



AZERBAIJAN

Highlights

- **Azerbaijan's economy escaped recession in 2017.** GDP grew by 0.1 per cent in 2017 following a 3.1 per cent contraction in 2016. In the first nine months of 2018, output has continued to rise slowly, supported by growth in the non-oil sector.
- **Strategic energy projects reached important milestones.** The first commercial gas deliveries were made from the new Shah Deniz 2 gas field to Turkey. Azerbaijan has extended the Production Sharing Agreement with a consortium of international energy companies for the management of the country's largest oil field.
- **New public agencies were set up to support the non-oil private sector, although their effectiveness is yet to be tested.** The newly established agencies aim to promote food safety standards, improve regulation of the energy sector and support the development of small and medium-sized enterprises, including by lowering their borrowing cost through unfunded risk participation.

Key priorities for 2019

- **Investment climate reforms should build on recent positive changes.** Tax administration reform should be one of the reform priorities, with an emphasis on enhancing predictability of taxation and shrinking the size of the shadow economy through improving taxpayer compliance, expanding the tax base and reducing tax exemptions.
- **Decisive steps are needed to finalise banking sector restructuring.** Privatisation of the International Bank of Azerbaijan is one of the key priorities for lowering risk in the banking system and should be pursued without delay. The large stock of non-performing loans (NPLs) needs to be resolved, capital deficiencies in some banks addressed, and the independence and operations of the financial regulator (FIMSA) strengthened.
- **To fulfil their mandate, the newly established state agencies need to develop stronger institutional capacity.** Recently established public agencies are generally understaffed and lack both expertise and a sound operational framework. The authorities should take the necessary steps to ensure transparency and effectiveness of their operations.

Main macroeconomic indicators %

	2014	2015	2016	2017	2018 proj.
GDP growth	2.8	1.1	-3.1	0.1	1.5
Inflation (average)	1.4	4.0	12.4	12.9	3.5
Government balance ¹ /GDP	2.7	-4.8	-1.2	-1.7	4.8
Current account balance/GDP	13.9	-0.4	-3.6	4.1	6.6
Net FDI/GDP [neg. sign = inflows]	-2.9	-1.5	-5.1	-0.7	-3.5
External debt ² /GDP	14.5	18.5	20.4	n.a.	n.a.
Gross reserves ³ /GDP	18.3	9.5	10.5	13.1	n.a.
Credit to private sector/GDP	31.4	40.0	27.2	16.8	n.a.

¹ Includes central government and main extrabudgetary funds, including operations of the oil fund and the social protection fund. Figures for 2016 and 2017 are a projection.

² Public and publicly guaranteed external debt outstanding.

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

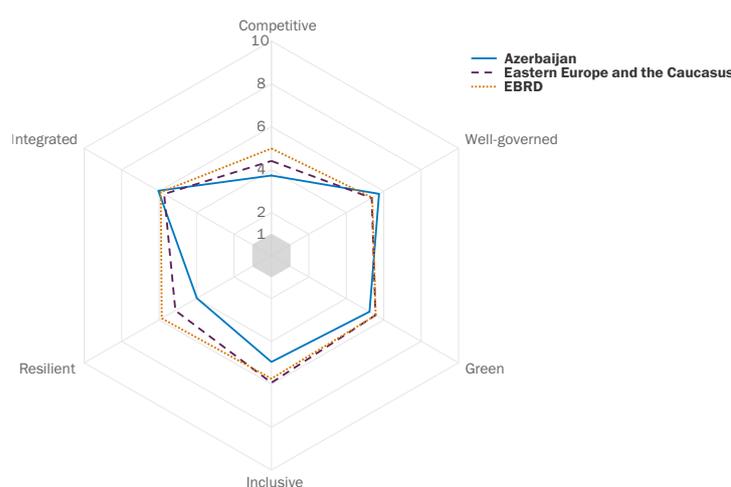
Macroeconomic performance

The economy has started growing slowly. After the GDP decline in 2016, economic growth was nearly flat at 0.1 per cent in 2017. The stabilisation of the economy was driven by a recovery in non-oil GDP, which grew by 2.7 per cent. In the first nine months of 2018, the economy expanded by 0.8 per cent year-on-year, although non-oil GDP growth slowed to 1.0 per cent year-on-year. Overall capital investment is in the fifth consecutive year of decline, although in the non-oil sector investment in fixed assets has posted growth in the first nine months of 2018. Inflation fell from an average of 12.9 per cent in 2017 to 2.6 per cent year-on-year in the first nine months of 2018, paving the way for looser monetary policy. The Central Bank of Azerbaijan (CBA) lowered the refinancing rate four times from 15 per cent in February 2018 to 9.75 per cent in October 2018.

