



FOREIGN BUSINESS  
IN **AZERBAIJAN**

Business Climate Survey 2020



**AHK**

Deutsch-Aserbaidshanische  
Auslandshandelskammer  
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The German-Azerbaijani Chamber of Commerce (AHK Azerbaijan), as the official representative of the German economy in Azerbaijan, offers a unique platform for the international business community, provides information services and supports companies in their market and business research since 2012. With more than 140 member companies, AHK Azerbaijan is the most powerful European economic association in Azerbaijan.

As a competent contact partner, the Chamber addresses all questions about the Azerbaijani market and benefit from an expanded network of the AHK in business and politics. AHK Azerbaijan cooperates actively and cross-sectorally with a large number of companies as well as public and private associations and institutions.

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# ABOUT **KPMG** AZERBAIJAN

KPMG has been working in Azerbaijan since 1998. We perform audit of financial statements, provide wide range of consulting services, including tax and legal advisory solutions, IT, risk and management consulting, as well as deals advisory, restructuring and attraction of funds. Our principal goal has always been to effectively combine the firm's global intellectual capital with the practical experience of our local professionals for the benefit of our clients and business partners.

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# FOREWORD





## Farid Isayev

Chairman at AHK Azerbaijan

Welcome to "Foreign Business in Azerbaijan", the new Business Climate Report 2020 from the German-Azerbaijani Chamber of Commerce (AHK Azerbaijan)! AHK Azerbaijan is one of the largest and most active foreign trade associations operating in Azerbaijan and within its mandate is in constant search for opportunities to help improve the business environment in the country.

AHK Azerbaijan has regularly conducted an annual business climate survey since 2016. However, this year's survey was broader in its scope and engagement levels. As before, this report on the Azerbaijan's business climate comprises feedback from German and European companies, yet this time it also includes the contributions of investors from other parts of the world. And as was the case in prior years, this year's edition focuses on economic, institutional reforms, as well as examines Foreign Direct Investment (FDI) in Azerbaijan. FDIs have been crucial to Azerbaijan's economic drive, following the restoration of independence and setting en route towards a market economy, thus achieving a transformation from the previous, Soviet-era economic model.

2020 was, and continues to be, a challenging year, with many factors impacting significantly the initially projected dynamics of economic development. Covid-19 has been a major disruptor of conventional economic planning and related investment activity for many countries across the globe and Azerbaijan has been no exception to that with pandemic responsible for a number of disturbances in the national economy. Despite these circumstances, the majority of survey respondents expect the negative impacts of COVID-19 to be relatively short-term. More importantly, almost half the respondents expressed confidence in their plans to expand or make new investments in 2020 and 2021. However, one should not underestimate the economic challenges that lie ahead or the significance of tackling common issues of concern through coordinated and collective effort.

The Covid-19 pandemic is likely to remain high on the agenda for all major corporations for some time yet, possibly beyond 2020. However, like any challenging and unforeseen event, it gives rise to new opportunities, previously not given due consideration, or acted upon with sufficient urgency. In the present circumstances, information and communication technologies (ICT) represent an attractive growth area for many economies worldwide, including Azerbaijan. It is no coincidence that our survey within the ICT sector records higher than average confidence in future growth. And apart from its hydrocarbon reserves, Azerbaijan may also bank on its wealth of other natural resources. In particular, the pure metal (especially non-ferrous) reserves in the western parts of the country and its sources of renewable energy could represent attractive directions for future investment.

Finally, I would like to express our most sincere gratitude to all participating companies, respondents, government bodies and individual experts for their valuable contributions to this report in their respective roles. May this Business Climate Report enhance dialogue and exchange between companies, government and business organisations and help Azerbaijan's economic development even further along the way to diversification and growth!

Yours faithfully



## A MESSAGE FROM THE EDITOR-IN-CHIEF

**Dear readers,**

We are delighted to introduce to you our stand-alone publication developed and published in cooperation with KPMG in Azerbaijan. The Foreign Business in Azerbaijan: Business Climate Report 2020, shaped by the findings of an online survey conducted in June/July 2020 and reflecting the views of the participating respondents, focuses on the activities of foreign businesses in Azerbaijan with a particular emphasis on the investment climate in the country.

The survey was launched at a peculiar juncture when businesses were exploring ways to mitigate the negative impact of the Covid-19 pandemic while the government was tailoring a new package of reforms to best adjust to the changing economic landscape. With this in mind, while not only shedding light on the ongoing economic reforms and the country's business and investment climate, the report also reflects the views of foreign businesses on the economic impact of pandemic-related disruption and their perceptions of relief programs offered by the government. The report, therefore, provides a unique snapshot into the business decisions and expectations of foreign companies at a time of great uncertainty, while also offering first-hand insight for policy-makers to aid recovery and stimulate constructive public-private dialogue for future progress.

The online survey consisted of 20 questions in total, incorporating basic information about the profiles of participating companies, questions about the current economic situation, and the near-term business outlook, as well as an inquiry about the investment environment in Azerbaijan and the efficiency of its ongoing economic reforms. The survey results also elicited responses about economic and regulatory challenges faced by foreign businesses, allowing relevant state authorities to identify and alleviate any barriers to future capital inflows.

In addition to the analysis of online responses, to add practical insides from major industries, the report was populated with the feedback obtained during face-to-face meetings and discussions with an identified group of experienced CEOs and senior representatives of selected international companies representing various sectors in Azerbaijan.

We are very appreciative of the time the companies have taken to participate in the online survey. Acknowledgement is also due to those who shared with us their valuable thoughts and comments in the interviews.

**Nigar Bayramli**

Head of Market Analysis and Communication Department  
AHK Azerbaijan

PROFILE OF SURVEYED COMPANIES



➤ The respondents had to satisfy a selection of identified criteria to constitute a valid response. The key elements of the criteria required the respondent companies to either have foreign investment in their ownership structure and/or act as a trade agent/distributor/exclusive reseller of foreign goods or services in Azerbaijan. The annexe presents more detailed information on survey methodology and provides more information on the profile of surveyed companies.

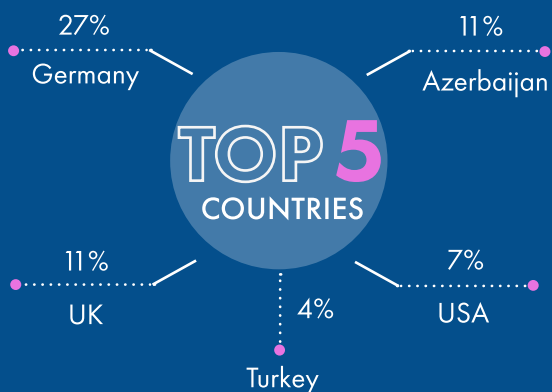
**450**  foreign companies, representing 32 countries were sent the business climate survey

**170**  valid and completed responses were selected as a representative and statistically significant sample

**15**  industries are represented in the survey




**91%**  of the foreign companies surveyed are micro-enterprises and SME's



**29**  different countries took part in the survey

**63%**  of companies are implementing their projects in or cooperating with Azerbaijan for more than 10 years

**70%**  of respondents are Directors, CEOs, or other C-level Executives



# EXECUTIVE SUMMARY

## **Despite the Covid-19 setback, a bird's eye view of the economy and particular industries reveals positive signs**

Aided by fiscal stimulus measures, stable crude oil prices, and increased gas production, the Azerbaijani economy returned to the path of growth in 2018- 2019, reversing two years of negative growth. This reflected positively across all major financial performance indicators of the country. Thus, according to Azerbaijan's central bank, the country's currency reserves exceeded \$51 billion as of January 2020; this figure is five times greater than its foreign debt and on par with GDP.

The outbreak of the Covid-19 pandemic globally and its subsequent spread in Azerbaijan prompted the government to impose restrictive measures on the economy to protect the population against the disease, while the affected businesses received, amongst other measures, financial support from the state. To make matters worse, a steep fall in crude oil prices on global markets coupled with associated OPEC+ restrictions on production, which included Azerbaijan's commitment to cut output, resulted in lower than expected revenues and a deteriorating trading balance. Despite these circumstances, unlike many of its trade partners, Azerbaijan's local currency retained its pre-pandemic value level, and Azerbaijan's central bank reported a 1.2% increase in the country's currency reserves in July 2020 to surpass the \$52 billion mark.

Despite the uncertainty in global markets and the possible effects on the Azerbaijani economy, a significant number of respondents to the survey (39%) assessed the current state of the Azerbaijani economy as stable in the period when the survey was conducted- i.e., June/July 2020. A similar mood was reflected in the assessment of the current state of the industry in which the respondents operate – 44% of them considered their industry stable. Understandably, given the high degree of uncertainty lurking behind expectations of stability, a quarter of surveyed foreign investors deemed the current state of the economy unpredictable. Notwithstanding the uncertain outlook, more than half of respondents (55%) expect the adverse effects of Covid-19 to be relatively short-lived.

It is also reassuring that foreign companies doing business in Azerbaijan recognise there are still untapped investment opportunities. Although new investments could be severely hindered by the high uncertainty associated with pandemic-related disruptions, yet the survey results suggest that foreign businesses do not plan to cut back significantly on planned investment activities. This view was supported by encouraging feedback showing that almost half of respondents (49%) plan to expand and/or make new investments in 2020/2021.

## **Economic reforms acknowledged by foreign investors, yet expectations for more reforms grow**

2019 also saw a large number of structural and institutional reforms in Azerbaijan, most of which were aimed at further improving the efficiency of public administration, as well as increasing transparency in the areas of tax, customs, labour and social security. Particular emphasis was placed on the labour and social protection sphere, including raising public sector wages and improving living standards to offset the impact of past currency depreciation. Institutional changes, coupled with the strong commitment to implement a challenging reform agenda across all major fields of economy, are expected to accelerate development of the non-oil sector, amplifying its role in overall economic growth.



## Survey respondents highlighted tax and customs as the most successful and efficient reforms.

There are spheres, however, where foreign businesses still see potential for more action. Thus, respondents pointed to privatisation of state-owned enterprises and institutional reforms in public administration as areas where the impact of the results of action taken was more muted. Moreover, foreign investors outlined their main challenges, with the more critical ones identified as follows: currency risk and rigid currency regulations; corruption in business-related processes, including the legal-judicial sphere, and the lack of a highly-skilled local workforce. When asked to rank the most needed reforms to ensure FDI in Azerbaijan, respondents' main concerns were the lack of more tangible investment incentive programs and the current state of legal-judicial system.

## Azerbaijan is viewed as an attractive destination for future investment

International companies and FDI inflows have played an integral role in the economic development of Azerbaijan, especially in the early post-Soviet years of independence. World Bank data suggests that FDI estimated at more than \$70 billion was pumped into the Azerbaijani economy in the period between 1995-2019. In pursuit of economic diversification, the country actively pursues through investment incentive packages and a wide range of economic reforms since 2016 – long-term FDI in its non-oil sectors, particularly those identified as priority areas in the Strategic Roadmap of the National Economy. Non-oil FDI flow has risen steadily from 2003 to 2014, although it still accounted for less than one-third of overall FDI inflow during this period.

Looking further ahead, sustainable and longer-term economic growth will increasingly depend on greater levels of private sector investment. The efforts made to transform the economy and to attract new FDI are recognised and appreciated by foreign businesses, but additional measures are needed to maintain the momentum in the progress achieved through reforms and to transform the economy into one with a more balanced diversification structure. In this context, the survey findings, alongside the interviews with selected foreign business representatives, suggest that new and consistent reforms are required in some key areas in order to attract foreign investors to the country.

According to the vast majority of respondents (73%), a more tangible and concrete investment incentive programme is an indispensable prerequisite for FDIs. Foreign companies will invest if investment incentives are tangible, and there is greater predictability in the government's economic (including fiscal) policies and more clarity in its long-term strategic vision.

A stable political environment is clearly also one of the most essential conditions for inflows of FDI. The survey's findings support the view that it is a credible anchor for foreign businesses in Azerbaijan. The survey respondents strongly believe that an inefficient legal-judicial system may well act as a brake, not only on attracting foreign investment but also on implementing and monitoring the reform agenda. It is, therefore, not surprising that 70% of companies emphasise the importance of a transparent and fair legal-judicial system in ensuring foreign investment in the country and highlight it as the next priority for the government to address.

