

ASIAN DEVELOPMENT BANK
REGIONAL-CAPACITY DEVELOPMENT TECHNICAL ASSISTANCE (R-CDTA)
STRENGTHENING KNOWLEDGE MANAGEMENT
IN CENTRAL AND WEST ASIA

RESPONDING TO EXTERNAL SHOCKS HITTING
THE ECONOMY OF AZERBAIJAN

9 March 2017

This report has been prepared under the Region-wide Study, *“Good Jobs for Inclusive Growth in Central and West Asia.”* The study is undertaken under R-CDTA-8936, *“Strengthening Knowledge Management in Central and West Asia.”* This report has been prepared by study consultant Alim Hasanov. The overall Study task manager is Giovanni Capannelli, Country Director, KARM, ADB.

Contents

Figures	ii
Executive Summary	iii
I. Introduction	1
II. Background	2
III. Shock.....	5
A. External balance	5
B. Consolidated budget.....	9
C. Banking sector.....	10
D. Summary of shock.....	12
IV. Policy response	13
A. Monetary policy response: devaluation and monetary tightening.....	13
B. Fiscal response: Budget revision.....	15
C. Changes in Tax and Customs policies.....	16
D. Changes in institutional and legal domains.....	17
V. Support from ADB and other IFIs.....	19
VI. Conclusion and recommendations	20
Bibliography.....	21
Appendix	22

Figures

Figure 1: Annual change in GDP and non-oil GDP, %	1
Figure 2: Contributidon of construction to non-oil GDP growth, %	1
Figure 3: GDP, US\$ bn	2
Figure 4: Exports, US\$ bn	2
Figure 5: Consolidated budget revenue, US\$ bn	2
Figure 6: State Oil Fund reserves	2
Figure 7: Crude oil production and price	3
Figure 8: Consolidated budget expenditure	3
Figure 9: Oil versus non-oil	3
Figure 10: Domestic versus foreign.....	3
Figure 11: Domestic: state versus non-state.....	4
Figure 12: Domestic: oil versus non-oil	4
Figure 13: Foreign: state versus non-state.....	4
Figure 14: Foreign: oil versus non-oil	4
Figure 15: Current account balance	5
Figure 16: Current account balance, quarterly average, US\$ bn	5
Figure 17: Exports, quarterly average, US\$ bn	6
Figure 18: Imports, quarterly average, US\$ bn	6
Figure 19: Services balance, quarterly average, US\$ bn.....	7
Figure 20: Current account balance and change in reserves, quarterly average, US\$ bn.....	8
Figure 21: Portfolio and other investments, quarterly average, US\$ bn.....	8
Figure 22: FDI flows, quarterly average, US\$ bn	8
Figure 23: Consolidated budget revenue, US\$ bn	10
Figure 24: Budget expenditure, US\$ bn	10
Figure 25: Banking sector assets	11
Figure 26: Loans and deposits, US\$ bn	11
Figure 27: Dollarization ratios in the banking system.....	12
Figure 28: AZN/US\$ exchange rate, daily	13
Figure 29: Brent crude oil price, daily	13
Figure 30: Central Bank interest rates.....	14
Figure 31: Central Bank notes.....	14

Executive Summary

Historical developments

1. Azerbaijan has achieved remarkable growth rates from early 2000s to 2014, with the economy expanding more than four folds in real terms, and moved from low income status to an upper middle income category. Rapid growth was achieved thanks to a massive oil windfall, helped by the increasing oil production that coincided with high oil prices. These inflows boosted economy through public expenditures. At the same time, conducive institutional setting developed to help this rapid growth. Massive public capital expenditure resulted in economic model whereby public sector provides financing and private sector was acting as a client. In a way, public investment squeezed private sources of finance. At the same time, fixed exchange rate helped to feed the trust to local currency.

2. However, in the process, Azerbaijan's dependence on oil sector increased, making the country vulnerable to swings in the global market for the crude.

The shock

3. Dependence on oil sector resulted in Azerbaijan's vulnerability to the developments in the international oil market. As soon as oil prices crashed starting with mid-2014, Azerbaijan felt the hit through pressure on the local currency, fall in consolidated budget revenue, and narrowing current account surplus. Eventually, economy slowed down to 1.1% in 2015 and contracted 3.0% in 7M16. Non-oil GDP was particularly hard hit. As public capital expenditures were cut, construction sector nosedived, taking non-oil GDP downward too.

4. Additionally, problems in the banking system, which were disguised by the oil windfall in the previous years, exacerbated challenges further. Closure of some small banks, partial bail out of the major lender and concerns regarding several other banks resulted in a fiscal burden and undermined trust to the banking system. Moreover, step by step closure of the small banks feed the expectations that there might be others to be closed soon.

Policy response

5. As a response to the crisis, among others, Azerbaijan devalued its currency twice, changed budget for 2016, created several new institutions, announced intention to privatize several state owned entities, passed several new laws and changed functions of existing institutions in the economic domain. Below is the list of major policy actions taken so far:

- As pressures mounted and Central Bank reserves were being exhausted, Azerbaijan sharply devalued its currency in February and then in December 2016. After the second devaluation exchange rate policy was changed from the fixed rate to a managed float and currency auctions were introduced.
- Continued decline in oil prices and devalued local currency led to revision of the budget for 2016 in February 2016, less than two months after the approval of the original budget. Expenditures were sharply cut, compared to the original budget and to the actual budgets of the previous years. Oil price for 2016 was set at pessimistic lower

bound, resulting in lower revenues but with upside possibilities, which would have helped to save reserves at the State Oil Fund. Commitment not to tap into reserves of the Fund was perceived as a credit positive for the country.

- As a part of institutional reforms, establishment of the Financial Market Supervisory Chamber was among the major moves. The new public entity was entrusted with regulation of the financial sector in the country, including oversight over the banks, securities and insurance market. As a result, some functions of the Central Bank were transferred to the new entity and State Securities Committee was abolished.
- Extension of the deposit insurance to cover all deposits, subject to interest rate restriction, privatization, some change in the domain of the taxes were actions taken on the legislative front.
- Cleanup of the major commercial bank through the issuance of the bonds bought by the Central Bank and closure of several small lenders were the steps taken in the domain of the commercial banks.

6. Along with these policy responses, authorities strongly stressed the importance of developing non-oil potential of the economy, developing its transport hub potential, agriculture, tourism, etc.

7. However, analysis of the recent data indicates that these reforms have yet to have impact as contraction in the economy is continuing, pressure on the local currency is not subsiding, non-oil private investments are at low levels and non-oil exports are declining. Despite devaluations, imports are still relatively high and capital outflow continues resulting in the current account deficit and pressuring reserves.

Prospects

8. Developments in the exchange market and data on investments suggest that a lack of trust in the local currency and, relatedly, lack of prospects regarding future path of the economy are hindering growth. Azerbaijan needs to restore this growth as soon as possible and institutional and legislative reforms should be implemented with certain targets that could be measured and evaluated. Some possible steps are:

- Restoring trust to the local currency: Rapid move to a fully functional floating exchange regime would allow the exchange rate to find its equilibrium level with minor burden on the reserves of the country. While in the short run it might have negative repercussions, it will be beneficial in the medium to long term.
- Throughout stress tests of the banks should be carried out. Based on the results, banks should be closed immediately, forced to consolidate or sold. Special efforts should be spent on attracting foreign lenders either through acquisition of the local banks or opening new one.
- Policies should be fine-tuned to attract FDI in the non-oil sector and these policies should be evaluated based on the actual success. This will likely require pro-active policies on the government side to meet and discuss necessary policies with the

potential investors. Also, practical steps should be taken to improve doing business indicators with particular attention to indicators in which Azerbaijan performs poorly.

- WTO membership process should be sped up.

9. These are some of the possible steps that should be taken to stabilize the economy and return to a solid growth in the medium to long term. As soon as the balance in the currency exchange market is reached investments may start flowing, subject to comprehensive reforms. Entrance of foreign commercial entities would send strong signal to other investors, helping economy to rebound. Banking system will only be in a position to finance the growth once it is cleaned up. Entrance of foreign lenders will improve competition, bring more financing options and lessen the cost of loans.

10. To achieve these goals, authorities should work in close collaboration with international financial institutes. This will send positive signal to all investors.

Conclusion

11. Azerbaijan has attained remarkable growth rates in the previous decade thanks to increasing oil production and elevated oil price. This growth model has resulted in certain institutional setting which contributed to rapid growth of the economy. Among these institutional developments major ones were fixed exchange rate and publicly financed growth. Massive public capital expenditure has likely improved Azerbaijan's infrastructure which was extremely dilapidated in the 1990s. Additionally, Azerbaijan has built up material reserve buffers and right now its debt to GDP ratio is in the lower bound.

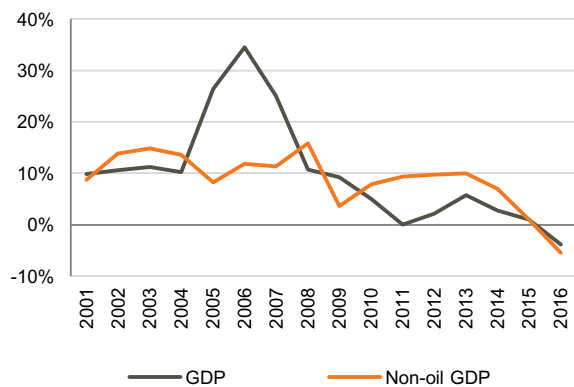
12. However, new realities present serious challenges for the current institutional set up. Low oil price along with flat oil production means that government centric financing model is not viable anymore. Azerbaijan needs to shift from publicly financed growth to private sector financed one, preferable with heavy foreign participation. For that to happen, institutional setting should be reformed to suit demands of the private sector. This means less red tape, transparent and prompt economic decision making.

I. Introduction

1. After growing by an average 15.9% per annum in the first decade of the 2000s, Azerbaijan's economy started to slow down. As oil production plateaued, growth retreated to 5.0% in 2010 and further down to almost zero in 2011. From 2012 to 2015 growth was relatively subdued at an annual average of 3.0% per year. Non-oil GDP, helped by massive construction boom in the country, continued to grow close to two digit levels until 2014, when it posted 7.0% growth. As oil price more than halved starting since mid-2014, however, Azerbaijan started to face challenges and non-oil growth further decelerated to 1.1% in 2015.

