

SECTOR ASSESSMENT (SUMMARY): PUBLIC SECTOR MANAGEMENT AND FINANCE

1. Sector Performance, Problems and Opportunities

1. After gaining independence in 1991, Azerbaijan emerged as a leader in the Caucasus region in terms of economic growth. Between 1995 and 2013, economic growth averaged 11% annually as the country transitioned into middle-income status, bolstered by high foreign direct investment in the oil industry and then by growing hydrocarbon production and exports. This has been accompanied by significant reductions in poverty and growth in consumption. The national poverty rate declined from around 50% in the early 2000s to 5% in 2015. In 1999, the Government of Azerbaijan created the State Oil Fund of the Republic of Azerbaijan (SOFAZ) to effectively manage the large oil revenues and to preserve the same for future generations. This was backed up by institutional changes which transformed Azerbaijan into a market-based economy.

2. The sharp fall in the oil prices around mid-2014 set the Azerbaijan economy back because of the country's heavy dependence on hydrocarbon revenues; as much as 60% of the state budget revenues came from hydrocarbon exports. This put pressure on both fiscal and current account balances which rapidly moved from a surplus to a deficit, thereby exerting a downward pull on the manat. This led to a heavy depletion of foreign exchange reserves attributable to market interventions that the Central Bank of Azerbaijan (CBA) employed to maintain the exchange rate stability. Manat was devalued twice in 2015 as the CBA moved to a managed floating rate regime with the aim of boosting exports and arresting the outflow of foreign exchange reserves. However, because of weak regional demand and corresponding currency devaluations of trading partners, the measure did not achieve the desired results. The devaluations spiked domestic inflation rates as the prices of commodities in the consumption basket, which is largely based on imports, became more expensive. These factors culminated in a sharp drop in the economic growth rate. Gross domestic product (GDP) growth fell from 2.8% in 2014 to 1.1% in 2015 and –3.1% in 2016. Moreover, the massive depreciation of the local currency by over 100% triggered higher dollarization, with 75.2% of deposits being held in foreign currency at the end of 2016. This created a severe shortage of credit and loanable funds to the private sector, especially in local currency, with manat denominated deposits as a percent of total bank deposits declining sharply to 24.7% in 2016 from 50.1% in 2014.

3. **Fiscal management.** Azerbaijan currently uses a fiscal policy framework consisting of ad hoc budget rules using SOFAZ revenues to finance public investment. In addition, the government also follows some form of rolling nonbinding 3-year budget plans. The current system, however, is highly linked to oil prices and lacks focus on long-term measures on reducing dependence on hydrocarbons. While the government maintained a consolidated fiscal surplus estimated at 0.6% of GDP in 2013, the trend reversed in 2014 with the consolidated budget running into deficit (table).¹

¹ The fiscal deficit figure presented in Table 1 for 2016 (–0.4% of GDP) significantly differs from the projection presented in the International Monetary Fund (IMF) Article IV Report (–9.9% of GDP) in 2016. (IMF. 2016. IMF Staff Country Reports. Republic of Azerbaijan: 2016 Article IV Consultation Press Release; Staff Report; and Informational Annex. <http://www.imf.org/en/Publications/CR/Issues/2016/12/31/Republic-of-Azerbaijan-2016-Article-IV-Consultation-Press-Release-Staff-Report-and-44269>.) The fiscal deficit figure at the central government level is expected to be –1.4% of GDP in 2016 (Source: CBA).

Azerbaijan Budget Trends
(% share of GDP)

Item	2012	2013	2014	2015	2016
Budget revenues	32.0	33.8	31.2	31.6	29.2
Budget expenditure	31.7	33.2	31.7	32.7	29.6
Balance	0.3	0.6	(0.5)	(1.2)	(0.4)

() = negative, GDP = gross domestic product.

Source: Statistical Bulletin, Central Bank of Azerbaijan.

4. **Public debt.** As a result of exchange rate depreciation and increase in the fiscal deficit stemming from decreased oil revenues and the absence of effective fiscal consolidation measures, the stock of public debt also rose substantially. The nominal gross debt as a share of GDP increased from 11.2% in 2014 to 28.3% in 2015 and further to 37.5% in 2016.² Unrecognized contingent liabilities remain another challenging issue with respect to debt management.

