



**Azerbaijan
Country Partnership Strategy
2017-2018**

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I. Main Economic Indicators

	2012	2013	2014	2015	2016
Population (mid-year; mln)	9.2	9.3	9.34	9.41	9.5
Average exchange rate (Local currency/USD)	0.8	0.8	0.8	1	1.6
Inflation rate (CPI average; %)	1.1	2.4	1.4	4.0	12.4
GDP at current prices (local cur.,bln)	54.7	58.2	59.0	54.4	60.4
GDP at current prices (USD bln)	69.7	74.2	75.2	53.0	37.8
GDP / capita (in cur. prices; USD)	7594	7977	7991	5562	3927
Real GDP growth (%)	2.2	5.8	2.8	1.1	-3.1
Unemployment rate (ILO definition; eop; %)	5.2	5.0	4.9	5.0	5.9
Direct foreign investment (USD bln)	2.0	2.62	4.41	4.05	4.5
Central Gov. Budget balance /GDP (%)	-0.2	0.6	-0.5	-0.5	-0.4
Gross Government Debt/GDP (%)	13.8	12.6	11.2	28.3	22.3
Export (fob, USD bln)	32.63	31.78	28.26	15.59	13.21
Import (fob, USD bln)	10.42	11.16	9.33	9.77	9.0
Trade balance (exp. fob. - imp.fob.; USD bln)	22.21	20.62	18.93	5.82	4.21
Current account balance (USD bln)	14.9	12.3	10.4	-0.22	-1.36
Current account / GDP (%)	21.41	16.61	13.86	-0.42	-3.60
Official reserves (incl. gold; eop; USD bln)	11.2	15	15.4	7.9	7.1

Source: IMF & ADB

II. Economic Overview and Outlook

Real Sector

Azerbaijan's economic growth was averaging above 15% in the decade preceding the global economic crisis while this performance boosted above 20% in the five year period approaching 2009. All this has dramatically changed in the post-global crisis years where average growth fell below 5%. In 2011, real GDP went up only 0.1% as the economy escaped contraction for the first time since 1995 mainly due to a 10.6% fall in oil output. In 2012 growth moderately accelerated to 2.2% as decline in oil production was more than offset by the expansion of non-oil sector, led by construction and services.

Azerbaijan's real GDP growth contracted by 3.1% in 2016 compared to 1.1% growth realized in the previous year. Non-oil sector's GDP growth shrank by 4.5% and it constitutes 65.9% of the overall GDP. The decline in growth was mainly on account of negative oil price shock, fall in oil production, and shrinking of domestic demand and public investment.

The industrial sector which constituted 37.2% of GDP rose slightly by 0.3% compared to previous year's growth of 1.6%. The primary factor for the dismal performance was the significant drop observed in the construction sector which fell by 22.9% due to curtailing of public investment. Services which constituted 39.1% of GDP contracted by 0.7% compared to 4.4% growth realized last year. The slowdown was on account of deceleration witnessed in financial and transport services. Agriculture sector which constituted 5.6% of GDP grew by 2.6% underpinned by growth in livestock and key crops significantly below the 6.6% growth realized last year.

External Sector

Azerbaijan's exports contracted fourth year in a row and in 2016 shrank by 15.2% to USD 13.2 billion compared to contraction of 44.8% witnessed last year. Exports shrank mainly on account of lower oil prices and cuts in oil production. Imports posted a decline of 7.9% and were realized at USD 9.0 billion compared to 4.7% growth recorded last year. The decline in imports was mainly on account of lower imports of cars, tobacco and pharmaceuticals. As a result, the trade balance shrank by 27.6% to USD 4.2 billion. Current account balance which switched to deficit last year further worsened in 2016 and stood at USD 1.36 billion and as percentage of GDP stood at 3.6%.

Fiscal Outlook

Fiscal policy in Azerbaijan is driven largely by oil income which accumulates in the State Oil Fund of Azerbaijan (SOFAZ) from which transfers are made to finance budget expenditures. Fiscal policy stance was tightened in 2016 as budget deficit narrowed to 0.4% of GDP in 2016 from 0.5% in 2015. Revenues as percentage of GDP stood at 29% down from 32.2% in 2015 as transfers from SOFAZ decreased by 6.3% due to government's desire to lessen the budget's dependence on oil income and decline in oil production by 1.5% also led to pressure on revenues. Outlays were realized at 29.4% of GDP and fell from 32.7% recorded in 2015.