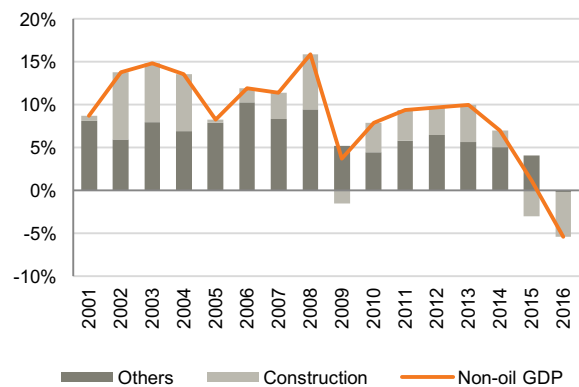
2. Growth eventually turned negative in 2016 as export and fiscal revenues contracted further and authorities slashed capital expenditures which were immediately reflected in the construction sector. With close to 30.0% y/y contraction in construction in 2016, non-oil GDP declined 5.4% y/y leading to 3.8% y/y fall in overall GDP.

Figure 1: Annual change in GDP and non-oil GDP (%)



Source: Statistical Committee.

Figure 2: Contribution of construction to non-oil GDP growth (%)

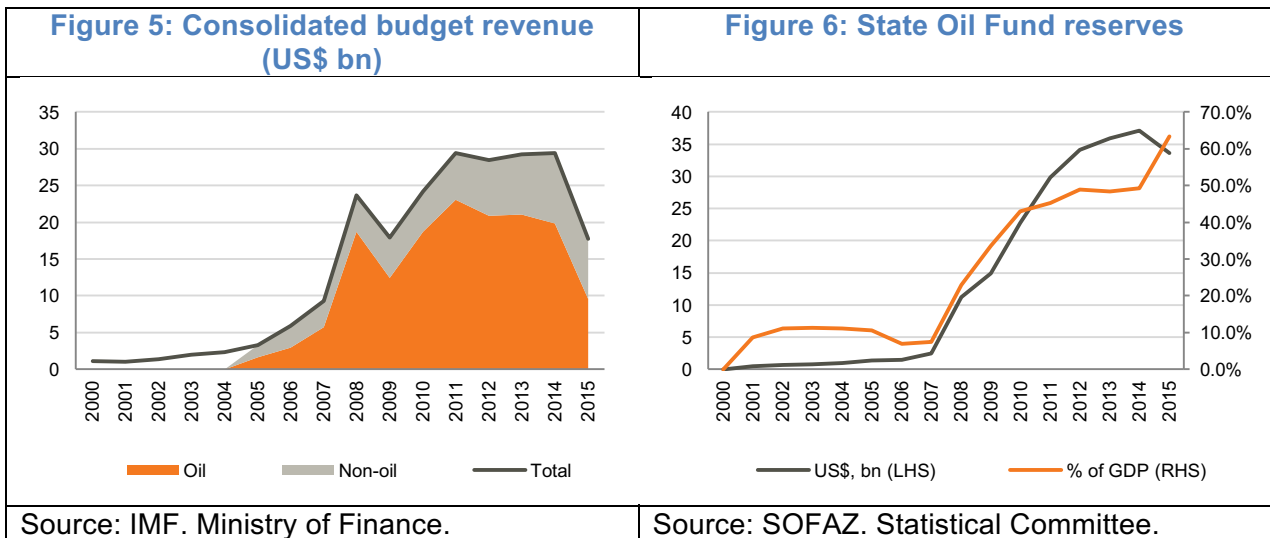
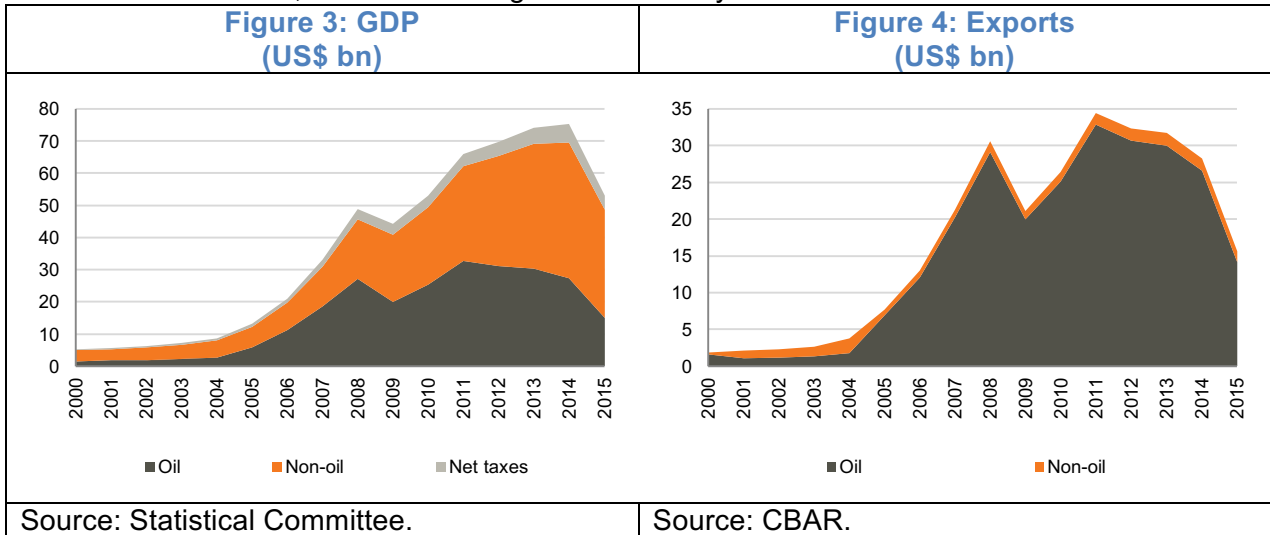


Source: Statistical Committee.

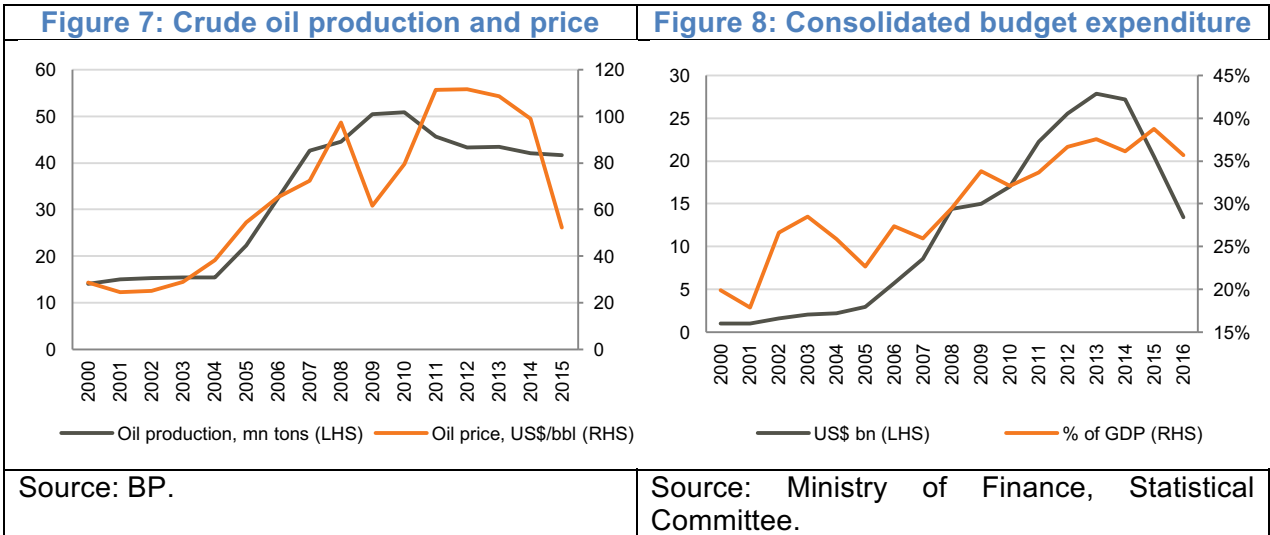
3. As an energy rich country, it was expected that collapse in the oil price will negatively impact Azerbaijan. According to BP, in 2015 Azerbaijan was 22nd and 34th biggest oil and gas producer respectively. From 2005 to 2015 oil and gas sector accounted for 49.0% of total GDP at factor cost, its share in export hovered around 94.0%, and provided 66.5% of consolidated budget revenue. Naturally, this high dependency on oil sector resulted in a serious challenge for Azerbaijan as oil prices nosedived. However, it should be noted that oil windfall helped Azerbaijan to triple its economy in real terms since 2005, provided financing for massive rebuilding of the infrastructure in the country and, thereby, financed growth of non-oil sector. To understand current challenges, therefore, we need to understand how oil dependence progressed in Azerbaijan since early 2000s.

II. Background

4. From 2000 to 2014 Azerbaijan’s GDP increased more than four fold in real terms and 14.3 times in US\$ terms, resulting in GDP per capita increasing from US\$ 662.9 in 2000 to US\$ 7,990.8 in 2014. Over the same period, merchandise exports increased from US\$ 1.9bn to US\$ 28.3bn, consolidated budget revenues from US\$ 1.1bn to US\$ 29.4bn, investment to the economy from US\$ 1.1bn to US\$ 22.5bn and Oil Fund reserves reached US\$ 37.1bn. As the charts below indicate, most of this surge was driven by the oil sector.

