Country diagnostics are an EBRD tool to identify the main obstacles to entrepreneurship and private sector development and to help shape the Bank’s strategic priorities and project selection in new country strategies. Each diagnostic informs the EBRD’s policy engagement with the authorities in the country.

Each country diagnostic assesses the progress and challenges of the country of operations in developing a sustainable market economy. Private sector development and entrepreneurship are at the heart of the Bank’s mandate in the regions of operation of the bank, but the private sector in all EBRD countries faces a range of problems and obstacles. The diagnostic highlights the key challenges facing private companies and shows where each country stands vis-à-vis its peers in terms of six qualities of transition – competitive, well-governed, resilient, integrated, green, and inclusive – and points out the main deficiencies and gaps in each quality.

The diagnostics draw on a range of methodologies and best practice for assessing how big different obstacles are. 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 International Monetary Fund, World Bank, and World Economic Forum. For some larger countries, the diagnostics also draw on specially commissioned studies of selected issues that are critical for private sector development in the country.

The diagnostics are led by the EBRD’s Country Economics and Policy team, drawing substantially on the expertise of sector, governance and political experts in the Economics, Policy and Governance department (EPG) 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.

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

For more information, go to: https://www.ebrd.com/publications/country-diagnostics
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5. QUALITIES OF A SUSTAINABLE MARKET ECONOMY

ANNEX 1: State of infrastructure in Azerbaijan
1. EXECUTIVE SUMMARY

- The steep oil price decline and manat devaluation in 2015-17 stimulated reforms but exposed the private sector's vulnerabilities. The main vulnerabilities are related to long-standing structural challenges arising from the economy's reliance on the resource sector. This has made private firms in other tradable sectors less competitive. The recent oil price recovery has weakened the reform momentum and hence the prospects of addressing those vulnerabilities in the near term.

- Azerbaijan lags behind on governance. Competitors’ practices in the informal sector remain one of the major obstacles for doing business. Monopolistic vested interests are powerful and contribute, among other things, to low firm entry and low engagement in formal entrepreneurship. Package of tax reforms was approved in end-2018, but effective mechanisms for enforcement of rights of private entities are lacking.

- Decline in credit activity has bottomed out following two years of deleveraging. A clean-up of the banking system has been launched by the authorities but more needs to be done to strengthen the resilience of this sector, including the restructuring and privatisation of the International Bank of Azerbaijan. Non-performing loans have subsided from the peak crisis levels but remain elevated.

- The energy sector is highly inefficient. Around 90 per cent of total power generation capacity is state-owned and benefits from significant cross-subsidization enabled by the abundance of natural resources. Privatizations in the energy sector could be implemented only after a new market design is in place. Developing energy efficiency measures and renewable sources of energy will make the energy system more resilient and green.

- Agriculture’s potential to support economic diversification is constrained by its low productivity. Obstacles to productivity growth faced by small private farms include excessive fragmentation, poor access to inputs, lack of mechanization and outdated processing technologies, weaknesses in the legal and regulatory systems, poor infrastructure and difficult access to finance. Addressing these problems and regulatory bottlenecks will help to make agribusinesses more competitive.
2. POLITICAL ECONOMY
Azerbaijan is situated at an important crossroads connecting Europe and Asia. It plays an essential role in diversification of the supply of energy resources and as a transport hub.

The current political economy in Azerbaijan makes the implementation of structural reforms a complicated task. For over a decade, Azerbaijan’s transition dynamics were shaped to a large extent by the country’s resource-driven economic model and centralised political system which is geared towards maintaining a steady state rather than fostering transformative changes. This combination made progress with structural reforms uneven. The recent rebound in oil price may lower the appetite for continuation of reforms initiated in the times of crisis.

Azerbaijan has a presidential form of government with key executive powers concentrated in the presidency. The president exercises wide constitutional powers relative to the legislature and the judiciary. Following the constitutional referendum on 26 September 2016, the presidential powers have been strengthened further.

A centralized political system is a double-edged sword. It could potentially make the reforms implementation easier but might also lead to incompatibility between the needs of economic modernisation and political realities. Challenges in the reform process include weak checks and balances in the political system, insufficient political accountability, and shortcomings related to the rule of law.

Diversification of the economy towards non-oil private sector has become a critical policy priority in recent years, although progress has been slow and might be stalled on the back of the oil price recovery. Following a sharp drop in the oil price, the authorities have launched structural reforms to accelerate growth in the non-oil private sector and mitigate the impact of the oil price decline during 2014-16. A forward-looking reform strategy is articulated in 12 strategic roadmaps endorsed in 2016 and covering key sectors of economy, including oil and gas industry, agriculture, small and medium enterprises, tourism, logistics and financial services among others. These roadmaps lay out a short-, medium- and long-term vision for each sector and provide action plans for 2016-2020.
Institutional and administrative capacities need to be enhanced to succeed with reforms and unleash the full potential of the private sector. The authorities have intensified efforts and made progress in preventing corruption in several sectors (e.g., in public services, through the establishment of ASAN service centres) and by creating relevant anti-corruption tools (e.g., the adoption of a National Action Plan for 2016-18 on Promotion of Open Government). Nevertheless, Transparency International ranked Azerbaijan 152nd out of 180 countries on its 2018 Corruption Perceptions Index.

The enhancement of civic and political participation in the public policy and decision-making processes is an important task. Having withdrawn from the Extractive Industries Transparency Initiative (EITI) in March 2017, Azerbaijan has nevertheless pledged its continued commitment to the principles of international transparency and accountability in the extractive industry and has established the national Extractive Industries Transparency Commission. The withdrawal followed the EITI Board decision to suspend the country’s membership on the grounds of not fully meeting the corrective actions related to civil society space. The situation with civil and political rights generally remains a contested issue in relations between Azerbaijan and some of its international partners.

Negotiations have been launched in February 2017 on a new comprehensive agreement between Azerbaijan and the EU. The new agreement is expected to replace the 1999 EU-Azerbaijan Partnership and Cooperation Agreement, but is unlikely to provide an equally significant transformational framework for political and economic reforms offered by association agreements with the EU’s Eastern Partners.
3. GROWTH PERFORMANCE AND PRIVATE SECTOR OVERVIEW
Azerbaijan was one of the fastest growing countries globally in the past two decades due to abundance of natural resources.

Between 1995 and 2015, real GDP in Azerbaijan increased approximately six times. It was growing at an average annual growth rate of close to 10% in that period. GDP per capita increased from US$ 310 in 1995 to US$ 7,991 in 2014, before going down to US$ 4,780 in 2018 as a result of major local currency devaluation. In purchasing power parity (PPP) terms, the fall in income levels was less dramatic with PPP adjusted GDP per capita falling from $18.0 thousand in 2015 to $17.5 thousand in 2017, before recovering to the pre-crisis level in 2018.

Oil production in Azerbaijan increased from 14 million tons in 2000 to 51 million tons at its peak in 2010 and then declined to 39 million in 2018. Between 2000 and 2018, gas production climbed from 6 billion cubic meters to 37 billion cubic meters.
Labour productivity increase was driven by the oil and gas industry while other sectors of the economy lagged far behind.