5. **State-owned enterprises.** A significant portion of the economic activities within the country is generated by 14 largest SOEs playing a key role in all important sectors of the economy. The SOEs are active in the oil and gas, power generation, water supply, railway, air passenger, and cargo areas. Dividends received from these entities accounted for 12.8% of the total budgetary receipts of the government in 2015. These SOEs, however, receive budget subsidies and are saddled with inefficiencies and many of them are incurring losses. They face important issues relating to ownership, management, transparency, accountability, financial sustainability, and societal value creation. Corporate governance is a major area of concern affecting the performance and profitability of the SOEs in Azerbaijan. The government has started privatizing some of these SOEs by offering to foreign investors since 2016.

6. **Small and medium-sized enterprise development.** A key determinant of reducing dependency on oil revenues is to diversify the economy, which in turn hinges upon development of a vibrant, non-oil private sector. Despite being a leader in terms of growth amongst the Caucasus and Central Asia Regional Economic Cooperation countries, Azerbaijan lags many countries in terms of ease of doing business.³ Azerbaijan has been ranked 65th amongst 190 countries and is only marginally ahead of Turkey (the lowest ranked country in the region) in 2017. A primary ingredient of private sector development is promotion of small and medium-sized enterprises (SMEs). However, this sector has not seen adequate growth because of a combination of issues such as regulatory bottlenecks, an unfriendly tax environment, unavailability of cheaper financing, and a weak entrepreneurship base. Consequently, growth in non-oil exports has remained extremely low.

7. **Finance sector.** Azerbaijan's finance sector remains relatively small and underdeveloped with limited institutional and capital resources. Moreover, the performance of the majority of lending institutions has been affected by constraints stemming from weak lending capabilities, risk management practices, and corporate governance standards. The devaluation of the currency also substantially increased the cost of the banks' liabilities denominated in foreign currency, which exceed the overall foreign currency assets. It has also reduced the quality of the domestic loan portfolio denominated in foreign currency. A weak economic outlook and manat devaluation negatively affected public confidence in the banking system, leading to a drastic decline in local currency deposits. The devaluation led to an increase in dollarization, weakened bank balance sheets, and deteriorated financial soundness

² International Monetary Fund (IMF). 2016. *World Economic Outlook*. Washington, DC.

³ World Bank. 2017. *Doing Business 2017: Equal Opportunity for All. Economy Profile 2017: Azerbaijan*. Washington, DC.

indicators, thereby raising significant financial stability concerns. This resulted in closure of several smaller banks during 2015–2016 by the CBA. The International Bank of Azerbaijan, a majority state-owned bank holding around 40% of the system wide assets, has been under severe stress because of an accumulation of a large portfolio of bad loans. In mid-2015, the government created a special purpose vehicle to manage and collect nonperforming loans from the International Bank of Azerbaijan.

2. Government's Sector Strategy

8. **Strategic road map on the national economy and key sectors of the economy of Azerbaijan.** A strategic road map covering national economic perspectives and strategic road maps on 11 economic sectors were approved by the president of Azerbaijan in December 2016.⁴ The Strategic Road Map on National Economic Perspectives covers short-, medium-, and long-term horizons and comprises an economic development concept and action plan for 2016–2020, a long-term outlook by 2025, and a target outlook for after 2025. The road map targets more than 3% annual growth in GDP and generation of an additional 450,000 jobs by 2025. The government also aims to increase the level of foreign direct investment in the non-oil sector up to 4% of GDP by 2025. It further aims to increase the share of non-oil sector exports from the current \$200 per capita to \$450 per capita by 2025 and \$1,200 per capita by 2035, and gradually reduce the dependence of the state budget on SOFAZ's transfers from the existing 50% to about 25% by 2025 and to 15% by 2035. This is expected to occur through a series of reform initiatives as outlined in the road map, which include fiscal measures such as enforcing a stricter transfer mechanism between SOFAZ and the Ministry of Finance, developing medium-term expenditure frameworks for key spending ministries, and implementing outcome-based budgeting arrangements. These initiatives are expected to improve the allocative efficiency of public resources. The government has already initiated some of the policy measures, such as development of fiscal rules and a medium-term debt management strategy, which is currently being finalized. The government has also initiated many reforms to create a conducive business environment for the private sector.