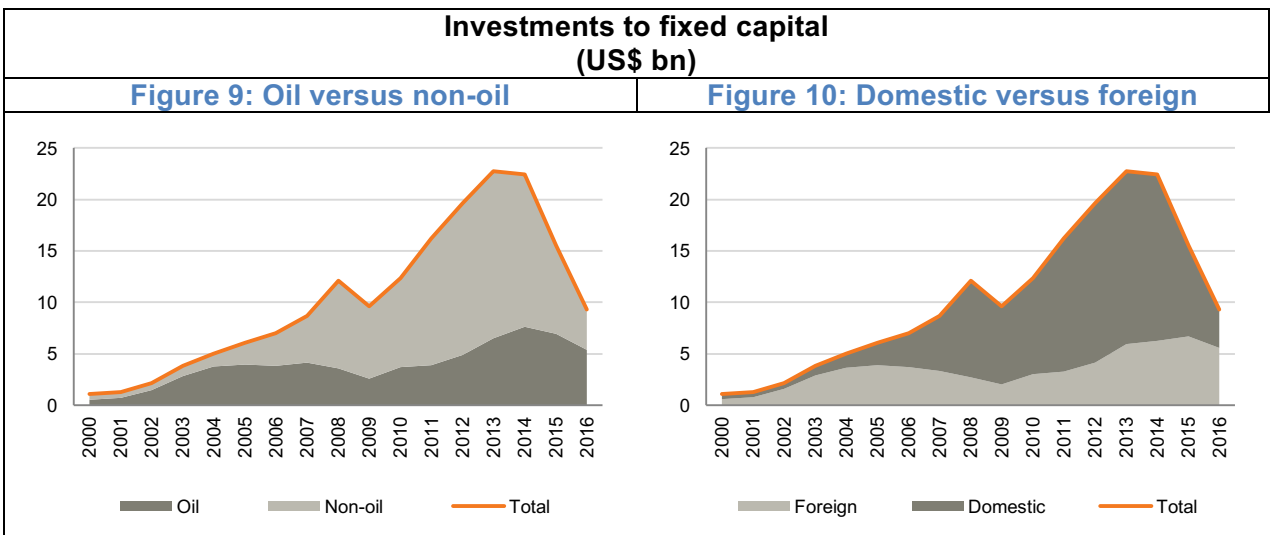


5. Oil sector itself, in turn was primarily developed by foreign direct investments, which eventually helped to propel export revenues, thereby feeding reserves and beef up public revenues. Oil production during this period increased from 14.1mn tons to 42.1mn tons and pipelines connecting Baku with the Mediterranean port in Turkey and Black Sea ports in Georgia and Russia allowed for smooth exports.

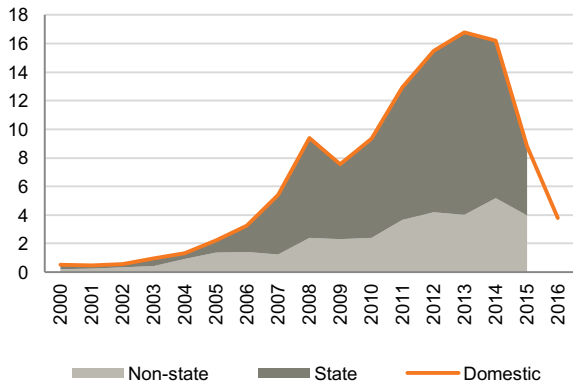


6. Investments in the non-oil sectors, however, was mainly oil sector generated public spending. Increase in consolidated budget expenditure from US\$ 1.1bn to US\$ 30.8bn has been providing essential fuel for the growth of non-oil sectors, particularly through construction.

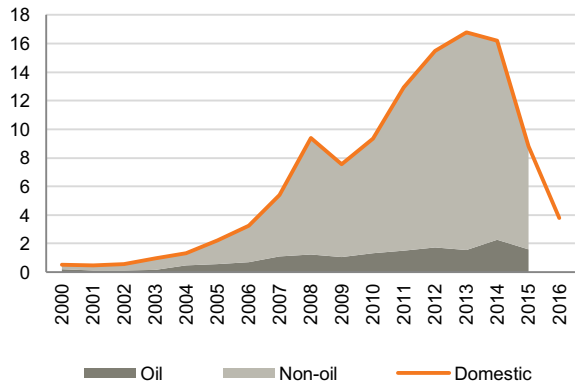
7. This has resulted in a particular growth model, where financing is provided by the state, and the private sector, instead of securing independent financing, was focused on securing public sector contracts. Naturally, concerns like the efficiency of the public investment, squeezing of private investment have occasionally arisen during this period. However, urge to catch up and improve infrastructure justified this model and as long as oil prices remained elevated country could afford it. In the process public sector expanded and institutional setting conducive to government financed growth model was formed.



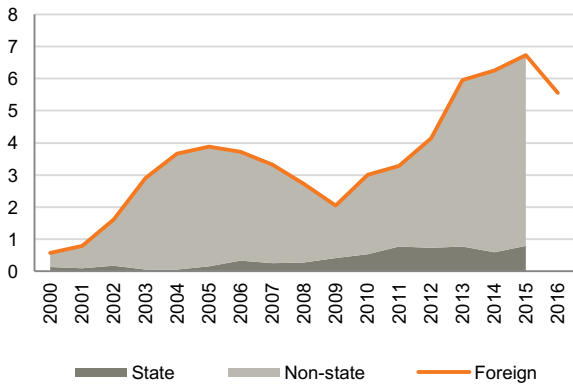
**Figure 11: Domestic:
state versus non-state**



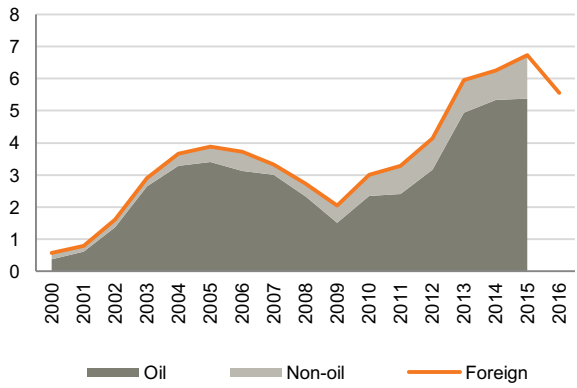
**Figure 12: Domestic:
oil versus non-oil**



**Figure 13: Foreign:
state versus non-state**



**Figure 14: Foreign:
oil versus non-oil**



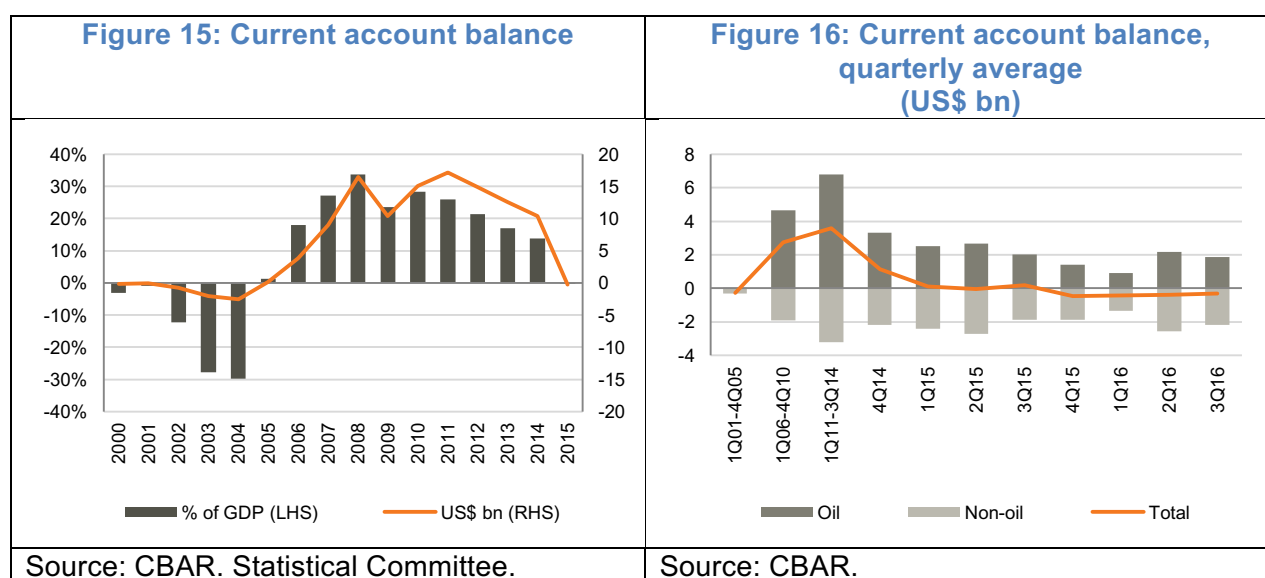
Source: Statistical Committee.

III. Shock

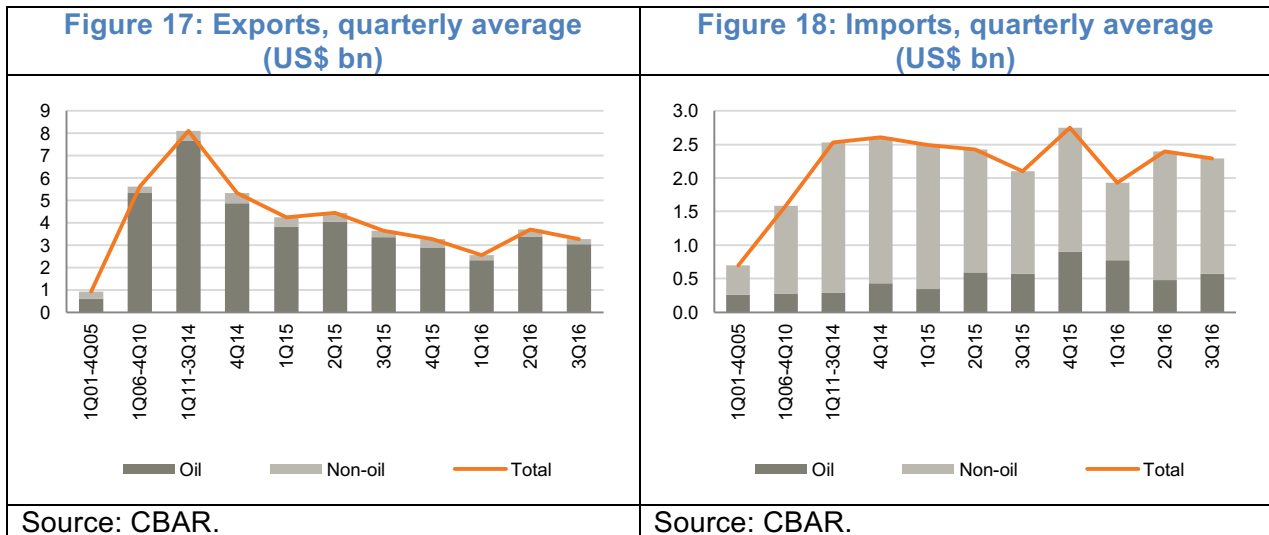
8. As oil price started downward trend from above US\$ 100/bbl in the first half of 2014 to below US\$ 30/bbl in early 2016, with subsequent partial recovery to US\$ 50/bbl, the existing model started facing serious challenges. External current account surplus started to narrow and turned into deficit, consolidated budget revenues declined and economic growth stalled as government prioritized long term fiscal position by cutting growth feeding capital expenditures, and banking sector was seriously challenged as economy started contracting.