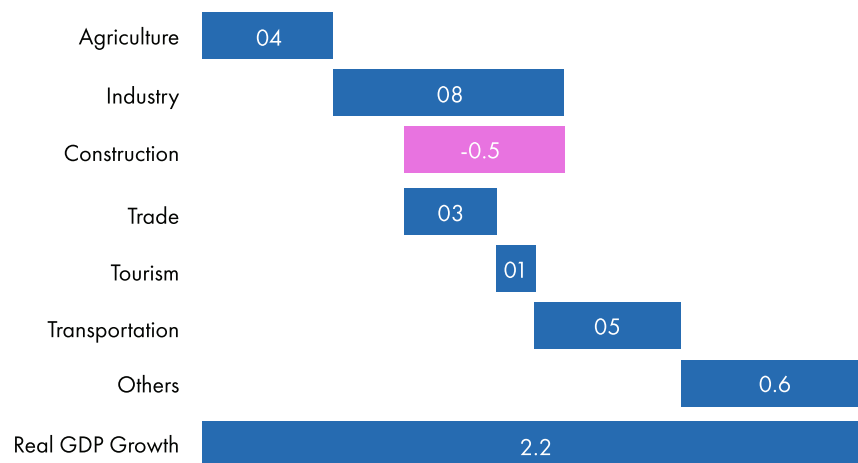


BUSINESS OUTLOOK AND ECONOMIC  
PERFORMANCE INDICATORS

## The economics behind the pandemic: recession, increasing uncertainty and sluggish global recovery

Fiscal stimulus and increasing gas production helped return the Azerbaijani economy to the growth path in 2018-2019, reversing two years of economic contraction. Despite some decrease in oil output (3.3%), gas production increased by 27.7% in 2019 with the Shah Deniz II field ramping up output. The growth rate of the non-oil sector also accelerated to 3.5%, largely due to gains in agriculture (7.3%), tourism (6.4%), and trade (3.6%). Industrial production grew by 1.8%, a slight increase compared to 1.4% in 2018, mainly driven by mining (0.6%) and various manufacturing sectors (11.1%). The construction sector, however, failed to recover from its 9% fall in the prior year and continued to shrink (-6.1%) in 2019 due to a reduction in capital investment (-2.3%) and lower public investment in oil and gas projects.<sup>1</sup>

**Chart 1. Contributions to real GDP growth by sector**  
(Percentage points)



Source: SSC

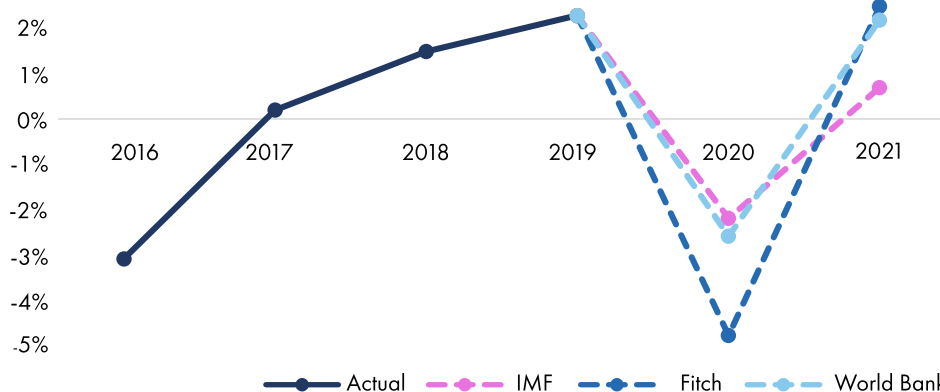
Azerbaijan had a strong fiscal position with a reasonable external debt ratio of around 19% of GDP in 2019. Combined sovereign foreign currency reserves comprising foreign exchange reserves of the Central Bank of the Republic of (CBAR) Azerbaijan and the State Oil Fund of the Republic of Azerbaijan (SOFAZ) assets amounted to \$51 billion in the beginning of 2020. Just as a rebound in the oil and gas sector and a deepening of government's structural and institutional reforms started to lift the country's economic prospects following some turbulent years, momentum was jeopardised by the outbreak of the Covid-19 pandemic and its resulting containment measures.

**Chart 2. Oil Price in 2020**  
Daily Brent Spot Price, \$ per barrel



Source: EIA

Chart 3. Azerbaijan's real GDP growth forecasts



Source: IMF, Fitch ratings, World Bank

With astonishingly alarming speed, the pandemic has caused the most massive shock the world economy has witnessed in decades and led to a steep economic downturn in many countries. The global economy has been hit hard at a time when it was already on a weak footing. Trade tensions and weakened global demand coupled with country-specific tighter financial conditions, trade wars between major economic powers and lower investment in 2019, meant the world's economy delivered its weakest growth performance since the global financial crisis 2007-2008. Amid elevated uncertainty surrounding the growth outlook, the baseline global economic forecast has been downgraded to a 5% contraction in 2020, with the recovery now projected to be more gradual than previously forecast.<sup>2</sup>

Hit doubly by a steep fall in oil prices and the recording of the first domestic coronavirus case in March 2020, the Azerbaijani economy is now projected to shrink by 2.2% in 2020. The total value of export of energy product exports dropped by 34.1% from January through May 2020, compared to the same period of 2019, and totaled \$5.07 billion. As a result of new production cuts announced by OPEC and its affiliates in April, Azerbaijan's oil production will decrease by 17.4 million barrels through December 2020. As oil revenues shrink, the country's high dependence on that sector (hydrocarbons account for roughly 40% of GDP, 90% of exports, and two-thirds of fiscal revenues) means the balances of both the fiscal and current accounts of the country are projected to deteriorate (-12.8% and -8.2%, respectively). Growth is expected to rebound to 0.7% in 2021 assuming a waning pandemic-related drag and the eventual effects of policy support measures.<sup>3</sup>

Some service sectors, including tourism, hospitality, food services, and retail, are among the hardest hit amid stringent and far-reaching lockdown measures. In the World Tourism Organization's estimated worst-case Covid-19 scenario, global tourism could plummet by as much as 80% in 2020, with potential recovery to pre-crisis levels within four years. According to the State Statistical Committee of the Republic of Azerbaijan, the number of tourists visiting Azerbaijan in the first five months of 2020 dropped by 53% compared to the same period in 2019. Given the situation as it stands, and assuming that mobility remains at a low level post-lockdown, the sector will remain depressed in the months ahead, and the road to recovery could be challenging.

To mitigate the economic impact of Covid-19 and to help set the stage for a quick recovery, the government announced a sizeable fiscal stimulus package equivalent to approximately 3% of GDP (\$1.5 billion) to support vulnerable groups, affected sectors of the economy, and entrepreneurs. These measures included cash support to households, wage subsidies to employers to protect jobs on the condition of avoidance of redundancies, business tax holidays, subsidising interest under loans and state guarantees particular categories of new loans.

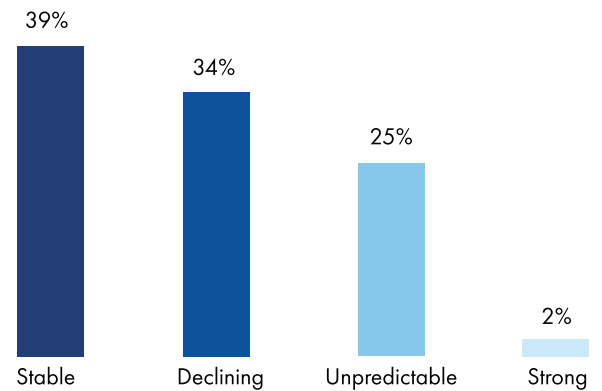
Yet new waves of the pandemic in some countries, including Azerbaijan's neighbours, and lengthy lockdown are inflicting additional burden on rather restricted economic activities and uncertainty regarding the economic outlook for the remainder of the year. Given the unpredictable course, the immediate challenge for policy-makers in Azerbaijan was to contain the outbreak to ensure public health. Once the health crisis abates, it is necessary to forcefully introduce comprehensive reform programs reemphasising the need for diversification, rekindling fundamental drivers of the economy, and creating a more conducive business and investment climate that will attract significant portions of non-oil FDIs.

## Foreign businesses do not expect the pandemic to weigh on business prospects in the medium- and long-term

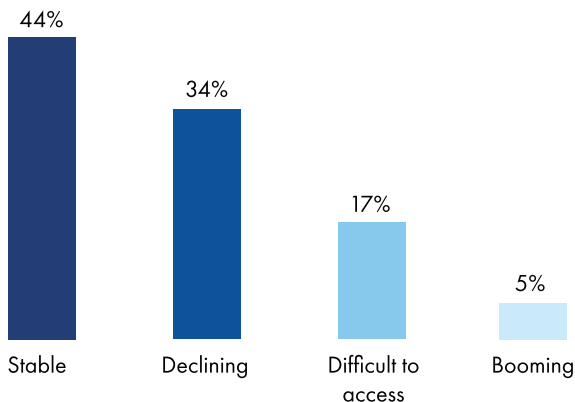
In light of unprecedented challenges caused by the health, macro-economic and social effects of the pandemic, businesses have also had to contend with disruptions to supply chains, travel restrictions, plummeting consumer demand, and limited access to financing. Given that the pandemic's full duration is still unknown, as is the effect of the support measures implemented as an immediate response, the erosion of business confidence and investor sentiment may prove to be longer-lasting.

Economic perspectives are riddled with uncertainty, and this is reflected in the subdued perception of foreign businesses regarding the current state of the Azerbaijani economy. One-third (34%) of foreign companies surveyed see the current situation as declining, whereas more companies (39%) reported a stable economic condition. Unsurprisingly, there is considerable unpredictability lurking behind expectations of stability, clouding the fields of vision of foreign businesses active in Azerbaijan. Hence a quarter of surveyed foreign companies deem the current state of the economy unpredictable in this period.

### The current state of the Azerbaijani economy as perceived by foreign businesses



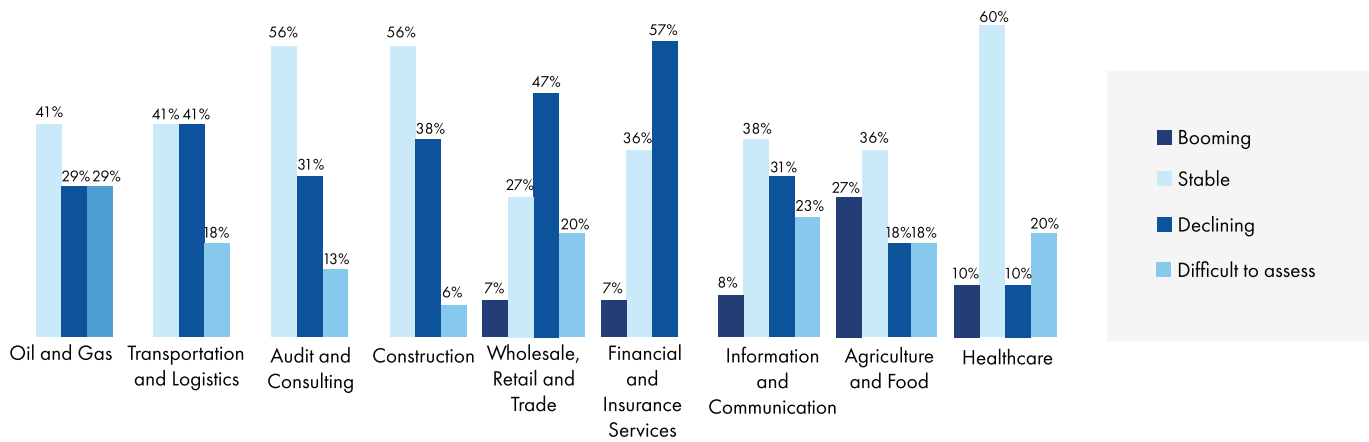
### The current state of industry as perceived by foreign businesses



A similar narrative unfolds at the industry level. Survey findings suggest that the largest share of respondents (44%) assessed the current situation in their own industries as stable, with 34% of companies concluding it was declining, and 17% responding that "it is difficult to assess."

Overall, foreign businesses across most industries are rather polarised in their views on the current situation in their respective industries. Of the best-represented sectors in the survey this year, construction, audit and consulting, and oil and gas were more confident about the current state of their respective sectors: the percentage of "stable" responses was 55% for the first two and 41% for the latter. Discussions suggest that the upbeat sentiment, albeit tempered, among construction companies is driven mainly by strong expectations of government investment in large physical and digital infrastructure projects once the pandemic is under control, aiming to stimulate economic activity, safeguard jobs and foster vital industries like construction, trade and transport and logistics. Most healthcare companies (6 of 10) also reported stable performance amid the health crisis, possibly due to increasing demand for medical services and pharmaceuticals.

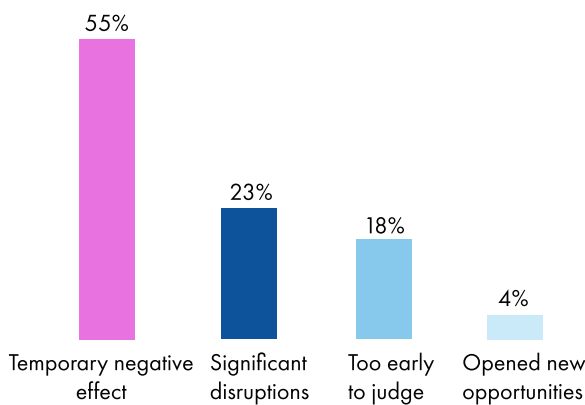
### Evaluation of the current state across the industries



Despite the uncertain outlook, when questioned how the Covid-19 pandemic has impacted business performance in Azerbaijan, only 23% of foreign businesses surveyed reported significant disruption, while 18% deemed the situation as “too early to judge.” The majority of respondents (55%) expected the adverse effects of Covid-19 to be relatively short-lived.

Further analysis across the industries reveals that among the top sectors represented in the survey, a vast majority of the oil and gas companies (13 of 17 respondents) expect the pandemic to result in a temporary negative effect. In fact, a recent rebound in the oil price has slightly lifted sentiment. Brent crude oil spot prices averaged \$40 per barrel in June, up \$11/pbl from May and up \$22/pbl from April (an 18-year low). The US Energy Information Administration expects the oil price to average \$41/pbl during the second half of 2020, and \$50/pbl during 2021, which would still be approximately 20% below the average in 2019.

### Impact of Covid-19 on business performance of foreign companies in Azerbaijan



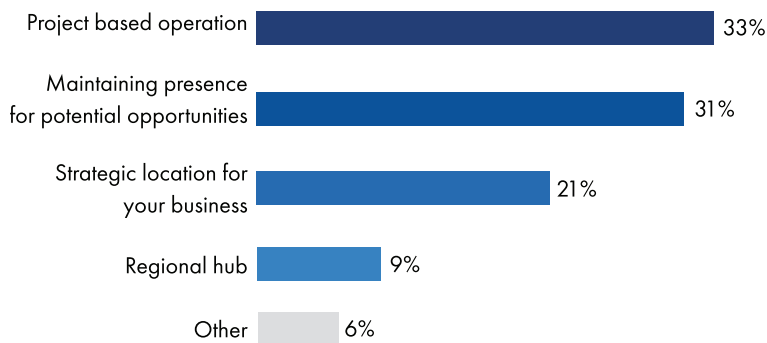
The global energy industry is facing a dual challenge today: to produce more energy in order to meet the growing energy demand of the world, while at the same time reduce carbon emissions making the produced energy cleaner and safer. In order to meet this challenge, the companies have to take urgent action and adapt themselves to the new environment in order to ultimately thrive in the changing energy landscape. On top of that, the COVID-19 pandemic has caused other serious challenges accelerating the need for this transition.

