Azerbaijan diagnostic

2024

European Bank
for Reconstruction and Development

Country diagnostics are a European Bank for Reconstruction and Development (EBRD) tool for identifying the main obstacles to entrepreneurship and private-sector development and shaping the Bank's strategic priorities and project selection in new country strategies. Each diagnostic informs the EBRD's policy engagement with the authorities in that country.

Diagnostics assess the progress and challenges of developing a sustainable market economy in the country in question. Private-sector development and entrepreneurship are at the heart of the Bank's mandate in the regions where the Bank operates, but the private sector in all EBRD economies faces a range of problems and obstacles. The diagnostics highlight the key challenges facing private companies and show where each country stands in relation to its peers in terms of six qualities of transition – competitive, well governed, resilient, integrated, green and inclusive – pointing out the main deficiencies and gaps in each.

The diagnostics draw on a range of methodologies and best practices for assessing the size of different obstacles. Extensive use is made of in-house expertise across the EBRD, along with surveys such as the Business Environment and Enterprise Performance Survey (BEEPS) and the Life in Transition Survey (LiTS), as well as other cross-country surveys and reports from institutions such as the World Bank, World Economic Forum and Organisation for Economic Co-operation and Development (OECD). For some larger countries, the diagnostics also draw on specially commissioned studies of selected issues that are critical to private-sector development in that country.

The diagnostics are led by the EBRD's Country Economics, Strategy and Policy team, drawing substantially on the expertise of sector, governance and political experts in the Policy, Strategy and Delivery department (PSD) and consulting widely with relevant experts across the EBRD when preparing the final product. The diagnostics are shared with the EBRD Board during the Country Strategy process and published during the public consultation period.

The views expressed in the diagnostic papers are those of the authors only and not of the EBRD.

This report was prepared by Jongwoo Lim, Economic Analyst, and Isabella Diez Imbriaco, Country Strategy Analyst, in the Policy, Strategy and Delivery (PSD) department, under the supervision of Dimitar Bogov, Eastern Europe and the Caucasus Regional Lead Economist. The authors are grateful for the contributions and comments provided by Peter Sanfey (CESP), Oleksandr Pavlyuk, Idil Bilgic-Alpaslan, Lizaveta Trakhalina, Hester Coutanche, Christine Hagedorn, Andrei Mazur, Nicola Lipari, Maxime Meftah, Yuliya Zemlytska, Anastasios Giamouridis (CGPA), Katie Tikanashvili, Mariam Kobalia (GEI), Samir Ismayilov, Rada Tomova (CFMD), Sung-Ah Kyun, Cem Gundogan, Mine Isik (CSD) and Pavle Djurik (LTT). Editor: Poilin Breathnach. The views expressed in this paper are those of the authors only and not necessarily those of the EBRD. The report is based on information and data available as at November 2023, with the exception of the macroeconomic overview section and Box 1, which were updated in September 2023, and the EBRD assessment of transition qualities (ATQ) score, updated in February 2024.

Contents

1. Executive summary

Azerbaijan's centralised political system and resource-driven economic model make implementing a consistent reform agenda a challenging task. Despite efforts to accelerate reforms and economic growth by diversifying the economy towards the non-oil sector, the dominant role of oil and gas in the economy remains. Amid Russia's continued war of aggression against Ukraine, Azerbaijan's role as an energy supplier and transport hub has grown, and the European Union (EU) considers the country a vital resource for diversifying its energy supply.

The oil and gas sector generates more than 40 per cent of gross domestic product (GDP) and accounts for more than 90 per cent of the country's exports. Volatile export revenues not only determine the performance of the oil and gas sector, but also influence domestic demand and, through it, non-oil sector growth. The oil and gas sector also attracts the majority of investment and, as a result, there has been limited progress on economic diversification, while the country's income convergence has slowed. Nevertheless, oil and gas export revenue has given Azerbaijan a strong foreign reserves buffer, which supports macroeconomic stability. Efforts to reduce budgetary dependence on oil revenues have yielded results recently.

The **competitiveness** of the economy is constrained by the dominance of state-owned enterprises (SOEs) and a few large politically connected conglomerates. The resource-dependent economy lacks diversity and sophistication. The business environment does not stimulate entrepreneurship and the development of small and medium-sized enterprises (SMEs). Despite some recent progress, businesses continue to face regulatory and administrative challenges, indicating a need to extend and deepen reforms.

There is lack of awareness about the benefits of **governance** reform, while regional geopolitical developments and high oil revenues undermine the need for change. Public institutions have insufficient capacity and highly hierarchical structures. The SOE sector is the only area where the authorities have clearly articulated reform ideas, but implementation to date has been hesitant.

The economy's lack of job creation, skills shortages and gender stereotypes contributes to broad **inclusion** gaps. The number of people entering the labour market every year is 2.5 times the number of jobs created. More than a third of employment is in low-productivity agriculture, generating a huge urban-rural divide in productivity and income levels. A gender pay gap of 40 per cent, on average, is present in all sectors of economic activity.

The huge revenues generated by oil and gas production and the availability of cheap domestic energy complicate the **green** transition. The country has significant untapped hydro, solar and wind power potential, but the share of renewable energy sources has remained low since the 1990s. Nevertheless, there is a growing awareness among the authorities that renewable energy exports might be a viable long-term alternative to hydrocarbons.

Azerbaijan's financial **resilience** is vulnerable to the dominance of the highly concentrated banking system, though it is rather small and credit penetration is low. Financial markets are in the early stages of development. Thanks to its large oil and gas reserves, Azerbaijan has one of the highest levels of energy self-sufficiency in the world. The energy sector is dominated by SOEs and involves heavy cross-subsidisation. More private-sector involvement in the energy sector will require structural reform and market deregulation.

Oil and gas exports play a crucial role in Azerbaijan's **integration** into the world economy. Non-oil exports remain subdued, accounting for around 5 per cent of GDP. Trade logistics are underdeveloped, while domestic road and rail networks require modernisation and better maintenance. Broadband internet speeds are among the lowest in Europe and digital divides continue to exist between the capital and other urban and rural areas. The Middle Corridor transport route connecting China and Central Asia with Europe is an emerging opportunity that requires regional cooperation and the attraction of private investment to materialise.

2. Political and economic overview

Political economy (as at 12 February 2024)

Azerbaijan's political economy remains defined by the country's centralised political system and resource-driven economic model, which have long made implementing a consistent reform agenda a challenging task.

Azerbaijan has a presidential form of government, with key powers concentrated in the presidency. President Ilham Aliyev has been in power since 2003. He has been re-elected four times since then, most recently in an early election on 7 February 2024 for a period of seven years. The end of more than 30 years of conflict with neighbouring Armenia has seen the return of territory to Azerbaijan. Developing that territory is now a top government priority. The government (Cabinet of Ministers) is formed by the president and accountable to him.

In autumn 2019, President Aliyev undertook a series of administrative reshuffles, appointing younger and more technocratic figures to the government. Following this "elite modernisation", the government was tasked with accelerating reforms and economic growth, with special emphasis on diversifying the economy towards the non-oil sector. Reform measures taken since then, such as empowering the popular Azerbaijan Service and Assessment Network (ASAN) government service centres, simplifying customs procedures, reforming the tax regime and eliminating certain business licences, have aimed to improve the business climate and stimulate private-sector development.

Progress on economic diversification and structural reforms has so far been limited. The economy remains dependent on oil and gas exports and is dominated by a small group of holding companies. The appetite for structural reforms has generally depended on the oil price. Although petty corruption has been reduced and high-level corruption is being addressed, corruption remains a serious challenge. In the 2023 Transparency International Corruption Perceptions Index, Azerbaijan ranked 154th out of 180 countries. Challenges related to the independence, impartiality and effectiveness of the judiciary affect the rule of law and protection of property rights. The business environment remains challenging.

Oil wealth has enabled Azerbaijan to be self-sufficient and has provided the foundation for the country's foreign policy confidence. Azerbaijan places emphasis on national sovereignty and its non-aligned status. It is not a member of the World Trade Organization, and its negotiations with the EU on a new comprehensive agreement (to replace the 1999 Partnership and Cooperation Agreement), launched in February 2017, have yet to be concluded.

Azerbaijan's important role as an energy supplier and transport hub has been reinforced in the wake of Russia's war on Ukraine. The EU considers Azerbaijan a vital resource for energy diversification. In July 2022, the European Commission and Azerbaijan signed a memorandum of understanding on a strategic partnership in the field of energy, pledging to double the capacity of the Southern Gas Corridor (to at least 20 bcm) and to enhance cooperation on energy efficiency and clean energy. Together with Georgia, Azerbaijan is developing an electricity cable project under the Black Sea to bring electricity from its renewable sources to the EU. Azerbaijan is also a critical part of the Middle Corridor transport route.

Concluding a peace treaty with Armenia is a stated priority for Azerbaijan. Finding a comprehensive settlement has proved difficult, as the remaining differences, including those related to the delimitation of the bilateral border and opening of transport routes, remain unresolved.

Deficiencies in ensuring the protection of human rights and fundamental freedoms, notably restrictions on freedom of assembly, association and expression, have persisted, according to international organisations.[1] Despite some technical improvements, the environment for civil society organisations (CSOs) has not improved.[2]

Macroeconomic overview

The economy remains highly dependent on the oil and gas sector, which generates more than 40 per cent of GDP and accounts for more than 90 per cent of the country's exports. It attracts the majority of investment and volatile export revenues determine the economy's non-oil sector growth. Slow progress on diversification and vulnerability to changes in oil prices have delayed the country's income convergence. However, significant progress has been made on reducing budgetary dependence on oil revenues (to 26 per cent in 2022 from the previous 50 per cent), mostly on the back of better-than-expected tax revenues generated by high oil and gas prices and high inflation.

Economy driven by oil revenues

Azerbaijan's economic growth in the last 10 years has been susceptible to oil price volatility. Due to high efficiency gains in US shale oil production, excessive oil supply led to significant price declines in 2014 (see Chart 1).[3] The lower oil price led to an almost 50 per cent depreciation of the domestic currency (manat) in the following three years,[4] a deep recession in 2015 and many years of declining investment. It also caused a deterioration in fiscal and trade balances, the erosion of disposable income and double-digit inflation until the end of 2017.

The recovery of the oil-dependent economy was sluggish in the years that followed, which were characterised by low oil prices, in sharp contrast to non-oil-dependent comparator countries, which experienced robust economic growth until the Covid-19 pandemic induced a global economic crisis in 2020. Azerbaijan was also hit hard by a slump in oil prices and a fall in global and domestic demand during the Covid-19 lockdowns. However, the government promptly implemented a Covid-19 Response Action Plan, supporting businesses with tax benefits and expanding social assistance for the vulnerable.[5] Timely government intervention and a recovery in global demand helped the country's economic rebound in 2021. More recently, the Russian war on Ukraine lifted oil and gas prices even more, boosting economic growth in 2022. Even so, growth turned anaemic once again in 2023, exposing the weaknesses of the hydrocarbon-centred economy.[6]

1 See United Nations Human Rights Council (2023).

2 See European Commission (2022b).

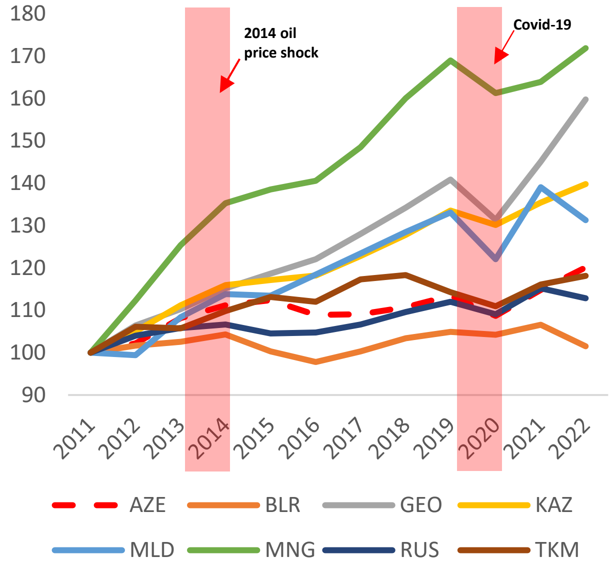
3 See World Bank (2018a).

4 See Hamidova (2018).

5 See EBRD (2021).

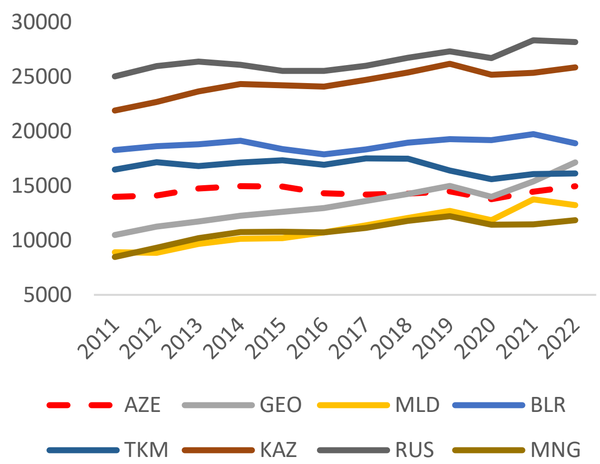
6 See EBRD (2019).

Chart 1. Real GDP index, 2011-22 (2011 = 100)[7]



Source: IMF data, authors' calculations.

Chart 2. GDP per capita growth, 2011-22 (ppp, 2017)



Source: IMF data, authors' calculations.

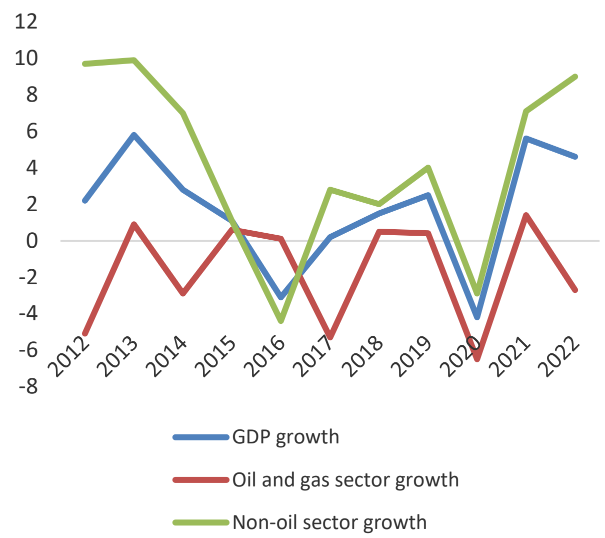
The vulnerability of economic growth to oil price fluctuations has slowed the country's income convergence. For the last 10 years, GDP per capita based on purchasing power parity has seen an annualised average growth rate of 0.58 per cent (see Chart 2). Due to this modest growth trajectory, there has been a lack of progress on reducing the income gap between Azerbaijan and more advanced comparators. Some non-oil economies, starting from a lower income level 10 years ago, have shown better progress in this respect.

The large oil and gas sector determines real GDP growth, not only because of its volatile performance, but also the high dependence of non-oil sector growth on oil export revenues. The oil and gas sector contracted at an annualised average growth rate of 0.8 per cent between 2012 and 2022 (see Chart 3) due to the depletion of oil fields. In 2017,[8] the State Oil Company of the Republic of Azerbaijan (SOCAR) and BP agreed to reduce oil production to slow the depletion rate of oil reserves in the Azeri-Chirag-Guneshli (ACG) field and prolong its exploitation period. At the same time, the volatility of oil prices heavily influenced non-oil sector growth by way of its impact on export revenues and fiscal spending. For instance, it led to a big plunge in non-oil sector growth of 4.4 per cent in 2016. However, the non-oil sector has registered robust growth since 2020 on the back of high oil and gas export revenues and fiscal stimulus.

7 In April 2022, the EBRD's Board of Governors decided to suspend access to the Bank's resources by Belarus and Russia in response to the invasion of Ukraine, reducing the number of economies in which the Bank operates to 36. The Bank has closed its offices in Moscow and Minsk. Russia and Belarus remain EBRD shareholders.

8 See Baku Research Institute (2018).

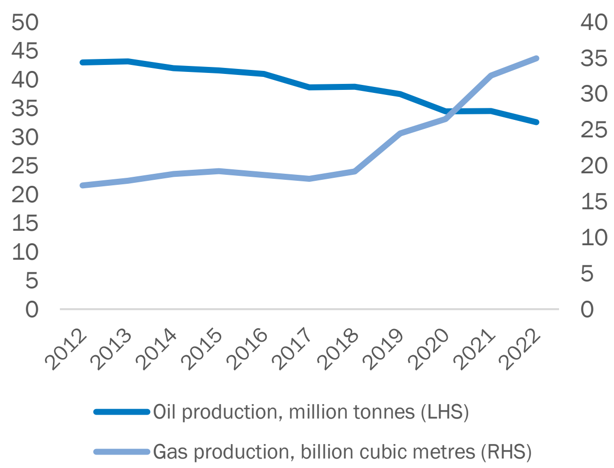
Chart 3. Oil and gas and non-oil sector growth rates, year on year, per cent (2012-22)



Source: State Statistical Committee of the Republic of Azerbaijan (SSCRA) data, authors' calculations.

