

## INCLUSIVE AND SUSTAINABLE GROWTH ASSESSMENT<sup>1</sup>

### A. Recent Growth, Poverty, Inequality, and Environmental Dynamics

1. Azerbaijan has undergone significant economic transformation since independence in 1991 and has quickly transformed itself into a middle-income country: its gross national income per capita (Atlas method) grew from \$610 in 2000 to an annual average of \$5,850 during 2008–2016 and the poverty rate was 4.9% in 2015. Since 2010, Azerbaijan has been categorized as a high human development country.<sup>2</sup> In 2018, the country ranked third out of 74 developing countries in inclusive development.<sup>3</sup> This success was fueled by revenues from oil exports. The economy still—though decreasingly—depends on the extractive industries, making the development attainments vulnerable to the volatility of oil production and prices.

2. **Economic growth.** During 2013–2017, gross domestic product (GDP) growth moderated to an annual average of 1.4% from an average of 5.5% during 2008–2012 (Figure 1). This was largely the effect of the contraction in the country's hydrocarbon subsector that contributed one-third of the GDP and made up more than 90% of the country's exports in 2013–2017.<sup>4</sup> The contraction was a result of the oil price drop during 2014–2015 and declining oil production during 2014–2017. The country also felt the economic slowdown in its oil-rich neighboring trading partners, as remittances, which go mostly to support the rural population, declined by one-third. From near-zero growth in 2017, the economy grew by 1.4% in 2018 and is forecast to grow by 2.5% in 2019, driven by the non-oil sector's growth, reviving oil prices, return to growth in key regional trading partners, and the start of production at the Shah Deniz II gas field.<sup>5</sup>

3. **Supply side.** Industry is the predominant sector in the economy, contributing on average about 51% of GDP during 2013–2017, followed by the services sector (36% of GDP) and agriculture (5.6% of GDP).<sup>6</sup> The mining industry (90% is oil and gas extraction) contributes about 80% of total industrial output and more than 50% of gross capital formation, pointing to limited diversification of the economy. Construction, which is mainly sourced from public investments, is the second largest industry after mining. During 2008–2012, there was a rough parity between the oil and non-oil sectors as a share of GDP. During 2013–2017, the non-oil sector rose to about 60% of GDP, reflecting the effect of the increased public investment (prior to the oil shock), the oil shock in 2014–2016, and progress in the diversification of the economy.

4. **Expenditure side.** Private and government consumption were major drivers of growth during 2013–2017. The share of investment in GDP increased from about 20% during 2008–2012 to more than 25% during 2013–2016, mainly on the back of increasing public investment making up 70% of total investment. Oil revenues—through transfers from the State Oil Fund of Azerbaijan (SOFAZ) to the budget—contributed to a significant rise of government expenditures, thereby fueling public investment. SOFAZ's contribution to the state budget was 9.7% in 2008, peaked at

<sup>1</sup> Based on Asian Development Bank (ADB). Forthcoming. *Azerbaijan: Country Diagnostic Study*. Manila.

<sup>2</sup> United Nations Development Programme. [Human Development Reports](#).

<sup>3</sup> World Economic Forum. 2018. *The Inclusive Growth and Development Report 2018*. Geneva.

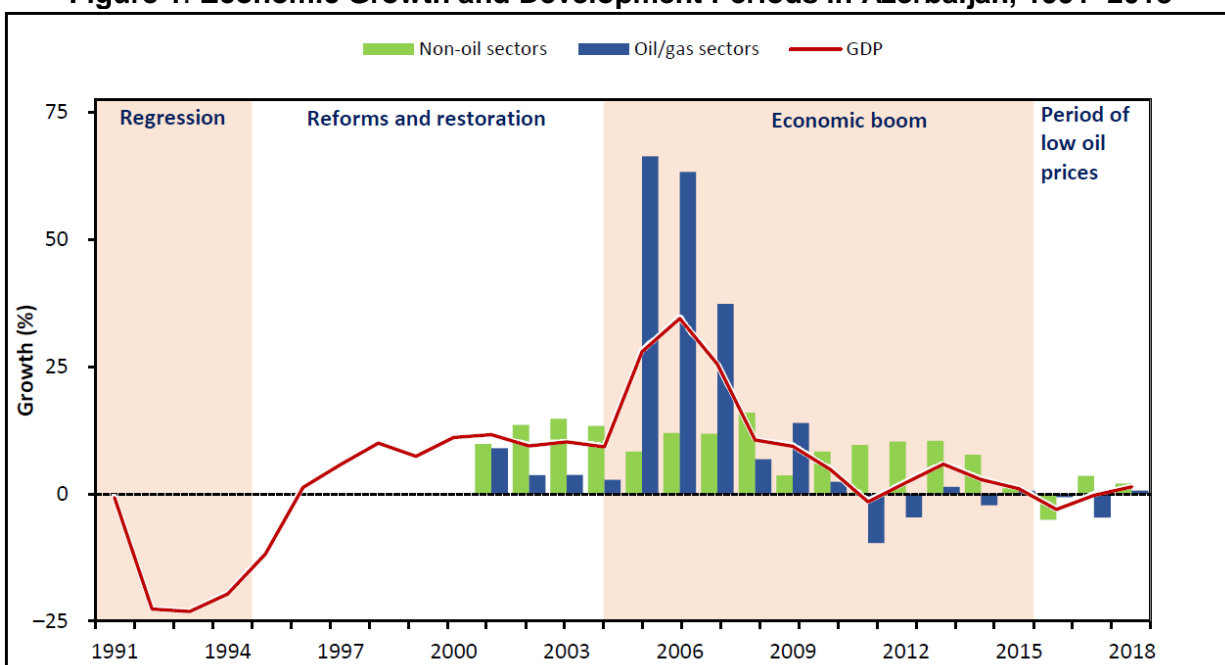
<sup>4</sup> The overall volume of the country's hydrocarbon reserves is an estimated 7 trillion barrels of oil equivalent. Natural gas reserves are estimated at 41 trillion cubic feet ([BP Statistical Review of World Energy 2017](#)). Azerbaijan's largest oil field is Azeri–Chirag–Deepwater Gunashli. In October 2017, the production sharing agreement for this field was extended until 2049 and it increased the share of the State Oil Company of Azerbaijan Republic to 25%.

<sup>5</sup> The Shah Deniz II gas field (one of the largest in the world) and South Caucasus Pipeline Expansion were officially inaugurated in May 2018. Development of the Shah Deniz II gas field is part of the South Gas Corridor project set to almost triple Azerbaijan's annual gas production capacity. Another part of the South Gas Corridor project, the Trans-Anatolian Pipeline, which will carry gas from Azerbaijan to Europe, became operational in June 2018.

<sup>6</sup> Share to GDP does not add up to 100% because of net taxes on production and imports.

58.2% in 2013, but subsequently declined gradually, in part because of declining oil prices.<sup>7</sup> In 2018–2019, SOFAZ transfers are expected to make up around 48% of the state budget revenues. Public investment as a share of state budget expenditure rose from 14.4% in 2017 to 22% in 2018, and is expected to make up 35% in 2019. Without SOFAZ's transfers to the state budget, the fiscal deficit, which averaged –1.7% of GDP during 2015–2017, would have averaged –33% of GDP.<sup>8</sup> During 2015–2017, government expenditure in Azerbaijan averaged 36.7% of GDP against the average of 27.3% of GDP for Caucasus and Central Asian countries, indicating the government's predominant role in the economy.

