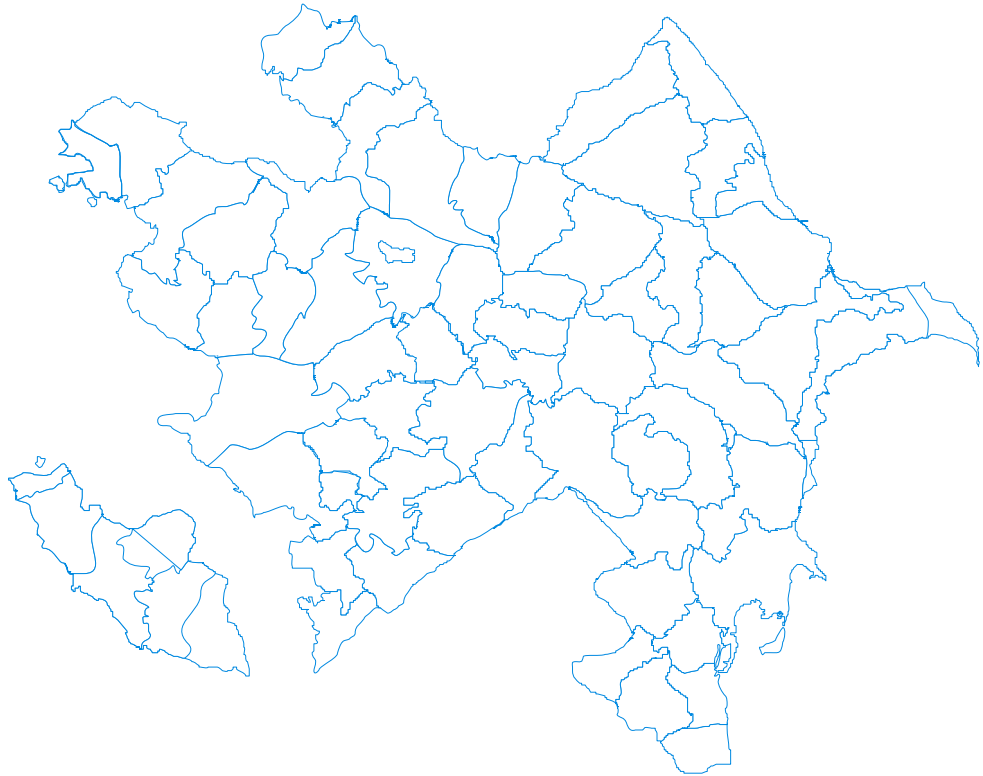


# The Republic of Azerbaijan

## Economic profile of the country-2006



# Ministry of Economic Development

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## Azerbaijan: overview

### Fact sheet 2006

<p><b>Capital</b> - Baku <b>Area</b> -86,600 sq. km <b>Currency</b> : Manat <b>Population</b> - 8,300,000 <b>Religious affiliations</b> - Muslim, Russian Orthodox, Judaism <b>Official Language</b> - Azeri <b>Independence</b> - October 18, 1991 (II republic) <b>Legal System</b> - Based on civil law system <b>Executive Branch</b> - Head of State – President <b>Head of Government</b> - Prime Minister <b>Judicial Branch</b> - Supreme Court <b>Legislative Branch</b>- Milli Majlis (National Assembly)</p>
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### *Azerbaijan is a top economic performer globally*

After restoration of independence in 1991 Azerbaijan has gone through a period of sharp economic decline (1991-1995) during which approximately 58% of the domestic product was lost. A long lasting military conflict with neighbor Armenia over Nagorno-Karabakh, succession of weak and short lived governments, loss of traditional markets etc. all added up to the severity of the economic crisis of the period.

Azerbaijan's political environment is notably stable. Domestically, the country has made steady progress in the arena of political and social reforms. Internationally, Azerbaijan has maintained harmonious relations with Russia, United States, EU, Turkey and Iran, strengthening not only political but commercial ties with these countries.

The government has taken effective measures to ensure price stability and currency convertibility. Gross Domestic Product (GDP), which was USD 6.2 billion in 2002, has grown steadily (USD 12.5 billion in 2005). The country is also making noteworthy progress towards a market economy. The government's commitment to this goal is attested to by its enthusiastic promotion of private sector development and the ongoing privatization process that it launched in 1995.

