Foreign Direct Investment in Azerbaijan's Economy: Current Status, Development Trends and Challenges

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It is of particular importance for Azerbaijan, seeking to reduce reliance on oil and gas revenues by diversifying its economy and exports, to attract foreign direct investment (FDI) to non-oil sectors, particularly to the processing industry. Thus it is altogether appropriate that the first major indicator out of the four outlined in the government's plan titled the Strategic Roadmap of the National Economy Prospects[i] is to reach a 4 per cent share of non-oil foreign direct investment in GDP until 2025 (compared to 2.6 per cent in 2015).

Hydrocarbon-rich Azerbaijan's oil and gas sectors have always been attractive for foreign investment: out of $77.8 billion of FDI to the country's economy from 2000 to 2017, more than 85 per cent, or $ 66.8 billion, went to the oil and gas sectors. Moreover, foreign investors had insufficient interest in the country's non-oil/gas sector, especially the processing industry during that period. Foreign investors' little interest in Azerbaijan's non-extractive industries is certainly thought-provoking, as they had invested heavily in the oil and gas sectors. In order to achieve an increase in FDI flows to these sectors, steps should be taken to identify and eliminate the factors that constrain foreign investors. The effectiveness and competency of the Government's decisions on promoting investment activity is also among the issues, which should be reevaluated.

Literature Summary

The competition to attract FDI among countries has been acute, especially in recent decades. Therefore, the issue of determining the factors that ensure the attractiveness of an economy and government policies for FDI is one of the key topics that is in the spotlight of purely scientific research, as well as practical studies of international organizations and national governments.

UNCTAD (United Nations Conference on Trade and Development) prepares and publishes annual World Investment Report, focusing on growth dynamics, analysis of related government policy measures and trends on foreign direct investment (FDI) worldwide[ii]. Under World Investment Report 2018 on Investment and New Industrial Policies, global foreign direct investment (FDI) flows fell by 23 percent, from $1.87 trillion in 2016 to $1.43 trillion in 2017.[iii] In 2017, 65 countries and economies adopted at least 126 investment policy measures (versus 124 investment policy measures adopted by 58 countries and economies in 2016), of which 84 percent were favorable to investors. They [countries and economies] liberalized entry conditions in a number of industries including transport, energy and manufacturing, the report says.

The World Bank Group's "Global Investment Competitiveness Report 2017-2018: Foreign Investor Perspectives and Policy Implications" presents a groundbreaking survey of 754 executives of multinational corporations investing in developing countries.[iv] The report assesses the effectiveness of fiscal incentives in attracting FDI.

Certain regional organizations, along with international development institutions, conduct researches on FDI flows. In particular, results on Azerbaijan in those reports conducted within Eurasia and CIS are of great interest. For example, the Eurasian Development Bank's Report "Monitoring of Mutual Investments in CIS Countries 2017" finds that by the end of 2016, Azerbaijan's direct investment stock in CIS countries and Georgia approached $2.4 billion. However, as a recipient

of FDI originating from CIS countries and Georgia, Azerbaijan's achievements as a capital importer are much more modest: $0.91 billion ($0.89 billion of which came from Russia).[v] "EAEU and Eurasia: Monitoring and Analysis of Direct Investments 2017", a second report by the Eurasian Development Bank, finds that Azerbaijan is the top capital exporter among CIS countries, that are not members of the Eurasian Economic Union, since the average annual increase of Azerbaijani FDI in non-CIS Eurasian countries was 41 percent during the last five years (2012-2016).[vi] By the end of 2016, the total amount of Azerbaijan's direct investments to the countries in the region reached $16.9 billion and almost three-fourths of all Azerbaijani investments are concentrated in Turkey, according to the report.

Dynamics and trends of FDI flows to Azerbaijan's economy

It can be said that the history of FDI flows to independent Azerbaijan's economy goes to 1995. An end to the political instability, which had been reigning over Azerbaijan since it regained its independence in 1991, the ceasefire reached in the Nagorno-Karabakh war[vii] and, in particular, the signing of the agreement on joint development and production sharing (PSA) for the Azeri Chirag fields and the Deep Water Portion of the Guneshli Field (ACG) in the Azerbaijan Sector of the Caspian Sea[viii] paved the way for foreign investment flows to Azerbaijan.