**Figure 1: Economic Growth and Development Periods in Azerbaijan, 1991–2018**



GDP = gross domestic product.

Note: Data on oil and non-oil sectors is available from 2000 only. Development periods are from the Strategic Road Map on National Economy Perspective approved by Presidential Decree No. 1138 on 6 December 2016.

Source: Asian Development Bank staff estimates based on databases of Azerbaijan's State Statistics Committee and United Nations Statistical Division.

5. **Prices.** The Azerbaijan manat lost about 115% of its value against the US dollar during 2015–2016, reflecting decreasing oil revenues. Since March 2017, the exchange rate has been stable at about AZN1.7 = \$1.0. Largely because of the lagged effect of the devaluation during 2015–2016 (and a rise in fuel and electricity tariffs), inflation accelerated from 4.0% in 2015 to 12.4% in 2016 and to 12.9% in 2017. Inflation plunged to 2.3% in 2018 as the devaluation effect was over and the exchange rate was stable. Still, maintaining price stability will remain important for inclusive growth, requiring continued effective coordination of monetary and fiscal policies.

<sup>7</sup> SOFAZ, a sovereign wealth fund, was established in December 1999. Its aim is to accumulate and efficiently manage the country's energy-related earnings for future generations, support macroeconomic stability and fiscal discipline, and decrease the country's dependence on oil revenues through stimulating development of the non-oil sector. At the end of 2018, SOFAZ had assets of \$38.5 billion, or 82% of 2018 GDP in US dollar terms.

<sup>8</sup> International Monetary Fund (IMF). 2018. *Regional Economic Outlook: Middle East and Central Asia. – Statistical Appendix*. Washington, DC.

6. **Government debt.** Two waves of sharp devaluation of the Azerbaijan manat against the United States (US) dollar in 2015, large state spending on the Shah Deniz II gas field, and the rescue of a major state-owned bank almost tripled the government foreign debt from 8.6% of GDP in 2014 to 22.8% of GDP in 2017 (it dropped to 19.0% of GDP in 2018). This ratio is expected to gradually decrease to 12% of GDP by 2025.<sup>9</sup> The International Monetary Fund estimates that the total government gross debt surged from 35.0% of GDP in 2015 to 54.7% in 2017, and would stay at about 56% of GDP during 2019–2023.<sup>10</sup>

7. **Current account.** With the recovery in oil prices in 2017, the current account showed a surplus of 4.1% after a deficit of 3.6% of GDP in 2016. Exports grew by 14.7%, reversing a 15.2% drop in 2016, on the back of growth of oil exports and a 27.0% growth (year-over-year) of non-oil exports because of external demand, mainly from Russia. Imports grew by 0.4%, versus a 7.8% decline in 2016, as lower oil sector imports offset a rise in other imports. Higher oil prices contributed to an appreciation of the real effective exchange rate in 2017, putting pressure on non-oil exports and possibly having a future adverse effect on employment if the non-traded sectors (e.g., services) fail to absorb the labor freed from the shrinking tradable sectors.<sup>11</sup>

8. **Poverty reduction.** During 2001–2013, economic growth was largely inclusive because of the substantial poverty reduction, the decline in regional poverty disparities, the rise in rural employment rates, and the broad-based impact on household consumption in urban and rural areas.<sup>12</sup> In 2001, 49.0% of the population lived below the national poverty line; by 2013 this figure had dropped to just 5.3%. Extreme poverty and hunger were eradicated in 2007.<sup>13</sup> Poverty continued to fall in 2014 to 5.0% and further to 4.9% in 2015 (measured at the national poverty line).<sup>14</sup> This is consistent with incremental growth of Azerbaijan's Human Development Index, which improved from 0.745 in 2012 to 0.759 in 2015.<sup>15</sup> High inflation during 2016–2017 adversely affected household incomes, reduced the real purchasing power, and contributed to a rise in the poverty rate to 5.9% in 2016. In 2017, the increase (year-over-year) in the minimal cost of living by 13.9% and nominal average wages by 5.7% was insufficient to compensate for higher prices. Given this and despite the return to growth, the poverty level only decreased to 5.4%, in 2017.

9. **Poverty vulnerability.** Many households remain vulnerable to falling back into poverty: the economic recession associated with the oil price shock led to payroll deductions or lay-offs in 2015–2016. Poverty vulnerability is also high because of high out-of-pocket health payments, which stood at 79% of total health expenditure in 2016, and high incidence of catastrophic expenditures of households on health care (in 2015, 23% of households allocated more than 20%

<sup>9</sup> Public foreign debt is government and government-guaranteed debt. Public foreign debt represents about 95% of the total public debt. Order of the President of Azerbaijan on Approval of the Medium and Long-term Strategy for Public Debt Management in the Republic of Azerbaijan (no. 424 dated 24 August 2018).

<sup>10</sup> During 2000–2014, the IMF reports that total government gross debt averaged 15.2% of GDP. The difference in the estimates of the government and the IMF are attributable to the different methodology of estimating public debt arising from contingent external liabilities of several state-owned enterprises (SOEs).

<sup>11</sup> The correlation coefficient between the real effective exchange rate (REER) and the non-oil exports is estimated at 0.85, with a 1-year lag between the change in REER and the change in non-oil exports (H. Onder. 2013. *Azerbaijan: Inclusive Growth in a Resource-Rich Country*. Washington, DC: World Bank).

<sup>12</sup> ADB. 2014. *Country Partnership Strategy, 2014–2018: Azerbaijan*. Manila.

<sup>13</sup> Since 2007, the extreme poverty rate (<0.1%) and the share of underweight children aged under 5 years (0.6%) in the country have been at a negligible level (Government of Azerbaijan. 2017. *Azerbaijan – 2030: From the Millennium Development Goals Towards the Sustainable Development Goals. Voluntary National Review 2017*. Baku).

<sup>14</sup> The national poverty line equals the living minimum adopted annually as part of the state budget. In 2017, the monthly living minimum was AZN155, in 2018 AZN173, and in 2019 AZN180. In February 2019, the government raised the monthly minimum wage from AZN130 to AZN180, the level of the living minimum for 2019.

<sup>15</sup> This development is particularly noteworthy considering that around 1 million people in Azerbaijan are internally displaced people because of the Nagorno–Karabakh conflict.

of their total consumption to health, pushing households into poverty).<sup>16</sup> Low-wage rural people working in agriculture are particularly vulnerable to falling into poverty, as are the internally displaced people who are less integrated in the economy and labor market than the rest of the population. These households continue to experience a decline in their real purchasing power, especially for imported consumption items, undermining future poverty reduction.<sup>17</sup> The government is committed to implement the “leaving no-one behind” principle of the Sustainable Development Goals (SDGs) by strengthening the integration of the vulnerable groups in the social protection system and the labor market.