Labour productivity growth has petered out, following a steep rise in the second half of 2000s

- Gains in productivity were driven by foreign investment into Azerbaijan’s oil extraction capacity and subsequent boost in production.
- Labour productivity still lags behind some of the other commodity exporting countries in the region as well as EBRD and OECD averages. It is dragged down by a low productivity of the non-oil private sector.

Oil and gas industry is well-managed and significantly more efficient than other sectors

- Labour productivity in the extractive sector is on average 108 times higher than in the rest of the economy, and 335 times higher than labour productivity in agriculture, the least productive sector. At the same time, agriculture employs the highest share of workforce in Azerbaijan – 46 times more workers than mining and quarrying sector.

Source: National statistical authorities, The Conference Board Total Economy Database, EBRD calculations
Reliance on the resource sector persists despite efforts by the authorities to diversify the economy

Azerbaijan has built and maintained significant FX buffers thanks to the oil and gas revenues

- In 2013, the oil and gas sector accounted for 41% of GDP, 93% of total exports of goods and it contributed up to 72% of general government revenues. SOFAZ transfers to the state budget amounted to 20% of GDP (US$ 14.5 billion). These ratios have declined somewhat in recent years owing to lower oil prices, declining oil output and more conservative fiscal framework focused on maintaining foreign exchange liquidity buffers.

- As of end-2018, the combined assets of the State Oil Fund (SOFAZ) and of the CBA’s foreign exchange reserves stood at US$ 44.1 billion, that is, approximately 94% of nominal 2018 GDP in US dollars and 30 months of imports, providing an adequate safety cushion against foreign exchange liquidity and refinancing risks.

3. GROWTH PERFORMANCE AND PRIVATE SECTOR OVERVIEW

Resource extraction is presently efficient

**Gradual decline in oil production is partly offset by growing gas extraction capacity**

![Chart: Oil and Gas Production]

Oil and gas production is operationally led by multinational energy companies but control over sector strategy remains fully in state hands.

- The largest oilfield is Azeri-Chirag-Deepwater Gunashli (ACG) accounting for three-quarters of Azerbaijan’s oil output. The ACG oilfield is operated by BP on the basis of the Production Sharing Agreement (PSA) signed in 1994 between the Government of Azerbaijan and a consortium of foreign oil companies. In September 2017, an amended PSA was signed, effective until the end of 2049. Presently, BP is the largest shareholder in the ACG with 35.8% share. The State Oil Company of Azerbaijan Republic (SOCAR) – an integrated state-owned energy company operating the country’s two refineries and its pipeline network – is the second largest shareholder in the oilfield. Under the renewed PSA, its ownership share has increased from 11.6% to 25% of total equity. The remaining ownership rights are distributed among seven international oil companies. Overall, SOCAR produces about 20% of Azerbaijan's total oil and 18% of total gas output (as of 2018) with the remainder produced by international oil companies.

- Azerbaijan’s largest gas field is also developed and operated by BP on the basis of the Shah Deniz PSA. The second stage of Shah Deniz gas field development is part of the South Gas Corridor (SGC) project, which will add 16 billion cubic meters (bcm) by 2020 to Azerbaijan’s annual gas production. In US$ value terms, this is estimated to be equivalent of approx. 20% of the country’s 2017 goods exports, assuming average gas price in 2017. BP, the government of Azerbaijan and SOCAR are major stakeholders in the SGC along with other international companies.

**Foreign and joint ventures are concentrated in hydrocarbon sector and in adjacent activities**

- ~43% of GDP (volume of goods and services)
- ~2% of workforce
- ~3.5 times higher wage than the average (US$ 460) close to 6 times higher wages than the average for foreign and joint ventures in industry sector
- Concentrated in industry, construction, transportation and storage due to strong involvement of large foreign firms in production, development and distribution of Azerbaijan’s hydrocarbon endowments

Source: SOCAR, National central bank, National statistical authorities, Moody’s Feb 2018, BP, EBRD calculations
3. GROWTH PERFORMANCE AND PRIVATE SECTOR OVERVIEW
Private sector characteristics reflect business environment challenges

The private sector’s contribution to value added has evolved significantly over the past two decades

![Private sector share in sectoral output graph]

Attempts to set up business fail more often than in other countries of the region and firm entry density is lower compared to regional peers

![Attempts to set up business failure and firm entry density graph]

Small enterprises (<25 employees)
are mostly inward oriented and less productive than foreign and joint ventures

- ~4% of GVA (up from 1.6% in 2007)
- ~6.3% of the labour force
- ~80% of total number of companies
- Concentrated in trade and vehicle repair services: half of all small enterprises in 2015, down from 70% in 2011
- SMEs are predominately domestically owned and focused on the local market
- Contribution to exports is negligibly small

- Azerbaijan’s economy is dominated by private firms. In 2018, the private sector in Azerbaijan accounted for 84.7% of GDP. Non-state sector employed 76% of the workforce in 2017.

- Data from EBRD’s latest round of Life in Transition Survey (LiTS) suggests that Azerbaijan has the highest business failure rate in the EaP region, with around 62% of attempts to set up a business in Azerbaijan ending in failure (compared to 34% in the rest of the region).

- Azerbaijan also scores poorly in terms of willingness to engage in entrepreneurial activity – 92% of LiTS respondents never tried to set up a business – higher than the 88% average across the rest of the region.

- Firm entry density in Azerbaijan – defined as number of new registered limited liability companies per 1,000 working aged (15-64) population, is 6.8 times lower than in the EU and 8.1 times lower than in Georgia.

4. OBSTACLES TO PRIVATE SECTOR DEVELOPMENT

4.1 Linkages between the hydrocarbon sector and the rest of the economy

*Private sector growth continues to be influenced by the non-oil sector’s linkages with the oil sector and high state involvement in the energy sector*
4.1 Linkages between the hydrocarbon sector and the rest of the economy

Rapid expansion of the oil and gas industry led to crowding out of businesses producing other tradable goods

Rapid expansion of the oil and gas industry resulted in real exchange rate (REER) appreciation, ...

REER appreciation, Index [Jan 2005=100]

Azerbaijan | Kazakhstan | Russia

...and to crowding out of businesses in agriculture and manufacturing.

Non-oil exports, US$ billion (LHS) | Oil exports, US$ billion (LHS) | Non-oil exports, % of GDP (RHS)

...wage inflation in extractive and non-tradable sectors...

Average monthly wages in prices of 2000 (adjusted for inflation), in US$

- Extractive industries
- Financial and insurance activities
- Information and communication
- Prof., scientific and technical act.
- Construction
- Admin.and support services
- Transportation and storage
- Manufacturing
- Electricity, gas and steam
- State mngmt, defence, social security
- Accommodation and food service
- Total economy
- Other service activities
- Trade, repair of transport means
- Water supply, waste management
- Real estate activities
- Education
- Art, entertainment and recreation
- Agriculture, forestry and fishing
- Health and social work act.