In the period of lower crude oil prices and economic uncertainty currently facing us, new investments in any location worldwide will depend on commercial feasibility. As energy companies are working to reduce their capital budgets in response to the current hostile environment, less and less capital will be available for new oil and gas projects making the competition for capital even more intense.

**Bakhtiyar Aslanbayli**  
 Vice President for Communications & Advocacy in Middle East and Caspian  
 BP



## Operating model of foreign businesses in Azerbaijan



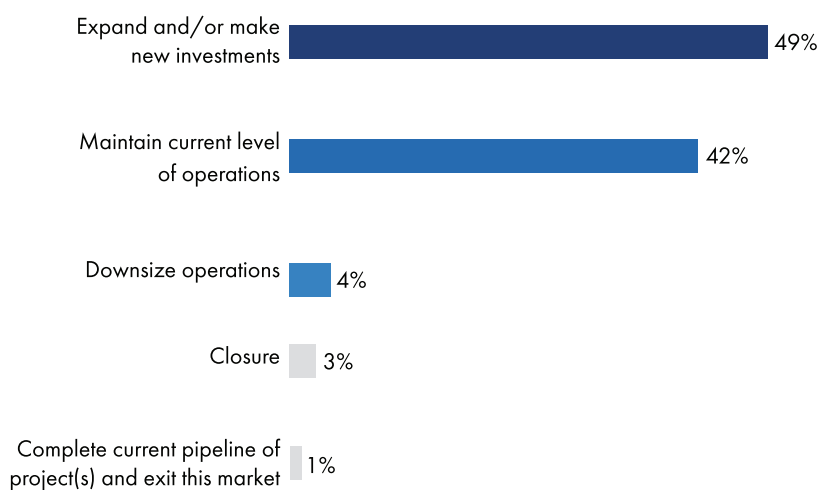
Approximately every third (33%) company participating in the survey reports project-based operations in Azerbaijan, mainly oil and gas (8 of 17), transport (8 of 17), and ICT (7 of 13). Another third (31%) maintains a presence in case of potential opportunities – these are mostly finance and insurance companies (6 of 14 companies). For a further 21% of respondents, Azerbaijan is a strategic location for doing business. Given that the country is next to the very large consumer markets of Russia and the Middle East, this is particularly the case for companies from the wholesale and retail industry (6 out of 15).

To diversify foreign investments away from the traditionally dominant oil and gas industry to the non-oil sector, the government has so far focused on investing in the reconstruction and modernisation of road and railway networks, ports, and electricity generation plants. Most investment has gone into expanding road and railway routes along the country's north-south and east-west transport corridors, aiming to make Azerbaijan an attractive transit and trade hub. To this end, investment of nearly \$7 billion (4.7% of GDP) was planned between 2017–2020.<sup>3</sup>

Moreover, the "Azerbaijan Digital Hub"<sup>5</sup> program was presented in December 2019; this aims to develop key infrastructure, turning Baku into the Internet Exchange Point (IXP), to establish a large regional data center in the country and, eventually, to enhance the digital ecosystem. Yet survey findings reveal that merely 9% of foreign companies regard Azerbaijan as a regional hub for their business operations. The feedback suggests that the efforts made are recognised and appreciated, however, further steps are necessary to accelerate the process of transforming Azerbaijan into a regional transit and digital hub.

With the situation in flux, maintaining the business is more critical than ever to successfully navigate the current challenges while also sowing the seeds for future growth. When questioned about their business targets for the 2020 and 2021 financial year in Azerbaijan, the vast majority of foreign businesses (91%) are committed to Azerbaijan and are not planning to downsize or exit the market. 42% of surveyed companies plan to take a second look at their business targets against the backdrop of a volatile economy and maintain their current level of operations in 2020 and 2021. In this context, worthy of note are the sectors that have been acutely affected by closures and disruptions, construction (10 out of 16 companies), and wholesale and retail trade (8 out of 15 companies).

## Business targets of foreign businesses for 2020 and 2021 financial years in Azerbaijan



It is reassuring that foreign companies doing business in Azerbaijan recognise the potential of still untapped investment opportunities. Even though new investments are severely hindered by the high levels of uncertainty associated with pandemic-related disruptions, the survey results suggest that foreign businesses do not plan to cut back on investment. When asked about the road ahead, almost half of the companies surveyed (49%) plan to expand and/or make new investments in 2020 and 2021. In terms of the business targets of specific industries for 2020 and 2021 in Azerbaijan, ICT companies reported greater optimism regarding their near-term investment outlays, with 9 of 13 companies planning an expansion, followed by oil and gas (10 out of 17) and transport (9 out of 17). The pandemic has revealed the pressing need to bridge the digital divide and supply chain disruptions in the country and speed up the transition towards a digital ecosystem.

To capitalise on these opportunities, it is an ideal time for foreign ICT and transport companies to expand their business and investment in Azerbaijan. At the same time, to help the private sector recover quickly, the government is urged to tailor the reforms according to the rapidly changing business landscape and become an attractive destination for future investments.

# ECONOMIC REFORMS AND REGULATORY FRAMEWORK

## **Reforms are starting to deliver tangible results, but more efforts are required to re-energise the economy**

The difficult economic situation, against the backdrop of the sharp drop in global oil prices in 2015, created renewed momentum for the country's agenda of legislative and institutional reforms. Central to the government's reform agenda has been a widespread acknowledgement that the key to developing a path towards sustainable growth shall be the diversification in the national economy, shifting the country's economic model towards post oil and gas period, and essentially facilitating private sector-led growth. After several years of negative growth or quasi-stagnation, a surge in public investments and the Southern Gas Corridor project coming on stream ensured Azerbaijan's economy recorded positive growth (2.2%) in 2019; at the same time, inflation remained contained during this period.

2019 also witnessed a large number of legislative and institutional reforms, most of which were aimed at modernising the public administration and improving tax and customs administration, alongside ensuring the stability of the financial system and making social services more attainable to the masses. Particular emphasis was placed on the labour and social protection sphere to increase public sector wages and improve living standards to offset the impact of past devaluations. This included a rise in the minimum monthly salary (to \$147) and the national living wage (to \$112), among others, which increased the current spending of the state budget by 17.3%.<sup>6</sup>

Tax legislation underwent significant changes in 2019. One of the significant changes to the Tax Code has been the exemption of monthly income up to 8,000 AZN from personal income tax for individuals employed in private non-oil industries.

Following the Presidential Executive Order dated 23 October 2019, the Ministry of Taxes, the State Committee for Property Issues and the State Agency for Antimonopoly Policy, and Supervision of the Consumer Market were included in the structure of the Ministry of Economy. Equally fundamental restructuring took place within the financial sector, whereby the Financial Market Supervision Authority (FIMSA) was liquidated in November 2019, and its powers and rights, including licensing, regulation, and supervisory authorities in the financial services market and protection of the rights of investors and consumers of financial services were transferred to the CBAR. These institutional changes, coupled with the strong commitment to implement challenging reforms effectively across the economy, are expected to accelerate the non-oil sector's development, amplifying its role in future economic growth.





## Key international reports paint a mixed picture; significant leaps in international rankings

The key reform indicators from the World Bank and the World Economic Forum suggest two things: modest recent progress in improving the business climate has been achieved, and more steps are still required to enhance the country's attractiveness and competitiveness as a competitive investment destination. Detailed analyses of key international reports highlight remaining development bottlenecks that need to be addressed by future reforms.

In the "Global Competitiveness Index 2019" published by the World Economic Forum, Azerbaijan ranked 58 among 141 economies, a noticeable improvement of 11 places compared to the 2018 report. Thus, the country became the highest-ranked in the competitiveness index in the Caucasus region. Although the country has improved or retained its position with respect to the majority of key indicators used to compile the index (basic requirements such as institutions, infrastructure, business dynamism, and product and labor markets), Macroeconomic stability (ranked 103), Financial system (ranked 96), ICT adoption (ranked 73), and Innovation capability (ranked 68) are major areas weighing on the country's ranking.

In 2019 Azerbaijan continued to undertake several reform measures to address obstacles in doing business. The country is still among the top 20 reformers globally, according to the World Bank's "Doing Business 2020" report and was ranked 34, despite a slide of 9 places compared with 2019. This ranking placed Azerbaijan ahead of most Eastern Partnership countries and several EU member states. Simplification of the state registration of legal entities, implementation of the "one window" principle in obtaining building permits via an electronic portal, creation of an electronic system to reduce the number of procedures to connect to the power grid, among other relevant steps, have been put in place to ease obstacles in the business environment and boost market liberalisation.

As a result, the country has made essential improvements in Getting Credit (ranked 1), Enforcing Contracts (ranked 28), and Dealing with Construction Permits (ranked 59) while maintaining its position in Starting a Business (ranked 9). It is noteworthy that the country's position fell significantly in Protecting Minority Investors (ranked 105, compared to 2 in 2019), Paying Taxes (ranked 40, down from 28 in 2019), Registering Property (ranked 44, a decline of 27 places), Resolving Insolvency (ranked 47, a small decline by 2 places compared to 2019), and Getting Electricity (ranked 80, compared to 74 in 2019). These changes are mainly due to increased time spent on replacements and refunds of VAT payments, the high share of social insurance payments to profit, insufficient actions to improve corporate transparency, low level of repayment of businesses, and high property registration costs (7% of property value<sup>7</sup>).

Thus, moving forward, the government could opt to capitalise on the reform agenda to address the lack of transparency in the judiciary and judicial bodies, to adopt the Competition Code and other anti-trust laws which warrant further improvements, in order to determine the optimum currency policy, ultimately ensuring level playing field for all market participants. Given the mentioned results, the views of foreign businesses could be used as a useful tool to reflect on the efficiency and effectiveness of recent reforms in Azerbaijan.

Azerbaijan recognises that the road to a more successful and vibrant business and investment climate depends on closer cooperation with the international institutions and business community to design workable, long-term solutions. This is evident in the genuine steps taken by the Commission on Business Environment and International Rankings (established in July 2016) in recent years to improve the country's position in international rankings.

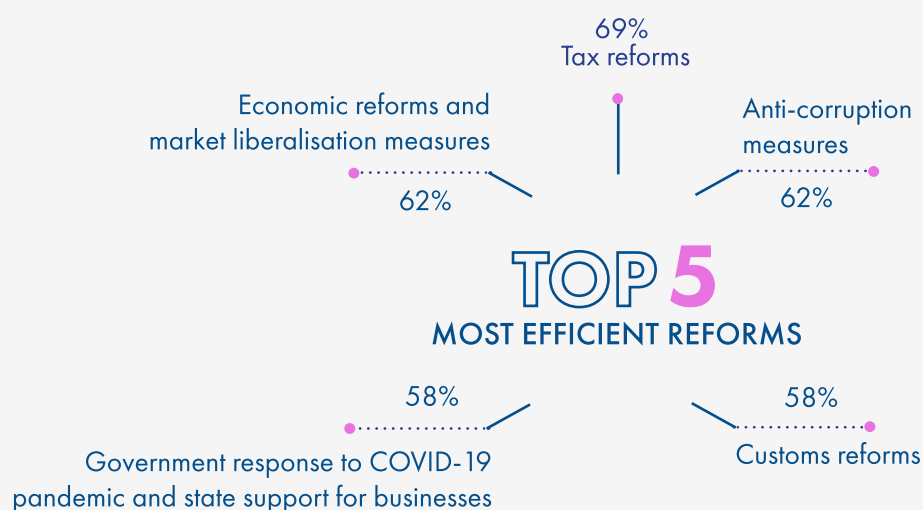
## Azerbaijan displays a promising appetite for reforms, and this is acknowledged by foreign businesses

Survey results, further supported by interviews and expert opinions, provide a comprehensive picture of gradually materialising institutional and economic reforms on the one hand, and remaining regulatory and operational challenges inhibiting development on the other. It is worth mentioning that the consistency of respondents' reflections can be observed between the questions related to the efficiency of reforms and the challenges still faced by foreign businesses in Azerbaijan.

Ongoing modernisation and restructuring in various fields of the economy seem to have been responsible for the encouraging assessment of many reforms, with tax reforms topping the poll. When asked to identify the most critical regulatory and economic constraints they face while conducting business in Azerbaijan, 47 and 36 respondents, respectively, (out of 170) do not report any challenges. Yet, there are areas where foreign businesses identified the need for further action. Currency risk, together with higher customs tariffs, are the top issues identified by the companies surveyed this year. Moreover, when asked to rank the reforms most needed to ensure FDI in Azerbaijan, respondents' principal concerns were the lack of more tangible investment incentive programs and the current state of the legal-judicial system.

## Reforms advance in some areas and stall in others, while tax and customs reforms top the ranking this year

The taxation system as a whole has undergone successful reforms since 2018, and this is duly recognised by the business community. The substantial steps taken by the tax authorities to simplify tax procedures, lower the tax burden, and enhance the efficiency of tax collections, alongside the reduction of the tax rate for SMEs (from 4% to 2%) and the introduction of tax incentives for those employed in the non-oil private sector, have clearly given further impetus to foreign businesses active in Azerbaijan. As anticipated, following these measures, the scale of the shadow economy and informal employment dropped notably; this has translated into an increased number of labour contracts and tax revenues for the state budget. With this in mind, it is not surprising that 7 of 10 (69%) foreign companies surveyed rank tax reforms as the most effective.



The encouraging assessments of tax reforms voiced by international companies this year have some strings attached. While welcoming these efforts, they express some concern about the tax burden being higher compared to other markets where they operate. According to the feedback, despite some recent amendments to current regulations on the reimbursement of taxes and measures aimed at avoiding double taxation, companies still face serious challenges when exercising their rights. Often the respondents voiced concerns for artificial and bureaucratic barriers, unclear arguments, and biased decisions from the tax authorities. Hence, taken as a whole, the foreign business community sees further potential and need for improvement and, accordingly, calls for reforms to continue and thus enforce greater transparency of the tax system, which ultimately should strengthen mutual trust between taxpayers and tax authorities.