10. **Social protection system.** During 2014–2017, state budget spending on social protection averaged 11.8% of the budget; social security spending rose from an average of 0.2% of the budget in 2014–2016 to 1.6% in 2017. About 2.8 million people (28.3% of the country's population) receive various social payments from the state social protection system. The system of social transfers reaches more than 90.1% of the targeted population. More than 7% of the country's population receive monthly or one-off social benefits as a poverty prevention measure. The main pro-poor social transfers are implemented through the targeted social assistance (TSA) program, the coverage of which rose from 415,000 people at the beginning of 2015 to 558,000 in 2017 (5.6% of the population). At the beginning of 2018, the TSA's coverage went down to 327,000 people.<sup>18</sup> Social assistance is key for internally displaced people; nearly 75% report social assistance as their main source of income.

11. **Inequality.** The oil-fueled economic boom during 2003–2014 helped reduce inequality: the Gini index steadily decreased from 0.341 in 2003 to 0.227 in 2014 (the last year when Gini index was reported). The oil price shock seems to have affected the positive equality dynamic, as the share of the poorest quintile in national income decreased from 17.3% in 2008 to 15.4% in 2015.<sup>19</sup> Inequality also seems to be taking a toll on the human development achievements: the inequality-related loss of the country's Human Development Index is estimated at 13%, with the largest contributor being the inequality in life expectancy at birth.<sup>20</sup> The child mortality rate in families with low income is much higher than in other income groups.<sup>21</sup> Urban–rural education inequality is prominent because of the small number and lower capacity of schools and weaker teaching standards in rural areas. Children from rural households also have much lower attendance rates than children from urban areas.

12. **Regional disparity.** Baku, the capital of Azerbaijan, leads other regions in major development indicators. With a higher concentration of the population (22.9% in 2016) and being home for 33.6% of the businesses registered in the country, 71.8% of total national output was generated in Baku in 2016. Urbanization has increased because of increasing employment opportunities in cities, particularly in Baku. In 2016, Baku received 74.5% of total capital investments. Baku hosts major industrial complexes, such as petrochemical refineries and metallurgy, shipyard, machinery, and textile complexes. To raise the profile of other parts of the

<sup>16</sup> Bonilla-Chacin, M. E., Afandiyeva, G., and Suaya, A. 2018. Challenges on the Path to Universal Health Coverage: The Experience of Azerbaijan. *Universal Health Care Coverage Series 28*. Washington, DC: World Bank.

<sup>17</sup> World Bank. 2017. *ECA Economic Update October 2017: Migration and Mobility*. Washington, DC.

<sup>18</sup> Law of the Republic of Azerbaijan "On Targeted State Social Assistance" was approved on October 21st, 2005. TSA implementation started in 2006. On average, 50.6% of TSA recipients are men and 49.4% are women, while 50.0% of those receiving TSA are children under 18. The government intends to raise TSA effectiveness by involving eligible beneficiaries in the self-employment program to gradually phase out their dependence on TSA.

<sup>19</sup> [MDG indicators of the Republic of Azerbaijan](#).

<sup>20</sup> United Nations Development Programme. 2016. *Human Development Report*. New York. Briefing Note for Azerbaijan.

<sup>21</sup> Scholz, G. 2017. *From MDGs to SDGs in Azerbaijan: The Way to Sustainability and Inclusion*. Baku: Center for Economic and Social Development.

country, the government has implemented three state programs on socioeconomic development of regions. The programs promote investments in the regions to establish industrial facilities, increase agricultural input, and produce goods with comparative advantage.

13. **Employment.** Since 2010, Azerbaijan's unemployment rate has been low at an average of 5.0%, though many jobs are temporary. However, most Azerbaijanis work in low-wage and low-productivity sectors. The oil industry, which generates around one-third of GDP and is well-paid, employs only 1% of the total labor force. On the other hand, agriculture employs almost 37.0% of total labor but contributes only 5.6% to GDP. In 2016, youth unemployment was 13.1%, with the rate for men being 11.3% and for women 15.1%. Underemployment among youth was 28% in 2016. Almost 25% of the labor force is concentrated in Baku. In 2016, there were 11,086 job vacancies, 22 times lower than the number of unemployed. Young people (aged 15–29) make up 49.8% of all unemployed, and 27.9% of them have higher, college, and vocational education, which indicates a skills mismatch in the labor market. Azerbaijan falls in the category of countries that have the highest percentage of youth not in education, employment, or training in the 15–25 year cohort of population (footnote 22).

14. **Labor skills and education.** An inadequately educated workforce is a top constraint for doing business in Azerbaijan. The country ranks 54 (out of 130 countries; Kazakhstan ranks 29 and Russia 28) in its current human capital with quality of education system, workplace learning, and lack of skilled labor being the most lagging dimensions.<sup>22</sup> In terms of its future human capital, Azerbaijan ranks 69 (out of 157 countries; Kazakhstan ranks 31 and Georgia 61) with the quality of schooling adversely affecting the productivity of the next generation of workers.<sup>23</sup> While primary and secondary enrollment rates are high, pre-primary and tertiary enrollment rates are relatively low.<sup>24</sup> In 2014–2016, Azerbaijan's tertiary education enrollment ratio averaged 25%, against 46% in Georgia and 47% in Kazakhstan. Many graduates lack job-specific and technical skills as well as cognitive and socio-behavioral skills like problem solving, communication, or teamwork. Availability of skilled workers is becoming a growing challenge for foreign companies in Azerbaijan.<sup>25</sup> The government spending on education (as a share of the non-oil GDP) decreased from 6.2% in 2010 to 4.3% in 2017, while the number of students increased.

15. **Gender equality.** Women seem to benefit less than men from the steadily improving overall human development: during 2000–2017, Azerbaijan's Gender Development Index (GDI) remained virtually the same despite the high economic growth (GDI was 0.951 in 2000 and 0.949 in 2017). During the 2016/17 academic year, 46% of general secondary education students were female and 54% were male; the lower secondary school completion rate for girls dropped from 90% in 2007 to 86% in 2015. The country's gender gap score of 0.676 is the second lowest of the 26 countries in Eastern Europe and Central Asia.<sup>26</sup> In 2016, the women's unemployment rate (6%) was higher than that for men (4%). Overall women earn only 48% of what men earn in the labor market, and within similar positions women earn only 73% of what men earn. Since joining the United Nations Convention on the Elimination of All Forms of Discrimination Against Women in 1995, Azerbaijan has been progressively improving its legislation on gender equality. The State

<sup>22</sup> World Economic Forum. 2015. *Human Capital Report 2015*. Geneva; World Economic Forum. 2016. *Human Capital Report 2016*. Geneva.

<sup>23</sup> <http://www.worldbank.org/en/publication/human-capital>.

<sup>24</sup> The government's reforms helped increase the share of 5-year-old children's coverage by preschool education courses organized in secondary schools from 55% in the 2016/17 school year to 75% in the 2018/19 school year. This share is expected to reach 90% by 2020.

<sup>25</sup> German-Azerbaijani Chamber of Commerce. 2018. *EU Business Climate Report: Azerbaijan 2018*. Baku.

<sup>26</sup> World Economic Forum. 2017. *Global Gender Gap Report*. Geneva.