As oil reserves in Azerbaijan have depleted, gas production has been increasing. Unlike oil, the country's gas production has a relatively short history, as gas exports had not begun at scale until 2018, when the Trans Anatolian Pipeline of the Southern Gas Corridor (SGC)[9] was completed. Further development of the Shah Deniz gas field and, in particular, the finalisation of the Trans Adriatic Pipeline in 2020 have boosted gas exports to EU countries (Italy, Greece and Bulgaria) and Türkiye. The recent expansion of gas export capacity to Türkiye and the EU has almost doubled gas production in the past 10 years and positioned the country to benefit from the current geopolitical reshuffle on the European gas market (see Chart 4).

Chart 4. Oil and gas production (2012-22)

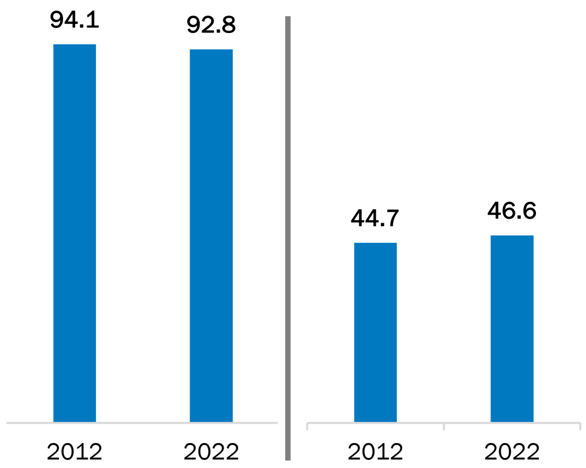


Source: SSCRA data, authors' calculations.

Azerbaijan's GDP still relies heavily on oil and gas sector output, while oil accounts for most exports. Despite oil price fluctuations and the gradual depletion of oil reserves, the hydrocarbon sector still plays a key role in economic growth. The oil sector has accounted for over 90 per cent of goods exports over the past 10 years (see Chart 5) and still generates over 40 per cent of total GDP. This shows that the diversification of the economy has not progressed and may even have been impeded by over-reliance on the oil and gas sector.

9 See Ministry of Energy of the Republic of Azerbaijan (2023).

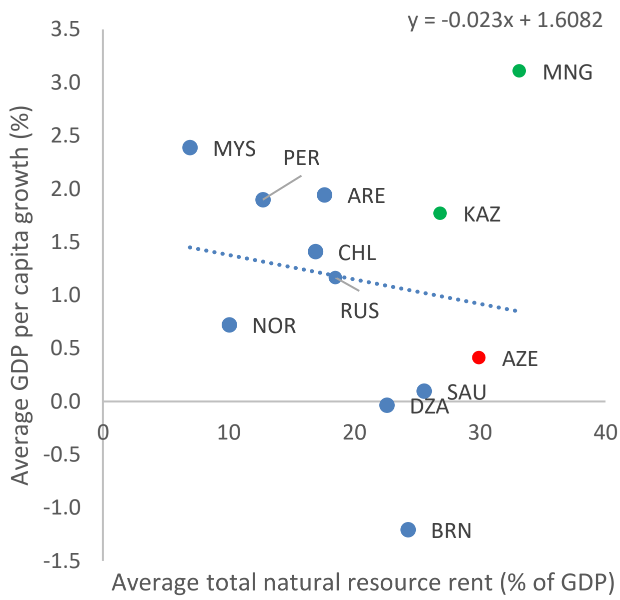
Chart 5. Share of oil in goods exports (per cent, LHS) and oil and gas sector's share of GDP (per cent, RHS) (2012, 2022)



Source: SSCRA data, authors' calculations.

Empirical findings suggest that high natural resource rents (the difference between the price of a commodity and the average cost of producing it) in natural resource-rich economies are negatively associated with economic growth (see Chart 6).[10] Oil-rich countries usually have higher natural resource rents because their energy export revenue surpasses the extraction cost of oil. However, that usually reduces the incentive to make growth-enhancing reforms and diversify the economy. With the exception of Kazakhstan and Mongolia, which have relatively better governance and human capital scores,[11] countries with the highest natural resource rents, such as Azerbaijan, Saudi Arabia, Brunei and Algeria, show the lowest GDP per capita growth.[12] Other comparators (the United Arab Emirates, Chile, Malaysia and Peru) have lower natural resource rents, but higher governance index scores (in particular, a lower level of corruption and a higher human capital index).[13] This indicates that while natural resources can be helpful, broader institutional quality and human capital are likely to boost long-term economic growth.

Chart 6. GDP growth and natural resource rents (2012-21)[14]



Source: World Development Indicators, World Bank data, authors' calculations.

Investment is heavily skewed towards the oil and gas sector. Over the last 10 years, investment in the oil and gas sector has accounted for more than 60 per cent of all investment in industry (see Chart 7). The substantial share of investment in this sector indicates that progress on economic diversification has been slow. In the non-oil and gas sector, manufacturing accounts for the biggest share of investment, in line with the government's

10 See World Bank, Metadata Glossary (total natural resource rents, percentage of GDP).

11 See Mehlum, Moene and Torvik (2006) and Raggl (2017).

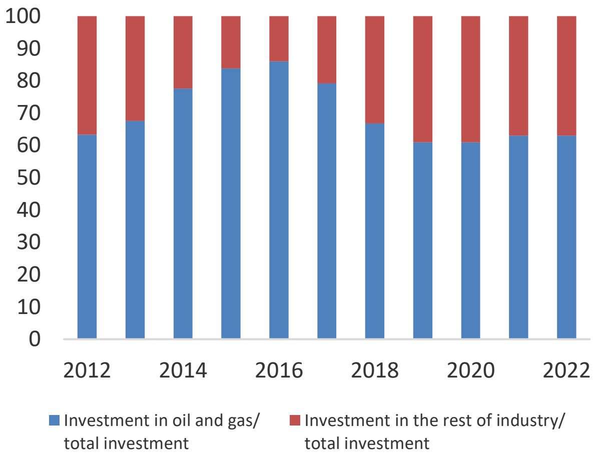
12 Natural resource-abundant countries tend to have slower economic growth than natural resource-scarce countries. See Sachs and Warner (1995; 2001).

13 See 2023 World Bank Governance Indicators and 2023 World Bank Development Indicators.

14 Comparators comprise 11 countries, 2 of which are economies in which the EBRD invests (green dots; red dot for Azerbaijan; Russia is not included in this category, as the EBRD no longer invests there). Countries with blue dots are upper-middle-income countries. The exercise does not imply causality, but indicates correlation. For instance, the GDP per capita of Norway is one of the highest in the OECD. Therefore, Norway would likely have a lower return on investment than other comparators.

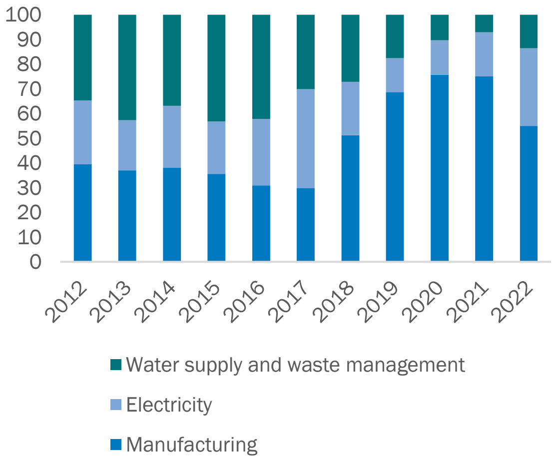
plan to reduce dependence on oil and gas (see Chart 8).

Chart 7. Investment in the extractive industry and the rest of industry (per cent of total investment, 2012-22)



Source: SSCRA data, authors' calculations.

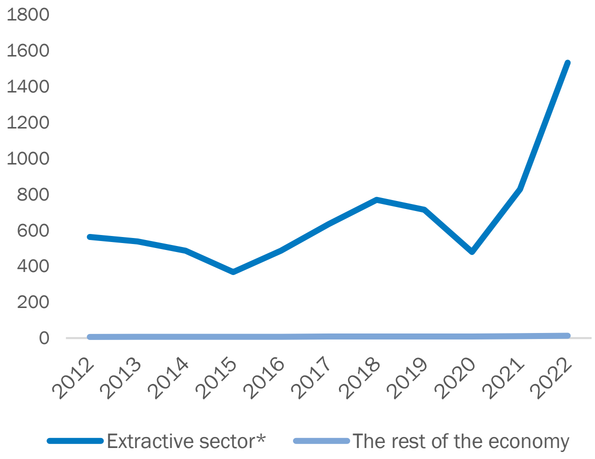
Chart 8. Dynamics of non-oil sector investment (per cent, 2012-22)



Source: SSCRA data, authors' calculations.

This has led to a huge gap between labour productivity in the extractive industry and the rest of the economy (see Chart 9). Outside the technology-intensive oil sector, the rest of the economy mostly produces labour-intensive, low-value-added agricultural products and services. Consequently, the productivity of the extractive industry is, on average, 74 times that of the rest of the economy, with some dips during the oil-price shocks of 2014 and 2020 and a peak at the time of the oil-price surge in 2022.

Chart 9. Labour productivity gap (AZN million), gross value added (2012-22)

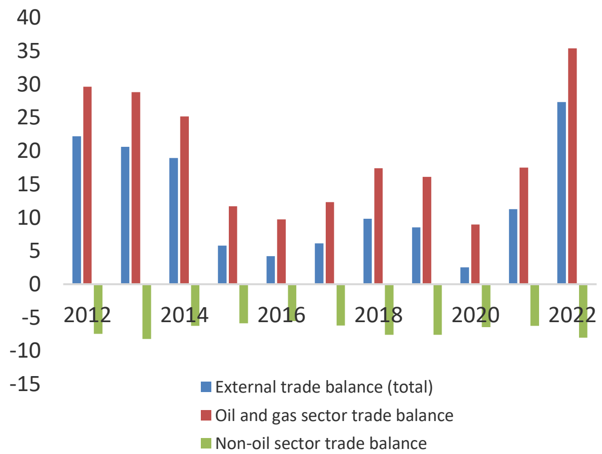


Source: SSCRA (2023), authors' calculations.
* The extractive sector comprises oil and gas including mining.

External sector dominated by oil and gas

The external trade surplus is highly dependent on volatile oil and gas prices, so subject to major fluctuations (see Chart 10). The war on Ukraine led to a sharp increase in oil and gas prices in 2022, generating Azerbaijan's highest external trade surplus since 2008. The non-oil sector, in contrast, recorded a large trade deficit – the size of which closely follows the country's volatile oil surpluses. Although the country's overall goods trade is usually in surplus, the current account tends to turn negative in years with very low oil prices, for example, 2015, 2016 and 2020. Such a performance usually coincides with a recession in the domestic economy.

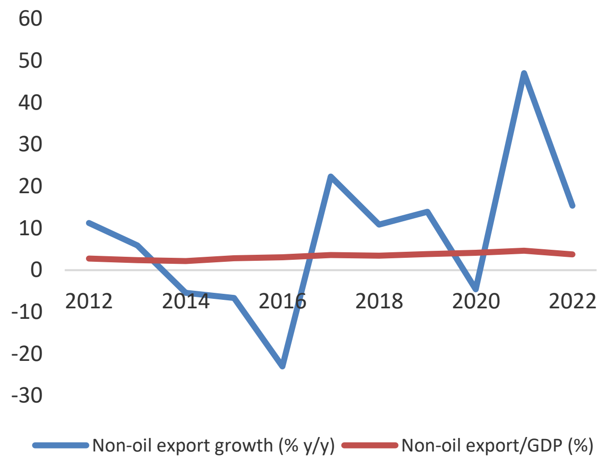
Chart 10. External trade balance (2012-22, US$ billion)



Source: Balance of payments, Central Bank of the Republic of Azerbaijan (CBAR) data, authors' calculations.

Despite the dominance of oil in external trade, non-oil sector exports have been growing in the past five years (see Chart 11). The recent growth in non-oil exports mainly stems from the government's efforts to diversify the country's export structure, especially by strengthening agriculture and information technology (IT). However, the share of non-oil goods exports in the economy is almost flat, at less than 5 per cent of GDP for the past 10 years. This shows the scale of the challenge in diversifying the export structure.

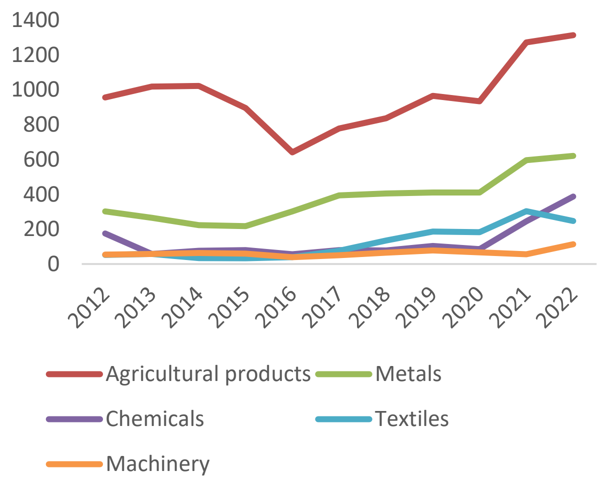
Chart 11. Non-oil export growth (2012-22)



Source: SSCRA data, authors' calculations.

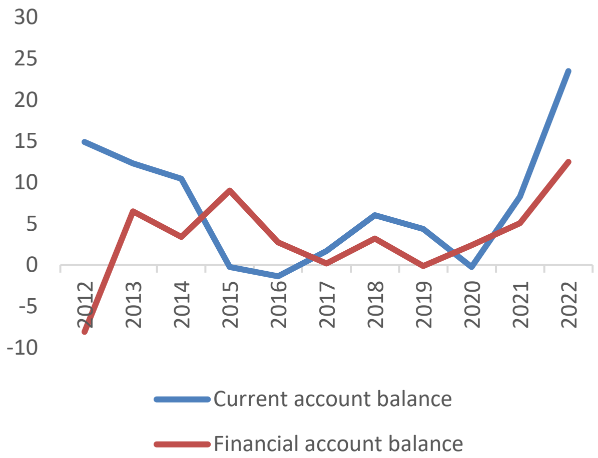
Non-oil exports consist mainly of primary goods. The agricultural sector plays a key role in non-oil exports, as do metals and chemicals (see Chart 12). Domestic yields, however, fluctuate significantly in line with seasonal factors. Also, the sluggish progress of the World Trade Organization (WTO) accession process is holding back the development of non-oil exports. As at March 2023, the process was still under discussion. Vested interests, monopolies and underdeveloped regulatory frameworks further hinder the growth of non-oil exports.

Chart 12. Top five non-oil export sectors (2012-22, US$ million)



Source: SSCRA data, authors' calculations.

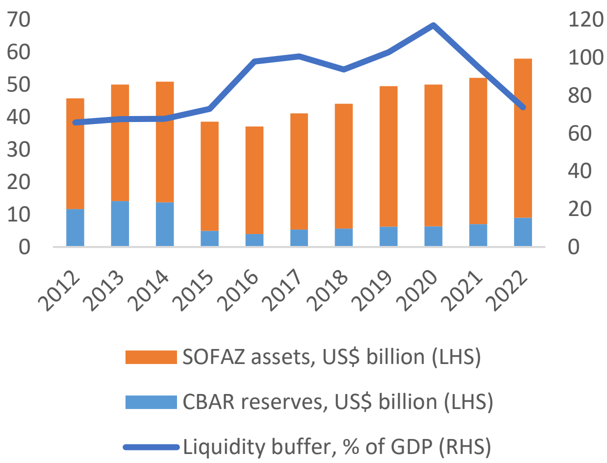
Chart 13. Current account and financial account balances (2012-22, US$ billion)



Source: CBAR, IMF data, authors' calculations.
Note: Positive financial account balance denotes capital outflows.

Oil and gas export revenues have contributed to Azerbaijan's strong foreign reserves buffer. The assets of the Sovereign Oil Fund of Azerbaijan (SOFAZ) account for most of the country's foreign reserves (see Chart 14). In 2020, the country's liquidity buffer reached 117 per cent of GDP because of the decline in nominal GDP during the Covid-19 pandemic, but this ratio fell subsequently due to strong GDP growth in 2021 and 2022.