Equally commendable is the broad-based work and concerted efforts of customs authorities over the past few years to simplify and harmonise customs procedures and minimise the corruption and bribery instances. In this context, progress in improving e-customs initiatives to limit the role of direct human contact and in enhancing public-private dialogue to better address the needs of businesses was highly appreciated by foreign businesses operating in Azerbaijan. Feedback received suggests that some of the steps taken to optimise the Green Corridor regime, one of the pressing needs signaled by the business community in previous years, is starting to bearing fruit. Consequently, more than half the respondents (58%) rank the customs reforms as the most efficient this year, placing them in the top 5.

Despite the considerable success of these measures, discussions reinforce the necessity of additional adjustments to minimise paperwork and further eliminate the bureaucracy in customs administration and simplification of customs clearance procedures. According to respondents' comments, customs administration requires the submission of a large number of documents and excessive amounts of information (certificate of origin, phytosanitary, sanitary controls, and laboratory tests) that respondents argue have no practical value for customs clearance procedures but rather this results in delays at the border. In fact, this feedback is in line with the "Doing Business 2020" report in which, for trading across borders, Azerbaijan ranked 83, below the regional average. Similarly, in "The Global Competitiveness Report 2019", Azerbaijan ranked 82 among 141 countries for border clearance efficiency.

It is worth mentioning that in EU countries customs clearance takes less than 5 minutes in 67% of cases and exceeds 1 hour in only 7% of cases.<sup>8</sup> Improving border clearance efficiency can be achieved by furthering and sustaining the automation of customs procedures (including the certification process) and risk management measures. At the same time, customs administrations should endeavor to work closely together with businesses to better understand their needs and priorities and to ensure that the private sector is kept informed about new initiatives (i.e., the usage of the e-declaration system, reporting procedure).

Border enforcement against goods infringing intellectual property rights is another area requiring closer cooperation between customs and business. Foreign businesses active in Azerbaijan highlighted counterfeiting as one of the major threats, jeopardising not only brand reputation but also customer safety and loyalty.

## **Despite the unprecedented spectrum of uncertainty, diversification efforts are expected to gain renewed momentum in the years to come**

In the aftermath of the 2015 oil crisis, Azerbaijan took several fundamental steps towards implementing reforms aimed at reshaping the economy and reducing heavy dependence on hydrocarbon resources. In accordance with the relevant action plans underlined in the Strategic Roadmap, an increased emphasis was placed upon non-oil competitiveness and exports by targeting certain key sectors, such as agriculture, industry, and tourism, and strengthening cross-sector issues, such as SME development and logistics and transportation networks. In view of the recently expanded functions and new structure of the Ministry of Economy, the economic reforms and diversification efforts are expected to gain renewed momentum in the years to come.

Discussions confirm that the foreign business community expects this new structure to eliminate cross-functional bureaucracy among related government bodies, and thus to produce more tangible outcomes on the ground. While some new initiatives should be given time to deliver real results, 62% of respondents positively acknowledge economic reforms and Azerbaijan's commitment to further liberalise its market. The survey results also reveal that foreign businesses strongly concur with the prolongation of the moratorium on state inspections beyond 2021, as this year they seem least concerned (selected as a challenge by only 22 respondents out of 170) about the frequency of state audits. At the same time, the Ministry is called upon to be particularly forceful in translating plans and strategies into concrete actions to accelerate the privatisation of state-owned enterprises, further stimulate the SME sector, and to increase transparency and digitalisation in state procurement procedures.

Hence they believe that the control system at the border needs to be fortified to prevent illicit trade and counterfeit goods from entering the country. In the light of the emerging tax and customs reforms (such as enhanced digitalisation of customs procedures, improved transparency in tax collection), three out of five companies (62%) believe that the measures to minimise petty corruption have yielded effective results, and accordingly view anti-corruption measures as efficient. But this does not mean that the fight against corruption is over. At the same time, corruption was ranked as the third most critical operational and economic challenge in the country by 56 of 170 foreign businesses participating in the survey. Comments reveal that corruption is primarily tied to the lack of transparency, objectivity, and digitalisation in the legal-judiciary system. In fact, this has been a longstanding and urgent priority for reform raised by the business community, which is increasingly being voiced with more determination.

In this context, the presidential decree on the approval of "The National Action Plan on the Promotion of the Open Government for 2020-2022" of 27 February 2020 is of crucial importance in setting a new stage for the development of the country's general business and investment climate. The reform programme set out by the President envisages the expansion "of the principles of openness, transparency and accountability, increased financial transparency and increased tools for ensuring the rights to obtain information, support of civil society institutions and strengthening of public control and ensuring the continuity of measures taken for the promotion of the open government."

Of particular note is the timing of this report. It is drafted at a critical juncture when significant shadows are being cast over the economic outlook and business confidence by the pandemic. As the evolution of Covid-19 and the associated macroeconomic fallout continue to be very unpredictable, particularly given that the strict quarantine regime has been prolonged several times, "ad-hoc" government measures and the state support programme for businesses seem to be a credible anchor for the majority (58%) of foreign companies surveyed.

Yet businesses remain concerned about the unprecedented spectrum of uncertainty hindering their field of vision and endangering recovery. The lifting of quarantine measures will likely be gradual, and even after they are unwound, the economic activity might take a while to normalise. This, in turn, will require even greater involvement of the government and stronger cooperation with the private sector.

Obviously the tourism industry is the hardest hit by the pandemic and it is facing an uncertain future amid stringent (but necessary) domestic containment measures. As the situation continues to evolve, the outlook remains unpredictable. Slower-than-expected recovery and coronavirus fears will further dampen appetite for travel both domestically and internationally and any meaningful recovery is essentially delayed until the end of Q1 2021.

I highly appreciate the stimulus package launched by the government to support the affected sectors in the country, with the tourism ecosystem at the forefront. Given that a number of businesses in Azerbaijan is seasonal and the property tax is paid for the whole year, of particular note is the full exemption from property and land taxes for one year. At this stage reopening and rebuilding the industry will require a joined effort by all the affected businesses including hotels, airlines, hospitality, and tourism agencies and the government. Azerbaijan has improved its tourism sector considerably over the past years and I believe that, this crisis is a good opportunity to rethink, refine and recreate a new momentum for further development.

**Martin Kleinmann**

CEO

Absheron Hotel Group



## Turning the crisis into an opportunity for reforms

Four years on from the 2016 recession, which hit the financial sector hardest, a broad range of remedial measures have set the stage for a gradual recovery of Azerbaijan's financial sector. Progress has been visible on many fronts, including financial sector regulations, restructuring the banking system, the level of capitalisation and liquidity, and digitalisation of financial services.<sup>9</sup> Just prior to the pandemic, inflation had been contained within the central bank's target band (2.6%), and the share of nonperforming loans had been reduced from 12.1% in 2019 to 8.2% following the presidential decree on problem loans dated 28 February 2019.<sup>10</sup> Although still high (with 35% of loans and 61% of deposits in foreign currency), efforts to combat dollarisation lowered the share of foreign currency deposits. With greater exchange rate stability and more consumer confidence one year on, the supply of credit grew by 6.8%, with loans to households rising by 31.2%.<sup>11</sup>

As a result, in the event of renewed strains threatening the financial sector, the system is better prepared and relatively less vulnerable to external shock compared to the pre-2015 period. Particularly appreciated is the temporary softer prudential framework introduced by the central bank to offset the adverse impact of the pandemic. This includes waiving additional loan loss provisioning for restructured loans until 1 October, reducing total capital adequacy requirements until 1 January 2021, and postponing add-on capital requirement for market and operational risks until January 2021. Further, the central bank decided to revoke the licenses of four problematic banks in April 2020, cleaning up the banking system. This may explain why 53% of respondents view the reforms to ensure the financial sector's stability and sustainability as efficient this year.



However, while acknowledging the government’s success in implementing relevant anti-crisis measures, 47% of companies surveyed believe that there are still gaps to be bridged to establish a competitive, sound and resilient financial system. Foreign businesses regard currency risk and rigid currency regulations as a leading economic challenge for conducting business. Other evident concerns are the limited number of foreign financial institutions in the country and access to affordable local financing. These three main operational and economic challenges cloud the business outlook of foreign companies on the road ahead.

To respond to these challenges, the CBAR is urged to continue robust reforms in the financial sector to strengthen the financial security, further improve the regulatory framework and maintain liquidity of the banking system, as well as to ensure compliance with international standards and create a level playing field for international investors. Given that the CBAR has been entrusted to regulate the entire financial sector (since November 2019) and in line with the Bank’s announced plans to conduct intensive monitoring this year to identify potential systemic risks, 2020 is expected to be a year of genuine reforms in the financial sector.<sup>12</sup>

Amidst the rapidly advancing digital age and rising expectations of foreign companies, the gap between the existing labour force and business requirements is widening every year. Hiring and retaining highly skilled local workers are challenging across all sectors, and is confirmed by 63% of companies participating in the survey. To emerge stronger from this crisis and to deliver new ways of working and new business models, companies acknowledge the need for reskilling and upskilling the workforce. Clearly, businesses alone cannot address the shortage of a highly skilled workforce in the country. It will take the harmonised approach of the relevant government bodies and agencies, educational institutions, and the wider business community.

# WHO WE ARE

The German-Azerbaijani Chamber of Commerce (AHK Azerbaijan) is a part of the global network of German Chambers of Commerce (AHKs) operating in **92** countries at **140** locations. With more than **140** member companies today, the AHK Azerbaijan is the most powerful European economic association in Azerbaijan.

# WHAT WE DO

As the official representation of the German economy in Azerbaijan, the Chamber provides information services and supports companies in their market and business research since 2012. We closely assist the companies at every step of the establishment and development of their business activities in Azerbaijan and Germany.

# MEMBERSHIP BENEFITS

**BECOME  
A MEMBER**

- **1.** Opportunity to become a part of a valuable network in Azerbaijan and Germany
- **2.** Exclusive participation in the activities of AHK Working Groups
- **3.** Free participation or high discounts for AHK networking and social events
- **4.** VIP invitation to annual business forums and delegation visits and other important events



Deutsch-Aserbaidtschanische  
Auslandshandelskammer  
Alman-Azərbaycan  
Xarici Ticarət Palatası



**5.** Schengen business visa service in collaboration with the Embassy of the Federal Republic of Germany

**6.** Subscription to the digital AHK Newsletter with compiled information on the latest financial, market and economy news from Azerbaijan and Germany

**7.** Access to the AHK Azerbaijan online membership directory

**8.** Up to 30% discounts to the products and services offered by AHK member companies

**9.** Exposure to a greater publicity and visibility within the international business community

**10.** Effective protection of your business interest through our well-established dialogue with the relevant institutions and policy makers.

## A robust legal-judicial framework is a necessary condition for FDI inflows

What hinders conducting business in Azerbaijan? There appears to be a general consensus in the business communities that the lack of a fair and transparent legal-judicial system is a big challenge for smooth business operations. Survey findings and discussions point to overly bureaucratic and lengthy procedures, with the enforcement stage posing even a bigger headache, as the primary regulatory difficulty faced by businesses. The collected feedback suggests that problems in this field – courts' inefficiency, low productivity, and lesser degree of digitalisation, lack of transparency and sometimes objectivity – are critical issues requiring immediate action. Furthermore, the need for professional training and improving judges' qualifications are considered essential elements to increase public trust in the judicial system. In April 2019, a decree was enacted to deepen reforms in the legal/judicial system, which was of crucial importance in setting a new stage of development in the country's general business environment and investment climate. The across-the-board reform programme intends to embrace the legislative, institutional and practical issues raised with some urgency by businesses. Of particular note is the envisaged establishment of a specialist court to deal exclusively with cases involving tax and customs, the creation of a mediation institution, as well as the promotion of alternative mechanisms for the enforcement of court decisions. These measures, along with planned improvements to judges' social welfare and the development of courts' infrastructure, were expected to contribute to the country's investment climate by boosting business confidence. Feedback from businesses suggests that the progress so far on anticipated legal reforms is somewhat mixed, and subsequently, more than half of companies surveyed (54%) rank the legal-judicial reforms as inefficient this year.

As discontent with the judicial system becomes more evident, the most critical state regulatory challenges as perceived by foreign companies mirror inefficiencies in the legal-judicial system. When prioritising the regulatory challenges they face, companies surveyed are mainly concerned with state control over the implementation of anti-trust and competition laws and the inefficiency of administrative appeal proceedings (pre-court disputes with state bodies); these issues rank second and third only to high customs tariffs.

In respect of customs tariffs, calls for more coherent tariff policies are louder in this year's survey. The majority (68%) of foreign companies believe that current customs tariffs are higher compared to other markets and call for an in-depth analysis of trade tariffs to avoid possible distortions of trade and exports. Discussions indicate that it is particularly important to revise the duties on imported raw materials and products that are not locally available in order to avoid stifling local manufacturing and eventually offsetting the benefits of export-oriented measures. This feedback echoes "The Global Competitiveness Report 2019", in which Azerbaijan ranked 93 of 141 countries in respect of trade tariffs. Optimisation of customs tariffs to address the challenges faced by foreign businesses will contribute to the government's efforts to transform the country into Eurasia's transport and logistics hub.

To summarise the implications of the survey, progress is visible on many fronts this year, but the need for concrete and efficient measures to ensure greater transparency across-the-board and enhance the private sector's competitiveness is nevertheless evident. Deepening tax and customs reforms, upgrading the labour market, and strengthening institutional dimensions could remove current obstacles for generating more external investments.

The COVID-19 pandemic was a powerful shock to the world community and led to a sharp downturn in the economies of many countries. According to the baseline forecast, global GDP is expected to decline more than 5% in 2020. Most emerging and developing countries will see a significant decline in per capita income this year. Azerbaijan should turn this period into the opportunity to diversify its economy and to stimulate the export-based industry. In this period foreign capital will seek settled conditions where they can run their business smoothly. Also they want to rely on skilled staff to ensure their success in the country. Therefore, providing a structured system and improving occupational education will bring new opportunities for Azerbaijan.

