



AZERBAIJAN

Highlights

- **The economy is in recession but the pace of decline has slowed.** GDP declined by 3.1 per cent in 2016 but by just 0.6 per cent year-on-year in the first nine months of 2017. The modest recovery in oil prices and adjustment of macroeconomic policies are helping to stabilise the economy.
- **The International Bank of Azerbaijan (IBA) completed a voluntary debt restructuring.** This is part of the bank's broader restructuring plan that aims to clean up the balance sheet and prepare the bank for eventual privatisation.
- **The Commission on Transparency in Extractive Industries has been established and is operational.** Following Azerbaijan's withdrawal from the Extractive Industries Transparency Initiative (EITI), the authorities have pledged to continue to uphold the principles of revenue transparency and accountability.

Key priorities for 2018

- **Macroeconomic stability needs to be reinforced to improve business confidence.** Policies should be geared towards bringing down inflation while maintaining flexibility of the exchange rate and preserving the fiscal consolidation gains achieved in 2016.
- **IBA privatisation is a crucial priority.** The declared plan to privatise the IBA needs to be implemented on completion of the bank's restructuring process. This will help both to ensure the sustainability of the IBA's operations and to eschew contingent fiscal costs in the future.
- **Reform roadmaps should be implemented vigorously.** Key priorities in the short term include tax administration reforms to enhance predictability, fairness and taxpayer compliance, and decisive steps to tackle informality in the economy.

Main macroeconomic indicators %

	2013	2014	2015	2016	2017 proj.
GDP growth	5.8	2.8	1.1	-3.1	-0.5
Inflation (average)	2.4	1.4	4.0	12.4	12.0
Government balance ¹ /GDP	1.7	2.7	-4.8	-1.1	-0.3
Current account balance/GDP	16.6	13.9	-0.4	-3.6	1.9
Net FDI/GDP [neg. sign = inflows]	-1.5	-2.9	-1.5	-5.1	-5.7
External debt ² /GDP	11.7	14.5	18.5	20.4	n.a.
Gross reserves ³ /GDP	19.1	18.3	9.5	10.5	n.a.
Credit to private sector/GDP	26.5	31.4	40.0	27.2	n.a.

¹ Includes central government and main extrabudgetary funds, including operations of the oil fund and the social protection fund. Figure for 2016 is a projection.

² Public and publicly guaranteed external debt outstanding.

³ Excluding assets of the State Oil Fund (SOFAZ).

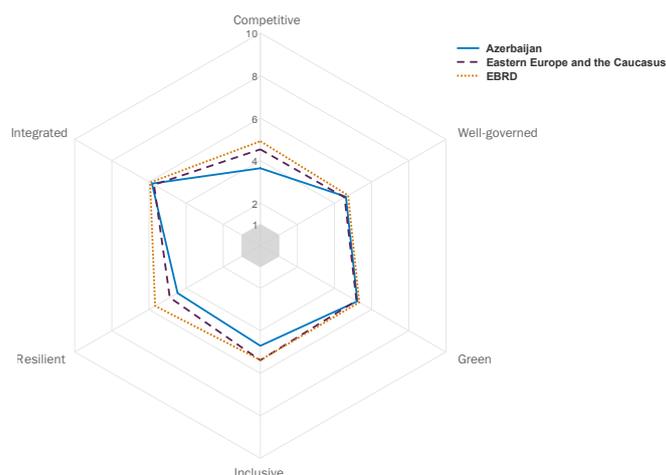
Macroeconomic performance

The economic recession is looking less severe. GDP declined by 3.1 per cent in 2016, but the pace of contraction decelerated to 0.6 per cent year-on-year in the first nine months of 2017. Non-oil GDP grew by 2.5 per cent in the first nine months of 2017 following a 4.5 per cent contraction in 2016. Last year's recession was accompanied by a major 21.7 per cent drop in capital investment, but the decline in investment has since levelled off during 2017. Macroeconomic policies have remained relatively tight to curb inflation, defuse foreign exchange pressures and safeguard liquidity buffers. However, inflation has picked up to 13.9 per cent year-on-year in the first nine months of 2017, reflecting the delayed pass-through effect of the manat devaluation in 2015-16.