The public sector balance sheet remains strong given the support from a large oil fund and low external debt. Public and publicly guaranteed debt rose slightly to 20.4% of GDP from 19.8% last year.

Inflation Dynamics and Monetary Policy

Over the last decade, there have been huge fluctuations in the average consumer price inflation as rates made huge swings ranging from 1% to 20%. But over the last two years price volatility has moderated. Average CPI annual inflation more than doubled to 2.4% in 2013 from 1.1% in 2012 due to higher civil service wages and expanding credit. The inflation rate tripled to 12.4% in 2016 from 4% in 2015 mainly on account of exchange rate pass through due to depreciation of manat in 2015 and rise of 14.7% in food prices.

In 2016 monetary and financial policy focus was to tame inflation and restructures the banking sector in the wake of the steep depreciation. On the inflation front, Central Bank of Azerbaijan (CBA) raised the policy rate four times in 2016 to combat high inflation and support the exchange rate. The policy rate stood at 15% as of September 2016 from 3% level in September 2015.

In 2015 with reserves falling and facing headwinds from external shocks CBA decided to devalue the manat and shift to managed float exchange rate regime towards the end of the year. Manat further depreciated by 13.6% in 2016. While the devaluation helped improve the competitiveness it also led to spike in balance sheet and liquidity risks. Dollarization remained high with 75.3% of the deposit in dollars but coming down from a high of 81.6% witnessed last year.

Future Outlook

Economic growth is projected to further contract by 1.1% in 2017 and is expected to rebound by 1.2% in 2018. The economic recovery is based on the assumption that oil and gas production will pick up once the expansion of Shah Deniz gas field comes on board. Next exports are also expected to increase as gas production increases.

Diversifying the economy by encouraging the non-oil sector to expand is of prime importance for the country. Government has launched large scale reforms to develop the non-oil sector and these efforts are expected to stimulate growth in agriculture and services sector.

Public and publicly guaranteed debt is expected to increase in the medium term as government raises funds to complete the Shah Deniz project and carry out investments in the agriculture sector. The current account is projected to realize a huge surplus equivalent to 5.9% of GDP underpinned by widening of trade balance and shrinking of services deficit. Remittances are also expected to rise as the Russian Federation recovers. Fiscal prudence will be adhered to limit deficit and government expects budget deficit including transfers from SOFAZ to equal 1% of GDP in 2017 and 0.98% in 2018.

III. Main Business Strategy

Within the framework of its business plan, the Bank continues to pursue a comprehensive program to encourage other ECO member states to become a member of the Bank. In this context, Azerbaijan with paid-in capital contribution of SDR 9.75 mln signed the Articles of Agreement establishing the Bank on 28 September 2012. Afterwards, the Milli Mejlis of the Republic of Azerbaijan has ratified the subject agreement and Azerbaijan has become the member of the Bank in 2013. As the new shareholder of the Bank having 2.98% share Azerbaijan continues its paid-in capital contribution payments through equal consecutive annual installments.

Azerbaijan's high economic growth period has been challenged during the post-global crisis years. Due to weak oil prices and lower oil production accompanied by fall in domestic demand, reduced public investment, the GDP contracted by 3.1% in 2016 and the current account fall into deficit. On the demand side, growth in consumption slowed with depreciation of the Azerbaijan manat and reduced consumer lending. Recovery in the economy is expected to turn up in 2018. The sustained oil prices with the onset of production from the gas fields projected to return the current account to surplus.

The Government is continuing with targeted programs to address challenges in inflation, unemployment and restructuring the banking system. Government efforts to strengthen agriculture and agro-processing and stimulate non-oil exports would catalyze the economic growth. Today, Azerbaijan faces a unique opportunity to propel itself into the ranks of a sustainable higher middle income country which would offer new challenges. Therefore, diversification of economy and development of non-oil industries became key strategic goal for the country. As a result of sound economic policy and economic reforms conducted in recent years, the country is expected to register favorable development results.