**Tolga Baysinop**  
General Manager  
BASF



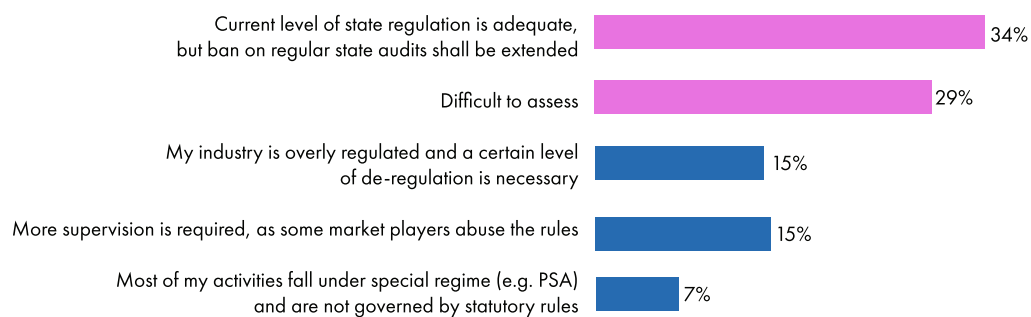




## Regulatory Framework

In light of ongoing reforms, state regulations over business activities also play an important role in promoting a favourable business and investment climate. Hence, the survey aims to shed light on foreign businesses' perceptions of the current state regulation level over their respective industries. A relatively large number (34%) of foreign companies say that the current level of state regulation is adequate but that the ban on regular state audits shall be extended. A further 29%, dominated by transportation and logistics companies, says it is difficult to assess the current level of regulation for their operations in practical terms. International companies representing the ICT sector appear more concerned about overregulation in the sector and believe that a certain level of deregulation is necessary. The construction sector, however, reports that more supervision is required as some market players abuse the rules.

### Current level of state regulation as perceived by foreign businesses



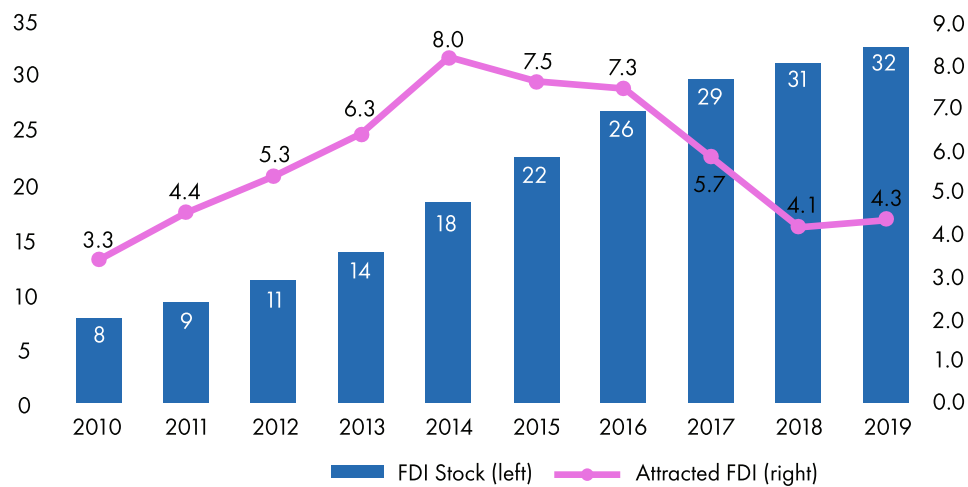


INVESTMENT CLIMATE IN AZERBAIJAN:  
OPPORTUNITIES AND CHALLENGES

## Spotlight on Current Topic: Azerbaijan as an Investment Destination

International companies and FDI inflows have played an integral role in the economic development of Azerbaijan, with the stock of inward FDI reaching 70% of GDP in 2016. As reported by the World Bank, FDI estimated at more than \$70 billion was pumped into the Azerbaijani economy in 1995-2019. Clearly, the oil and gas sector accounted for the lion's share of FDI entering the country for many years. According to the CBAR, Azerbaijan received \$4.3 billion in FDI inflows in 2019, 78% of which went to the oil and gas industry.<sup>13</sup>

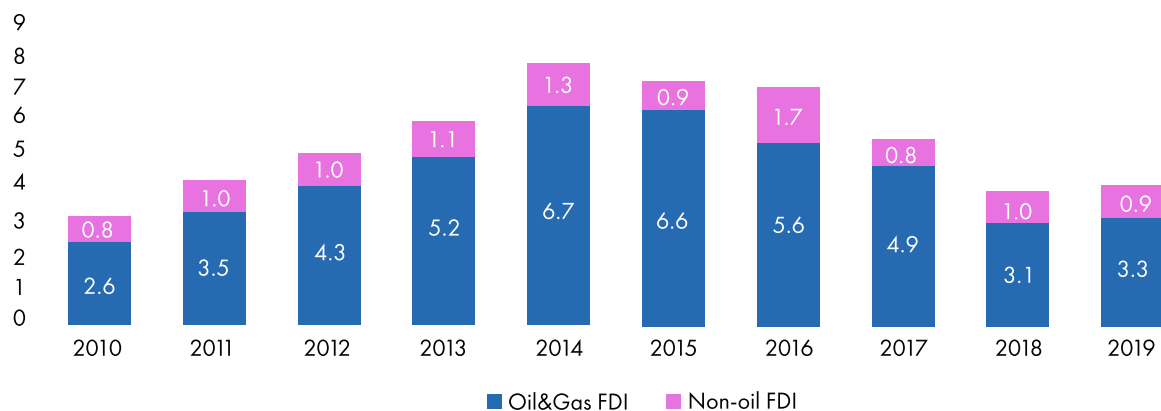
Chart 4. FDIs in Azerbaijan 2010-2019 (\$bn)



Source: CBAR, UNCTAD

In its underlying objective to diversify the economy, Azerbaijan has been actively seeking to attract long-term FDI to its non-oil sectors, particularly those identified as priority areas in the Strategic Roadmap of the National Economy, through investment incentive packages and a wide-range of economic reforms since 2016. These include, among others, extending the moratorium on inspections of business activities until 2021, establishing industrial parks with a number of tax privileges, simplifying the process of obtaining licenses and permits, introducing a 7-year tax exemption for individuals who have obtained an investment promotion certificate, and full exemption from customs duties for imports of technological equipment for high priority industry lines. So far, more than \$2.6 billion have been invested in the creation of industrial parks in Azerbaijan, with plans for a further \$1.1 billion in the next stage.<sup>14</sup> The exemption period for income, land, and property taxes for the resident companies of industrial and hi-tech parks, as well as for VAT and customs duties on imports of equipment for construction of production facilities, has been recently extended from seven to ten years to further stimulate investment.

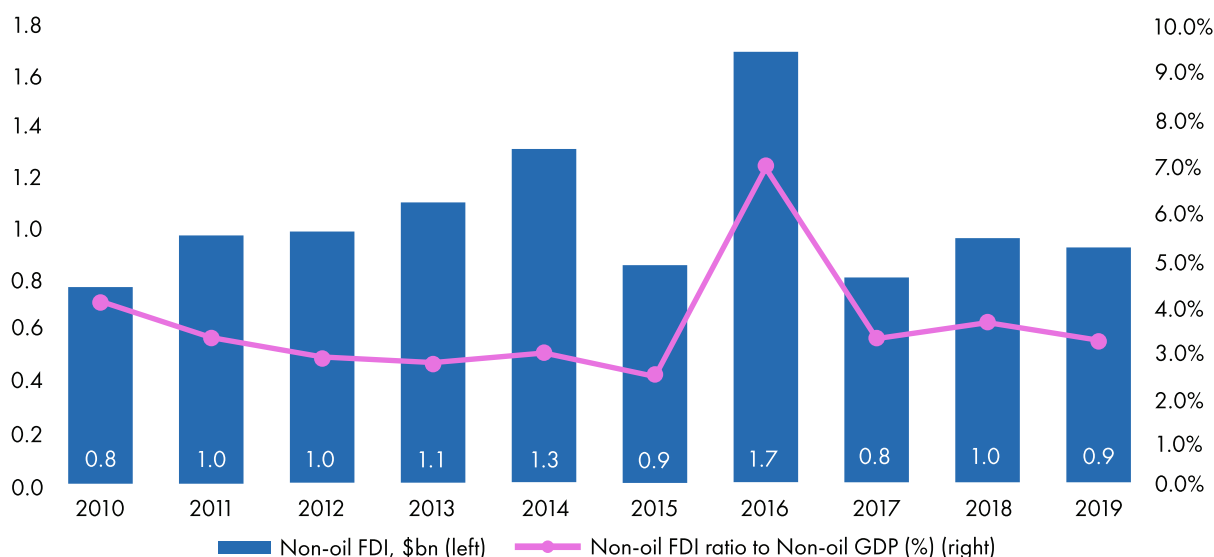
Chart 5. Oil and Non-oil FDI (\$bn)



Source: CBAR

Statistics suggest, however, that these incentives have done less than expected (thus far) to attract new long-term foreign investments in recent periods. Non-oil FDI flows have risen steadily from 2003 to 2014, although they still account for less than under one-third of overall FDI flows. Over the past five years (2015-2020), the inflow of non-oil FDIs has been notably volatile. It increased from \$860 million in 2015 to \$1.7 billion in 2016 and then slumped by more than 50% to \$800 million in 2017. Needless to say, this fluctuation is strongly influenced by other macroeconomic variables, such as GDP and trade, which saw substantial stagnation in the aftermath of the 2015 plunge in oil prices.

**Chart 6. Non-oil FDI (\$bn) and Non-oil FDI ratio to Non-oil GDP (%)**



Source: CBAR, SSC

Recently, Azerbaijan has also been exploring the potential for engaging the private sector in power generation and distribution as well as projects in renewable energy and water supply, currently managed by state agencies with limited capabilities. In this context, new laws on gas supply, on regulators for energy and public utility services, and on electricity generation from renewable energy sources are being drafted following best practices and with the financial and technical support of international organisations to establish a competitive market model and to create a favourable investment environment.<sup>15</sup> Together with modernising infrastructure and developing concepts to boost agriculture and tourism, several initiatives are in place to encourage greater private sector investment, including the establishment of special economic zones.

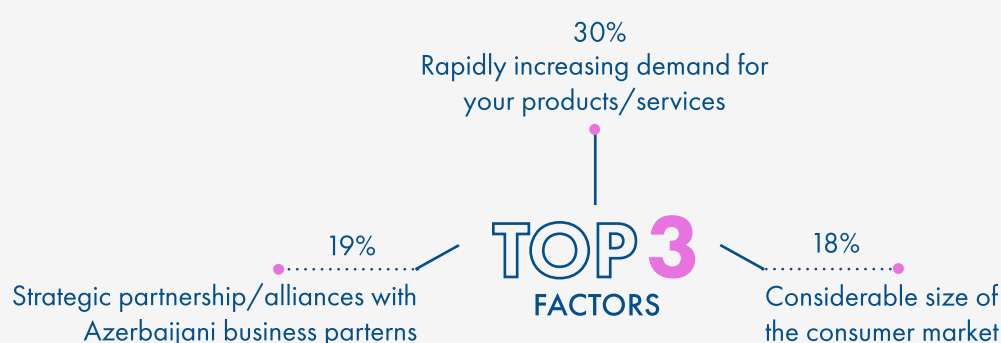
In respect of special economic zones, a recent important step towards making Azerbaijan an attractive transit and trade hub has been the establishment of the Alat Free Economic Zone (FEZ) by virtue of the Presidential decree of 22 May 2020. According to this decree, resident companies of the FEZ are exempt from value-added taxes on the goods, works, and services imported into the zone, and they are exempted from the payment of customs fees. The overall turnover from supplied goods performed services and work in the free economic zone is expected to be subject to a 0.5% tax.<sup>16</sup> While there are no restrictions on 100% ownership of the charter capital and investments of companies in the FEZ by foreign legal entities and individuals, no nationalisation, confiscation measures, or any other restriction on private property may be applied to those entities. The free economic zone is expected to play a catalyst role in supporting structural transformation, attracting foreign investment, promoting export-oriented growth, and generating employment.

FDI is not only an essential instrument for supplying the local market with new technologies, practices, and skills. Leveraging FDI is also decisive in stimulating the SME sector, which often operates as a supplier to large international companies, and achieving more sustainable and inclusive economic growth. The proportion of SMEs in the Azerbaijani economy is among the lowest in the Eastern Partnership. According to the scheme laid out in the 2016 roadmap, SMEs contribution to GDP is expected to rise to 15% by 2020 and to 35% by 2025. After 2025, the figure is projected to be around 60%. Taking this into account, the investment policies should focus not only on directing FDI into large-scale infrastructural projects, but also leveraging FDI as a means to support SME development (particularly manufacturing and production-related services, which to date remain limited).

## How to ensure FDI in Azerbaijan?

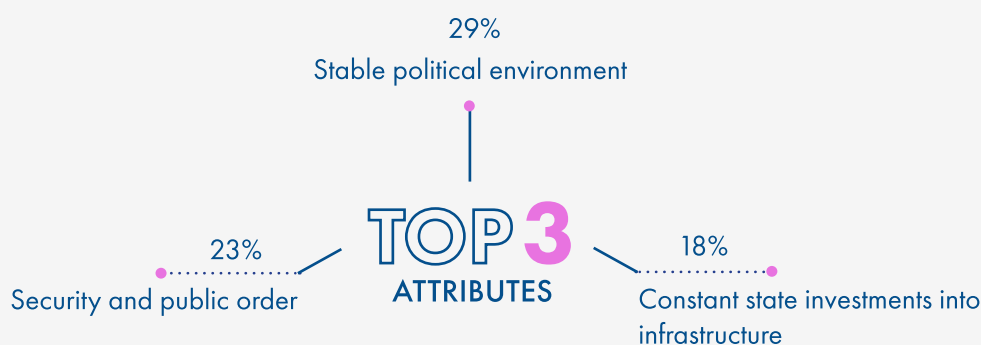
To identify the foreign investors' needs, it is essential to understand their drive behind doing business and investing in Azerbaijan. The survey results indicate that rapidly increasing demand for their products and services is the main reason for entering and maintaining operations in the Azerbaijani market. Strategic partnerships and alliances with Azerbaijani business partners is the second significant motivation for the foreign companies present in the country. This is followed by the considerable size of the consumer market and access to other markets through Azerbaijan. It is noteworthy that attractive foreign investment incentives or schemes are the last driving factor for investment in the country. This, once again, highlights the immediate need to reconsider and refine tailor new investment incentive packages according to the rapidly changing global business landscape.