Committee for Family, Women and Children Affairs is the government's gender equality focal agency; all government agencies are supposed have gender-focal staff.<sup>27</sup>

**16. Provision of water supply and sanitation.** Some 95% of the population in Baku and about 83% of those living in secondary cities and towns are connected to piped water supply. About 55% of Azerbaijan's population has access to improved sanitation facilities. Access to sanitation facilities in urban areas is higher (73%) than in rural areas (36%). In many schools the sanitation facilities are insufficient; there is a lack of separate toilets and washing facilities for girls. The sewerage network in Baku serves about 78% of the population compared to only about 32% in other urban areas, and only a minor portion of the sewage undergoes treatment before disposal. In recognition of the challenge of access to water, the government initiated a national program to reconstruct the water and sewerage systems in almost all secondary cities and provide customers with 24-hour pressurized water supply and sanitation.

**17. Access to electricity and gas.** Government investment has improved power generation and transmission facilities and there is 100% access to electricity. The time entrepreneurs need to get connected to the power supply grid was reduced from 69 days in 2017 to 41 days in 2018. Despite these improvements, the country ranks 74 (out of 190 countries) in the "getting electricity" category of doing business.<sup>28</sup> Azerbaijan's per capita power consumption is less than one-third of the World Bank's Europe and Central Asia average, while transmission and distribution losses are more than double the Europe and Central Asia average.<sup>29</sup> The lack of reliable power undermines the growth of businesses and living conditions of households. The efficiency of power generation is below the design capacity: in 2018 the average efficiency of thermal power generation was about 44%. Most of the power transmission and distribution facilities in districts have been in operation for more than 30 years. The equipment has reached the end of its service life and has become unreliable, with risks of frequent outages and increasing losses.<sup>30</sup> Though the country's gasification level was 93% in 2017 (with 95% target in 2018), the gas distribution networks in several regions are up to 60 years old and there are huge losses because of underground pipe leakages, leading to financial losses, and environmental and health issues. Many gas compressor stations have outlived their working life and are overdue for replacement.

**18. Transport infrastructure.** Azerbaijan's transport infrastructure scores well: in the quality of overall infrastructure it ranks 26 (out of 137 countries).<sup>31</sup> Unlike its regional comparators, infrastructure is not among the most problematic constraints to doing business. This is largely because of the significant public infrastructure investment during 2010–2014. In Azerbaijan, more than 80% of passengers and more than 60% of goods are transported by road. The road freight turnover increased from 7.5 billion ton-kilometers in 2005 to 16.8 billion ton-kilometers in 2016. The vehicle fleet increased from 0.98 million in 2010 to 1.30 million in 2016. In Baku, the car fleet has quadrupled since the early 1990s, with 200 vehicles per 1,000 inhabitants. In 2018, Azerbaijan Railway transported 13.9 million tons of freight and 2.8 million passengers, making the railway a vital mode of transport. The diversification of the economy and the realization of the

<sup>27</sup> The country's gender legislation includes the Law on State Guarantees of Equal Rights of Women and Men adopted in 2006, and the national policy statement and action plan on gender equality for 2000–2005. Gender equality is also mainstreamed in the strategic road maps adopted by the Presidential Decree No. 1138 on 6 December 2016.

<sup>28</sup> The country ranks low in dealing with construction permits (rank 61) and in trading across borders (84). Source: <http://www.doingbusiness.org/data/exploreeconomies/azerbaijan>.

<sup>29</sup> World Bank. 2015. *Azerbaijan: Systemic Country Diagnostic*. Washington, DC.

<sup>30</sup> A similar situation exists in gas distribution. Despite the 90% coverage of the country's territory, in 2014–2018 the losses in the main gas pipelines have averaged 10% and in the retail gas distribution networks 23%.

<sup>31</sup> World Economic Forum. 2017. *The Global Competitiveness Report 2017–2018*. Geneva.

regional economic hub aspiration will depend on the continuous expansion (including at rural and community levels) and proper maintenance of the country's transport network.

**19. Millennium Development Goals.** Azerbaijan achieved most of the Millennium Development Goal targets before 2015. Significant progress was achieved in such indicators as (i) net enrolment ratio in primary education (84.2% in 2000 to 99.8% in 2015), (ii) representation of women in parliament (10.7% in 2000 to 16.8% in 2015), (iii) the level of female unemployment (reduced from 12.7% in 2000 to 5.9% in 2015), (iv) infant mortality rate per 1,000 live births (16.4 in 2000 to 11.0 in 2015), (v) under 5 mortality rate per 1,000 live births (30.5 in 2000 to 13.3 in 2015), and (vi) maternal mortality ratio per 100,000 live births (37.6 in 2000 to 14.4 in 2015). At the same time the country's health outcomes are low compared to most European countries in indicators such as (i) infant, child, and maternal mortality; (ii) prevalence of stunting in children under 5 years old; (iii) drug-resistant tuberculosis; and (iv) proportion of married or in-union women of reproductive age who have access to modern contraception methods. The risk of falling into poverty because of health expenditures is high: in 2015, 16% of households spent more than 30% of their total expenditure on health.

**20. Sustainable Development Goals.** Azerbaijan endorsed the 2030 Agenda for Sustainable Development in 2015 and has initiated nationalization of the SDGs. In October 2016 the government established the National Coordination Council for Sustainable Development (supported by interagency working groups on economic development and decent employment, social issues, environment, and monitoring and evaluation) to coordinate implementation of the SDG agenda by government agencies. In February 2019, the council approved 88 targets (out of 169) and 119 indicators (out of 242) that are relevant and a priority for Azerbaijan. Azerbaijan conducted its first voluntary national review of implementation of the 2030 Agenda for Sustainable Development in 2017. The next review is scheduled in 2019.

**21. Oil-related pollution and solid waste.** Cognizant of the need to promote environmental sustainability given the oil production impact, the government has successfully implemented projects to clean the oil-polluted areas in the Absheron Peninsula. There are, however, still contaminated areas of land that cannot be used for settlements or farming. Municipal solid waste generated in Azerbaijan is not disposed of in accordance with internationally accepted practices. The waste is either burned or illegally dumped in piles and permanently left uncovered and exposed, potentially creating serious health hazards. Decomposing waste produces gases with toxic and carcinogenic compounds, and this adds to the dust in the air. The regional administrations that are responsible for collecting, treating, and disposing of waste lack technical expertise to operate comprehensive solid-waste management systems and depend heavily on central government transfers. To address these issues, in 2018 the government approved the National Strategy for the Improvement of Solid Waste Management in Azerbaijan for 2018–2022, envisaging a set of institutional, tariff, public health, and infrastructure actions.<sup>32</sup>

**22. Climate change and disaster risk.** Azerbaijan ratified the United Nations Framework Convention on Climate Change's Paris Agreement in January 2017 with an associated nationally determined contribution that included a target of 35% reduction in the level of greenhouse gas emissions by 2030 (relative to 1990 baseline).<sup>33</sup> In November 2017, a value-added tax exemption was introduced for the import of vehicles operated solely by electric engines.<sup>34</sup> The country's

<sup>32</sup> Presidential Order No. 637 on 1 November 2018.

<sup>33</sup> The country is also party to the 1997 Kyoto Protocol and the 2003 Framework Convention for the Protection of the Marine Environment of the Caspian Sea.