Macroeconomic balances have improved. The manat devaluation in 2015-16 paved the way for increasing the competitiveness of non-oil exports and for the containment of imports, but external adjustment has been slow. In the first half of 2017, Azerbaijan's current account receipts from the oil and gas sector grew by approximately 8.0 per cent year-on-year in US dollar terms, enabled by the recovery in the oil price. As a result, Azerbaijan's overall current account moved from a deficit of 3.6 per cent of GDP in 2016 to a small surplus in the first half of 2017, but the non-oil current account balance remained negative. After a brief period of volatility at the beginning of 2017, the manat-US dollar exchange rate has stabilised amid stringent monetary conditions and a recovery in the oil price. Meanwhile, the consolidated fiscal deficit declined closer to 1 per cent of GDP in 2016 after reaching approximately 5 per cent of GDP in 2015, with the improvement driven by conservative budget planning and downsizing of public investment spending. Azerbaijan has maintained sizeable liquidity buffers despite pressures arising from the low oil price environment. As of mid-2017, the combined assets of the State Oil Fund of Azerbaijan (SOFAZ) and of the foreign exchange reserves of the central bank were US\$ 41 billion, which is approximately equivalent to the country's GDP.

GDP growth should rebound in 2018. A slight GDP downturn of 0.5 per cent is likely in 2017 as a whole as tight monetary and fiscal policies, necessary to safeguard macroeconomic stability and preserve liquidity buffers, weigh on the near-term growth outlook. However, the completion of landmark gas infrastructure projects (Shah Deniz stage 2, Southern Gas Corridor) is expected to provide impetus to growth from 2018 onwards, with GDP projected to rise by 2.0 per cent next year. Downside risks remain significant, associated mainly with the dependence on the resources sector and banking sector challenges.

Assessment of transition qualities (1-10)



Major structural reform developments

A series of reform roadmaps have been adopted. In December 2016, the President of Azerbaijan endorsed a set of strategic roadmaps for reforms in the key sectors of the economy, such as the oil and gas industry, agriculture, small and medium-sized enterprises, tourism, logistics and financial services among others. These roadmaps detail a short-, medium- and long-term horizon for each sector and provide action plans for 2016-20. A Center for Economic Reforms Analysis and Communication was established to promote the realisation of economic reforms and work on public outreach. However, the capacity to implement the reform roadmaps without delays remains uncertain.

Administrative requirements for doing business have been simplified. Following the streamlining of procedures for issuing licences and permits in 2016, ASAN (Azerbaijan Service and Assessment Network) introduced an e-visa portal in January 2017 which simplifies and substantially shortens the time period for issuing visas to foreigners, including business travellers. A moratorium on some of the inspections, which has been extended until January 2021, reduces the regulatory burden on businesses. A Board of Appeals introduced within ministries and under the presidential administration during the course of 2016 aims to create a dispute resolution mechanism for addressing private sector complaints, but its effectiveness remains largely untested. Improvements in customs administration as well as in other areas of government regulation have paved the way for more transparent and accurate financial reporting by companies operating in Azerbaijan. Azerbaijan ranks 57th out of 190 countries in the World Bank's *Doing Business 2018* report. Recent improvements relate to getting credit, protecting minority investors, enforcing contracts and resolving insolvency although the scores remain low in dealing with construction permits, getting electricity, getting credit and trading across borders.

The banking sector clean-up and consolidation is under way. The manat devaluation in 2015-16 negatively affected dollarised balance sheets in the banking sector, exposing capital shortfalls. Between its establishment in February 2016 and June 2017, the Financial Markets Supervisory Authority (FiMSA) closed 11 banks which failed to comply with regulatory capital requirements. Non-performing loans remain elevated, mainly reflecting foreign exchange-induced credit risks and the economic recession. Credit activity has shrunk in 2016 and in the first eight months of 2017 due to the turbulence in the banking system and the lack of credit demand from the real sector.

The authorities have initiated restructuring of the IBA. Following significant capital injections into the majority state-owned IBA in 2016-17 and transfer of some of its bad assets to a separate entity, the authorities launched a liability management operation to further de-risk and downsize the IBA's balance sheet. The IBA is the largest bank in Azerbaijan and accounted for approximately one-third of total banking assets before the debt operation. In May 2017, the IBA announced a voluntary restructuring of foreign exchange liabilities amounting to US\$ 3.3 billion, offering creditors to swap the IBA's debt for new sovereign bonds and limited new IBA debt. The debt restructuring was concluded in September 2017. As part of the broader bank restructuring effort, the IBA aims to dispose of non-core foreign assets and take further steps to clean-up the balance sheet ahead of the declared plan to privatise the bank in 2018.

Establishment of the Commission on Transparency in Extractive Industries followed Azerbaijan's withdrawal from the EITI. Azerbaijan joined the EITI in 2004 at the outset of the initiative and was the first country to be validated as fully compliant with EITI standards in 2009. In March 2017, the EITI suspended Azerbaijan's membership over concerns about the enabling environment for civil society. In response, Azerbaijan decided to withdraw from the EITI. The authorities stressed that Azerbaijan would remain committed to the principles of good governance, revenue transparency and accountability in the extractive sectors. In April 2017, the President of Azerbaijan signed a decree establishing a Commission on Transparency in Extractive Industries. The Commission has become operational under the chairmanship of the executive director of SOFAZ.