

Approved by the Decree of the President
of the Republic of Azerbaijan
dated December 6, 2016



**Strategic Roadmap for
National Economy Perspective of the
Republic of Azerbaijan**

Contents

1. EXECUTIVE SUMMARY	3
2. GLOBAL AND REGIONAL CONTEXT FOR AZERBAIJAN	4
3. HIGHLIGHTS ON CURRENT SITUATION IN AZERBAIJAN	9
4. STRATEGIC VISION	47
4.1. STRATEGIC VISION FOR 2020.....	47
4.2. LONG-TERM VISION FOR 2025.....	48
4.3. ASPIRATIONAL VISION OF AZERBAIJAN FOR POST 2025.....	52
5. TARGET INDICATORS.....	56
6. STRATEGIC OBJECTIVES	58
7. STRATEGIC TARGETS.....	60
7.1. STRATEGIC TARGET1: STRENGTHEN FISCAL SUSTAINABILITY AND ENSURE A ROBUST MONETARY POLICY	60
7.2. STRATEGIC TARGET 2: PRIVATIZATION AND STATE-OWNED ENTERPRISE REFORMS	72
7.2.1. <i>PRIORITY2.1: COORDINATE THE OVERALL APPROACH TO IMPROVE EFFICIENCY OF PUBLIC SECTOR'S ROLE IN THE ECONOMY</i>	<i>75</i>
7.2.2. <i>PRIORITY2.2: SUCCESSFULLY IMPLEMENT THE PRIVATIZATION AGENDA AND CARRY OUT PRIVATIZATION IN PRIORITY SECTORS.....</i>	<i>76</i>
7.2.3. <i>PRIORITY2.3: ATTRACT MOST APPROPRIATE INVESTORS FOR PRIVATIZATION AND FOREIGN DIRECT INVESTMENT.....</i>	<i>79</i>
7.3. STRATEGIC TARGET 3: DEVELOP HUMAN CAPITAL	86
7.3.1. <i>PRIORITY3.1: IMPROVE QUALITY AT ALL STAGES OF EDUCATION.....</i>	<i>89</i>
7.3.2. <i>PRIORITY3.2. STIMULATE HUMAN CAPITAL TO INCREASE LABOR PRODUCTIVITY.....</i>	<i>95</i>
7.4. STRATEGIC TARGET 4: DEVELOP A SUITABLE BUSINESS ENVIRONMENT.....	98
8. FINANCING MECHANISMS	108
9. IMPLEMENTATION, MONITORING AND EVALUATION	109
10. ACTION PLAN	112

1. Executive summary

Strategic Roadmaps for Azerbaijan's economy

The strategic roadmaps for national economy and its key sectors will ensure increased economic competitiveness, inclusiveness and welfare based on a sustainable economic development model in Azerbaijan. Azerbaijan will strengthen its position in the world economy and will be included in the group of high income countries as a result of attracting investments, creating competitive environment, providing access to markets and developing human capital in response to the global challenges.

In accordance with the Decree of the President of the Republic of Azerbaijan No.1897 dated March 16, 2016 "On approval of "Main directions of strategic roadmap for national economy and main sectors of economy" and subsequent issues", a total of 12 strategic roadmaps have been prepared for 11 sectors of economy. By covering short, medium and long terms, the Strategic Roadmap for National Economy Perspective is comprised of economic development strategy and action plan for 2020, long term vision for 2025 and aspirational vision for post 2025. It not only covers the development objectives and principles, but also encompasses global trends for each direction, 360-degree assessment of economy and SWOT analysis of the current situation, action items, required investments and result indicators. The focus on the priorities that have been selected in the short term will lay foundation for economic development in the medium to long term. The Strategic Roadmap will ensure all the enablers that contribute to economic development including opportunities for communication and collaboration across domestic and international private sector representatives. Governmental investments will act as a catalyst for and the private sector will be the driver of the economic development.

It is still critical to note that, following the adoption of the Strategic Roadmap, the relevant governmental bodies will build their activities on more detailed programs in order to implement such a roadmap. Yet, detailed feasibility will be conducted before approving any projects that are specified in the document and the relevant governmental bodies will be accountable for each initiative.

Major highlights about National Economy Perspective

In the last 10 years, Azerbaijan has been in the first ranks in terms of its economic growth rate in the world. Using the revenues that have been obtained by implementing a successful oil strategy, Azerbaijan has modernized its infrastructure, developed non-oil economy, improved social welfare, increased assets in the government balance and created strategic currency reserves exceeding GDP. The need for a new economic growth approach has arisen in Azerbaijan on the background of the deceleration of the country's economic growth, institutional and structural challenges, deficits in balance of payments and non-oil budget as well as the processes ongoing in the financial-banking sector which has resulted from the significant drop in oil and gas prices since 2014 and associated economic slowdown in trading partner countries. By focusing on new "flagman" sectors that will ensure sustainable development, the economic structure will be re-balanced due to more advantageous growth

of trade sectors versus non-trade sectors, processing sectors versus production sectors, private entrepreneurship versus governmental entrepreneurship, high technology-based sectors versus low technology-based sectors, highly qualified labor based sectors versus to low qualified labor-based sectors, high – income markets relative to low income markets and high value creating sectors versus to low value creating sectors. The upgrading of the national economy's structure will be enabled by further improvement of the business environment, implementation of a new policy with the framework of medium term cost strategy, healthier financial-banking system, improvement of the monetary policy on floating currency rate as well as expansion of the opportunities for the access to foreign markets.

Therefore, four strategic priorities have been selected within the framework of the national economy perspective. Sustainable economic development will be possible by ensuring balance between real and financial sectors as a result of the implementation of these targets and strategic roadmaps for 11 sectors. In line with the first strategic target, fiscal sustainability will be ensured in Azerbaijan and monetary policy will be established based on a floating rate. Alignment of fiscal and monetary policies will ensure macroeconomic stability. The second target in the national economy perspective is to ensure economic dynamics by increasing efficiency in the activities of the legal entities whose controlling share belongs to the government and by carrying out privatization. The third target relates to the development of human capital by which the development of labor market will be aligned with the national economy perspective. Finally, the fourth target envisages further improvement of the business environment.

National economy perspective covers general issues that will ensure sustainable development of the 11 sectors defined.

2. Global and regional context for Azerbaijan

Azerbaijan's economy will develop in an environment subject to various forces of change in medium to long term. Observing and understanding these forces is essential to addressing the challenges they pose and capturing the opportunities they bring. While unpredictable developments will certainly take place, several forces of change that are already evident today will continue to influence the global economy over the coming decades. Four such forces will likely be most important for Azerbaijan: the shift in the center of global economic gravity toward emerging markets in Asia, the disruptive effects of technological innovation, the changing geopolitical landscape, and oil – gas prices.

Continued increase of economic importance of emerging markets

Emerging markets in Asia currently account for about one-fifth of economic value generated worldwide. In 2030 this share will rise to one-third. A corresponding increase is expected in the size of the Asian middle class. According to forecasts, the global middle class will grow from less than 3 billion people today to around 5 billion in 2023 and 80 percent of this growth will be concentrated in Asia. A similar development will be evident at the company level: while emerging markets are currently home to around a quarter of the world's companies with annual revenue of more than USD 1 billion, this share will increase to almost half in 2025. Nearly

3,000 new companies with revenues topping USD 1 billion are expected in Asia alone. At the same time, global trade in goods and services has been growing twice as fast as GDP. Increasing trade flows allow countries such as Azerbaijan located at the Center of Eurasia and at the intersection of North - South and East - West corridors to benefit from this growth.¹

Economic effects of new technologies

The spread of the Internet, and more recently the mobile Internet, has already changed global consumption patterns. By offering new avenues for communication, the Internet has allowed companies to address consumers online, as well as provided a sales channel that crosses national borders.

At the same time, new technologies are transforming both established and new industries. Trends such as automated knowledge creation, the “Internet of things” (automated Internet-based collaboration among physical assets along value chains), cloud technologies, artificial intellect and advanced robotics will challenge existing market leaders and create opportunities for new entrants to establish themselves as global champions. Governance both in government and private sector in Azerbaijan will be adapted to the requirements of biotechnology, nanotechnology, information, communication, industrial technologies and leading technologies in other fields. In addition to the development of new technologies, the management of growing cyber security risks, being a global challenge, is important for Azerbaijan as well. In addition to the import of leading technologies, the formation of the human capital to control such technology and the way of thinking on the whole will develop in line with these new global challenges and trends. More leading technologies and human capital create higher added value. Scientific potential of Azerbaijan will contribute to the development of new technologies in line with global trends.

Geopolitical instability

Recent years have been marked by levels of political instability not seen for several decades. The consequences include frequent changes in political leadership, war, terrorism, and vastly expanding flows of refugees. In the face of political uncertainty, trade volumes into areas with security issues or where sanctions have been imposed have fallen sharply while areas where crisis situations have been mastered, economies have been opened, or sanctions have been lifted have seen equally dramatic increases. Stable development will be ensured in Azerbaijan by properly assessing the risks and challenges in the geopolitically re-formed world. In particular, sustainable security of the main components of economic security such as energy, food, financial and transport security further strengthens sustainability of the country against geopolitical cataclysms.

New oil price ranges

¹ Data mentioned in this paragraph are based on the estimations by experts from World Bank and Organization for Economic Cooperation and Development.

In recent years, oil prices have fallen and become more volatile: while a barrel of oil was worth nearly USD 150 in 2008, prices fell to less than USD 30 in 2016². The global drop in oil prices had a significant impact also on Azerbaijan economy. According to the State Statistical Committee, from 2010 to 2014, economic growth rate slowed down to an average of 2.7 percent. Unemployment rates have increased recently by 2 percent due to reduction in the export volume and government budget incomes dwindled. Due to lower oil prices, the tension in the current accounts balance increased the pressure on the exchange rate of AZN and the national currency was subject to devaluation for two times in 2015.

Forecasts anticipate that growth in the structural global demand for oil and gas will decelerate by 0.7 percent per year through 2050 (30 percent below previous growth estimates) and the share of fossil fuels in the overall energy mix will shrink. Under these conditions, no rebound to previous oil price levels can be expected, so sustained record growth will not return any time soon. In fact, the International Monetary Fund expects Azerbaijan economy to grow by between 2 and 3 percent annually through 2025. This level is similar to the growth experienced in the last few years. This very modest growth is insufficient to achieve the goals set for economy, including creating the jobs our needed for current and future generations. Therefore, higher growth rate will be achieved by building economy on new foundations under the circumstances of lower oil prices in Azerbaijan.

As the power of oil and gas to fuel the economic development fades, resource rich economies around the world including Kazakhstan, Saudi Arabia, and Russia, are facing challenges and have embarked on efforts to diversify their economy. Azerbaijan is in a similar position today. The country has a strong political willpower and opportunity to change its position in the global economy, building on achievements in the last decade, which provide the base to build on.

Window of opportunity for Azerbaijan

Waiting for oil prices to bounce back to the levels seen in 2008-2009 is not an option, however, it is unlikely that they will, and even if they did, the resources industry is not the answer to all our questions. Despite their past economic significance, the oil and gas sector has never accounted for more than 1 percent of total employment³. Diversifying the growth of our economy will help 10 million Azerbaijan citizens to realize their professional dreams and achieve a satisfying standard of living.

There are three windows of opportunities for accelerating economic diversification and it is of utmost importance to implement relevant measures just now in order not to miss these opportunities:

- The economic dynamics in the region are changing, creating the opportunity to expand exports. Azerbaijan is located between Iran, Turkey and Russia – three major economic blocks that together have a population of 300 million and a GDP of more than USD 3

² Source: Economist Intelligence Unit

³ Source: State Statistics Committee

trillion⁴. As sanctions on Iran are lifted and new trade patterns emerge between other economies in the region, a unique opportunity arises for the country. And in wider diameter, Azerbaijan is located at the center of the circle created by markets of European Union, China and Gulf countries with total GDP reaching 30 trillion⁵. For example the only country between China which is considered the second economy of the world and Azerbaijan is Kazakhstan; and the only country between Azerbaijan and Gulf countries is Iran while the only country between Azerbaijan and European Union is Georgia. So Azerbaijan has great potential to access to markets both in short and large circle.

- The global economic landscape is shifting due to slow growth in Europe and reduced growth in China. In response, China is planning the “New Silk Road”, a multi-modal logistics link connecting China with all major economic regions. One of the routes of the New Silk Road leads through Azerbaijan. At the same time, one line of the North-South transport corridor that will join Europe, Russia, Iran, India and Central Asia also crosses the territory of Azerbaijan. This development will increase the flow of goods through our economy and provide opportunities to offer manufacturing and transport - logistics services along the way. Azerbaijan has potential to create added value not only as a transit country but also over the goods crossing its territory. In general, the position of the country may be strengthened in the global value chains on account of the transport corridors crossing the territory of Azerbaijan. The unveiling of such new international opportunities for Azerbaijan creates high and sustainable economic growth potential. Strategic Roadmap has been developed in order to benefit from these opportunities.
- Global investment trends will be taken into account in Azerbaijan which is interesting in investments that will ensure sustainable economic growth. Direct investment flow in the world was increased by 36 percent to USD 1,7 thousand billion in 2015 as compared to 2007. In 2015, developed countries could attract 55 percent of foreign direct investments. This growth occurred mainly on account of mergers and acquisitions (M&As). Developing countries in Asian region attracted 1/3 of the foreign direct investments in the world in 2015. In this respect, Asian region is the most investment attracting region in the world. Foreign direct investment flow to transition countries, primarily Russia and Kazakhstan reduced by 54 percent in 2015⁶. Low raw material prices and regional conflicts was the main obstacle for direct foreign investment flows in the transition countries. To set aside mergers and acquisitions, foreign direct investment flow in the world will decline in the short term perspective. Because, global economy is fragile while global financial markets are volatile, there are low needs and low growth rate in the developing countries. To attract the flow of

⁴ Source: World bank

⁵ <http://www.tradingeconomics.com/european-union/gdp>

⁶ Source: World Investment Report, 2016

investments, Azerbaijan will ensure suitable business environment in Azerbaijan and further encourage the development of private entrepreneurship.

3. HIGHLIGHTS ON CURRENT SITUATION IN AZERBAIJAN

Azerbaijan's economy has entered a new stage in terms of quality as one of the countries of the world with the highest growth rate in the recent 10 years. Economic policy implemented in the country during this period has allowed significantly expanding the size of economy, improving the living standards of people, and entirely modernizing socio economic infrastructure.

During 2004 – 2015, there was a 10,6 percent economic growth while nominal volume of GDP increased by 7,6 times⁷. GDP per capita increased 6,5 times during this period which brought Azerbaijan to the rank of 79 among 134 countries around the world⁸, and the living standards of people were improved significantly. Level of poverty dropped from 40,2 percent in 2004 to 4,9 percent.

Successful realization of the oil strategy established by the National Leader Heydar Aliyev was accompanied by an increase in the oil revenues of the country, and the obtained financial resources allowed financing the fast economic growth. The economic growth model, which was realized by using oil revenues in 2004-2015 and characterized as “actively investing in fixed capital”, paved the way for achieving the targets that were set for that period.

The economic reforms realized in Azerbaijan were also accompanied by significant improvement of the country's global rating indicators. It was not a coincidence that Azerbaijan was evaluated as the “leading reformist country” of the world in 2009 as per World Bank “Doing Business” report. According to “Global Competitiveness Report for 2016 – 2017” of the World Economic Forum, Azerbaijan ranked 37th among 138 countries upgrading by 27 ranks as compared to 2006. According to this report, Azerbaijan ranks 39th in the world for macro-economic environment performance indicator, 26th for labor market efficiency, 37th for ratio of national revenues to GDP and 55th for infrastructure quality.

The implemented economic policy enabled Azerbaijan to progress significantly in terms of the size of national revenue per capita among countries around the world countries. According to the World Bank classification (as per Atlas methods) while Azerbaijan was ranked in the group of poor countries by its size of national revenue per capita in 2004, it was included in the group of low to medium income countries in 2005 and high to medium income countries in 2009.

The economic growth model, which has been realized in the recent years, has allowed accumulating large amounts of strategic currency reserves which may be an important contribution to absorption of the potential risks the economy is likely to face and to the process of financing future economic development. According to information of State Statistical Committee, while economic growth rate in 2004 – 2010 constituted 16,9 percent on the

⁷ GDP and poverty level indicators are based on data from State Statistics Committee

⁸ According to World Economic Forum's global competitiveness report for 2016–2017

average, this indicator made 2,7 percent in 2011- 2014. At the same time, while investments in the country's economy amounted to 17,9 percent in 2004 – 2010, this indicators was 11,9 percent in 2011- 2014. Despite the decrease in the amount of investments by 6 percent, the economic growth rate dropped by 14,2 percent. This means that the successful economic growth model, which was successfully implemented in 2004 – 2014, reached its “saturation” limit and necessitated the transition to a new economic growth approach as far as quality is concerned.

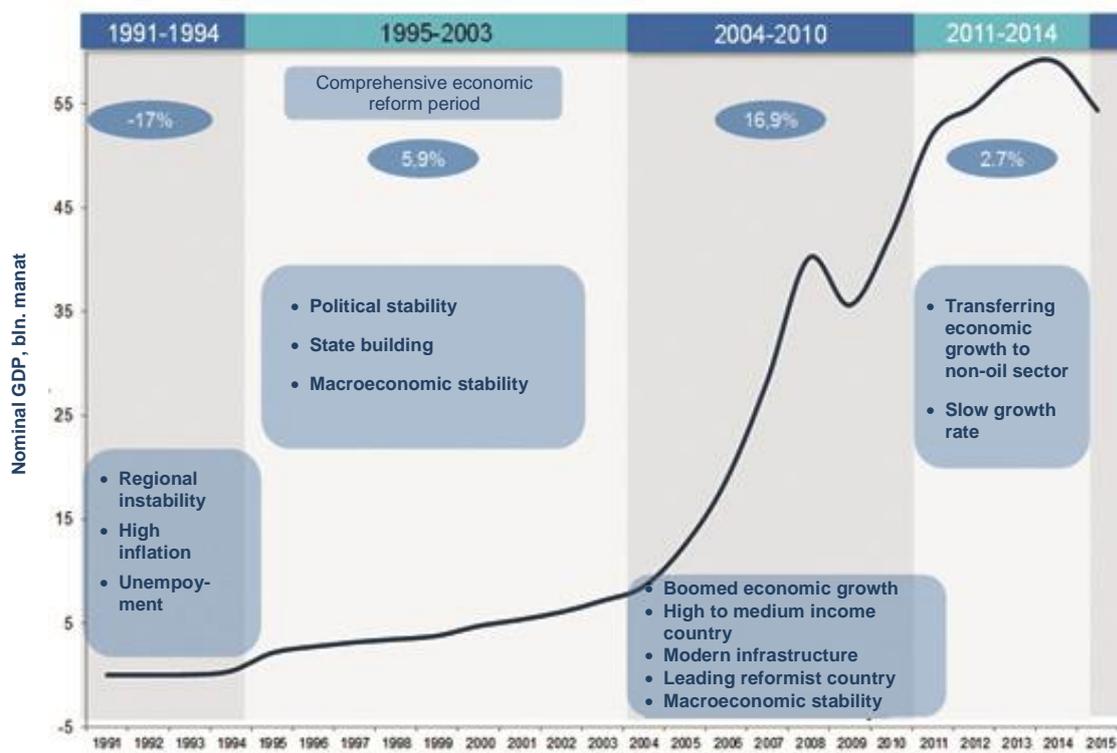
The significant drop in the prices for utilities in world commodity markets since late 2014 has been accompanied by a reduction in foreign currency revenues of Azerbaijan which has restricted the opportunities to finance the economic growth model realized in the last 10 years. The reduction of oil revenues, in its turn, has further necessitated the transformation to a new economic growth approach.

Both factors once again indicate that, having realized its life cycle successfully, the existing economic growth model has allowed achieving its established targets. Already, the most important challenge of the new period is to ensure transition from “capital accumulation” based model to “productivity (efficiency)” based growth model. Therefore, it is required to further increase the quality of the institutional environment and to prepare accessible financial sources, correctly segmented and specialized business environment and, most importantly, to intensively develop highly qualified human capital.

3.1 Stages of Economic Development: from regress to progress

Azerbaijan faced a number of challenges and risks along with the restoration of its independence in 1991. The process of economic growth of the country in the last 25 years may be classified in 4 stages (Exhibit 1).

Exhibit 1. Stages of economic growth in Azerbaijan



Source: State Statistics Committee

- Period of regress (1991 – 1994):** the period that coincided with the first years of the restoration of state independence may be characterized with the fact that Azerbaijan faced with the problems of over one million refugees and internally displaced persons as a result of military aggression by Armenia while the trade relations among the former Union republics weakened, and social economic situation worsened. Over that period, regional instability, incompetency in economic management, entire inefficiency of the existing economic institutes deepened the economic crisis in Azerbaijan. According to reports of International Monetary Fund, at that time Azerbaijan lost 60 percent of its economic potential, the existing manufacturing structure became significantly unserviceable and hyperinflation was observed in the face of sharp increase in unemployment. During 1991 – 1994, Azerbaijan’s real GDP dropped by 17 percent on the average, state budget financing was implemented mainly through emission channels and the national currency issued for turnover was sharply cheapened.
- Deep economic reforms, transition and restoration period (1995-2003):** that period when National Leader Heydar Aliyev returned to political rule may be characterized, first of all, by the restoration of political stability in the country and paving the way for high quality economic growth as a result of the realization of strategic economic reforms that ensured the transition to market economy and efficient economic relations. This period also covers the realization of large- scale land reforms and important reforms such as privatization of state property and establishment of oil strategy which laid foundation for

ensuring the fast development of Azerbaijan. The first benefits of “the Contract of Century”, which was authored by and signed at the direct initiative of National Leader Heydar Aliyev in 1994 for the development of Azeri - Chirag – Gunashli oil fields with the involvement of international consortium comprised of 13 companies, became evident. Over that period, the lost potential was recovered by ensuring the economic growth and stability of the national currency and prices and significant reduction in unemployment was achieved. The strategic currency reserves of the country were created, trust in the banking system was restored and sustainable financing sources of the state budget were ensured.

- **Period of economic development and progress (2004 –2014):** As a result of the economic growth model realized during this period Azerbaijani economy became one of the fastest growing economies of the world. Azerbaijan became a high to medium income country within a short period of time, socio-economic infrastructure was renewed entirely and Azerbaijan ranked 37th for its global competitiveness in the world due to investing part of the oil revenues into the country’s economy⁹. The actions taken and increased prices of natural resources laid foundation for boosted development of the country’s economy and GDP increase by 16,9 percent per year on an average during 2004 – 2010. Increase in the volume and prices of oil and gas production sector made its contribution to attracting foreign direct investment (FDI) to the oil sector. Baku-Tbilisi-Jeyhan pipeline was officially launched in 2006 and Azerbaijan ensured the sustainability of oil-gas production and trade by improving its global economic relations. During those years, oil revenues brought progress to the country by paving the way directly for the development of other sectors such as construction, service sector, public administration, defense and social security. Economy grew by 6 times and national income per capita was increased by over 5 times due to a growth model allowing to successfully realize an important stage of the economic growth process¹⁰. During that period, the stability of prices was maintained, a large amount of strategic currency reserves was generated as a result of a significant increase in foreign currency incomes, and international competitiveness was maintained by avoiding unnecessary strengthening of the national currency exchange. At that time, the activities in the banking sector were accelerated, deposit volume was increased by 11 times, and loans volume by 19 times accordingly¹¹. Another noticeable point in that period is the decline in economic growth rate following 2011¹¹. Despite the increase in investments that were attracted to economy during this period, the weakening of economic activities was observed. Active capital accumulation model became “saturated” following that period.
- **Low oil prices period:** the adverse effects of the sharp drop of oil prices in the world’s commodity markets starting from late 2014 were seen in Azerbaijan’s economy as of the second half of 2015. The adverse impact, first of all, was transmitted to the balance of

⁹ According to World Economic Forum’s global competitiveness report for 2016–2017

¹⁰ Source: State Statistics Committee

¹¹ Source: Central Bank of the Republic of Azerbaijan

payments, and then to economy performance via the financing channels of economic growth. USD dollar exchange rate rose nearly twice as much as the national currency, a number of risks emerged in ensuring financial stability and there emerged an increased fiscal burden on the repayment of the government debt. Azerbaijan's government took a range of measures for further improving the economic policy and speeding up the institutional reforms with a view to restoring the economic activity.