A. External balance

9. As a ratio to GDP Azerbaijan's current account surplus peaked in 2008 reaching 33.7% of GDP and in nominal US\$ terms in 2011 reaching US\$ 17.2bn. Since 2011 surplus has been narrowing as oil exports have been slowly falling and imports continued to increase. However, it was still at a solid US\$ 10.4bn (13.9% of GDP) surplus in 2014. With the oil price shock, this surplus turned to US\$ 222.5mn (0.4% of GDP) deficit in 2015, first deficit since 2004.

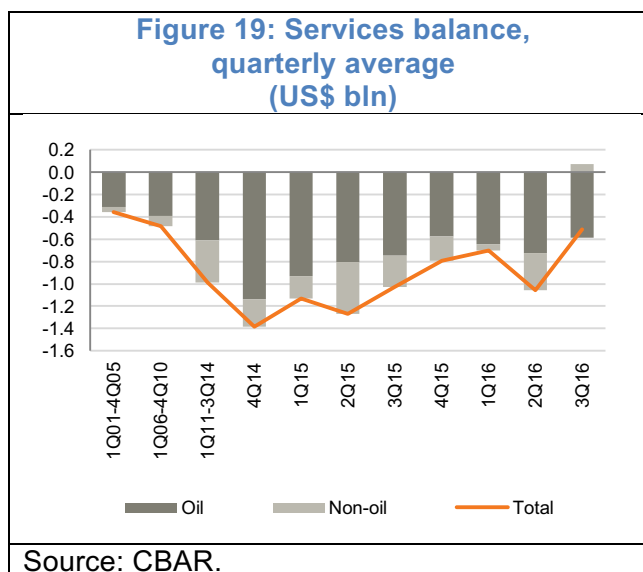


10. In quarterly terms, current account balance eventually turned to deficit in the second and last quarter of 2015 and remained in deficit in the first three quarters of 2016 as fall in oil exports was far higher than relatively smaller decrease in imports and service balances. From 1Q11 to 3Q14 Azerbaijan's quarterly oil exports averaged US\$ 7.7bn. Since then however, oil exports receipts sharply declined and were just US\$ 2.9bn in 4Q15 and US\$ 2.3bn in 1Q16, with minor recovery in 2Q16 and 3Q16. So, on the average, Azerbaijan has failed to get around US\$ 5.0bn per quarter due to a fall in oil prices. At the same time, non-oil export have also been falling since 2Q15, probably due to falling prices of its non-oil exports and continued contraction in Russia, Azerbaijan's major non-oil export destination.



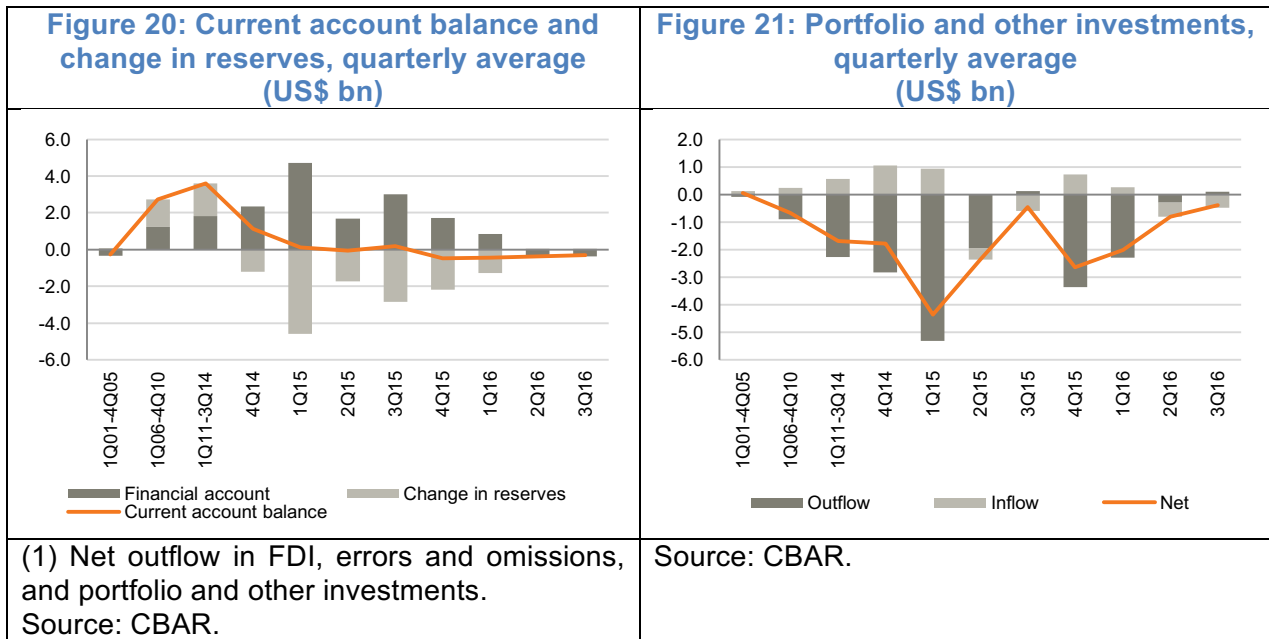
11. Unlike exports, imports have remained relatively robust, increasing 5.6% y/y in 4Q15, then falling 22.5% in 1Q16 and again increasing 9.1% y/y in 3Q16. Actually, fall in non-oil imports started since the last quarter of 2013 and intensified recently as devaluations started to have an impact until 2Q16. However, investments into oil sector were driving oil related imports, which have been increasing at above 100% y/y in 4Q15 and 1Q16, and settling at high plateau thereafter. Given strategically important oil and gas projects, these imports will probably continue to weigh on the external balance for a while, thereby undermining benefits from the fall in non-oil imports.

12. Just like in imports, oil sector has been preventing radical adjustment in the services balance, which has generally been in deficit in Azerbaijan. While falling, oil related service balance was still at US\$ 0.6bn deficit in early 2015 compared to almost balance in the non-oil services. Actually, leaving aside construction sector, services actually posted surplus in 1Q15. Again, like in the non-oil imports, non-oil services balance has likely been affected by the devaluations of 2015. However, like in the case of oil related imports, deficit in construction will probably continue for a while, given the needs and commitments to develop oil and gas related production and transportation.

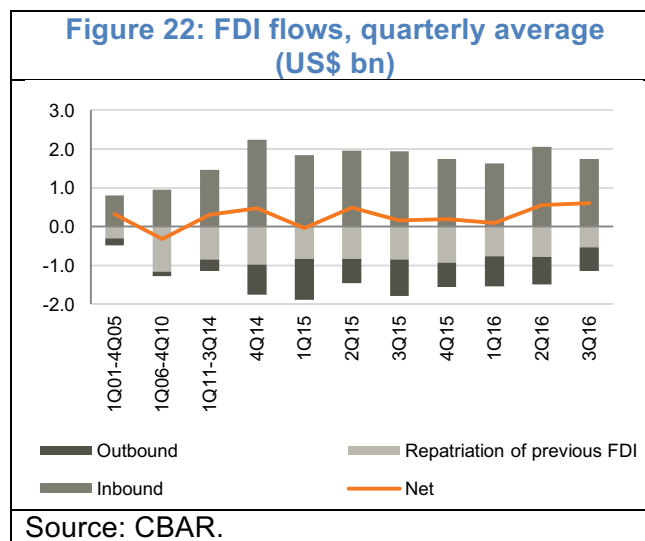


13. Analysis of the current account data indicates that oil related import bill, both in goods and services, has remained relatively inelastic to devaluations in the country, which is understandable. Country is still in the process of developing its massive oil and gas fields and associated infrastructure to export these commodities to global markets. Therefore, except for a relatively minor adjustment from non-oil imports, flexibility on the import front is limited unless oil and gas related projects are suspended.

14. On the financial account side, current account surpluses of the previous decade were enough to cover capital outflow from the country and also feed reserves. This trend was reversed as oil price shock started to bite exports receipts. In 1Q14, reserves were in negative for the first time since mid-2009. Narrowing current account surplus and increasing capital outflows were tapping Azerbaijan's reserves. Reserves recorded even stronger fall in 1Q15, reaching US\$ 4.6bn, compared to US\$ 1.2bn in 4Q14 as net portfolio and other investments outflow surged to US\$ 4.4bn, a clear sign of capital outflow intensification. Probably not coincidentally, first devaluation happened in 1Q15. However, devaluation was not enough to arrest capital outflows, as net outflow from portfolio and other investment categories continued in the following quarters too. After subsiding to US\$ 0.5bn, outflows again increased to US\$ 2.6bn in the last quarter of 2015, thereby partially explaining second devaluation.



15. While Azerbaijan continued to receive FDI, particularly to the oil sector, it was generally matched by the outbound FDI and repatriation of previous years' investments.



16. Balance of payments data analysis of Azerbaijan indicates that Azerbaijan has limited space for the adjustment of its external balance on the imports front given the strategically important projects in the country. At the same time authorities are trying to preserve country's international reserves, which is important for the country's credit rating and for the long term development. So, the gap stemming from the falling export receipts can only be filled by FDI and/or portfolio and other investments. In a way, if Azerbaijan wishes to continue to develop its rich resources without undermining welfare of its citizens, there is a need to adopt policies suitable for current account deficit economies.