In recent years, the role of the private sector in the development of industry is growing. However, it will be crucial for Azerbaijan to continue in developing a sustainable financial sector that is able to support private sector development and economic diversification. In this respect, by cooperating with financial intermediaries, ETDB intends to support Azerbaijan's financial sector and further expand its financing programs in favor of SMEs and trade finance. Moreover, ETDB would put all its efforts to contribute and partnership towards financing small and medium scale projects to contribute the dynamic and balanced pace of development in the country.

This country strategy document is the primary analytical and planning tool that would enable ETDB to design, execute, monitor, review, and evaluate its operations in Azerbaijan. The Bank's role and priorities are defined according to (i) country development priorities and (ii) available resources, strategies and policies of ETDB. In this respect, ETDB will seek viable opportunities and will continue closely monitoring the developments in the Azerbaijan economy in order to stand prepared to support bankable projects. In close coordination with development partners, the Bank would align its operations with the development priorities of Azerbaijan and foster co-financing opportunities.

Macroeconomic stability, sustainable economic growth and a favorable business environment in Azerbaijan offer a wide range of business opportunities. The Bank supports long-term direction of development targets reflected in the concept of "Azerbaijan 2020: vision for the future", which envisage attaining a stage characterized by sustainable economic growth and high social welfare through developing non-oil industry, promoting innovative activities and increasing competitiveness.

The total disbursement level of the Bank in Azerbaijan reached to USD 6.83 million by the end of July 2017. The operations of the Bank in Azerbaijan are expected to grow over the coming years. Specifically, for diversification of economy, the ETDB will provide support for implementation of development projects in various sectors including agriculture, energy, rural infrastructure, transport, transit and logistical infrastructure, manufacturing, tourism, etc., foster trade finance and support development of small and medium-sized enterprises. Moreover, realization of projects on public-private partnership would be other focus areas for the Bank in its engagement with Azerbaijan.

The Bank will work with selected local financial institutions in Azerbaijan where such delegation of responsibility will assist the Bank in serving a targeted market segment more efficiently and effectively than the Bank might be able to do directly. Supporting expansion of the financial sector and improving financial inclusion is important in enhancing credit flow to development of real sector.

(i) Micro, Small and Medium Sized Enterprises (M-SMEs) Development Facility

Under this facility the ETDB provides loans to local banks and financial intermediaries for supporting development of loans extended to the M-SMEs. The main goal of these intermediated loans is to support growth and employment potential of the M-SMEs and poverty alleviation efforts. Thus, promoting the production and innovation capacity of vibrant SMEs in the member states remains a priority for the Bank.

Starting from late 1990's, restoration of macro-economic and political stability in Azerbaijan instigated an ideal atmosphere for the development of SMEs. The government's economic diversification agenda and support of the non-oil sector is galvanizing reforms for the development of the SME sector. The country has been quite active to support the SME sector by introduction of one-stop-shop company registration and a best practice e-government portal. Financial and institutional support measures for innovation and SME capacity building was also introduced. Given the importance of SME development for the country's diversification agenda, Azerbaijan would benefit from a more structured and strategic approach to SME policy, including the development of an SME strategy, co-ordination structure and implementation body. In particular, government initiatives have further improved the business enabling environment, and the country has become a top performer in some dimensions of the World Bank's Doing Business report. The significant part of the enterprises are involved in wholesale and retail trade, car and motorcycle repair, agriculture, forestry and fishery, construction, processing industry, vocational, scientific and technical spheres. Geographically, small business activity is heavily concentrated in Baku.

Since M-SME finance demand is still higher than the actual supply, the ETDB would contribute for the development of M-SME segment in Azerbaijan through local financial institutions- Banks and MFIs. The microfinance sector remains an attractive one, with strong growth and high profitability on average, thus reducing the incentives for MFIs to aggressively pursue SME clients. The Bank will also consider the options to find suitable partners to support the development of non-bank financial sector as well. The ETDB executed its first SME transaction of USD 3 million and with the stability expected in the economy in the coming months, ETDB expects to book more transactions as new financial institutions become partner under this facility.

(ii) Short Term Trade Finance Facility (STTF)

Trade finance is a distinct core business of the Bank. The STTF facility has been designed to strengthen the ability of local banks to support entrepreneurs throughout the member states to expand their trade transactions. The Bank offers a number of instruments designed to address funding needs of suppliers/exporters and /or buyers/importers.