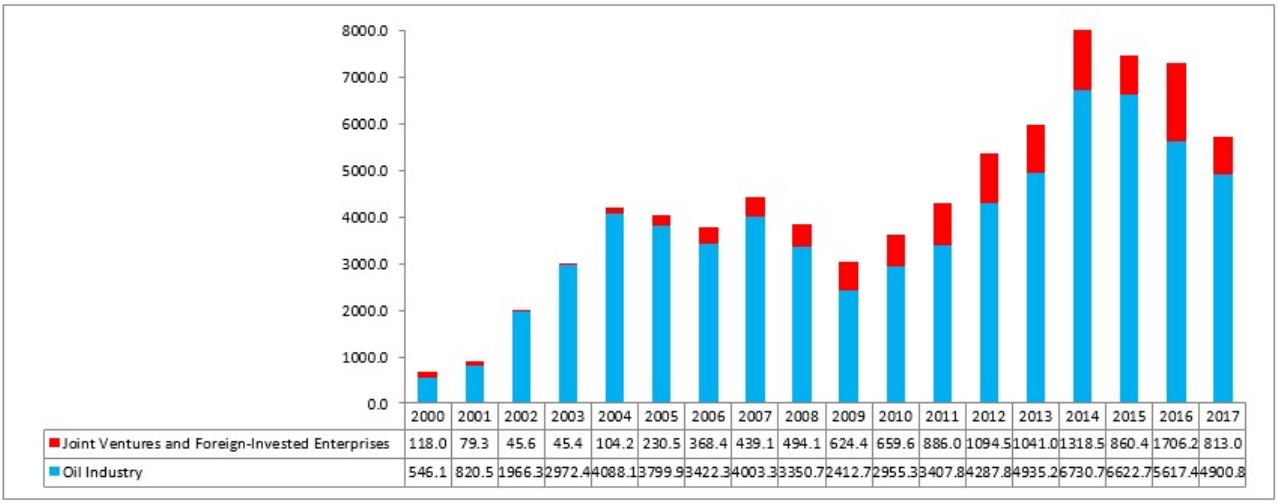
Azerbaijan had FDI flows of $125.5 billion between 1995 and 2017, including $120.6 billion (96.1 percent) from 2000 to 2017, according to the State Statistical Committee (SSC). $29.2 billion (24.2 percent) of the all foreign investments between 2000 and 2017 were loans the Government of Azerbaijan and state-run and private firms had received from a variety of international finance and credit institutions. $77.8 billion (64.5 percent) were direct investments, $217.7 million (0.2 percent) were bonus payments under oil agreements, and the remaining $13.4 billion (11.1 percent) were other investments

(mainly portfolio investments).[ix]

Out of the total FDI of $77.8 billion into Azerbaijan's economy between 2000 and 2017, $66.8 billion, or 85.9 percent, went to the oil sector, while $19.9 billion (14.1 percent) went to the non-oil sector.

FDI stock in the oil sector has always been greater than in the non-oil sector (*see Figure 1*).

Figure 1: Dynamics of Oil and Non-Oil Foreign Direct Investment (in millions of USD)