2014 | 2000

- The real effective exchange rate (REER) appreciated by 106% between December 2004 and January 2015, due to the influx of foreign exchange from the sale of oil and gas and from foreign investment flowing into this industry.

- Combined with a rapid wage growth, REER appreciation undermined the competitiveness of non-oil goods produced by firms in Azerbaijan, including in manufacturing and agriculture.

- Non-oil exports as a share of GDP fell from approximately 8% in 1997 to 2% in 2014, before picking up closer to 4% in 2017, largely thanks to manat devaluation which deflated the value of nominal GDP in US dollars. In 1997-2017, the share of non-oil exports in total exports of goods shrank from 39% to 11%.

Source: National statistical authorities, CEIC, EBRD calculations
4.1 Linkages between the hydrocarbon sector and the rest of the economy
The private sector lacks diversification and depends significantly on trends in the oil and gas industry

The private sector lacks diversification and depends significantly on trends in the oil and gas industry.

**Construction and other non-tradable sectors that render services on the domestic market flourished**

**Large public investment served as a key transmission mechanism of oil wealth to the non-oil sector**

- Businesses in non-tradable sectors (including construction) expanded, having benefitted from accumulation of oil wealth in the economy. These sectors recorded generally faster growth than agriculture and manufacturing.
- Oil wealth was transferred to non-tradable sectors of the economy via large public spending. This led to non-oil private sector’s dependence on state-funded investment and to a narrow production and export base. As a result, private sector output in non-extractive industries is exposed significantly to volatility in the oil price and to fiscal policy variations. In some cases, such transfer of wealth occurred through the so called “vanity projects” with limited positive impact on long-term productivity growth.

Source: National statistical authorities, IMF WEO April 2017, EBRD calculations
Azerbaijan's model of domestic energy sector involves heavy cross-subsidization, enabled by the abundance of natural resources.

- Around 90% of total power generation is state-owned.
- Heavy cross subsidization: approximately 80% of total electricity production comes from gas-fired power stations, while gas produced locally is available substantially below export parity cost level. Subsidisation is reflected in the cash flows across several SOEs in the industry which receive direct funding from the state budget.
- Energy utilities companies demonstrate weak financial performance and 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 the authorities started to explore options to achieve better cost recovery through financial reform, adjustment of tariff levels and structure, and incentivising SOEs to be more efficient. These efforts should be pursued further.

Privatizations in the energy sector require structural reforms and could be implemented only after introduction of a new market design.

- 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 towards increasing competitiveness in public utilities and attracting investors (such as establishing an independent energy regulator), progress is hampered by a lack of strategic policy decisions (e.g. on power market design), weak coordination and unclear implementation responsibility.
- The Azerbaijan Energy Regulatory Agency (AERA) was established in December 2017. It’s goal is to propose and calculate utility tariffs and oversee their implementation, develop regulator law which is currently under preparation, and other measures to promote legislative approximation with EU benchmarks as well as enhancing transparency and competition in the utility markets. However, AERA's institutional capacity requires strengthening.

Azerbaijan withdrew from the EITI.

- Azerbaijan joined EITI in 2004 and was the first country to be validated as fully compliant with EITI standards in 2009.
- In March 2017, EITI suspended Azerbaijan’s membership over concerns about the enabling environment for civil society.
- Commission on Transparency in Extractive Industries was established in April 2017 and became operational under the chairmanship of the executive director of SOFAZ, and publication of the annual transparency report has continued.
4.1 Linkages between the hydrocarbon sector and the rest of the economy

Overwhelming state involvement in the domestic energy system fosters inefficiencies (cont’d)

Southern Gas Corridor will make more evident the opportunity cost of consuming local energy resources at subsidized prices

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- **SGC energy corridor** entails gas infrastructure investments for a total cost of over US$ 40 billion across 3,500km. Since 2018, it carries 6 bcm annual volume of gas from Shah Deniz II field to Turkey. It will carry another 10 bcm to Europe by 2020 through Georgia, Turkey, Greece, Albania and Italy via the South Caucasus Pipeline Expansion (SCPX), the Trans Adriatic Pipeline (TAP) and the Trans-Anatolian Pipeline (TANAP).

- The Shah Deniz 2 gas field and SCPX were officially inaugurated in May 2018. TANAP became operational in June 2018. TAP is expected to become operational in early 2020.

- SGC will deliver market-priced gas directly to the European market starting from 2020, hence promoting cooperation, regional integration and the creation of new gas markets.

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SGC will lead to increased connectivity with export markets putting spotlight on domestic energy prices which are below the export parity level.

- The country will face a trade-off between cross-subsidization from the extractive industries to power generation, and the increase in oil and gas production to expand its share in new markets. This will create pressures to modernize Azerbaijan’s energy governance system and could require a new strategy for deployment of natural resources across the entire value chain in the energy sector.

source: SOCAR, BP
4.1 Linkages between the hydrocarbon sector and the rest of the economy

Better utilization of renewable energy (RE) can help direct more natural resources to higher value export markets, but obstacles for private investment in this area are significant.

Clear policy, legal and regulatory framework for promotion of renewables is lacking. Renewable energy law needs to be adopted and implemented to introduce auctions mechanism and avoid costly subsidisation schemes.

- Absence of a single RE law complicates understanding of the operational environment in this sector, especially for new players not familiar with the local context, and increases perception of risk (resulting in higher project costs);
- No official RE targets beyond 2020;
- Permitting and licensing is a lengthy and scattered process (in contrast to neighbouring Georgia which has a one-stop-shop for licensing of hydro projects);
- Lack of support mechanisms in conjuncture with presently low RE tariffs and missing PPA standards (such as tenure, dispute settlement, accounting for currency risk and indexation to hard currency) make entry into the market unattractive for investors.

Power grid regulation for RE is missing. There is a need to develop power network codes in line with EU 3rd Energy Package.

- Without a grid code, potential RE developers are lacking reference points with respect to the standards for connection of variable renewable energy and its dispatch mechanisms. There is a need to study a grid absorption capacity of renewables.

Other key obstacles for renewable energy development include difficult investment climate (lack of FDI and limited access to capital, high interest rates and reluctance of banks to finance RE) as well as the need for technical knowledge and better awareness to move away from an excessive focus on oil and gas industry.
4. OBSTACLES TO PRIVATE SECTOR DEVELOPMENT

4.2 Business environment in the non-oil sector

*Private sector outside of the extractive industry suffers from macroeconomic volatility, informality and governance challenges.*
4.2 Business environment in the non-oil sector

Uncertain economic outlook, concerns about further volatility, declining credit availability and lack of confidence in the banking sector affect business planning in the non-oil sector.

Business confidence has been eroded by oil price declines, unexpected step devaluations in 2015 and subsequent bank failures.

In 2015-17, Azerbaijan experienced economic calamity of the magnitude unseen in the recent past.