The performance of Azerbaijan in achieving macroeconomic stability and resumption of growth since 1996 has been impressive, according to the World Bank and the European Bank for Reconstruction and Development (EBRD). Azerbaijan's responsible fiscal and monetary management, accompanied by favorable global economic trends have significantly improved the country's macroeconomic situation. As an acknowledgement of this achievement, the IMF approved a 3-year Poverty Reduction and Growth Facility program in July 2001. This was a clear sign of support for the government's economic reform efforts. Securing this agreement sent a strong signal to foreign investors of the government's commitment to structural reforms. Commerzbank Securities defines economy of Azerbaijan as an economy with spectacular growth forecasts, no financing problems, with low debt levels, modest fiscal deficits and well-financed current account.<sup>1</sup>

As a result a massive economic growth of 26.4% has been attained in 2005. With these indicators Azerbaijan is likely to become the top performer globally and this statement is accepted by various IFIs. Notwithstanding the apparent successes there are substantial challenges remaining such as poverty reduction and achievement of sustainable long term growth. The Government clearly understands the necessity to efficiently use favorable economic trends to tackle these issues, to diversify the economy and to reduce potential threats of the fluctuating oil price for the economic prospects.

The country by now is well integrated in the pan-European cooperation system via participation in OSCE, Council of Europe, CIS, GUUAM (Georgia, Ukraine, Uzbekistan, Azerbaijan and Moldova alliance), Black Sea Economic Cooperation, Economic Cooperation Organization etc. as well as a system of multilateral and bilateral treaties on trade and economic affairs. Azerbaijan has also been included into the European Neighborhood Policy.

Azerbaijan has stakes and is actively engaged with the EBRD, ADB, World Bank, International Monetary Fund, Black Sea Trade & Development Bank etc. all of which have running projects portfolios in the country.

Azerbaijan lies on the transportation corridor linking Central Asia with the western shore of the Black Sea. Strengthening this historical trading route is an important element of the strategy oriented towards closer regional integration and further diversification of trade. In March 2000 an inter-

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<sup>1</sup> [www.cbksec.com/rsh/marketstrategy.html](http://www.cbksec.com/rsh/marketstrategy.html)

governmental commission of the countries participating in the Transport Corridor Europe, Caucasus, Asia (TRACECA) initiative confirmed that its priorities would be to start preparing agreements on tariff liberalization and simplification of tariff procedures. This goal is also being pursued in the process of negotiations on the accession to the World Trade Organization (WTO) which is very likely to take place soon.

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The government of Azerbaijan welcomes foreign direct investment (FDI) in the country. In the relatively short period since independence, it has made continuous efforts to open up the economy and establish laws and regulations that are favorable to foreign investors. The foreign exchange regime and currency transfer policies are liberal and there are no major constraints on commercial activity.

The law permits foreigners to wholly own companies, and protects them from nationalization and expropriation of assets. Special efforts are currently being made to improve the transparency of the regulatory system, further reduce bureaucracy and corruption, and develop additional incentives for attracting foreign investors.