B. Consolidated budget

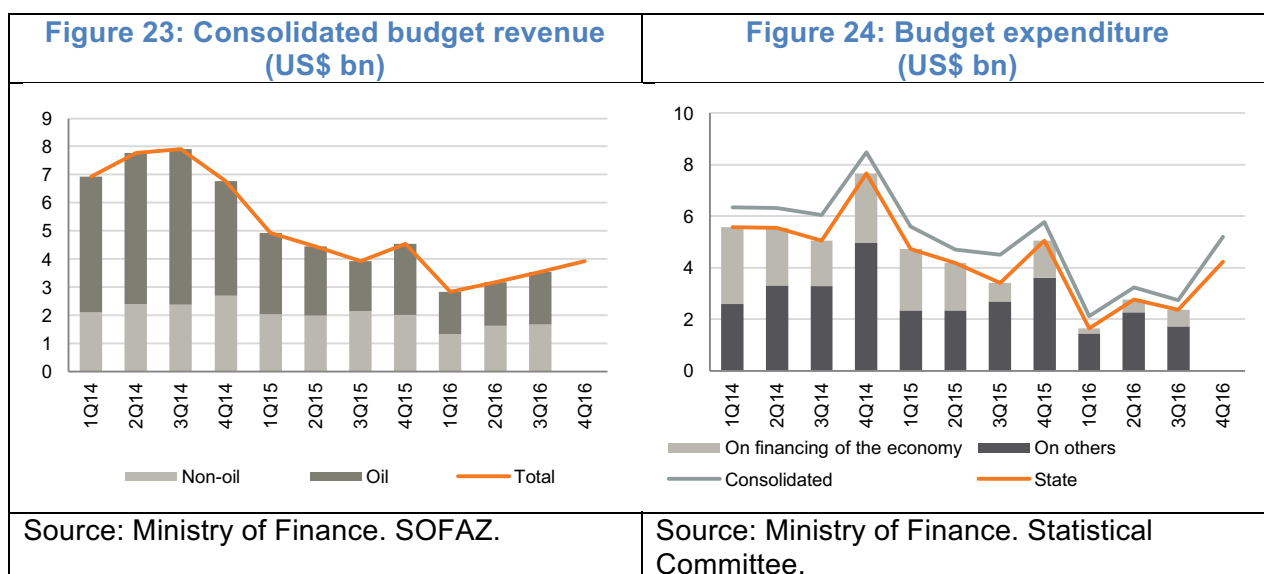
17. Like external balance, Azerbaijan's public finances are heavily dependent on the oil revenue. In nominal US\$ terms, consolidated budget revenues increased 34.7 times from 1999 to 2011 to US\$ 29.3bn. Receipts began to accelerate in 2005 and peaked in 2008, alongside the global oil price, to reach 48.4% of GDP. Oil related revenues in 2008 accounted for almost 80.0% of all revenues. While the share of oil revenues slightly subsided in the next few years, it still remained at annual average 70.3% from 2009 to 2015. Expenditures followed a similar upwards path albeit at a slower rate, surging 27.0 times over the same period.

18. The budget surplus also peaked in 2008 at almost 20% of GDP. Subsequent decline in revenues and an increase in expenditure served to shrink the surplus in the following years. After retreating to low single digit levels, budget balance turned into deficit of 5.3% of GDP in 2015. With the positive net balance in the previous years, the government was able to keep its debt to GDP ratio at relatively low levels until 2015 when it surged from 8.6% in the previous year to 19.8% in 2015 as two devaluations have slashed nominal GDP in US\$ terms.

19. Increased oil output and elevated oil prices from 2007 to 2014 drove SOFAZ revenues which increased from US\$ 2.2bn in 2007 to US\$ 16.2bn in 2014, with peak reached in 2011 at US\$ 19.8bn. Fund's expenditures, however, remained well below income, especially in the early boom years, resulting in higher savings. As a result, SOFAZ's assets increased from 7.5% of GDP in 2007 to 43% of GDP in 2010. However, as revenues stagnated and expenditures rose, the savings rate declined and the fund's assets-to-GDP ratio increased slightly thereafter to reach 49.3% in 2014. With two devaluations, however, manat value of reserves increased proportionately to the magnitude of devaluations resulting in SOFAZ reserves to GDP ratio reaching almost 100% in 2015 and 2016.

20. Impact of the oil shock is better illustrated through quarterly data. Oil related budget revenues averaged US\$ 5.2bn per quarter in the first three quarters of 2014, while non-oil revenues were US\$ 2.3bn per quarter. As oil price collapse started to take its toll since the last quarter of 2014, oil related revenues retreated to US\$ 2.4bn per quarter in 2015 and to US\$ 1.6bn per quarter in the first three quarters of 2016. So, compared to pre "shock" period, Azerbaijan's public budget was receiving US\$ 3.6bn less per quarter in 2016, which is a significant amount given the size of Azerbaijan's budget. Non-oil revenues in US\$ terms also declined, albeit at far lower level due to devaluation of the local currency. In local currency terms, however, fall was less dramatic as devaluations inflated foreign exchange receipts in the local currency terms.

21. Fall in revenues pushed the authorities to rein in spending by cutting capital expenditures. Unfortunately data for capital expenditure for the consolidated budget is not unavailable. However, state budget figures shed enough light to understand the developments. According to the Statistical Committee data, of the US\$ 6.0bn quarterly state budget spending in 2014, US\$ 2.4bn, or 40.6%, was spent on "financing of economy" (proxy for the capital expenditures). In the first three quarters of 2016, however, total quarterly state budget expenditures were US\$ 2.3bn, of which US\$ 0.4bn, or 19.9% was spent on financing economy.



22. In the local currency terms however, fall was less dramatic due to devaluations. While in US\$ terms expenditures for all categories was down, in local currency terms it was broadly stable. Increase in socially oriented spending was more than offset by the cuts in capital expenditures.

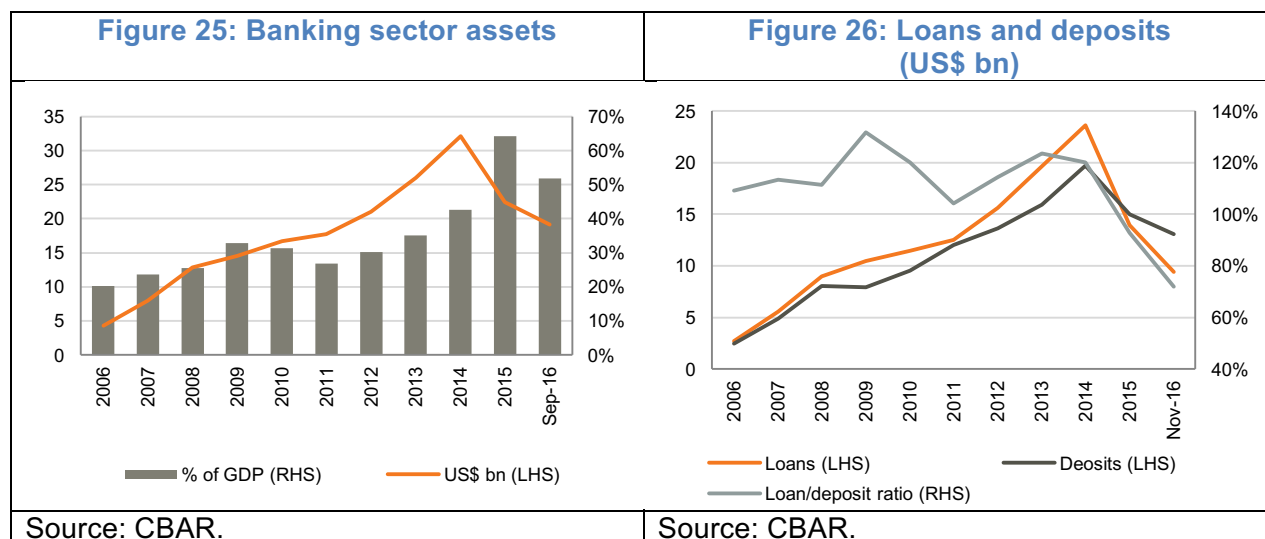
23. Again, like in the external balances, oil related revenues will likely not reach previous highs for the foreseeable future, thereby challenging capital expenditure oriented budget policy. As was mentioned above, public capital expenditure was the driving force behind GDP growth of the previous years. For the growth to resume and take a solid footing, therefore, there is a need to substitute this financing source from the public sector to the private sector, which naturally, requires appropriate institutional setting that will benefit the private investors.

24. Theoretically, authorities could have continued with spending spree by tapping reserves and/or international debt markets. This, however, would have resulted in a fast depletion of the reserves and/or fast increase in debt ratios and debt service cost. Budget revision for 2016 and conservative spending compared to the budget document indicate that authorities are aware of these possibilities and do not wish to exacerbate long term fiscal sustainability. Cuts in spending and commitment to preservation of reserves actually served a credit positive for the economy and will benefit country in the medium to long term.

C. Banking sector

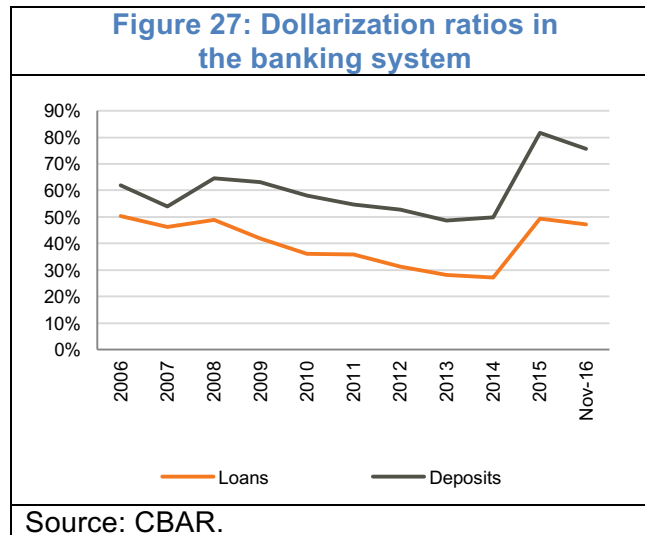
25. Rapidly growing economy of the previous several years have resulted in an expansion of the banking system too. From 2006 to 2014 total assets of the banking system increased from US\$ 4.3bn (20.2% of GDP) to US\$ 32.1bn (42.7% of GDP) while gross capital increased from US\$ 0.7bn to US\$ 5.4bn. Loan book of the banks increased from US\$ 2.7bn in 2006 to US\$ 23.6bn in 2014, driven by local currency loans. While loans in local currency increased

12.8 times over the mentioned period, loans in foreign exchange increased 4.7 times. As a result, loan dollarization ratio in the banking system declined from 50.5% in 2006 to 27.2% in 2014. Dollarization ratio of deposits also declined during the same period, albeit at a slower pace, retreating from 62.0% in 2006 to 49.9% in 2014. Additionally, commercial banks' net foreign assets, has generally been in the negative territory, meaning that banks' financing was mainly in foreign exchange while its assets were in local currency.