Since 2015, Azerbaijan's economy has stepped into a new stage quality-wise. As a result of conducting an analysis of the economic growth model of 2010 -2014 and economic policy which were implemented over that period, it has become necessary to define the new growth pillars by considering the major risks and challenges in order to transform to a new economic growth approach.

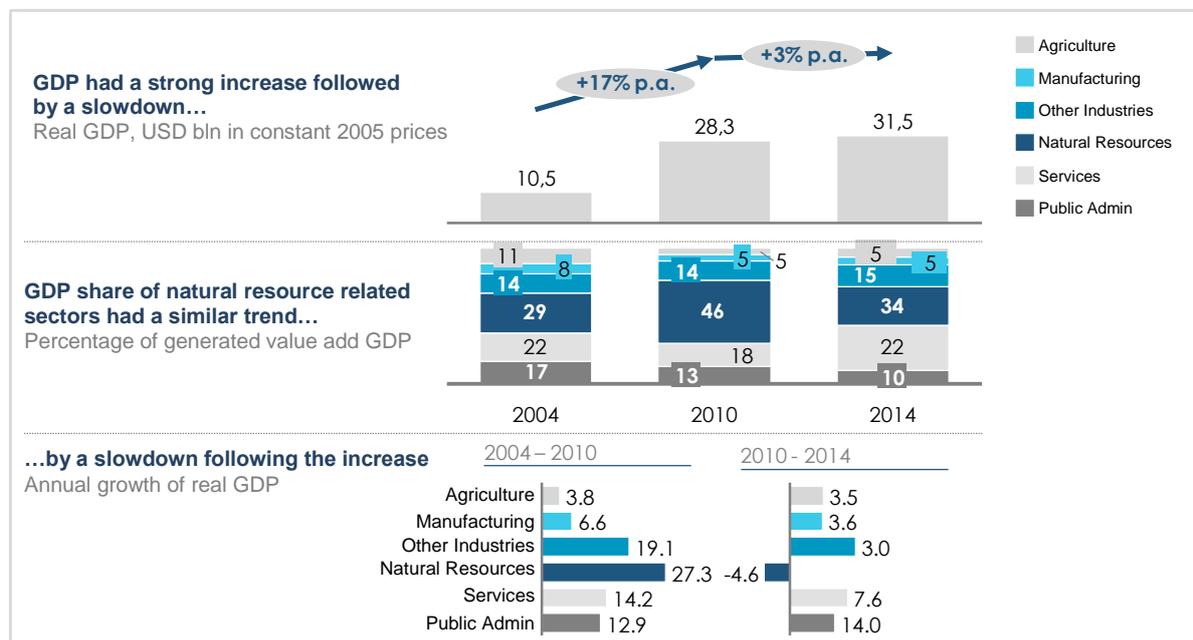
3.2 Analysis of growth boost period (2004 – 2010)

Azerbaijan achieved high economic growth as a result of directing certain portion of the oil revenues, which were generated in 2004 – 2010, to its economy. The average growth rate of economy constituted 16,9 percent during this period which was higher than the similar global indicator by 12,9 percentage points, 10,6 percentage point higher than the relevant indicator in emerging countries and by 12.6 percentage points higher than the relevant indicator for CIS countries¹².

Average yearly growth was 24,9 percent in the oil sector and 11,7 percent in non-oil sector. It should be noted that large amounts of investments, which were made in the non-oil sector, allowed a significant increase in that sector. Starting from 2010, the main driver of economic growth in the country was transferred from oil sector to non- oil sector and despite the decline of 2,9 percent in the oil sector during 2010 - 2014, non-oil sector grew by 8,8 percent and a total of 3 percent economic growth was achieved (Exhibit 2).

¹² Data from International Monetary Fund and State Statistics Committee

Exhibit 2: Sectoral economic growth



- 1 Agriculture includes agriculture, forestry and fishing
- 2 Other Industry includes electricity and water supply, construction
- 3 Services includes trade, tourist accommodation and public catering, transport and warehousing, information and communication, financial and insurance, real estate, renting and business services
- 4 Public Administration includes public administration and defense, education, health and social work, service provision in other areas

SOURCE: State Statistical Committee

High growth rate allowed further strengthening of the macroeconomic stability. As reported by the World Economic Forum, Azerbaijan ranked 9th in 2014 moving up by 36 ranks among 144 countries for quality indicator of macroeconomic environment as compared to 2008, and ranked 15th moving up by 16 ranks for the ratio of state budget balance to GDP indicator, and was positioned 9th for the ratio of national incomes to GDP indicator and 12th for the ratio of total state debt to GDP indicator.

The analysis of the economic growth shows that the impact of oil factor on obtained macroeconomic stability and welfare is still significant. During the time of high oil prices, pro-cyclical economic policy increased the dependence of economic growth on state requirements. As one of the main challenges, it is still important to transform the dependence of economic growth on state requirement to sustainable private requirement.

Main challenge in sectoral breakdown: from non – trading sector to trading sector

The implemented economic growth boost model was characterized by active “capital accumulation”, and, consequently, large-capacity and modern socio– economic infrastructure was built in the country. Azerbaijan used a “State capitalism” development model which was applied in fast developing South-Eastern Asian countries of the world. Fiscal policy was the most active and characteristic area of the macroeconomic policy of “State capitalism” nature.

Spending on investment in the state budget acted as the major channel for the government to direct large-volume oil revenues to economy.

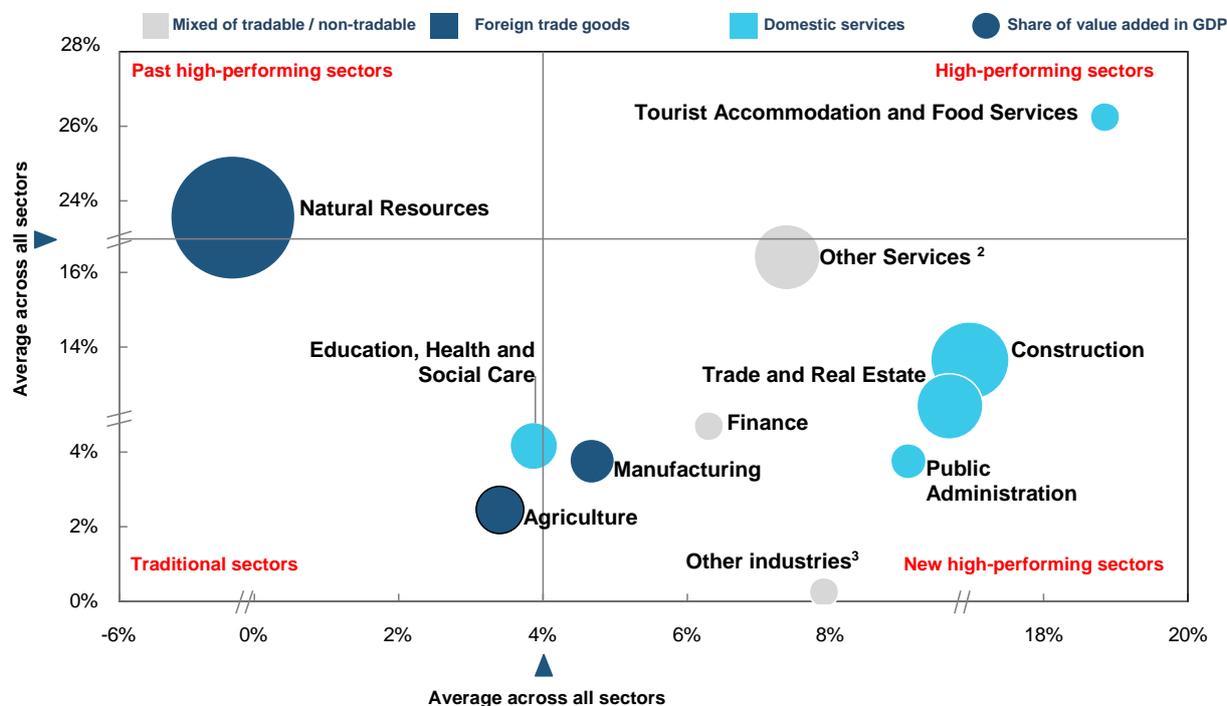
Though the main driver for economic growth by 2010 was the traditional oil sector, the non-oil sectors made primary contribution to the growth in years 2010 – 2014. According to information from State Statistics Committee, a growth of 6,9 percent in non – oil sector, 8,8 percent in the construction sector and 7,6 percent in services sector were recorded in 2014. The analysis of the shares of these sectors in GDP shows that natural resources made 37 percent contribution to economic growth in 2014 followed by construction sector with a 14 percent contribution.

The sectorial analysis of the economic growth in 2014 shows that due to an active state capitalism nearly 80 percent of GDP and nearly 60 percent of employment were generated in non – trading sector. Social and other services, which are related to non – trading sectors, accounted for 28 percent, construction sector – 21 percent, trading sector- 13 percent, transportation and warehousing – 7 percent in non-oil GDP (Exhibit 3). In this period, a total of 8 percent of non-oil GDP was created on account of non-oil industry. While added value created in agriculture in 2014 accounted for 6 percent of GDP, this area accounted for 36,7 percent of the employed people in the country. The high employment indicator in agriculture was due to the fact that those having parcels of land in their possession were considered employed people.

Another impact of the active state capitalism in the structure of economy appears to be in the unprofitability of competition between private sector and state investment activities. As a result, private initiatives become limited. In this respect, if the contribution made to economy by Azerbaijan International Operating Company is not considered, it is still an important challenge to improve the share of private sector in economy.

Exhibit 3. Grouping of sectors according to economic growth rate

Average annual growth rate, 2005-2010¹, %



Average annual growth rate, 2010-2014

- 1 Based on 2005 constant GDP of Azerbaijan, before Tax and FISM (Financial Intermediation Services Indirectly Measured)
 - 2 Transport, storage and communication, other community, social and personal service activities
 - 3 Electricity, gas and water supply
- SOURCE: State Statistical Committee

It is still important to develop the trading sectors, expand private initiative activities taking account of the cyclical sensitivity of growth in non- trading sectors, its high dependency on government funding and finally of poor opportunities for integration into global value chain.

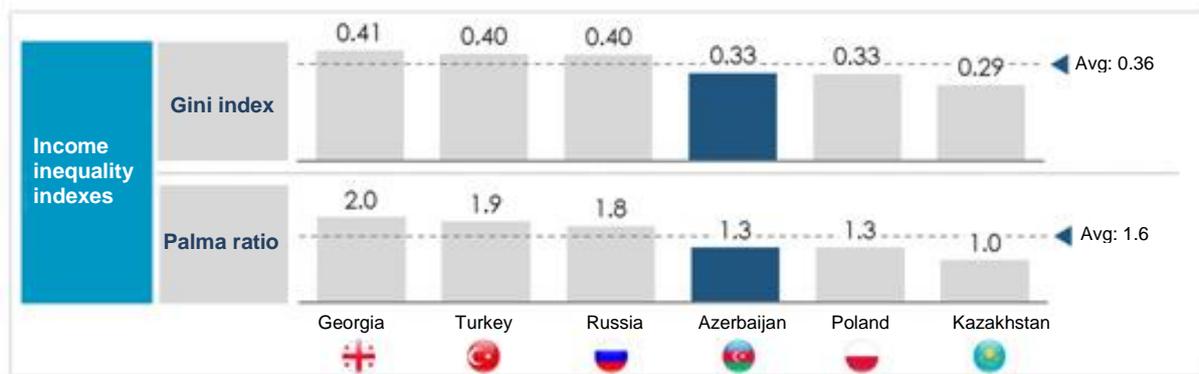
Welfare of people: from poverty to high - medium income

High economic growth was also accompanied by the improvement of the living standards of the people in 2004 - 2014. National income per capita (World Bank Atlas methodology) reached USD 7600 increasing by 8 times as compared to 2004, and Azerbaijan was transformed into a high- medium income country from low income country within a short period of time. Economic growth was accompanied by an increase in employment, over 1,3 million new work places were created and 77,1 percent of these workplaces were permanent workplaces and regions accounted for 62,9 percent out of this. Income of people per capita was increased 2.6 times in real terms.

Gini index for Azerbaijan (quality measurement of income distribution in the country: 0 indicates full equality and 1 indicates inequality) indicates low income inequality versus the

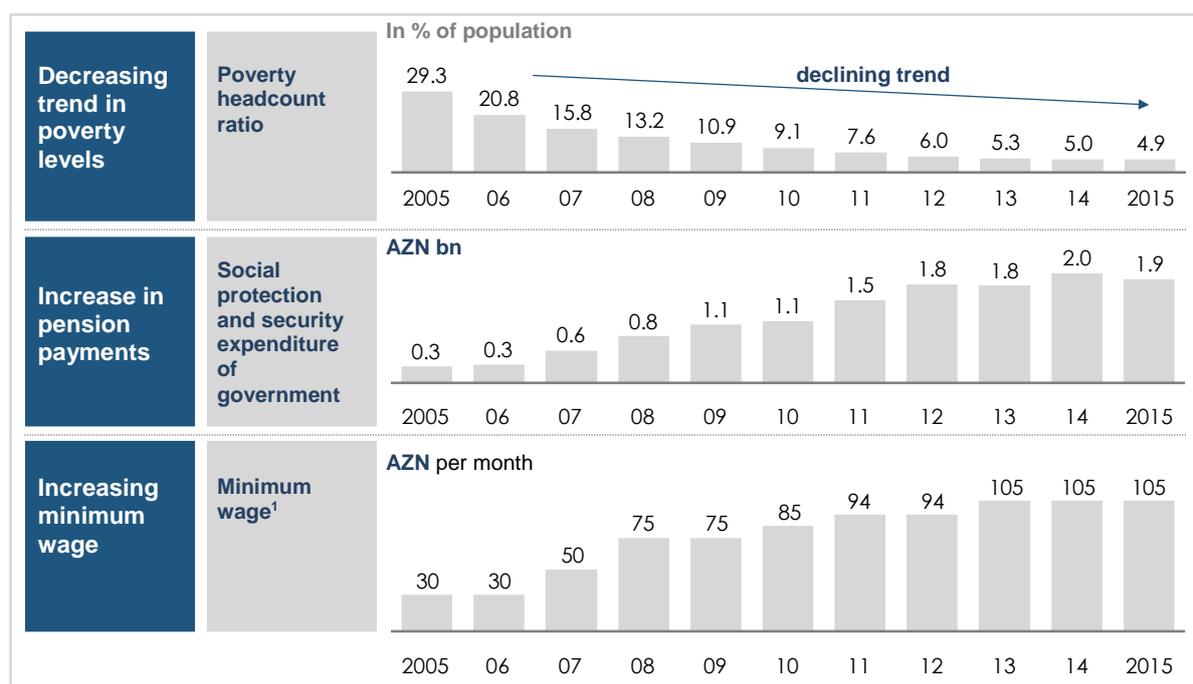
average assessment of the compared countries. Palm ratio also indicates low income inequality versus the average indicator for the countries which can be compared (determined by dividing the share of the most wealthy 10 percent of people by the share of the poorest 40 percent) (Exhibit 4).

Exhibit 4. Inequality in income distribution



In fact, several important indicators visually show that the standard of life of the citizens has been improved in Azerbaijan. That is, the specific share of the people living in poverty has been decreased by six times within ten years and dropped to 5 percent in 2014 from 29,3 percent in 2005. Over these years, the pension and allowance payments have increased by 6,7 times as a result of growth in social security and allowance spending of the government. Another social indicator such as minimum salary was increased by over 3 times from 30 manats in 2005 to 105 manats in 2014 (Exhibit 5).

Exhibit 5: Poverty levels, social transfers and minimum wage indicator



1 Based on end of years

SOURCE: State Statistical Committee, World Bank

Social services provided to low-income population group are mainly limited by financial aid. And this is not beneficial in terms of bringing poor and unprofessional persons back to the labor market. It is critical that the social portfolio should include quality education and health care services as well as qualification upgrading services if required, in terms of integrating this population class into active workforce.

Another important component for improving the social welfare of the population is to enhance the quality of utilities sector. Large-size investments, which were directed to infrastructure during that period, expanded the opportunities of people for access to utilities services such as electricity, gas and water supply. Despite the fact that utilities quality has been improved sufficiently, the public sector still acts as the driving force in these services. The liberalization of utility services market and the development of this market by involving the private sector may be beneficial in terms of ensuring the sustainability of service quality and reducing its fiscal burden on the public sector as well.

Accommodation is also one of the indicators showing the social welfare of population. Currently, the average accommodation fund per capita in Azerbaijan is 17,9 m² which is below the average indicator in CIS (30 m²) and Eastern European countries¹³.

¹³ Source: State Statistics Committee

Enablers of economic growth: consumption and investment activity

GDP growth in Azerbaijan was proportionate to domestic consumption and public investments. That is, according to information of State Statistics Committee, the actual recent consumer spending increased 14,0 percent on an average in 2005 - 2010 and 9,0 percent in 2010 - 2014 accordingly.

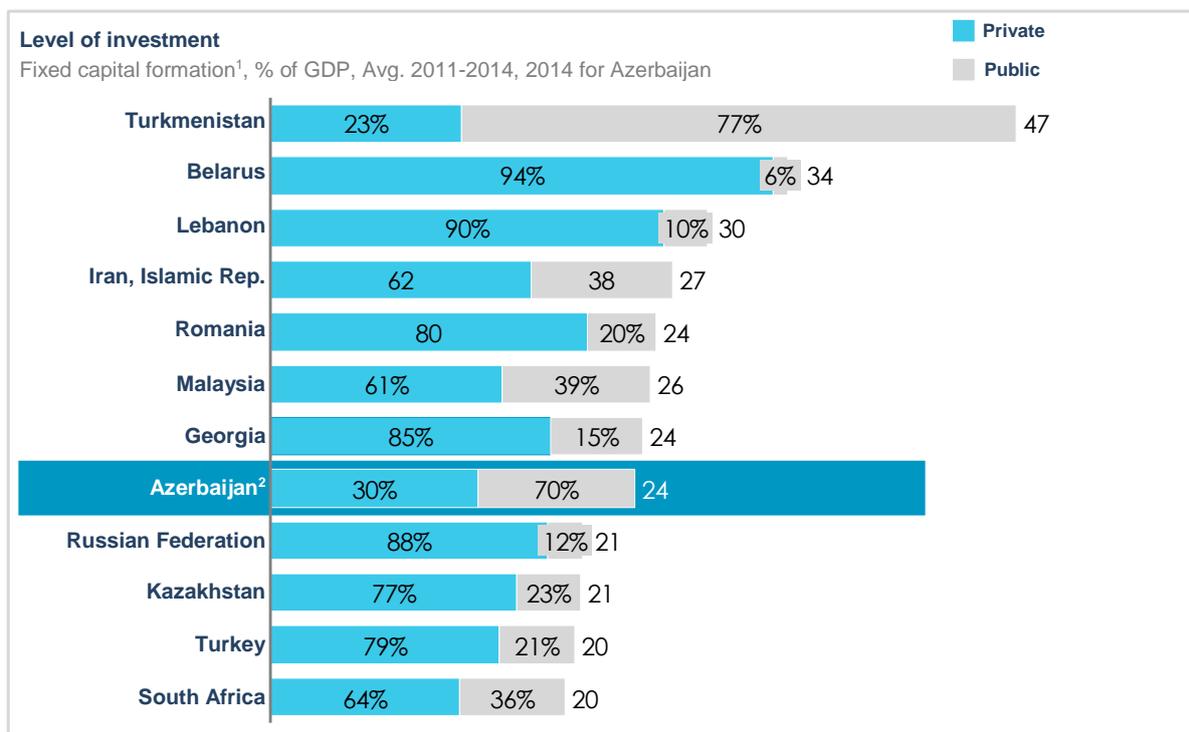
High investment activity was observed in Azerbaijan in 2004 - 2014. Investments in the country's economy totaled AZN 148,9 billion during this period, 54,1 percent of which was financed at the expense of internal sources and 45,9 percent through foreign ones. The specific share of total investments in GDP constituted 36,3 percent and the specific share of investments in non-oil sector was 50,7 percent.

Azerbaijan's high oil revenues were the main source of high investment activity at that time. During this period (2004-2014), funds in the amount of USD 90 billion were received by State Oil Fund of the Republic of Azerbaijan, out of which USD 61 billion was invested in the development of the country's economy. 92 percent of these funds were directed as transfers to the government budget while 8 percent was directed to financing the projects of government importance¹⁴.

The amount of the investments implemented on account of internal sources made AZN 80,5 billion, out of which 47,7 percent was financed through government budget (capital expenditures). Governmental investments constituted 68,2 percent of domestic investments in 2014. (Exhibit 6).

¹⁴ Source: State Oil Fund of Azerbaijan Republic

Exhibit 6: Investment share in GDP



1 Note that Fixed Capital Formation does not include all foreign direct investment inflows, some of which do not go towards fixed assets

2 Private and public investment division are assumed based on %30-%70 division based on 2014 budget published document

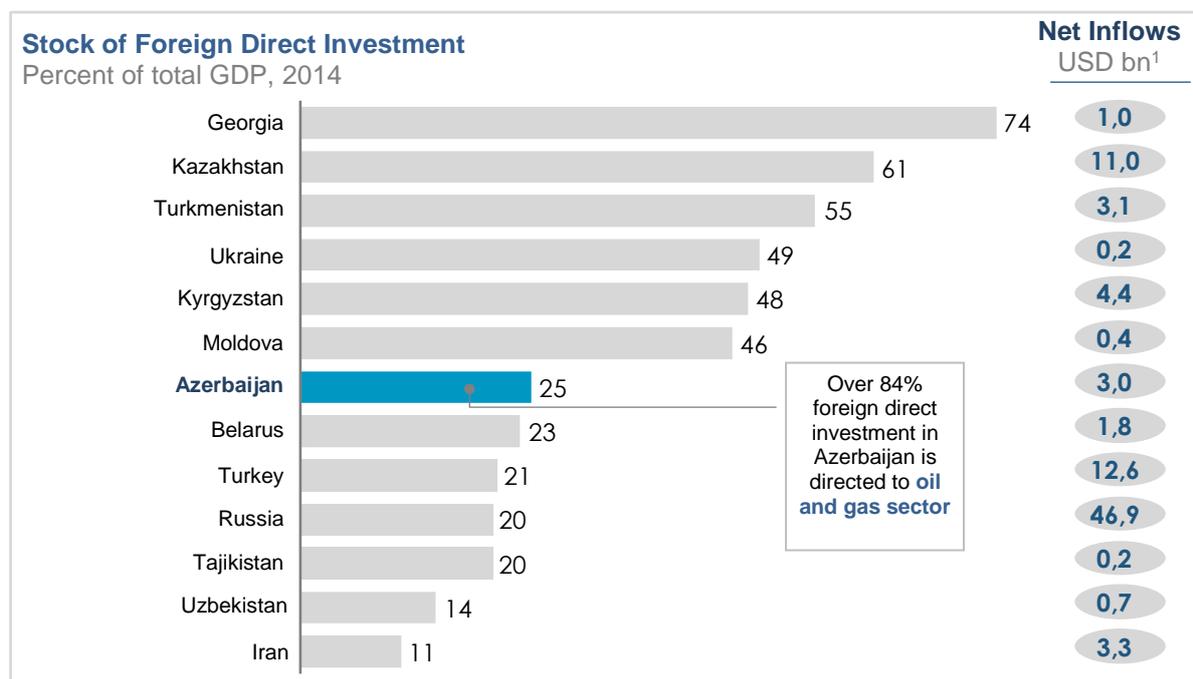
Iran analysis is based on only publicly available data

SOURCE: World Bank Development Indicators

Foreign direct investments (FDI) were the main source of the investments that had been made in Azerbaijan's economy by 2007. However, the landscape changed during the following period and domestic investment activity increased due to government funding. It should be noted that the share of fixed capital generated due to foreign direct investments is below the regional average. That is, foreign direct investments in Azerbaijan constituted 25 percent of the GDP in 2014 as compared to 74 percent in Georgia, 61 percent in Kazakhstan, 55 percent in Turkmenistan, 49 percent in Ukraine, 48 percent in Kyrgyzstan and 46 percent in Moldova accordingly.