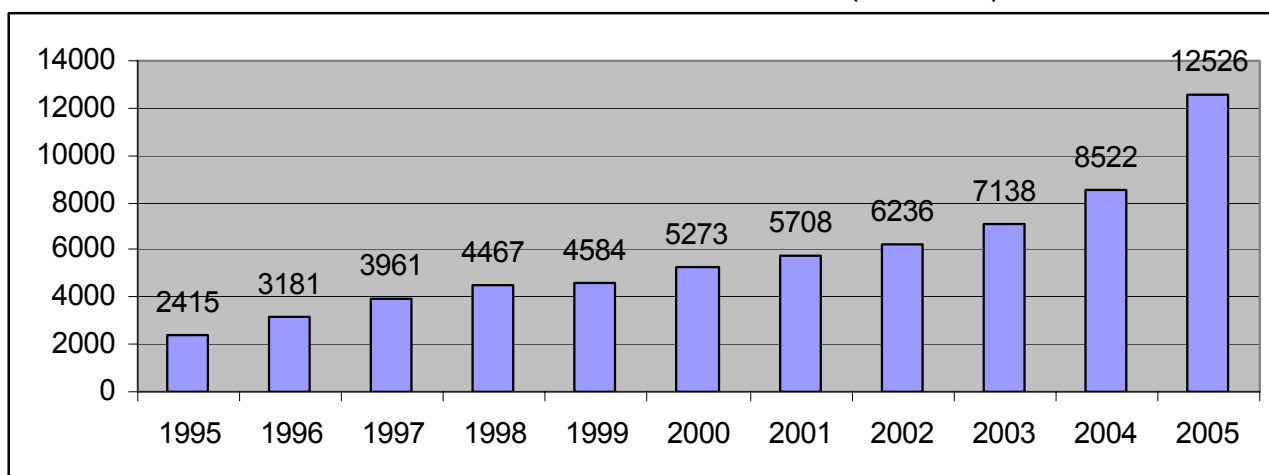
The country has an overwhelmingly positive record of co-operation with the private international business in the oil & gas industry. It includes large offshore oil & gas projects as well as massive investments in the infrastructure (e.g. Baku-Tbilisi-Ceyhan pipeline). Total inward investments in Azerbaijan is 28.9 billion USD most of it due to the above projects, a huge sum for a country with GDP worth USD 12.5 billion in 2005.

## Decade of rapid growth

### *Economic development trend has been stable since mid 90-s*

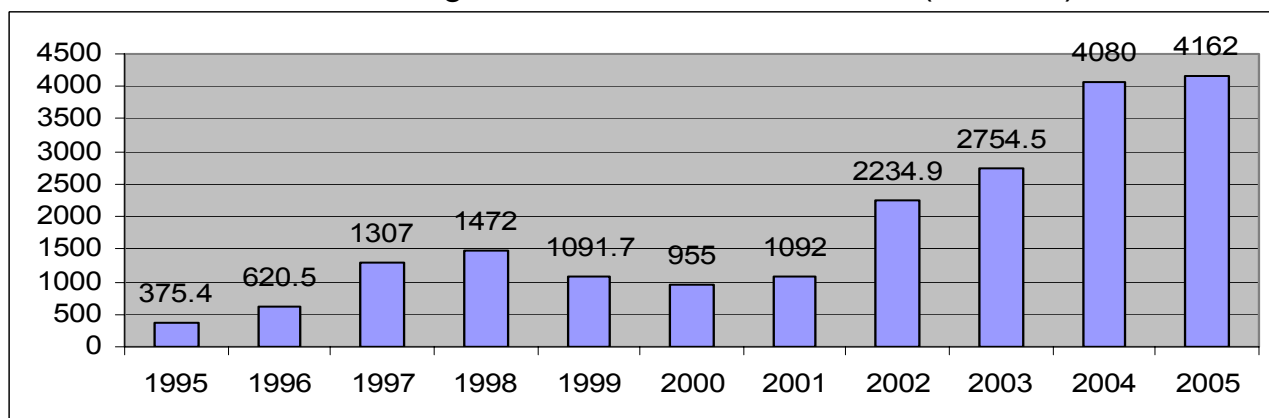
A number of charts will demonstrate the developmental patterns achieved in the Azerbaijani economy over the last few years.

Chart 1. Gross Domestic Product (mln usd)



As demonstrated on the chart Azerbaijani domestic product has more than tripled over the last decade. The average annual economic growth is 13.6%. The growth in the year 2005 was 26.4%. The governmental forecast supported by few prominent international sources (e.g. Commerzbank Securities)<sup>2</sup> says that the GDP will double again in the next 4 years.

Chart 2. Foreign Direct Investments inflow (mln usd)