<sup>34</sup> Since 1 April 2014, Azerbaijan has applied the Euro-4 environmental standard to hazardous substances emitted by motor vehicles. The use of small motor vehicles is promoted through lower excise rates and insurance premiums on



current annual per capita carbon dioxide emissions of approximately 7 tons of carbon dioxide are roughly in line with the global average.<sup>35</sup> A 1.0°–1.5° Celsius change increase in annual mean temperature and up to 10% increase in annual precipitation is expected by 2050 relative to 1995 levels. Among the key sectors likely to be impacted by climate change are coastal resources and infrastructure, water resources, forestry, agriculture, and health. Overall, Azerbaijan ranks 78th highest globally (out of 180 countries) and fourth highest within the Central and West Asia region (out of 10 countries) with respect to its resilience to expected future climate change impacts.<sup>36</sup> Azerbaijan is a flood-prone country, especially in the low-lying areas below sea level. Factors which contribute to the flooding are the overflowing of the Kur and Araz Rivers because of increased precipitation. Risk of disasters also increases because of land degradation and erosion arising from agricultural overuse, land conversion, forest destruction, and improper irrigation techniques. Desertification issues are expected to be exacerbated by climate change.<sup>37</sup>

**23. Doing business: reforms and constraints.** Azerbaijan has been gradually improving its ranking in global surveys related to the business environment. In the World Bank's 2019 Doing Business ranking, the country managed to jump 32 places over the previous year because of important institutional reforms, such as (i) opening a single window in the country's capital for dealing with construction permits (reducing the time to obtain a building permit by 80 days and the cost by about \$7,500), (ii) introducing a one-stop shop for connecting to the electricity grid, (iii) opening the country's first-ever private credit bureau in March 2018, and (iv) establishing the Collateral Registry of Movable Property. Other reforms with significant potential impact on doing business are establishment of (i) the Mortgage and Credit Guarantee Fund to ease small and medium-size enterprise (SME) access to bank finance in September 2017; (ii) the Small and Medium Business Development Agency (SMBDA) in December 2017 to enhance provision of public services to SMEs, (iii) the Food Safety Agency in January 2018 to uphold quality standards and thus improve agricultural exports potential, and (iv) a broadened range of services offered by the Azerbaijan Service and Assessment Network (ASAN) (e.g., issuance of energy-related permits and implementation of state policy on e-government). The institutional capacities of these new agencies need strengthening to raise their effectiveness. However, corruption, access to finance, taxation (rate and regulations), inadequate workforce, and infrastructure have been persistently among the top five most problematic factors for doing business in Azerbaijan.<sup>38</sup>

**24. Anticorruption measures.** Since 1 November 2015 the government has suspended all inspections related to entrepreneurial activities by state agencies. The number of inspections dropped from about 60,000 in 2015 to only 127 in 2016–2017 (excluding tax inspections). The moratorium on business inspections has been extended to 2021. In 2016, the Board of Appeals was introduced within ministries to create a dispute resolution mechanism for addressing private sector complaints. In 2016, Azerbaijan also simplified licensing requirements. The provision of business licenses by the Ministry of Economy through the single window at ASAN centers has increased transparency, accelerated the process, and reduced costs of obtaining licenses.<sup>39</sup>

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such vehicles. Other measures to reduce gas emissions in transport include introduction of the Intelligent Transport Management System, replacing small cars for passenger transportation with large-capacity buses, and the launch of modern high-speed electric trains on the Baku–Sumgayit and Baku–Ganja routes.

<sup>35</sup> CAIT Climate Data Explorer. 2017. Country Greenhouse Gas Emissions. Washington, DC: World Resources Institute. Available online at: <http://cait.wri.org> (accessed 14 June 2018).

<sup>36</sup> Notre Dame Global Adaptation Index. It illustrates the comparative ability of countries to undertake adaptive actions to increase their resilience to climate change.

<sup>37</sup> ADB. 2017. *Economics of Climate Change Mitigation in Central and West Asia*. Manila.

<sup>38</sup> World Economic Forum's Global Competitiveness Reports during 2012–2018.

<sup>39</sup> ASAN is a government-operated network of 11 mobile and permanent service points intended to streamline public service delivery with reported 98% user satisfaction. In January 2017 ASAN introduced an e-visa portal which simplifies and substantially shortens the time for issuing visas to foreigners, including business travelers.



Moreover, the number of licensed activities decreased from 59 to 29. Important customs reforms were implemented: the Customs Code was amended, an e-declaration system was introduced, and certain customs services have been channeled through the “ASAN pay” portal since the beginning of 2017. Customs clearance procedures became more efficient and transparent, and corruption cases at the customs points have been reduced. The inspections, licensing, and customs reforms have contributed to a reduced perception of corruption.<sup>40</sup>

25. **Access to finance.** Overall, financial intermediation in the country is low: the ratio of broad money to GDP (a broad intermediation measure) declined from 39.2% in 2015 to 32.4% in 2017 because of the tightened monetary policy. Banks dominate the finance sector: during 2014–2017 they provided about 97% of the sector’s credit to the economy. Because of the sharp local currency devaluation and weak governance, the banking industry has been in difficulties since 2015. The share of nonperforming loans (NPLs) increased from 5.3% in December 2014 to 12.2% in December 2018 (net of bad loans of the International Bank of Azerbaijan transferred to Aqrarkredit).<sup>41</sup> Given the banking industry’s distress, credit to the economy declined sharply by 24% in 2016 and by a further 28% in 2017. In 2018, the credit to the economy showed a modest growth of 1.4%. To resolve banking industry challenges in the short term and to improve coordination of the macroeconomic, fiscal, and monetary policies, the government established the Financial Stability Council chaired by the Prime Minister. In 2016, the government established the Financial Market Supervision Authority as a single finance sector regulator, while the Central Bank was mandated to conduct monetary policy. To strengthen the support to the non-oil sector, in August 2018 the government established the Azerbaijan Entrepreneurship Development Fund (a public legal agency).<sup>42</sup> On 28 February 2019, the President of Azerbaijan issued a decree on resolving problem loans of individual borrowers that is expected to improve the banks’ asset quality, enhance the debt service capacity of individual borrowers, and support new lending by banks.<sup>43</sup>

26. **Economic transformation.** Azerbaijan’s economy was relatively broadly based in the early 1990s with more than 50 products with revealed comparative advantage in 10 product groups. In 2016, the country had less than 25 revealed comparative advantage products in only four product groups.<sup>44</sup> Though the share of manufacturing has picked up since 2010, it remains closely linked to the oil economy: production of value-added hydrocarbon products accounts for 28.0% of total manufacturing output. Manufacturing has not been able to drive growth and generate employment. Agriculture was around 16.0% of GDP in 2000 but fell to 5.6% in 2017. There has been a visible change in the country’s export composition: from raw cotton being the major export product (41% of total exports) in 1995 to crude oil (76% of total exports) in 2016.<sup>45</sup>

<sup>40</sup> A survey by the European Bank for Reconstruction and Development in 2016 showed that 59% of respondents think that there was less corruption in 2016 than in the 4 years before.

<sup>41</sup> Source: Central Bank of Azerbaijan. According to a rating agency, reportedly performing but restructured loans are estimated to make up a further 25% of gross loans. Most dollar-denominated loans are restructured or impaired.

<sup>42</sup> The annual interest rate under the fund’s loans is 1%. An additional 4% is the margin charged by the participating credit organization. The minimum size of the loan provided by the fund is AZN5,000 and the maximum loan size is AZN10 million. Depending on amount, loans are extended for up to 3, 5, and 10 years.