26. Banking sector statistics worsened particularly following two devaluations in 2015 and contraction of the economy in 2016. Devaluations resulted in sudden changes in the banking sector ratios depending on the share of foreign denominated assets and liabilities and by mass scale move from local currency deposits to foreign exchange, leading to deposit dollarization ratio surging to 81.6% by the end of 2015, with subsequent minor retreat to 75.6% in November 2016. Balance sheet items, used to upward trend now headed down, distorting various ratios. For example, banking sector assets as a share of GDP jumped from 42.7% in 2014 to 64.2% in 2015, non-performing loans increased to 8.9% in November 2016. From the last month of 2015 to November 2016, total loan portfolio of the banking system declined 25.1% in local currency terms while deposits slightly retreated and remained skewed towards foreign exchange, and so on.

27. Naturally, health of the banking system was stress tested and serious problems began to emerge, which were disguised until now thanks to a booming economic activity in the previous years. Withdrawal of banking licenses from several banks, plus ad hoc changes in regulations and other measures further undermined trust to the banking sector. So, rather than finance economic growth, banks are more concerned about improving their conditions.



D. Summary of shock

28. Vital pillars of the growth were seriously undermined as oil price shock took its toll: shrinking current account balance is eroding reserves, less oil revenue forces budget spending down and the banking system, which was probably not in a good condition even before the crisis, is reeling in problems. As low oil prices are expected to remain for a long period, Azerbaijan needs to address these challenges by attracting foreign investments (both direct and portfolio/other investments) to compensate for the fall in exports; switch from public led growth to private led growth. Foreign investors can probably plug the gap if proper reforms are implemented in a fast and committed way.

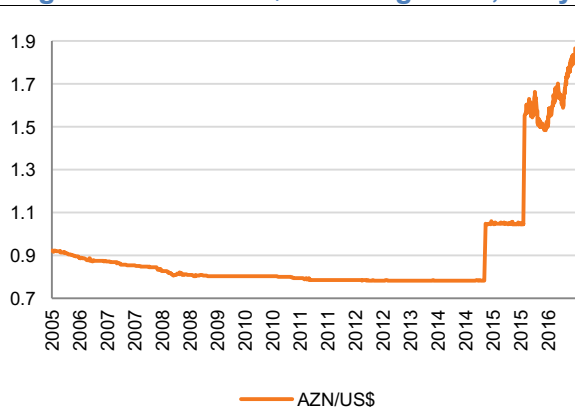
IV. Policy response

A. Monetary policy response: devaluation and monetary tightening

29. Faced with the pressure on reserves, possibility of double digit budget deficit and narrowing external surplus, regulator in Azerbaijan stepped in by devaluing the currency on February 21, 2015. By then central bank reserves were already down to US\$ 11.0bn, 27.6% less compared to a peak reached in July 2014 at US\$ 15.2bn. Central bank slashed exchange rate from 0.7862 AZN/US\$ to 1.05 AZN/US\$. It should be remembered that local currency has broadly remained stable over the previous decade.

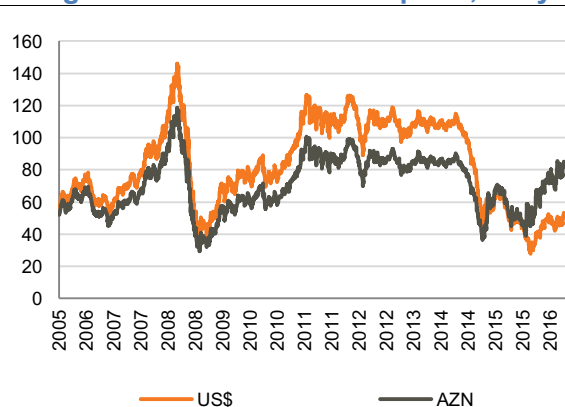
30. Calculations indicate that new exchange rate was enough to balance the budget, as it served to inflate oil related revenues. Azerbaijan's budget document for 2015 has set oil price at US\$ 90/bbl and exchange rate at 0.78AZN/US\$, meaning that local currency price of crude oil was set at AZN 70.2/bbl. However, by then oil price had fallen to US\$ 60.2/bbl (AZN 47.0/bbl at 0.78 AZN/US\$ exchange rate). With devaluation, local currency price of the crude oil was brought back to AZN63.1/bbl, thereby eliminating the need to revise the budget.

Figure 28: AZN/US\$ exchange rate, daily



Source: Bloomberg.

Figure 29: Brent crude oil price, daily



Source: Bloomberg.

31. However, pressure on reserves was not eliminated after the devaluation as fall in reserves picked up in the second half of the year. With reserves retreating to almost US\$ 5.0bn in December 2015, regulator stepped in to announce second devaluation by changing exchange rate from 1.0499 AZN/US\$ to 1.55 AZN/US\$ along with change of exchange rate policy from targeting to managed float.

32. At the same time, regulator started policy of monetary tightening. Money supply (M2) contracted sharply in 2015 from 29.5% of GDP in 2014 to 16.0% in 2015. It increased in 2016 but only partially to 18.2% of GDP. In nominal AZN terms, M2 was down 50.2% y/y in 2015 to AZN 8.7bn. In 2016 M2 was up 26.1% y/y to AZN 10.9bn.

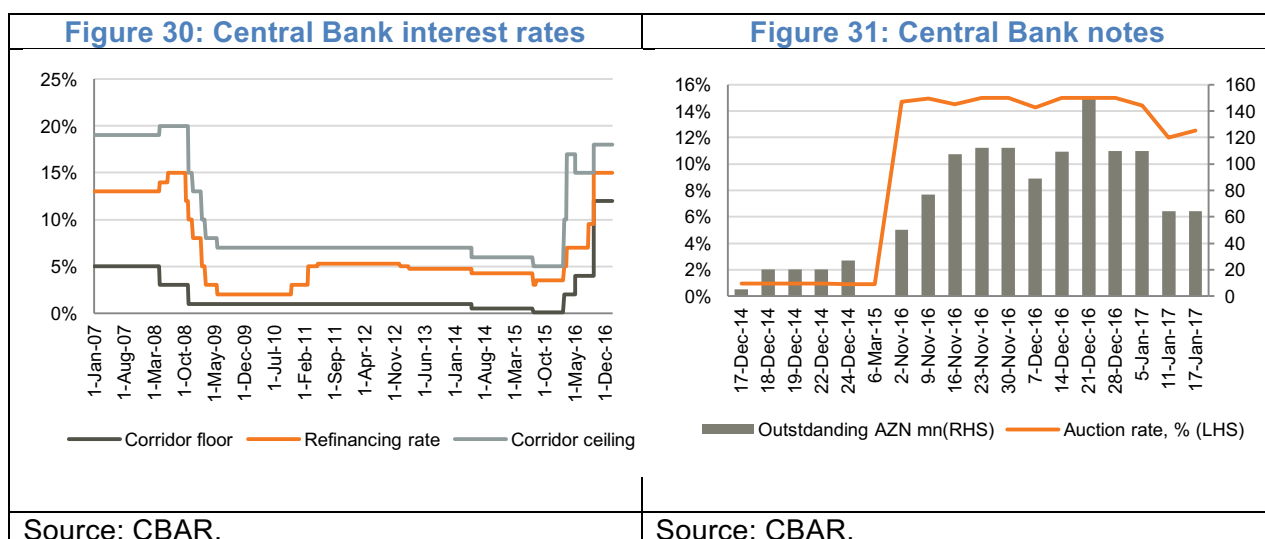
33. Monetary supply contracted mainly due to sharp fall in cash in circulation which was down 53.0% y/y to AZN 4.8bn, followed by 61.3% y/y fall in time deposits in the local currency.

33. In 2016 cash in circulation was up 22.1% y/y to AZN 5.8bn while time deposits in local currency were up 43.5% y/y to AZN 2.6bn. Demand deposits, however, remained broadly stable, recovering to AZN 2.6bn in 2016 following 20.8% y/y fall in 2015.

34. While it is highly likely that one of the reasons of fall in money supply is conversion of local currency holdings (cash in circulation) to FX, other drivers were Central Bank's hike in policy rate, introduction of deposit auctions and re-introduction of Central Bank debt instruments to collect local currency liquidity from the market.

35. Central bank raised refinancing rate four times in 2015 with the aim to restore trust in the local currency. The rate was first raised on February 15, 2016 from 3.0% to 5.0%, then, on March 4, 2016 to 7.0% and on August 8, 2016 to 9.5% followed by the decision on September 14, 2016 to increase it to 15.0%. However, given high levels of dollarization, the impact of the interest rate increases will probably be limited.

36. Another instrument used by the Central Bank to restore trust in the local currency is the initiation of deposit auctions. From June 13, 2016 to the end of 2016 central bank has held 25 auctions and in 13 of them demand was lower than central bank's offer. At the same time, interest rate on the deposits has been increasing from 6.5% in the first auction to 9.5% on August 8, 2016, and then to 14.99% since September 19, 2016.



37. Other monetary and related policy responses:

- Extension of the deposit guarantee to cover all deposits, subject to interest rate restrictions, is still another policy response to recover trust to the local currency. All Foreign exchange deposits with less than 3% interest rate and local currency deposits with less than 12% are fully insured effective since February 2016. However, this move will increase burden on the deposit insurance fund. According to some sources, fund is supposed to meet its obligations by issuing bonds and/or taking loan from the central bank. This in turn will increase supply of local currency, thereby, assisting the pressure

on the local tender. It should be remembered that 10 banks have already been closed, and according to the fund, by January 17, 2017 AZN 722.0mn has already been spent to cover obligations arising from deposit insurance.