## Factors affecting the decision to enter and/or maintain operations in the Azerbaijani market



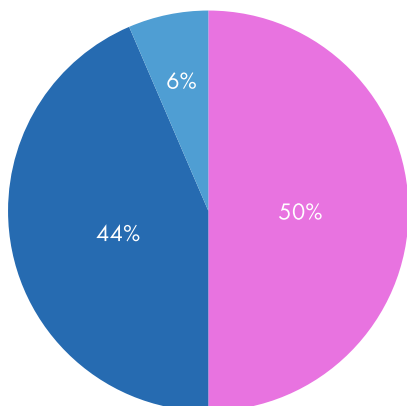
A stable political environment is clearly one of the essential conditions for FDI inflows, and findings reveal that it is also a credible anchor for foreign businesses. The second most important indicator of the business environment appears to be security and public order as perceived by the companies surveyed. Undeniably, public investments into infrastructure, particularly that of rail transport, tourism, connectivity, and agriculture, have been responsible for the investment inflows and economic momentum in the country over the years. Findings show that international companies have also benefited from these investments, and hence companies acknowledge continual state investment in infrastructure as one of the country's strengths. Of all the local business environment attributes, the legal-judicial system stands out as being the least attractive.

## Perceived strong attributes of the business environment in Azerbaijan



## Would you recommend Azerbaijan as a good location for business investment?

■ Yes ■ Unsure in this period of time ■ No



Turning to investment intentions, half of the companies surveyed recognise the potential for still untapped investment opportunities when asked if they would recommend Azerbaijan as a good location for business investments. Further analysis across sectors reveals that the companies representing wholesale and retail trade and transport and logistics are particularly optimistic about Azerbaijan as an investment destination. By contrast, financial, insurance, and ICT companies remain relatively downbeat. That is to say, a majority of companies from these sectors are reluctant to recommend Azerbaijan as a business investment location at this point. This is clearly attributed to the current spillover effects of the pandemic and significant uncertainty about the future.

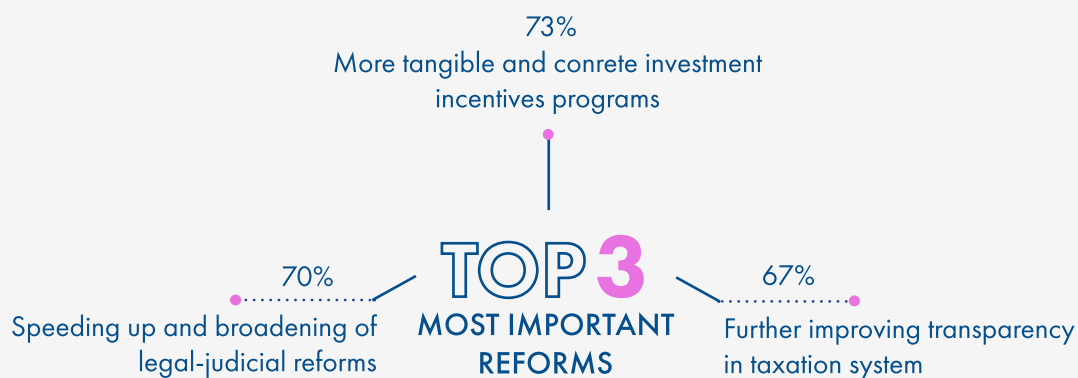
Looking further ahead, sustainable and longer-term economic growth will increasingly depend on greater levels of private sector investment. The efforts made to transform the economy and to attract new FDI are recognised and appreciated by foreign businesses, but further measures are expected to maintain the pace of reform and transform the economy. In this context, the survey findings, alongside the interviews with selected foreign business representatives, suggest that new and rigorous reforms are required in some key areas to attract foreign investors to the country. According to the vast majority of respondents (73%), a more tangible and concrete investment incentives programme is an indispensable prerequisite for FDI. While ensuring that the investment incentives are relevant, foreign companies also await greater predictability in economic policies and more clarity regarding the government's longer-term strategic vision when it comes to attracting international investors.

Concerns about the predictability of economic policies discussed in interviews are tied closely to a lack of certainty and continuity in some policy measures. Reforms often have a short-term horizon, and their longer-term benefits appear elusive from the perspective of the foreign business community.

### More reforms needed to ensure FDI in Azerbaijan

As previously highlighted, the survey participants strongly believe that an inefficient legal-judicial system may well act as a brake, not only on attracting foreign investment but also in implementing and monitoring the reform agenda. Therefore, it is not surprising that 70% of companies emphasise the importance of a transparent and fair legal-judicial system in fostering foreign investment in the country and see it as the next priority to be addressed.

Tax administration in Azerbaijan has long been perceived as a burdensome and stressful process, particularly in the enforcement and collection of taxes. In light of genuine changes since 2018, the tax authorities' credibility has seen considerable improvements. This year, foreign businesses remain optimistic about impending tax reforms. Now, with new institutional frameworks mostly in place and several reform initiatives being implemented, the companies surveyed expect more far-reaching measures to further improve transparency in the taxation system, and consequently place it as the third priority for reform.



Although there has been slightly improved competition, with more companies participating in procurement procedures over recent years, the lack of transparency in respect of public procurement constitutes a serious impediment for all foreign businesses. A first step towards ensuring transparency has been the launch of a website (etender.gov.az) in 2019 to fully automate public procurement processes for all state agencies on one online platform. However, judging by this year’s survey results, its effectiveness is questioned. Further highlighted areas include the paucity of publicly available information on the criteria and procedures for tendering (requirements are often vaguely formulated) and the general obscurity of assessment and selection processes. Hence improving transparency in public procurement is one of the key grounds for concern this year for 59% of the foreign companies surveyed.

Moreover, the results reveal that the transformation of the State Migration Service over the past years under the new management is well recognised and appreciated. All-around improvements in the immigration system and work permit regulations are reflected in the positive shift in the business community’s perception. The optimisation of e-services to facilitate procedures for obtaining visa and work permits and establishing structured dialogue with the private sector have proved successful in ensuring a more favourable and transparent migration regime for a highly skilled foreign workforce.

On the downside, the Covid-19 crisis and its potentially lasting implications will add pressure to Azerbaijan’s efforts to attract FDI in the years to come. Global FDI flows are forecast to decrease by up to 40% in 2020, from their 2019 value of \$1.54 trillion, bringing FDI below \$1 trillion for the first time since 2005. Recovery is projected in 2022 but a reversion to the pre-pandemic underlying trend is at the upper bound of expectations. On the upside, this will trigger increased competition for investment as economies strive to recover from the crisis and re-establish disrupted supply chains. This implies that to outperform the competition, Azerbaijan needs to develop a more coherent investment policy framework and a broader economic reform program to increase efficiency and competitiveness in its economy and to reap the beneficial effects for long-term sustainability. Despite concerns over slowing growth, the foreign business communities believe in the country’s economic potential provided that firm plans are put in place to push reform initiatives further ahead, the effective implementation of reforms is closely supervised, and impediments to their progress are actively addressed.

I write this during what could be the worst economic period of my lifetime and one that leaves so many questions rhetorically hanging that to be able to suggest that we know where the economy is heading would be perhaps futile. That being said, the fact that the government has passed reforms over the last few years and with the changes made within the Government and its Ministries it seems that Azerbaijan is better placed to deal with the challenges that it currently faces than it has ever been.

The need to expand the non-oil sector is ever more important and as such one hopes that the steps taken to become more business friendly will continue and so allow wealth to be created across the population thus increasing income tax and corporate tax revenues generically through an overall expanding economy leading to the reduction of red tape etc. We seem to be on the right path now at least.

**John Patterson**  
OBE  
Chairman  
British Business Group





# ANNEXE A:

## Methodology

Business Climate Survey 2020 was conducted by the German-Azerbaijani Chamber of Commerce (AHK Azerbaijan) in cooperation with the KPMG Azerbaijan. Based on the findings of the survey, the Foreign Business in Azerbaijan: Business Climate Report 2020 was devised to present the current economic situation, effectiveness of ongoing reforms, business and investment climate in Azerbaijan as perceived by international companies doing business in the country.

The questionnaire comprises of 20 multiple choice and ranking questions in total focusing on 4 sections:

- Company Demographics
- Business Outlook and Key Performance Indicators
- Business and Investment Climate
- Economic Reforms and Regulatory Framework

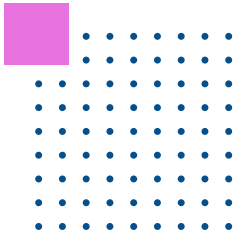
The questionnaire was distributed during the period from 1 June to 1 July 2020 through an online survey platform QuestionPro to around 450 foreign companies active in Azerbaijan, representing 22 EU states and 10 non-EU countries. Following the data verification and elimination of partial and double responses, 170 valid and complete responses (corresponding to a response rate of 38%) were selected as a representative and statistically significant sample. It is necessary to underline that the aggregated responses were processed and further analysed under strict confidentiality and anonymity.

Moreover, to facilitate further elaboration of online survey findings 10 online interviews were conducted with the prominent experts representing selected international companies active in 10 various sectors. Some of those valuable insights and remarks are explicitly shared with the readers throughout the publication.

For the purpose of providing more detailed analysis of the survey findings, the statistical data of international financial organisations, including World Bank, Asian Development Bank and International Monetary Fund, as well as the State Statistical Committee of the Republic of Azerbaijan, the Central Bank of Azerbaijan and the State Customs Committee of the Republic of Azerbaijan, was referred to in the report.

The overall “mean values” and average rates were calculated by using the arithmetic mean. Not all figures add up to 100%, as a result of rounding percentages.





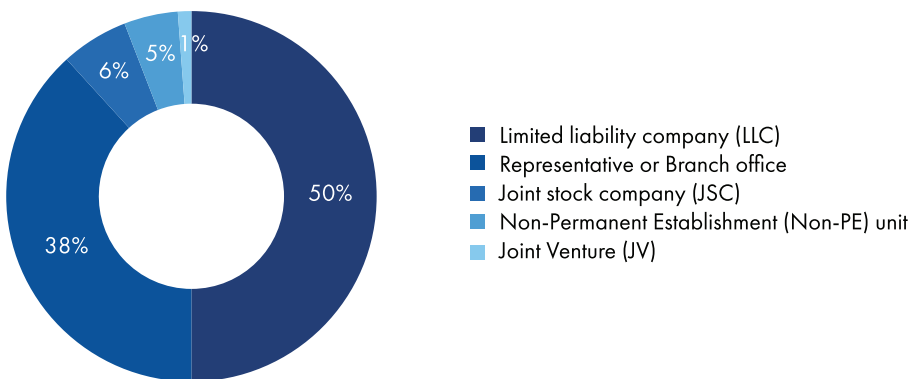
# ANNEXE B:

## Detailed Survey Findings

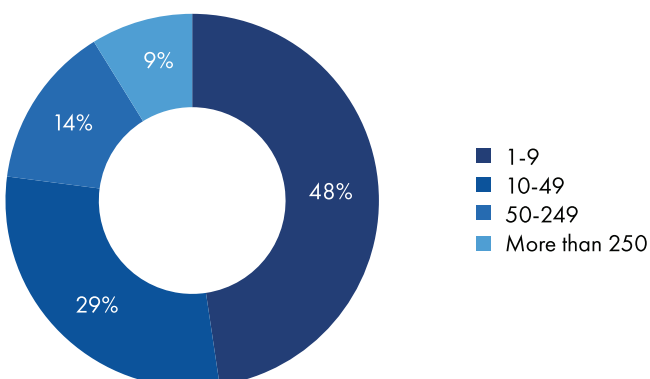
### Q1. Please specify the main industry of your company.