The amount of foreign direct investments made in the country's economy in 2004 – 2014 constituted USD 52 billion, out of which 85 percent was directed to oil sector, and 15 percent to non-oil sector. Despite the low specific weight of FDI made in non-oil sector during this period, the growth rate was high. According to the State Statistical Committee, while the average yearly growth of total FDI was 8.2 percent, the relevant indicator for non-oil sector reached 32,5 percent. Despite the high growth rate, FDI directed to non-oil sector still remains below the existing potential (Exhibit 7).

Exhibit 7: Foreign Direct Investment share in GDP



1 2012-2014 Average

Iran analysis is based on only publicly available data

SOURCE: United Nations Conference on Trade and Development (UNCTAD)

One of the most important challenges to the structure of the existing investment activity is a reduced productivity of investments that are directed to the economy. While the growth rate of investments in the country's economy in 2004 -2010 was 17,9 percent, this indicator made 11,9 percent in 2011 - 2014. Despite the fact that the amount of the investments made was reduced by 6 percentage, the economic growth rate dropped by 14,2 percent¹⁵. This suggests that the current model cannot fully respond to large-scale state funding "impulses". It can be concluded that the traditional non-trading sectors where investments have been made has already reached to its "saturation" limit and therefore investments should be targeted at the trading sector that can demonstrate higher productivity in the short to medium term.

Another important challenge to the investment activity is to succeed in transforming the main sources of domestic investments from government funding to the private sector. Delays in this process will create risks for government funding, particularly for the government budget's sustainability and burden as well as its efficient management. Just for this reason, the business investment environment should be further improved and efforts should be made to involve FDI in non - oil sector with the aim of supporting private initiatives.

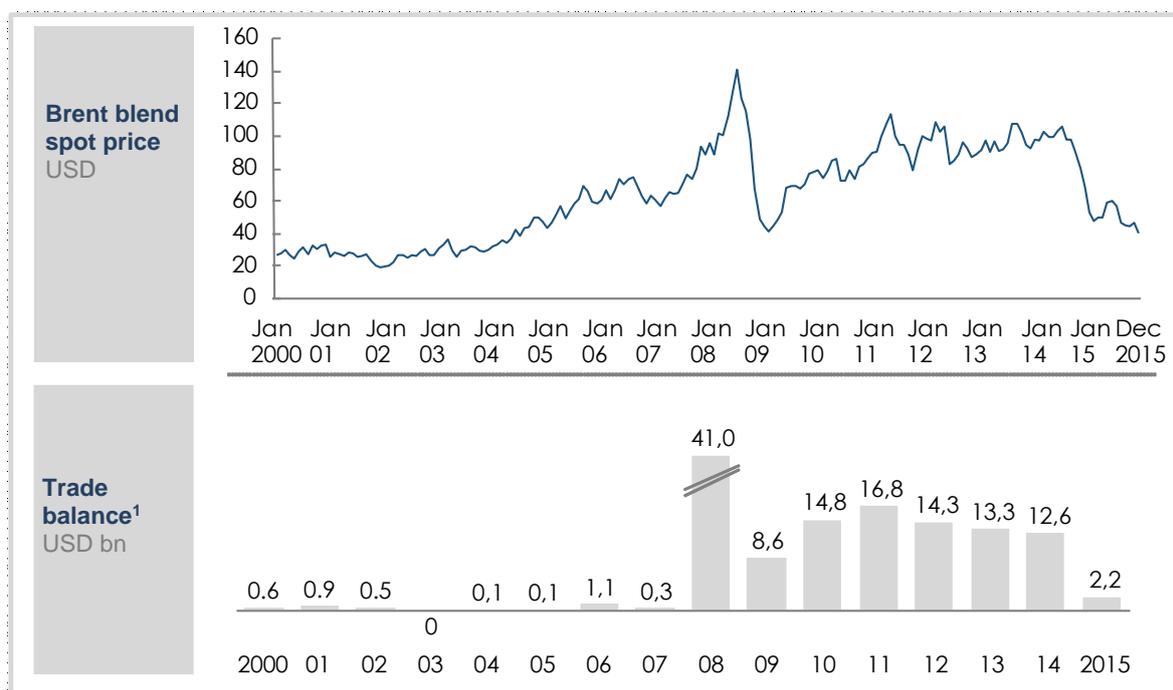
¹⁵According to data from State Statistical Committee

Economic growth factor: net export

Net export was another important driver of economic growth in Azerbaijan. Execution of the oil contracts significantly increased oil export from Azerbaijan and the indicators of the balance of payments were improved.

While there existed a deficit in amount of USD 5,8 billion in the current account balance (CAB) in 2004, this deficit started to give way to surplus from 2005. During 2005 - 2014, CAB surplus reached USD 110 billion during 2005 – 2014. In 2011, this indicator amounted to nearly USD 17 billion and its specific share in GDP was 25,8 percent ¹⁶.

Exhibit 8: Oil price impact on trade balance



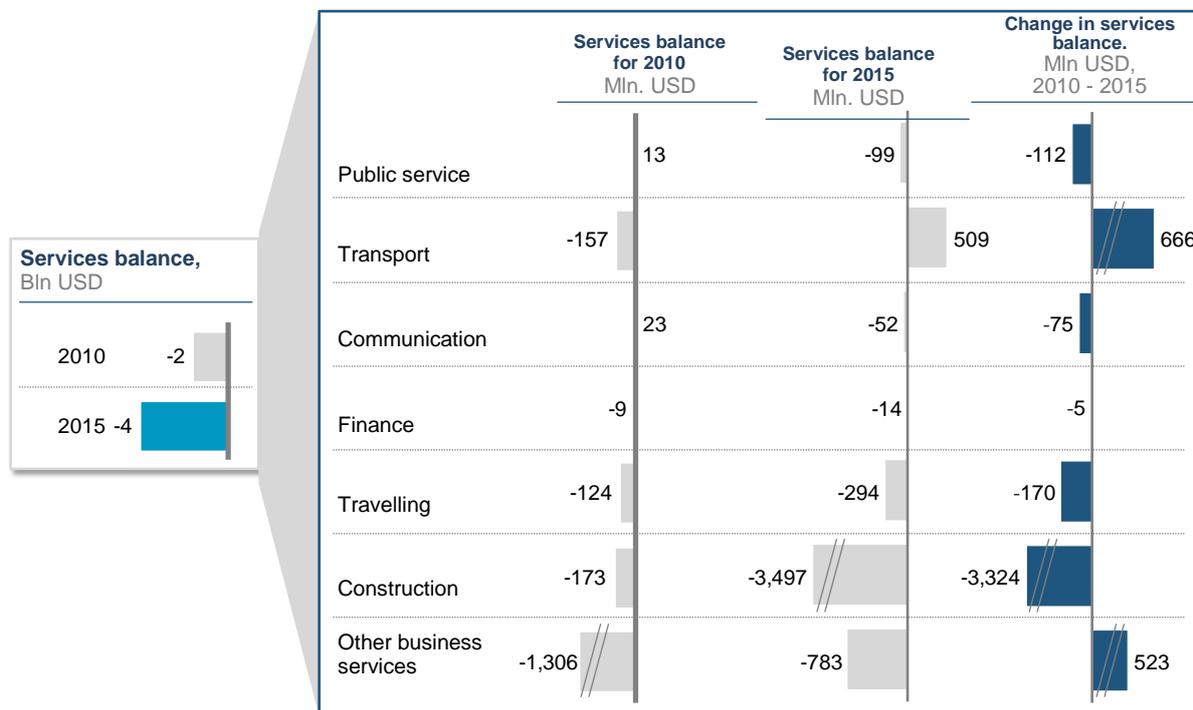
1 Balance of goods

SOURCE: Global Insights World Market Monitor and State Statistical Committee

Foreign trade balance was increased from a deficit of USD 3 billion in 2004 to a surplus of USD 19 billion in 2014. During this period, the export of goods was increased 6 times and import by 2,6 times. The services balance is an important and noteworthy component of CAB (Exhibit 9). The major noteworthy point in the services balance is that high economic growth and improvement of welfare resulted in the increase of its deficit. Thus, the balance deficit increased 2 times and reached USD 4 billion from USD 2 billion during 2010-2015. However, some growth was observed in certain services.

¹⁶ Indicators are based on balance of payments of the Central Bank.

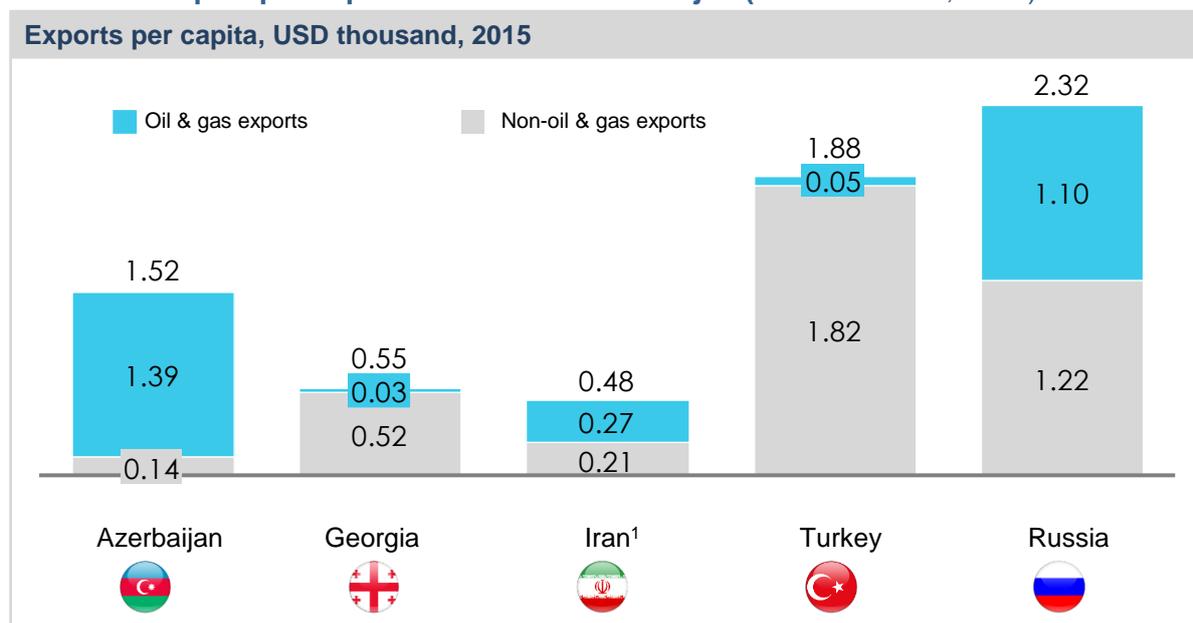
Exhibit 9. Change in services balance



Source: Central Bank of Azerbaijan

The analysis of the balance of payments of Azerbaijan shows that the foreign economic position of the country during the period was strengthened. However, if the oil sector indicators are not taken into consideration in the balance of payments within the same period, this will shape a different landscape. Thus, CAB deficit in the oil sector constituted cumulatively USD 56 billion during 2004 – 2014 and the deficit increased by 5 times in 2014 as compared with the beginning of the period. This shows that high oil revenues increased the dependence of the non-oil sector of the country's economy on import and created the issue of "twin deficits" when we take into account non-oil budget dynamics. These circumstances caused certain risks for the flexibility of exchange rate policy and its potential efficiency, including the accumulation of foreign currency reserves.

Exhibit 10: Export per capita indicator for Azerbaijan (thousand USD, 2015)



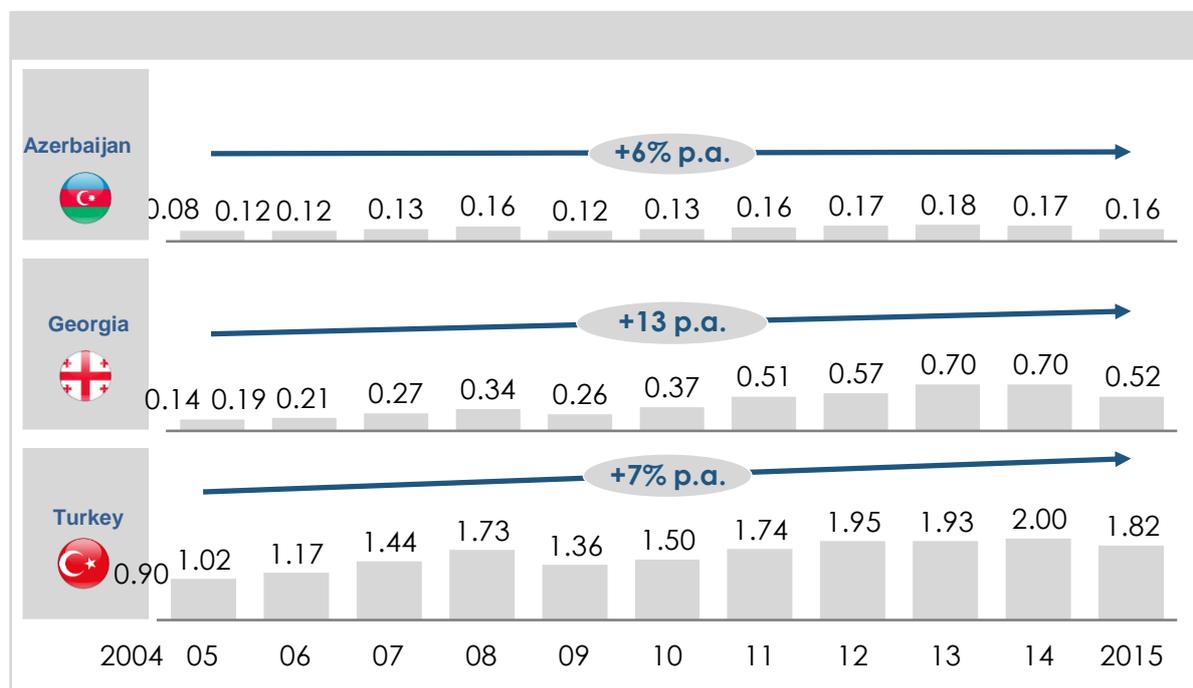
1 Estimation for 2015

Iran analysis is based on only publicly available data

SOURCE: United Nations Comtrade Database, International Monetary Fund

Though the non-oil export of Azerbaijan grew by 17 percent on an average in 2004 – 2014 (USD 1,6 billion in 2014) it is lower than oil export by 16 times and 5 times than non–oil import. This suggests that the non-oil export did not allow financing the non –oil import which makes the diversification of non-oil export inevitable (Exhibit 11).

Exhibit: 11. Non-oil & gas exports per capita, thousands USD

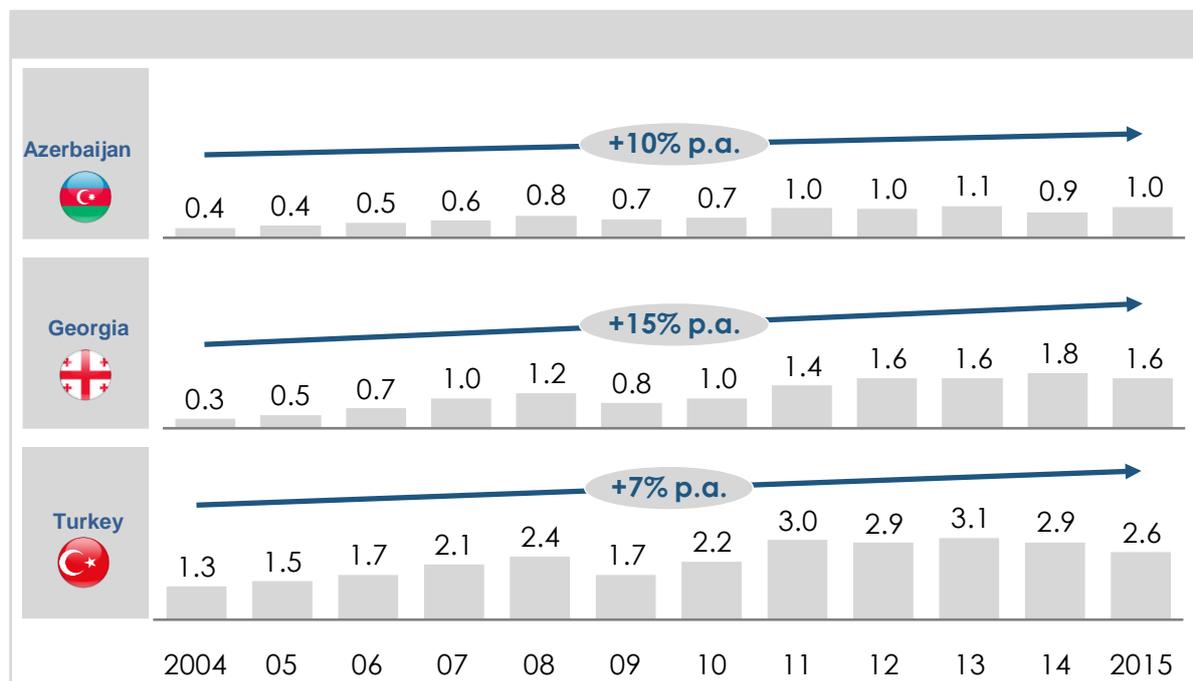


SOURCE: International Monetary Fund

During the period under consideration, Azerbaijan's non-oil import grew by 18 percent on an average. Starting from 2011, relative slowdown in the economic growth also affected import and its volume declined by USD 1,4 billion down to USD 7,9 billion USD in 2014 while volume per capita reduced to USD 900-1100.

As with exports, Azerbaijan's non-oil and gas imports have been on the rise. From 2004 to 2015 they grew by 10 percent a year (see exhibit 12). This growth has outpaced that of Turkey, at 7 percent a year, but is slower than that of Georgia, which began around the same benchmark as Azerbaijan (approximately USD 300–400 per capita) but has grown by 15 percent a year.

Exhibit 12: Comparison of Azerbaijan’s Non-oil&gas imports per capita, USD thousand



SOURCE: United Nations Comtrade Database, International Monetary Fund

Since 2004, in addition to high growth trends in the economy of Azerbaijan a decline in the level of export diversification has also been observed. At the same time, the variety of export products has also decreased¹⁷. Thus, according to report “Observatory of Economic Complexity”, while Azerbaijan was represented in export by 56 items of competitive products in 2004, Azerbaijan ranked 108 in the world for the index of “export diversification” with just 23 competitive commodities in 2014. Being trade partners of Azerbaijan, Georgia ranks 66 in the world with 106 competitive export commodities and Turkey ranks 51 with 380 commodities respectively.

As reported “Observatory of Economic Complexity” for 2014, Azerbaijan ranked 70th among 144 countries for volume of export in the world.

For the purpose of minimizing the dependency on import and further increasing the level of self-supply with domestic products in the future, Azerbaijan’s government has made a number of important amendments to the legislative framework in order to encourage the production and export of competitive non-oil products. The Executive Order of the President of the Republic of Azerbaijan “On additional measures for stimulating the export of non-oil products” dated January 18, 2016 No.1713 and Decree on “Additional measures for the encouragement

¹⁷ <http://atlas.media.mit.edu/en/profile/country/aze/>

of non-oil product exports” dated March 1, 2016No. 811, will give an impetus to the diversification of the country’s exports and improvement of competitiveness.

Economic growth enablers: quality of human capital

According to Human Capital Index prepared by the World Economic Forum (2015), Azerbaijan ranks 63rd out of 124 countries. Azerbaijan ranks 15th for human capital among 30 high-medium income countries. The highest indicators among the countries included in this income group belong to Hungary and Kazakhstan. The lowest quality indicator in different age groups (education and employment) in Azerbaijan belongs to the age group of 15 – 24 while the highest belongs to the age group of 55 – 64. This means that the highest qualified personnel potential is among the aged population while the lowest qualified personnel are among the youth, and our country ranks 85th in the world for the indicator of the availability of qualified personnel in the age group of 25 – 54.

According to State Statistical Committee, though agriculture accounted for 36,7 percent of employment in the country in 2014, a total of 2658 students out of 218690 studying in the higher education institutions and vocational education schools are educated in agricultural disciplines. The lack of qualified specialists in this discipline is one of the key reasons of low productivity in agriculture.

According to Global Competitiveness Report of the World Economic Forum (2016), Azerbaijan ranked 78th for the quality indicator of higher education and training among 144 countries and ranked 94th for the involvement in higher education, 82th for staff training and 81th for the quality indicator of primary education. In this respect, on the background of challenges to the transition to productivity- based development model, one of the most important improvement directions is to further improve the human capital development process.

3.3. Ensuring high economic growth: macroeconomic policy

During 2004 - 2014, both directions of the macroeconomic policy pursued in Azerbaijan, fiscal and monetary exchange polices were aimed at supporting the economic growth. Within this period, Azerbaijan was among the frontiers in global scale for the indicators of macroeconomic stability, the achievements made in economic policy significantly raised the business-investment attractiveness of the country. The analysis of the macroeconomic policy in the past period shows that oil was the most important enabler in the formation and realization of economic policy.

Driver of economic growth: fiscal expansion

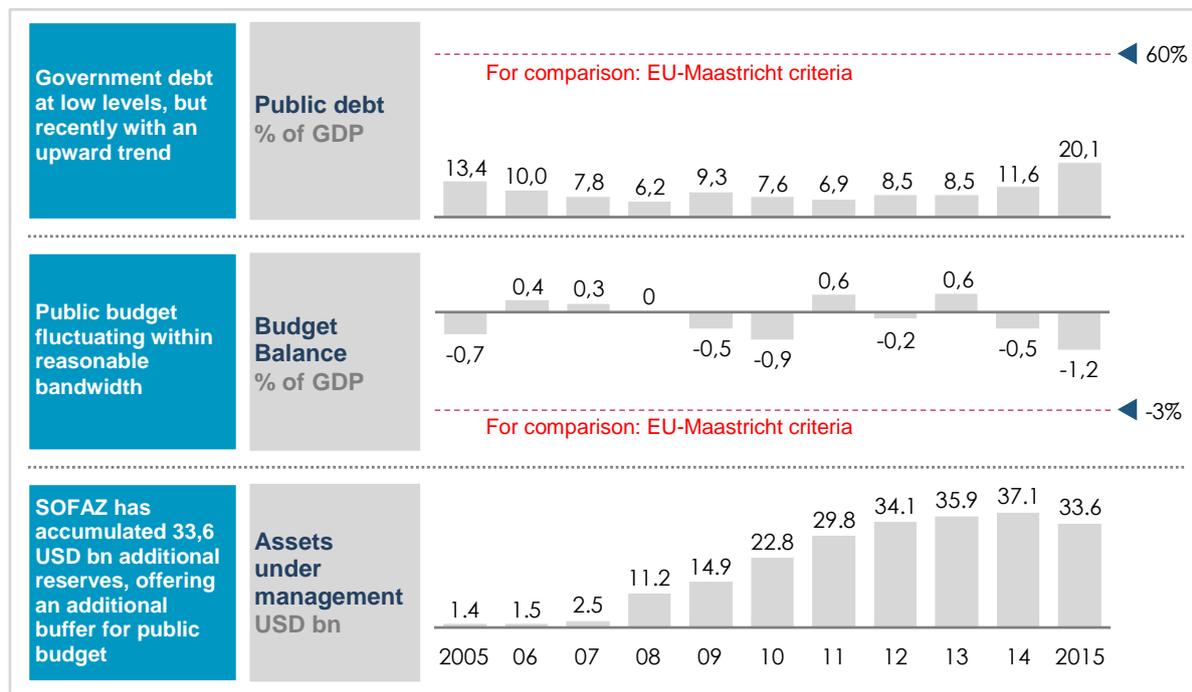
The fiscal policy was the most important direction of the policy, which acted as a strong catalyst to economic growth during the boost period of Azerbaijan’s economy. Fiscal indicators were improved significantly within that period and the contribution of government funding to economic growth increased largely.

