decade, in reality:

- *the real growth rates of investment in fixed capital are unstable*: in five of the past 10 years, the real growth rate of investment in fixed capital was negative; in the other four years (with the exception of 2023), growth rates fluctuated within very narrow bounds;
- *investment intensity has weakened*: investment intensity,

measured by the ratio of annual investment in fixed capital to GDP, declined from 20–26% in 2016–2020 (considered a “normal and sustainable” level) to approximately 16–18% in recent years (that is, to the minimum threshold regarded as “acceptable”).

These are important macroeconomic indicators showing that investment activity in the country has weakened compared with the previous period.

Another important trend in investment in fixed capital is the continuing dominance of public investment:

- *70–75% of investment in the non-oil and gas sector is directly accounted for by the public sector.* In particular, since 2022, against the backdrop of the reconstruction of the liberated Karabakh and East Zangezur regions and large-scale infrastructure projects, the dominance of public investment has again increased sharply;

- *the private sector is withdrawing from industry:* a particularly concerning issue is the dynamics of private investment in non-oil and gas industry. Although private domestic investment directed to industrial sectors increased substantially in 2016–2019 (from AZN 289 million to AZN 2,0 billion), it declined sharply after 2020 (to AZN 408 million in 2024). This indicates serious institutional problems in the formation of domestic private industrial capital capable of driving long-term growth.

It is clear that public investment is essential for the implementation of strategic projects. Nevertheless, international experience shows that private investment is the principal driver of sustainable economic growth.

An [analysis of the dynamics and structure](#) of foreign direct investment (FDI) attracted to the country provides grounds for concluding that the picture is concerning here as well:

- *Over the past decade, the majority of FDI attracted to the country (up to 80%) has continued to be directed to the oil and gas sector;*
- *In the non-oil sector, both the volume and intensity of such investment have declined significantly: The ratio of foreign investment in fixed capital in the non-oil sector to non-oil GDP fell from 6,9% to 0,7%;*
- *The volume of net FDI inflows into the country has declined sharply and was even negative in some years. This is a serious signal that investment income flowing out of the country (repatriated income) exceeded new foreign capital inflows.*

These findings indicate that the country's non-oil economy is still not sufficiently attractive to international investors. This is not merely a financial issue, but also a signal concerning the institutional environment, competition, legal safeguards, and market prospects.

Finally, the most serious problem is found in the structure of investment, that is, its quality and productivity. In recent years, while investment directed to services and residential construction has increased rapidly, investment directed to goods-producing sectors has hardly increased. Yet economic theory and international experience show that the main sources of long-term economic growth are the expansion of productive capacity, technological upgrading, and higher productivity. Although residential construction and the service sector stimulate economic activity, their impact on productivity is limited.

According to economic theory, the general chain through which investment affects economic growth is as follows:

Capital investment increases

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Capital accumulation increases

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Capital deepening (capital per worker) increases

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Technological upgrading occurs

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Productivity (total factor productivity – TFP) increases

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Long-term sustainable growth emerges.

However, an important point to note in this chain is that not every increase in capital leads to higher productivity. In other words, high investment does not always produce high productivity. Here, the “quality of investment” plays a crucial role. For investment to generate high productivity, it must be effectively converted into capital accumulation (especially fixed capital accumulation) and technological upgrading. Thus, the “volume of investment” is not sufficient: The way its structure is allocated determines productivity and the quality of growth.

A question may arise: what should an efficient investment structure look like? The structure of annual investment is considered efficient when it:

1. *Generates productivity growth* – capital investment increases capital per worker (i.e., K/L rises) and technology is upgraded (TFP rises);
2. *Ensures long-term growth* – not only construction, but also more productive technological assets increase;
3. *Allocates resources optimally* – capital does not become “trapped” in low-productivity sectors (i.e., there is no “misallocation”), but is directed toward sectors that generate higher value added;
4. *Creates cyclical stability* – it produces not only a short-term increase in demand, but also adaptation to structural changes in the economy, that is, to the challenges of the period.

In the experience of developed and successfully developing countries, the following balanced composition is observed as a typical “efficient structure” of capital investment:

Direction	Role	Risk	Productivity effect	Appropriate share (range)	Rationale
Infrastructure	Creates a foundation	High public-sector burden	Indirect but broad	20–30%	Foundation and network effects
Production (industry)	Real sector	Medium	Direct and high	25–40%	Main source of productivity
Technology and innovation (R&D)	Qualitative leap	High risk	Very high	10–20%	Long-term growth
Real estate/housing construction	Short-term stimulus	Risk of a “capital bubble”	Low	15–20%	Social and short-term effect

Our research on Azerbaijan shows that the structure of capital investment is not oriented toward production and technology, but is characterized by physical expansion:

- public investment accounts for a high share;
- infrastructure and construction occupy a dominant position;
- manufacturing is at a low level (weak);
- the share of technology/R&D is very low (critically weak);
- even in the past two years, the share of inventories (warehouse stocks, etc.) in gross capital formation has increased.

The productivity effect of such a structure of capital investment is limited.

It is clear that the impact of investment on productivity does not materialize immediately. In fact, rigorous empirical research is needed to evaluate the productivity of capital investment. Within the scope of this small-scale study, we

used simpler methods to determine the correlation between capital investment and productivity in Azerbaijan. Although the results obtained are not fully academic in nature, they may be significant for assessing the overall situation.

The approximate results of the *lag model* we used show that, over the past 10 years, the correlation between capital investment and productivity in the country:

- is negative in the same year: $-0,12$;
- a weak positive effect emerges after one year: $0,18$;
- the maximum positive effect emerges after two years: $0,38$;
- after three years, the effect weakens because of depreciation and technological obsolescence: $0,26$.

This result is theoretically fully consistent with endogenous growth models in economics: investment generates productivity, but in Azerbaijan this effect occurs with a two-year lag and at medium-low strength ($0,36$). For comparison, in developed countries and countries on a sustained development path, this indicator is in the range of $0,6-0,8$.

Conclusion

Thus, the central problem for Azerbaijan can be summarized as follows: Although the structure of capital investment generates expansion, it fails to generate sufficient productivity. This empirically demonstrates the phenomena of “inefficient allocation of capital” (misallocation of capital) and “low-quality investment” (construction-oriented projects with low technological intensity).

As the purpose of this study is to present the current situation in the field of investment, we do not offer policy recommendations in the conclusion. We leave the preparation of substantiated policy recommendations to future research.