

# IS AZERBAIJAN GOING TO CONTINUE TO GET MASSIVE INWARD FOREIGN DIRECT INVESTMENTS?

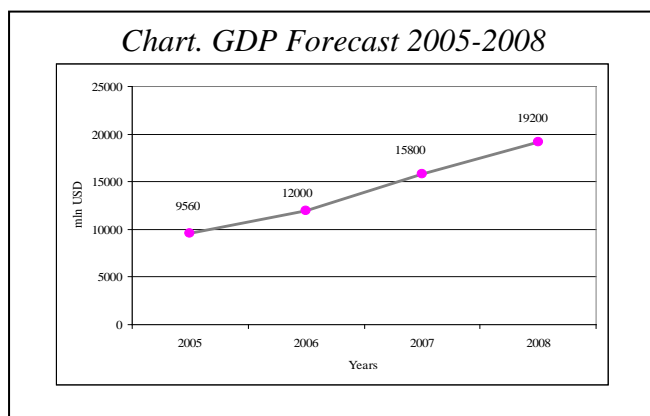
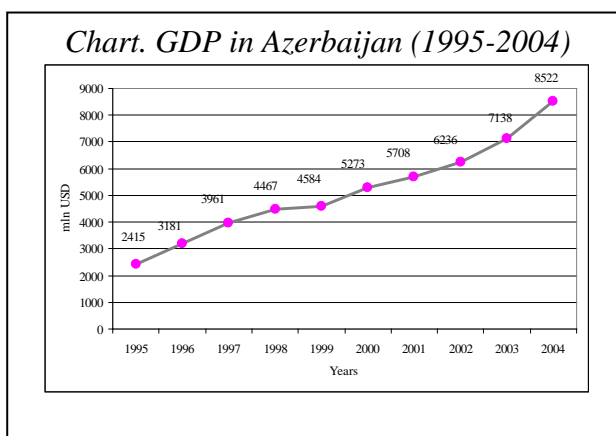
## Policy issues, risks & opportunities

### A COMMENT

by Emil Majidov\*

#### Recent macroeconomic performance

Azerbaijan is one of the fastest growing economies in the world. The GDP annual surplus in 2003 was above 11%. The growth for the year 2004 is 10.2%. A record growth of circa 17% is expected in the year 2005. As per some forecasts (ADB 2005) growth in 2007 may be as much as 26%! It is highly probable that the country will be the global leader in economic growth in the coming next 2-3 years. GDP per capita is growing respectively although from a very low base. In 2004 it was USD 1042 per capita. Nominal wages grew by 26%. Almost all other major economic indicators point out a similar growth pattern.



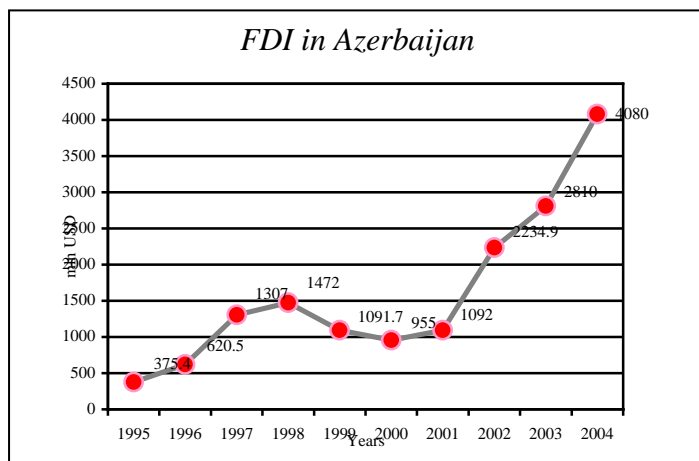
The GDP growth forecast for the years to come look even brighter (see the chart). As illustrated the Gross Domestic Product is expected to nearly double in the next four years. It is noteworthy that Azerbaijan managed to sustain economic stability even during the period of fluctuation of oil prices in late 90-s of the XX century and general economic downfall of early

2000-s.

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## Bright FDI statistics

Plus to the general economic growth with circa 5,000 million USD actually invested by foreign companies in the economy in 2005, Azerbaijan is now living through an investment boom. The boom, however, is largely conditioned by the ongoing development of the oil & gas industry which accounts for approximately 90% of inward investments registered.



Most of the flow goes into 3 major projects: Azeri-Chirag-Guneshli oil field, Shahdeniz gas field and Baku-Tbilisi-Ceyhan pipeline. The development phase for these projects is due to end by 2008 and consequently the investment flows is expected to decline sharply unless new major oil field discoveries occur or investments in other sectors of economy are approved.

Interestingly, in all of the above oil & gas projects the lead violin is being played by the British Petroleum as the major stakeholder and investor, which apparently is another risk of depending on one single large investor.