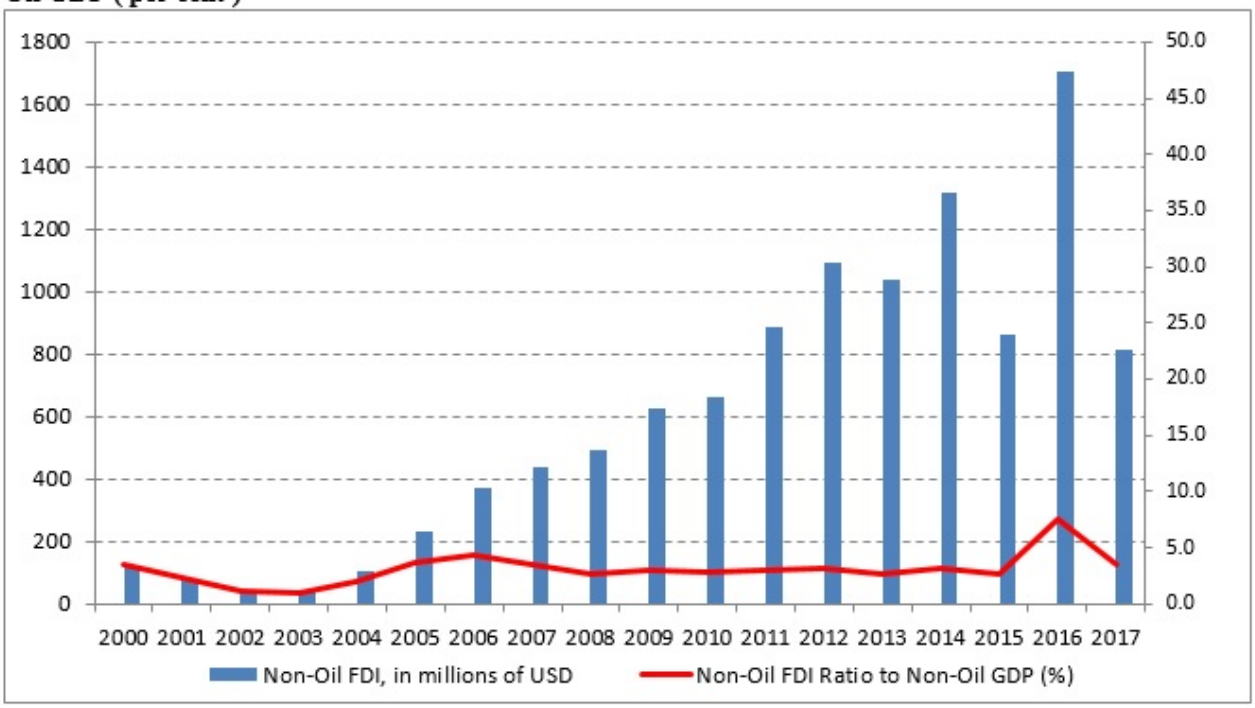


	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Joint Ventures and Foreign-Invested Enterprises	118.0	79.3	45.6	45.4	104.2	230.5	368.4	439.1	494.1	624.4	659.6	886.0	1094.5	1041.0	1318.5	860.4	1706.2	813.0
Oil Industry	546.1	820.5	1966.3	2972.4	4088.1	3799.9	3422.3	4003.3	3350.7	2412.7	2955.3	3407.8	4287.8	4935.2	6730.7	6622.7	5617.4	4900.8

Source: State Statistical Committee (SSC)

In 2008, non-oil FDI was $500 million, and reached $1 billion in 2012. From 2003 to 2014, there was a gradual increase in non-oil FDI. However, the last three years (2015-2017) saw a sharp volatility in non-oil FDI. It fell by 34.7 percent in 2015, yet there was a considerable growth of 98.3 percent ($1.7 billion) in 2016 and then in 2017 it fell by 52.4 percent (more than twice) (*see Figure 2*) again.

Figure 2: Dynamics of Non-Oil FDI by Years (in millions of USD) and Non-Oil FDI Ratio to Non-Oil GDP (per cent)