- Reserve requirement for assets in foreign exchange was increased from 0.5% to 1.0%.
- Some other policy responses are:
 - Closure of currency exchange bureaus. From early January 2016 currency exchange operations are done only at bank branches.
 - Identification document should be presented when more than US\$ 500 is exchanged.
 - Widening of the allowable spread from the officially set exchange rate from 2% to 4% (revoked in early January 2017).

38. However, in spite of the monetary tightening policy, Central Bank's loans to commercial banks surged starting from the second half of 2015. Central Bank's claims on commercial banks were broadly flat at around AZN 1.4bn in 2014. By the end of 2015, however, claims increased 265.0% y/y to AZN 5.4bn, and further up 35.3% y/y in 2016 to AZN 7.3bn. Unfortunately, increasing claims on commercial banks do not fit into the policy of monetary tightening that aims to limit local currency money supply eventually undermining the announced policy of monetary tightening.

B. Fiscal response: Budget revision

39. Azerbaijan's budget for 2016 was drafted and eventually approved in the second half of 2015, when oil price was around US\$ 50/bbl. Budget had assumed US\$ 50.0/bbl oil price along with 1.05 AZN/US\$ exchange rate. However, by the second half of December oil price was already below US\$ 40/bbl and continued to fall. Eventually, government revised budget early in 2016 to reflect new conditions in the oil price and exchange rate. In the revised document oil price was set at a very conservative US\$25/bbl, and exchange rate at 1.6 AZN/US\$. Additionally, socially oriented expenditures were slightly increased to address 10% increase in salaries of several public sector entities, while capital expenditures were cut. Actual data for 2016 indicates that authorities have remained committed to cuts in spending with actual consolidated government expenditure coming at AZN 21.4bn or 12.9% less than budgeted. Revenues, on the other hand, have performed far better on the back of a relative pick up of oil price. According to Ministry of Finance data, consolidated budget revenues reached AZN 21.6bn or 37.1% more than budgeted. This has helped budget to return to surplus at AZN 0.2bn (0.3% of GDP) compared to the budgeted deficit of AZN 8.8bn (-15.3% of GDP).

40. Cut in public capital expenditure, however, had a shock effect on the economic growth, particularly on construction sector which contracted by close to 30% in 2016. On the positive side, however, budget came in comfortable surplus in 2016 and SOFAZ reserves are up compared to the end of the previous year.

C. Changes in Tax and Customs policies

41. Resolution for an extensive tax reform is signed on August 4, 2016, which should include the following (source: Deloitte):

- Simplification of tax administration procedures and tax burden reduction;
- Application of VAT on mark-up amount of goods sold by retailers;
- Introduction of indicators differentiating retail and wholesale trade;
- Application of Tax Free system at other border checkpoints in addition to airports;
- Definition of the list of products for application of differentiated VAT rates;
- Introduction of Advance Tax Ruling concept;
- Prohibition of desk tax audits by the tax authorities after 30 days from filing tax returns by taxpayers;
- Introduction of "Whistleblow" system allowing reporting of tax evasion;
- Introduction of Voluntary Tax Disclosure concept;
- Promotion of cashless payments and gradual restriction of cash payments;
- Introduction of Transfer Pricing regulations;
- Definition of spheres of activities that carry out cash transactions without application of cash register electronic equipment and definition of fixed monthly tax liability for individuals operating without application of cash register electronic equipment;
- Preparation of a mechanism for application of Common Reporting Standards;
- Simplification of tax administration procedures stipulated in double tax treaties concluded between Azerbaijan and other countries;
- Implication of Digital Economy to the tax system for the purposes of broadening the tax base;
- Introduction of rules for e-commerce taxation;
- Clarification of distinction between the production and processing of agricultural products;
- Conclusion of intergovernmental treaties allowing automatic exchange of financial information between the countries;
- Reconciling anti-avoidance rules contained in the Azerbaijan tax legislation with the international experience;
- Establishing effective tax controls over activities of tax residents of Azerbaijan in tax offshores and low tax jurisdictions;
- Undertaking necessary improvements in the legislation to obtain and maintain the OECD Global Forum's high rating on the indicators of transparency and exchange of tax information.

42. Additionally, the following has already been implemented:

- Tax on income from deposits suspended for 3 years effective from February 1, 2016. This tax was generally suspended in the previous years with the exception of 2015. Income tax rate for interest income is 10%.

- Tax refund procedure introduced on July 12, 2016 for foreigners and persons without citizenship for goods whose price is above AZN 300.
- Export subsidies introduced for further promotion of non-oil exports. According to the decree, the subsidy is set at 3% of declared customs value of the exported good.
- E-declaration systems introduced
- Some customs procedures transferred to ASAN service centers, an agency known for transparency, efficiency with least bureaucratic procedures.

D. Changes in institutional and legal domains

43. Among the major institutional innovations in the economic domain was the establishment of the Financial Market Supervisory Chamber. The new public entity was entrusted with regulation of the financial sector in the country, including oversight over the banks, securities and insurance market. As a result, some functions of the Central Bank, Ministry of Finance were transferred to the new entity and State Securities Committee was abolished.

Other responses are:

- Board of appeals under president established: it will provide venue for entrepreneurs to appeal decisions of central and local executive authorities.
- Center for the Economic Reform Analysis and Communications established to expand and coordinate ongoing economic reforms. Its vision is to provide advisory services in the path towards creating competitive socially oriented market model.
- Establishment of new industrial zones in the regions of Azerbaijan.
- Rules for the issuance of "Investment Promotion Document" were approved on January 18, 2016. IPD grants tax and customs benefits like exemption from land, asset taxes, along with VAT and customs duty exemption on imported equipment and technologies and exemption of 50% of income from the income tax for 7 years. 32 investment promotion documents have already been handed to the entrepreneurs, and, according to the deputy Economy Minister, they plan to give in total 51 investment promotion documents which should lead to AZN 0.5bn investments.
- Business inspections have been suspended for 2 years effective since November 2015.
- Document on main directions of the strategic road map of the national economy and main economic sectors approved on March 16, 2016.
- McKinsey & Company was hired by the government of Azerbaijan to develop a road map for the country until 2025 and beyond.
- Position of economic reforms advisor for president established and former deputy tax minister, Natig Amirov, appointed to the role. Natig Amirov defined reforms will be along four directions:
 - Stability in the financial markets, revival of local currency liquidity and improvement of financial discipline
 - Support to exports
 - Development of the domestic market and easing dependence on imports
 - Supporting entrepreneurs particularly in agriculture through public tenders

- Special commission for improving business environment created on July 13, 2016 with the purpose of improving Azerbaijan's business environment and its position in various international ratings which should increase country's attractiveness for local and foreign investors.
- Build-operate-transfer is to be introduced in Azerbaijan on construction and infrastructure projects.
- Visa procedures have been eased and processing days decreased from 10 to 5 days. Citizens of Qatar, Oman, Saudi Arabia, Bahrain, Kuwait, Japan, China, South Korea, Malaysia and Singapore can get 30 day single entry visa at the visa centers in the international airports of Azerbaijan starting from February 1, 2016.
- Privatization process is supposed to be revived and online portal has been inaugurated for this purpose. 51 state enterprises were put on a sale on August 29, 2016 within the process of privatization and according to State Property Issues Committee 30%-45% of shares of the controlling stake in the authorized capital of these enterprises are subject to privatization.

44. Summary of the main reform measures as classified by the newly formed Center for Analysis of Economic Reforms and Communication is presented in the Appendix. Quick look at these initiatives and various strategies indicates that they are more future oriented. While extensive, the impact of these reforms/changes has yet to be realized. However, administrative nature of these reforms and non-coordinated approach might limit their positive effect.

45. Macro economic developments since mid 2014 indicate that economic contraction continues despite recovery in oil prices far below than was budgeted. Eventually this could be explained by a relatively slow pace of reforms and their focus on long term perspective. At least as of late 2016 it seems that losses stemming from the fall in oil price have not been compensated yet from non-oil sources. External balance is still in deficit, and investments by the private sector into non-oil sector remaining limited. Dependence of the consolidated budget on the oil inflows was once more underlined as higher than expected oil prices helped public finances to return to surplus in 2016.

V. Support from ADB and other IFIs

46. Azerbaijan needs to secure non-oil external and fiscal financing sources to stabilize and revitalize its economy. In that respect, financial assistance from ADB and other IFIs can act as a first step in attracting private financing in the next stages. Additionally, ADB along with other IFIs are renowned for their commitment to good practices in the projects they participate. Therefore, increasing participation of ADB and other IFIs is naturally beneficial for Azerbaijan, both as a financing source and in terms of achieving good results.

47. ADB has already provided US\$ 2.3bn loans since 1999 to 26 projects including 10 in private sector, 1 grant and 21 technical assistance projects. These loans have helped to upgrade country's infrastructure, improved provision of basic services, etc. However, there is still more to be done and ADB and other IFIs should expand their presence in Azerbaijan. Particularly given that with low oil prices country's external financing needs will increase and diversification policy will require better governance standards.

48. In terms of project finance, it is important for ADB to finalize existing projects. Additionally, future projects should be selected on the basis of the prospective value generation for the country and Azerbaijani people. These will likely be the ones that support diversification, assure uninterrupted basic services to people and enterprises, and increase regional integration of Azerbaijan.

49. At the same time, advisory and technical assistance programs should be continued. In terms of advisory services, ADB should be mobilized to help authorities in building connection between policies and their eventual impact. This crisis, at least for now, has highlighted divergence between policy responses and actual outcome as numerous policy responses have not yet been translated to macroeconomic rebound.

50. In terms of assistance to private sector and, thereby, contribution to diversification, ADB should assist with the development of capital markets whereby investors would be able to get private financing for their projects. Additionally, private sector players should be advised to try to tap international capital markets as local sources of finance will likely be limited given low oil price.