As a result of using large-scale government funding resources, high quality socio-economic infrastructure was built, economic activity was spurred, and a significant revival was observed in banking- financial sector.

In 2004-2014, the spending of government budget increased by 12,5 times and the ratio of that spending to GDP increased by 14 percentage points to 32 percent. Fiscal expansion was mainly due to capital expenditures from the budget. Therefore, while the current expenditures in that period increased by 8 times, capital expenditures grew by 41.5 times and budgeted incomes by 12 times. However, particular focus should be given to the fact that the specific share of non-oil revenues in total revenue decreased by 30 percentage points from 64 percent to 34 percent. An increased amount of transfers from State Oil Fund (SOFAZ) of the Republic of Azerbaijan was the main driver of revenue growth. In that period, the volume of transfers increased by 72 times from AZN 130 million to AZN 9,3 billion. In total, the share of oil revenues in the budget (including tax revenues from oil sector) increased from 36 percent to 66 percent. Taxes included in the group of non-oil revenues, customs revenues and other receivables increased by 7 times from AZN 966 million to AZN 6.3 billion¹⁸.

¹⁸Data mentioned in this paragraph are based on information received from State Statistic Committee and Ministry of Finance.

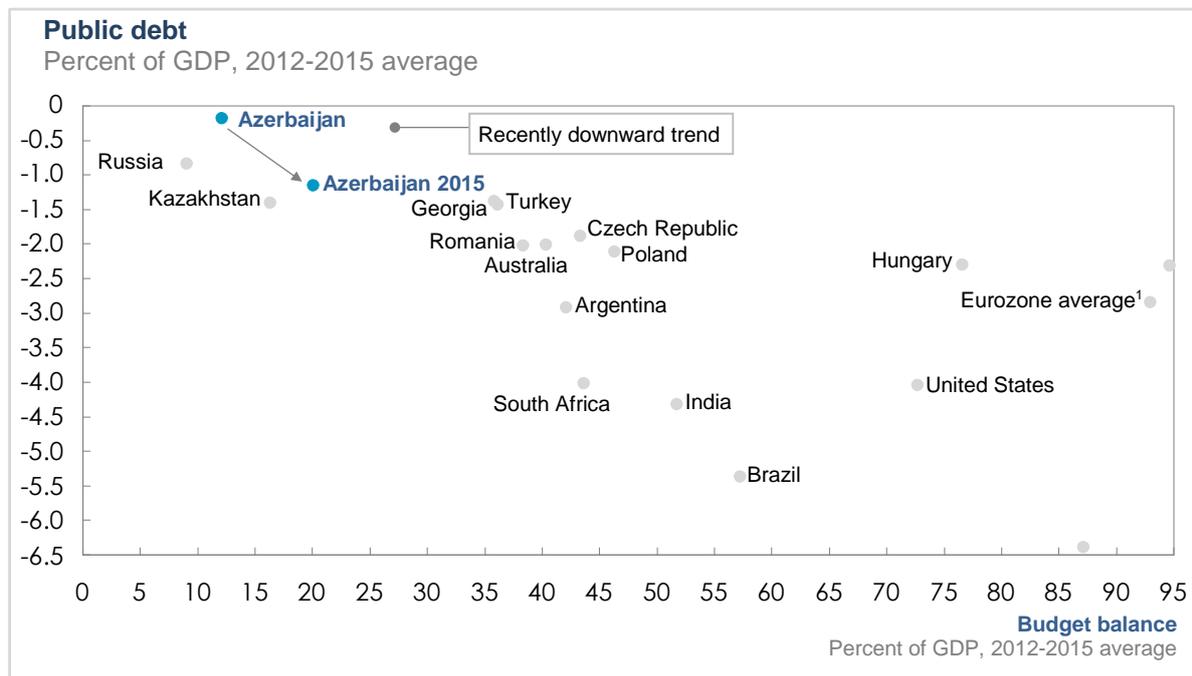
Exhibit 13: State debt and budget deficit levels



SOURCE: Economist Intelligence Unit, SOFAZ

The government budget was implemented almost without deficit during 2004-2014 (Exhibit 13). As reported by World Economic Forum report for 2015, Azerbaijan ranked 16th among 144 countries of the world for the ratio of budget balance to GDP, and 14th for the ratio of state debt to GDP (Exhibit 14).

Exhibit 14: Comparison of fiscal position of Azerbaijan



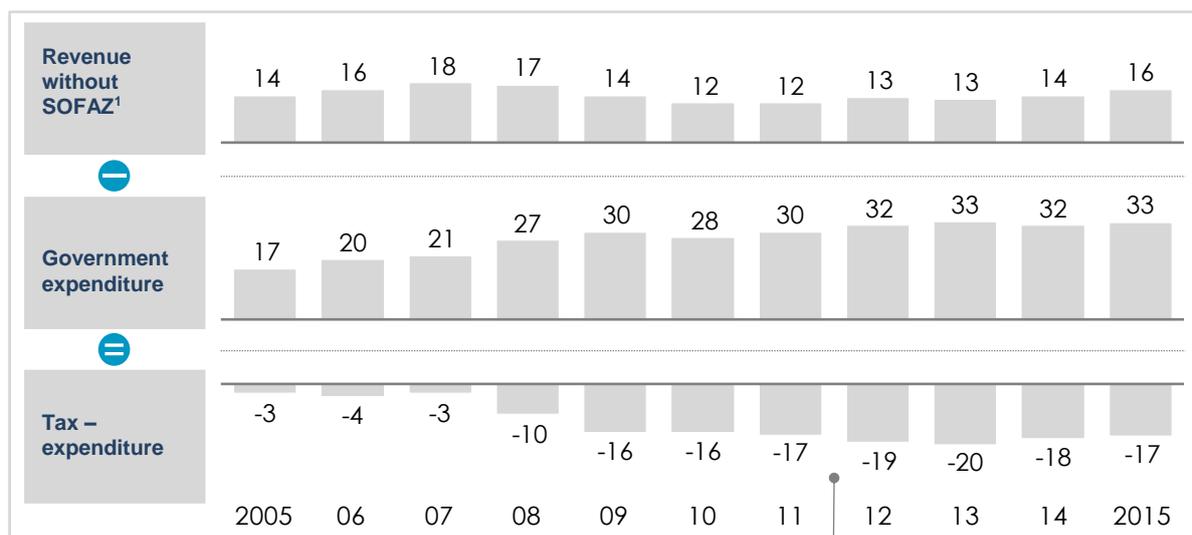
1. 2013 data, excluding Malta and Luxembourg, not adjusted to GDP size
SOURCE: Economist Intelligence Unit

Without taking into consideration the oil factor in budget revenues which were generated at the expense of high share of transfers from SOFAZ, a number of fiscal challenges can clearly be observed (Exhibit 15). Thus, the ratio of non-oil budget deficit to non-oil GDP increased from 11 percent indicator in 2004 to 37 percent in 2014. It should be noted that this indicator reached its 61 percent peak point in 2008 and then it tended to gradually decline in the following years. Non-oil revenues allowed financing only a total of 60 percent (2014) of current state budget spending.

Namely SOFAZ is another important enabler of government funding. As a result of realizing large-scale oil projects, the volume of the fund's revenues reached USD 98 billion by the end of 2015. 65 percent of those revenues or USD 64 billion was directed at the development of country's economy as transfers to the government budget. USD 6,3 billion out of SOFAZ reserves were spent on financing infrastructure and social projects, which made its contribution to the improvement of economic activity.

Exhibit 15: Dependence of budget balance on SOFAZ transfers

% of GDP



Constant tax - expenditure gap is offset by SOFAZ transfers to the budget

1 Only tax revenues. Other revenues not included

SOURCE: State Statistical Committee, Ministry of Finance

In terms of competitive tax rates, Azerbaijan ranks below the regional countries. Thus, while the total rate of tax payments is 39, 8 percent in Azerbaijan, this indicator is 16,4 percent in Georgia and 29,2 percent in Kazakhstan. According to the World Bank, import expenditures in Azerbaijan made USD 3450 (per container) in 2014, but this indicator was USD1235 in Turkey and USD 1595 in Georgia, and USD 2595 in Russia. According to the report of World Economic Forum for 2015, Azerbaijan ranked 122th among 144 countries around the world according to the index of "Burden of customs procedures on business".

There is a number of challenges in comparison with the key trade partners as far as the quality indicators of state investments management and technocratic directions of fiscal policy are concerned.

Certain monthly disproportion in the execution of the government budget is one more noteworthy point with regard to fiscal management. In a number of years, the realization of the government budget in December is significantly higher as compared to other months, which causes certain misbalances in economy in its turn.

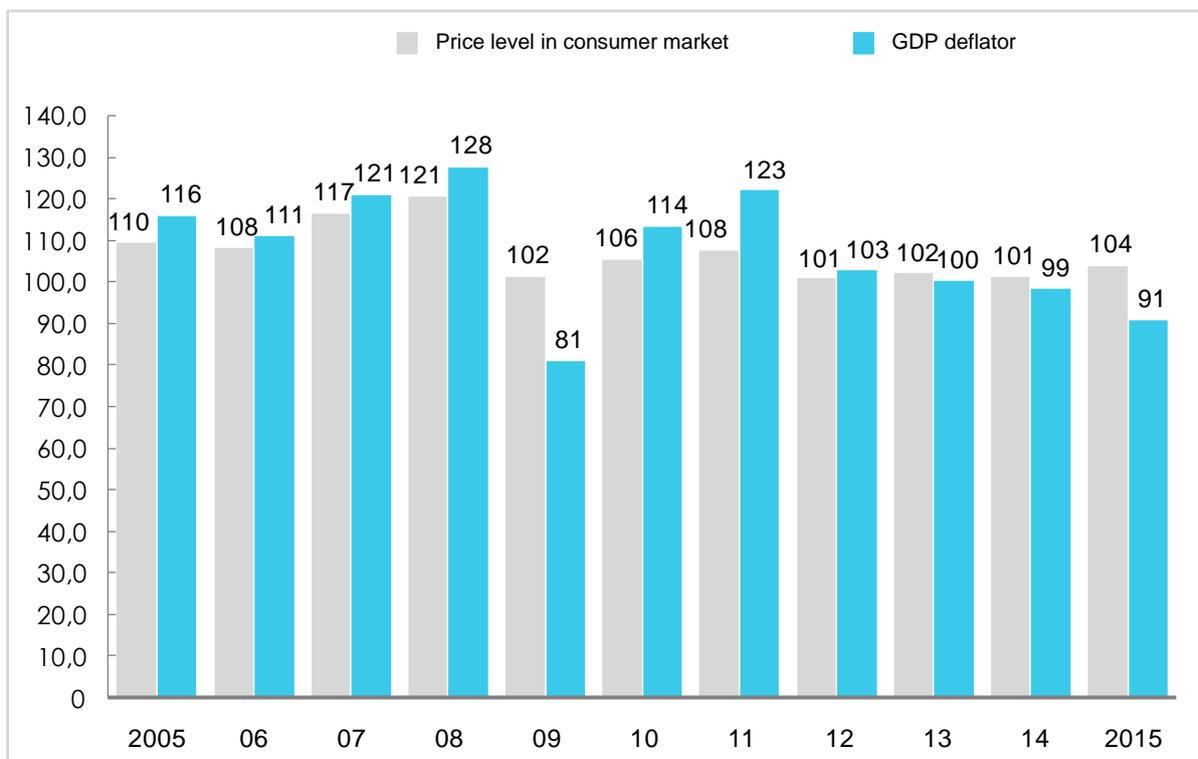
In the periods of high oil prices and revenues, significant fiscal expansion allows to draw a conclusion regarding the pro-cyclical characteristics of fiscal policy. The application of efficient rules capable of ensuring fiscal sustainability and high limit of the fiscal multiplier still remains as an important challenge in terms of further improvement of fiscal management quality.

Economic growth driver: monetary and exchange policy

Monetary and exchange policy was also largely affected by the use of high oil revenues for development purposes through state financing channels. During 2004 - 2014, growing dynamism was observed in the monetary policy indicators, and the country's financial activity improved.

According to the report of International Monetary Fund, the monetary policy of The Central Bank of the Republic of Azerbaijan (CBAR) during that period was de-facto targeted at the exchange rate. It was that period when the exchange rate stability allowed preventing import inflation (Exhibit 16).

Exhibit 16. Dynamics of the inflation level in Azerbaijan



Source: State Statistic Committee

According to the Central Bank, in 2004 – 2014, money supply – money base in national currency in Azerbaijan increased by 18 times, from AZN 640 million to AZN 11,5 billion. Money turnover increased by 21 times, and the amount of surplus liquid funds in the banks' correspondent accounts by 3,3times.

Broadly speaking, money stock in manats (M2) increased by 25 times to AZN 17 billion. During that period, the monetization of economy (m2/ GDP) increased from 8 percent to 30 percent. The amount of credits, which was lent by the bank sector to the economy, increased by 19 times to AZN 18 billion, while its share in GDP reached 30 percent.

The amount of deposits in the banking sector also had high dynamics during that period. The amount of deposits increased by 11 times during 2004 – 2014, which may be accounted for by increased confidence in the banking sector. Dollarization during that time (specific share of foreign currency deposits in total deposits) decreased by 44 percentage points to 36 percent.

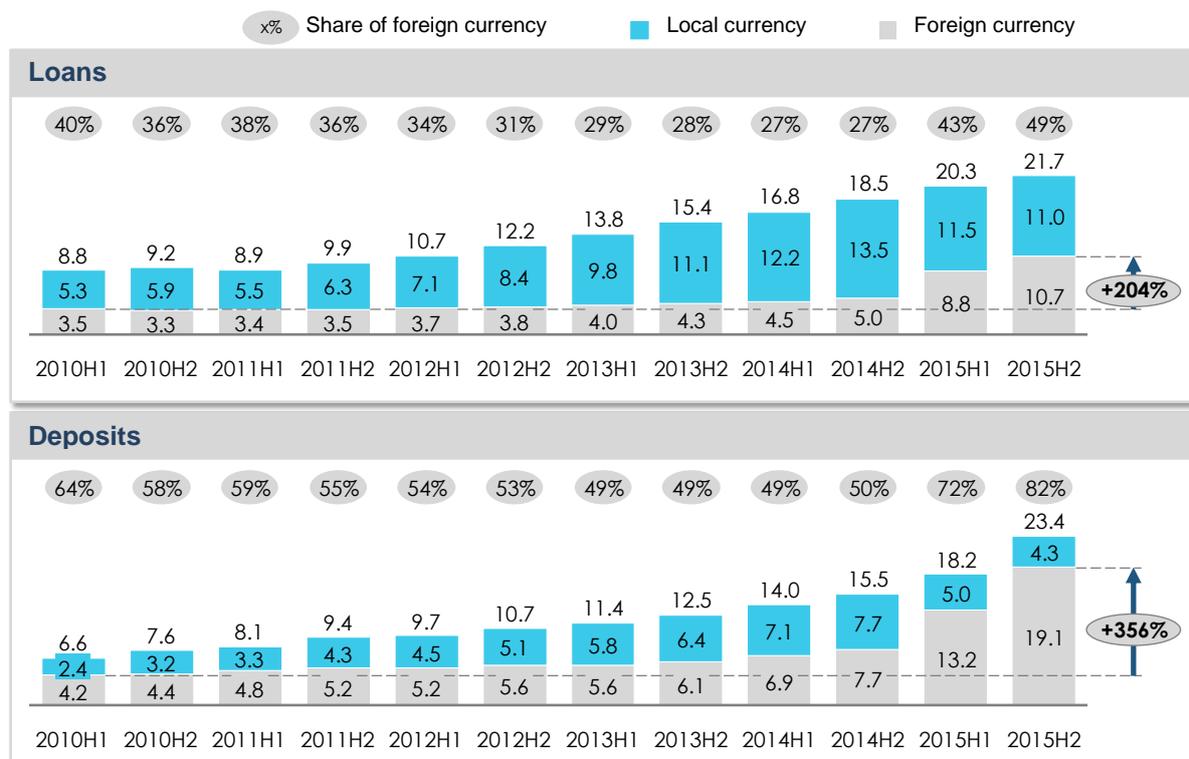
During that period, the intensive use of high oil revenues had indirect impact on the pursuit of expansive monetary policy on the background of dominant fiscal policy. Large-amount transfers from SOFAZ to the government budget created surplus currency in the financial market and CBAR sterilized the surplus currency supply with a view to preventing the national currency from sharp appreciation. As a result, money supply in manat increased at a rate near to the growth dynamics of the transfers, and CBAR accumulated foreign currency reserves in large amounts.

But there was no significant growth in the dynamics of the money multiplier which is one of the most important indicators of a monetary policy. The money multiplier, which was equal to 1,04 unit in 2004, equaled 1,51 unit with an increase of 0,44 points in total in late 2014. And the main reason behind it was that the growth in monetary depth did not keep pace with the adequate growth rate of money supply.

The structure of money stock is another noteworthy matter in the assessment of the transferability of monetary policy to economy. Cash money in circulation in late 2014 (M0) amounted to AZN 10,2 billion, money stock M1 – AZN 12,8 billion, money stock M2 – AZN 17,4 billion and money stock M3 – AZN 21,6 billion. Broadly speaking, the low share of cash money stock in the volume of money stock M2 is one of the important conditions for the transferability efficiency of the monetary policy. This indicator constituted 58,2 percent in 2014 and, despite its decrease by 10 percent as compared to 2004, the circulation of cash money in the economy still remains high. Though important works were performed in developing payment systems by CBAR, encashment level in the economy is still high.

The level of dollarization is also one of the most important factors affecting monetary policy transferability. In early 1990s, the negative processes occurring in the financial-banking system resulted in the diminishment of confidence in the banking system. However, starting from the second half of 90s, the economic reforms conducted and stabilization of the national currency exchange rate allowed to significantly reduce the dollarization indicator. The dollarization indicator, which was 80 percent in 2004, decreased down to 36 percent in 2014 thereby increasing the potential maneuvering capabilities of the monetary policy in its turn (Exhibit 17).

Exhibit 17: Dollarization trend in the economy



SOURCE: Central Bank of Azerbaijan

Another important condition in terms of enhancing the monetary policy transferability is to develop interbank money market. Interbank money market is considered the most important enabler in transferring the economic impact channel within the interest rate corridor of the Central Bank. The fact that any changes in the interest rate corridor have limited opportunities to impact the value and volume of operations in money market also negatively impacts the transferability of monetary policy to economy. In this respect, there is still a challenge of developing the money market on a higher level in Azerbaijan's financial-banking system.

Since the contemporary economy tends more towards to behavioral economy including extensive access to information for the consumers of financial banking services, it becomes inevitable to focus on monetary policy transparency and accountability. The evaluation of monetary policy accountability and transparency indicators against advanced central banking criteria brings satisfactory results. However, such tasks as a continuously increased focus on the channel of fast changing expectations against quality parameters and enhanced trust in money policy are still the most important challenges.

Another achievement of the monetary policy during 2004 – 2014 was preventing national currency from excessive strengthening during the boomed economic growth, which was accompanied by large oil revenues. During this period, the fact that targeting the exchange rate was selected as the main mode of monetary policy was essentially adequate for that economic cycle. In this economic cycle, the high oil prices and growing oil export was accompanied by a significant improvement of the foreign balance of the country's economy,

and large amounts of the foreign currency reserves were accumulated, which was one of the most important targets of the exchange policy. In terms of international requirements for foreign currency reserves (ratio to 3 months' import and M2 money aggregate), the reserves, which were owned by CBAR, exceeded these requirements by several times. However, it is still an important task to keep the low level of transferability of foreign exchange dynamics to prices, on the one hand, and to significantly expand the impacts of the exchange policy on foreign sector regulation.

3.4 New economic phase: low oil prices period

Sharp drops in oil prices in the world's commodity markets have been since late 2014. In late 2014, the price of Brent oil in world markets decreased by 44 percent as compared with the beginning of the year and constituted USD 62 at the end of the period¹⁹. In addition to oil prices, the decline of the economic activity in the countries which are the main trade partners of Azerbaijan and the devaluation of the national currency also negatively affected the country's economy and caused an increase of psychological tension in the financial banking market.

It was one of the main objectives of Azerbaijan to minimize the negative impacts of new economic realities on national economy and to protect macroeconomic stability by correcting foreign and domestic balance. In this direction, the scope of the institutional reforms, which were conducted under the leadership of Ilham Aliyev the President of the Republic of Azerbaijan and efficient steps were taken in the area of the government's economic regulation, further improvement of tax and customs governance. The impact of the reforms conducted was observed in business and investment activity within a short period of time and it is expected that the diversified efficiency of such impact will further increase in the medium term.

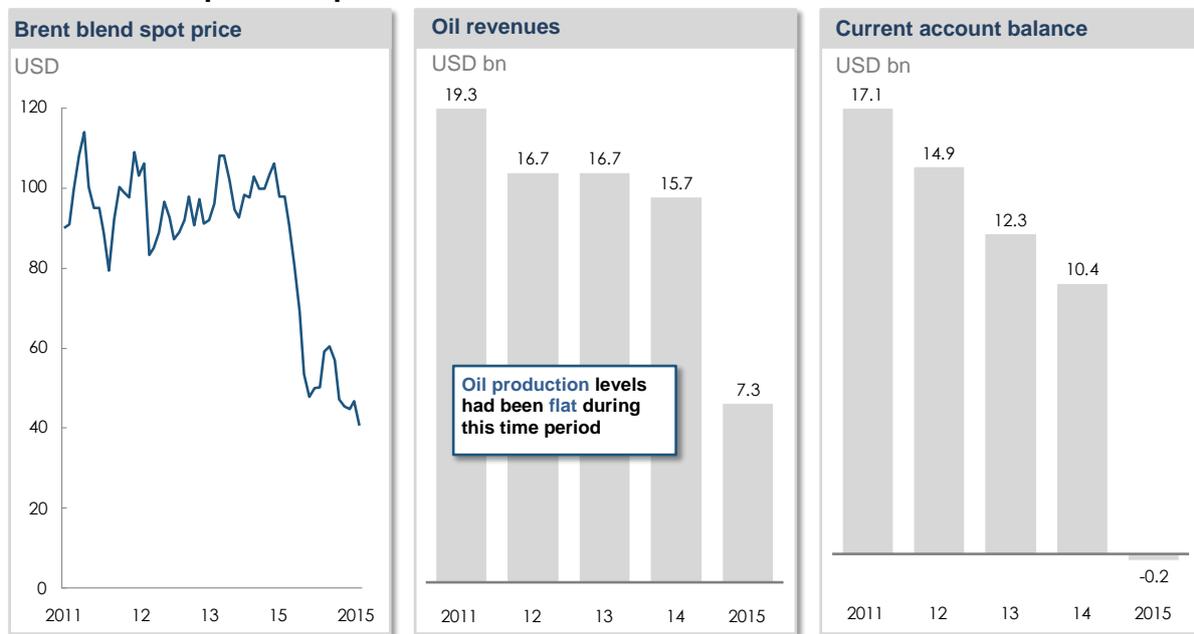
The start of the low oil price era created important challenges for Azerbaijani economy. Thus, the main channels of impact of the new conditions on national economy were foreign balance (balance of payments), domestic balance (government funding, including strategic currency reserves; private investment requirement → economic growth → macroeconomic stability) including banking – financial sector (financial stability).