## Mixed FDI attractiveness picture

The Government has not managed so far to secure any substantial inflows of investments in other segments of economy, though a number of state sponsored initiatives aimed at improving attractiveness of the economy as the location to do business outside the oil & gas were announced or are underway. One can name such government endorsed mechanisms as Regional Development State Programme and Poverty Reduction State Programme. The both have undoubtedly shaped up the agenda and the workload of the various Government Bodies during the last 2 years. A number of achievements have been reported, including openings of new enterprises, infrastructure improvements, new schools and hospitals in the regions outside Baku etc.

The country has undergone a major legal reform in early 2000-s. A number of vital legal acts were adopted in order to stimulate easier business conduct. Interestingly, however, that practically no specific measures targeting foreign investors as such have been taken lately. The legal regime for foreign businesses considering starting up in Azerbaijan has not been changing in essence for approximately a decade. The new draft Law on Investments which is now going through the Parliament approval stage does not contain any basic reform agenda and is merely a better legal technics compared with 1992 and 1994 laws. The Government continues to adhere to formal “non-discrimination” principle in respect of foreign capital. The practical trends, however, show that there are some indications that the Government lately is falling under increasing pressure from the developing local business community as regards to more protectionist policy for

foreigners who wish to do business in the country. The Government is formally continuing the liberalization policy (e.g. the average weighted customs import tariff went down by 1% in 2004 to 5.8%) while a number of practical difficulties are being created by various pressure groups to outcast local and international competitors.

The situation described above does not stimulate a better general business environment as it artificially boosts the “informal” side of regulation while making the “formal” regulatory framework less efficient. The phenomena that come together with “informality” such as corruption, red tape and arbitrariness of officials do not make the picture brighter.

As one might have gathered from the above Azerbaijan at the moment has two parallel stories to tell in respect of attraction of FDI. On one part Azerbaijan is the number one performer in the region of Central and Eastern Europe in respect of FDI attracted per GDP unit as well as one of the top performers as per this indicator globally. The country by now has an Oil & Gas business which is regarded as one of the best models internationally. Despite all the existing problems it is still the most liberal market among those of the Caspian region. The country is also perceived as a rapid grower with the wealth growth practically secured for the next 2 decades.

On the other hand Azerbaijan is not on the international investment maps of the largest TNCs outside oil business as it is regarded as the location outside traditional markets. There is also a perception of Azerbaijan as a generally “difficult” or “unknown” place for trade and investment. As the country is relatively small, it also does not attract extra attention compared with neighboring Russia, Ukraine or even Kazakhstan.

In short, Azerbaijan is a mixed picture when it comes to FDI. There are apparent strengths as well as actual and perceived weaknesses. The future flows of investments in the country is very likely to depend largely on whether the Government will implement an efficient strategy to capitalize on the abovementioned strengths and compensate for some of the weaknesses.

### **Variables for future FDI in Azerbaijan**

The complexity of the issue might be better apprehended if we would try to identify the most possible scenarios as well as the factors and decisions that are most likely to happen and if so, to make the strongest impact on the FDI attractiveness of the country (or in other words “Variables” for future FDI flows in Azerbaijan)

The following factors are, in our opinion, the most important Variables for the inflows of FDI in Azerbaijan in the next 3 to 5 years:

#### ***New oil & gas discoveries***

So far the Azerbaijani Government signed 23 oil contracts with a number of oil corporations from dozen of leading economies. To the moment only few of the contracts

reached full scale development phase. There were few disappointments when SIPCO (Italian led consortia) and JAOC (Japan led consortia) have stopped operations due to unsuccessful exploration and drilling attempts. However, it can not be ruled out that new discoveries of oil or gas in Azerbaijan as well as opening up of the neighboring Caspian countries for foreign investors may give another boost to the sector in the years to come. In any case, Azerbaijani oil & gas industry is likely to remain the strongest part of the economy and the largest attraction for foreign companies due to its openness and modernity.

### ***Liberalization of business climate***

The previous 5 years were the period of steady liberalization of the business climate in Azerbaijani albeit from a very low base as the governmental policies of mid 90-s were to some extent oppressive in respect of private sector development. So, the positive trend is certainly existing, however, one may argue that the pace of reform and liberalization is too slow. In general, the government of the last decade has been pretty conservative in respect of introducing any major steps in order to ease environment for both foreign and domestic investors, apart from few cases (reform of licensing system, introduction of “revision” registrars, abolishment of a large number of revisions of businesses etc.).

Another potential conflict is arising from the recent trend when the local companies, in particular, large holdings and state owned enterprises openly and discreetly lobbying against new arrivals to the economy. A clear agenda by the Government where it states which sectors will be genuinely open for FDI as well as a clever protectionist policy for local producers and financial groups will be a useful instrument to resolve this potential conflict of interests.

### ***Introduction of FDI incentives, free zones or industrial platforms***

There are no sector or territory specific incentives for doing business in Azerbaijan for local business. Neither there are any FDI oriented incentives. Few years ago the Government came very close to introducing tax incentives for the regions outside Baku in order to stimulate regional development there. However, the initiative was seriously opposed by the international financial institutions such as IMF and was later put away. UNDP office in Baku and the Government of Azerbaijan have been also long discussing establishment of a Free Economic Zone in Sumgayit, an industrial town of 200 thousand population north of Baku with strong traditions in chemicals and metallurgy. The idea was buried alive as well at the time.

