AZERBAIJAN

Highlights

- **Azerbaijan's economic recovery is strengthening.** The recent expansion of gas production and export capacities combined with positive price developments on the commodity markets bode well for the economy.
- **The authorities undertook important fiscal reforms.** Amendments to the tax code aim to simplify the rules, decrease the tax burden, increase taxpayer compliance and support the development of micro, small and medium private sector business, while implementation of the fiscal rule and public debt strategy should support the sustainability of public finances.
- **Steps were taken to decrease the stock of non-performing loans (NPLs) in the banking sector.** The state has funded generous measures that incentivise resolution of overdue individuals' loans, particularly those affected by the steep devaluation of the manat in 2015. participation.

Key priorities for 2020

- **Implementation of recent fiscal reforms is commendable and should be followed with additional steps.** The functioning of the tax and customs administration should be further improved, the efficiency of public spending should be enhanced, and there needs to be a better oversight of the risks arising from large contingent liabilities.
- **Banking sector reform remains incomplete and should be reinvigorated.** Privatisation of the International Bank of Azerbaijan (IBAR) needs to advance as initially planned. Remaining weaknesses in the banking sector also need to be addressed by strengthening both the regulatory framework and the independence and capacity of the regulator.
- **Policies that support private sector development and economic diversification should remain high on the priority list.** To ensure their effectiveness, horizontal policies improving the overall investment climate and sector-specific reform programmes should be combined with enhancing the institutional capacity of the implementing state agencies.

Main macroeconomic indicators %

	2015	2016	2017	2018	2019 proj.
GDP growth	1.1	-3.1	0.1	1.4	2.8
Inflation (average)	4.0	12.4	12.9	2.3	2.8
Government balance[1]/GDP	-4.8	-1.1	-1.4	5.6	5.3
Current account balance/GDP	-0.4	-3.6	4.1	12.9	9.7
Net FDI/GDP [neg. sign = inflows]	-1.5	-5.1	-0.7	1.7	-5.0
External debt[2]/GDP	19.8	20.4	22.8	19.0	n.a.
Gross reserves[3]/GDP	9.5	10.5	13.1	12.0	n.a.
Credit to private sector/GDP	40.0	27.2	16.7	16.3	n.a.

[1] Includes central government and main extrabudgetary funds, including operations of the oil fund and the social protection fund.
[2] Public and publicly guaranteed external debt outstanding.
[3] Excluding assets of the State Oil Fund (SOFAZ).

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Macroeconomic performance

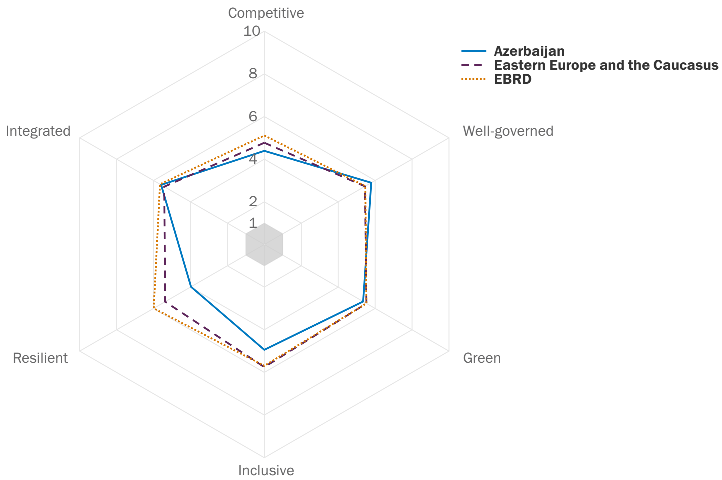
Output growth is gradually strengthening. Following a near-stagnation in 2017, GDP grew by 1.4 per cent in 2018. On the production side, transport, manufacturing, agriculture and retail trade were the main contributors to growth in 2018. Growth was supported by the ongoing expansion of hydrocarbon production and export capacity; real output in the oil and gas sector recovered from a 5.3 per cent contraction in 2017 to a 0.5 per cent expansion in 2018. In contrast, the construction sector was the main drag on overall economic performance, contracting by an estimated 9.0 per cent. Growth of output outside of the hydrocarbon sector strengthened from 1.9 per cent in 2018 to 3.5 per cent year-on-year in the first nine months of 2019. This strengthening of growth in non-oil sectors supported an overall acceleration of GDP growth to 2.5 per cent year-on-year in the same period.

The external surplus widened while the fiscal balance turned into a surplus on the back of higher hydrocarbon revenues. The current account surplus rose from 4.1 per cent of GDP in 2017 to 12.9 per cent in 2018 on the back of increased hydrocarbon exports and favourable commodity prices. In the first half of 2019, this trend halted on the back of weak exports of services combined with a near stagnation in the oil and gas sector balance in comparison to the same period last year. The consolidated budget moved from a deficit of 1.4 per cent of GDP in 2017 to a 5.6 per cent surplus in 2018.