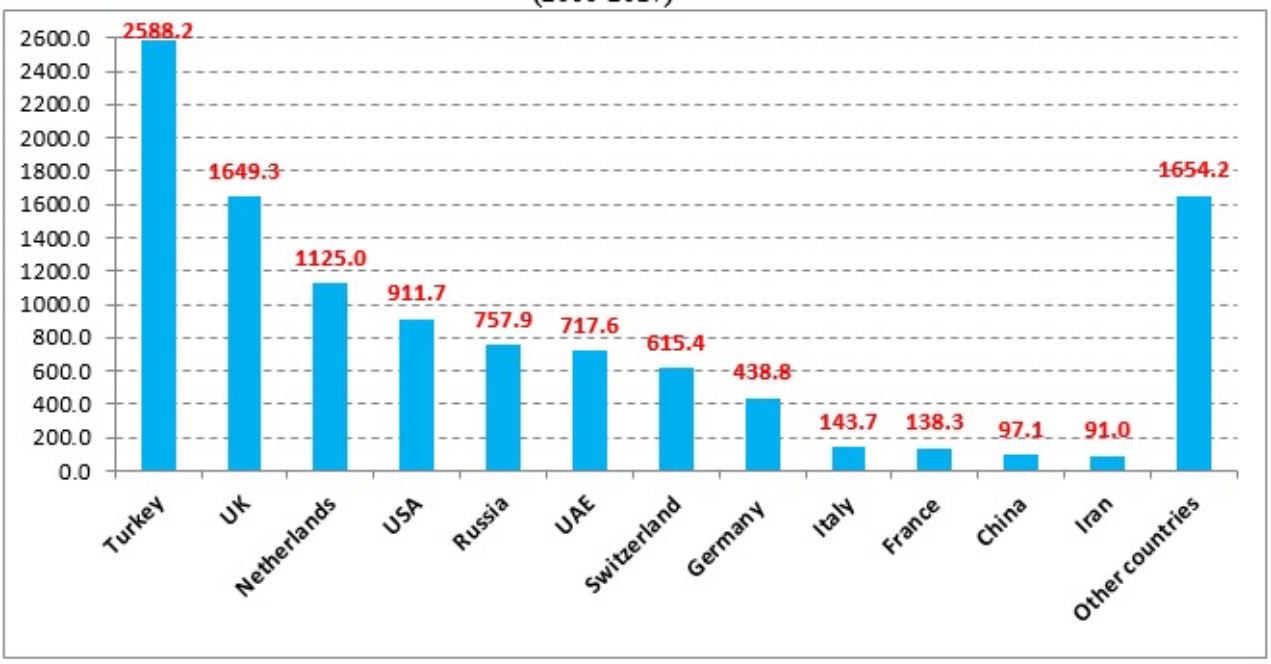
Source: Prepared on the basis of data from the State Statistical Committee (SSC)

The ratio of Azerbaijan's oil FDI to annual oil GDP had been more than 20 percent until 2007 (it even exceeded 150 percent in 2004), yet it varied between 10 and 20 percent from 2008 until 2013 and exceeded 30 percent in 2015.

In contrast, in most years the ratio of non-oil FDI to non-oil GDP has been below 3 percent (only slightly exceeding 3 percent during some years) and rose to 7.6 percent in 2016. The sharp change during that year was mainly due to the sudden decline in non-oil GDP: in 2016, non-oil GDP stood at about $22.5 billion, falling 46.8 percent from $42.3 billion in 2014. It was a 32.4 percent decline from the 2015 level, when the non-oil GDP was $33.3 billion. In 2017, the ratio of non-oil FDI to non-oil GDP dropped to 3.5 per cent as a result of a decline in FDI flows. *(It should be noted that the government's goal "to raise non-oil FDI to the level of 4 percent of GDP by 2025" as outlined in the Strategic Roadmap of the National Economy Prospects would prove deficient in this regards, as it does not take into consideration the fact that national currency rate can can have a significant impact on this ratio.*)

FDI to the non-oil sector reached $10.9 billion between 2000 and 2017, accounting for 3.3 percent of the total non-oil GDP in the same period. According to the State Statistical Committee, out of the total non-oil FDI stock exports to the country during this period (2000-2017), $2.5882 billion (23.7 percent) were investments from Turkey, $1.6493 billion (15.1 percent) from the UK, $1.1250 billion (10.3) from the Netherlands, $911.7 million (8.3 percent) from the United States, $757.9 million (6.9 percent) from the Russian Federation, $717.6 million (6.6 percent) from United Arab Emirates (UAE), $615.4 million (6.6 percent) from Germany, $143.7 million (1.3 percent) from Italy, $138.3 million (1.3 perceny) from France, 97.1 million (0.9 percent) from China and $91.0 million (0.8 percent) from Iran (*see Figure 3*).