<sup>43</sup> The decree focuses on (i) individual borrowers’ foreign-currency-denominated loans of less than \$10,000 taken before February 2015 or December 2015, and (ii) personal loans, denominated in either the local or foreign currencies, of up to \$10,000 or AZN17,000 that are overdue by more than 360 days and were taken out after 1 January 2012. To implement this measure, which is expected to cover more than 800,000 people, the Central Bank will provide government-guaranteed concessional loans to the banks for up to AZN682 million.

<sup>44</sup> A country has a revealed comparative advantage in a product if its revealed comparative advantage index is greater than or equal to 1. Revealed comparative advantage index is the ratio of the product’s share in the country’s exports to the product’s share in world exports.

<sup>45</sup> With petroleum gas (8.9% of total exports) and refined petroleum (3.4%), the hydrocarbon sector’s share in exports was 88.3% in 2016. Source: <https://atlas.media.mit.edu/en/profile/country/aze/>.

The share of highly sophisticated services in GDP, such as information and communication and finance, remains low.<sup>46</sup>

27. **Short-term prospects.** Given the slow progress in economic transformation, the country's development will continue to largely rely on the export of oil and gas. The upward trend in oil prices and the gas production from Shah Deniz II gas field suggest positive economic growth prospects and less constrained fiscal space because of increased revenues of SOFAZ, a major contributor to the state budget. This favorable external dynamic ought to be used to accelerate reforms towards a more profound and sustainable diversification of the economy.

28. **Government's development agenda.** The state-led oil-based development model of 2000–2013 has exhausted its potential of high inclusive and sustainable growth. The 2014 oil price crunch and the subsequent economic slowdown have reconfirmed the urgency of shifting towards a private-sector-led productivity-based development paradigm. Cognizant of this, in December 2016 the President of Azerbaijan approved the country's new development framework—the Strategic Road Maps on National Economy Perspective (SRNEP) and 11 main sectors with the objective of accelerating economic diversification. The SRNEP reflects three horizons: a strategic vision for 2020, a long-term vision for 2025, and an aspirational vision for post-2025.<sup>47</sup> The SRNEP promotes a two-prong approach: (i) facilitate labor-intensive growth in the short and medium terms given the availability of labor, and (ii) enable a transition to productivity-based growth in the long term. This is expected to be achieved through comprehensive reforms grouped in four strategic areas: (i) strengthening fiscal sustainability and ensuring a robust monetary policy, (ii) privatization and state-owned enterprise reforms, (iii) developing human capital, and (iv) developing a suitable business environment. The SRNEP envisages enhancing the social safety net to comprehensively cover the vulnerable groups.

## B. Key Impediments to Inclusive and Sustainable Growth

29. To attain the objectives of the SRNEP, Azerbaijan needs to accelerate reforms to improve the structure of the national economy, optimize the role of the public sector, and strengthen its physical and human capital. Effective implementation of reforms in these areas will foster the development of a dynamic non-oil private sector and help fully capture the benefit of the country's location at a strategic crossroad between Russia and Iran, and Turkey and Central Asia.

### 1. Structural Features

30. **Employment-oriented economic diversification.** Growth of agriculture (the sector with the largest share in employment and the highest employment elasticity of 0.45<sup>48</sup>) slowed from 3.9% of GDP during 2008–2012 to 3.1% during 2013–2017. The non-oil industry, whose share in employment is as low as 5.0% but employment elasticity is 0.21, contracted by an average of 1.4% of GDP during 2013–2017. Hence, it is important to accelerate reforms to unleash the potential of the labor-intensive sectors. Establishment of the Food Safety Agency in 2017 was an important milestone in facilitating the export of agricultural products that meet the standards of the target markets such as Europe, as well as ensuring the quality of domestic food products used in the tourism industry. Apart from the Food Safety Agency, the government has established several new and empowered institutions (e.g., SMBDA, State Tourism Agency, Mortgage and

<sup>46</sup> Services with low sophistication still dominate, with trade and transportation accounting for more than 75% of the services sector. Growth in transportation is largely because of the export of oil and gas through the pipelines.

<sup>47</sup> President's Decree no. 1138 dated 6 December 2016. The SRNEP is accessible at <http://ereforms.org/>.

<sup>48</sup> The oil industry's employment elasticity is estimated at 0.07, the lowest elasticity among the economy's sectors.

Credit Guarantee Fund, and the Agriculture Credit and Development Agency) in addition to the existing ones (e.g., the Azerbaijan Investment Company) to drive the diversification agenda in their respective areas and sectors. There is, however, a need for effective coordination to ensure synergy and impact towards the diversification and competitiveness objectives at the country level. Easing the access to finance remains an immediate priority.

31. **Restore financial intermediation.** Credit to the private sector, which predominantly comes from banks, has sharply declined in 2016–2017. The resolution of NPLs proceeded slowly during 2016–2017. There is a risk that NPL overhang could become a drag on economic growth. Hence, there is a need to step up the reform effort to accelerate resolution of NPLs through improving bank reporting and management of NPLs; operationalizing legal systems for debt resolution, recovery, and restructuring; introducing a secondary market for distressed debt and system for NPL sales and a secondary market for distressed debt; and complete resolution of public NPLs.<sup>49</sup> During 2014–2017, the share of nonbank credit institutions (NBCIs) was on average 3% of the total credit to the economy. Given the urgency of easing the access to finance constraint to support non-oil economic growth, development of NBCIs, including microfinance institutions, should be prioritized. The possible measures could include adopting a law on credit unions, including NBCIs in the scope of the Credit and Mortgage Guarantee Fund, and establishing a well-governed facility to enable NBCIs to access funding for lending to micro and SMEs in employment-intensive sectors such as agriculture, manufacturing, and tourism.

32. **Support to small and medium-sized enterprises.** During 2015–2016, the share of SMEs value added in GDP was low, averaging 7%, well below regional peers (e.g., more than 20% in Georgia and 25% in Kazakhstan). Despite the government's successful implementation of a one-stop shop for registering a new business, SMEs are still facing high costs associated with entry and exit procedures, contract enforcement, and property rights. Over 55% of SMEs face problems of access to finance. Low perception of SMEs' creditworthiness by potential lenders is also a key constraint. The number of nonbanking and microfinance institutions that support SMEs has declined because of the economic downturn and enforcement of stricter regulations by the Financial Market Supervisory Authority. To promote development of SMEs, the government has initiated reforms to facilitate SME financing (paras. 25 and 30) and strengthen the institutional framework by setting up the SMBDA.<sup>50</sup>

## 2. Role of the Public Sector

33. **Sustainable fiscal framework.** Windfall oil revenues led to an unsustainable level of public expenditures and vulnerability of the budget to the fluctuation of global oil prices and production. Expansionary budget spending (including large public investments) during 2005–2014 led to an appreciation of the real effective exchange rate and hence adversely affected the non-oil exports. A rise of public investment in 2018, associated with the recovery of oil prices, is expected to again put pressure on competitiveness of the non-oil tradable sector through appreciation of the real effective exchange rate. Hence, for the economy to grow in a sustainable and inclusive manner, it is imperative to optimize the use of the oil revenues by effectively implementing the fiscal rule and the medium-term fiscal framework approved in August 2018 to minimize dependency on oil prices, reduce macroeconomic volatility, stimulate non-oil sector export growth, and ensure efficient use of public resources.<sup>51</sup>

<sup>49</sup> World Bank. Forthcoming. *Legal and Regulatory Barriers to Resolution of Non-Performing Loans*. Technical Note.