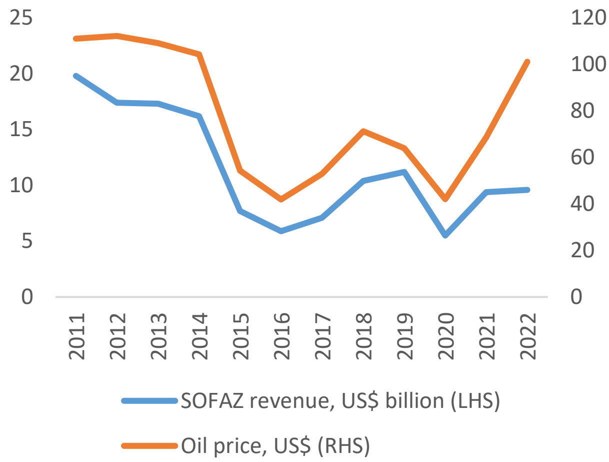
Chart 14. Liquidity buffer consisting of SOFAZ assets and CBAR foreign reserves (2012-22)



Source: SOFAZ (2022), authors' calculations.

Gradual reduction in budget dependence on oil revenue

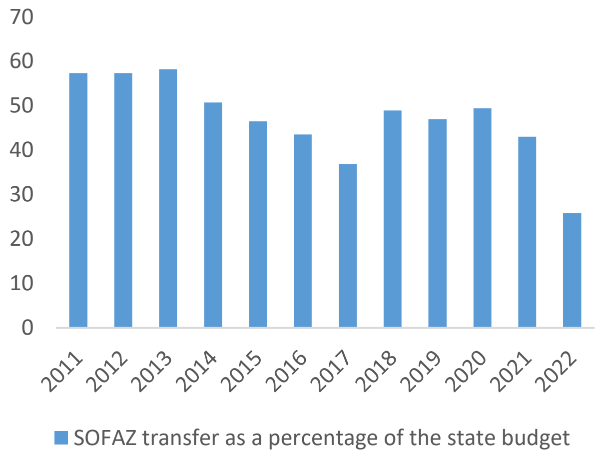
Chart 15. Volatility of SOFAZ revenue due to the oil price (2011-22)



Source: SOFAZ (2022), authors' calculations.

Oil revenues account for a significant amount of the government budget. SOFAZ's biggest revenue sources are SOCAR's oil and gas sales, followed by the oil fund's own financial asset management (see Chart 15). SOFAZ transfers funds directly to the state budget. Though the government budget has gradually reduced its dependence on SOFAZ revenues, the transfer has still accounted for almost 50 per cent of the total budget over the past 10 years (see Chart 16). In 2022, high oil and gas prices and high inflation generated higher-than-expected tax revenues, reducing the share of SOFAZ transfers in the state budget revenues to 25.8 per cent. However, SOFAZ has continued to finance government-led projects in education and skills development.[15] A reduction in budget transfers from SOFAZ and enhancing fiscal sustainability are fiscal policy priorities in the new national fiscal plan. In this regard, the authorities aim to expand the tax base by increasing the non-oil sector's share of the state budget by 2025.

Chart 16. Government budget dependence on oil revenue (per cent, 2011-22)



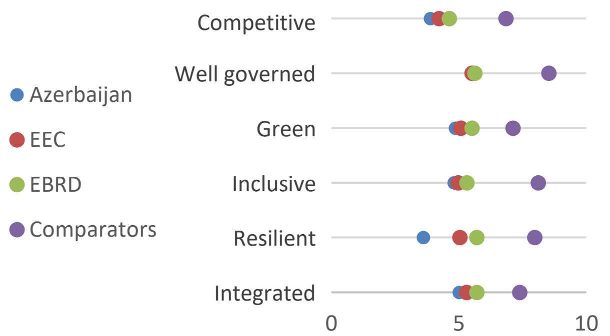
Source: SOFAZ (2022), CBAR (2023), authors' calculations.

15 State programme on increasing the international competitiveness of the higher education system in the Republic of Azerbaijan for 2019-23; State Programme for 2022-26 for youth to study in prestigious higher education institutions of foreign countries.

3. Assessment of the market economy

This section presents the EBRD's assessment of transition qualities (ATQ) for Azerbaijan. The ATQ is based on a methodology developed by the EBRD in 2016, whereby economies are measured on six desirable qualities of a sustainable market economy, namely: competitive, well governed, green, inclusive, resilient and integrated. Each quality is a composite index calibrated on a scale of 1 (lowest) to 10 (highest), based on a large number of indicators and assessments.[16]

Chart 17. Azerbaijan ATQ overview 2023



Source: EBRD (2023b).

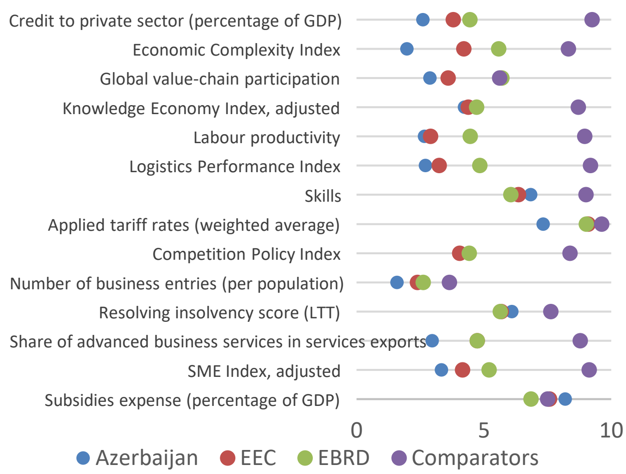
In the EBRD's 2023 ATQ, Azerbaijan ranks 24th out of the 36 economies in which the EBRD operates, based on a simple average of the different qualities.[17] The country is below the Eastern Europe and the Caucasus (EEC) and EBRD averages on all but the well governed quality (see Chart 17). It is closely catching up with the rest of the EEC region on the competitive, green, inclusive and integrated qualities, although it lags the EBRD average for those qualities. A significant gap (1.3 index points to the EEC average, 1.9 points to the EBRD average) remains when it comes to the resilient quality, where the country has a very low value.

There is a large gulf between Azerbaijan and its advanced-country comparators,[18] with the difference ranging from 2.2 index points for the integrated quality to 4.2 index points for the resilient quality.

Competitive – weak entrepreneurship in a challenging business environment

The resource-dependent economy lacks diversity and sophistication. The business environment does not stimulate entrepreneurship and SME development. There are ongoing efforts to improve the regulatory environment, but the institutional setting for the competition authority does not yet allow for its full independence. The strong presence of SOEs and politically connected private conglomerates does not leave sufficient space for private-sector development. Some reform progress has been achieved in recent years, with particular efforts on tax and customs reforms. Nonetheless, businesses continue to face regulatory and administrative challenges that highlight the need to extend and deepen recent reforms.

Chart 18. Competitive ATQ indicators, 2023



Source: EBRD (2023b).

Azerbaijan ranks lower than its EEC peers when it comes to competition policy (see Chart 18). Its economy is dominated by oil and gas and foreign

16 See EBRD (2016).

17 See EBRD (2023b).

18 The advanced comparator countries for which the EBRD also calculates ATQ scores are Canada, France, Germany, Japan, Sweden, the United Kingdom and the United States of America.

trade by primary products; exports consist of 90 per cent oil and gas, with the rest mostly agricultural products. Trade flows concentrate on Italy, Türkiye and Russia. The country is not yet a member of the World Trade Organization (WTO) and import duties remain relatively high. WTO accession negotiations are proceeding slowly, with limited progress so far.

Based on the ATQ, entrepreneurship is weak and the economy is not well integrated into global value chains. There are significant gaps to peers in the number of businesses relative to the population, credit penetration is low and the country lags on SME development. The economic structure is simple according to the Economic Complexity Index,[19] while services as a share of exports are far lower than in other countries in the region. The distance to peers is smaller in the areas of insolvency, skills and logistics, although the gap to the advanced comparators remains significant. Despite some improvements in recent years, the competition authority is not yet an independent market regulation entity. In 2018, it was integrated into the Ministry of Economy and later renamed the State Service for Antimonopoly and Consumer Market Control. In addition to the competition function, the institution also houses the country's metrology, standardisation and accreditation bureaus, which is quite unusual for a competition authority. The competition function focuses on three areas: the supervision of unfair competition and advertising legislation, antimonopoly (antitrust) control, and state oversight of natural monopolies. Following the reorganisation and the staffing decisions that went with it, there has been increased activity in all three areas. The number of investigations and probes of unfair competition jumped notably in 2022, when several market investigations into potential abuse were opened, and one case was opened against a state monopoly. In September 2023, a new competition code was sent to parliament. It aims to consolidate various laws, including those related to antimonopoly activities, unfair competition and natural monopolies, into a unified legal framework.

The economy is dominated by SOEs and a few large conglomerates with political connections. SOEs are active in many sectors of the economy (including oil and gas, power generation, communications, water supply, and transport and logistics).[20] Several have benefited from near-monopoly status, meaning that pricing is effectively controlled by the state in a number of critical sectors, including utilities.[21] In contrast to private businesses, SOEs also benefit from material advantages, such as preferential financing terms and priority access to land and raw materials, exacerbating the already uneven playing field.[22]

While diversification away from the oil and gas sector remains a major policy aim for Azerbaijan, many private firms in non-oil industries are uncompetitive and reliant on public financing. In a recent business climate survey,[23] 38 per cent of foreign business participants ranked the significant presence of SOEs as the second-highest economic impediment to conducting business in Azerbaijan.[24]

The government recognises the need to strengthen SOE governance and promote privatisation[25] and has introduced a number of high-level action plans and milestones to open up the market and address competition concerns. This includes a strategy to reduce state participation in SOEs and (as noted earlier) establish a competition authority. However, regulatory performance is inadequate and reform progress has been slow. This is partly due to the

19 One of the components of the competitive ATQ (see Chart 18).

20 See IMF (2021).

21 See Bertelsmann Stiftung (2022a).

22 See US Department of State (2022).

23 See AHK Azerbaijan and KPMG Azerbaijan (2021).

24 Ibid.

25 See World Bank (2022a).

lack of clear goals, as well as limited implementation capacity and coordination within the government. It is expected that the recent changes to the competition code will address some of the key constraints. However, it is important to have an independent competition agency to oversee implementation and enforcement. The updated code is also expected to have a positive impact on the speed at which mergers and acquisitions can be approved. It is currently a lengthy process, during which potential investors may lose interest.

The authorities have started making progress on reducing the regulatory and administrative burdens for businesses. This includes eliminating unnecessary business-licence categories and suspending certain business inspections, giving one-stop e-government service centres (ASAN) licensing authority, and reforming customs and tax regimes.[26] This has increased the transparency and efficiency of doing business, while the tax reforms, in particular, have stimulated some foreign investor interest. The government has also made significant progress on reforming the customs service in recent years, including the simplification and digitalisation of customs clearance procedures. Reform efforts should now focus on introducing more coherent customs tariffs (with Azerbaijan currently imposing comparatively high duties), reducing bureaucracy in the customs administration and enhancing communication between the customs administration and businesses.

Despite these positive developments, businesses continue to face regulatory and administrative challenges, indicating a need to extend and deepen recent customs and tax reforms. The results of the Foreign Business in Azerbaijan: Business Climate Survey 2021, carried out by KMPG and the German-Azerbaijani Chamber of Commerce, found that tax reform remained at the top of most companies' priority list of reforms, while the high tax burden was identified as a top-5 regulatory challenge to conducting business in Azerbaijan.[27] While some reforms are currently under way, future policy actions are needed to reform the tax regime for small businesses, increase the quality of taxpayer services and monitor tax exemptions.[28]

Well governed – high oil revenues negatively affect reform appetite

The government adopted a new vision for the country's development – Azerbaijan 2030: National Priorities for Socio-Economic Development – as well as an Economic Development Strategy for 2022-26, which together seek to diversify and build resilience in Azerbaijan's economy. However, reform progress has stalled since 2020 as a consequence of the renewed conflict between Azerbaijan and Armenia and Russia's invasion of Ukraine in February 2022. A lack of institutional capacity within the government has also hampered efforts to improve government accountability, control of corruption and application of the rule of law. Corporate governance standards have substantial room to converge on international best practices. The government recognises the need to strengthen SOE corporate governance and has established the Azerbaijan Investment Holding (AIH) with an ambitious agenda. However, it remains hesitant when it comes to potential privatisation plans.

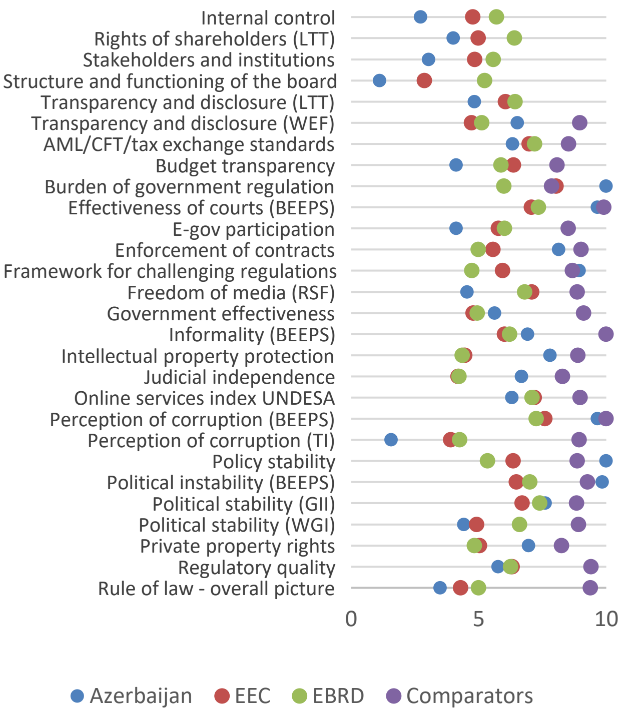
26 See US Department of State (2022).

27 See AHK Azerbaijan and KPMG Azerbaijan (2021).

28 See World Bank (2022a).

National-level governance

Chart 19. Well governed ATQ indicators 2023



Source: EBRD (2023b).

Economic reform momentum in Azerbaijan is inversely correlated to oil prices, and reform appetite has waned amid soaring oil prices since Russia's invasion of Ukraine in February 2022. Nonetheless, the government's Vision 2030 and Socioeconomic Development Strategy for 2022-26 provide important guidelines, setting out long-term priorities and direction for the country's development towards a resilient, sustainable, diversified and competitive economy.[29] Ensuring there is political will and that the public administration is supported and equipped to translate this vision into actual outcomes will be crucial to securing progress on the sustainable and equitable development of the country.

A lack of institutional capacity within the government is a major constraint on Azerbaijan achieving its Vision 2030. Public agencies and ministries – especially those in charge of delivering the strategy – need to be adequately staffed and have their expertise and capacity enhanced and operational framework strengthened.[30] To ensure that proposed reforms will result in actual improvements to the business environment, a more systematic dialogue should be established between the public and private sectors. This is particularly important in times of crisis, as it helps to ensure that the necessary tools and structures are in place for the government to be able to quickly assess the private sector's needs and respond accordingly. Prioritising digital transformation, including the development and implementation of a coordinated national digitalisation strategy, could further strengthen the government's ability to deliver on its reform agenda.

Progress on economic governance indicators has been inconsistent in recent years, with geopolitical developments in the region posing additional challenges to reform. The country's renewed hostilities with Armenia in 2020 and 2023, as well as Russia's invasion of Ukraine in 2022, have slowed reform momentum in Azerbaijan and exacerbated existing governance issues. In 2021, Azerbaijan scored lower than its regional peers on all six World Bank Worldwide Governance Indicators (see Chart 20).[31] Voice and accountability, political stability, rule of law and control of corruption have all remained unchanged or decreased since 2016. Nonetheless, some improvements can be observed in government effectiveness and regulatory quality, suggesting that the public's perception of the quality of the civil service, as well as the quality and independence of policy formulation and implementation, have improved. Governance indicators assessed by the Bertelsmann Stiftung in

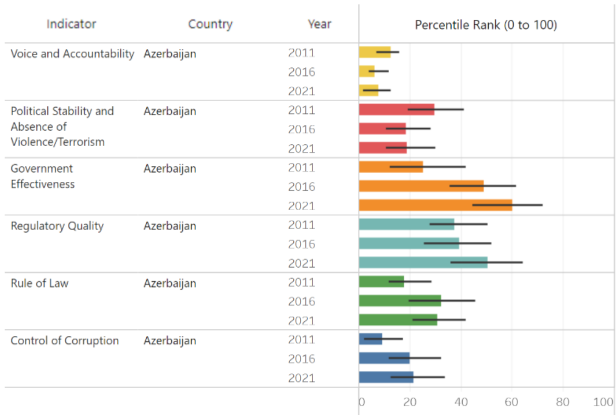
29 See President of the Republic of Azerbaijan (2021).