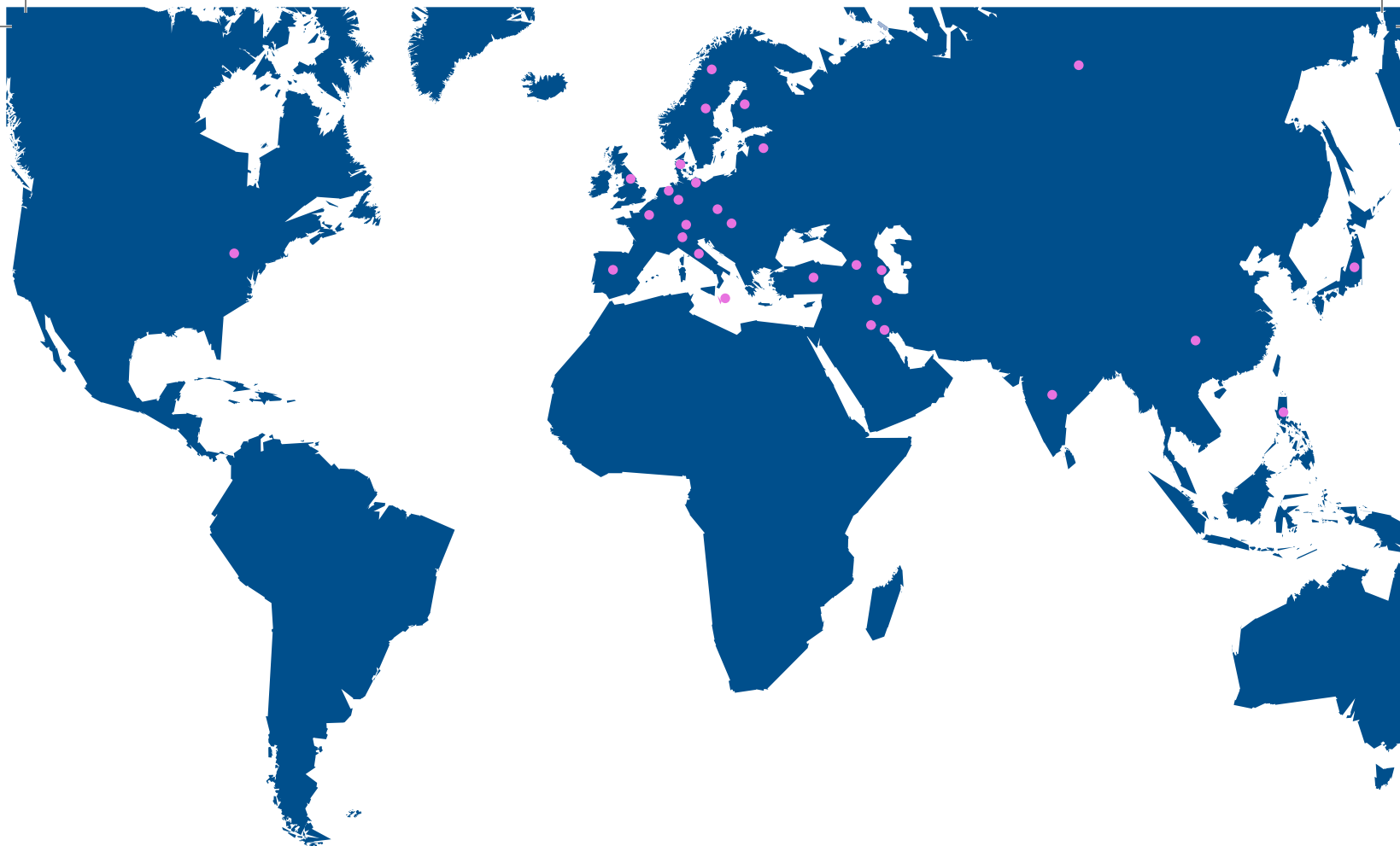


### Q2. Please indicate the legal-organisational form of your company in Azerbaijan?



### Q3. Please indicate the number of people employed in Azerbaijan.

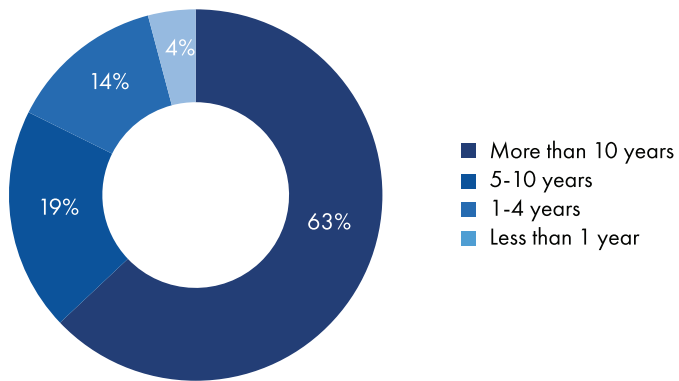




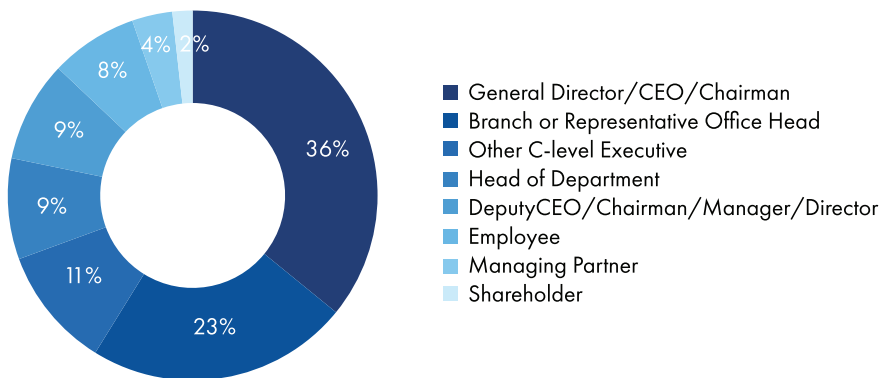
#### Q4. Which country does your majority shareholder or headquarters represent?

Answer options	Response rate	Response count
Germany	27%	46
Azerbaijan	11%	19
United Kingdom (UK)	11%	18
United States of America (USA)	7%	12
Turkey	4%	7
France	4%	6
Netherlands	4%	6
Switzerland	4%	6
Russia	3%	5
Spain	2%	4
Belgium	2%	4
Austria	2%	4
Sweden	2%	4
Italy	2%	3
Finland	2%	3
Japan	2%	3
United Arab Emirates (UAE)	2%	2
China	1%	2
Hungary	1%	2
Denmark	1%	2
Philippines	1%	2
Norway	1%	2
Czech Republic	1%	1
Estonia	1%	1
Malta	1%	1
Georgia	1%	1
India	1%	1
Iran	1%	1
Israel	1%	1
<b>Total</b>	<b>100%</b>	<b>170</b>

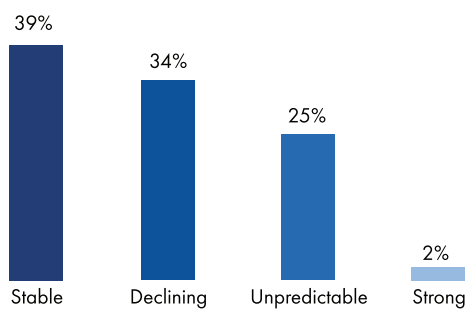
### Q5. How long have you been operating in Azerbaijan?



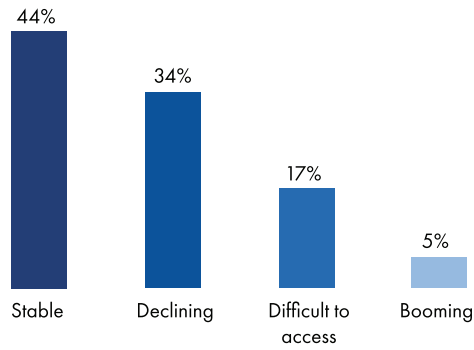
### Q6. Please specify your current position within the company.



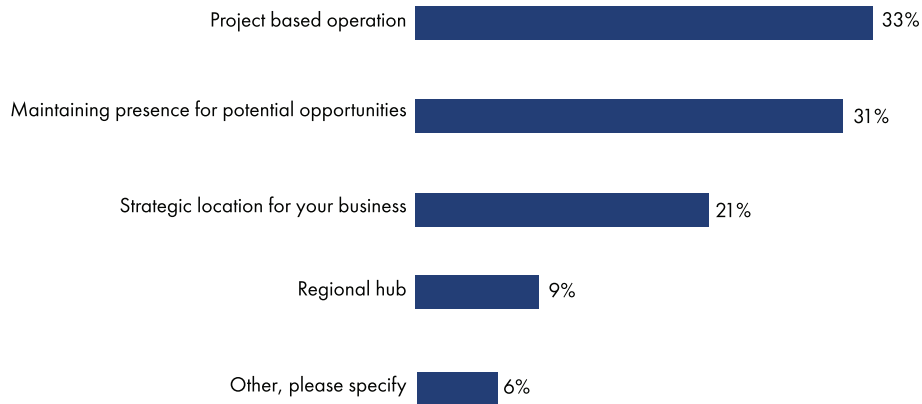
### Q7. How do you evaluate the current state of the Azerbaijani economy?



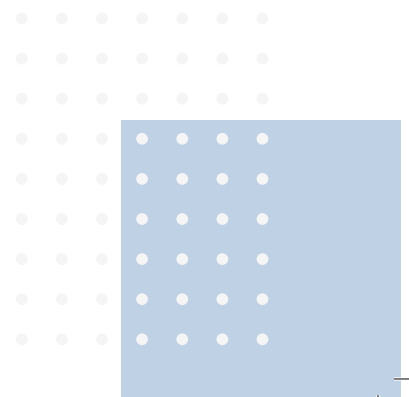
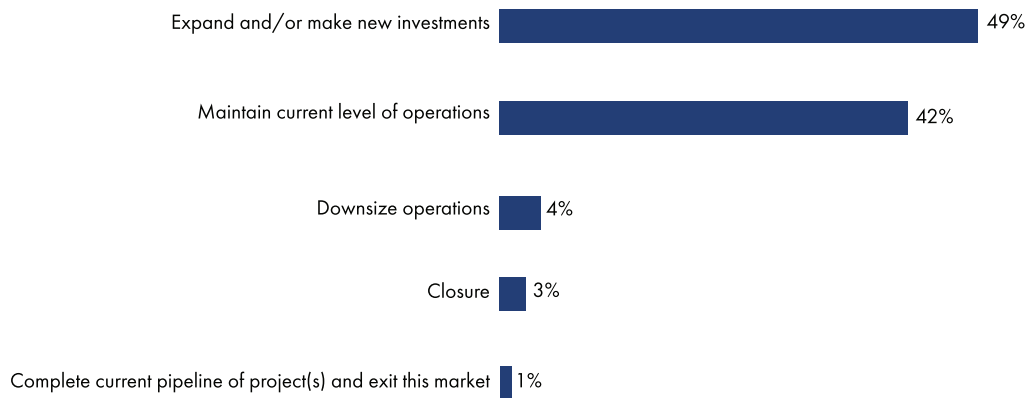
### Q8. How do you evaluate the current state of the industry you operate in?



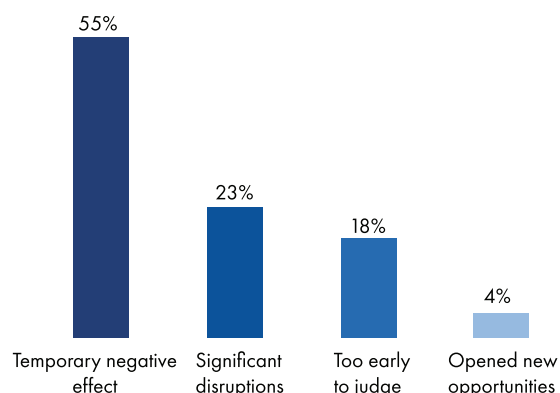
### Q9. What would best describe your operations in Azerbaijan?



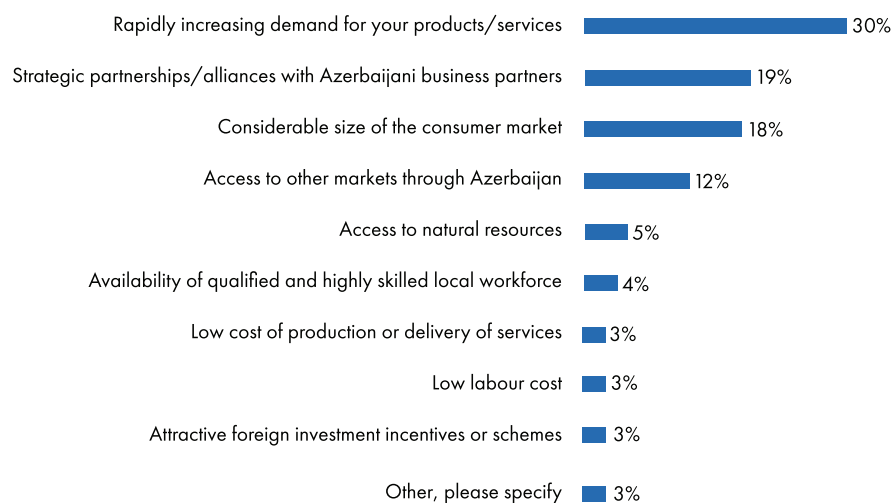
### Q10. What are your business targets for 2020 and 2021 financial years in Azerbaijan?



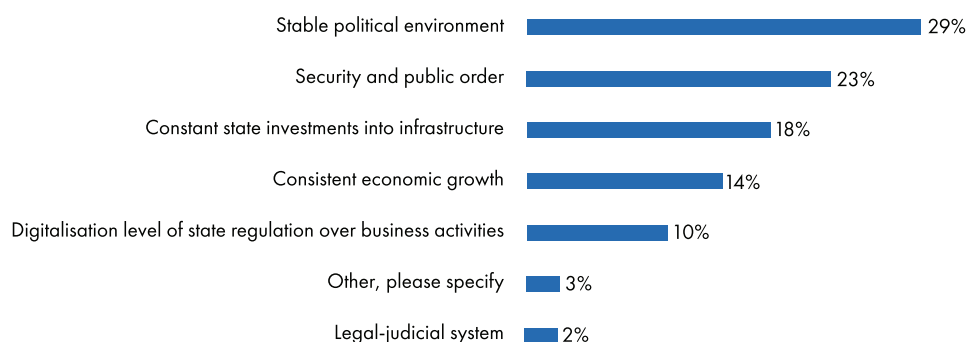
## Q11. How has the Covid-19 pandemic impacted your business performance in Azerbaijan?