<sup>50</sup> The government targets to increase the share of SMEs in the country's GDP to 15% by 2020 and to 35% by 2025.

<sup>51</sup> Presidential Decrees nos. 234 and 235 dated 24 August 2018.

34. **Efficiency of state-owned enterprises.** State-owned enterprises (SOEs) play a prominent role in the economy: e.g., the State Oil Company of Azerbaijan Republic contributed roughly 34.3% of GDP in 2016 and accounts for roughly 19% of corporate taxation; and the majority state-owned International Bank of Azerbaijan is the largest bank, accounting for 35% of finance sector assets. SOEs dominate in the areas of power, gas distribution, roads, rail, ports, air transport, water supply and sanitation, and telecommunication. The sharp devaluation of the national currency after the oil price crunch in 2014–2015 had a severe financial impact on the SOEs, which were already affected by inadequate corporate governance and weak oversight. Given the dominant nature of SOEs, the government had to step in with direct financial support or guarantees. Apart from causing sizable fiscal risk and periodic fiscal cost, the inefficient SOEs also adversely affect the productivity of the non-oil sector. Among the key issues of the SOE sector are (i) a high level of foreign debt and exchange rate vulnerability; (ii) poor financial performance and dependency on cost-inefficient and performance-incompatible fiscal support solutions;<sup>52</sup> (iii) low accountability, transparency, and reporting, (iv) fragmented and incomplete discharge of the ownership function by the government; and (v) lack of an autonomous and capable utility regulator to regulate market entry, set tariffs, and oversee customer service.<sup>53</sup> It is, therefore, critical to sustain the reforms initiated in 2017 on improving financial oversight and transparency of SOEs through rolling out the SOE corporate governance framework and implementing deeper efficiency-enhancing sector-specific reforms.<sup>54</sup> Implementation of these reforms could enable more private sector participation in the fields currently operated by SOEs.

### 3. Physical and Human Capital

35. **Infrastructure for economic diversification.** Azerbaijan is one of the most water-scarce countries in the Commonwealth of Independent States with a 77% dependency ratio on transboundary waters. Only 45% of the potentially arable area in Azerbaijan is equipped for irrigation. Almost half of all the irrigated agricultural land is salinized because of inadequate drainage.<sup>55</sup> There is ample room for increased agricultural production in Azerbaijan, especially in horticulture. Realizing this potential requires an efficient and cost-effective logistics system that links producers to global markets. Inadequate provision of water supply and sanitation constrains the expansion of the tourism sector. Overall, the country needs to strengthen its water resources infrastructure to enable the intended growth in agriculture and tourism. Access and use of internet vary significantly between urban and rural areas. Fixed broadband internet connection occurs predominantly through the telephone landline network. Expansion of a national broadband network, including through private sector participation and fiber optic connection, will improve digital connectivity for the country's industrial parks and SMEs and enable growth of computer and digital companies (at the high productivity end of the information and communication technology sector).<sup>56</sup> Strengthened transport infrastructure in the rural areas and more reliable electricity would help stimulate new businesses in the non-oil sector such as manufacturing that would in turn improve diversification.<sup>57</sup> The country also needs to continue upgrading its electricity and gas distribution networks to ensure stable provision of energy across the country.

<sup>52</sup> Fiscal support takes the form of ex-post outright outlays, not in an ex-ante defined or performance-based manner. This type of fiscal support perpetuates management and fiscal inefficiencies.

<sup>53</sup> ADB. Forthcoming. *Azerbaijan: SOE Sector Review*. Manila.

<sup>54</sup> Order of the Cabinet of Ministers from 1 December 2016 no. 636s. For example, the regulations on performance-based remuneration of SOE management and SOE efficiency evaluation have been under review since September 2017.

<sup>55</sup> Salinization is the increasing content of salt in the soil, which lowers crop yields and is exacerbated by poor irrigation.

<sup>56</sup> ADB. 2019. *Country Digital Development Overview: Azerbaijan*. Manila.

<sup>57</sup> Over the medium term, Azerbaijan's annual infrastructure investment need (excluding oil and gas) is estimated at 6%–7% of GDP. Fiscal support for infrastructure investment declined from over 6% of GDP during 2003–2017 to about 3% in 2019. (Source: Footnote 1.)

36. **Infrastructure to capture benefits from regional integration.** The growing momentum in the realization of the Belt and Road Initiative has opened new prospects for regional cooperation and integration. Because of its favorable location, Azerbaijan needs to seize these opportunities through enhancing and ensuring financial sustainability of the substantial investments in road, rail, port, and air connectivity.<sup>58</sup> Among the issues to be addressed are strengthening the government's institutional and policy frameworks in the transport sector, improving the asset management and maintenance systems, and raising private participation in transport infrastructure and services. Completion of the negotiations on the legal status of the Caspian Sea in September 2018 opened prospects for constructing the Trans-Caspian Pipeline, linking Turkmenistan to Azerbaijan and beyond to the European Union. This in turn will require adequate transport infrastructure and logistics.

37. **Human capital for a diversified economy.** An inadequately educated workforce is among the top constraints to doing business in Azerbaijan. There is a pronounced skills gap in the services, agriculture, and non-oil-related manufacturing sectors and for highly skilled positions such as machine operators, professionals, technicians, and managers. Almost 85% of government spending on education goes to salaries and only 11% to equipment. The share of the technical and vocational education (TVET) in the education sector's budget is about 5%. The quality of education in TVET institutions is low: teaching quality is low and school buildings are poorly maintained and often lack modern equipment. Existing facilities, equipment, curricula, textbooks, and other teaching materials have not been updated since Soviet times. Hence, TVET schools are far from capable of developing the skills needed for the labor market, and this adversely affects the economic diversification agenda. In this regard, it is important to accelerate and adequately finance implementation of the measures of the Strategic Road Map on Development of Vocational Education and Training, adopt and implement the new law on TVET, and facilitate private participation in the delivery of services and infrastructure in TVET and higher education.

### C. Implications for ADB Country Engagement

38. **Future directions.** Given Azerbaijan's upper middle-income country status and sizable revenues from oil and gas exports,<sup>59</sup> and following Strategy 2030's differentiated approach to various groups of countries, ADB should focus on areas where it can add the most value to (i) the implementation of the strategic road maps, (ii) addressing the binding constraints to inclusive growth and economic diversification identified by ADB's first-ever country diagnostic study on Azerbaijan (footnote 1), and (iii) achieving the SDGs and obligations under global climate change agreements.<sup>60</sup> While being demand driven and selective, the country partnership strategy should be flexible and adaptive to changing circumstances, drawing from the wide range of ADB's financial, credit enhancement, country and regional technical assistance, and advisory services instruments and modalities.<sup>61</sup> Specifically, the strategy should focus on supporting (i) boosting the

<sup>58</sup> Completion of the north-south highway from the border with Russia to the border with Iran is expected by mid-2020. The Baku-Tbilisi-Kars railway opened in September 2017, providing a rail link to Turkey and Europe. The ongoing reconstruction of the railways between Baku and the Russian border and between Baku and Astara on the Iranian border will enable continuous railway connectivity along the 'South Silk Road' corridor. Baku's International Airport is the busiest airport in the Caucasus and is a secondary hub for Cargolux, the eighth largest cargo airline. A new port is being developed in Alat to replace the port of Baku (65 kilometers to the north). The ferry rail terminal opened in 2014, enabling a direct link between Central Asia and the Black Sea, and the roll-on roll-off terminal opened in January 2018.