30 See EBRD (2021).

31 These are: voice and accountability, political stability and absence of violence/terrorism, government effectiveness, and regulatory quality, rule of law and control of corruption. For more details, see: https://info.worldbank.org/governance/wgi/.

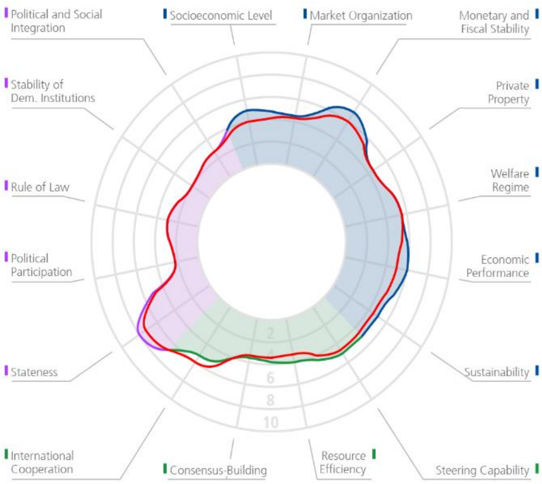
2018 and 2022 (see Chart 21) indicate slight improvements in government consensus building, resource efficiency and steering capability, while highlighting a deterioration in international cooperation.[32] The BTI Country Report ranked Azerbaijan 97th out of 129 countries in 2018 and 97th out of 137 countries in 2022.[33]

Chart 20. Worldwide Governance Indicators, 2021



Source: World Bank, 2021.

Chart 21. Azerbaijan's progress on governance and institutions, 2022 compared with 2018



Source: Bertelsmann Stiftung, Transformation Atlas, Azerbaijan, 2022.
Note: Red line refers to 2018; other line refers to 2022.

Recent efforts to modernise the courts, including the implementation of e-court technologies and simplified judicial processes, are encouraging.[34] Nevertheless, the judiciary and legal systems require comprehensive reforms to build investor confidence. Businesses highlight bureaucratic and lengthy court proceedings and the lack of enforcement of legal decisions as major impediments to investment and to the successful implementation of the government's reform agenda.[35] While independence of the judiciary is guaranteed by law, in practice, it requires improvement.

Corruption continues to pose a significant obstacle to Azerbaijan's development. Transparency International's 2022 Corruption Perceptions Index ranked Azerbaijan 157th out of 180 countries, its lowest ranking in the past decade (see Chart 22).[36] Government procurement, licensing, dispute settlement, regulation, customs and taxation are areas of particular concern,[37] exacerbated by the highly centralised decision-making system. While government approval of the National Action Plan to Strengthen Anti-Corruption (2022-26) shows willingness to act, only active implementation and strict adherence will deliver results.

32 See Bertelsmann Stiftung (2022b).

33 See Bertelsmann Stiftung (2018; 2022a).

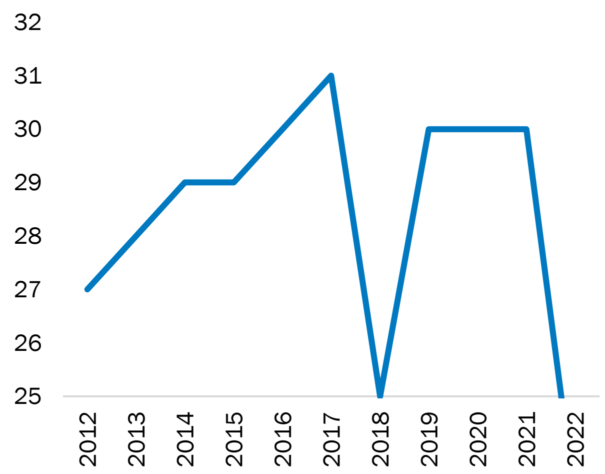
34 See World Bank (2021a).

35 See AHK Azerbaijan and KPMG Azerbaijan (2021).

36 See Transparency International (2023).

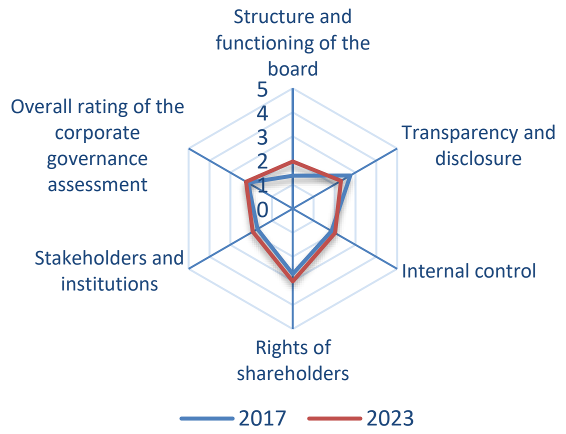
37 See US Department of State (2022).

Chart 22. Azerbaijan Corruption Perceptions Index, scores (on a scale of 1-100), 2022



Source: Transparency International, 2022.

Chart 23. EBRD Corporate Governance Assessment



Source: EBRD, 2023.

Note: The extremity of each axis represents an ideal score, corresponding to the standards set out in best practices and international standards (for example, the OECD Corporate Governance Principles). The fuller the "web", the closer the corporate governance legislation and practices of the country approximate best practice.

Key: 0 – very weak; 1 – weak; 2 – fair; 3 – moderately strong; 4 – strong; 5 – very strong.

Corporate governance legislation and practices in Azerbaijan

The corporate governance framework can mainly be found in the Civil Code, the Law on Banks the Law on Insurance Activity, the Law on Accounting and the Law on Internal Audit. The Azerbaijan Corporate Governance Standards were adopted in 2011. In 2012, the Ministry of Economy issued a methodology for assessing compliance with the standards. In 2014, the standards became mandatory for companies in which the Azerbaijani Investment Company had made equity investments. For all other companies, the standards are voluntary. Overall, there is no evidence that they are being used as a reference. In 2019, the Cabinet of Ministers approved new corporate governance guidelines for SOEs, as well as corporate governance standards for banks.

There is a lack of awareness of the importance of corporate governance that leads to serious gaps in the structuring and functioning of boards (see Chart 23). The legal framework generally favours a two-tier board structure, yet it does not provide a coherent framework for it. Joint stock companies with 50 shareholders or more must have a supervisory board, but not necessarily a management board. Boards do not seem to have any authority over the company's strategic functions, and they are not entitled by law to appoint or dismiss executives. Boards appear to be generally small and include specialists with different backgrounds, including finance, legal, accounting and international relations, although skills diversity could be further enhanced. Gender diversity at board level appears to be very limited. In large SOEs, boards often exist only on paper, with little information provided on board meetings. Implementation of the corporate governance guidelines for SOEs issued in July 2019 has been slow so far. Insurance companies and companies listed on the exchange's Premium Segment are required to have independent directors. This requirement does not seem to be implemented, as none of the companies in our sample disclose having any independent directors on their boards. Public interest entities (that is, banks and insurance, listed and large companies) are required to have an “audit committee” appointed by the general shareholders’ meeting. This body is not a board committee. In practice, this requirement does not seem to apply to large SOEs. Banks are also required to establish nomination, remuneration and risk management committees in addition to audit committees. These committees may include a minority of non-board members (outsiders), which is not in line with best practice. There seems to be no practice of performing board evaluations or appointing corporate secretaries. There is no disclosure on the number of board and committee meetings and their activities.

Transparency and disclosure are limited to financial statements only. Public interest entities are required to prepare their financial statements in accordance with international standards. Joint stock companies are further required to prepare and disclose their annual reports without any specific mention of non-financial information. In practice, there are very few non-financial disclosures, including on governance and ownership structure. There is no general practice of disclosing the minutes of general shareholders’ meetings (GSMs). Companies’ websites are typically incomplete and not easily accessible. There is little guidance on disclosure in law and regulation and hardly any evidence of enforcement. Companies are required to have independent external auditors and to disclose their names. However, there is no time limit on their engagement, and external auditors are allowed to perform non-auditing services for the same companies, without the obligation to disclose information on it. These shortcomings may undermine the auditor’s independence.

Protection of shareholders’ rights is relatively fair. Basic shareholders’ rights are enshrined in law, and major corporate decisions are subject to a supermajority. Shareholders have inspection rights. Also, shareholders owning at least 10 per cent of a company’s shares can nominate directors, call a GSM and propose items on the agenda. However, shareholders do not seem to have the right to ask questions at the GSM. Voting by proxy at the GSM is allowed. Related-party transactions and conflicts of interest are regulated by law, as well as insider trading, but they do not seem to be enforced in practice. Large companies are required to keep their shares in a private registry or in the National Depository Centre.

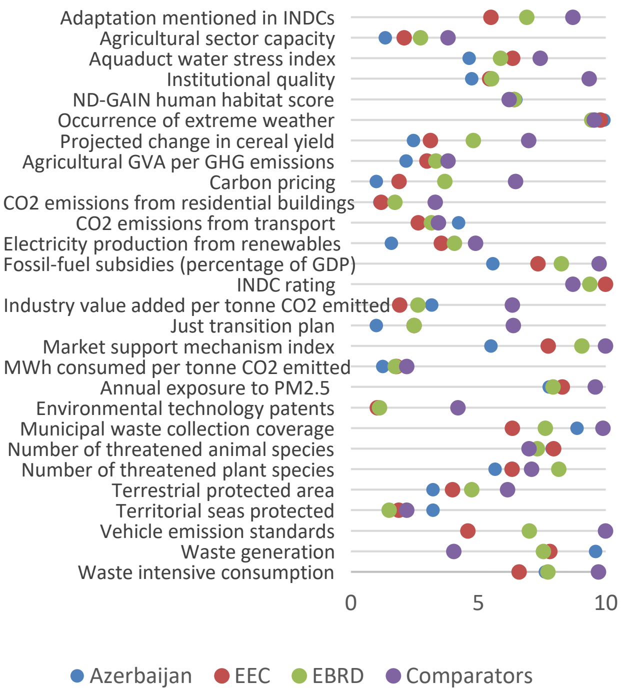
The establishment of the Azerbaijan Investment Holding (AIH) signals the government’s commitment to strengthening corporate governance of SOEs. The AIH was established in August 2020 and started operating in January 2021. It employs around 100 (predominantly young) people with finance and legal skills. Though there are more than 2,000 SOEs in the country, there are far fewer major SOEs. The idea is that the AIH manages 17 of the major SOEs in the natural resources, transport, utilities and financial sectors on behalf of the government, which is the shareholder. Telecoms sector SOEs are not part of the AIH. The AIH Board is chaired by the Prime Minister and comprises four other members, of which two are ministers and two are presidential aides. SOEs are gradually being placed under AIH management following the preparation of a diagnostic study by one of the big four consulting companies. Currently, the AIH manages 12 SOEs and has representatives on the Board, as well as the Audit, Strategy and Reward Committees of each company, in addition to a corporate secretary.

The AIH is engaging with international partners to introduce modern corporate governance and management practices into its portfolio companies. It is working with the OECD to screen the corporate governance of the 12 companies under its management. The OECD will eventually make recommendations for improving corporate governance at the analysed SOEs. However, the ongoing reform initiatives by the AIH lack ambition to address the underlying issues of political interference in SOE activities, which, among other things, manifests itself in the presence of political appointees on SOE boards.

Green – growing awareness about significant untapped renewable energy potential

Ranked 26th out of the 36 EBRD investee economies, Azerbaijan is the second-weakest-performing EEC country on the green transition quality after Moldova (see Chart 24). Economic growth over the past three decades has largely been driven by fossil-fuel extraction, with oil and natural gas continuing to bring in around 90 per cent of Azerbaijan's export revenues, thus discouraging a green transition. Nevertheless, the country has significant untapped hydro, solar and wind power potential. The share of renewable energy sources has remained stable but low since the 1990s. There is growing awareness among the authorities that renewable energy exports might be a viable long-term alternative to hydrocarbons, but significant challenges remain on the long road to greening the economy.

Chart 24. Green ATQ indicators 2023



Source: EBRD (2023b).

With a population of around 10 million, Azerbaijan is the world's 87th-largest greenhouse gas (GHG) emitter, accounting for a total global share of 0.11 per cent (2019).[38] Azerbaijan's per capita emissions are below the OECD, EU27 and global averages (see Chart 25). In contrast, the country's GHG emissions per unit of GDP are twice as high as the global average and five times higher than those of the EU27 (see Chart 26).[39] GHG intensity has been increasing since 2010, while the country's GDP at purchasing power parity (ppp) has followed a relatively stable path, highlighting the increased role of fossil fuels in its energy system.[40]

The oil and gas sector is the largest contributor to the size and dynamics of GHG emissions. The two largest-emitting sectors are energy (75 per cent) and agriculture (14 per cent), while at the subsector level, electricity and heat (13.7 Mt CO_2), transport (7 Mt CO_2) and buildings (7.95 Mt CO_2) are the dominant sources (2020) of GHG emissions.[41] Fugitive methane emissions are also

38 See Climate Watch (2023).

39 Ibid.

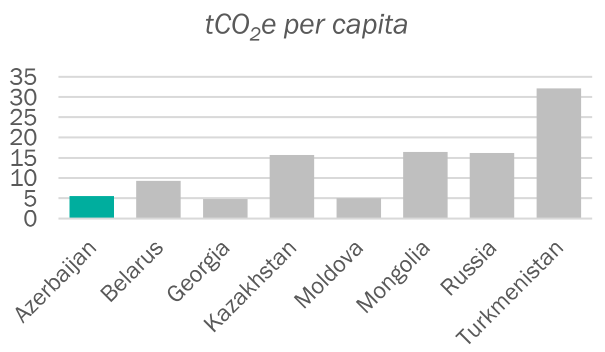
40 Ibid.

41 Ibid.

a significant GHG emissions source (8.11 Mt CO_2e in 2020, rising from 2.98 Mt CO_2e in 2000).[42]

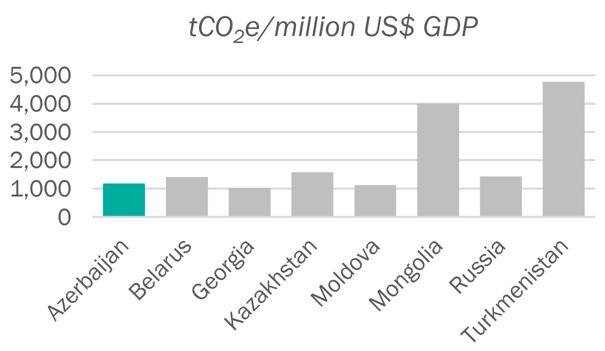
CO_2 emissions from the industrial sector have increased 184 per cent compared with 1990, while emissions from the buildings and transport sectors have grown by 61 per cent and 34 per cent, respectively, in the same period. Due to the knock-on effects of the old Soviet economic system in the 1990s, the increase in CO_2 emissions is much higher from the year 2000, when the oil boom generated high growth rates over the subsequent 15 years. Industrial sector-related CO_2 emissions grew 800 per cent, followed by transport sector emissions (251 per cent) and buildings sector emissions (85 per cent).[43]

Chart 25. GHG emissions per capita, 2020



Source: Climate Watch (2020).

Chart 26. GHG emissions per unit of GDP, 2019



Source: Climate Watch (2020).

Azerbaijan has developed a number of policies to pursue low-carbon and climate-resilient development. The "Azerbaijan 2020: Look into the Future" concept of development highlights Azerbaijan's commitment to preparing policy measures to spur and lay the ground for a climate-resilient future.[44] Importantly, the document identifies the economy's energy and carbon intensity as action areas where alignment with OECD indicators will be sought. The State Commission on Climate Change was established in 1997. It ratified the Kyoto Protocol in 2000, became a member of the International Renewable Energy Agency (IRENA) in 2009, and is a non-Annex I Party to the United Nations Framework Convention on Climate Change (UNFCCC). In 2016-17 Azerbaijan signed and ratified the Paris Agreement.