Figure 3: Countries of Origin of Foreign Direct Investments to Azerbaijan's Non-Oil Sector (2000-2017)

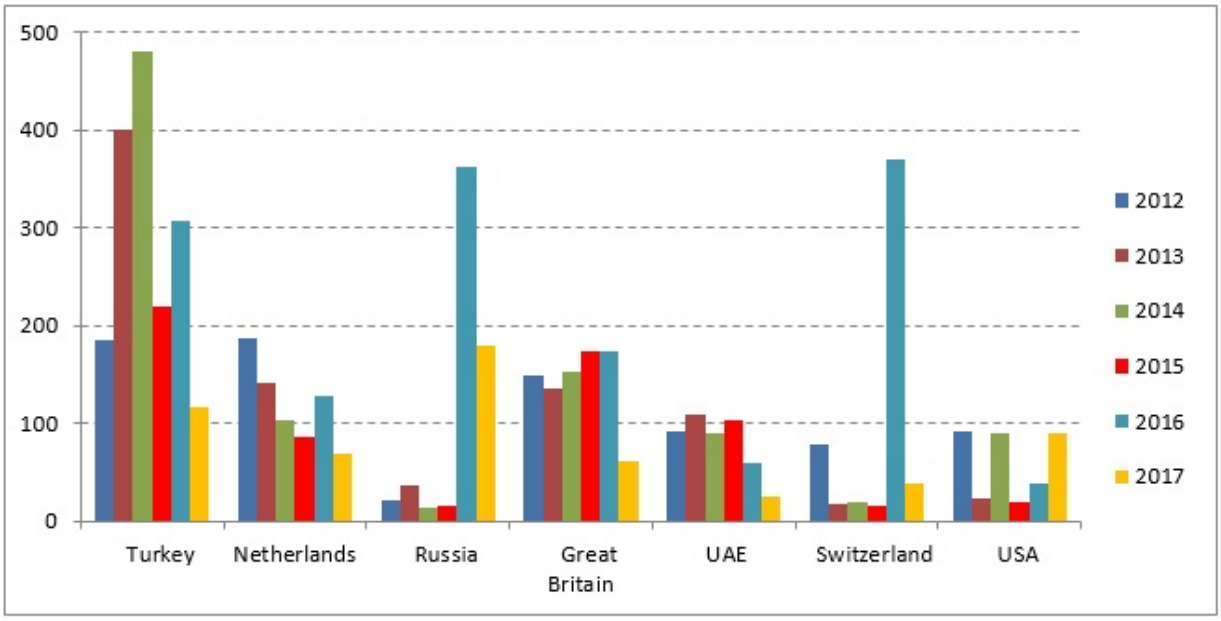


Source: State Statistical Committee (SSC)

Turkish investors, with the exception of some years, have always maintained a leading role in in Azerbaijan's non-oil sector. Additionally, there were investments from the US, UK, UAE, German, French and Russian companies as well. However, the country has seen a sharp growth in investments from Russian, Turkish and Swiss companies in the past 2-3 years after the drop in non-oil FDI inward stocks in 2015: out of

$1.7 billion FDI stock, $1.04 billion, or 61 percent, fell to the share of the three countries (*see Figure 4*).

Figure 4: Dynamics of FDI from some of the Largest Investing Countries to Azerbaijan's Non-Oil Sector (2012-2017)



Source: State Statistical Committee (SSC)

In 2016, the largest inward FDI inward stock into Azerbaijan's non-oil sector was from Switzerland, amounting to $370.5, and accounting for 60.2 percent of total inward non-oil FDI flows to Azerbaijan from Switzerland from 2000 to 2017. The second largest investor of inward FDI investments in Azerbaijan in 2016 was Russia, with inward flows amounting to $363.2 million. It should be noted that 71.6 per cent ($542.2 million) of total inward FDI flows to Azerbaijan's non-oil sector originating from Russia had been recorded in the past two years (2016 and 2017).