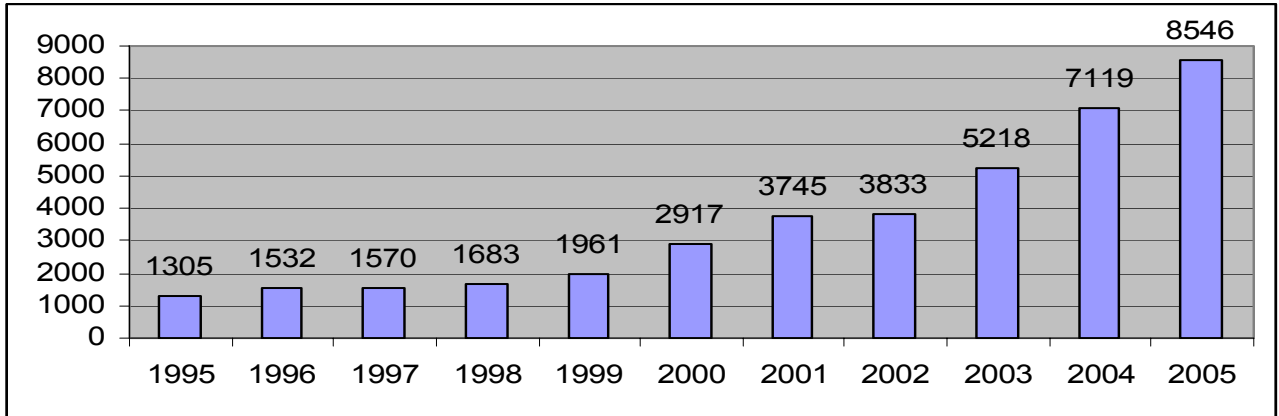


<sup>2</sup> [www.cbksec.com/rsh/marketstrategy.html](http://www.cbksec.com/rsh/marketstrategy.html)

Azerbaijan remains among leaders in the Central and Eastern Europe in attraction of FDI. The per capita indicator remains the highest among the former Soviet Republics for the last several years.

Azerbaijan is top 3<sup>rd</sup> FDI inflow performer globally as per UNCTAD 2004 survey.

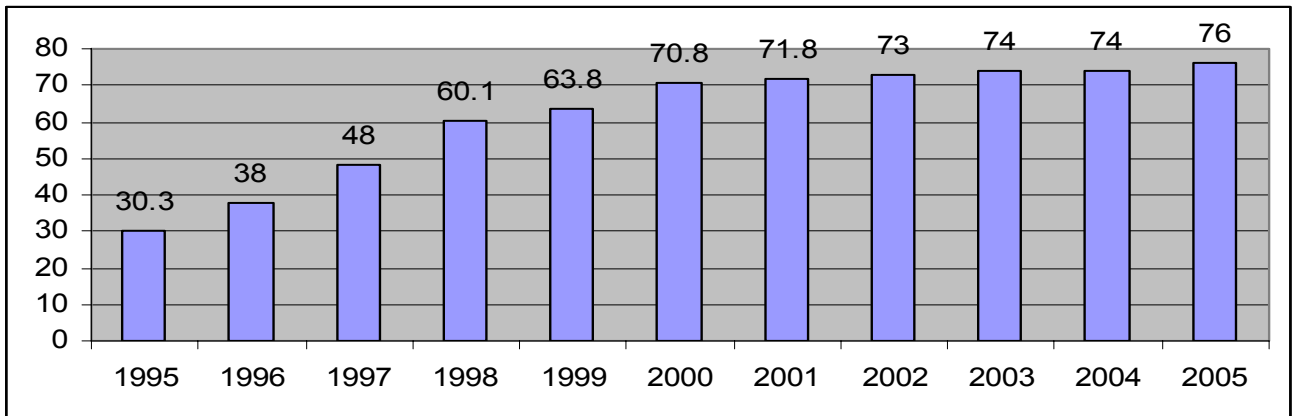
Chart 3. Foreign Trade (mln usd)



Azerbaijani foreign trade is balanced and the year 2005 ended with a small trade surplus. The major trade commodities are oil and oil products. Azerbaijan is importing machinery, luxury goods, raw materials for local manufacturing etc.

The major trade partner is EU followed by Russia and Turkey.

Chart 4. Private share in GDP (%)



Azerbaijan went through a dramatic change of the nature of its economy. The private business that was practically non-existent in mid 90-s now accounts for 76% of the domestic output. This may be attributed to both ongoing privatization process and establishment of new businesses. The Government will continue the policy of denationalization and withdrawal from commercial activities. Azerbaijani economy continued to grow in all segments. For example there were several impressive developments in the

financial services. The total deposits in the local banks in 2005 grew by 27.3% . Liquidity of the assets went down substantially. The National Bank continues to pursue the policy of fewer but stronger banks. The Government introduced a number of changes to the legislation that allowed for the development of financial leasing and transition to the new Accounting Standards that derive from IAS.