Azerbaijan adopted its first nationally determined contribution (NDC) in 2021, setting a quantitative target of a 35 per cent GHG emissions reduction by 2030 from 1990 levels. At the COP 26 climate conference, Azerbaijan further pledged to reduce emissions by 40 per cent before 2050 and create a zero-emissions zone. Azerbaijan's NDC spans different sectors and action areas, including energy efficiency and modernisation, renewables and alternative fuels, oil and gas, transport, industry, agriculture, land use, land-use change and forestry, and waste. In the energy sector, the NDC sets out a commitment to developing legislative acts and regulatory documents for the energy sector, replacing existing technology with modern, environmentally friendly technology, and reconstructing energy distribution networks to reduce gas losses. Azerbaijan also aims to promote the use of e-vehicles for public transportation and to focus on the electrification of railway lines, while developing a modern solid-waste management system. Although no policy or legal document has been put in place specifically for climate adaptation, in its first NDC, Azerbaijan

42 Ibid.

43 Ibid.

44 See President of the Republic of Azerbaijan (2012).

said it was considering developing relevant adaptation measures, by sector, to decrease or minimise potential losses caused by climate change at national, local and community level.

Efforts to formalise national climate commitments have been coupled with increasing international cooperation on the green agenda. The EU has been supporting the Ministry of Energy of Azerbaijan in building a long-term energy strategy through 2050. The strategy has not yet been adopted. In July 2022, Azerbaijan and the EU signed a memorandum of understanding (MoU) on a strategic partnership in the energy field, superseding an earlier MoU signed in 2006. The new MoU includes a commitment to doubling the capacity of the Southern Gas Corridor to deliver at least 20 billion cubic metres of gas per year to the EU by 2027, as well as to accelerating the development and deployment of renewable energy generation, capitalising on Azerbaijan's untapped renewable energy potential. The MoU also supports Azerbaijan's accession to the Global Methane Pledge and acknowledges the importance of making the natural gas supply chain as efficient and environmentally and climate friendly as possible.[45]

In 2019, Azerbaijan joined the Eastern Europe Energy Efficiency and Environment Partnership (E5P). This was done with further EU support and it catalysed the development and adoption of different policies and documents related to the green transition. For example, the country's Law on the Use of Renewable Energy Sources in Electricity Generation was approved in July 2021. Similarly, a Law on the Rational Use of Energy Resources and Energy Efficiency was adopted by presidential decree in August 2021. Also, the first National Energy Efficiency Action Plan of the Republic of Azerbaijan (NEEAP) was developed, along with a roadmap for accelerating the adoption of eco-design and labelling requirements for energy-using products.

In February 2021, the country adopted the "Azerbaijan 2030: National Priorities for Socioeconomic Development" national plan.[46] Priority 5 of the framework relates to clean environment and green growth.

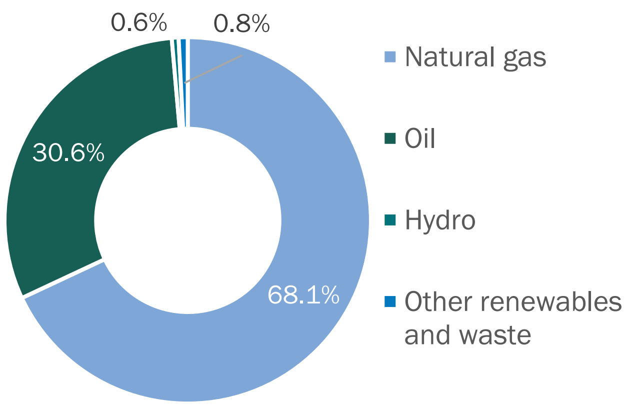
Due to a combination of political, geographical and social factors, Azerbaijan is highly vulnerable to the impacts of climate change. The country is ranked 73rd out of 181 countries in the 2020 ND-GAIN Index, which ranks countries based on their vulnerability to climate change and other global challenges, as well as their readiness to improve resilience. Temperatures in Azerbaijan are projected to rise at a faster rate than the global average, which will amplify the impacts on human health, livelihoods and ecosystems. Extreme weather events, such as flooding, droughts and heat stress, are expected to increase in frequency. Climate change will also significantly impact the coastal zones. The most vulnerable sectors are agriculture, human health, water resources, forestry and tourism.

Azerbaijan's domestic total energy supply relies heavily on natural gas (68 per cent in 2020) and oil (31 per cent in 2020) (see Chart 27). Natural gas is used to generate most of the electricity and heat in the country (over 90 per cent in 2020). Crude oil is refined locally to satisfy most national oil product consumption, and local production will expand following a refinery upgrade currently under way. Importantly, coal is not used in the country.

45 See European Commission (2022a).

46 See President of the Republic of Azerbaijan (2021).

Chart 27. Total energy supply by source, 2020



Source: International Energy Agency (2021).

While natural gas is the largest source in the total energy supply, a substantial share of it is transformed into electricity and heat. This explains the relatively equal shares of oil products and gas in total final consumption, with oil averaging 42 per cent of total final consumption in 2010-20 and gas 40 per cent. At the same time, electricity accounted for 16 per cent, on average, of total final consumption.

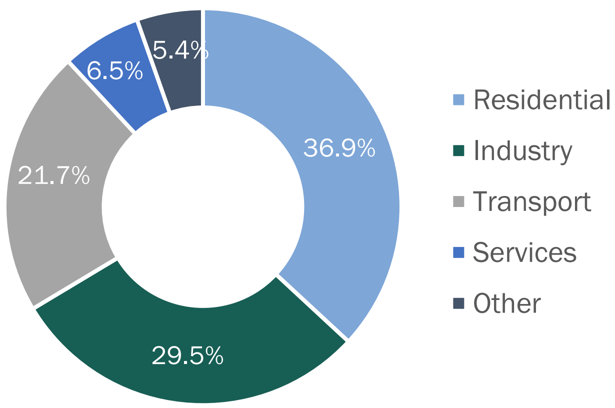
The share of district heating in total final consumption was only 3 per cent in 2020, but its consumption has grown more than fivefold since 2010. Oil is the primary energy source in transport and industry. The primary energy source in the residential sector is natural gas, which is also becoming increasingly important in the service and industrial sectors.

The residential sector is traditionally the largest final energy consumer and was responsible for 37 per cent of total final consumption in 2020. Households consume energy mostly in the form of natural gas; gas made up over 80 per cent of total household consumption in 2020.

Industry was responsible for around 30 per cent of total final consumption (see Chart 28), with oil being the main energy source (46 per cent of the sectoral total in 2020). Energy consumption in the transport sector has almost tripled in volume since 2000 and accounted for 22 per cent of total final consumption in 2020, almost all in the form of oil (around 97 per cent of total transport consumption in 2019).

The service and agricultural sectors together accounted for around 12 per cent of total final consumption in 2020, with electricity the main energy source (48 per cent of the sectoral total).

Chart 28. Total final consumption by sector, 2020



Source: International Energy Agency (2021).

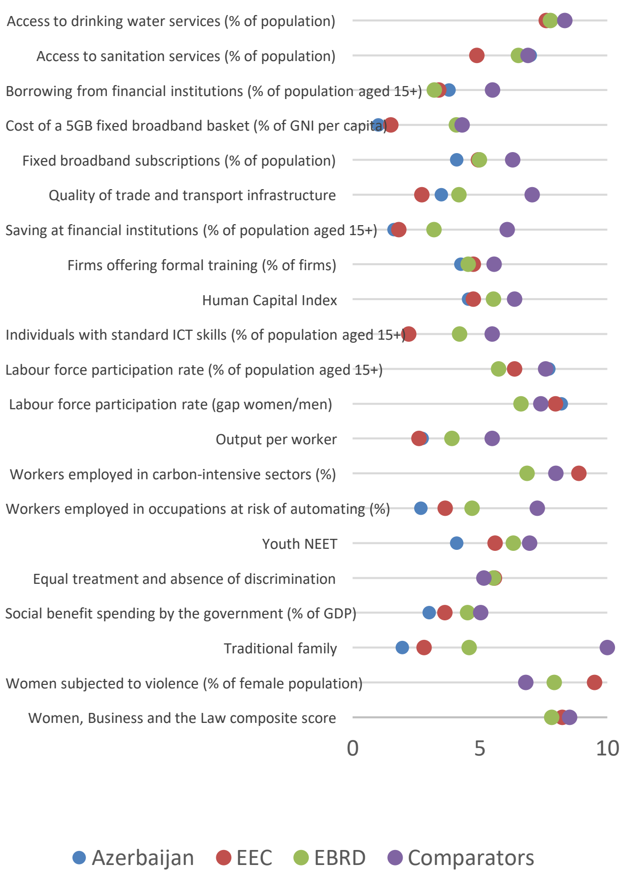
The share of renewable energy sources in Azerbaijan's total energy supply has remained stable but low since the 1990s. The share in electricity generation has declined from 18 per cent in 2010 to 5.1 per cent in 2020, mainly due to a reduction in hydropower output.[47] The dominance of hydropower among renewables leads to similarities in the patterns of renewable energy sources in total energy supply and total final consumption. While interest in renewable energy and energy efficiency has only recently begun to grow, the Azerbaijani government recognises that renewable energy in power generation can help diversify energy sources and meet climate policy objectives.

47 See International Energy Agency (2021).

The country has excellent solar and wind resources and significant prospects for biomass, geothermal and hydropower. Judging by planned and ongoing investment projects in electricity generation, the main focus is on windfarm projects.[48] Indeed, wind-power generation is one of the biggest potential sources of renewable energy generation, with a potential capacity of 4,500 MW.[49] The government is aiming for renewable energy to provide 30 per cent of electricity generating capacity by 2030, roughly twice the current share. Major contracts for building wind and solar power capacity were signed in early 2020, and construction is currently under way. Yet, despite this potential, investments in wind-power projects are small compared with continued investment in the oil and gas industry. There is a strong focus on large-scale upstream oil and gas projects, as well as oil and gas pipelines, among Azerbaijan's energy projects. Several of these projects are part of the Southern Gas Corridor, which consists of several infrastructure projects aimed at increasing the energy security of Türkiye and the EU by bringing gas from the Caspian region to Europe.[50]

Inclusive – low job creation, gender bias and skills shortages undermine the productive capacity of the economy

Chart 29. Inclusive ATQ indicators 2023



Source: EBRD (2023b).

Demographic and labour-market trends emphasise the increased importance of promoting human capital development. According to the State Statistical Committee of the Republic of Azerbaijan (SSCRA), the country's total population was slightly below 10.16 million at the end of 2022, of which 2.12 million (20.9 per cent) were young people between the ages of 15 and 29 years.[51] The country has relatively young demographics. However, due to increasing life expectancy and falling fertility, the speed of population ageing is much faster than in

48 See OECD (2019).

49 See Aliyeva (2018).

50 See IEA (2021).

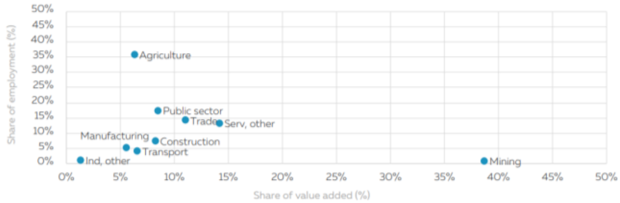
51 See SSCRA (2023).

neighbouring countries, and Azerbaijan is expected to become a "high-ageing society" by 2040.[52]

The overall unemployment rate is 5.5 per cent, but the youth (aged 15-24) unemployment rate is almost three times that (13.4 per cent).[53] There is a high rate of economic inactivity among older workers – only one-third of the population aged 55-59 is still employed.[54] In parallel, it is estimated that by 2025, 125,200 people will be entering the labour market on a yearly basis, which is almost 2.5 times the number of jobs created annually.[55]

Azerbaijan's labour productivity is the fifth lowest among the developing countries of Europe and Central Asia. Employment is mainly concentrated in low-productivity sectors (see Chart 30); over a third of the employed population works in agriculture, which accounts for only 7 per cent of value added. Growth is low in potentially productive sectors and, hence, the demand for skilled labour is also low, as are returns to education in the private sector. This vicious circle reduces incentives to invest in education, limiting the availability of skills. Large and innovative companies that are in a position to drive the structural transformation of the labour market report a lack of skilled workers with the necessary digital skills or experience in practical and modern methods of production.[56]

Chart 30. Employment is concentrated in low-productivity sectors



Source: World Bank (2022b).

Azerbaijan has shown progress on its human capital development in recent years. The World Bank's Human Capital Index, published in 2019, ranks Azerbaijan 69th out of 157 countries with a score of 0.58 – up from 0.50 in 2010. This is significant progress compared with other countries globally and in the region.[57] Even though Azerbaijan is among the top human capital improvers, human capital levels in terms of skills remain low relative to other countries in Europe and Central Asia.[58]

There are multiple systemic challenges in the development of human capital in Azerbaijan, with skills shortages being predominant. On the Global Competitiveness Index, Azerbaijan ranks 58th out of 141 countries, with a particularly poor performance on "digital skills for active population" and "ease of finding skilled employees".[59] The EBRD's Knowledge Economy Index ranks Azerbaijan in the intermediate group, but also as the second-worst performer (after Moldova) in the EEC region when it comes to "skills for innovation" – one of the index pillars.[60] According to a study carried out by the SSCRA in 2016, a qualifications mismatch affected 44 per cent of employed young people (aged 15 to

52 See UNFPA (2021).

53 See World Bank Data (2022).

54 See World Bank (2022b).

55 See European Training Foundation (2022).

56 See World Bank (2022b).

57 Data from the World Bank's Human Capital Project, available at: https://www.worldbank.org/en/publication/human-capital#Index

58 See World Bank (2022b).

59 See European Training Foundation (2020a).

60 See EBRD (2019b).

29) and 37 per cent were employed in jobs that did not match their qualifications.[61]

The challenge of skills shortages can be partly attributed to the low level of participation in vocational education and training (VET). Azerbaijan's participation in secondary VET is one of the lowest in the Eastern Partnership region,[62] at 14.5 per cent in 2018, and enrolment numbers confirm little interest.[63] Covid-19 appears to have adversely affected the already low levels of interest in vocational training. In 2019, 3,168 people were enrolled in vocational training, while in 2020 and 2021, the numbers dropped to 1,014 and 988, respectively (see Table 1). According to the SSCRA, 66.3 per cent of the economically active population did not have formal vocational or higher education in 2021.[64]

Azerbaijan's employment strategy, adopted in 2019, envisages increasing the number of vocational training centres from the current four to ten by 2030. Amendments have been made to legal documents, increasing the duration of vocational training for job seekers and the unemployed to six months. However, these are still fragmented steps and a more holistic approach is required to tackle the challenge. Potential solutions have been suggested by the European Training Foundation: 1) shifting the focus to improving the attractiveness of VET by prioritising it in all relevant investments; 2) boosting the relevance of VET for human capital development through enhanced engagement of the private sector; 3) improving the conditions of professional staff working in VET; and 4) prioritising evidence-based skills policy development processes.[65]

The government of Azerbaijan is taking steps to follow the recommendations of international institutions and development partners. The VET Roadmap and the Law on Vocational Education set a strategic target of involving employers in VET to modernise the system and improve its overall efficiency. In line with this strategic direction, the Ministry of Education and the State Agency for Vocational Education have entered into cooperation agreements with representatives of the private sector to respond to the needs of the labour market and increase youth employment.

The government has also acknowledged the role of lifelong learning as an instrument for human capital development. A decree on a national qualifications framework for lifelong learning was adopted in July 2018. It is aligned with the European Qualifications Framework for lifelong learning.[66]

Table 1. Vocational training statistics

	2013	2014	2015	2016	2017	2018	2019	2020	2021
Total	4,329	3,786	4,147	3,352	3,561	2,559	3,168	1,014	988
Male	2,262	2,031	2,440	1,862	1,735	1,112	1,191	563	444
Female	2,067	1,755	1,707	1,490	1,826	1,447	1,977	451	544
Under 29 years	3,013	2,705	2,964	2,047	1,972	1,275	1,358	310	443
29+ years	1,316	1,801	1,183	1,305	1,589	1,284	1,810	704	545
Low	413	325	123	84	176	182	110	276	151
Medium	3,404	3,047	3,464	2,727	2,846	2,021	2,310	449	574

Source: European Training Foundation based on data from the Azerbaijan State Employment Agency under the Ministry of Labour and Social Protection of the Population.

61 See European Training Foundation (2020a).

62 The Eastern Partnership is a joint initiative involving the EU, its member states and six eastern European partner countries: Armenia, Azerbaijan, Belarus, Georgia, Moldova and Ukraine.