While Azerbaijan's exports are mainly dominated by oil and natural gas, recent economic reforms in customs, licensing and permits, as well as incentives to encourage export-oriented manufacturing are welcome and expected to improve the ability of the non-oil private sector to further develop and operate more efficiently. So far, ETDB provided USD 3.8 million for short

term trade finance transactions but with the improvement in economy, the Bank would further support trade activities through cooperation with local financial intermediaries.

(iii) Corporate and Project Finance

The Corporate & Project Finance operations are aimed to contribute towards attainment of ETDB's primary objective of nurturing and promoting sustainable economic development. By providing a full range of financing and facilitation options to its clientele in member states, the Bank is targeting both public and private sector enterprises in the designated business segments. In this respect, the Bank has conducted a visit to the member country and in view of the national development priorities the primary objective is to maximize economic and developmental impact in a most efficient and effective manner from perspectives of risk, return and value addition.

On the other hand, positive contribution to development of non-oil sector and promoting complementarities and reciprocity among member states tend to be a preferential factor in allocation of funds towards projects. Therefore, corporate and project finance operations in Azerbaijan would primarily focus on priority sectors like infrastructure development, private sector development, transport and energy and water sectors. It is envisaged that the new investments will be undertaken selectively in the areas where there is clear demand and ownership from the government and private sector with strong record of institutional capacity to facilitate such investments. Additionally, trade financing requirements of large scale manufacturers would also be explored to offer customized trade finance solutions which will accelerate economic diversification, rapid non-oil economic growth, increased competitiveness, and expanded export opportunities.

IV. Conclusion

Over the last decade, Azerbaijan has been taking great steps on the level of economic development, welfare growth, and international business. In order to achieve stronger results and ensure sustainable development, Azerbaijan has been undertaking a wide range of reforms on development of non-oil sector. Programs are being implemented to develop industrial production and agriculture. The creation of industrial parks has been particularly successful. In the agricultural sector, new agro-parks are developing at a rapid pace in order to enhance the country's export potential. Development of non-oil industries through encouragement of private sector and regional economic development are among the key strategic goals. The decline in the oil price and the stagnation in the construction sector inevitably had impact on economic development of Azerbaijan. In general, macroeconomic stability in the country is strengthening since the beginning of 2017 and implementation of prudent policy measures will ensure expected economic growth in comparison to previous years.

The country pursues sustaining welcoming business environment which is quite competitive. The Azerbaijani economy is ranked in 35th place in the Global Competitiveness Index 2017–2018 ranking. Along with oil and gas industry which is the major recipient of foreign investments in Azerbaijan, the non-oil sectors such as agriculture, manufacturing, transport, food industry, financial services, tourism, renewable energy, ICT, chemistry, waste management have wide investment opportunities. The Bank will cooperate closely with international financial institutions and other development partners to mobilize further resources for maximum development impact in Azerbaijan.

The current country program document has been developed with the strategic goal of promoting market-driven economic diversification in alignment with the Azerbaijan 2020 Vision. ETDB will strengthen its cooperation with the Ministry of Economy and Industry in order to identify opportunities in projects that are strategically important for the country. In the coming years, the Bank would inter alia focus on following major areas:

Financial sector: Support developing sustainable financial sector. Providing short-medium-term funds to local financial institutions aimed to ensure efficient financing of the private sector and improve competitiveness of M-SMEs.

Trade: Support expansion & diversification of trade in terms of markets and products with an aim to contribute the target of Azerbaijan to boost non-oil exports.

Manufacturing: The Bank will seek to support development major non-oil sectors and enhancing capacity and competitiveness of the enterprises with a particular focus on supporting involvement of new technologies, innovation, R&D, exports and high value-added products. Development of industrial parks, techno-parks and business incubators will be supported.

Agriculture: Agricultural supports will be structured for increasing efficiency, productivity and quality in production. Support investments in rehabilitation of irrigation networks, agri-food processing as well as packing, certification, etc. to boost production, competitiveness and exports.

Infrastructure: Support realization of priority infrastructure projects as critical for development of transport infrastructure to enhance internal and regional connectivity. The Bank will also focus on projects for development of water and waste water management systems.

Energy: The Bank will strive to contribute developing and promoting energy efficiency investment projects and construction/reconstruction of power lines. Promote projects that will increase the share of alternative and renewable sources of energy in total energy production.