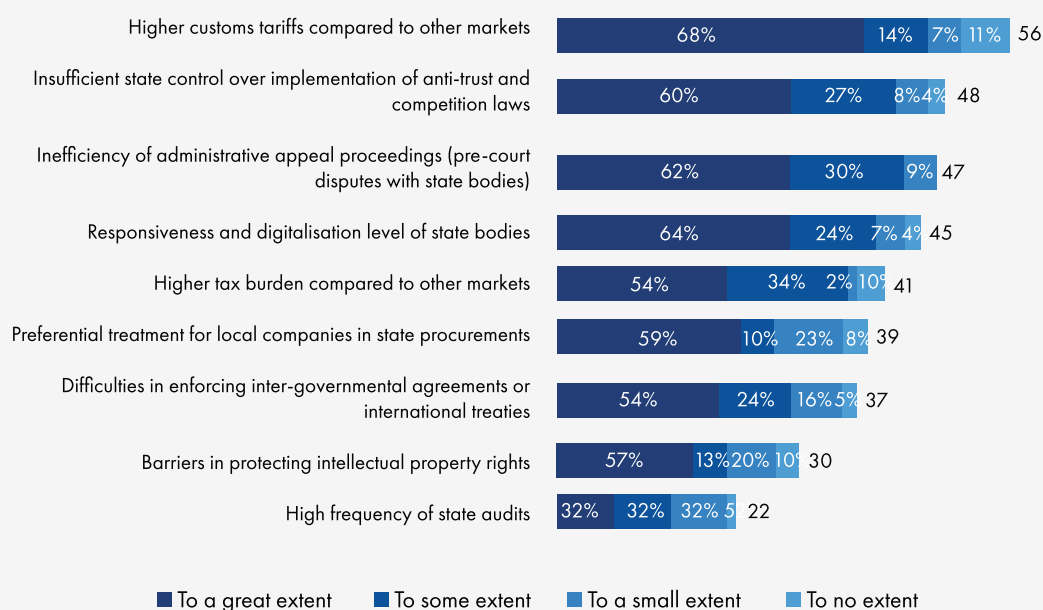
## Q12. Which of the below factors affected your decision to enter and/or maintain operations in the Azerbaijani market? (You can choose more than one)



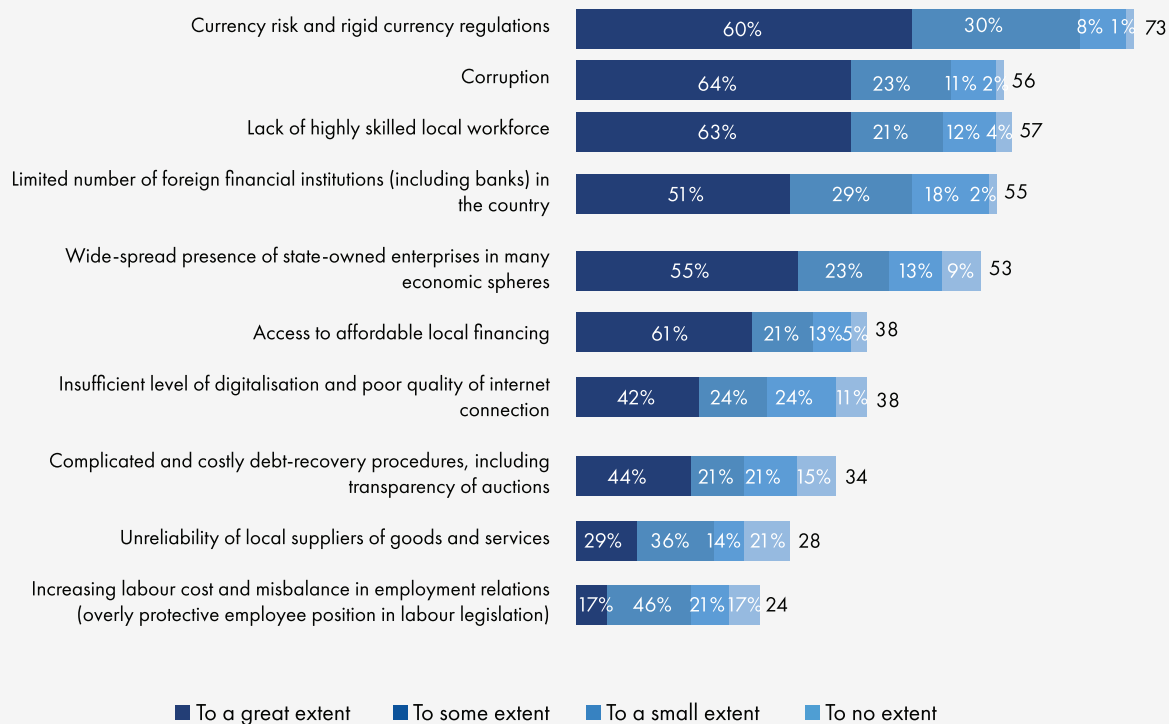
## Q13 Which of the below would you regard as the strong attributes of business environment in Azerbaijan? (You can choose more than one)



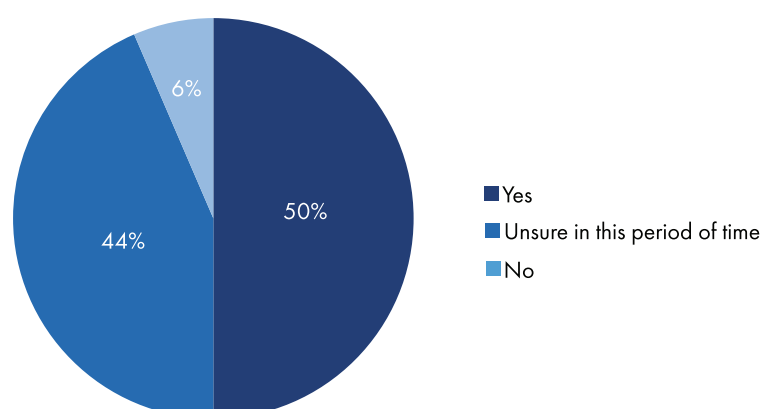
## Q14. Please rank your state regulatory challenges in conducting business in descending order starting with most critical ones.



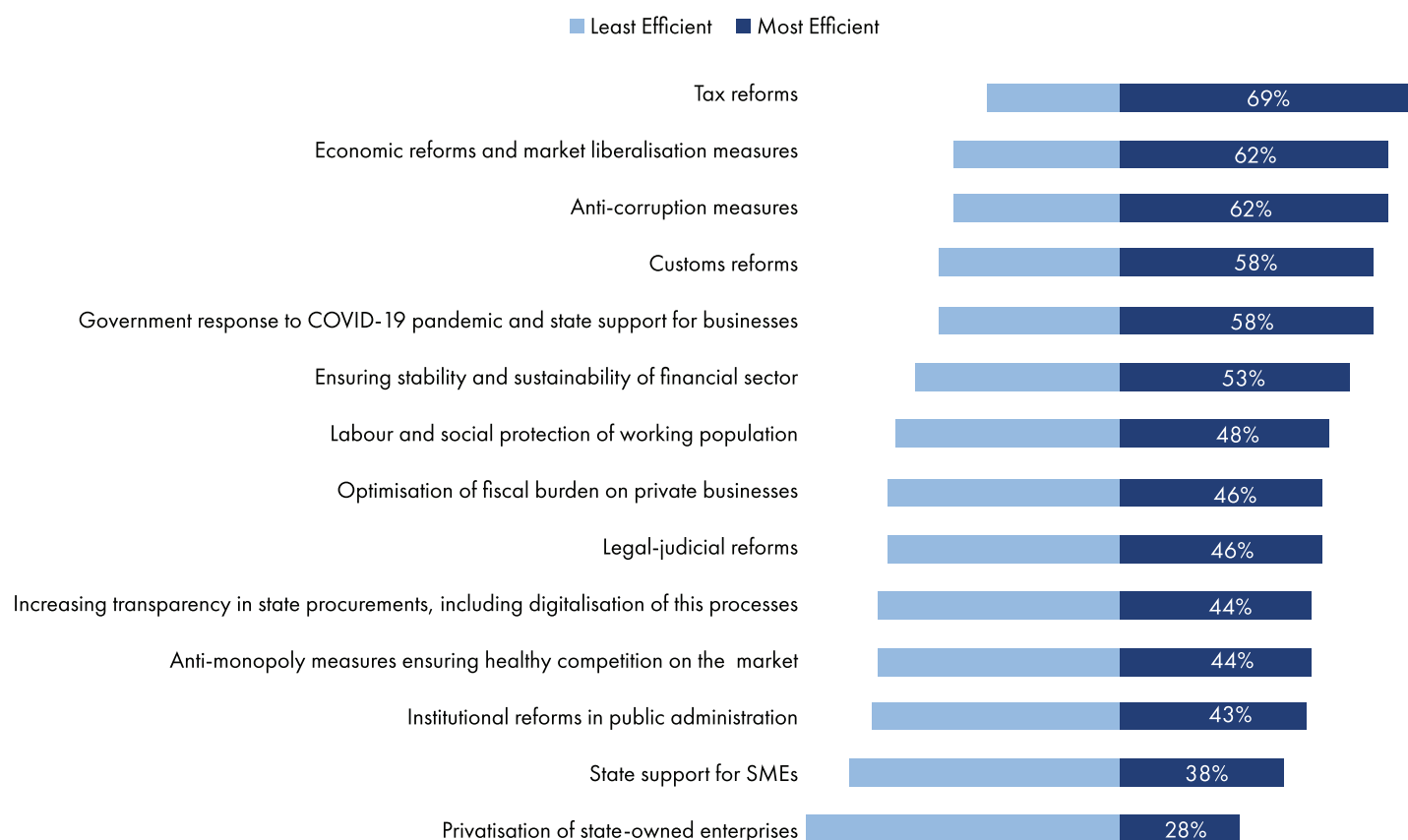
## Q15. Please rank your operational and economic challenges in conducting business in descending order starting with most critical ones.



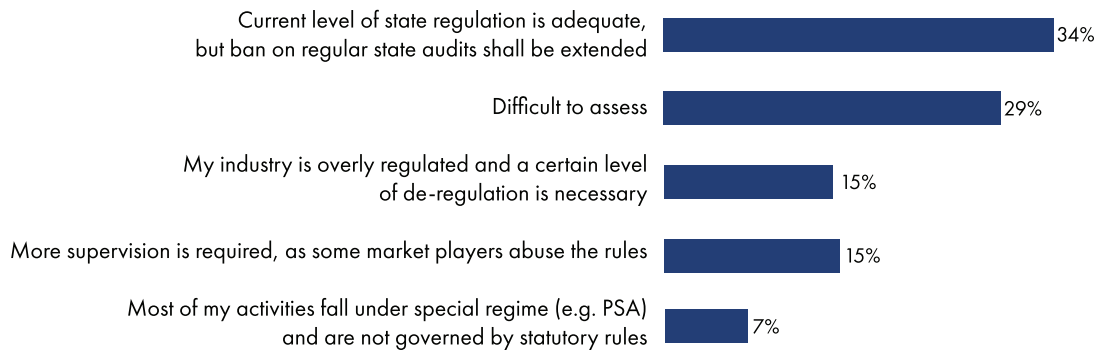
## Q16. Would you recommend Azerbaijan as a good location for business investments?



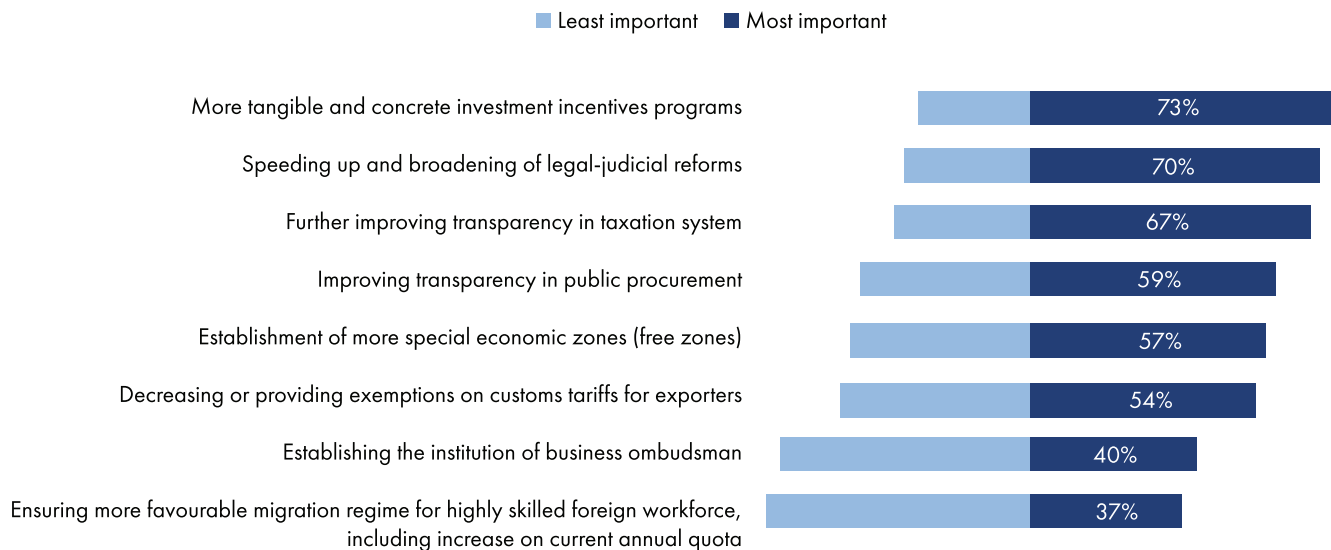
## Q17. Please rank the efficiency of reforms in the below mentioned areas in descending order starting with the most efficient ones.



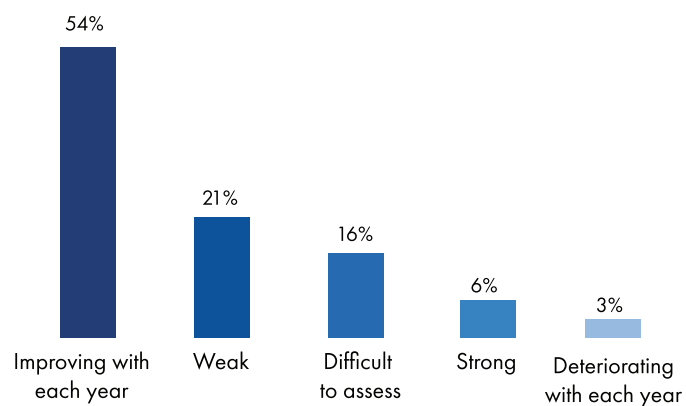
## Q18. How do you assess the current level of state regulation over business activities?



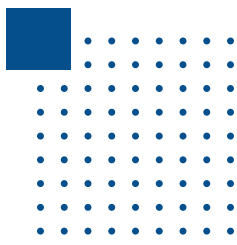
## Q19. Which of the following reforms do you consider more needed to ensure FDIs in Azerbaijan? (Please rate in descending order starting from most important ones)



## Q20. How do you assess the level of public-private dialogue in Azerbaijan?

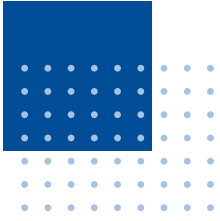






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