63 See European Training Foundation (2020a).

65 See SSCRA (n.d.).

65 See European Training Foundation (2020a).

66 See European Training Foundation (2020b).

Labour-market challenges are closely connected to the quality of education. According to the World Bank's Human Capital Review of Azerbaijan 2022, four out of the country's average 12 years of schooling are considered lost as a result of poor-quality education.[67] According to a UNESCO report, the gross enrolment ratios in 2020 were 95.8 per cent, 94.1 per cent and 35.2 per cent for primary, secondary and tertiary education, respectively. Primary (98.0 per cent versus 93.9 per cent) and tertiary levels (38.4 per cent versus 32.4 per cent) showed higher enrolment of women, while secondary level education demonstrated a higher male enrolment ratio (95.0 per cent male versus 93.1 per cent female).[68] It should also be noted that, according to the World Bank, 69 per cent of the population has completed secondary education and 20 per cent tertiary education, which is low for an upper-middle-income country.[69] According to the OECD Programme for International Student Assessment (PISA) 2018, students in Baku scored lower than the OECD average on all three dimensions: reading, mathematics and sciences. Azerbaijan's PISA scores lagged those of Moldova and Ukraine, but were slightly ahead of Georgia's.[70] It is noteworthy that girls performed better than boys and lower results were observed in socioeconomically disadvantaged groups.

Azerbaijan has taken certain measures to promote gender equality. From a legal perspective, the Constitution of the Republic of Azerbaijan (Article 25) guarantees equal rights and freedoms for men and women. The Family Code (Articles 2.2, 29.1 and 29.3) ensures that women can get a job in the same way as men, while the Labour Code (Article 16) prohibits employment discrimination based on gender. The Law on Guarantees of Gender Equality (Article 7) obliges employers to provide equal treatment and opportunities to men and women and to ensure that no differences in treatment occur on the grounds of gender (Article 8). The Labour Code (Article 125) establishes 126 days of paid leave available to mothers and prohibits (Article 79) the dismissal of pregnant workers. On a global scale, Azerbaijan has ratified key International Labour Organization (ILO) gender equality conventions, such as the Equal Remuneration Convention of 1951 (no. 100), the Discrimination (Employment and Occupation) Convention of 1958 (no. 111) and the Maternity Protection Convention of 2000 (no. 183).

Nevertheless, many challenges persist. Despite the aforementioned legal commitments, there are no legal provisions requiring equal remuneration for work of equal value and there are still restrictions on women's employment on night shifts and in certain industrial jobs. Azerbaijan has only recently reduced the list of professions prohibited to women. Until November 2022, women in Azerbaijan were legally prohibited from being hired for as many as 674 jobs across many sectors of the economy, including transport, energy, agriculture and others. These restrictions were part of the country's Soviet legacy, intended to protect women's health, but were not based on risk assessments and did not take into consideration technological developments or associated occupational changes over the years.[71] The existence of legal restrictions only exacerbated workplace segregation and contributed to high gender pay gaps. In November 2022, these restrictions were repealed for non-pregnant and non-nursing women. This progress, taking a health risk-based approach, bodes well for higher female participation in the labour force. However, certain limitations still apply. According to the Labour Code, pregnant women and women with children under the age of three are prohibited from working at night and/or working in labour-intensive, hazardous and underground jobs. Participation in

67 See World Bank (2022b).

68 See UNESCO (2020).

69 See World Bank (2022b).

70 See OECD (2018).

71 See World Bank (2023a).

work duties that involve lifting and carrying heavy objects is also not permitted.

The share of economically active women is 59.7 per cent as opposed to 66.7 per cent of men. The unemployment rate is 7.0 per cent for females as opposed to 4.9 per cent for males. Even though female labour-force participation is higher (65 per cent) than the regional average, the labour-force participation rate gap between women and men is higher than the EBRD average and the regional average. The presence of high sectoral segregation is confirmed by assessing the fields of economic activity in which women are the most or least involved. Women dominate lower-remunerated fields such as education, human health and social work (78.3 per cent), as well as art, entertainment and recreation (61.2 per cent), and are under-represented in higher-paid industries, such as construction (7 per cent), electricity, gas and steam production, distribution and supply (11.2 per cent), mining (12.6 per cent) and transportation and storage (16.6 per cent).[72]

Gender gaps are reflected in different international ratings. The World Bank's Women, Business and the Law Index score for Azerbaijan in 2023 was 78.8 out of 100.[73] This is lower than the regional average for Europe and Central Asia (84.4) and lower than Georgia (88.1) and Moldova (87.5). Laws affecting women's pay and women's work after having children and laws relating to women's pensions are the main areas that need improvement, according to the report.[74] The United Nations Country Results Report for Azerbaijan 2021 highlighted gender equality as a key challenge on Azerbaijan's path to achieving the Sustainable Development Goals.[75] According to the 2021 Global Gender Gap Report of the World Economic Forum, Azerbaijan Ranks 100th out of 156 countries globally.[76]

Government offices are predominantly staffed by men. According to the Social Institutions and Gender Index (SIGI) 2023 database, 82 per cent of Azerbaijan's members of parliament are men and only 18 per cent are women. Azerbaijan has no female ministers.[77] The Cabinet of Ministers (comprising the prime minister, their deputies, ministers and heads of other central bodies of executive power) has only one female member, the head of the State Committee for Family, Women and Children's Affairs. However, the speaker of the newly elected parliament is female.[78] In 2022, women accounted for only 28 per cent of all civil-service employees.[79]

The gender pay gap remains substantial. Unequal remuneration is observed in every field of economic activity, with the average monthly salary of men being 40 per cent (AZN 300 or €163) higher than that of women. In the education and healthcare sectors, where women are highly represented, women earn 70-80 per cent of men's earnings.[80] According to the Social Institutions and Gender Index 2023 database, gender gaps in management positions are substantial – women account for just 35 per cent of managers. This gap is further exacerbated in top management positions, where women hold only 17 per cent of such jobs. This is in line with the rate of women managers in most other EEC countries, except in Ukraine (41 per cent) and Moldova (46 per cent), which have performed better on closing the gap for managerial positions.[81]

72 See SSCRA (2022a).

73 See World Bank (2023b).

74 Ibid.

75 See United Nations Azerbaijan (2021).

76 See World Economic Forum (2021).

77 See OECD (2023).

78 See Bertelsmann Stiftung (2022b).

79 See SSCRA (2022a).

80 See SSCRA (2022b).

81 See OECD (2023).

The low rate of employment among the elderly indicates that they are making a minimal contribution to the labour force.
The United Nations Population Fund (UNFPA) Active Aging Index Report for Azerbaijan shows that the employment level of older people is low compared with that observed in the 27 EU countries. Many older workers, even those with higher levels of education, currently drop out of the labour force relatively early, with only a third of the population aged 55-59 still employed.[82] The decline in economic activity affects older women more than men. According to the State Statistical Committee, only 6.6 per cent of women and 8.3 per cent of men from the 55-59 age group are economically active. Gender differences seem to be less stark after 60 years: 3 per cent of both sexes are economically active in the 60-64 age category and between 0.7 and 1 per cent in the 65-plus age category. The limited involvement of the elderly in the labour force may lead to a risk of poverty and of the elderly becoming a financial burden on their families, as well as the social security system.[83]

A possible explanation for the low employment rate is the lack of job opportunities for the elderly. The creation of incentives for the private sector to recruit older workers is especially relevant, considering that the share of the population older than 60 is forecast to more than double from the current 12 per cent to 25 per cent by 2050. Harnessing the productive potential of this group will become increasingly important.[84]

Challenges persist when comparing equality of opportunity in rural and urban areas. Baku City, the wealthiest region in the country, has a GDP per capita that is ten times that of the poorest region. More than half of Azerbaijan's population lives in urban areas, with 47.1 per cent living rurally.[85] People in rural areas seem to be more active economically, with the rural share of the economically active population at 68 per cent compared with 58.9 per cent in urban areas.[86] Unemployment is higher in the cities. This can be attributed to the fact that most people in rural areas are involved in subsistence farming. According to the Asian Development Bank's 2019 Digital Development Overview for Azerbaijan, there is a digital divide within Azerbaijan, as evidenced by differences in wired broadband penetration.[87] While data from the International Telecommunication Union show that about 42 per cent of Azerbaijan's population has a fixed broadband subscription,[88] there is a 20 percentage-point gap in household fixed internet penetration between urban and rural residents, and similar gaps among the different regions of the country (see Chart 31). These gaps are due to shortages in fixed infrastructure and lower levels of digital literacy in rural areas.[89] Data from the Business Environment and Enterprise Performance Survey (BEEPS) for 2018-20 highlight that businesses outside the main capital are more prone to credit constraints: 36 per cent of firms, compared with 20 per cent in the capital.[90] In addition, these firms are more likely to identify access to finance as a major obstacle to their operations (20 per cent versus 9 per cent) and are less likely to have a line of credit or loan from a financial institution (again, 20 per cent compared with 9 per cent).[91]

82 See UNFPA (2021).

83 See SSCRA (2022b).

84 See World Bank (2022b).

85 See SSCRA (2023).

86 See SSCRA (2022b).

87 See ADB (2019).

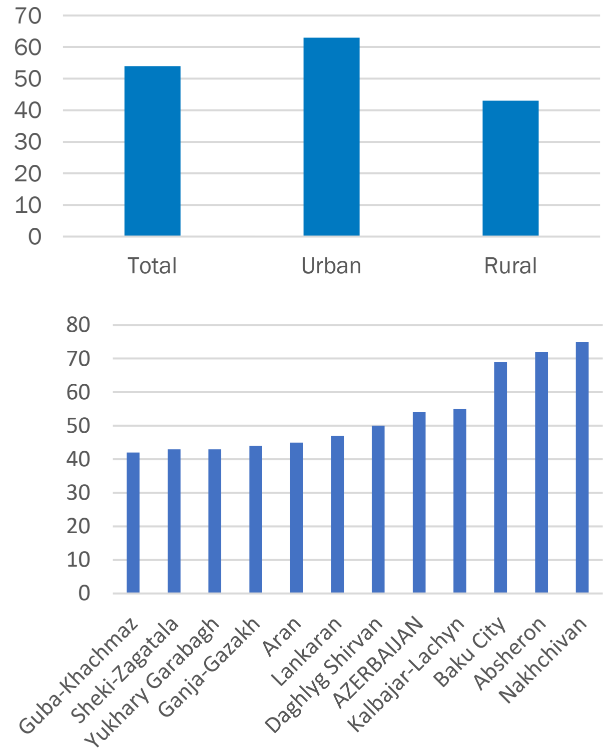
88 See ITU (2021).

89 See ADB (2019).

90 See EBRD (n.d.).

91 Ibid.

Chart 31. Household fixed internet penetration in 2017 (by area [top panel] and by region [bottom panel])



Source: ADB (2019), Figure 5 – Household Access to Fixed Broadband Internet, 2017.

The government of Azerbaijan acknowledges the importance of human capital development as a prerequisite to reducing the country's dependence on oil and gas revenues and strengthening its resilience to external shocks and is taking steps to address labour-market dysfunction. On 2 February 2021, the President approved the "Azerbaijan 2030: National Priorities for Socioeconomic Development" strategy. This policy document identifies five national priorities for the socioeconomic development of Azerbaijan. These include a society based on dynamic, inclusive and social justice, as well as competitive human capital and space for modern innovations. Challenges related to youth unemployment and productive employment in general are also addressed as part of the National Employment Strategy 2019-30 approved in October 2018, which aims to reduce the share of youth (aged 15-24) not in education, employment or training to 15 per cent by 2030.[92] Both Azerbaijan's Vision 2030 and Strategy for 2022-26 highlight the development of digital skills as a priority. The government has committed to increasing knowledge and skills in the information and communications technology (ICT) sector, and applying ICT in the education system by 2025, with a view to increasing digital literacy and equipping students and adults with market-relevant skills. The new strategy also aims to bring science, technology, engineering and mathematics (STEM)-based programmes into national curricula.[93]

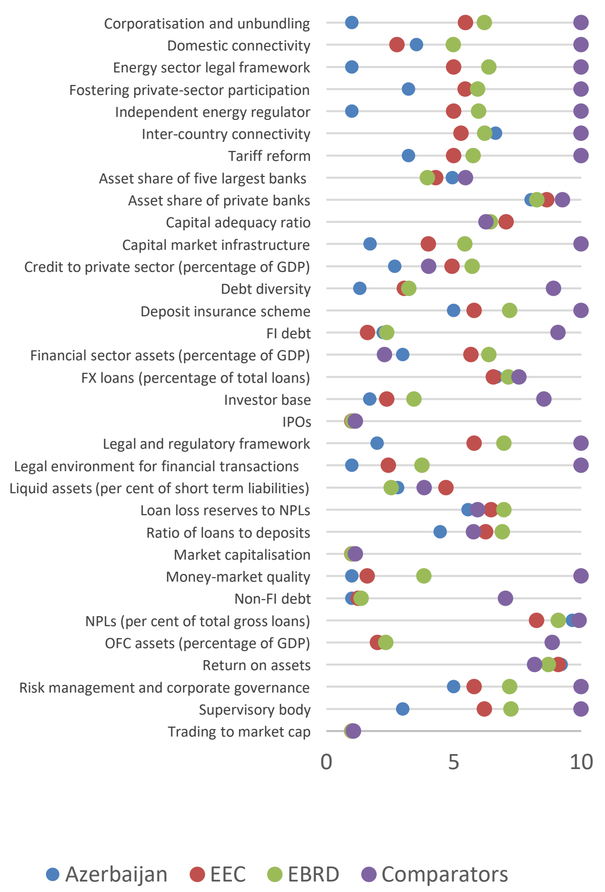
Resilient – a shallow and nascent financial market and an unreformed state-dominated energy sector create vulnerabilities

The financial system is dominated by the banking sector, the soundness of which has improved in recent years. Credit penetration remains very low despite strong credit growth in the post-pandemic years. Financial markets are in the early stages of development and activities are under way to improve financial infrastructure and develop money markets. Thanks to its large oil and gas reserves, Azerbaijan has one of the highest energy self-sufficiency levels in the world. The energy sector is dominated by SOEs and involves heavy cross-subsidisation, enabled by the abundance of natural resources. More private-sector involvement in the energy sector requires structural reforms and market deregulation, as envisaged by the new energy law.

92 See European Training Foundation (2020a).

93 See World Bank (2022b).

Chart 32. Resilient ATQ indicators 2023

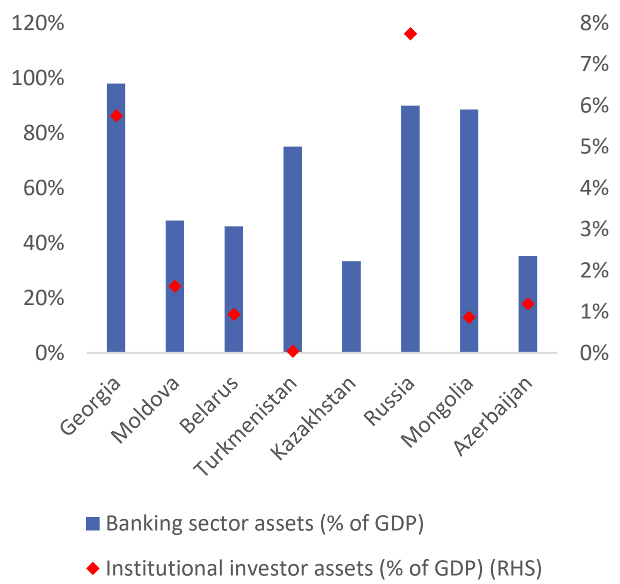


Source: EBRD (2023b).

Financial resilience

Azerbaijan's financial system is dominated by the banking sector, which remains the main source of financing for businesses. The banking sector consists of 23 banks, including two state-owned and nine foreign-owned banks. The banking sector accounts for more than 95 per cent of all financial-sector assets, given the limited number of non-bank financial institutions (NBFIs)/other financing institutions (OFIs) and institutional investors in Azerbaijan. The banking sector is small, accounting for 35.2 per cent of GDP in 2022, but at the same time concentrated, with three systemically important banks accounting for 65 per cent of the market by total assets (48 per cent of total loans) and 70 per cent of the market by total deposits. The state-owned International Bank of Azerbaijan dominates the system, accounting for more than 30 per cent of total assets (but only 18 per cent of total loans) at the end of 2022. Credit penetration remains low (14.6 per cent of GDP as at end-2022). The total deposit portfolio of banks accounts for 81.5 per cent of total banking-sector liabilities. The sector operates under a standard commercial banking model, with loans constituting the largest part of banks' assets and deposits the dominant source of funding. Apart from banks, the financial system comprises non-bank credit institutions, a growing insurance industry and capital markets. In the absence of private pension or investment fund activity, and with a small life-insurance segment, institutional investors' assets as at end-2022 stood at 1.2 per cent of GDP (see Chart 33).