- In 2015, Azerbaijan abandoned the dollar peg after decades of exchange rate stability and devalued the manat by 50% against the US dollar (two step devaluations in 2015), contrary to expectations of a gradual devaluation. This affected real disposable incomes and led to balance sheet pressures in the real and financial sectors. 2016 and 2017 EU business surveys rated exchange rate volatility as having the biggest negative impact on business in Azerbaijan. More recently, manat flexibility has been called into question again because of very narrow fluctuations band since April 2017. Public debt-to-GDP ratio increased from 12.6% in 2013 to 54.1% in 2017, affected *inter alia* by manat devaluation which deflated the nominal GDP in US dollar terms and by the banking sector restructuring costs incurred by the sovereign.

- Credit activity fell on the back of growing non-performing loans, bank closures and general economic adversity. Large capital investment and other spending by the public sector which benefited private companies (suppliers, providers, contractors for construction works and services) in previous years shrank in the context of fiscal policy tightening. In 2016, combined output of enterprises in the non-oil economy contracted for the first time in at least 15 years, declining by 4.4% y-o-y in real terms.

- This episode showed that the economy can face painful growth reversal due to its reliance on the resource sector and that ill-suited macroeconomic/financial policies can exacerbate the decline rather than mitigate its impact.

- Number of reforms aimed at restoring macroeconomic stability have been initiated: banking system restructuring, strategic reform roadmaps, new state debt management strategy with a cap on new public borrowing and guarantees, limitations on transfers from the oil fund to the state budget) but more needs to be done to make sure that Azerbaijan is better prepared for the next cyclical downturn.

Competitors’ practices in the informal sector remain a significant challenge for private firms.

- Monopolistic vested interests remain powerful and contribute, among other things, to low firm density and low engagement in formal entrepreneurship.
- Practices of competitors in the informal sector ranks as a top obstacle for doing business in Azerbaijan according to BEEPS V.
- Informal labour is widespread and there are significant regional disparities in formal employment opportunities.
- IMF estimated Azerbaijan’s shadow economy at 43.7% of GDP in 2015 – among top 15 out of 158 countries covered by the study according to the size of the informal economy.
- The study by the Association of Chartered Certified Accountants (ACCA) estimated that the size of the informal economy in Azerbaijan increased from 47% of GDP in 2011 to 67% of GDP in 2016 – the highest level and largest increase out of 28 countries covered by the study. ACCA identified the following as primary drivers behind the large scale shadow economy and its increase in Azerbaijan: lack of corruption control, weak public accountability and expectations of low economic growth.

4.2 Business environment in the non-oil sector

Administrative constraints for doing business persist despite tangible improvements in customs, inspections and permits/licensing

Improved transparency in customs administration is manifested by increasing customs revenues amid lower cross-border trade

Per cent change, year-on-year

-6% 5% 18% 6% 55% -8% -6%

2015 2016 2017

Business environment reforms have been driven by the need to support viability of the non-oil sector in times of low oil revenues. An upturn in oil prices has weakened and might even reverse the reform momentum.

- In October 2015, ASAN (Azerbaijan service and assessment network) established the single window for business licensing that, together with the reduction in the number of licensed activities from 59 to 29, brought down costs and accelerated the process for obtaining licenses by private firms. The range of services offered by ASAN was recently broadened to include energy-related permits.

- Introduction of the ASAN e-visa portal in 2017 simplified and substantially shortened the procedure of issuing visa to foreigners, including business travellers.

- 2 year moratorium on inspections (other than by tax authorities) introduced in November 2015 reduced the regulatory burden on firms. The moratorium was subsequently extended until 2021, but a permanent solution is required to stabilise firms’ expectations.

- Transparency of customs procedures increased and petty corruption at customs checkpoints was reportedly phased out. Transparent customs clearance of goods enabled businesses to reduce informality in retail operations and at other stages of the business cycle. Improvements in customs administration have been achieved through top-down directives and ad-hoc changes in employee incentives. However, reversibility of customs reform is a concern in the absence of a thorough overhaul of the institutional framework.

- At the end of 2018, the authorities rolled out the reform of the tax system to foster reduction of informality, broaden the tax base and stimulate the development of the MSME sector. The changes included, among other things, exemptions from the personal income tax up to a generous income threshold, as well as measures to simplify and lower taxation of small businesses.

- Agency for Development of SMEs, established in 2017, aims to enhance and better coordinate the provision of financial and non-financial public services to SMEs. It has been developing dynamically, but its effectiveness remains to be tested.

Strategic roadmaps adopted at the end of 2016 signal appetite for creating better conditions for the private sector, but execution challenges are significant

- In some cases, clear ownership for reform implementation is lacking and no specific milestones have been set.
- Carrying out reforms without changes in the institutional framework can undermine their durability.
- Systemic dialogue between the public and private sector is missing, although some attempts are being made by the Government to involve the private sector in consultations.

Source: Central Bank of the Republic of Azerbaijan, Ministry of Finance of Azerbaijan, EBRD calculations
4. OBSTACLES TO PRIVATE SECTOR DEVELOPMENT

4.3 Banking sector’s unfinished restructuring

The manat devaluation in 2015 led to balance sheet and asset quality concerns and to pressure on deposits.
Devaluation dealt a significant blow to the dollarized balance sheets of the banking sector

<table>
<thead>
<tr>
<th>Number of banks</th>
<th>Overdue loans</th>
<th>Per cent of all loans</th>
</tr>
</thead>
<tbody>
<tr>
<td>2014: 45</td>
<td>2014: 5%</td>
<td>2018: 30</td>
</tr>
<tr>
<td></td>
<td>Source: CBAR</td>
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</tr>
</tbody>
</table>

Financial penetration is very low, exacerbated by the shrinkage of the IBA balance sheet and loanbook contraction in the rest of the banking sector

<table>
<thead>
<tr>
<th>Loan dollarisation</th>
<th>Deposit dollarisation</th>
<th>Bank credit-to-GDP ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>2014: 27%</td>
<td>2014: 50%</td>
<td>2015: 40%</td>
</tr>
<tr>
<td>2018: 38%</td>
<td>2018: 65%</td>
<td>2018: 16%</td>
</tr>
</tbody>
</table>

Businesses are affected by the turbulence in the banking sector
- The manat devaluation has exposed capital shortfalls in the banking sector. The restructuring is underway, although progress in banks’ recapitalisation is slow.
- A new agency – the Financial Markets Supervisory Authority (FiMSA) – was established in February 2016 to replace the central bank as the financial sector’s regulator. It has been actively taking steps to sanitize the banking sector.
- 13 banks which were unable to comply with capital requirements were closed by FiMSA as of end-2017. Several other banks are on the regulator’s watchlist as capitalisation remains thin and subject to pressures in case of further deterioration in the portfolio quality.

Deleveraging by banks has led to a limited access to finance for domestic firms.
- Loanbook contracted by an estimated 10% in 2016 and additional 7% in 2017 excluding devaluation effects and transfers of bad assets from IBA balance sheet. In 2018, loan portfolio contractions levelled-off. Recovery in credit activity is affected by the restrictive monetary policy, tight management of manat liquidity and general economic weakness. Deposit dollarization declined from 81.6% at end-2015, but remains high at 65.3% in end-2018.
- Credit crunch affects SMEs, although the demand for new loans has been also subdued.
- Increased NPLs mainly reflect foreign exchange-induced credit risks but also reduced creditworthiness of private borrowers due to the deterioration in the macroeconomic environment.
- The authorities have set up an asset management company (Azerbaijan Industrial Corporation) to promote better public property management, including turnaround management of non-performing assets transferred from Aqrarkredit.