Meanwhile, SSC revealed the amount of inward FDI flows to Azerbaijan's non-oil sector by country, but details of areas impacted by FDIs are unavailable. The balance of payments by the Central Bank of the Republic of Azerbaijan only presents the amount of FDIs to the non-oil sector; however, projects and areas impacted by FDIs are unavailable.[x] Therefore, it is difficult to explain the sharp increase in FDI stocks originating from Russia and Switzerland even in 2016. The

increase could be due to Gazprombank's loan to finance the SOCAR Polymer project, a resident of the Sumgait Chemical Industry Park (SCIP): 60 percent ($450 million) of the $750 million project[xi] came from the Gazprombank's loan.[xii]

During FDI flows to the non-oil sector, it is also important to track the foreign investment in fixed capital by sectoral divisions and businesses operations of joint ventures and foreign-invested enterprises in the country. According to Azerbaijan's Minister of Economic Development Shahin Mustafayev, over 9,000 foreign companies engaged in different fields of the economy had so far been registered in Azerbaijan.[xiii] Moreover, the State Statistical Committee reports that as much as 1,424 joint ventures and foreign-invested enterprises run in Azerbaijan in 2017 (compared to 551 in 2000, 1,091 in 2010, and 1,235 in 2015). 528 (37 per cent) of the joint ventures and foreign-invested enterprises in 2017 were engaged in trade and maintenance, 271 (19 per cent) industry (including oil and gas), 151 (10.6 per cent) professional, science and technical activity, 138 (9.7 per cent) construction, 74 (5.2 per cent) transportation and storage, 41 (2.9 per cent) information and communication, 41 (2.9 per cent) accommodation and food service activities, and 30 (2.1 per cent) farming and fishing.[xiv] There are no data on the country of origin of joint ventures and foreign-invested enterprises in Azerbaijan.

Out of the total fixed capital formation of AZN 8.7 billion (including FDI) in Azerbaijan's economy in 2017, AZN 6.3 billion (72.6 per cent) were formed in the extraction industry (oil and gas output in particular) and AZN 2.4 billion in other economic spheres, according to the State Statistical Committee (SSC). [xv] Out of the total non-oil/non-gas foreign investments in fixed capital, 1.07 billion AZN (about 45 percent) fell to the share of construction, 548.1 million AZN (22.8 percent)to transportation and storage, 468.9 million AZN (19.5 percent) to water supply, and 200 million AZN (8.3 percent) to electricity, gas, steam and air conditioning

supply.

The sectoral structure of foreign investments in fixed capital in 2017 has remained almost unchanged in the last three years (2015-2017). Our calculations based on SSC data [xvi] show that extractive industry (mainly oil and gas industry) received 75 percent of foreign investments' share (18.6 billion AZN out of 24.8 billion AZN) directed to the main capital from all sources during the last three years. The rest, which is 6.2 billion AZN, of foreign investment was directed to construction (51.3 percent or 3.2 billion AZN); storage business (21.2 percent or 1.3 billion AZN); water supply (18.2 percent or 1.14 billion AZN) and electricity supply (4.6 per cent or 288.5 million AZN). In contrast, during the last three years farming, forestry and fishery received 76.8 million AZN (1.2 percent), processing industry received 48.2 million AZN (0.8 percent), information and communication 22.0 million AZN (0.3 percent) foreign investments to the fixed capital.

It should be noted, that the bulk of foreign investments in water and electricity supply are comprised of loans provided by international financial institutions.

Thus, construction and storage as non-trade sectors seem to be more attractive for foreign investors in terms of inward FDI flows to the non-oil sector. Manufacturing areas, such as processing and farming in particular, have failed to attract significant FDI flows. However, the Strategic Roadmap of the National Economy Prospects signed by President Ilham Aliyev in late 2016 defines farming, information, and communication, small and medium-sized enterprises that produce consuming products, in addition to transportation and tourism as priorities.

How do investors know Azerbaijan?

To attract FDI, foreign investors must be well aware of the country and its expected development perspectives, business

and investment environment in the country and potential changes to this environment. The literature (Dunning and Lundan 2008) distinguishes between four kinds of FDI depending on the source of motivation for FDI inflows to the country: i) natural resource-seeking; ii) market (market size and accessibility) seeking; iii) strategic asset-seeking in the domestic market; and iv) efficiency-seeking to save costs. [xvii] The authors find that depending on the source of motivation and the type of investment, investors have different reactions to the government's political decisions in the destination country and the overall investment environment in the country. In their opinion, natural resource and strategic asset seeking investors are not too sensitive to the changes in the investment climate, while those seeking cost-saving motivations are too sensitive to changes that could increase their costs hampering free exchanges. Processing industry and other sectors could be interesting for investors in terms of cost-saving market size.