Foreign balance of the country was an area which was mostly affected by low oil prices. According to the State Customs Committee, foreign trade (commodity) turnover decreased by 33,3 percent to USD 20,7 billion in 2015 and by 24,9 percent in January-August 2016 to USD 11,3 billion in comparison with the respective period of the previous year. The foreign trade surplus of the country amounted to USD 2,2 billion (decreased by 5.7 times) by the end of 2015 and USD 250,3 million in January- August 2016.

¹⁹Source: "Economist" Intelligence Unit

In 2015, a deficit (USD 222 million) in the country's balance of payments had been generated for the first time since 2004. The major source of the deficit was the fact that the surplus of the trade balance decreased by over 3 times from USD 19 billion to USD 6 billion (Exhibit 18).

Exhibit 18: Oil prices impact on oil revenues and current account balance

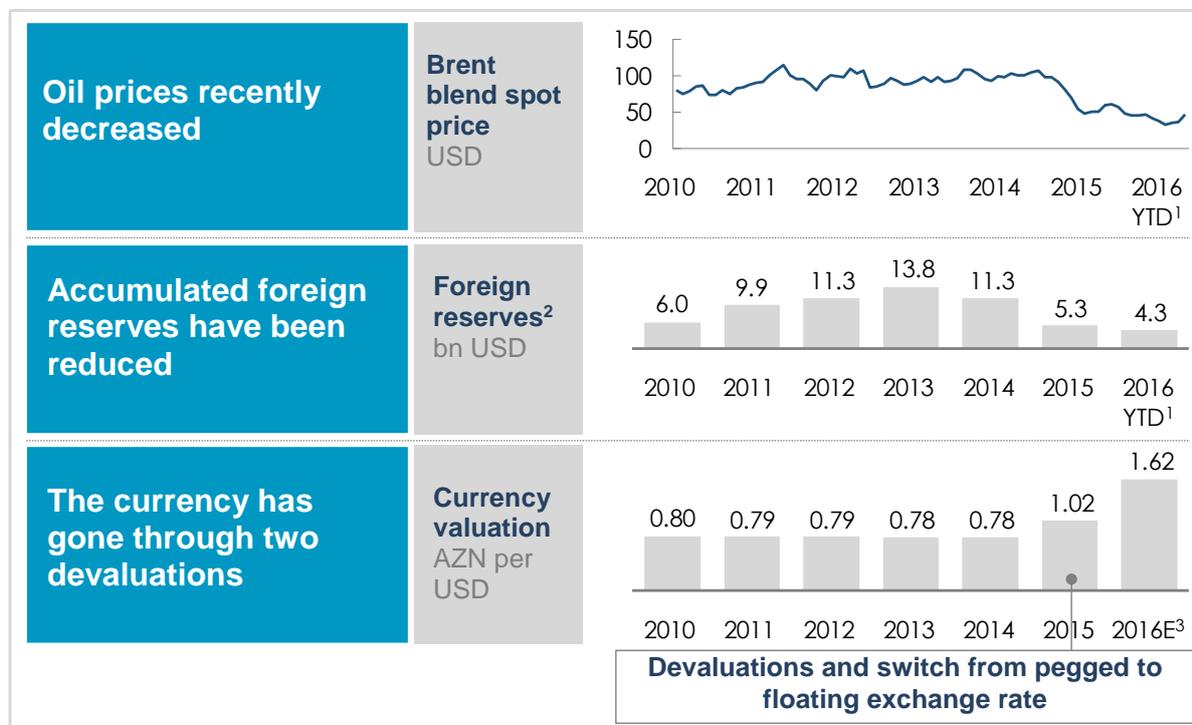


SOURCE: Economist Intelligence Unit, SOFAZ, Ministry of Finance

The balance of capital and cash flow account, which is another important component of the balance of payments, did not allow financing the deficit in current account balance, and the deficit in this account increased by 3 times to USD 9 billion.

The national currency was corrected for 2 times during 2015 with a view to improving the framework formed in the foreign sector, restoring the foreign balance based on the realities of the new period as well as minimizing adverse effects on internal economic balance, and the USD – AZN exchange rate increased from AZN 0,78 at the beginning of the year to AZN 1,55 at the end of the year (Exhibit 19).

Exhibit 19: Factors bringing down exchange rate of manat



1 As of May 2016 end

2 Excluding SOFAZ's USD ~33.6 bn reserves

3 Ministry of Finance's year-end estimate

SOURCE: Central Bank of Azerbaijan, Economist Intelligence Unit, Ministry of Finance

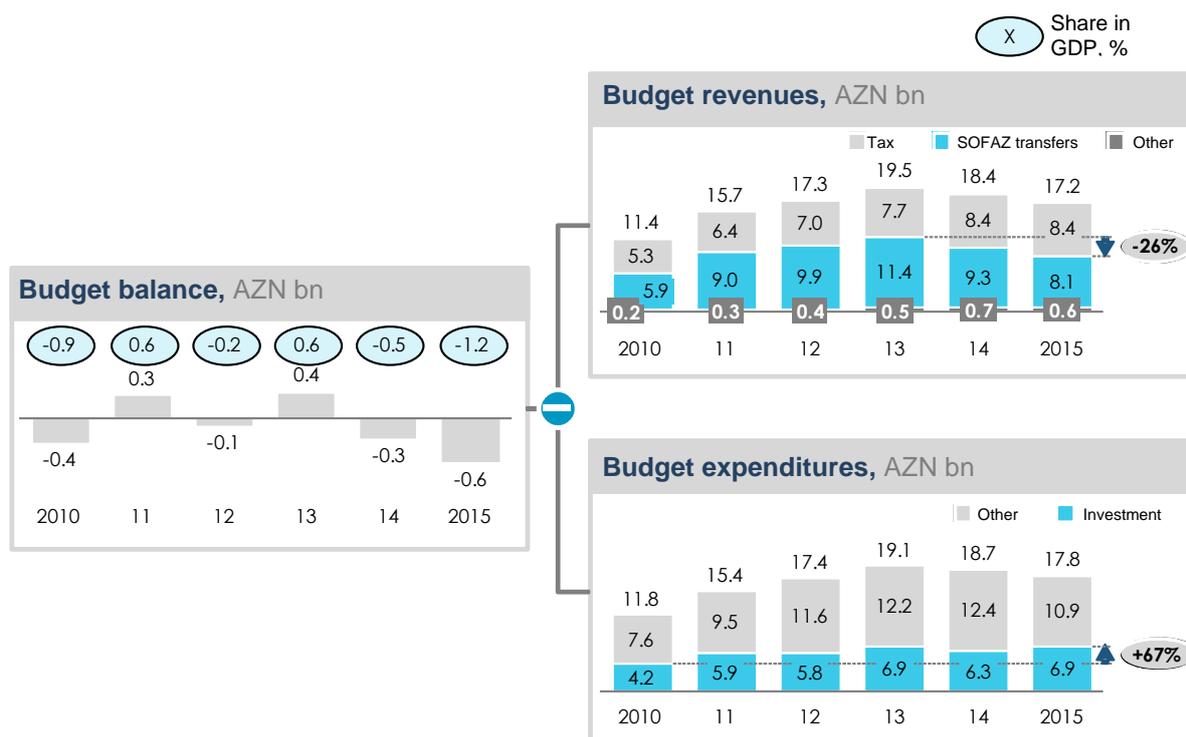
The depreciation of the national currency partly affected the alignment of the balance of payments on a new level. Thus, non-oil import in foreign trade balance decreased by a total of 7 percent. But despite the correction of the exchange rate, the import of oil sector increased by 1,7 times due to the implementation of new large-scale oil projects in the country. On the whole, the deficit of current account balance in non – oil sector decreased nearly by USD 1 billion.

The new circumstances, which were created by low oil prices, also affected the governmental funding (Exhibit 20). The revenues of SOFAZ, which are a significant component of the governmental funding, decreased by 38 percent or AZN 4,9 billion in 2015. On the other hand, corrections to the national currency provided opportunities for saving foreign currency reserves in the amount of the transfers to the government budget.

According to the Central Bank, the total strategic currency reserves of the country decreased by 24,4 percent or USD 12,5 billion in 2015 down to USD 38,9 billion. Furthermore, the State Oil Fund reserves decreased by 9,1 percent (USD 3,3 billion) down to USD 33,6 billion at the end of the period.

In line with the realities of the new period, the Azerbaijan's government decided to take fiscal consolidation measures with a view to ensuring the integrity of the state funding. Thus, capital expenditures envisaged in the government budget for 2016 decreased significantly. Though fiscal consolidation on it sown is a positive trend, it is inevitable that economic activity, which is highly dependent on state investments, decreases in this regard. However, in the medium run, there is no economic policy alternative to fiscal consolidation in terms of transformation of economic growth from government demand to private demand.

Exhibit 20: Impact of decrease in SOFAZ transfers on budget balance



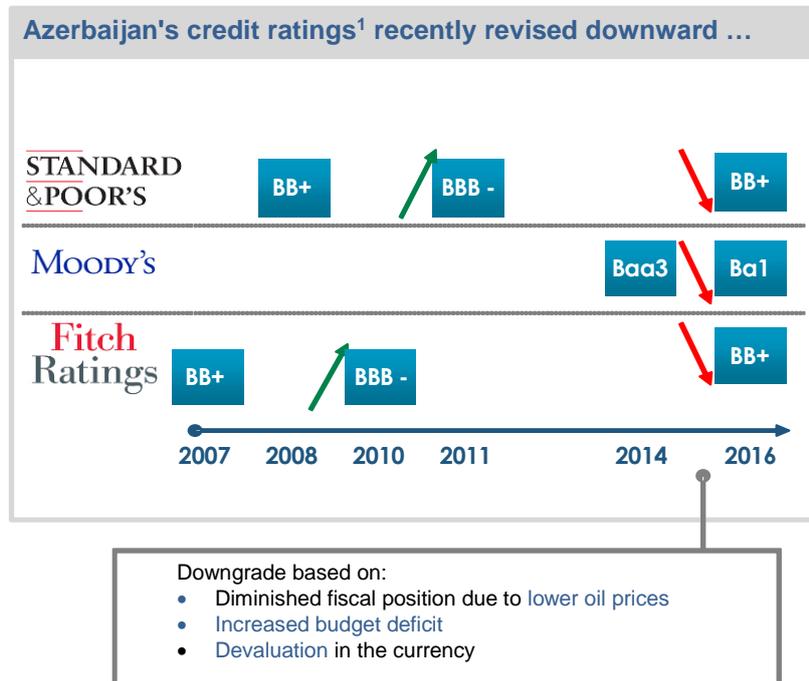
1 Based on budgeted construction spend, not actual

SOURCE: Ministry of Finance, Azerbaijan yearly budget laws and amendments

Increase in the fiscal burden on state and state-guaranteed foreign debt repayments is one of other adverse effects on state funding caused by the new period.

The adverse effects of decline of oil prices did not bypass the banking sector which is one of the channels of financing the total private demand (investment or rather consumption). The shrinking of the total demand, as well as corrections made to the exchange rate considerably restricted the profitable scope of banking activities. The current economic risks are forcing the banks to pursue highly conservative credit policy as a result of which surplus liquidity/low profitability (and damages in some cases) is created.

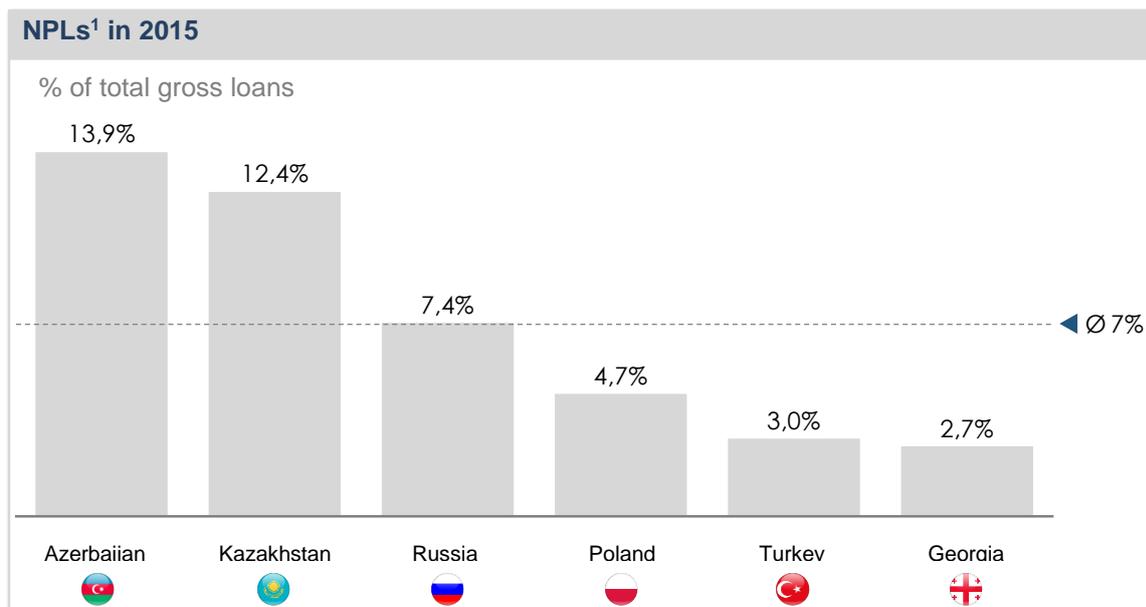
Exhibit 21: International risk



SOURCE: Bloomberg

According to studies conducted by Moody's rating agency, there is a disproportional relation between state budget capital expenditure dynamics and non-performing loans dynamics (Exhibit 21). This may pose a risk for financial stability under the circumstances of fiscal consolidation.

Exhibit 22: Comparison of non-performing loans (NPL) ratios



¹ The value of nonperforming loans divided by the total value of the loan portfolio (including nonperforming loans before the deduction of specific loan-loss provisions)

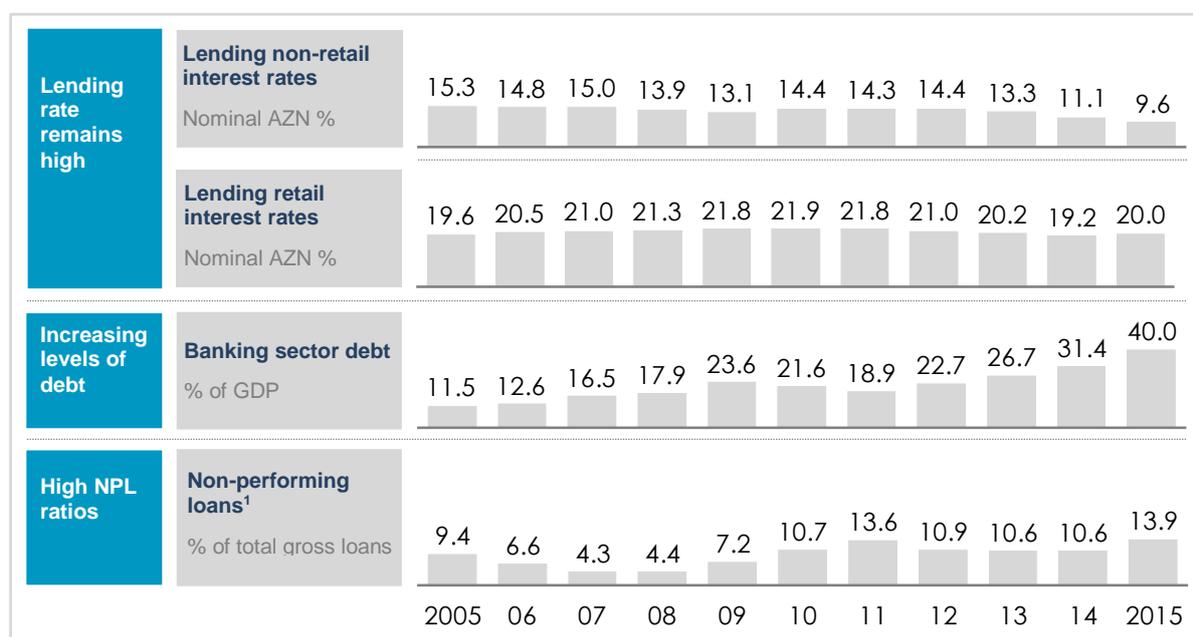
2 Data from Central Bank of the Republic of Azerbaijan, as World Bank not available

SOURCE: World Bank, Financial Markets Supervision Authority (FSA)

The revitalizing dollarization trends also have an adverse effect on the banking sector of the new period and on the efficient transferability of monetary policy to the economy.

The level of dollarization of the economy increased sharply again at the end of 2015 (Exhibit 17). In its turn, this may cause the banks' currency standing to weaken while also having a restricting effect on the maneuvering capabilities of the economic policy (Exhibit 23).

Exhibit 23: Interest rates in the banking sector, debt levels and non-performing loans (NPL) ratio



1 2011-2015 NPL rates are calculated based on total fund that are over 90 days payment time. 2005-2010 NPL rates are extrapolated based on Central Bank NPL rates which was calculated based on only portion of funds that are over 90 days payment period

SOURCE: State Statistical Committee, Central Bank of Azerbaijan

The economic growth dynamics also reflects the actualization of the adverse effects that low oil prices have on the internal balance through impact channels. According to official statistic information, real growth in GDP constituted 1,1 percent in 2015 (2,8 percent in 2014) including 1,1 percent growth in non-oil sector (7 percent in 2014) and 1,2 percent in oil sector (decreased by 2,9 percent in 2014). In January - August of 2016, GDP decreased by 3.1 percent in real terms including a decrease by 5.8 percent in non-oil sector and 2,5 percent in oil sector.

In September 2016, inflation constituted 8.9 percent in comparison with the beginning of the year and average annual inflation 11,2 percent, and it amounted to 14.3 percent in the last 12 months. Since the beginning of the year, the prices of food products have increased by 10,9 percent (average annual 12,7 percent), and non-food products by 10,4 percent (average annual 15,9 percent), and the services by 5,1 percent (average annual 5,2 percent). The growth in inflation dynamics occurred basically in connection with the currency exchange and import prices. Currently, the amount of the strategic currency reserves Azerbaijan has exceeded 100 percent of the GDP. ²⁰

²⁰Source: Central Bank of Azerbaijan

3.5 Final assessment of the economic situation: SWOT analysis

During the period of boomed economic growth in 2004 – 2014, Azerbaijan’s economy gained a significant economic growth potential on a level that will pave the way for future. Even under the circumstances when the adverse effects of low oil prices are continuous, there is a foundation to transform to a new growth approach for future economic development.

Strengths	Weaknesses
<ul style="list-style-type: none"> • Strategically important geographical location • Socio-political stability • Continuous government focus on social areas • Increase deficiency and transparency in provision of government services to citizens (“ASAN” service centers) • Government support to development of entrepreneurship, stimulation of export, diversification of economy and creation of suitable investment environment • Participation in important global projects related to energy and transport corridors • Satisfactory level of self- supply in terms of energy and food security • Satisfactory level of government debt, unemployment and inflation 	<ul style="list-style-type: none"> • Pro-cyclic macroeconomic policy • Poor diversification of economy and export • Dependence of the country’s economy on oil-gas revenues • Insufficient level of corporate management both in governmental institutions and private sector • Direction of direct foreign investments to oil and gas sector • Weak capabilities for absorbing foreign shocks • High share of government in investments, low dynamics of private initiative • Exports are mainly raw material oriented • Import-dependent manufacturing sectors • High level of informal employment • Weak global standing in human capital development • Poor promotion of service export.
Opportunities	Threats
<ul style="list-style-type: none"> • Integration with global value chain, opportunities for diversification of economy • Available development opportunities for priority areas • Creation of suitable business environment for non-resident entrepreneurs • Encouragement of private investments by creating business environment suitable for both local and foreign entrepreneurs to participate in the privatization of state-owned business entities with low profitability • Increase of the non – oil sector role in employment 	<ul style="list-style-type: none"> • Increased geopolitical tension in the region • Increased fiscal burden • Attracting more investments to infrastructure projects than manufacturing sectors • Depletion of natural resources, low level of new growth areas to reimburse the losses • Drop to the level of medium income or drop to lower income group

The outcomes of SWOT analysis shows that there are significant advantages for transforming the drivers of economic growth to a new economic approach.

3.6 Economic prospects: forecasts in basic scenario

The nature of the existing growth approach, the dynamics that have been observed in the last 4 years and the expectations for the global oil market allow drawing such a conclusion that Azerbaijan's economy will face a number of challenges in the near and medium term in the basic scenario.

The statement of International Monetary Fund on 2016 Article IV Mission, which was published in September, has revealed forecasts for macroeconomic framework in the basic scenario by considering the challenges that Azerbaijan's economy will face over the period of low oil prices (Schedule 1).

Schedule 1. International Monetary Fund forecasts for Azerbaijan

Indicator	2014	2015	Forecast				
			2016	2017	2018	2019	2020
<i>(annual change, percent)</i>							
GDP, at fixed prices	2,8	1,1	-2,4	1,4	2,3	2,9	2,5
Oil sector	-2,4	0,3	-0,4	-0,1	3,0	4,3	1,0
Non-oil sector	6,9	1,1	-3,6	2,4	1,8	2,0	3,4
Inflation, average annual	1,5	4,1	10,2	8,5	4,2	4,1	4,0
Monetary base in AZN	-0,9	-40,2	17,0	21,7	16,2	12,3	12,5
Broad money supply in AZN M2	6,1	-50,6	2,8	13,2	16,8	19,1	24,3
Export	-11,1	-44,8	-13,2	13,6	8,7	8,5	4,6
Import	-16,3	4,7	-13,7	10,9	10,7	2,3	2,3
Non-oil budget deficit/ Non-oil GDP (share, percent)	-35,8	-34,4	-37,7	-32,6	-31,8	-28,3	-27,4

Source: International Monetary Fund

Forecasts show that the capabilities of boomed economic growth approach to create added value are restricted under the new circumstances. Weakening economic activity is being

accompanied by a decline in employment and increase in the social burden of the government. Under fiscal consolidation conditions, employment is not expected to grow in the sectors that are highly sensitive to the investment activity of the government, such as construction, service and trade sectors.

Some difficulties may arise in the basic scenario while implementing non-oil revenues (taxes, customs) of the government budget under the conditions of shrinking private demand. At the same time, the shrinking private demand may result in further increase of burden on the government budget when financing social security expenditures.

3.7 New economic growth approach: strategic choice

It is strategically important to decide on the “points of growth” for future economic growth of the country. There are two choices for the country with respect to the future growth approach due to the shrinking capacity of the active capital accumulation model in creating added value for the new strategic period:

- a) labor-intensive growth approach;
- b) productivity-efficiency based growth approach.

It may be a strategic choice to transform to the productivity- efficiency based growth approach within a suitable and reasonable period of time in terms of integration into global value chain, quality and sustainability of economic growth. However, in the short to medium term, a combined use of the two models might allow to have shorter period of transition to the strategic choice approach.