51. To sum up, along with the project finance, ADB and other IFIs should assist Azerbaijan in translating announced policies into practical results, provide financing to the projects that have the potential to add value in the future by improving input costs for the private sector players, contribute to the development of the local capital markets, help private investors in accessing both local and international capital markets.

VI. Conclusion and recommendations

52. Future growth, and thereby employment opportunities, in Azerbaijan will be subject to investment flows from the private, specifically foreign, sources. GDP growth has already been hurt by cuts to capital investments in 2015 and 2016 particularly in construction. This trend of low public investments will likely continue in the years to come, dragging down the overall growth rate, unless private investments start flowing.

53. To counter with this possibility Azerbaijan should attract non-public investments and make fundamentals of the economy more attractive for foreign investors. Massive capital expenditures of previous years, particularly investment in infrastructure, have probably expanded Azerbaijan's potential economic output. Additionally, significant international reserves along low foreign penetration in the non-oil sectors are other important sources of attraction. The Azerbaijani authorities now need to develop policies to build on these advantages, particularly by attracting foreign investment and know-how. Foreign financial and non-financial entities can revitalize economy through competition and by bringing in foreign capital. Financial entities are vital in the process as local banks are in no position to finance growth and as foreign entities can take financial intermediation to a new level that will assure the efficient utilization of investments.

54. Reform process, therefore, should prioritize private investments and preferably set measurable indicators. Stability in the exchange market, trend in private investments and non-oil exports are some among macro economically measurable indicators. At the same time, Azerbaijan should improve its scores for every indicator of World Bank's Doing Business report, particularly the one which have the lowest scores.

55. But before the investments come, there is a need to restore trust to local currency with forward looking credible projections/commitments. This will probably require fully functional floating exchange rate regime. Additionally, uncertainty in the banking sector should be addressed as soon as possible. Closing banks one by one over the extended period further intensifies negative expectations regarding banking sector. Therefore, policy should be announced to stress test all banks at once and take firm action based on the results.

56. On the institutional side, it means that the set up formed over the long years of publicly financed growth should be reformed to serve the privately financed growth. This, in turn, means prompt, transparent and concentrated decision making. Diffusion of economic decision making generally leads to fragmentation of the process. So, in case there is a need, cuts in staff and mergers of some public entities/departments/agencies should be carried out. Close coordination of policies with the private sector are more than welcome and it could be facilitated by bringing new faces from the private sector. To sum up, shift from publicly financed growth to privately financed one requires that institutional setting should be adjusted to demands of the private sector, rather than decided in the administrative top down way within state bureaucracy.

Bibliography

British Petroleum. 2016. *BP Statistical Review of World Energy June 2016*.

Central Bank of Azerbaijan Republic. (n.d.). Retrieved from <https://en.cbar.az/>

Azerbaijan tax news. 2016. *Deloitte Azerbaijan*. 5 August.

<https://www2.deloitte.com/content/dam/Deloitte/az/Documents/tax/aze/Tax%20News%20-%20August%204.pdf> (accessed 17 January 2017).

Azerbaihan news. 2016. *Deloitte: Legal News Update*. 10 October.

<https://www2.deloitte.com/content/dam/Deloitte/az/Documents/legal/aze/Deloitte%20Azerbaijan%20-%20Legal%20News%20October.pdf>

Financial Market Supervisory Authority of the Republic of Azerbaijan. (n.d.). <http://en.fimsa.az/>

Musayev, V. 2016. *Azərbaycanda 2016-cı ildə həyata keçirilən iqtisadi islahatlar*. Baku: Center for Analysis of Economic Reforms and Communication.

PwC Azerbaijan Times. 2016. April. <http://www.pwc.com/az/en/publications/pwc-az-times/assets/pwc-az-times-issue-06-2016-eng.pdf>

State Agency on Mandatory Health Insurance under the Cabinet of Ministers of the Republic of Azerbaijan. (n.d.). <http://its.gov.az/en/>

State Housing Construction Agency. (n.d.). <http://mida.gov.az/az/>

Appendix

This appendix summarizes main reform measures. Documents published by the Center for Analysis of Economic Reforms and Communication formed the main basis of the appendix.¹

- Main reform measures
 - Institutional reforms
 - **Financial Market Supervisory Authority of the Republic of Azerbaijan (FIMSA).** FIMSA is a public legal entity in charge of licensing, regulation and supervision of the credit institutions, insurance sector and securities market. According to Decree of the President of the Republic of Azerbaijan, dated February 3, 2016, FIMSA was established with the goal of improving licensing, regulation and supervision of:
 - Securities market
 - Investment funds
 - Insurance
 - Credit organizations (banks, non-bank credit organization and postal operator)
 - Payment systems operations

In addition, improving a supervisory system for the following:

- Prevention of legalizing criminally obtained funds and other property
- Financing of terrorism
- Maintenance of transparency and flexibility in the supervision of these fields.

<http://en.fimsa.az/>

- **State Agency on Mandatory Health Insurance under the Cabinet of Ministers of the Republic of Azerbaijan.** The Agency, whose regulation and structure were approved by the presidential decree dated February 15, 2016, operates:
 - To ensure implementation of a state policy on mandatory health insurance;
 - To improve accessibility of healthcare services for the public;
 - To improve quality and efficiency of healthcare services in order to protect and boost public health.

The Agency also aims to achieve the following:

¹ V. Musayev. 2016. Azərbaycanca 2016-cı ildə həyata keçirilən iqtisadi islahatlar. Baku, Azerbaijan: Center for Analysis of Economic Reforms and Communication.

- Change of hospital management system;
- Reorganization of healthcare sector in line with existing international standards;
- Promotion of transparency and competition between state and private hospitals.

<http://its.gov.az/en/>

- **State Housing Construction Agency (MIDA).** The Agency, whose regulation and structure were approved by the presidential decree dated April 11, 2016, aims to meet housing needs of Azerbaijani citizens. The Agency is a central executive power body, responsible for building residential buildings and other construction projects; for providing citizens of Azerbaijan with an opportunity to purchase housings at discounted price and ensuring efficient use of funds allocated for the construction of residential buildings (PwC Azerbaijan Times, April 2016)

<http://mida.gov.az/>

- **Food Product Procurement and Supply Open Joint Stock Company (OJSC).** OJSC, whose regulation and structure were approved by the presidential decree dated April 11, 2016, aims to stimulate the production and utilization of agricultural products by (Deloitte Legal, October 10, 2016):
 - Organizing the centralized supply of food products purchased by state companies and organizations
 - Monitoring activities of local producers
 - Facilitating the direct purchase of food products by state companies and organizations from producers via the Company's e-portal, etc.
- **State Examination Center.** Center is a public legal entity established by the presidential decree dated April 11, 2016, will combine functions previously overseen by State Students Admission Commission and State Civil Service Commission.
- **Center for Analysis of Economic Reforms and Communication.** Center, established by the presidential decree dated April 20, 2016, is tasked with developing proposals for economic reforms based on macro and micro level economic research. Additionally, Center is responsible for preparation of forecasts for other government entities and communicating reforms.

- **State Commission to improve business environment and international ratings.** Commission was established based on the presidential decree dated July 13, 2016. Commission is tasked with improvement of business and investment environment in Azerbaijan.
 - **Financial Stability Council.** Established by the presidential decree dated July 15, 2016, Council's function is to ensure macroeconomic and financial stability, implement coordinated policies, and effective regulation and implementation of laws. Council comprises of authorities from both entities responsible for monetary and fiscal policies.
 - **Tourism Council of the Republic of Azerbaijan.** Established by the presidential decree dated September 1, 2016, Council's function are:
 - To prepare directions of development of tourism potential of Azerbaijan
 - To assess situation in the tourism sector and provide solutions to problems in this area
 - To advise on necessary legislation changes to promote tourism
 - Improve tourism potential of the country and regions
 - Coordinate functions related to tourism among other state entities, etc
 - **ABD - Easy Support for Family Business (ABAD).** ABAD was established by the presidential decree dated September 23, 2016 as a public entity under State Agency for Public Service and Social Innovations under the President of Azerbaijan. It aims to encourage development of competitive family businesses, thereby promote active participation on citizens in the economic development of the country and improve employment opportunities. The purpose is to support development of the regions and involve citizens in the economic growth.
 - **National Coordination Council on Sustainable Development.** Council was established by the presidential decree dated October 6, 2016. Council is responsible for the determination of national priorities and associated targets in accordance with global goals and targets of importance to Azerbaijan by 2030, and coordinate state socio-economic programs and strategies with Sustainable Development Goals.
- Policies to improve business and investment environment
- In order to provide systematic approach Azerbaijani president signed a decree on March 16, 2016 to start the work on **Strategic Road Map of National Economy of Azerbaijan** which was eventually endorsed on December 6, 2016. Road map is focused on 11 priority sectors each

assigned separate road map under an umbrella of the Strategic Road Map of National Economy. These 11 priority sectors and their respective road maps are below:

- Strategic Road Map for the development of the oil and gas industry (including chemical products) of the Republic of Azerbaijan
 - Strategic Road Map for the manufacture and processing of agricultural products in the Republic of Azerbaijan
 - Strategic Road Map for the manufacture of small and medium entrepreneurship-level consumer goods in the Republic of Azerbaijan
 - Strategic Road Map for the development of heavy industry and machinery in the Republic of Azerbaijan
 - Strategic Road Map for the development of specialized tourism industry in the Republic of Azerbaijan
 - Strategic Road Map for the development of logistics and trade in the Republic of Azerbaijan
 - Strategic Road Map for the development of housing provision at a reasonable price in the Republic of Azerbaijan
 - Strategic Road Map for the development of vocational education and training in the Republic of Azerbaijan
 - Strategic Road Map for the development of financial services in the Republic of Azerbaijan
 - Strategic Road Map for the development of communication and information technologies in the Republic of Azerbaijan
 - Strategic Road Map for the development of utilities (electricity and thermal energy, water and gas supply) in the Republic of Azerbaijan
-
- Rules on “**Green Corridor**” at the customs were signed on May 21, 2016 which aims to simplify border crossing procedures by introducing four corridors: Green, Blue, Yellow, and Red.

 - On September 21, 2016 decree was issued to establish “**Azexport.az**” portal which will keep unified database for the goods produced in Azerbaijan.