Population's income continues to grow consistently though, unfortunately, from a very low base. Average wage in 2005 grew by 21.9% in comparison with the previous year and reached USD 124 monthly (Currently, the average wage is USD140 monthly).

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Macroeconomic stability remains one of the major factors of the economic growth. The Government's policies are predictable and cautious which allowed the country to go through the global economic downfall of early 2000-s without any major loss.

## Key Macroeconomic Indicators for Azerbaijan

	2000	2001	2002	2003	2004	2005
<b>Domestic Economy</b>						
GDP growth (%)	11.1	9.9	10.6	11.2	10.2	26.4
GDP per capita (USD)	665	714.3	774.5	896.7	1,041	1,517
Consumer Price index	1.8	1.7	2.8	2.6	6.7	9.6
Average AZM rate (to USD)	4474	4656	4860.8	4910.8	4913.6	0.95 ( <i>new AZM</i> )
Wages (% annual growth)	20.2	17.3	21.3	21.4	26.2	21.9
<b>Public Finance, Assets and Liabilities</b>						
Budget revenues growth (% to previous year)	17.3	9.8	16	34.1	20.8	43.5
Budget deficit (% of GDP)	1.0	0.4	0.4	0.2	0.2	0.7
Gross governmental debt (% of GDP)	23.9	23.7	23.5	23.4	18.6	13.2
Gross governmental debt (mln USD)	1,259	1,355	1,467	1,673	1,588	1,650
*Official International reserves (mln USD)		1,092.5	1,374	1,572	1,845	2,360
<b>Balance of Payments</b>						
Current account balance (mln USD)	-168	-52	-768	2020.6	2589.2	
Current account balance (% of GDP)	-13.1	-3.2	-0.9	27.7	30.2	21.0
Current account balance plus net FDI (mln USD)	-139	246	280	272.5	259.6	
Current account balance plus net FDI (% of GDP)	-2.6	4.3	4.4	3.7	3	
FDI inflow (mln USD)	927	1,091.8	2011.9	3060.3	3981.3	4161.5

\* Includes National Bank and Oil Fund reserves

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## Legal Framework

### ***Azerbaijan uses non discrimination principle in respect of foreign investors***

***FDI regime.*** Azerbaijan carried out a revolutionary legal reform of the business related legislation. Between 1999-2001 new Tax Code, Civil and Civil Procedure Codes, Customs Code, Labor Code, Law on Banks etc., came into force thus totally changing the legal framework for doing business in Azerbaijan.

Foreign investments are being administered by the above mentioned legislation as well as the Law on the Protection of Foreign Investments 1992. At the moment a new draft Law On Investment Activities is under consideration in the Parliament. The Draft Law contains general definitions and in general announces non-discrimination policy towards foreign investments.

Foreigners are free to incorporate their companies or act as private businesses in Azerbaijan. JV regulation is flexible. Foreign investors can buy businesses, buildings and constructions, become shareholders of companies incorporated in Azerbaijan and buy any other property they can own according to the legislation of Azerbaijan.

Foreign investors can also participate in the privatization process on conditions specified by the legislation (Article 4 of the Law “On Protection of Foreign Investment”).

The law guarantees to foreign investments “national treatment” although there is no non-discrimination or “most favoured nation” provisions as between investors from different home countries (Article 5 of the Law “On Protection of Foreign Investment”).

Clause II of the Law states special provisions about state guarantees to foreign investments. The following is a brief summary of the clause:

If there are any subsequent changes to the legislation that worsen investment conditions prevailing when such investments were made the latter will be applied for 10 years. The exclusion is a list of public interest matters such as national security, environment and public health, public morals, credits and finances. Foreign investments can't be nationalised

except of acts against public interests and people of Azerbaijan. Except of events of *force majeure* foreign investments can't be seized. Accordingly, if foreign investments are nationalized or seized foreign investors will receive adequate and efficient compensation equal to the real cost of the investments. There is a special article giving foreign investors the right to claim damage caused due to illegal acts of state authorities or civil servants.

One of the most crucial points in this law is profit repatriation. According to Article 14 of the law it is guaranteed that foreign investors can repatriate their profit gained from their investment activity or any other sums, including compensation provided that all taxes and charges are paid. Without going into details such repatriation tax specified in Article 126 of the Tax Code of Azerbaijan is 10 per cent payable from the net profit of a permanent representation of the relevant non-resident.