The higher oil price is driving stronger external balances. Since April 2017, the manat-US dollar exchange rate has been maintained within a very narrow fluctuation band despite the recovery in the oil price. The current account switched from a deficit in 2016 to a surplus of 4.1 per cent of GDP in 2017 on the back of higher hydrocarbon revenues. In the first half of 2018, the current account surplus surged by growing more than fourfold compared with the first half of 2017. External trade trends were also positive outside of the oil and gas sector, supported by competitiveness-enhancing real devaluation of the manat in recent years. Exports of non-oil goods and services increased by 15.6 per cent in 2017 and by 19.5 per cent year-on-year in the first half of 2018, both in nominal US dollar terms, but their overall volume remains low compared with exports of hydrocarbons. Official foreign exchange reserves of the CBA are slowly recovering from US\$ 4 billion in December 2016 to US\$ 5.5 billion as of September 2018, covering 3.8 months of imports. Assets of the State Oil Fund of Azerbaijan (SOFAZ) increased from US\$ 33.1 billion in 2016 to US\$ 39.0 billion in the third quarter of 2018, providing a significant liquidity buffer.

Economic recovery is expected to continue in the absence of further commodity price shocks. Real GDP is forecast to grow by 1.5 per cent in 2018 and by 3.5 per cent in 2019. Near-term growth prospects are supported by a relatively stable oil price trend and ongoing expansion of gas production and export capacity. Recent moderate diversification gains augur well for medium-term economic growth but much more needs to be done to bolster the role of the non-oil economy.

Assessment of transition qualities (1-10)



Major structural reform developments

New agencies have been established to enhance delivery of public services and render assistance to small and medium-sized enterprises (SMEs). In December 2017, the authorities established the Agency for Development of Small and Medium-Sized Enterprises to enhance and better coordinate the provision of public services to SMEs. The agency is planning to expand its geographical coverage by setting up outposts in the regions of Azerbaijan and offer a range of financial and non-financial services, as well as provide information on all other public resources available to SMEs. A Food Safety Agency was set up in the first quarter of 2018. It is aiming to help uphold quality standards and thus improve Azerbaijan's agricultural exports potential. Meanwhile, the state agency for public services (ASAN) has broadened the range of offered services. As of February 2018, ASAN has been issuing energy-related permits. In March 2018 the agency was mandated to implement and regulate state policy on e-government. The institutional capacities of these agencies remain to be tested and are likely to need strengthening over time.

Initiatives to promote the credit flow to the economy have been rolled out but their effectiveness is still uncertain. The credit to GDP ratio declined from approximately 40.0 per cent in 2015 to 16.8 per cent in 2017 due to the contraction in credit activity and IBA balance sheet restructuring. The decline in credit activity levelled off in the first half of 2018, but loan portfolio growth remains subdued. The authorities have taken a number of remedial steps. A credit guarantee fund was established and made operational in the second half of 2017. Entrepreneurs in the non-oil and gas sector are able to apply to the fund for state guarantees and interest rate subsidisation on loans provided by the authorised commercial banks. In December 2017, the Financial Market Supervision Authority (FIMSA) started discussing a new mechanism to encourage restructuring of NPLs. In the first quarter of 2018, the IBA together with seven other banks set up the first private credit bureau. Compared with the existing state-managed credit bureau, the private bureau is expected to cover a larger number of borrowers and to provide more exhaustive information. In March 2018, the state collateral registry for movable assets established by the FIMSA started operating online.

Meaningful progress has been made in strategically important energy projects. The Shah Deniz 2 gas field and South Caucasus Pipeline Expansion (SCPX) were officially inaugurated in May 2018. The second stage of the Shah Deniz gas field development is part of the South Gas Corridor (SGC) project which is set to almost triple Azerbaijan's annual gas production capacity. Another part of the SGC project, the Trans-Anatolian Pipeline (TANAP) which will carry gas from Azerbaijan to Europe, became operational in June 2018. In September 2017 Azerbaijan signed an amended and restated Production Sharing Agreement (PSA) for continued development of its largest oil field Azeri-Chirag-Deepwater Gunashli (ACG), extending the PSA tenure until 2049 and increasing the share of the State Oil Company of Azerbaijan Republic (SOCAR) in the project to 25 per cent. The agreement was ratified by Azerbaijan's parliament in October 2017.

A new energy regulator has been established. In December 2017 the Azerbaijan Energy Regulatory Agency (AERA) was created, in line with the government's Strategic Roadmap on the development of utilities. AERA's goal is to propose and calculate utility tariffs and oversee their implementation. Other objectives include the development of regulator law, currently under preparation, and other measures to promote legislative approximation with EU benchmarks. The regulator is also tasked with enhancing transparency and competition in the utility markets.