Initiatives to promote the credit flow to the economy have been rolled out but their effectiveness is still uncertain.
- Establishment of a credit guarantee fund in 2017 and introduction of a private credit bureau may support potential credit recovery.
- In 2017, FiMSA started discussing a new mechanism to encourage restructuring of NPLs, ease the debt-service burden of distressed borrowers and eventually lower the level of NPLs in the banking system.

Source: Central Bank of the Republic of Azerbaijan, National statistical authorities, FiMSA, Fitch, EBRD calculations
4.3 Banking sector’s unfinished restructuring
IBA privatization will be a litmus test for the financial sector reform

State-owned IBA dominates the structure of the banking sector assets

Per cent of total banking assets, 2017

- IBA, 31.0%
- Pasha Bank and Kapital Bank, 24.1%
- Remaining banks, 44.7%

Restructuring and privatization of the International Bank of Azerbaijan (IBA) is a crucial priority in the banking sector.

- At end-2017, the state-owned IBA was the largest bank in the country accounting for approximately one third of the sector’s total assets.
- Following significant capital injections into IBA in 2016-2017 and transfer of some of its bad assets to a separate entity (total government support to IBA in 2013-17 estimated at up to 30% of 2016 GDP), the authorities launched a liability management operation to further de-risk and downsize the IBA’s balance sheet.
- Voluntary debt restructuring in the amount of USD 3.3bn was concluded in September 2017: IBA’s debt swapped with a 20% haircut for new longer tenure sovereign bonds (~USD 2.3bn, 5-6% of GDP) and new IBA debt.
- IBA has also been disposing of non-core foreign assets and taking further steps to clean-up the balance sheet ahead of the planned privatization.
- The declared plan to privatise the IBA needs to be implemented upon completion of the bank’s restructuring process. This will help to ensure the sustainability of the IBA’s operations and to eschew contingent fiscal costs in the future.

Government support to IBA in 2013-17 amounted to up to 30% of 2016 GDP

<table>
<thead>
<tr>
<th>Year</th>
<th>AZN</th>
<th>USD equiv.</th>
</tr>
</thead>
<tbody>
<tr>
<td>2013</td>
<td>50m</td>
<td>64m</td>
</tr>
<tr>
<td>2014</td>
<td>115m</td>
<td>147m</td>
</tr>
<tr>
<td>2015</td>
<td>16m</td>
<td>14m</td>
</tr>
<tr>
<td>2016</td>
<td>51m</td>
<td>30m</td>
</tr>
<tr>
<td>2017</td>
<td>600m</td>
<td>338m</td>
</tr>
</tbody>
</table>

Capital injections

Other support measures

Cash received by Aqrarkredit due to the transfer of bad assets

Source: IBA, EBRD calculations
4.4 Barriers to enhancing productivity of the agricultural sector

*Agriculture can become a pocket of growth and one of the contributors to economic diversification but it remains an unproductive sector.*
4.4 Barriers to enhancing productivity of the agricultural sector

Agriculture can become a pocket of growth and one of the contributors to economic diversification but it remains an unproductive sector.

In agriculture, opportunities for private investment are limited by legacy challenges:

- Small privately-owned farms generate >90% of the country’s agricultural output and only ~1.5% of all farms are larger than 20ha. Such excessive fragmentation of land negatively affects the productivity and financial viability of agribusinesses, as well as the quality of agricultural production.
- Fertile lands and climatic diversity create favourable conditions for the production of a variety of crops (fruits, vegetables and grains) over an extended growing season. There is a potential to develop food processing industry, with several products (e.g. nuts and tea) being of high quality and enjoying strong brand recognition in CIS countries.
- Still, small private farms face a number of major obstacles to productivity growth including poor access to inputs, lack of mechanisation and outdated processing technologies, weaknesses in the legal and regulatory systems, poor infrastructure and difficult access to finance.
- Agribusiness value chains need substantial improvements including in production, handling, distribution, warehousing, processing, wholesale and retail operations. Improvements in infrastructure, food safety and quality (including veterinary services and sanitary and phyto-sanitary controls) should be prioritised. Establishment of the Food Safety Agency in January 2018 should be followed by efforts to enhance its capacity. Integration of suppliers with processors and retailers could be a way to stimulate adherence to high standards and improved competitiveness.
- Firms exporting and importing agricultural produce face regulatory and logistical barriers which should be dismantled. Trade integration is low compared with regional peers due to, among else, high costs of logistics which increases transaction costs for importers and exporters. Recent investments in trade facilitation infrastructure are welcome, though further transparency and uniformity in customs management is necessary.
- In 2014-17, subsidies to agriculture averaged 1% of GDP (in line with the EEC average). Anecdotal evidence suggests the current allocation of subsidies distorts incentives, fails to motivate more efficient production and is not targeted optimally.

Source: National statistical authorities, UNCTAD
5. QUALITIES OF A SUSTAINABLE MARKET ECONOMY
EBRD methodology for measuring transition gaps is based on the following six desirable qualities of a sustainable market economy: **competitive, well-governed, green, inclusive, resilient** and **integrated**. Progress on a transition path is measured on a continuous scale of 1 to 10, where 10 is the best possible score and denotes the frontier. The composite indicators at quality level aggregate a wide range of sub-indicators.

* Score for advanced comparator economies is a simple average of scores for Canada, Czech Republic, France, Germany, Japan, Sweden, United Kingdom and United States.
5. QUALITIES OF A SUSTAINABLE MARKET ECONOMY

Competitive [3.7 out of 10]

Recent improvements in the Doing Business ranking attest to improvements in the regulatory framework

Private sector competitiveness is limited due to the economy’s heavy dependence on state-backed investment which has led to narrow production and export base outside of oil and gas sectors. The roles of the public and private sectors need to be rebalanced, with the former becoming a facilitator rather than a driver of growth in the non-oil economy.

- **Difficult business environment** deters entry of new firms and expansion of existing firms due to distortive regulatory and tax regimes, constrained access to finance and to basic production inputs (electricity, permits), despite some progress in recent years.
- Given the small domestic market, the country’s integration with international markets is critical to the growth of local firms. Efforts to improve private sector competitiveness should go hand in hand with further progress in addressing regulatory and logistical barriers faced by exporting and importing companies, and with steps to de-monopolize industries affected by excessive concentration and high barriers to entry.
- Productivity growth in the non-oil sector is constrained by limited investments in human capital and R&D as well as paucity of foreign investment into the non-oil economy. All this translates into low complexity and lack of diversification of exports.
- Productivity of the agribusiness sector, which employs a sizeable share of the population, remains low.
- Labour market is affected by high degree of informality, skills mismatches and weak system of vocational education. Access to on-the-job-training levels is low. According to the BEEPS V, only up to 20% of companies offer formal training to its employees, which is lower than approximately 31% in the rest of the EEC region.
- Financial sector is underdeveloped and businesses in the non-oil sector face difficulties in accessing finance.
- Innovation outside of the hydrocarbon industries is scarce. Collaboration between the universities and businesses is ineffective. Tertiary education enrolment rate (25%) is low compared to the EBRD average (54%) and number of graduates in science and engineering has been declining. Majority of the PhD holders (60%) are over 60 years old. Availability of the ICT infrastructure is at decent levels.