Particularly, it should be taken into account that the workforce in the regions of Azerbaijan is significantly cheaper in comparison with Baku and this creates a considerable potential for developing labor-intensive clusters in the regions. However, the strategic choice is to establish a productivity-efficiency based growth approach. Therefore, high quality institutional environment, accessible financing resources, proper business segmentation and, primarily, intensive development of highly qualified human capital are required.

Transition to new economic growth approach: priority steps

Large-scale institutional reforms are on the reforms agenda to adequately respond to strategic challenges both in the short to medium and long term. More qualitative, effective and inclusive institutions will pave the way for minimizing the adverse effects of low oil prices in the short term and for transforming to the productivity - efficiency based growth approach in the medium and long term.

It is necessary to take the following steps in order *to conduct institutional reforms*:

- **Continue judicial – legal reforms.** Strengthening the independent judicial institutions and ensuring the rule of law are a prerequisite for the protection of property rights. The acceleration of reforms in this area will enhance the trust of existing and potential investors in the protection of investments and return of investment.

- **Strengthening the rule of law.** It is particularly critical to improve the legislation, strengthen law enforcement mechanisms and make them more transparent, improve the capabilities of making legislative forecasts, and, at the same time, expand the mechanisms for supporting legislative initiatives.
- **Improvement of business environment.** Improving the efficiency of the state regulation mechanisms for businesses, further enhancing the quality of tax-customs governance, minimizing the restrictions to access the market and, at the same time, ensuring competitive environment will enable improving the business environment. In addition, it is of great importance to expand the opportunities for private initiative by shrinking commercial activities of the public sector (industrial, transport, communication, financial services etc.)

Expanding the sources to finance the new growth approach is among the important issues on the reforms agenda. First of all, there is a need for clarifying the opportunities of public and private financing sources and for promoting foreign investments heavily.

- **Public funding.** In the first place, it is necessary to finance the priority development sectors. Afterwards, it will be possible to implement sectorial lending at the expense of funding from National Entrepreneurship Fund.
- **Applying private savings to investment.** Improving the business environment may allow to attract the savings of businesses and households to the development of economy as investments.
- **Expanding foreign financing sources.** Accelerating judicial - legal reforms in the country and ensuring the rule of law may also spur the expansion of business initiatives by foreign investors. In addition to conducting such reforms, it is possible to facilitate financing the new growth approach by involving foreign sources through actively holding investment fairs abroad and providing certain privileges for investments in priority sectors (on the same conditions as for domestic investors).

There is a need for further improvement and modernization of the economic policy and the process of economic policy making as well as the mechanisms for their realization. The following reforms are required to achieve this goal:

- **Improve fiscal policy efficiency.** It is one of the important directions to improve the transferability of the fiscal policy in the new economic approach by reducing its dominance. Diversification of the competitive non- oil sector may also support expanding the taxation base of the budget as compared with regional countries and main trade partners. In this respect, it may be possible to promptly consider building a framework that will enable expanding optimal and competitive business and investment opportunities. On the other hand, the application of counter-cyclic fiscal rules and further quality enhancement in public investment management are among the main priorities in terms of improving the technocratic framework of fiscal governance.

- **Improve efficiency in monetary-exchange policy:** the most important challenge in this area is to improve the monetary policy transferability to economy. With respect to ensuring high transferability, it is required to establish an interbank monetary market, reduce dollarization by enhancing confidence in the monetary policy, set up and adequate management framework based on economic expectations and further strengthen coordination with the financial stability policy.
- **Predictable economic policy model.** Predicting economic policies by economic agents allows formulating adequate expectations and, thereby, making rational decisions in this respect. Therefore, it is necessary to improve the mechanisms to formulate the expectations of the economic policy authorities, pre-consider the impact of information and analyses communicated to the public, and ensure that public relations within the government are treated in a thorough and coordinated manner. Building transparency and accountability on a high level and strengthening of sincere cooperation relations with business will enhance the efficiency of economic policy and reforms.
- **Provide high level coordination.** There is a need for forming a structural and macro-economic policy, strengthening the coordination institutions across authorities during its implementation, and improving its efficiency thereafter. In this direction, the Financial Stability Council was established in accordance with Decree of the President of the Republic of Azerbaijan dated July 15, 2016. Further expansion of the activities of this Council will allow improving the economic policy efficiency.

Transition to new growth approach: efficient communication

Another undesirable situation, which may arise in the process of implementing economic reforms under complicated economic conditions, is that economic agents (investors and consumers) may have inadequate expectations and make irrational economic decisions as a result.

Sharp drops in oil prices and, at the same time, serious economic and financial crisis occurred in the countries, which are the main trade partners of the Republic of Azerbaijan, have caused psychological tension among economic agents in the country. One (probably, the main) of the reasons for increased psychological tension consists in the drawbacks of macroeconomic policy communication as well as in the mechanisms of forming adequate expectations. Information gaps are created in an environment where there is no adequate information flow from policy making authorities to economic agents and this enables speculators to benefit from the situation for their own interests and to maximize the tension by increasing speculations. Consequently, both businesses and households blame economic policy making authorities rather than speculators as responsible for the damages that are incurred as a result of the speculations, and trust in these authorities weakens. But it should be noted that high trust is one of the most important values in contemporary economic relations. Namely high trust is considered to be a prerequisite for future successful economic reforms.

4. Strategic Vision

4.1. Strategic Vision for 2020

The strategic vision for 2020 for National Economy is to achieve the stabilizing of Azerbaijan's economy in the short term in order to resolve the situation resulting from adverse effect of the foreign shocks, then to restore the line of development owing to diversification and new drivers in the medium term and to enhance competitiveness by further integrating into the world economy at the end of the period.

Highlights on strategic vision

The strategic vision for 2020 will serve for developing the economic foundations to be built for 2025 and the following period. While Azerbaijan's important role in the energy security of Europe as well as in the development of the transport–logistic corridors will be maintained, economic progress in the directions envisaged in Strategic Road Map will be ensured.

The main objective of diversifying the economy and enhancing its specialization is to increase the amount of revenues based on creating more values in non–oil sector and to carry out their fair distribution. In the last 10 years, the revenues generated from oil have increased the employment level of the population. However, due to poor intensity of labor in oil sector the number of the workers directly involved in this sector constitutes 1 percent²¹ of the total workforce. Revenues from natural resources have increased employment level in public sector and in construction. There is a need for creating new workplaces due to are venue decline in non-trade sectors, which cannot ensure the previous level of employment, and also due to economic recession in the neighboring countries where Azerbaijani migrants live. The development of infrastructure and improvement of business environment will allow attracting more investments to the country's economy on through domestic and foreign sources and will enable creating new workplaces in trade, manufacturing and service sectors. In this case, particular focus will be given to the improvement of workforce qualification and adaptation to new economic challenges.

The strategic vision for 2020 also reflects further expansion of market access opportunities. The improvement of trade infrastructure and strengthening of trade openness should be aligned with the policy of domestic market protection so that more value can remain in the country and, as a result, can be fairly distributed based on more efficient use of natural resources.

In order to make growth more sustainable, it is needed to reduce the extent to which the economy, public budget and currency depend on oil prices. Because oil funds drive much of the domestic demand for goods and services, the changes in oil prices cause economic instability. This could have been observed in the economy between 2004 and 2014 when annual growth rates fluctuated by 11,5 percentage on average, which resulted in limited

²¹Source: State Statistic Committee

planning capabilities of companies and decreased investments in the private sector²². Moreover, since oil revenues are the major source of foreign currency, changes in the oil price can destabilize the national currency.

It is envisaged to apply a “golden rule” in order to eliminate the dependence of the main macroeconomic indicators and, especially, of the government budget on the volatility of oil revenues. In this way, the oil revenues accumulated will be fairly distributed among the generations and amount of the transfers from SOFAZ to the government budget will be aligned with the need for sustainable economic development. As a result of this monetary policy, the stability of prices will enhance confidence in the national currency and serve for creating a disciplined fiscal policy. In short, monetary policy objectives, fiscal framework and economic growth goals will mutually support each other. This will increase the depth of financial markets, varieties of services, their quality and affordability.

The implementation of the Strategic Roadmap in 2016-2020 will include the assessment of social impacts and efforts to reduce poverty through the improvement of accommodation, development of the educational system and healthcare services that will meet modern requirements, improvement of utilities and through ensuring the transition from targeted social assistance system to rehabilitation, in addition to creating workplaces.

4.2. Long-term vision for 2025

Long-term vision of the national economy for 2025 is to achieve strengthened competitiveness by creating further value under the circumstances of collaboration of all economic stakeholders in Azerbaijan, which is already on the path of sustainable development.

Highlights on long-term vision

Particularly, the development of competitive environment will result in attracting more investments to the national economy and expanding market access which will be accompanied by supporting the private sector. Development of the national economy will be ensured by considering the main trends in global and regional context and also integration into global and regional value chains will be assumed as a basis. The protection of macroeconomic stability, improvement of business environment, promotion of private sector investments and support from the public sector is the fundamental basis of the economic development prospect of Azerbaijan during the period until 2025.

Macroeconomic stability

A stable macroeconomic environment lays foundation for a more diversified and sustainable economy. Macroeconomic policy choices determine the shape that this environment takes. Over the past years, Azerbaijan has positioned itself among the top 10 most stable macroeconomic environments (based on the Global Competitiveness Index). In order to keep Azerbaijan in the global top 10, the public sector in the next 10 years will feature a more

²²Source: World Bank and State Statistics Committee

diversified income structure. Fiscal discipline that is ensured by using the “golden rule” for SOFAZ fund transfers and by a strong expenditure framework will protect the economy from oil price volatility, allow SOFAZ to accumulate reserves and keep public debt at low levels. The fiscal rule will be designed to ensure that debt levels are in line with the sustainable long-term growth potential, taking both resource revenues and off-balance-sheet debt into account. Furthermore, this rule will link government expenditures to non-oil GDP and increase the extent to which non-oil revenues cover public expenditures. To ensure that public spending is effective, budget requests should be linked to clearly defined objectives and, ideally, key performance indicators showing the impact they achieve.

As such, Azerbaijan may achieve an investment-grade credit rating from all major international rating agencies. In parallel, close tracking of key economic indicators and a system for monitoring key risks, such as credit exposure or potential asset bubbles, will support sustainable development.

In order to convey important information and offer the transparency required by domestic and international investors, manat will continue to be a floating currency. This approach will make the macroeconomic environment more predictable, supporting higher foreign direct investment and more stable trade flows. Similarly, it will also lead to an increasingly stable, predictable inflationary environment, which will encourage Azerbaijani households to save and thereby increase the stability of the banking system. As exchange rates become less volatile, the perceived risk of investment in Azerbaijan will decline. The risk premium applied by international lenders will decrease as a result, lowering the cost of capital.

To support effective fiscal and monetary management, stability and liquidity of the financial sector will be fully ensured by 2025. This involves ensuring greater liquidity of government bonds and other tradable securities. The liquidity increase will convey important price signals and trigger a liquid interbank market, resulting in a larger supply of credit to our real economy. At the same time, deeper capital markets provide the opportunity for liquid domestic investments, which are especially important for investors seeking temporary investment opportunities. The central purpose of this priority is to attract more domestic lenders and borrowers into capital markets. Doing so will increase the diversification of these markets and thereby reduce their volatility. It will also create more opportunity for manat-denominated investment, so that holding manat becomes more attractive. As a result, deposits, which are currently held predominantly in USD, will be increasingly converted back into manat. A deeper capital market will also allow the central bank to design more effective monetary policy as well as act as a lender of last resort in times of market disturbance. There will be ensured short-term stability in financial sector in the period by 2025 in Azerbaijan, and the structural reforms will strengthen the development in the medium term and the financial sector will be prepared for globally open competition in the long term. The fact that reforms in the financial sector in the country are carried out faster than those in the regional countries will give an impetus to the sustainable development of national economy by expanding foreign investment attraction into the country.

Improved business conditions and private sector investments

By 2025, Azerbaijan will achieve a competitive environment that will ensure fair access to recent technologies, markets and financial resources. There will be ensured business environment that allows domestic companies to thrive and foreign investors to operate at world standards. Ease of doing business entails three key areas: enabling investments, integration to international value chains and achieving global standards in business operations.

To strengthen Azerbaijan's position as a regional hub, investment in quality infrastructure will remain at high levels. In 2025, the Azerbaijani economy will benefit from the completion of today's landmark investments, such as the Baku-Tbilisi-Qars and Astara - Astara railway project connecting railway systems in Azerbaijan with those in Georgia, Turkey and Iran, and Baku International Sea Trade Port in the Caspian Basin. Azerbaijan's diversified transport-logistics opportunities will pave the way for increased export from country and result in savings in business expenditures on the whole. Moreover, improved transport infrastructure will enable better integration across all regions in Azerbaijan, thereby giving additional boost to development of business in the regions. Be using modern communications services, the coverage of electronic services (e-education, e- health, e-banking, e-trading etc.) will be expanded through high-speed broadband network. Particularly, digitalization in public administration will create transparent, accountable, efficient and predictable prospects for business. Expanding the scope of electronic services will be the basis for the internationalization of business in Azerbaijan. More active involvement of the private sector in infrastructure deployment will be ensured in the perspective of 2025 which will lead to the increase of economic efficiency. Moreover, quality utility services will be offered at competitive costs. As a result, Azerbaijan will be ranked among the top countries in the region in terms of utility costs (equal to a global rank of around 35, up from 65 today)²³.

Azerbaijan's position as a regional trade hub in the 2025 economy will be supported by efficient and effective customs procedures in a low-tariff environment based on favorable trade agreements with all major regional economies – most importantly, the CIS countries, Turkey, Georgia and Iran. Regional integration is key in Azerbaijan's geopolitical and economic position, as most trade in non-oil goods and services is regional. For example, almost 90 percent of Azerbaijani agricultural and food exports are shipped to Russia, Georgia or the Central Asian countries²⁴. Finalizing the trade agreements with neighboring countries will enable Azerbaijan to expand export of goods and services to foreign markets under more efficient conditions. At the same time, regional integration will increase the attractiveness of Azerbaijan for foreign investors. Building on success of regional integration until 2025, Azerbaijan will also build connections and agreements for integration to global value chains, particularly for its high value products and services.

To facilitate trade and the accurate assessment of quality, companies in Azerbaijan will adopt global standards and certifications. In the years before 2025, harmonization with global standards will increase the competitiveness of goods which are exported from Azerbaijan.

²³ Source: World Bank

²⁴ Source: UN Comtrade database

Greater use of international quality certifications will promote domestic consumption by establishing reliable measurements of quality. Since WTO standards are assumed as basis in two regional markets such as European Union and Eurasian Union which are geographically closest regional markets to Azerbaijan, the volume of non-oil export of goods and services meeting these standards in Azerbaijan will also be expanded. As consumers in Azerbaijan begin demanding higher quality, companies will respond by upgrading the quality of their products. As a result, “Made in Azerbaijan” will become a seal of quality in international markets. With a view to increasing the efficiency of the works to be performed in promotion of “Made in Azerbaijan” brand, an internet portal, which will contain information on such goods produced in the country and the producers of these goods, will be created. Since this portal will contain information in three languages – Azerbaijani, English and Russian, user coverage will be expanded and this will be beneficial in terms of promoting domestic products. As a result, producer-consumer relationship will improve, and the volume of competitive domestic product exports will increase.

In the perspective of 2025, the investors, who have made investments in Azerbaijan, will have a stronger standing and new foreign direct investments will be attracted. Especially, concrete investment opportunities based on clear competitive advantages will be introduced to the investors who are interested in investing. Tailored investments will be offered to “anchor investors,” i.e., major investors whose involvement will make it possible to integrate Azerbaijan into global value chains, or investors whose presence in Azerbaijan will send a strong signal to the community of large companies operating in the same sector. Services to existing and potential investors will allow them to complete administrative processes quickly and connect with local partners such as construction firms, suppliers or institutions in the education sector. Mechanisms will be established to create needs of foreign investors for domestic products and services.

A stable and deep financial system offering varied and suitable financial services will be created, which will make contribution to economic development by meeting relevant needs of the economy and households.

Supportive and enabling public sector

Economic progress will be given a boost in the next decade in Azerbaijan too. During government intervention in economy, policy, regulation, government order and state entrepreneurship will be separated institutionally from each other. Instead of being the economy’s principal actor, the public sector will focus more strongly on three areas: providing tools and opportunities for Azerbaijan’s citizens, enabling economic development with an appropriate macroeconomic and regulatory framework, and ensuring administrative management that puts tax revenue to use in the most rational way.

Stable macroeconomic conditions and strict fiscal discipline will create a sound business environment – one in which rights to physical and intellectual property are vigorously protected. Private investment will increase significantly as a result. Furthermore, appropriate regulatory policies will enhance competition, leading to a significant boost in the availability, quality, and cost-effectiveness of domestically produced goods and services. Special emphasis will be

placed on supporting the development of local small and medium-sized enterprises (SMEs). Initiatives in this area will improve access to credit, promote exports, offer quality training programs, or simplify administrative procedures. Enhanced public planning processes will facilitate the construction of critical infrastructure required for Azerbaijan's position as a major logistics hub and for better economic integration across the country's regions, thereby helping to close the gap between urban and rural incomes.

For public sector to fulfill its renewed role in the 2025 economy, state owned enterprises (SOEs) will be managed and monitored in a robust way. The main aim of this effort will be to clarify the governance framework, monitoring approach, and strategic processes within SOEs. Clear mandates and performance targets will be developed that take account of the non-commercial objectives many SOEs pursue. Doing so will increase transparency and establish a constructive dialogue between each SOE, the government and public. Monitoring and ownership will be further consolidated and professional corporate structures will be strengthened. Moreover, Azerbaijan will carry out a strategic review of the portfolio and consider the possible transfer of non-strategic assets to private ownership in cases where privatized entities are likely to be more productive. This entire process will carefully take societal and national interests into account, and protecting them and creating proper regulation and market structure at the outset of any privatization.

4.3. Aspirational vision of Azerbaijan for post 2025

Aspirational vision for post 2025 envisages building a strong competitive and inclusive economy ensuring the improvement of social prosperity and maximizing the human development index and based on high technologic development and optimum structure of economy.

Highlights on aspirational vision

The main pillars of Aspirational Vision post 2025 will comprise strong middle class, deep specialization in areas with competitive advantage, effective integration into world economy, provision of national economic security and developed structure. In accordance with the UN Sustainability Goals, Azerbaijan will be committed to taking urgent, courageous and transformative actions that will make the world sustainable and strong.

Social prosperity

Aspirational vision post 2025 proposes to create broad opportunities for realization of human potential. Prerequisites for a good quality of life include prosperity, health, and education.

In the post-2025 period, poverty will be fully eliminated in a targeted way and access to quality healthcare services and education will be expanded. By continuing to follow the path which has been taken over the last ten years, the government will ensure that economic growth reaches those most in need and will thereby eliminate poverty in a targeted manner. The post-2025 economy will take two approaches to address the issue of poverty: increasing the number of proper jobs available; and providing targeted transfers for those whose salaries are insufficient to cover their basic needs. A gradual increase in the minimum wage will prevent

broad growth in the ranks of the working poor. Specifically, the minimum wage will approach 60 percent of the wage average.

In order to ensure food security of the country, major changes and issues, which are likely to occur in economic, social, demographic, natural and technological areas in post 2025 period, will be taken into consideration. In order to establish adequate food security system it is envisaged to expand the application of new food chain technologies (increasing the use of biotechnology and nanotechnologies, increasing food production by also using other technologies, medicalization of food and creation of new types of food) and to create new agricultural food chain structure (expanding the production of organic products, creating domestic, regional and alternative food chains, waste reduction, lowering the losses in food chain and expanding the opportunities for recycling). Today, the Global Food Security Index lists Azerbaijan as the 61st most food-secure country in terms of food availability, and No. 86 with respect to the quality of this food. A better agricultural system will make it possible to bring Azerbaijan up to about 40th place in both global rankings²⁵.

Affordable urban housing options will allow an increasing share of Azerbaijan's current rural workforce to benefit from urban employment opportunities. This will not only help to decrease poverty levels, but also lead to less regional income inequality. Housing will be available for the growing urban population, which will account for 70-75 percent of all Azerbaijani citizens, up from about 55 percent today. Thanks to this migration toward cities with better employment opportunities and growth in higher-paying rural jobs, income inequality will decrease. After 2025 the income gap between Baku and the country's other regions will fall from more than 50 percent of per capita income to around 40 percent.

Economic growth rate will be kept on a high level by strengthening the middle class as a result of carrying out urbanization in a planned manner and considering economic development prospects such as improvement of financial welfare of the middle class, enhancement of its buying capacity and increase of labor productivity.

Contribution to human capital through health and education services quality improvement will play an important role in economic development in the years after 2025. Azerbaijan currently ranks 107th²⁶ globally in terms of education quality, which indicates a significant improvement potential. Public services will be provided in a way that guarantees both equal accesses to all people and convenient digital services for the technologically skilled population.

An improved education system will be the backbone of the transition towards an economy based on efficiency and innovation. This will allow income to approach the levels achieved by EU member countries in Eastern Europe. The salary increases necessary to ensure this quality of life, especially for lower-income workers, depend on higher productivity and access to

²⁵ Source: Economist intelligence unit

²⁶ Data for global ranking of Azerbaijan stated in this section are based on World Economic Forum's Global Competitiveness Report.

suitable job opportunities. The post-2025 system will be rated in terms of international standards, such as the PISA scores awarded by the Organization for Economic Development and Cooperation, and earn scores comparable with those in Eastern European countries. Furthermore, preschool enrolment will be at typical European levels, giving children a head start in their educational lives. The share of people receiving higher education (currently around 20 percent in Azerbaijan, for a global rank of 91) will also grow significantly. IT skills will form a fundamental part of the modernized curriculum in the post-2025 education system. Aligning with international education standards, this system will provide more opportunities for support international exchange at the school and university levels.

Competitive workforce will be the main driver of Azerbaijan's economy for the period after 2025. Particularly, more focus will be given to the employment of youth and women. Social dialogue development and increase in inclusive employment will be achieved through institutes ensuring that flexible policy is realized in the labor market. Development of human capital in Azerbaijan in line with the requirements of not only national economy but also the global world economy will allow regulating the labor migration so that more value will remain in the country. Strong, highly-qualified and innovative workforce will play an important role in strengthening the positions of Azerbaijan in global value chains. Rise in technological opportunities will allow Azerbaijani workforce to perform export activities in a number of service areas. Labor productivity in Azerbaijan will reach the relevant indicator level of the Eastern European countries as a result of skills development and efficient use of the resources. In general, when regulating the labor market in post 2025 period, the impact of high technologies including factors such as the application of smart machines and systems and expansion of communication opportunities will be taken into consideration.

After 2025, more attention will be paid to environmental protection in Azerbaijan; reduction of carbon emission will result in cleaner air, water, and soil. Based on the principle of energy efficiency, energy consumption will be minimized for the production of each GDP unit in Azerbaijan, and, in the post-2025 period, the share of renewable types of energy in the energy balance will be increased. Moreover, efficient waste management system including harmful gases, waste waters and radioactive waste management will be created by taking the ecologic balance as a basis.

Economic prosperity

In 2025, Azerbaijani economy will be more sustainable against the foreign shocks as a result of macroeconomic stability, especially fiscal sustainability, suitable business environment, developed infrastructure, free access to foreign markets and attraction of foreign investments, and the labor productivity in the country will reach the relevant indicator of the Eastern European countries. Azerbaijan's economy will be transitioning from an efficiency-driven model to an innovation-driven one, as defined by the World Economic Forum. Real per capita income will increase by an average of 5 percent every year, and Azerbaijan will meet the conditions to be classified as a "high-income country" according to the World Bank. As a result of these developments, the post-2025 economy will offer per capita income levels approaching those seen in Eastern European countries.