Since mid-2015, the Government of Azerbaijan has adopted and implemented measures to improve business and investment environment in the country (simplifying the process of license and permits obtainment) and extended the moratorium on inspections of business activities until 2021 to promote investments (for example, the application of the document "investment promotion certificate" and tax exemption for individuals who get this certificate valid for 7 years from the date of obtaining it, as well as full exemption from customs duties upon import of technological equipment for the high priority industry lines), to create industrial parks (full exemption from customs duties and VAT upon import of technological equipment by resident legal entities and individuals of industrial and technological parks for construction and research & development purposes for seven years from the date of obtaining investment promotion certificate), to support domestic production and protect internal market, to stimulate non-oil exports (application of

export promotion, organization of missions to foreign countries and opening of trade houses abroad), to apply progressive mechanisms for import and export operations (green corridor, electronic declaration, etc.) and to provide subsidies to some agricultural products.

Information about investment promotions, as well as business and investment environment in the country has been, to some extent, posted in three languages on the website of Azerbaijan Export and Investment Promotion Foundation (AZPROMO).[xviii] According to the website, currently Azerbaijan has double tax treaties with 51 countries and bilateral investment agreements with 47 countries. The web content has been greatly expanded compared to the previous two years. However, the information on AZPROMO's website is more limited, compared to that of the World Association of Investment Promotion Agencies (WAIPA). Even the Bureau of Economic and Business Affairs (EB) of the U.S. Department of State has posted broader information about Azerbaijan's business and investment environment in its *2017 Investment Climate Statements* Report.[xix]

Moreover, the document called "Favorable tax environment for foreign investments in the Republic of Azerbaijan" posted on the website of the Ministry of Taxes is not updated in a timely manner. Macroeconomic indicators are outdated. The most recent information cover 2016. It should have been updated taking into consideration amendments to the legislation in 2017 and beyond.[xx] It is very important to expand and update information that introduces Azerbaijan and the country's business environment to the world. According to international experts, investors are more interested in information on the country's future development rather than the current state of investment, because such information allows investors to evaluate their future expectations.[xxi] Therefore, it is important that the information posted on the web and other sources reflect the potential and development perspectives for different sectors of the country's economy, as well as the current situation.

As far as how the environment should be in the country to attract FDI, it is worth looking at the World Bank Group's document named "Global Investment Competitiveness Report 2017-2018: Foreign Investor Perspectives and Policy Implications". According to a groundbreaking survey of 754 executives of multinational corporations investing in developing countries, the following are the most important factors in investment decisions:

1) Political stability and security (50 percent of investors rate this as a critically important factor and 37 percent as an important factor); 2) Legal and regulatory environment (40 and 46 percent, respectively); 3) Large domestic market size (42 and 38 percent); and 4) Macroeconomic stability and favorable exchange rate (34 and 44 percent).[xxii]

Next factors are: Available talent and skill of labor (28 and 45 percent); Good physical infrastructure (25 and 46 percent); Low tax rates (19 and 39 percent); Low cost of labor and inputs (18 and 35 percent); Access to land or real estate (14 and 28 percent); and Financing in the domestic market (16 and 28 percent).

In this report's survey, investors also seek predictability and efficiency in the implementation of laws and regulations. In this regard, investors rate following factors as very important and important respectively: transparency and predictability in the conduct of public agencies" (37 and 45 percent), investment protection guarantees provided in the country's laws (45 and 36 per cent), ease of obtaining government approvals to start a business and to own all equities in the company (36 and 41 percent). Investment incentives, such as tax holidays (21 and 35 percent), having a preferential trade agreement (14 and 40 percent) and having a bilateral investment treaty (15 and 36 percent) are ranked further below.

Reports by a variety of international development

institutions, such as EU Business Climate Report Azerbaijan 2018,[xxiii] as well as their ratings updated on a regular basis play an important role in assessing the situation on Azerbaijan in accordance with the abovementioned factors.

Although Azerbaijan climbed 23 spots to rank 57th (from 80th in 2015) in the Doing Business 2018 across 189 economies[xxiv], there is a need to improve the following factors: Dealing with construction permits (161), Getting electricity (102), Getting credit (122) and Trading across borders (83).