Despite steps taken by the authorities to improve public services, institutional strength, transparency and public governance standards are lagging behind. While a number of governance reforms have been undertaken since 2015, with tangible results in some aspects of the business environment, the regulatory framework needs to be overhauled and the operational environment remains challenging overall.

- **Public governance** requires improvement. Despite some appetite for reforms aimed at improving governance, implementation is lagging behind. A lack of accountable and effective institutions, transparent policy-making and effective institutional capacity to support policy implementation are all undermining investors’ trust.

- Challenges with the **rule of law** remain largely unchanged. Some efforts are being made to increase the number of judges and ensure their training is more systematic. However, the courts remain overloaded and their effectiveness is limited. Wider reforms to enhance the independence of the judiciary are needed. Effective mechanisms of rights enforcement are lacking, and alternative dispute resolution mechanisms are dysfunctional.

- **Customs reforms** have increased transparency and reportedly brought down petty corruption at customs checkpoints. However, unpredictable **tax administration** remains a source of complaints from private businesses.

- **Informal sector** is estimated to be one of the largest in the world. Informality is one of the key business environment obstacles (BEEPS V).

- Some efforts have been made to **tackle corruption**, but much remains to be done. Azerbaijan ranked 152nd out of 180 countries in Transparency International’s 2018 Corruption Perception Index – among the lowest in the EBRD region.

- **Corporate governance** frameworks and company practices suffer from a number of weaknesses. Shortcomings persist in the structure and functioning of boards (i.e. limited effectiveness and lack of independence), transparency and disclosure (particularly for non-financial information) and internal controls (no real assurance of auditors’ independence). In terms of business integrity, efforts are being undertaken by large corporates with foreign ownership, but challenges in small to medium sized domestic companies remain to be addressed.
5. QUALITIES OF A SUSTAINABLE MARKET ECONOMY
Green [5.2 out of 10]

Electricity is mainly generated from gas

Around 86% of total power generation comes from 13 fossil fuel power plants (IEA).

Azerbaijan contributes to below 0.2% of global GHG emissions – but 43% of this is attributable to gas flaring (WB).

Approximately 62% of municipal waste is landfilled, 33% incinerated and the recycling rate is close to null (UN).

A green economy transition will need to focus on diversifying away from hydrocarbons and effectively managing a number of wider environmental challenges. Azerbaijan’s submitted Nationally Determined Contributions (NDCs) aim for improvements in mitigation areas such as energy, waste, agriculture, and emissions, but adaptation is not mentioned.

- **Renewable energy (RE)** accounts for only ~7% power generation. The government has set a target of increasing RE sources to 20% of total electricity consumption by 2020 considering that Azerbaijan has significant untapped RE technical potential from wind, solar, and small hydro. The development of RE capacity is undermined by the absence of enabling regulatory framework (e.g. absence of feed-in-tariffs and PPAs) which provides few incentives for the private sector.

- **Energy production and consumption measures** are needed to meet energy efficiency (EE) targets (increase EE by 20% by 2020). Introduction of modern energy generation, distribution and transmission systems is needed. In particular, reducing fugitive GHG emissions mainly through prevention of gas leakages during oil-gas processing and at distribution networks is a priority. This is partly being addressed through the SOCAR membership in the Global Gas Flaring Reduction partnership. EE potential is significant in the residential and commercial buildings where electricity use is high (residential sector is the largest consumer of energy accounting for 36% of the total consumption).

- **Regulatory framework for water treatment and solid waste management** requires an update as they lack most international best practice principles, enforcement mechanisms and incentives. The Greater Baku Area receives preferential services in water treatment and solid waste management, while, rural areas, secondary and tertiary towns where the majority of the poor live remain critically underserved.

- **Vehicles now account for 80% air pollution**, but as yet, national air quality legislation is based on soviet environmental standards. Domestic and industrial wastewater delivered by the rivers flowing into the Caspian Sea and discharged directly from coastal cities, towns and industrial facilities is a significant source of pollution.

- **The country is vulnerable to the impacts of climate change**, particularly in the agricultural sector which will be increasingly at risk from higher temperatures, unpredictable rainfall and natural disasters. More than 40% of land in Azerbaijan is subject to degradation due to over-exploitation, excessive cattle grazing, forest destruction and the use of poor irrigation methods.

Source: International energy Agency, World Bank WDI
5. QUALITIES OF A SUSTAINABLE MARKET ECONOMY

Inclusive [5.0 out of 10]

Vulnerable employment is prevalent, in particular among women

Vulnerable employment is widespread in Azerbaijan, posing challenge to inclusive growth. Although overall unemployment and youth unemployment, which stand at 5% and 14% respectively, are lower than that in regional comparators, the proportion of own-account workers (i.e. self-employed without hired employees) and contributing family workers is large. This is due to the agriculture’s role as a major source of employment and low growth in the formal economy. These factors have implications on regional as well as gender inclusion.

- Large regional disparities in formal employment opportunities indicating heterogeneity in access to decent job opportunities across the regions.
- Gender gap is substantial. Women suffer from higher rates of vulnerable employment (at 64%, this is the highest among EBRD CoOs), lower labour participation rates, higher unemployment rates, low representation in high-level occupations, lower access to finance compared to men (26% of women have an account in the financial institution compared to 33% of men), and are highly unlikely to participate in firm ownership. Gender pay gap, estimated at 46%, is one of the largest in the region. Rates of women entrepreneurship are extremely low at 4.5% and women-led businesses tend to be home-based, smaller than those of men and more likely to be informal.
- More than 80% of young people report that they do not have access to financial means as well as training to establish their own businesses. Employers offer very little in order to develop the skills of the youth.
- The education system in Azerbaijan does not cater well for the labour market needs. In the higher education and training pillar of the WEF’s GCI 2017-18 (captures education enrolment rates, quality of education and access to training) Azerbaijan is ranked 68th out of 137 countries which is the country’s second lowest ranking among all twelve pillars. In the skills pillar of WEF’s GCI 2018, Azerbaijan ranks 54th out of 140 countries. Some employers claim that it is difficult to find workers with required skills. The shortage is particularly pronounced in modern, innovative firms, which tend to require more advanced skills.