The most recent developments in this area include announcement of establishment of an Industrial Town (industrial platform of 300 ha, 25 km north of Baku), which is at the moment at the stage of going through approvals in the Government as well as the recently revived discussion on the establishment of the first Free Economic Zone in Azerbaijan, and probably in the Caspian Region.

Introduction of incentive schemes might boost few sectors of the economy as well as potentially the re-export and regional trade (in particular, in the case with Free Economic Zones).

The ongoing negotiations with the WTO on accession of Azerbaijan is another factor that might affect its international competitiveness.

### ***Change to the perception of the country as a difficult place to do business outside oil & gas***

Azerbaijan traditionally ranks very low in the international rankings devoted to such topics as corruption, economic freedom, governance. E.g. TI ranks Azerbaijan 140 (6<sup>th</sup> place from the bottom), Heritage puts Azerbaijan in a row with “predominantly unfree economies” (rank 103 in 2005). This may be attributed to both reflections on the reality in Azerbaijan and somewhat distorted perception of Azerbaijan in the international media as a country that went through a military conflict, located in a complex part of the world and that never really made any targeted efforts to remedy such perception. Obviously, the Government may potentially launch an international campaign aimed at improvement of the international perception of the country. The clever design of the campaign, the correct positioning of the country might become a factor behind the future success in getting FDI or else.

### **Development of Azerbaijan’s strategy and policies towards FDI**

As mentioned above the strategy of the Azerbaijani Government in respect of FDI went through a certain evolution. The first and so far the most decisive step was taken in mid 1995 with opening of the oil & gas industry for foreign companies. Since then the Government has undergone some evolution to realizing the need to diversify the investment stock and to attract businesses in the non mining projects. However, to the moment, not much has been done to provide for really competitive environment for FDI.

The Government is preaching the so called “equal playing field” approach, according to which no sector or territory should receive special treatment or enjoy exemptions from the general legal regime. This concept, however, has a very serious weakpoint in Azerbaijan specifically, as a number of businesses to the moment have managed to break the principle by securing near monopolistic positions in many segments of the local market, or enjoying more liberal administrative regime through the so called “informal” instruments. The resolution of this mere problem in the local business climate requires a number of decisive and maybe even unorthodox steps.

It is likely that the Government will be forced to take a number of decisions in the area of policy making as well as reform continuation if it is genuinely interested in removing the obstacles for investments.

In our opinion a sound strategy towards FDI would include the following necessary elements:

- prioritization of sectors in which the Government is welcoming the investors in particular, though the “umbrella” principle remains in place that all sectors remain open
- introduction of incentive schemes with emphasize on such criteria as sector, export element, jobs creation etc.
- further liberalization of the general business climate or creation of “red tape free” zones such as special economic zones or industrial platforms
- support to targeted country promotion campaign

This approach has been to some extent reflected in the INOTIS 2003 study prepared by the World Bank team in form of the sector prioritization proposal. The sectors that have been picked up by WB experts and that they believe to be potentially competitive internationally are Fruit and Vegetable processing, Oil & Gas related industries, Trade and Transport, Telecom and IT.

It is also vital for the Government to design an efficient public investment programme which will boost the business development including FDI projects. The current strategy of the Government aimed at construction of high class transport infrastructure is seen as the major tool. One can only reiterate the importance of establishment of the international legal infrastructure for businesses including system of international agreements on such issues as double taxation, investments protection, free trade zones as well as introduction of international certification and quality standards in Azerbaijan, harmonization of FDI approval procedures and better Government services to investors.

WTO accession process speed up, more efficient utilization of existing bilateral trade and investment treaties, improvement of customs policies and practices, upgrade of the critical infrastructure, need for bonded warehouses and free zones, reform of investment law, business start up procedure streamlining, simplified land titling and access to land for projects, improve application of IP laws, strengthen competition, access to financing, public private partnerships, market info dissolution, development of industry clusters; exchange of data etc. are other supplemental factors that would help Azerbaijan to overcome a number of apparent weaknesses such as, small market, mixed image and lack of positive record in non-oil FDI.

## **Conclusion**

The development of the Azerbaijani economy during the last decade and the set of policy instruments that has been used by the Government so far is to some extent determining the future of this line of business in Azerbaijan. It is safe to say that unless major oil & gas discoveries take place in Azerbaijan in the near time the structure of FDI inflow will change dramatically. Should even the most efficient non oil FDI policy be implemented in Azerbaijan it is unlikely that the country will be able to secure so much capital in the economy. However, the stock may be diversified in future, and include other segments of

business. We might point out few sectors which are likely to be the next targets for investors in Azerbaijan. They include telecom and logistics, construction, food processing and maybe some segments of tourism.

A non proactive Government stance will end in the minimal or no FDI inflow after the oil projects expansion phase is over and should be avoided by all means.

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