Azerbaijan, so far has signed Agreements on Promotion and Reciprocal Protection of Investments with the following countries: France, Austria, Greece, UK, Belgium, Switzerland, USA, Germany, Italy, Iran, Finland, Lebanon, China, Pakistan, Turkey, Poland, Latvia, Egypt, Saudi Arabia, Kazakhstan, Ukraine, Moldova, Bulgaria, Romania, Georgia, Kyrgyz Republic.

**Exchange Regime.** The National Bank of Azerbaijan that is vested with powers to determine foreign exchange policy introduced a number of liberalization measures over the last several years. In 2004 the limits for foreign capital participation in Azerbaijani banks was abolished.

The National Bank abolished monetary limitations in respect of making outbound advance payments by residents and non-residents in connection with import of goods and services rendered in Azerbaijan or imported into Azerbaijan. Despite abolishment of limitation on advance payments the goods should be brought into Azerbaijan within 365 days of payment being made. Foreign exchange regulations provide for various cases when residents and non-residents may transfer foreign currency from Azerbaijan (e.g. re-payment of loans, royalties, franchising fees etc.). In general, there are no restrictions on converting or transferring funds into freely usable currency at a legal market-clearing rate. This is a major improvement compared to the previous foreign exchange control regime. Cash exchange is very liberal too. Foreign exchange market operators also have access to real time exchange markets.

**Taxation.** Azerbaijan Government continued to reduce the tax burden on the businesses. The Value Added Tax rate was reduced from 28% to 18%. From the 1 January 2006 the corporate tax rate went down to 22%. Reduction was also introduced for the obligatory social contribution payable by employers. It is 22% in total now. Since enactment of the Tax Code in 2001, the total number of payable taxes was reduced from 15 to 9. A liberal Consortia Tax regime continues to regulate tax issues related to the international oil & gas projects.

**Accounting.** The new Accounting Law 2004 stipulates gradual transition to the new accounting standards based on IAS by 2008. Thus the Soviet-era accounting principles will eventually cease to regulate the financial reporting. It should be noted that Azerbaijan has already made substantial advancement towards new financial reporting philosophy. The banks as well as the companies under Production Sharing Agreements and similar commercial deals are not regulated by the 1995 Law on Accounting.

### **Bank system.**

In 1999 the government embarked on a program of reform of bank system in coordination with the World Bank and the IMF. Key elements of the strategy included restructuring and privatizing the remaining state-owned banks; consolidating and rationalizing privately-owned banks; enhancing the regulatory, supervisory and banking capacity of the National Bank of Azerbaijan (NBA); improving the legal framework; and developing the institutional and technical infrastructure to support a healthy, efficient, and competitive banking system, including accounting, payment systems, and auditing.

In 2001 a Real Time Gross Settlement System, AZIPS, the immediate settlement of payments between banks (within 30 to 60 seconds) went live.

A legislative basis for banking activity was advanced in 2004 when the third generation law on Banks and Law on the National Bank of Azerbaijan were passed. With their adoption, implementation of Azerbaijani banking laws pertinent to the European Union Directives on Banking Activity and banking supervision standards of the Basel Committee has been finalized. The National Bank of Azerbaijan has maintained its 2004 policy on the capitalization and consolidation of commercial banks, deciding to increase the requirement for the minimum regulatory capital of the banks to USD 5 million by January 1, 2006. With the adoption of the new banking laws, a legal basis has been established for corporate governance of banks, in line with international standards.

Centralized Credit Register and Milli Kart Processing Center of the National Bank in operation since the beginning of 2005 are important tools for

diversifying and enhancing the quality of banking services and expanding access to them.

As of January 1, 2006 there are 129 credit organizations operating in the country of which 42 are banks and 85 non-bank credit organizations. From the end of 2003 all limits for participation of foreign capital in the Azerbaijan banks was abolished. At the moment there are 18 banks with foreign participation. The deposit and savings base is growing very rapidly. The Securities Committee (state regulator) and the Baku Stock Exchange were also established.