Source: World Bank’s estimates based on ILO data, World Gallup Data 2013-15, EBRD calculations
5. QUALITIES OF A SUSTAINABLE MARKET ECONOMY

Resilient [4.0 out of 10]

**Credit penetration is very shallow**

<table>
<thead>
<tr>
<th>Country</th>
<th>Share of f/x loans</th>
<th>Share of l/c loans</th>
</tr>
</thead>
<tbody>
<tr>
<td>Azerbaijan</td>
<td>16.3%</td>
<td>18.7%</td>
</tr>
<tr>
<td>Moldova</td>
<td>30.2%</td>
<td>36.2%</td>
</tr>
<tr>
<td>Ukraine</td>
<td>53.5%</td>
<td>64.7%</td>
</tr>
<tr>
<td>Belarus</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Armenia</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Georgia</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Per cent of GDP, 2018

- **Economic resilience** is weakened by banking vulnerabilities and reliance on the resource sector.
  - Although some steps have been taken to address **banking sector problems** (several banks were closed/merged, the largest state-owned bank was recapitalized with some of its bad assets moved to SPV and its liabilities under restructuring), major vulnerabilities such as weak sector capitalization, high dollarization, currency mismatches, NPLs, and concerns about governance remain.
  - **Banking sector rehabilitation** hinges on the restructuring and privatization of the **systemic SOB** (1/3 of sector assets) and completion of the clean-up and recapitalisation of the rest of the banking system.
  - **Regulatory uncertainties** undermine financial resilience.
  - On the back of monetary policy tightening and limitations on foreign exchange lending, banks have kept a significant portion of their liquidity in government securities. This has **limited provision of credit to the real sector**.
  - At around 16% of GDP, **credit penetration** is shallow compared to the regional peers. Azerbaijan moved from being 122nd out 190 countries in Getting Credit according to the World Bank’s 2018 Doing Business report to 22nd one year later on the back of targeted reforms.
  - **Foreign presence** in the banking sector is moderate, with foreign-owned banks representing approximately 22% of sector assets.
  - **Oil and gas sector** dominates the economy. It accounts for 40% of GDP, close to 92% of exports of goods and over half of total fiscal revenues. Domestic oil and gas market is dominated by SOCAR. Allowing greater competition in the granting of oil and gas licenses would enable the liberalisation of the downstream market and the attraction of foreign investors.
  - Capacity of the recently established **energy regulator** needs to be significantly strengthened to pave the way for introducing cost reflective tariffs for end consumers and to provide comfort to private investors.

**Share of non-oil products in total exports remains very low**

- **Oil export** accounted for 92% in 2018.
- **Non-oil export** represented 8%.

- **The banking sector** loans as a share of GDP declined from 40% in 2015 to 16% in 2018 (CBAR).
- **Loan dollarization** equalled 38% and deposit dollarization 65.3% as of end-2018 (CBAR).
- **Electricity generation** is dominated by natural gas (approx. 80%) and 90% of the capacity is state-owned.

Source: National statistical authorities and central banks, ECB
5. QUALITIES OF A SUSTAINABLE MARKET ECONOMY

Integrated [6.0 out of 10]

Azerbaijan’s trade openness is driven by large volumes of oil and gas exports

<table>
<thead>
<tr>
<th>Country</th>
<th>Sum of imports and exports as per cent of GDP, 2017</th>
</tr>
</thead>
<tbody>
<tr>
<td>Russia</td>
<td>47%</td>
</tr>
<tr>
<td>Kazakhstan</td>
<td>60%</td>
</tr>
<tr>
<td>Azerbaijan</td>
<td>91%</td>
</tr>
<tr>
<td>Ukraine</td>
<td>102%</td>
</tr>
<tr>
<td>Georgia</td>
<td>113%</td>
</tr>
<tr>
<td>Belarus</td>
<td>134%</td>
</tr>
</tbody>
</table>

Transport infrastructure is of good quality according to the Global Competitiveness Index, but there is space for improvements

<table>
<thead>
<tr>
<th>Indicator</th>
<th>WEF GCI (Transport Infrastructure pillar), rank out of 140, 2018</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reliability of water supply</td>
<td>65</td>
</tr>
<tr>
<td>Exposure to unsafe drinking water</td>
<td>63</td>
</tr>
<tr>
<td>Electric power losses</td>
<td>77</td>
</tr>
<tr>
<td>Electrification rate</td>
<td>29</td>
</tr>
<tr>
<td>Efficiency of seaport services</td>
<td>12</td>
</tr>
<tr>
<td>Efficiency of air transport services</td>
<td>79</td>
</tr>
<tr>
<td>Airplane connectivity</td>
<td>17</td>
</tr>
<tr>
<td>Efficiency of train services</td>
<td>32</td>
</tr>
<tr>
<td>Road connectivity</td>
<td>34</td>
</tr>
<tr>
<td>Quality of roads</td>
<td>89</td>
</tr>
<tr>
<td>Infrastructure</td>
<td>46</td>
</tr>
</tbody>
</table>

Azerbaijan has invested significantly in infrastructure over recent years, achieving large improvements in its relative ranking in the WEF Global Competitiveness Index. However, international trade, FDI and portfolio inflows are relatively low and high cost of trading across borders and poor logistics services limit integration potential.

- Azerbaijan holds a strategic geographical position – part of Trans-Caspian International Transport Route (TCITR) connecting China and Europe and North-South Transport Corridor (NSTC) connecting Iran and Russia. The country has a key role in the development of regional transport infrastructure.
- Transport infrastructure (rail, road, water, air) is of good quality due to high levels of public investment. A new port under development at Alyat, 70 km south of Baku, aims to address cargo flow limitations. At the same time, growth in Baku city is creating pressure on the transport network and railway sector needs significant investment.
- Significant geographical disparities in basic infrastructure such as roads and telecommunications remain, posing a constraint to agribusiness and regional development.
- FDI stock per capita equalled US$ 3,007 in 2017, higher than the EaP average, but lower than Georgia (US$ 4,445 per capita) and significantly below Kazakhstan’s level (US$ 8,078 per capita).
- Trade openness has increased but is still lagging behind the EBRD and OECD average.
- Cost and time required for trading across borders are higher than in the EEC region but have improved significantly since 2014, with the World Bank Doing Business trading across borders ‘distance to frontier’ measure improving from 41% in 2014 to 73% in 2018, compared to 81% across other EEC countries on average.
- According to the 2014 Logistics Performance Index, Azerbaijan ranked 125th out of 160 countries. The weak results in LPI relate primarily to the logistics service provision – international shipments, logistics quality and competence, tracking and tracing and timeliness – whereas in infrastructure and customs clearance process the country ranks better.