To develop an innovation-driven model, physical, human, institutional and social capitals will be ensured.

After 2025, more than three-quarters of total added value in Azerbaijan's diversified and sustainable economy will be generated by non-oil sectors. In subsequent years, competitive labor costs will act as a short-term catalyzer for Azerbaijan's economy. However, actual competitive advantage will be created by high productivity resulting from quality education and vocational training, along with the use of advanced technology and other forms of innovation. In other words, by 2025, development towards a knowledge-based economy will be underway.

In post 2025 period, the transition to a innovation- driven model of development will ensure that more value remains inside the country due to more deepened specialization in the non-oil sectors that had competition advantages and developed in the previous years. Technology transfer and commercialization of knowledge will increase investment efficiency. The optimality of both regional and inter-sectorial structure of economy will increase which will ensure balanced and sustainable development. Particularly, the establishment of regional development centers in Azerbaijan will ensure general economic development due to deepened specialization in competitive fields of economy. Baku will be established as a thriving industrial and service hub of international importance.

In post 2025, a balance between oil and non-oil trade will be reached, and the oil funds injected into the economy by SOFAZ each year will be provided based on "golden rule". Such approach will mitigate the impact of oil price changes and build trust in the freely floating local currency among households and businesses. Macroeconomic stability will lay foundation for stimulating both domestic and international private sector investments. Competitive financial system will support sustainable development and improve the prosperity of the people as a result of integration into international financial markets and application of financial technologies.

Additional investment in non-oil sectors is an important enabler of a more competitive economy overall in 2025 and beyond. For this reason, foreign direct investment in industries and services will be attracted on a wider scale in the future. With large multinational companies offering technologies, skills, and access to global value chains, increased foreign investment in non-oil sectors will position Azerbaijan firmly on the global economic map. Azerbaijan will attract foreign investors in a strategic approach with three aspects: the development of highly attractive investment opportunities such as industrial parks with modern infrastructure; targeted outreach to leading international companies; and first-class services to existing and future investors.

In post 2025, export will be diversified and grow based on increase not only in goods, but also in service range. The fact that export will be based on growing number of products and services will reduce dependence on the fluctuations in oil and gas prices and stabilize the foreign currency inflow.

5. TARGET INDICATORS

The Strategic Roadmap aspires to achieve more than 3 percent growth every year in GDP, creating over 450,000 new jobs by 2025. The creation of these workplaces will be possible due to the impact of three enablers: I) measures taken within the frame of the Strategic Roadmap; II) other additional measures and III) rise in economic growth rate as a result of improvement of overall economic environment. The share of informal employment will decrease and the following four special targets will be achieved as a result of implementing the actions proposed for economic sectors:

Increase the share of non-oil foreign direct investment (FDI) in non-oil GDP from current 2,6²⁷ percent to 4 percent by 2025. Foreign investors play an important role in diversifying an economy as they not only contribute the investment itself, but also the skills, technologies, and networks required to enter into new sectors and value chains. Diversification requires attracting more investment in non-oil sectors.

Increase non-oil exports from less than USD 170²⁸ per capita today to at least USD 450 by 2025. In 2015, Azerbaijan's economy required imports equivalent to USD 1,000 per capita. To balance these imports, Azerbaijan exported goods worth more than USD 1,500 per capita, 90 percent of which were oil and gas products²⁹. Balancing the imports of goods and services with exports is important for economic independence and currency stability, but more non-oil exports are needed to decrease the dependence on oil prices.

Create 150,000 new jobs in tradable sectors, such as manufacturing or tourism, by 2025. Creating jobs for citizens is always a priority for government, but jobs in some sectors have more economic impact than others. In order to diversify exports, there is need to create jobs in so-called tradable sectors, i.e. sectors producing output that can be traded internationally in the form of goods (such as manufacturing or food products) or services (such as tourism or transport). Tradable sectors face international competition, which usually leads to fast productivity growth.

Decrease the dependence of public budget on SOFAZ transfers. Today about every second manat spent by public sector (about 50 percent) is financed by SOFAZ transfers³⁰, but this share should sink to less than 15 percent in 2025. The amount that SOFAZ can transfer has been closely linked to its income and, in turn, the price of oil. This dependence is one of the main reasons why Azerbaijan economy reacts significantly to oil price changes. In order to increase private investment into the

²⁷ This indicator has been estimated as the ratio of average amount of foreign investments in fixed assets in non –oil and gas sector in the last 5 years to average non – oil GDP for that period.

²⁸ Source: State Statistics Committee

²⁹ Source: UN Comtrade database

³⁰ Source: Ministry of Finance, SOFAZ

economy, stable growth is paramount and requires making the public budget less dependent on oil fund transfers.

It is critical to note that this aspiration requires successful execution of strategic objectives and priorities of the roadmap in national economy perspective and 11 priority sectors. In addition to disciplined implementation and diligent monitoring & evaluation, this necessitates mobilization of investments and other resources. According to estimations, AZN 27 billion of investment will be needed to be channeled into the economy until 2020 to implement the priorities that have been envisaged. This amount indicates total funds required within the framework of the strategic roadmaps throughout all the sectors. The proposed funds will be ensured by using all types of public and private (domestic and foreign) sources. These investments will build the foundation for the Azerbaijan's economy to deliver impact beyond aspirational vision defined for 2020. Determining new strategic objectives within priority sectors or in other sectors of the economy can help Azerbaijan to achieve even higher aspiration, upon positive trajectory of the objectives of the Strategic Roadmap.

6. STRATEGIC OBJECTIVES

Due to proper management of oil revenues, Azerbaijan has succeeded in building social and economic infrastructure, high collectability and relatively small foreign debt, poverty reduction, high share of private sector in GDP and business environment improvement. It is planned to ensure macroeconomic stability based on good management within the scope of Strategic Roadmap, improve the structure of economy, increase employment, ensure balanced regional development, improve business environment and strengthen private sector involvement. Azerbaijan has achieved a number of targets for Millennium Development Goals and joined UN Sustainability Development Goals approved for 2016 – 2030. Azerbaijan will establish an efficient execution mechanism for the development of more sustainable, broader and diversified economy and for ensuring a balanced development of social areas.

Four main strategic priorities have been envisaged in the Strategic Roadmap for national economy perspective.

The current global environment and the oil prices have objectively necessitated strengthening fiscal sustainability, ensuring the efficient use of resource revenue and adopting a robust national macroeconomic policy framework. In the path forward for economic developments, the government aims to more rationally align its fiscal and monetary policy in order to realize its objectives. The future actions regarding Azerbaijan's policy of strong fiscal sustainability and monetary policy are described in the first priority of the "Strategic Roadmaps for National Economy and main sectors of economy".

From this perspective, ensuring fiscal policy frameworks and sufficient rates of savings from resource revenues together with sound management of Azerbaijan's natural resources are considered. The main institutions proposed are: "golden rule" approach for rational use of oil revenues and necessary fiscal framework for the management of public debt. In this context, continuous actions will be undertaken to effectively reinforce the Medium Term Expenditure Framework, strong budgeting management and its adjustment to outcome based budgeting, to ensure efficient public expenditure, and to mitigate the volatility of oil revenue. The first priority is related to monetary framework in addition to sound fiscal framework.

A sound monetary policy framework, and effective execution of the monetary policy aspirations are essential components of macroeconomic environment. In this light, in order to further expand the economy's potential it is vital to conduct a monetary policy in coordination with the fiscal policy, assess the adjustments that are required for monetary factors to reflect changes in the economy.

Along with monetary and fiscal frameworks necessary to further strengthen the economy's potential, another strategic objective consists in privatization and reforms in state owned enterprises. This document includes provisions with regard to adopting the government's shareholding approach and improving the efficiency of public sector's role in the economy through carrying out a reform program in state-owned enterprises. The Strategic Roadmap

aims to bolster the existing government efforts undertaken to encourage private sector activity, maintain efficient state-owned enterprises, and increase attraction of foreign direct investment to shape the business environment and the steps to be taken in this area are described in the second priority.

The third priority is to accelerate the development of human capital, as an integral part of the efforts undertaken towards the competitive, inclusive and sustainable economy goals. For this purpose, initiatives will be substantiated and measures will be planned in line with the following directions: commitment of education to human capital and improving labor productivity to help companies to become more efficient.

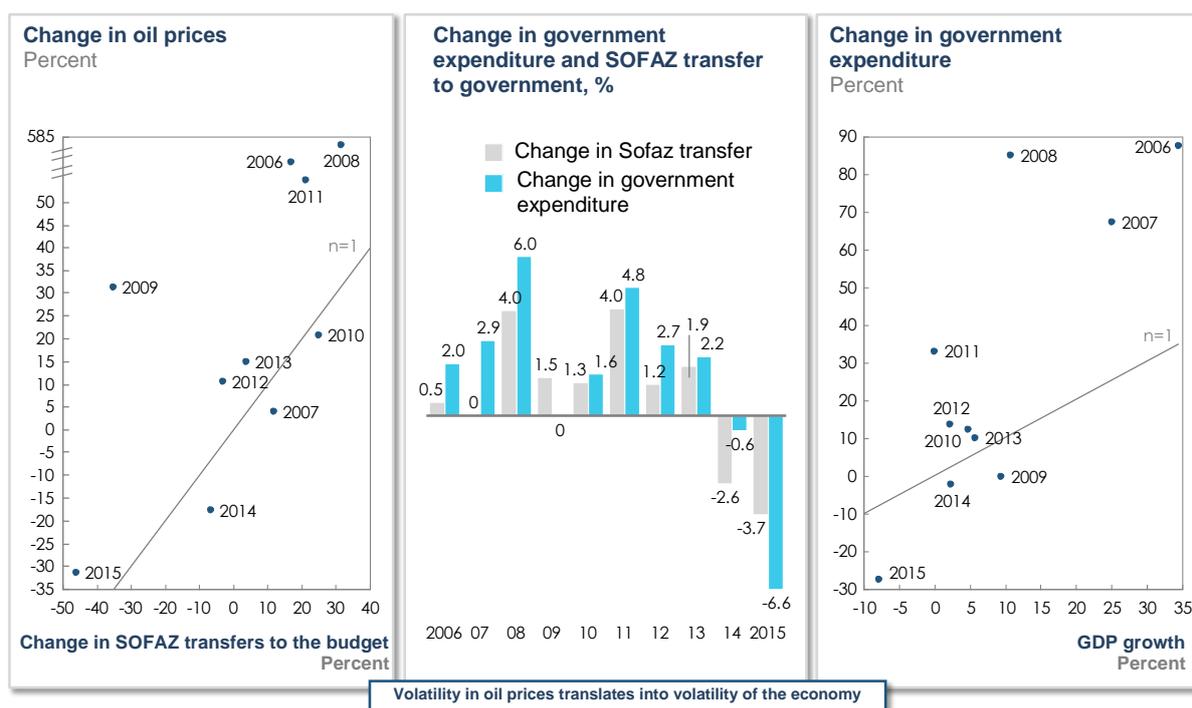
The fourth objective is related to further improvement of business environment. As a result of fiscal and monetary policy, giving a boost to economy may allow efficiently using the existing resources under suitable business environment conditions. Sectorial strategic roadmaps provide more detailed approach regarding the improvement of the business environment to support economy.

7. STRATEGIC TARGETS

7.1. Strategic TARGET1: Strengthen fiscal sustainability and ensure a robust monetary policy

The processes taking place in Azerbaijan's economy are considerably linked with the volatility of oil prices in the world's market and the GDP impact of this volatility occurred as consecutive triggering mechanisms (see exhibit 24). The volatility of oil prices has directly affected SOFAZ transfers to the public budget. At the same time, fluctuations in the volume of SOFAZ's transfers to the government budget are reflected in government expenditures. Given the high overall weight of government expenditure in the economy, the change in government expenditure resonates with the changes in the GDP. Because of this link and the variability of oil prices over the last years, GDP growth in Azerbaijan was very volatile, with an average standard deviation of GDP growth of 11 percent between 2004 and 2014, compared with just 4 percent in Turkey³¹.

Exhibit 24: Impact of oil price volatility and SOFAZ transfers on Azerbaijani economy



SOURCE: Ministry of Finance, World Bank

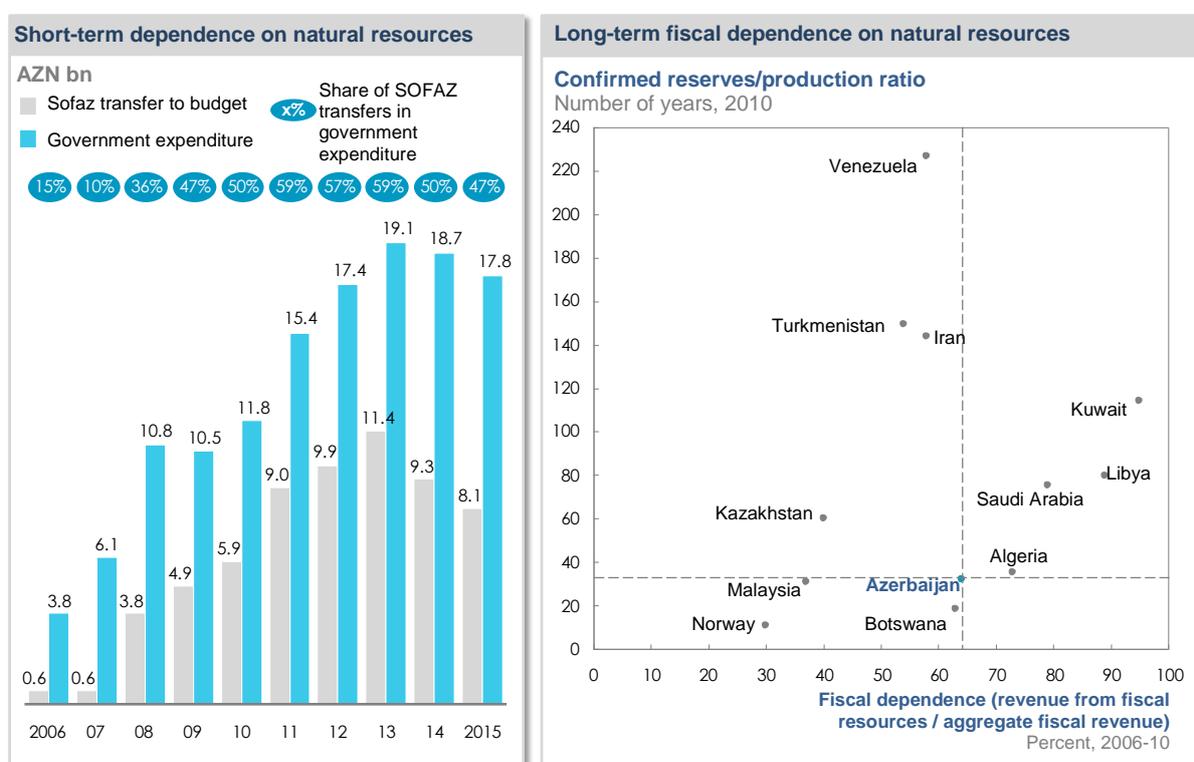
Azerbaijan should decrease its economy's dependence on natural resources and oil in particular in both the short and the long term. The high share of SOFAZ transfers in

³¹ Source: World Bank

government expenditures peaked at 59 percent in 2013³² and this poses challenges to macroeconomic stability. And while the budget's dependence on SOFAZ transfers has been declining since 2013, the overall share of the budget funded by SOFAZ transfers remains high. This situation is likely to have a direct impact on GDP growth as a consequence of future oil price changes.

In the long-term, fiscal dependence on oil warrants focused consideration. The finite nature of Azerbaijan's natural resources calls attention to the need for alternative approaches to ensure a sustainable economic development model. Thus, it is estimated that confirmed oil-gas reserves in Azerbaijan will last for a shorter time frame than for Iran, Saudi Arabia, or Kazakhstan. Although it is likely that continued exploration (particularly of smaller fields) will add to this time frame, the situation today requires to reduce dependence on oil and gas revenues over the next 30 years.

Exhibit 25: Level of dependence on oil



SOURCE: Ministry of Finance, International Monetary Fund

High dependence on oil affects the economy in various additional ways. To begin with, as a consequence of the constantly changing inflows of foreign currency related to oil trade and the resulting instability of the AZN, trust in the local currency weakens.

³² Source: Ministry of Finance, SOFAZ

According to information of State Statistics Committee, while the share in GDP of the total savings of fixed capital were accumulated at the expense of public sector in Azerbaijan in 2014 was 20 percent, this ratio for private sector constituted just 8.6 percent in total. This can be explained by the government's access to vast oil revenues, but also by limited access to financial resources by the private sector. The latter effect is partly because, to date, the availability of oil revenues has made it unnecessary for the government to issue bonds, but government bonds are often the backbone of a liquid capital market. Moreover, the sheer size of the public sector in relation to the overall economy indicates a "crowding out" of the private sector: the ratio of public expenditures to non-oil GDP has been 52 - 59 percent in the recent years. Although not as capital scarce as Azerbaijan, Norway's ratio of 28 percent for the same Exhibit puts forward a further development opportunity for Azerbaijan³³.

Growth concentrated on resources sectors also typically translates into low overall private sector employment, due to the low labor intensity of these sectors. And the low labor intensity of resource sectors has adversely affected Azerbaijan: while the oil and gas sector contributes 36.3 percent to GDP, it generates only 1-2 percent of employment. As a consequence, total formal private sector employment was 623,6 thousand in 2015, while increasing public expenditures enabled Azerbaijan to employ about 878,9 thousand people in the public sector³⁴.

Moreover, a vast increase in public expenditures typically causes additional problems such as selected overspending, lower budgetary discipline, and inefficiencies in the public sector. With Azerbaijan's government expenditures increasing by more than 50 percent in some years, these challenges are very likely reality in Azerbaijan, too³⁵.

7.1.1. *Priority 1.1: Establish a golden rule to regulate the transfers of oil revenues to the government budget*

Rationale

In light of the global macroeconomic trends, and its implications mentioned above, to avoid any potential challenges resulting from unpredictable external shocks, and to ensure preservation of wealth for future generations, effectively administering the integrated fiscal management guidelines would be important for Azerbaijan. In this direction, four major components to be considered are: establishing a golden rule to ensure transfers of oil funds to the government budget, establishing mechanisms to ensure expenditure and investment discipline, effectively reinforcing Medium-Term Expenditure Framework and considering implementing outcome-based budgeting mechanism. In this direction, the fiscal, monetary and economic objectives as well as their interdependencies require more optimum consideration to ensure they reinforce each other.

³³ Source: European Commission and World Bank

³⁴ Source: State Statistics Committee

³⁵ Ministry of Finance data for 2006-2008

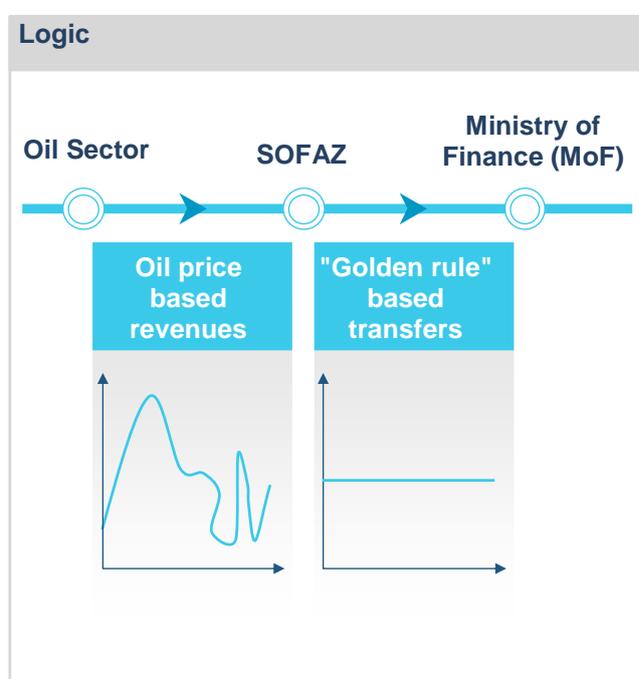
Actions to be taken

Action 1.1.1: Create alignment on “golden rule” principles

Establishing a “golden rule” to increase stability of SOFAZ transfers to the government budget will be taken into consideration.

Today, the amount of funds transferred by SOFAZ to the Ministry of Finance varies depending on the price of oil. Enacting a more strict transfer mechanism between SOFAZ and the Ministry of Finance—a so-called “golden rule”—can stabilize these transfer amounts, thereby better isolating government expenditures (and thus GDP growth) from oil prices movements (see Exhibit 26).

Exhibit 26: "Golden rule" principle



This mechanism would confer many benefits, chief among them being greater stability. This golden rule will reduce the volatility of Azerbaijan's GDP and make it easier to predict the funds available to the Ministry of Finance and foreign exchange rates. The increased predictability, in turn, will provide a better base for long-term growth and diversification as well as the base for long term planning and more efficient public spending. Limiting the scale and variation in government expenditures will also lessen the extent to which the private sector gets crowded out. As a side effect, the need for the Ministry of Finance to access capital markets to cover potential public budget deficits in certain years would support the deepening of a local capital market.

Moreover, because currently the optimum amount to be transferred by SOFAZ into the government coffers has not been determined precisely, it's difficult for SOFAZ to commit to

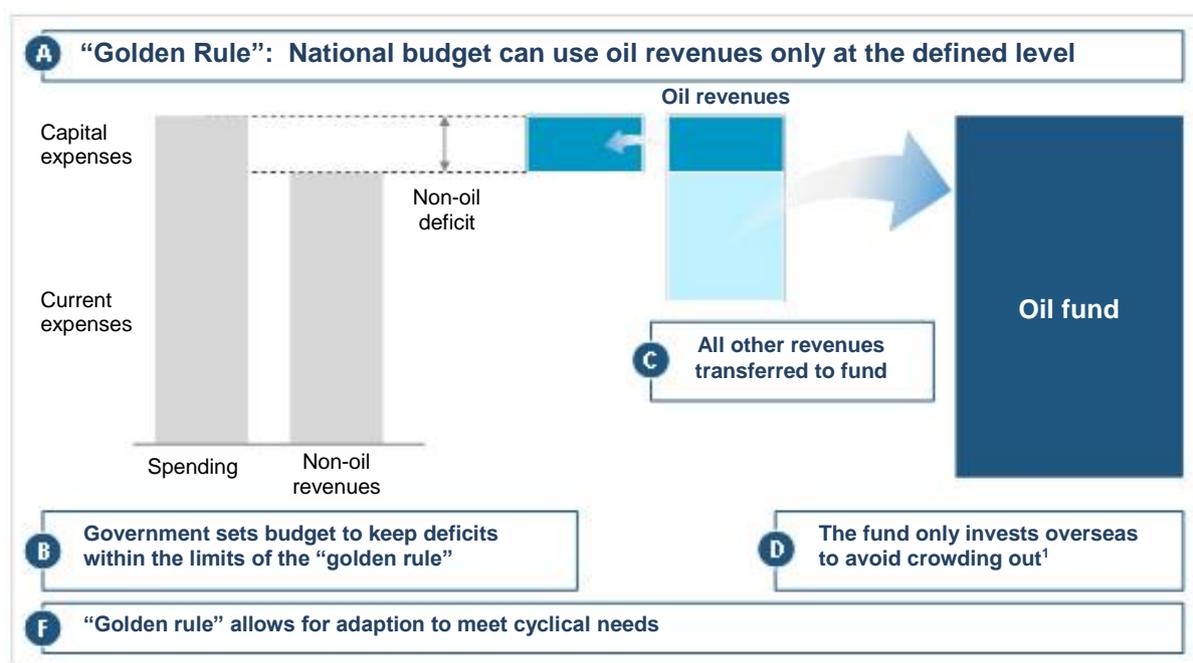
high income and longer-term investments. Limiting the overall size of transfers will boost the size of the funds accumulated in SOFAZ thereby benefiting generations to come.