Credit activity started recovering but weaknesses in the financial sector remain. The loan portfolio stopped contracting in 2018 and started to gradually increase in nominal terms at the end of the year amid overall macroeconomic stabilisation and the resumption of economic growth. However, the ratio of private credit to GDP, at 16.3 per cent in 2018, is low by regional standards. Loan and deposit dollarisation has been declining, but remains high at 34.3 per cent and 63.0 per cent respectively as of August 2019. The share of overdue loans as defined by the Central Bank of the Republic of Azerbaijan (CBA) has dropped in the past two years but, at 10.8 per cent, is still significant.

A modest economic recovery is expected to continue. We forecast the economy to grow by 2.8 per cent in 2019 and 2.4 per cent in 2020. Volatility in commodity prices represents the main risk to the near-term growth prospects. The economy's resilience to external shocks is supported by significant liquidity buffers, as the combined official foreign exchange reserves of the CBA and assets of the State Oil Fund of Azerbaijan (SOFAZ) are approximately equal to the forecasted 2019 GDP. Steeper longer-term growth requires deeper reforms that would enable the private sector outside of the oil and gas industry to play a more significant role in growth creation.

Assessment of transition qualities (1-10)



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Major structural reform developments

Tax reforms have been introduced. The reforms were adopted in December 2018 and entered into force in January 2019. They aim to increase transparency and accountability, encourage businesses to formalise and promote economic diversification. The reforms include measures to foster development of the private sector outside of the hydrocarbon sector. The tax rate for micro, small and medium sized enterprises (MSMEs) was reduced from 4 per cent to 2 per cent, while sole entrepreneurs are taxed at a minuscule fixed rate. Furthermore, MSMEs are exempted from profit and land tax as well as from VAT on imported manufacturing and processing machinery for seven years since the date of their establishment. At the same time, sanctions for non-compliance with the new tax rules were increased.

New fiscal rules are in place. Adopted in the second half of 2018 and implemented with the 2019 budget, the new fiscal rule fosters fiscal prudence and reduces the pro-cyclicality of the budget at times of high oil prices. The rule sets an upper limit on the overall amount and annual nominal increase of the consolidated budget expenditures, obliges the government to gradually decrease the non-oil budget deficit in the coming years and determines escape clauses in the events of significant budget underperformance. In addition a new strategy for managing the state debt in 2018-25, adopted in August 2018, sets ceilings on the government debt to GDP ratio, the overall government debt service and the level of debt denominated in foreign currency. It also defines specific projects eligible for foreign financing and government guarantees in the strategy period.

Problem loans are being addressed. Various measures to tackle the high share of overdue loans were authorised by the presidential decree signed in February 2019. The first set refers to foreign currency-denominated loans taken out by individual borrowers prior to the step-devaluation of the manat that started in February 2015. The authorities are obliged to pay back a certain share of such loans. To be eligible for the scheme, the loan must not be higher than US$ 10,000 and the maximum amount of compensation is limited to half of that amount. The second set of measures aims to incentivise banks to restructure non-performing loans, which the authorities offer to fund at very low preferential terms and with a grace period of one year. This applies to loans in any currency in the maximum amount of AZN 17,000 or US$ 10,000 that are overdue by more than 360 days and were taken out by individuals not earlier than 2012.

Presidential decrees aim to speed up reforms in the judicial system and energy sector. Published in April 2019, a decree on enhancing reforms in the judicial-legal system recommends setting up a specialised court that would handle cases related to entrepreneurs and clarifying timeframes for judicial examination of disputes in various areas. It also aims to increase awareness of the mediation process; a law on mediation which provides the legal basis for this alternative dispute resolution mechanism was approved at the same time. An Order of the President, issued in May 2019, intends to accelerate institutional reforms in the energy sector with the aim of developing private sector activity in the sector, including attracting foreign investments, and creating a competitive environment.

The authorities have continued to introduce focused business environment reforms. A green corridor gating system, launched in February 2019, is expected to facilitate foreign trade of best-performing companies in non-oil sectors with external markets. Companies granted the right to use the green corridor will face faster customs procedures and increased flexibility and transparency in customs control. Building on the success of ASAN, the state agency for public services, authorities has established a one-stop-shop agency for social services. Opened in May 2019, the Centre for Sustainable and Operational Social Security (DOST) provides 126 different services including those related to labour market, social benefits and pensions, medical services, and social protection. A single e-procurement website, integrating all state agencies in one platform and automating the public procurement process, was launched in January 2019. Efforts to advance digitalisation in public services and cut the red tape, among others, were recognised in the World Bank's *Doing Business 2020* report; Azerbaijan improved its rank from 57th place in 2018 to 34th in 2020.