In the World Economic Forum's Global Competitiveness Index 2017-2018 edition, Azerbaijan climbed from 51st place in 2010 (133 economies ranked) to 35th place in 2018 (137 economies ranked).[xxv] However, Azerbaijan's relatively poor ranking in such areas as financial market development (79th), health and primary education (74th), higher education and training (68th), macroeconomic environment (65th), market size (63rd) and technological preparedness (56th) urges the government to implement significant reforms.

Azerbaijan's economic freedom score of 64.3 in the Heritage Foundation's 2018 Index of Economic Freedom elevated its status to "moderately free" from "repressed", with the score of 49.8 in the same Index published in 2010.[xxvi] However, low judicial effectiveness (36.8), government integrity (39.9), investment freedom (55.0) and property rights (53.6) scores could bar investors from investing in Azerbaijan's economy.

Corruption Perceptions Index 2017 of Transparency International ranks Azerbaijan 112th among 175 countries with a score of 31 out of 100. The index found that Azerbaijan had made little progress in ending corruption: it scored 27 out of 100 in 2012.[xxvii] This index is reliable and taken

seriously by investors worldwide.

It is also clear that Azerbaijan's poor ranking among European economies (45th out of 46 countries) in the EuCham's report "Best European countries for business 2018" (based on indexes of the World Bank and Transparency International) [xxviii] makes investors very skeptical about this country.

The Fragile States Index, produced by the U.S.-based Fund for Peace, is based on twelve key political, social and economic indicators. In the 2018 index, Azerbaijan ranks 78th among 178 countries with a total score of 74.6 (out of maximum 120) and is placed in the group of countries of elevated warning.[xxix]

The World Bank Group's Worldwide Governance Indicators (WGI) with a percentile rank (0 to 100) has been measuring six dimensions of governance since 1996: In the 2016 Index, Azerbaijan received a very low score (7.39) on Voice and Accountability. It scored 17.62; 17.79, 31.73, 43.75 and 49.04 on five other indicators, namely on Political Stability and Absence of Violence/Terrorism; Control of Corruption; Rule of Law; Regulatory Quality; Government Effectiveness, respectively[xxx], with the total score averaging below 50.

The Legatum Prosperity Index™ (which began in 2006) prepared annually by UK's The Legatum Institute captures the breadth of prosperity across nine pillars of prosperity using 104 indicators. Azerbaijan was ranked 106th (53.33 scores) out of 149 nations on the 2017 Legatum Prosperity Index. Its sub-index scores were as following: Natural Environment (138), Social Capital (137), Governance (128), Personal Freedom (123), Economic Quality (98), Business Environment (81), Health (71), Safety & Security (70) and Education (46).[xxxi]

Thus, based on our analyses and Azerbaijan's rankings in the indexes of respected foreign institutions, we can conclude that in order to attract FDI to the non-oil sectors of the

country's economy the government needs to significantly improve investment climate by carrying the very much needed reforms. These reforms, in addition to tax preferences and extension of subsidies, must encompass other issues sensitive for investors, such as:

- Increasing governance transparency and accountability and ending corruption;
- Providing property protection guarantees;
- Complying with the principle of an independent and fair court system;
- Expanding economic freedoms;
- Improving the legal and regulatory environment (ensuring the rule of law, ensuring equality before the law, predictable behavior of government agencies, refusing to adopt government measures that affect business expenses and revenues without public discussion, ensuring the validity of such a change at least after six month of its adoption, etc.);
- Preparing and adopting a single Government policy to attract FDI;
- Adopting a new Competition Code and law on the protection of foreign investments.

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[viii] The Production Sharing Agreement (PSA), dubbed “the contract of the century”, was signed on September 20, 1994 in Baku by the Government of Azerbaijan and a consortium of 10 foreign oil companies from seven nations, and was ratified by the Azerbaijan Parliament in December the same year.

[ix] Source: based on data posted on SSC’s web; Azerbaijan’s statistical indicators-2018. Baku, SSC, 2018; https://www.stat.gov.az/menu/6/statistical_yearbooks/

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