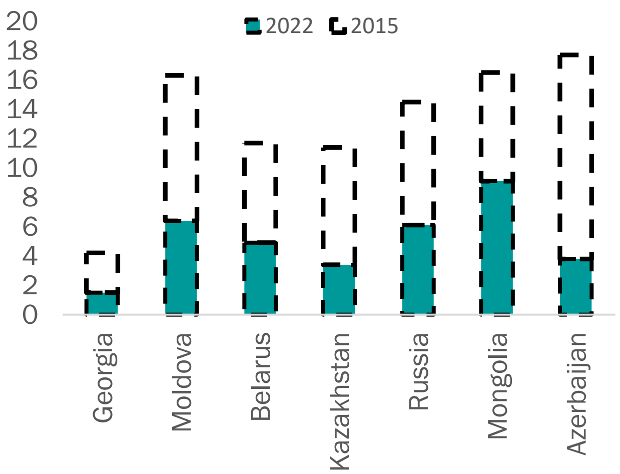
Chart 33. Banking-sector and institutional investor assets as a percentage of GDP (2022)



Source: IMF FSI, OECD, S&P Capital, World Bank.

The banking sector's soundness indicators are robust. The sector maintains high liquidity buffers and sound capitalisation (a capital adequacy ratio of 19.3 per cent) and had a low non-performing loan (NPL) ratio (3.8 per cent) at the end of 2022 (see Chart 34). The net profits of the banking sector increased by 50 per cent in 2022, with an average return on equity of 16.3 per cent and an average return on assets of 2.2 per cent. Growth in loans and deposits was reported at 17.6 per cent and 25.1 per cent, respectively, in 2022. Credit risk remains subdued amid positive dynamics in asset quality and more advanced risk management in credit institutions. The de-dollarisation trends of recent years have continued, with foreign currency-denominated loans declining to 20.1 per cent of banks' total loan portfolio at the end of 2022.

Chart 34. NPLs as a percentage of total gross loans



Source: CBAR for Azerbaijan and World Bank for other countries.

The quality of banking regulation is continuously improving. Recent updates to the macroprudential framework by the Central Bank of Azerbaijan (CBAR) have underpinned the reduction in potential risks to the banking sector. Regulatory updates in recent years include:

1. The Basel III requirement on a countercyclical capital buffer, designed to counteract pro-cyclicality in the financial system and help dampen excessive credit growth during the upswing of the financial cycle, came into force in 2021.

2. The prudential framework for consumer loans was tightened by restricting the issuance of consumer loans with more than a 70 per cent debt-to-income (DTI) ratio, and higher risk weights were imposed on consumer loans with a high DTI ratio and interest rate in 2022.

3. The maturity requirements for consumer loans, including restructured consumer loans, were tightened in 2022 to ensure that the aggregate amount of all credit exposure on consumer loans with terms of five years and more should not exceed 0.1 per cent of Tier 1 capital after deductions.

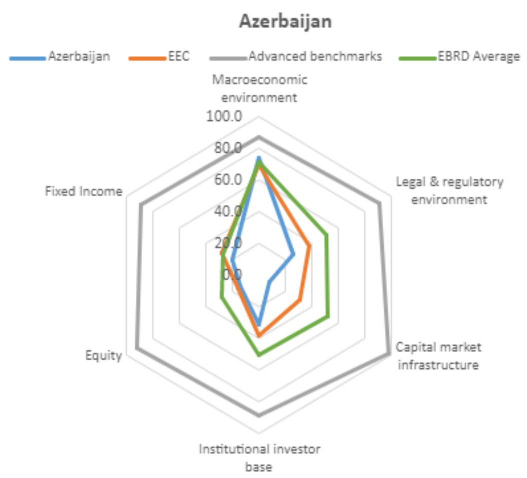
4. The provisioning requirements on risky consumer loans were tightened in 2022.

5. To ensure the resilience of the banking sector to environmental, social and governance (ESG) risks, the regulatory framework was eased in 2022 to stimulate the use of eco-friendly cars.

Financial market infrastructure

Financial markets in Azerbaijan are in the early stages of development. According to the EBRD Financial Markets Development Index (FMDI),[94] Azerbaijan ranks 31st out of 38 economies,[95] reflecting the low levels of depth, liquidity and diversification of its debt and equity markets and the absence of local derivatives markets (see Chart 35). Gaps remain in the legal and regulatory framework (for example, as regards the rule of law, local derivatives and legal frameworks for repos) and the local institutional investor base. The relatively undiversified economy, being highly reliant on the state- and foreign-owned oil and gas sector and dominated by politically connected corporate groups in other industries, is not conducive to the development of an equity market.

Chart 35. Financial-market development in Azerbaijan and selected comparator economies



Source: EBRD, 2023.

There are efforts under way to develop money markets. The local money market comprises government T-bills, CBAR notes, repos and the direct unsecured interbank market. The CBAR follows a de facto exchange rate-targeting regime, while officially targeting monetary aggregates. Against this backdrop, local-currency money-market development has been slow, though there is growing interbank repo activity using local-currency government bonds, CBAR notes and corporate bonds as collateral. From September 2022, the CBAR introduced changes to its monetary policy operational framework, aiming to underpin the development of local money markets and expand the range of open market operations. With its new operational framework, the CBAR aims to strengthen the pass-through of monetary policy decisions on inflation through the interest rate channel, ensure balanced growth of credit to the economy, optimise banking asset distribution and support equilibrium in the FX market. Nonetheless, it would be challenging for the CBAR to achieve these goals without significant improvement in its monetary policy implementation. In May 2023, the CBAR launched the Azerbaijan Interbank Rate (AZIR), reflecting the average weighted interest rate on short-term loans (from one day to 12 months) concluded by local banks in local currency on the unsecured interbank market through the Bloomberg trading platform. The CBAR publishes the AZIR index daily on its website. Publicly available one-day and one-week AZIR indices are consistently below the lower end of the CBAR's interest-rate corridor, a sign of persistent inefficiencies in monetary policy implementation and the operational framework, despite recent amendments. The lack of an active money market and the absence of a reliable local

94 The FMDI measures local financial-market development based on publicly available quantitative and qualitative criteria. The FMDI score is derived from 54 individual indicators, split across two equally weighted sub-indices covering (i) the necessary conditions for sustainable market development, including macro-financial conditions, the legal and regulatory framework, market infrastructure and the institutional investor base; and (ii) asset class-specific indicators reflecting the extent of such development across debt, equity, money and derivatives markets. See EBRD (2021) for more details on the FMDI.

95 In April 2022, the EBRD's Board of Governors decided to suspend access to the Bank's resources by Russia and Belarus in response to the invasion of Ukraine, reducing the number of economies in which the Bank operates to 36. The Bank has closed its offices in Moscow and Minsk. Russia and Belarus remain EBRD shareholders.

benchmark rate in turn limit the development of derivatives and capital markets.

Local bond markets, dominated by local-currency issuance on the regulated market, have started to grow, but remain shallow overall. The government issues domestic AZN bonds with one-, two-, three-, five- and seven-year tenors, which are placed and listed on the Baku Stock Exchange (BSE). In 2022, the volume of government bond issuance amounted to US$ 1.4 billion (€0.9 billion, or 1.8 per cent of GDP). The outstanding stock of sovereign bonds totalled US$ 4.7 billion (€4.3 billion, or 6 per cent of GDP) as at end-2022, of which about 52 per cent was issued on the BSE. Secondary market volumes in government bonds have grown significantly over the last two years, reaching a record number of 811 transactions with a volume of US$ 386 million (€354.9 million) in 2022. The domestic institutional investor base is shallow, with no private pension or investment fund activity. Banks are the main investors, holding around 50 per cent of the total outstanding volume of government bonds. Insurance companies and SOEs are also actively investing in government bonds, while retail investors only hold around 1 per cent of outstanding government bonds. In April 2023, the CBAR expanded the investor base to allow private non-financial and non-oil resident legal entities to own notes with certain limits, a move intended to support the formation of a yield curve for maturities of less than a year.

Non-sovereign local bonds listed on the regulated market have seen steady expansion in recent years. With around US$ 9.8 billion (€9 billion, or 12 per cent of GDP) in outstanding nominal value listed on the BSE, they are nearly double the size of sovereign issuance. However, 98 per cent of that issuance stems from five SOEs. Despite the dominance of SOEs in the corporate securities market, issuer diversification on the BSE has increased significantly in recent years. While there were only 40 bond issues between 2010 and 2020, 27 were issued in 2021 alone, followed by 38 bonds in 2022, totalling US$ 421 million (€387.1 million), four-fifths of it in local currency. The secondary market for corporate bonds on the BSE registered a fivefold increase in volumes in 2022, to US$ 467 million (€429.4 million), while the number of secondary market transactions doubled to 919 in 2022. The recent expansion of the corporate bond market was supported by several regulatory and market development initiatives by the CBAR and BSE. The local bond market is expected to develop further in the coming years, benefiting from new initiatives to promote sustainable finance, tax incentives for listed bonds, the digitalisation of securities issuance processes and the introduction of a bond guarantee scheme for private companies. The CBAR adopted the Sustainable Finance Roadmap for 2023-26[96] in April 2023 to ensure the sustainability of the financial sector in the face of ESG risks, to enable taxonomy and facilitate the issuance of green bonds, green loans and sustainability-linked financial instruments. In 2022, discount and interest income paid on publicly offered and listed bonds were exempted from taxation for five years. The CBAR launched a digital solution at the end of 2022, which enables the CBAR, BSE and the Central Securities Depository of Azerbaijan (NDC) to provide e-services to issuers for the registration of stocks and bonds, approval of prospectuses, safekeeping of securities and their listing on the BSE. This new e-service platform is freely accessible to all market participants.

Azerbaijan's equity market remains underdeveloped and illiquid, with a limited number of listed companies. Equity market activity remains low, with an annual trading volume of US$ 237 million (€217.9 million) in 2022. Most of the primary and secondary market trading involves over-the-counter (OTC) deals, which account for about 84 per cent of the total, but only 11 per cent of the number of transactions. Public equity listings on the BSE are rare. While 20 companies are listed on the BSE with a total market capitalisation of US$ 2.3 billion

96 See CBAR (2023).

(€2.1 billion, or 3 per cent of GDP) as at April 2023, the free float is negligible and market liquidity is scant. In 2022, only four of the 20 listed companies were traded, with a total of 52 transactions and an annual trading volume of US$ 6.8 million (€6.3 million). The vast majority of equity transactions on the BSE involve the 586 companies whose shares are not officially listed, but which are available for trading. For 2022, this amounted to 2,498 transactions with a total value of US$ 1.7 million (€1.6 million). Consequently, Azerbaijan's equity market is not classified by either of the two benchmark index providers (MSCI or FTSE). With its limited trading activity and investor base, companies have few incentives to take on the additional disclosure and transparency requirements associated with a public listing.

Financial market infrastructure has seen improvements in recent years. The BSE has been operating for more than 20 years, and in 2015 the single Central Securities Depository (NDC) was launched for all corporate securities, government securities and CBAR notes, to ensure the safekeeping of financial instruments and a higher level of protection for operations. The NDC, fully owned by the CBAR, delivers a full range of services, including depository, clearing and settlement services, offering omnibus accounts and providing a delivery-versus-payment (DVP) settlement system. The securities clearing and settlement system was modernised in 2019 by: i) introducing banks as settlement agents for transactions executed on the BSE; ii) removing pre-funding and substituting it with trade caps for investment firms using DVP1 and DVP2 settlement models; and iii) transitioning to a mostly T+1 settlement cycle. The new settlement model eased the execution of transactions and provided a better liquidity management facility for market participants. However, international investor participation remains low in the absence of links to international central securities depositories. In 2022, the NDC and Türkiye's local central securities depository opened bilateral nominee holder accounts that allow local investors to purchase government securities in the other country. The capital markets systems in Azerbaijan were upgraded with the launch of new depository and trading systems in March 2023. The new depository system allows the NDC to efficiently manage the complete lifecycle of dematerialised securities, including registration, clearing, settlement and corporate actions processing, and allows investors to directly monitor their accounts and transactions and enter operations. The new trading system gives members of the BSE integration capabilities using the Financial Information eXchange (FIX) protocol and application programming interface (API) to perform trading activities and obtain market data.

Energy resilience and security

Azerbaijan produces around four times the energy it consumes and has one of the highest levels of energy self-sufficiency in the world. In recent years, almost 90 per cent of the country's oil and over 40 per cent of its natural gas have been exported. Completion of the Southern Gas Corridor, consisting of the Trans-Anatolian Natural Gas Pipeline (TANAP) (operational since 2018) and the Trans Adriatic Pipeline (TAP) (operational since 2020), has brought Azerbaijani gas to the European market. It has enabled a near tripling of annual gas production capacity, with realistic prospects for further increases in light of increased European appetite for alternative suppliers. The Southern Gas Corridor has highlighted the opportunity cost of consuming natural gas on the domestic market at subsidised prices. Although fossil-fuel resources are plentiful, major importing countries' commitments to net-zero GHG emissions by 2050 will eventually affect long-term demand, prompting the need for a strategic rethink of Azerbaijan's growth model.

The domestic energy sector involves heavy cross-subsidisation, enabled by the country's abundance of natural resources. The energy sector remains predominantly state-owned, as SOEs control almost 90 per cent of total power generation. Around 80 per cent of total electricity production comes from gas-fired power stations, while gas produced locally is available at substantially below export parity. Subsidisation is evident in the weak financial performance of these SOEs, which receive budget support to cover capital expenditure. Energy assets are outdated (especially transmission and distribution networks) and in need of investment. In response to low oil prices in recent years, the authorities have started to explore options to achieve better cost recovery through financial reform, adjusting tariff levels and structure, and incentivising SOEs to be more efficient.

Privatisation in the energy sector requires structural reform and can only be implemented once a new market design is in place. Private ownership has started in a limited way through some small power generation plants and two independent regional power distribution companies under private ownership. While the authorities' strategic roadmap outlines reforms aimed at increasing competitiveness in public utilities and attracting investors, progress is hampered by a lack of strategic policy decisions on power market design, weak coordination and unclear implementation responsibility.

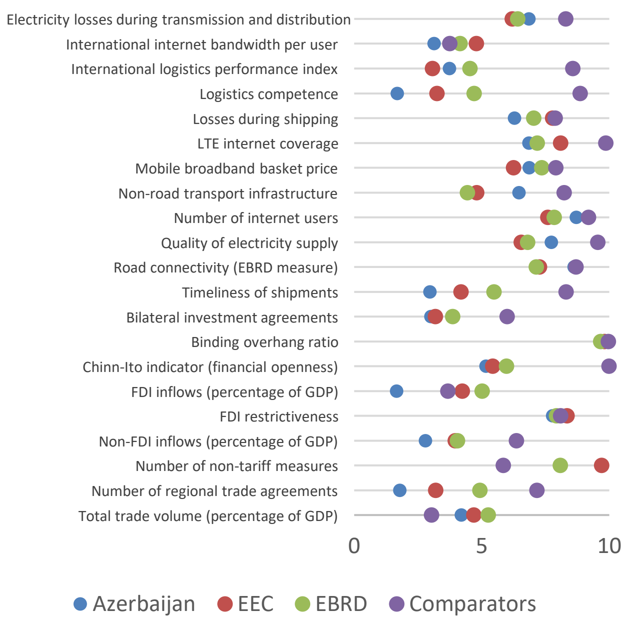
The energy regulator is still part of the Ministry of Energy. The Azerbaijan Energy Regulatory Agency (AERA) was established in December 2017. Its goal is to propose and calculate utility tariffs and oversee their implementation, and to develop a regulator law (currently being prepared) and other measures to promote legislative approximation with EU benchmarks. It is also charged with enhancing transparency and competition in the utility markets. However, AERA's institutional capacity requires strengthening.

The new energy law envisages a gradual deregulation of electricity markets. The main changes to the energy law were introduced in line with the Azerbaijan 2030 National Priorities for Socioeconomic Development. In 2021, the authorities created a regulatory framework for renewables by enacting a renewable energy law that opened the door for renewable energy development. The main elements of the new law include a guaranteed tariff and offtake agreement for potential renewable generators (investors). The selection process for these generators will be an auction based on the lowest power generation price, while the authorities can still undertake direct negotiations with potential generators. The auctioning process will be recorded on the country's e-platform, the Atlas, which also serves as an archive for storing information about renewables projects. This new approach aims to attract long-term investors to the electricity market. In addition, the Law on Electric Power adopted in 2023 outlines further reform planning for energy market privatisation. Traditionally, electricity generation, transmission and distribution have been rolled out by the fully state-owned company Azerenergy. The Law on Electric Power promises a legal unbundling of the electricity generation value chain, so that the current state monopoly in the electricity market can be reduced. The implementation of this new Law will progress in steps, beginning in July 2025, when electricity generation will be unbundled from transmission and distribution. Efforts to institutionalise electricity market operators and regulators with the development of retail markets will follow from July 2028. However, there are still various issues that need to be resolved in order to develop the renewables market. For example, investors in electricity are still required to have an investment agreement with the Ministry of Energy to initiate projects. Further limitations include slow and weak implementation of the regulatory framework.