Source: WB WDI, WEF GCI, EBRD calculations
ANNEX 1: State of infrastructure in Azerbaijan
ANNEX 1: State of infrastructure in Azerbaijan

East-West and North-South transport routes are key to cross-border regional integration. Azerbaijan lies on the crossroads between Europe, China, Russia, Iran and India and has a key role in facilitating regional transport and logistics integration. Azerbaijan is part of the Trans-Caspian International Transport Route (TCITR). The initial concept of TCITR dates back to 1993, however it gained momentum only in 2015 when the first train successfully travelled from China's Shihezi, passed through the port of Aktau and arrived at Baku in August 2015. To facilitate further the route development, Azerbaijan initiated the establishment of Trans Caspian Transport Consortium to operate the TCITR. In 2016, four host countries signed a protocol on setting competitive preferential tariffs for cargo transportation via TCITR. Since then, a number of logistics companies from Ukraine, Moldova, Poland and Hungary have joined the consortium. The North-South Transport Corridor (NSTC) connecting Iran / India and Russia was initiated in 2002 but suffered major delays in developing essential infrastructure along the route, including the missing rail link on Iranian territory. Nevertheless, the first containers were delivered from the Iranian port of Bandar Abbas, transferred to Astara on the Azeri border by vehicles and then sent to Russia by railway. Recognising the potential benefits of the NSTC, three participating countries have agreed to reduce tariffs on interstate cargo transit by 50 per cent in March 2017.

The span of Azerbaijan’s road network is about 19,000 km, of which roughly 4,500 km are primary international and national roads that carry approximately 90 per cent of the road traffic. Azerbaijan's supply chains rely heavily on its road network, accounting for about 64 per cent of total freight. Road freight volumes in the country have expanded, tripling from 2000-2017 with the country's trucking fleet increasing by 80 per cent. The condition of the main arterial roads has improved due to significant government investment and support from international financial institutions over the past decade. During 2004-2013, the government invested more than USD 10 billion in the modernisation and maintenance of road infrastructure, building major highways and urban infrastructure. As a result there has been a major improvement in the quality of roads in the country. In the 2017 WEF Global Competitiveness Index Azerbaijan was ranked in 36th place for road quality – overtaking all other post Soviet countries in WEF index. This has been attributed to the countries significant investment to upgrade its road infrastructure.

Since 2012 the government of Azerbaijan has been implementing a priority programme to upgrade the M2 highway (500 km), a strategic transport route along the TCITR that goes from the port of Baku to Georgia and further to Turkey. The upgrade of around 370 km of the highway has been completed with support of various IFIs. The remaining 130 km long section remains the bottleneck to the completion of this transport corridor.
Upgraded M1 highway that connects Baku with the Russian border is one of the major transportation arteries along the NSTC (together with the M3). It was opened in 2010 with only 56 km remaining unfinished. The M3 highway is another crucial link of the NSTC that connects Azerbaijan’s new port of Alyat with the Iranian border in Astara. Road sections on this highway are in poor condition, leading to high transport costs, long delivery times and traffic accidents due to limited capacity. This corridor needs rehabilitation, possibly through alternative infrastructure such as a new road.

Azerbaijan’s total railway network length is around 2,100 km, of which about 60 per cent is electrified. Traffic has been on a declining trajectory since its peak in 2006 (11 billion tonne-km) and reached 4.6 billion tonne-km transported in 2017. The railway sector is dominated by one company - Azerbaijan Railways. Railways do not appear to offer an attractive alternative for non-oil trade compared to the road network at present, which means that supply chains are becoming increasingly reliant on road transport. Reform of the company and sector has been identified as a priority by the Asian Development Bank. Currently, rail connections with Russia and Georgia are strengthened by the fact that they all share the same rail gauge system which enables rail freight to continue rolling, with no delay for bogie changes. However, rail links with Iran and Turkey remain underdeveloped.

Development of a rail link into Iran is in the pipeline. In 2016, Azerbaijan completed the construction of the missing 8.3 km railway link that leads to Iran in order to facilitate NSTC development. Furthermore, Azerbaijan has also launched the construction of a bridge over the Astara river on the Iranian border and agreed to provide Iran with a loan of USD 500 million to partly finance the construction of the Rasht-Astara section on the Qazvin-Rasht-Astara railway line – the missing rail link along the route on the Iranian territory.

The development of the Baku-Tbilisi-Kars (BTK) railway provides a transportation link to Turkey. The BTK line (826 km) is designed to become a key part of the TCITR, reducing cargo transportation time between Europe and China from the current 45-60 days to 12-15 days. The line began test operations in late 2017 and will link into the new Alyat port south of Baku (see below). This rail line is designed to become a key part of the TCITR and improve the competitiveness and capacity of rail. The line is expected to have an initial capacity for up to 1 million passengers and 5 million tonnes of freight.
## ANNEX 1: State of infrastructure in Azerbaijan (cont’d)

<table>
<thead>
<tr>
<th>The port of Baku, with an annual capacity of about 20 million tons of freight, is the main international port on the Caspian Sea and forms a strategic part of Azerbaijan’s logistics infrastructure and a key point in the whole logistics chain of TCITR and NSTC routes. The port of Baku is able to meet a range of supply chain demands but its inner city location limits the potential for expansion to accommodate further cargo flows. The new port in Alyat, approximately 70 km south of Baku began freight operations in early 2018. The port will offer additional supply chain options as it will be able to handle more cargo, relieve traffic pressure in the area and offer quicker transit links to areas outside of the capital. There are plans for further expansions of the port to accommodate increasing demand.</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Growth in the city of Baku, combined with intensified city centre land use development and increased levels of car ownership is creating pressure on the city’s transport infrastructure.</strong> The population of Baku has increased from around 1.8 million in 2000 to 2.3 million in 2018 according to national statistical authorities. Azerbaijan has also experienced a construction boom with numerous new large and modern buildings. The city has also attracted a number of major sporting and entertainment events such as the Grand Prix and European Song Contest. This growth has led to gentrification and commercialisation in some areas, altering spatial development and movement patterns and creating new demands on the transport network. Car ownership has also increased from around 35 cars per 1,000 people in the 1970s to around 280 today. This has increased traffic and parking demand and undermined the competitiveness of public transport – weakening the profitability of municipal transport providers. There are plans for the extension of Metro services – with new lines and stations. The renewal and expansion of bus services is also a priority.</td>
</tr>
<tr>
<td><strong>Reforms to the country’s rail sector are a high priority.</strong> The competitiveness of the rail sector for freight and passenger transport has been undermined by investment in road improvements, rising car ownership. Several problems in the sector have also been identified, including deteriorating infrastructure and rolling stock, a lack of commercial orientation, and a lack of policy and instructional support for the sector. Improvements in financial control and management systems of the rail company as well as general improvements in operational efficiency are also required to restore competitiveness. The ADB has recently approved loans totalling $400 million to help reform the sector and rehabilitate the Sumgayit-Yalama rail line on the North South rail corridor.</td>
</tr>
<tr>
<td><strong>The country has experienced major growth in air transport – supported by investment in aviation infrastructure.</strong> Passenger numbers have risen from 1 million in 2010 to 2.4 million in 2018. To accommodate this growth Azerbaijan’s largest airport Heydar Aliyev (serving Baku) built a new terminal in 2014 expanding its capacity to around 6 million passengers. Azerbaijan airlines has also agreed to purchase seven new aircraft from Boeing at a cost of around $2 billion. Air freight has also experienced major growth with growth of almost 500 per cent between 2000 and 2017 – although this only accounts for a tiny portion of total freight transport by weight. Further growth in air transport demand is expected.</td>
</tr>
</tbody>
</table>