9. **Implementation of pension system reform.** The government is in the process of implementing reforms in the pension system, which will increase the focus on social insurance principles and linking the benefits to individual retirement accounts. Retirement ages and contribution periods will increase to optimize the build-up of pension contributions and contain the rise of social insurance and pension payments in the future. However, substantial unfunded legacy pension fund deficits will remain.

10. **Decree on creation of credit bureaus to improve access to financial services.** To improve access to financial services in Azerbaijan, a decree was passed by the president establishing the legal basis for the activities of the credit bureaus.⁵ The decree, passed in October 2016, aims at strengthening financial discipline in debt relations and ensuring stability of the financial system in the country. The credit bureaus will be a joint venture of 20 banks, microfinance companies, and insurance companies, and Creditinfo has been selected to operate Azerbaijan's first credit bureau. In addition, the strategic road map envisaged setting up of a credit guarantee fund for SMEs in 2017, which not only promotes banking subsector development but also increases the access to finance for SMEs.

⁴ Office of the President of Azerbaijan. 2012. Azerbaijan 2020: Look Into the Future Concept of Development. http://www.president.az/files/future_en.pdf

⁵ CIS Legislation. Law of the Azerbaijan Republic "About credit bureaus". <https://cis-legislation.com/document.fwx?rgn=92144>

11. **Tax reforms aimed at streamlining the ease of doing business.** In an attempt to ease the tax burden, promote the development of entrepreneurship (especially among SMEs), and create a more favorable business environment in the country, the government passed a law on regulation of the tax debt of taxpayers effective from January 2017.⁶ The president also approved a series of tax reform measures—such as the introduction of an advance tax ruling concept, transfer pricing regulations, the concept of voluntary tax disclosure, modification of value-added tax rules, and promotion of cashless payments—for a friendlier tax regime that is conducive to a better business environment.

12. **Establishment of the Financial Market Supervision Authority.** The most significant reform has been the establishment of the Financial Market Supervision Authority (FMSA) in 2016. The FMSA was set up to improve the licensing, regulation, and supervision of the securities market and oversee the operations of other financial companies, as well as to prevent money laundering activities. Since its inception, the FMSA has already taken a number of steps in regulating activities in the finance sector through measures such as closure of insolvent banks and warning those engaged in risky practices.

13. **Amendments to the Law of the Republic of Azerbaijan on Banks.** The new banking law amendments in April 2017 specified provisions such as the appointment of a temporary administrator for a distressed bank. The FMSA has been mandated to exercise control over the performance of the temporary administrator. The amendments ordained that upon a court's declaration of a bank's insolvency or compulsory liquidation, the Azerbaijan Deposit Insurance Fund would be appointed as liquidator of the bank.

3. ADB Sector Experience and Assistance Program

14. The Asian Development Bank (ADB) extended an emergency line of credit in the form of the Countercyclical Support Facility Program in 2016 to help the government address the immediate macroeconomic effects of the recession and to protect the vulnerable segments of the population.⁷ It was envisaged that the loan would help the government mitigate the significant negative economic impact caused by the crash in oil prices and the recession in the country's trading partners, which compounded the recession in Azerbaijan. ADB provided a loan of \$500 million accompanied by technical assistance to facilitate design of structural reforms covering macro fiscal management, SOE reforms, and finance sector development, as well as augment capacity of relevant government departments for implementing the reforms.

15. ADB and the government also agreed that transforming Azerbaijan into a dynamic and diversified economy will require comprehensive improvements in governance, ease of doing business, and fostering competition in the economy. The government has therefore sought ADB's assistance to support structural reforms in the medium term related to the three broad directions. These directions have been incorporated in the proposed policy-based loan in 2017, which covers (i) rules-based fiscal planning to improve efficiency of public resource utilization, (ii) restructuring SOEs by improving legal and institutional arrangements and strengthening private sector participation in economic activities, and (iii) improving access to local currency credit to facilitate economic diversification.

⁶ CIS Legislation. Law of the Azerbaijan Republic On regulation of the tax debt of taxpayers, 1 January 2017. <https://cis-legislation.com/document.fwx?rgn=92937>;

⁷ ADB. 2016. *Proposed Loan and Technical Assistance Grant to the Republic of Azerbaijan: Countercyclical Support Facility Program*. Manila.

Problem Tree for Public Sector Management and Finance