**Foreign Trade.** Azerbaijan has started negotiations with the WTO on accession to the organization. The government has undertaken a number of steps to liberalize the foreign trade regime. As of the end 2005 the weighted average import tariff in Azerbaijan was 5.7% i.e. a way below the international average.

**Licensing.** In 2002 a major reform of licensing in Azerbaijan reduced the number of business activities requiring licensing from more 240 to circa 30. The license validity was extended from 2 to 5 years.

**Anti-corruption.** The government appreciates that the corruption in Azerbaijan is the major obstacle for the private sector development and is one of the main reasons for the inadequacy of the rule of law application in the country. The Government has recently embarked on a program to deal with the issue. The appropriate law and the action plan (Programme) were endorsed by the President and the programme on curbing corruption came into force on the 1<sup>st</sup> January 2005.

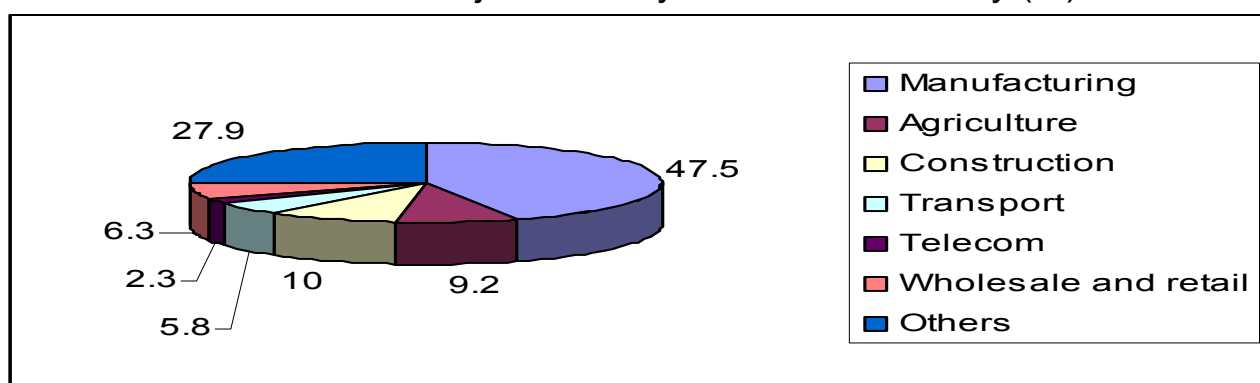
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## Government's economic strategy

### ***Despite oil & gas industry's leading role Azerbaijan is a diverse economy***

Oil & gas projects remain the major locomotive for the economic development. They provide for the most of the growth and substantial portion of revenues. According to Commerzbank securities Azerbaijan is the birthplace of modern oil industry. However, the development of the non oil economy has been consistent and rapid for the last decade too.

Chart 5. Azerbaijani GDP by sectors of economy (%)



All other sectors demonstrate strong performance as well. The Azerbaijan Government declared the following tasks to be a priority for the years to come:

- poverty reduction
- diversification of economy
- regional social & economic development

The Government introduced a number of policy instruments to achieve these goals. Below is the review of some of them:

**Oil Fund** or the so called “future generations fund” is by law accumulating all proceeds from the internationally developed oil & gas projects in Azerbaijan. The Fund is audited by one of the top five and is subject to public scrutiny via Advisory Board, obligatory press releases, Parliamentary monitoring etc.

**EITI (Extractive Industries Transparency Initiative).** Azerbaijan is a pioneer country to introduce new standards for the Government to report internationally on the revenues received from mining activities.

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### **Entrepreneurship Development**

A State Program on SME development was adopted in 2002. The Program ensures the SME development in Azerbaijan on the basis of the improvement of entrepreneur activities regulation system, the SME manpower development, intensification of the mechanisms of technical and financial assistance, strengthening of legal reasoning of entrepreneurship and creation of favorable conditions for the entrepreneurship development in the regions.

### **Poverty Reduction.**

Worldwide, more than 60 countries are currently engaged in developing or strengthening poverty reduction strategies. Azerbaijan is one of these countries.

**Regional Development.** A State Programme on the Social & Economic Development of the Regions was adopted in Azerbaijan in 2004 in order to narrow the gap in development between capital Baku and the rest of the country. One of the main directions of the Programme is support to private businesses in the regions.