Integrated – domestic connectivity and slow progress on digitalisation remain weak spots, but the Middle Corridor offers new opportunities for cross-border ties

Azerbaijan ranks 21st on the integrated transition quality across the economies in which the EBRD operates and second in the EEC region after Georgia (see Chart 36). While the country has relatively high infrastructure quality, domestic connectivity, especially outside of Baku, and performance on trade logistics remain poor. Cross-border connectivity remains a key priority for the country as it strives to develop the Middle Corridor and establish itself as a key transit and transport hub along the East-West and North-South corridors. On digital infrastructure, while broadband coverage and adoption are generally high, Azerbaijan's home internet speed is among the lowest in Europe, and digital gaps remain between the capital and other urban and rural areas.

Chart 36. Integrated ATQ indicators 2023



Source: EBRD (2023b).

External integration

External trade accounts for a relatively small share of total output (two-thirds), lagging the EBRD average. Exports of energy account for around 90 per cent of the country's goods exports and generate huge (though volatile) trade surpluses. Non-oil exports are growing in value terms, but remain subdued, at around 5 per cent of GDP. Low-value-added products like fruit and vegetables, chemicals, textiles and base metals dominate non-oil exports and are sold mostly to Russia and Türkiye. The completion of the Trans Anatolian Natural Gas Pipeline (TANAP) and Trans Adriatic Pipeline (TAP) means that almost half of total exports now go to Italy, with Türkiye a distant second market with a 10 per cent share. On the import side, half of total imports originate from Russia, Türkiye and China, while one-quarter come from EU countries.[97]

Azerbaijan is an observer at the World Trade Organization (WTO) and has had a Partnership and Cooperation Agreement with the EU since 1999. There is interest in becoming a full member of the WTO, but there has been little progress so far on membership negotiations. Azerbaijan is a target country under the EU's European Neighbourhood policy – specifically, the Eastern Partnership initiative. This initiative aims to strengthen EU-Azerbaijan relations by focusing on economic development, governance, connectivity, and people-to-people contact. Azerbaijan's trade relationship with the EU has been governed by the aforementioned 1999 agreement and negotiations have been under way since 2017 to establish a more comprehensive trade agreement.

Azerbaijan has relatively good infrastructure, thanks to high public spending in this area since achieving independence. The country performs especially well on transport infrastructure, ranking 31st out of 141 countries when it comes to overall infrastructure quality.[98] The government wants to position the country as a major transit and transport hub along the East-West and North-South corridors and has invested heavily in inland transport, with investments reaching 2.6 per cent of GDP in 2021. Public spending on inland transport from the state budget totalled €5.4 billion in 2015-21 (see Chart 37).[99] Road transport accounted for the lion's share of that, receiving more than 99 per cent of total spending during this period.

Despite heavy spending on road transport and the relatively good quality of the country's road infrastructure (ranked 27th out of 141 countries in the World Economic Forum's 2019 Global

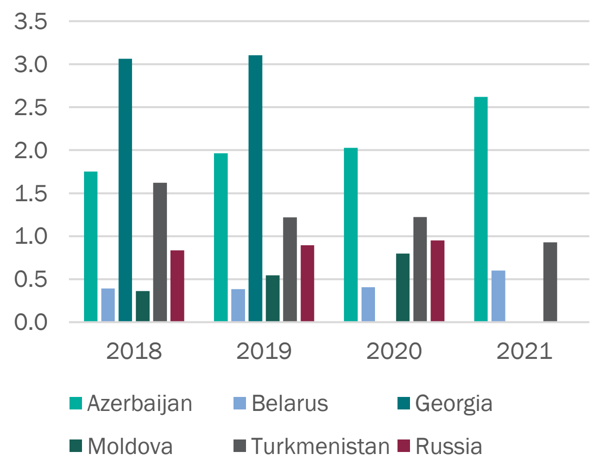
97 See SSCRA (2022).

98 See World Economic Forum (2019).

99 See OECD (2021).

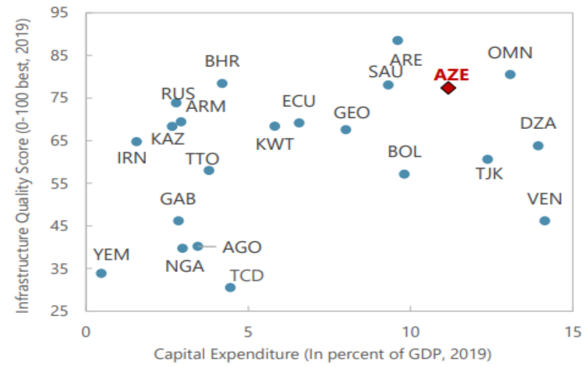
Competitiveness Index), road connectivity remains poor.[100]

Chart 37. Total inland transport infrastructure investment (percentage of GDP)[101]



Source: OECD (2021).

Chart 38. Quality of infrastructure and capital expenditure



Source: World Economic Forum (2019).

100 See World Economic Forum (2019).

101 The omission of certain comparators in some years is due to data availability issues.

While Azerbaijan performs well on infrastructure quality compared with its peers (see Chart 38), it ranks poorly in the World Bank's Logistics Performance Index (123rd out of 167 countries in 2018) due to poor "soft" trade infrastructure, such as the competence of transport operators and customs officials and the quality of logistics services.[102]

Azerbaijan's rail network is owned and operated by the state-owned rail company, Azerbaijan Railways. The country has established international connections with Georgia, Iran (limited to the Nakhchivan exclave), Russia and Türkiye through the Kars-Tbilisi-Baku railway. However, there are no rail links with Armenia. Rail traffic between mainland Azerbaijan and the Nakhchivan exclave must bypass Armenia via Iran or Georgia and Türkiye.

Oil and gas pipelines are critical to Azerbaijan's export capabilities, with the key export routes being northwest through Russia and southwest through the Caucasus. The Baku-Grozny-Novorossiysk pipeline (Northern Route) transports Azerbaijani oil to the Black Sea port of Novorossiysk. To export oil and gas to Türkiye and onwards to Europe, Azerbaijan has several pipelines that cross its neighbour, Georgia: the Baku-Tbilisi-Ceyhan (BTC) pipeline, the Baku-Tbilisi-Erzurum (BTE) pipeline and TANAP. Oil and gas pipeline projects continue to account for the majority of national energy investments.[103] One of the largest gas development projects in the world and the first subsea infrastructure in the Caspian Sea, the Shaz-Deniz Full Field Development Project (currently in stage two of development) will allow exports of gas from Azerbaijan to Europe and Türkiye through more than 3,500 kilometres of pipeline across Azerbaijan, Georgia, Türkiye, Greece and Albania and under the Adriatic Sea to Italy.

Baku's Caspian Sea port complex is one of Azerbaijan's most crucial transport infrastructure assets. In light of recent world events, the port has seen increased demand due to cargo traffic growth along the East-West Corridor (from China to Europe). From January to May 2022, the freight flow through the Baku port reached 2.2 million tonnes, up nearly 20 per cent from the same period the previous year. In 2021, the port adopted a climate strategy and action plan, setting out actions to mitigate contributions to climate change and achieve the full decarbonisation of port operations by 2035.

Because of Azerbaijan's location on the Middle Corridor between Asia and Europe, prioritising reforms in the transport and logistics sectors and strengthening cooperation with Georgia and Kazakhstan could harness the economic opportunities of being a regional logistics hub. Trade sanctions on Russia have prompted significant logistics interest in the Trans-Caspian International Transport Route (TCITR)[104] connecting eastern and Central Asia to Europe, resulting in a 45 per cent year-on-year increase in cargo turnover in the first ten months of 2022.[105] To fully capitalise on these economic benefits, Azerbaijan needs to increase its cooperation and coordination with neighbouring Georgia and Kazakhstan to reduce both non-physical (for example, cross-border policy harmonisation) and physical (for example, interconnecting infrastructure) barriers, improve related institutional frameworks and develop a common transitional regulatory framework.[106] Further strengthening and upgrading of Azerbaijan's infrastructure are also needed to meet growing demand on the Trans-Caspian International Transport Route, particularly warehousing and cold-storage facilities. While nearly 40 per cent of businesses say that government investment in infrastructure has had a positive impact on

102 See World Bank (2018b).

103 See IEA (2021).

104 Also referred to as the Middle Corridor (see Box 1 for more detail).

105 See Eurasia Daily Monitor (2023).

106 See World Bank (2021b).

Azerbaijan's business climate,[107] the World Bank Logistics Performance Index ranked Azerbaijan 153rd out of 167 nations for the quality and competence of its logistics services, supply-chain competitiveness, diversification and investment attractiveness.[108]

Even though the country is in a favourable location to assist with the expansion of the Middle Corridor, Azerbaijan's economy may also benefit from the development of the North-South corridor. As half of the country's non-oil exports are agricultural products and 80 per cent of these are sent to the Russian market, maintaining good transport links with one of the country's key trading partners is beneficial to the domestic economy. However, exporting agricultural products requires specialised fleets and efficient logistics services.

In recent years, Azerbaijan has implemented significant reforms aimed at improving its investment climate. The focus has been on strengthening the institutional, regulatory and operational environment to facilitate business operations and enhance the country's global reputation. These efforts are part of government initiatives to promote industrial development and improve the overall image of Azerbaijan worldwide.[109] As foreign direct investment (FDI) inflows to Azerbaijan mainly focus on the oil and gas sector, dividend payments in the extractive industries caused net FDI flows to turn negative in 2022 and 2021.[110] Consequently, the five-year average of FDI inflows as a share of GDP was -0.3 per cent, below the EEC and EBRD averages.[111]

According to the Foreign Business in Azerbaijan Report produced by the German-Azerbaijani Chamber of Commerce in 2021, Azerbaijan has made noteworthy advances in various areas. These include tax and financial-sector reforms, including tackling currency risk and rigid regulation frameworks, simplifying customs clearance procedures and minimising instances of corruption and bribery. Such reforms have led to a significant improvement in the country's overall business environment, with 60 per cent of companies in the aforementioned survey recommending Azerbaijan as a good place for business investment in 2021, up from 50 per cent in 2020.[112] While political stability remains a credible anchor for foreign businesses in Azerbaijan, the weak judicial system, lack of a highly skilled workforce, high customs tariffs and large SOE presence are the least attractive local business environment attributes.

Internal integration

Azerbaijan's road and rail networks require modernisation and maintenance. While cross-border connectivity projects are top priorities for the country, domestic connectivity remains a key barrier to inclusive growth, particularly outside Baku, with improvements needed to lower travel costs and improve secondary and local roads. Over time, Azerbaijan has witnessed a shift in its inland transport modal split for freight, with growing reliance on road transport. In 2005, roads accounted for 44 per cent of the country's freight, measured in tonne-kilometres, but by 2018 this had increased to 79 per cent. In the same period, the share of rail transport dropped from 56 per cent to 21 per cent. When it comes to passenger transport, roads dominate even more, with 98 per cent of travel occurring by road in 2018, compared with a mere 2 per cent by rail.[113]

Access to services that enable economic opportunities shows that while Azerbaijan has a stronger position than the regional average, gaps remain. For example, although 87.7 per cent of Azerbaijan's population was using safely managed

107 See AHK Azerbaijan and KPMG Azerbaijan (2021).

108 See World Bank (2018b).

109 See OECD (2019).

110 See UNCTAD (2022).

111 See World Bank 2022 World Development Indicators.

112 German-Azerbaijani Chamber of Commerce (2021).

113 See UNECE (2019).

drinking-water services in 2020, only 21.0 per cent was using safely managed sanitation services in 2019, well below the levels of regional peers.

Digital infrastructure

Azerbaijan still faces digital divides between the capital city and other urban and rural areas.[114] Gaps in fixed internet penetration compared with urban households are mainly due to a lack of fixed infrastructure and lower levels of digital literacy in rural areas.[115] Mobile broadband coverage and adoption are generally high, with 99 per cent of the population covered by at least a 3G mobile network and 94 per cent covered by at least a 4G mobile network.[116] Eighty-seven per cent of homes have fixed broadband access and costs for fixed and mobile broadband are generally considered affordable in relation to monthly gross national income per capita.[117] The utilisation of the internet for interactions with authorities, public services and education is relatively low, with only a small percentage of individuals engaging in these activities.[118] Azerbaijan's internet speed is the lowest in the EEC region,[119] with only 22 per cent of fixed broadband subscriptions having an advertised speed of at least 10 Mbit/second.[120] However, the country ranks relatively highly in terms of mobile internet speed.[121]

114 See Baku Research Institute (2021).

115 See ADB (2019).

116 See ITU (2021).

117 Ibid.

118 See Baku Research Institute (2021).

119 See Baku Research Institute (2021).

120 See ITU (2021).

121 See Speedtest Global Index (2021).

4. Box 1. Middle Corridor opportunities and challenges

The idea of a Middle Corridor connecting Asia to Europe is not new, but became increasingly popular after the Russian invasion of Ukraine and the introduction of heavy sanctions on Russia. The Middle Corridor was always considered an alternative to the Northern Corridor for the land transport of goods, but due to its multimodal character and many borders, it has remained slower and more expensive. Since March 2021, Azerbaijan, Kazakhstan and Georgia have been increasing their efforts to coordinate the many players along the corridor, reduce the idle time in the three ports on the route, speed up customs formalities and introduce a unified tariff.

Azerbaijan is making significant efforts to develop the Middle Corridor. This branches off the southernmost Beijing-Moscow route near Urumqi, crosses the Kazakh border at Khorgos and reaches the Caspian Sea at the port of Aktau, with a ferry crossing to the port of Baku. The onward journey is then by rail to the port of Poti in Georgia, with a Black Sea crossing to Romania or Bulgaria, or via the Baku-Tbilisi-Kars railway to Istanbul (completed in 2017), crossing the Bosphorus via the Marmaray tunnel. The Middle Corridor is coordinated by the Trans Caspian International Transport Route (TITR), with different train operators responsible for different sections.

A range of institutions in Azerbaijan have an important role to play in developing the Middle Corridor. Baku Seaport, Azerbaijan Railways, the Caspian Shipping Company (ASCO) and the Transit Council all have ambitious plans when it comes to increasing capacity along their part of the route. Baku Seaport is the country's most important transport infrastructure asset, and the government has plans to modernise it and increase its capacity, including by deep dredging. Azerbaijan Railways, which is fully state-owned, owns and operates the rail network, which is linked to Georgia, Iran, Russia and Türkiye. The government of Azerbaijan has been investing in upgrading the railway from Baku to Tbilisi to the Turkish town of Kars to further develop the Baku-Tbilisi-Kars rail link.

The Middle Corridor could be of regional significance (connecting Central Asia with Europe) or global importance if it is used to connect China and Europe. At present, cross-Caspian transit traffic is mainly between Kazakhstan/Turkmenistan and the countries of south-eastern Europe, the Caucasus and Türkiye. However, there is a much larger potential traffic flow between China and Europe, the majority of which is currently carried in containers, by either rail or sea. Interest in diverting this cargo to the Middle Corridor has increased significantly in recent years given the impact of the Covid-19 pandemic on international sea transport logistics and freight rates. More recently, the war in Ukraine has resulted in sanctions on Russia, which have put at risk international access to the Trans-Siberian railway and the northern rail corridor.

Nevertheless, there is high uncertainty about the long-term potential and viability of the Middle Corridor. A clear picture is lacking when it comes to the long-term potential demand for Middle Corridor services, as well as the necessary investment, with limited private-sector interest expressed so far. In contrast, there is political will not just in the region but also from the major western countries that consider the Middle Corridor a politically viable project that could increase trade relations and improve the connectivity of Central Asia and the Caucasus with Europe. The EBRD has conducted a study on sustainable transport connections between Europe and Central Asia to identify the most sustainable transport routes and prioritise key investments in Central Asia to make this route a viable alternative.[122]

122 See EBRD (2023a).

The benefits of developing the Middle Corridor could be far-reaching. It encourages long-term planning, stronger regional coordination, unified tariffs and a commercially oriented single corridor manager. Investments in the Middle Corridor would increase connectivity between economic centres along the route, including those in Azerbaijan, and improve border-crossing practices. Greater utilisation of railways and multimodality would also bring better environmental outcomes. While the development of the Middle Corridor is usually assessed from a transport perspective, the possible benefits for economic development could be significant. The identification of complementary production patterns in the economic centres of the corridor countries could support the development and integration of regional value chains, which could facilitate economic diversification.

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