<sup>59</sup> Azerbaijan's 2018 ratings are *BB+ stable* by both Standard & Poor's and Fitch Ratings (one notch below investment grade), and *Ba2 stable* by Moody's Investor Service (two notches below investment grade).

<sup>60</sup> ADB. 2018. *Strategy 2030: Achieving a Prosperous, Inclusive, Resilient, and Sustainable Asia and the Pacific*. Manila.

<sup>61</sup> To raise accountability, ADB can suitably promote more active involvement of civil society in the preparation and monitoring of implementation of its operations.

development of the non-oil private sector and improving access to finance to help improve the country's economic resilience, (ii) raising efficiency of the public sector through setting fiscally sustainable and non-oil growth-friendly government expenditure and public corporate sector, and (iii) improving infrastructure and raising the quality of human capital necessary to facilitate economic diversification.

39. **Boosting private sector development.** ADB could help promote economic diversification by facilitating private sector development and investment to support the production of non-oil tradable goods and services. This may involve strengthening and partnering with the institutions the government has set up to drive the economic diversification agenda (e.g., in food safety), SME development and finance, and direct engagement with eligible SMEs and SOEs through private sector operations. Through SME support and regional technical assistance, ADB can also support strengthening the value chains in non-oil products. To address the constraint on access to finance, ADB should continue supporting the finance sector reforms, including strengthening the sector's governance and oversight, introducing new finance sector instruments to raise resilience against external shocks, and developing capital and insurance markets.

40. **Public sector efficiency.** To strengthen economic resilience, ADB should continue supporting macroeconomic stability and non-oil growth-friendly and sustainable fiscal policy in Azerbaijan. This may involve support to the roll-out of the medium-term expenditure framework and the fiscal rule to optimize the use and raise intergenerational equity of the oil rents;<sup>62</sup> strengthen public financial management and procurement systems and tax administration; ensure fiscal sustainability of infrastructure investments; and raise efficiency of social protection and insurance systems. ADB should also continue supporting improvements in the efficiency of the public corporate sector to transform it from a constraint on development to an agent of Azerbaijan's development. ADB should support mainstreaming digital technologies in its operations to improve governance and quality of public service delivery.<sup>63</sup> Cognizant of the SOEs' financing needs during restructuring and sector reforms, as well as the importance of maintaining SOEs' provision of public services, ADB could provide tailored financing solutions to SOEs that may involve a combination of public and private finance, credit enhancement, cofinancing, technical assistance, and transaction advisory services to structure projects for private sector participation. Special attention needs to be paid to the risks arising from weakness in institutional governance of SOEs and independence and capacity of utility regulators. ADB should continue supporting institutional strengthening in anticorruption and in business regulation.

41. **Strengthening infrastructure and human capital.** ADB could help strengthen sustainability of the existing infrastructure stock and enhance access to and quality of infrastructure and public services in sectors and areas important for economic diversification and regional equality through combining infrastructure investments with regulatory, tariff, institutional, and governance reforms. Based on long experience in the country, ADB is well placed to continue supporting the government programs on promoting transport connectivity and strengthening the energy sector efficiency (e.g., power and gas distribution). ADB can also provide integrated solutions for urban and rural infrastructure development (e.g., solid-waste management, modern irrigation schemes). Drawing on innovative approaches in the region, ADB can support strengthening the education sector, including TVET, through building links between education,

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<sup>62</sup> At current levels of production, Azerbaijan's oil reserves will run out in around 20–25 years. Moody's Investor Service. 2018. *Government of Azerbaijan: FAQ on impact of oil prices on growth and public finances, and prospects for economic diversification*. (11 February).

<sup>63</sup> This may involve introduction of artificial intelligence and machine learning in provision of public services, and organization of new public services based on digital and blockchain technologies.



science, and the private sector; promoting private delivery of public education services and infrastructure; and raising private provision of education through innovative instruments.<sup>64</sup>

42. **Private sector operations.** ADB should expand its private sector operations in Azerbaijan. This may involve direct engagement with eligible private entities, including SMEs, in the non-oil sector. ADB may also engage with reforming SOEs to crowd in private capital. ADB may also consider loans or equity investments in banks, microfinance institutions, and private companies with a focus on supporting micro and SMEs or infrastructure development. This may require technical assistance support to the selected finance sector stakeholders, who are still recuperating from the adverse effect of the finance sector crunch in 2016–2017, to help develop new business plans, strengthen risk management, and reach out to new clients. ADB should seek to provide financing in local currency by eventually tapping the domestic capital market. ADB should seek to support local banks through the trade facilitation program to close market gaps and promoting trade of Azerbaijan's non-oil sector. ADB should also engage in the crosscutting areas described in paras. 43–46.

43. **Gender equality.** ADB could advance gender equality through (i) enhancing the business climate and access to credit for women entrepreneurs; (ii) mainstreaming gender responsiveness and enhancing women's voice during the design, implementation, and monitoring of infrastructure projects; and (iii) promoting gender-responsive budgeting as a tool that integrates gender and other social dimensions into decision making about public resource allocation.

44. **Climate change and environmental sustainability.** ADB could support the attainment of the country's target of 35% reduction in greenhouse gas emissions by 2030 through localization and facilitation of low-carbon interventions in the energy and transport sectors, including through phasing out of old technologies and equipment. In the transport sector, this may involve electrification of railway lines, transition to an alternating current system, and increasing travel speeds by reducing highway congestion. ADB may also support the government in diversifying the country's energy mix away from mostly gas-based energy generation to more renewable sources. As part of support to SMEs, ADB should support mainstreaming environmental sustainability and climate resilience in business practices.

45. **Regional cooperation and integration.** Azerbaijan should continue to be closely involved in the Central Asia Regional Economic Cooperation (CAREC) program's initiatives in transport, energy, trade facilitation, and other cooperation dimensions per CAREC Strategy 2030.<sup>65</sup> Under CAREC, ADB could provide various support for the government's aspiration of positioning Azerbaijan as transport hub in the South Caucasus and Central Asia region.

46. **Public–private partnerships.** Adoption of a build–operate–transfer legal framework in 2016 manifests the government's commitment to raise private investment in infrastructure. The government, however, has yet to improve the legal framework and build the institutional set-up and capacity to adequately (and in a fiscally responsible manner) manage public–private partnerships throughout the project cycle. In 2018, ADB provided support to pilot the provision of university student accommodation in Baku under a build–operate–transfer framework and to prepare two projects in the power sector for private sector participation. Building on this, ADB should support strengthening the government capacity and enabling environment, as well as help prepare an initial pipeline of public–private partnership projects to bring to market.

<sup>64</sup> Through regional technical assistance ADB could support the roll-out of the compulsory medical insurance scheme.

<sup>65</sup> ADB. 2017. *CAREC 2030: Connecting the Region for Shared and Sustainable Development*. Manila.