A key criterion for success in implementing such a “golden rule” and building a foundation for growth, however, is to maintain a certain level of spending. Prospects for long-term benefits will become bleak when government spending levels in Azerbaijan sink below a certain level. The economy needs this money to thrive, and so immediate needs will not be ignored for the sake of the long-term vision.

The “golden rule” in practice

A golden rule, in essence, can wean a national budget off an overdependence on oil revenues (see exhibit 27). It works like this: The government sets a budget for current expenses and capital expenditures. As the bulk of budgeted spending is covered by non-oil revenues, and the non-oil deficit (the “tax-expenditure gap”) is small enough, a transfer amount from oil revenues that is set at a mean level covers the difference as defined by the golden rule. The rest of the oil revenues are collected into a separate fund that is invested overseas to avoid crowding out private investments. This separate fund grows over time, accumulating wealth for the people. The fund itself also acts as a buffer; when oil prices dip below a certain threshold, accumulated wealth from the fund can ensure a constant injection into the government budget, thus providing a buffer against cyclical volatility.

Exhibit 27. Mechanism for application of “golden rule”



1 Also prevents “off-budget financing” in domestic sectors

Multiple resource-dependent countries have applied different principles to establish a separate reserve fund and to reduce oil sector dependency. Norway, for example, allows for an annual 4 percent transfer from Norway State Pension Fund, which is its oil fund, to the government

budget. Similarly, Botswana's Pula Fund aims to preserve its diamond income for future generations. Unlike Norway's Pension Fund, the Pula Fund does not have a percentage rule; instead it transfers all foreign reserves above a defined budget to the fund.

Other natural-resource dependent nations have used similar strategies as Norway and Botswana, though with less emphasis on hedging against resource price volatility. These mechanisms do not necessarily share the key characteristics of a golden rule, as defined here. Chile, for example, has established two funds for copper revenues: its Pension Reserve Fund (PRF) and its Economic and Social Stabilization Fund (ESSF). Any positive fiscal balance is transferred to the funds. Despite large withdrawals from the funds to minimize the effects of the 2009 crisis, both funds keep growing. Kazakhstan, Kuwait, and Turkmenistan all have similar funds to preserve oil revenues for future generations, with varying degrees of success.

Action 1.1.2: Establish and adopt "golden rule" mechanism and parameters

Based on a general alignment on the need for a golden rule, the mechanism and its parameters need to be determined. The mechanism of a "golden rule" for Azerbaijan could be based on various calculation logics. Possible options include:

Option 1: Fixed transfer amount. Azerbaijan may consider fixed SOFAZ transfers based on a constant, "conservative" oil price and expected average export volumes. This approach offers short-term stability by buffering against volatility caused by oil-price changes. Such a rule would result in increased predictability of the amount of foreign exchange entering the economy and thus the exchange of the national currency. However, this option might not allow for perpetual transfers into the government budget: once oil and gas reserves have been depleted, the fixed transfer might exceed the annual interest income of the fund and thus draw down the fund to zero.

Option 2: Transfers calculated based on a fixed oil price. SOFAZ transfers could be defined by the actual sales volumes (in contrast to the fixed-transfer option, where average sales volumes are assumed) valued at a constant, "conservative" oil price. This approach would lead to changing transfers only if traded volumes change. Over the long term, once oil and gas reserves have been depleted, a new "golden rule" would be needed to define the usage of potential funds still existing in the oil fund.

Option 3: Constant returns on investment. Azerbaijan may also assume a transfer based on an assumed constant return on SOFAZ investments (a rule in line with the logic applied in Norway). This approach would cut dependency on oil price movements, but given the relatively small size of the fund, from the start a 4 percent³⁶ (as applied in Norway) transfer may not be enough to meet the needs of the government budget. In the long-term, transferring only an average interest income into the national budget and preserving and

³⁶Source: Bank of Norway

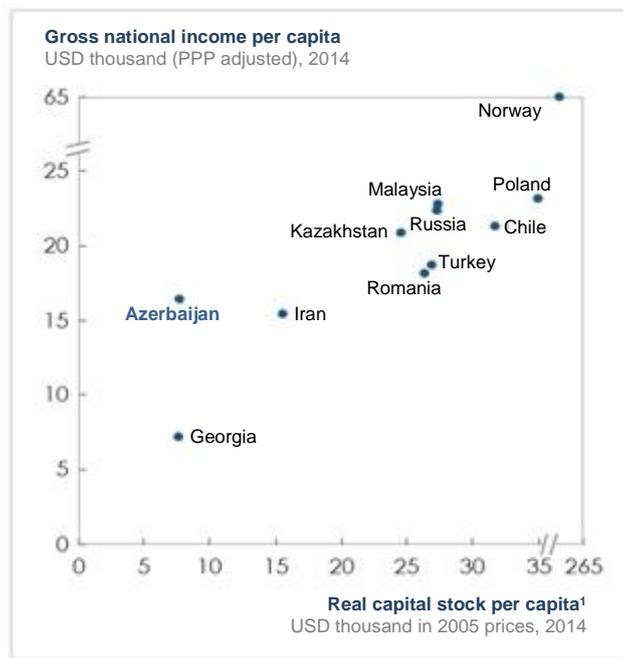
growing the capital balance is advantageous, as it would provide perpetual distribution of funds for generations to come.

Option 4: Investment financing. The other alternative for Azerbaijan is to establish a route for gradual transition into a golden rule mechanism similar to one of the options above. This approach assumes that, as Azerbaijan is in early stages of its development, capital investment can enable the development of non-oil sector and diversification of the country's economy. Based on potential investment opportunities available and institutional absorption capacity, a rule for gradually decreasing the transfers from SOFAZ can be adopted. Balancing the decreased transfers from the oil fund by increasing revenues from non-oil investment projects will minimize the overall impact into economy.

Defining the right level of a “golden rule” based transfer

Once the mechanism has been selected, the desired level of transfers needs to be set by agreeing on the rule's parameters. The desired level must balance the described benefits of stability of transfers with short-term funding needs. This balance is crucial to the country's economic and social development; currently, Azerbaijan is trailing several benchmark nations in both gross national income per capita and real capital stock per capita (see exhibit 28). For the purpose of sustainable economic development, the government needs to sustain appropriate levels of public investments.

Exhibit 28: Need for oil revenues in the short term



1 Accumulated over 1990-2014

SOURCE: WorldBank, United Nations Development Programme (UNDP), State Statistical Committee
Iran analysis is based on only publicly available data and Azerbaijan government-owned data

While funding budget deficits with public debt is possible, the magnitude of the current tax-expenditure gap calls for SOFAZ transfers at significant levels. The parameterization of the

golden rule must take this into account. While the stability of the golden rule is of key issues, scheduled periodic reviews of the parameters could be required to allow for predicted change of injections over time. For instance, a golden rule could be established with a five-year time horizon, with a review in the third year to evaluate fund growth and necessity for changes.

Azerbaijan will thus seek to implement a golden rule that allows the country to meet short-term budgetary needs, while limiting the exposure to oil price movements and ensuring a fair distribution of oil funds across the current and future generations. Both institutional and practical measures are vital to ensure fiscal sustainability and pursue sustainable economic development through fiscal policy. In addition, outlining strategic targets, preventing possible budgetary risks for the potential future operations and effectively employing these programs are essential to further promote fiscal discipline in Azerbaijan.

Given that Azerbaijan aims to foster an environment to further promote investment for its growth and economic development, implementation of a strict “golden rule” is complementary to the comprehensive set of actions ongoing to diversify the economy. Sustainable fiscal management that is resilient to the volatile global oil prices and mitigates the potential risks on the economy supports the future growth in the economy. The golden rule will shield the economy from external shocks and strengthen the macroeconomic framework by providing a foundation for two additional, critical actions: efficient and effective spending. As a result of actions undertaken in this direction and in view of the golden rule detailed previously, effective implementation of the Medium Term Expenditure Framework will ensure more rational use of the mechanisms for the transition to performance based budgeting processes.

7.1.2. Priority 1.2: Create a mechanism to ensure expenditure/investment discipline

Rationale

The implementation of the “golden rule”, with efficient and effective spending policy, will help Azerbaijan to maintain a sustainable and productive public sector. Efficient spending policy ensures that the right level of resources is used on capital expenses and considers factors such as the payback period. In other words, budgetary discipline is applied. Such a policy ensures that the right projects are chosen to build the necessary technological and human capital and that spending is focused on needs which will catalyze further growth.

To ensure financial sustainability and its multiple fiscal policy targets, Azerbaijan aims to establish an integrated fiscal expenditure management framework by taking into consideration the revenues, expenditures, and the balance sheet of the government. In this light, to sustainably execute this framework, it is essential to undertake continuous measures that encourage the expenditure and investment discipline. For this reason, Azerbaijan will carry out ongoing activities targeted to standardize and ensure this discipline. These ongoing activities include initiatives on achieving a sustainable share of oil revenues, the Public Expenditure and Financial Accountability (PEFA) compliance measures, and the efforts on enhancement of the fiscal framework along with the tax model, as well as programs on strengthening the public debt management processes. As this discipline is one of the primary factors complementing Azerbaijan’s ongoing comprehensive initiatives, ensuring effective execution of the fiscal

policy and framework enabled through publishing and monitoring the key guiding principles is essential. Moreover, further support is achieved through involving, and aligning the relevant public and private parties on their commitment on these overarching principles.

Actions to be taken

Action 1.2.1: Establish medium-term expenditure framework

Azerbaijan will consider improving the mechanism of budgeting in accordance with Medium-term Expenditure Framework (MEF). The main objective of this budgeting mechanism is to define economic policy, long-term economic (including coordinating budget planning and budgeting processes) as well as strategic objectives.

MEF should provide inputs to the government regarding the main areas of the investment projects as part of the development budget necessary for capacity, breakdown, and application of both organizational and sectorial budget resources for the purpose of budget expenditures planning. MEF stipulates the allocation of the funds from budget in line with the main targets specified by the government in its strategy. In this case, the annual budget expenditures of government shall be specified (for example, in line with the established “golden rule”). The specified amount shall be distributed among various state bodies at a later stage. During such distribution in systems where MEF is applied, there are taken into account short and medium term impacts of the specified economic and social policy course of the relevant state authorities.

Development of MEF shall eventually have the following advantages in terms of managing financial resources of the government: fiscal discipline, predictability of the state budget indicators, and proper distribution of the budget resources between and inside sectors, performance-based increase of responsibility of particular entities and improvement of efficiency of state budget expenditures.

Action 1.2.2: Implement outcome based budgeting mechanism

By laying the foundation for MEF, it is necessary to realize outcome-based budget under the following conditions:

- Ensure that government’s financial resources are implemented as per programs and strategic objectives rather than separate items;
- Clearly define the programs and strategic objectives including main outcomes expected from these activities;
- Bring the objectives and strategic priorities of state authorities in line with integrated and planned programs;
- Develop the budgets of state authorities based on the outcomes expected from these authorities;
- Build mechanisms of control over use of the budget funds by state authorities;

- Draft the budget based on the system of indicators allowing the relevant executive authorities to assess the performance, outcomes and efficiency of budget organizations activities.

7.1.3. *Priority1.3: Apply an efficient monetary policy framework for the new economic model*

Rationale

Pursuant to current legislation, the primary objective of the monetary policy in the Republic of Azerbaijan is to ensure price stability. Ensuring price stability will significantly contribute to realization of the strategic targets by strengthening macroeconomic stability in the country. The existing realities of Azerbaijani economy and international best practices suggest that transition to the most optimum monetary policy framework will be ensured in order to make a significant contribution to the achievement of macro-economy and financial stability in the medium and long term through high transferability of the monetary policy in the economy.

Actions to be taken

Action 1.3.1: Coordinate the macroeconomic policy

Provision of coordination among state authorities regarding macroeconomic and financial stability is of special importance in terms of realization of the objectives that have been set. Significant actions have been taken in Azerbaijan in this regard. In this light, the Financial Stability Council (FSC) has been established in Azerbaijan based on a clear allocation of responsibilities with a view to ensuring full coordination among the main stakeholders. By analyzing the changing global, regional and domestic environment, FSC will make a significant contribution to policy making and execution with regard to coordinated and flexible macroeconomic stability.

The establishment of the FSC indicates the importance of high level coordination among various state bodies in order to ensure liaison between fiscal and monetary operations. The governmental bodies that carryout macroeconomic policy in various areas are represented in FSC and the macroeconomic policy is coordinated under the leadership of the Prime Minister of the Republic of Azerbaijan. One of the main goals of FSC is to create a sound platform and to ensure effective communication between monetary and fiscal authorities in the early stage of policy making.

Through FSC, the macroeconomic situation will be continuously analyzed in Azerbaijan, market assessments and prospects as well as developing market structures and mediation platforms will be taken into account. This suggests that CBA will be provided with detailed information when defining policy options. In order to assess whether economy develops in line with the specified objectives, the FSC will hold regular meetings. For the purpose of supporting these efforts, the FSC may establish ad-hoc working groups for critical subjects in order to create an understanding of the relationship between broader economic objectives and monetary policy (regarding the sustainability of market infrastructure and institutional

establishments, competitiveness and comparative advantage of Azerbaijan, foreign direct investments (FDI) etc.).

Providing strict coordination through FSC is important for economic sustainability by taking account of mandates and authorities. Through its efficient activities, FSC may be a very beneficial establishment in terms of creating public confidence. Through this council, sound coordination and effective performance may ensure that the attraction of AZN is increased and level of dollarization is reduced accordingly. At the same time, as part of this Strategic Roadmap, the increase in FDI and export will help to restrict dollarization in the economy. In the long term, de-dollarization, which is based on the conversion of liabilities to AZN and potentially to more advanced tools including derivatives instruments, will be used. Furthermore, the council will undertake relevant measures in order to strengthen the financial stability. And this, in its turn, will strengthen the transferability of monetary policy by deepening financial mediation.

Action 1.3.2: Target a new alternative anchor

As reported by IMF, Azerbaijan had realized the regime of targeting de-facto exchange by the end of 2015. Exchange rate acted as an anchor of the monetary policy within that regime. Sharp decline in oil price in the world market created serious challenges with regard to ensuring balance in the foreign sector, and the foreign sector issues created adverse effects on the domestic economic balance. Adapting to the conditions of the new period, the national currency was devaluated nearly two times in order to ensure domestic and foreign economic balance and, in fact, targeting at the money supply regime was applied. The realization of this regime was ensured by selecting the money supply – monetary base model as the anchor of the monetary policy.

In the medium and long term, interest rates may be selected as one of the anchors which is intended for the purpose of improving the monetary policy regime. By improving the transferability of the monetary policy to the economy through the choice of interest rates as an anchor, more efficient monetary and financial stability will be enabled.

Action 1.3.3. Ensure transition to fully floating exchange regime

The fixed exchange regime was cancelled by the resolution of the Board of the Central Bank of Azerbaijan Republic dated December 21, 2015 and a floating exchange rate was initiated with a view to minimizing the adverse effects of sharp drops in oil prices in global commodity markets on the foreign and domestic economic balance of Azerbaijan, improving the international competitiveness of the country's economy as well as the integrity of the foreign currency reserves belonging to the country.

In the first place, it is important to re-clarify the contents of the currently applied floating regulated exchange regime in the short and medium term in order to achieve fully floating exchange regime. The transition to fully floating exchange regime should be implemented and, in this respect, the key strategic target of supporting the import substitution policy may be selected as a priority in the short and medium term. Efficient transition to floating regime will be ensured by expanding the actually applied exchange corridor in line with the level of

achieving a reduced share of imported products in consumer spending and by completely cancelling this corridor in the medium term. Another prerequisite for the transition to a floating exchange regime is to achieve the development of internal financial market, and to be insured against hedging and exchange risks in the market.

In addition, the actions, which are aimed to ensure developing the Central Bank's strategy of intervention in the currency market and communicating this to the financial market participants efficiently, will be taken into consideration.

Action 1.3.4. Improve the activities of the interbank market

Interbank market is an important intermediate area for ensuring efficient transferability of monetary policy to economy. The efficient activities of this market allow transferring monetary policy decisions to economy through interest rates.

Currently, there is a relatively low volume of the operations in the interbank market, which is the key segment of the monetary market. It is of special importance to enhance confidence between commercial banks and to analyze the opportunities of using interest corridor parameters as a supportive structure for interbank market activities in order to develop the interbank market. At the same time, deep and liquid securities market is one of the factors ensuring the development of the interbank market. Especially, the development of government securities market may give a boost to increasing the size of the operations by solving the issue of security in the interbank market. Detailed actions for the development of the interbank market are provided in the “Strategic Roadmap for the development of financial services in the Republic of Azerbaijan.

Action 1.3.5: Form and manage adequate economic expectations

During efficient application of the monetary policy regime, one of the frequently used transmission channels is a channel of expectations. Ensuring efficient communication forms adequate economic expectations from adopted monetary policy solutions of businesses, public sector and households. Another advantage of establishing an effective communication framework is that it allows adequately managing these expectations and ensuring rational conducts as a result.

Effective communication strategy has become one of the main elements of the modern decision making process and currently it has a significant impact on enhancing confidence in Central Bank and efficiency of the monetary policy. The analysis of global economic trends once more proves that the effective communication policy of central banks is one of the most important tools for the formation and management of public expectations.

Monetary policy communication encompasses communicating the details of the current situation to the public and future directions of the monetary policy of the market players, predicted inflation level in the short term, interest rates, lending conditions and the like. Communication strategy is one of the most important conditions for the public to make predictions related to the monetary policy. The main target of monetary policy communication is to impact economic processes including the formation of adequate expectations as far as decision making to achieve the specified goals is concerned. Intermediate targets should be specified in order to achieve the final target of the communication strategy. This intermediate target includes enhancing confidence in the monetary policy and transparency as well as increasing the level of economic awareness of key target segments.

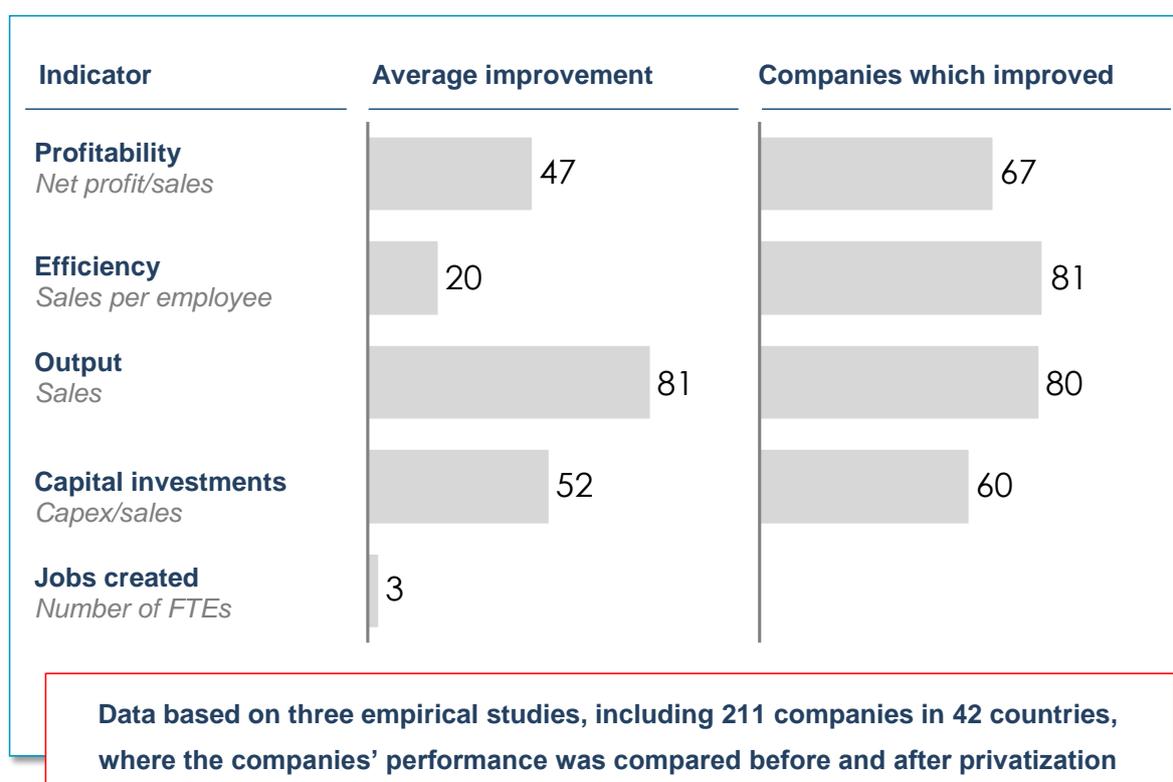
7.2. Strategic target 2: Privatization and state-owned enterprise reforms

Azerbaijan has been undertaking considerable reform programs on increasing private sector participation to support its objectives of tapping into new sources of growth, diversifying its economy, and attracting more investment in the non-oil sectors. In the same light, there are programs that are being developed to further improve the management practices and efficiency of local companies to enable them to compete more successfully in the global market.

Accelerating state property privatization is one of the main directions of the economic policy with a view to increasing economic activity in the country, supporting private initiatives, making necessary structural changes in the economy in line with up-to-date requirements, creating a sound competition environment and improving the efficiency of the national economy.

Experience in many countries shows that increasing private sector participation typically leads to significant financial and operational improvements, as well as improving access to capital for attracting investments (Exhibit 29). Three global trends necessitate the lowering of public sector ownership gradually: first, more global industry and faster technology development necessitates rapid response and adaption from management teams; second, increased focus on governance and ownership policies makes these one of the principal drivers of value creation; third, increased pressure on public sector finances leads to increased emphasis on state owned companies (SOEs) to create value. All these trends provide strong rationale to further promote private sector participation measures by ensuring the necessary resources to consider the privatization efforts with high priority in relation with overall economic and sectorial level aspirations.

Exhibit 29: Financial and operational improvements after privatization, %



SOURCE: Megginson, Nash & van Randenborgh (1994); Boubarki & Cosset (1998); D'Souza & Megginson (1998); OECD Privatising State-Owned Enterprises, November 2003

In this direction, Azerbaijan has implemented two state property privatization programs until 2016 within the framework of the I State Program on State Property Privatization of the Republic of Azerbaijan and II State Program on State Property Privatization (hereinafter – I State Program and II State Program) of the Republic. The overarching theme of launching the two state programs was to facilitate structural reforms conducted in the economy, develop entrepreneurship and create a sound competition environment as well as increase economic efficiency by attracting investments. As a result of implementing these state programs, significant progress has been achieved in increasing investments attracted to non-oil sector, further expanding an entrepreneur and shareholder class, creating or restoring new workplaces in the country.

Furthermore, these programs have enabled Azerbaijan to build economic capacity, form a competitive environment, re-organize the activities of multiple state entities, and apply new equipment and technologies as well as modern management methods. Benefiting from experience of the world's developed countries. Azerbaijan has been continuing the activities to promote the developments in private sector involvement. A new draft law is under development, aimed at increasing the efficiency of using state property in the country, improving its management and privatization.

The draft law of the Republic of Azerbaijan on the privatization of state property may be considered as a continuation of the previous programs for increasing private sector involvement in the economy. That is, the purpose of the new law is to decrease government spending through replacing administration functions of the government gradually with the regulation functions of the government, to give a boost to transparent and independent administration as well as further increasing the market economy by applying new privatization methods. Furthermore, among other draft law targets, it is especially important to further increase the inflow of investments to Azerbaijani economy by reputed investors, including international financial institutes, investment banks and funds. The new draft law will also reflect completing the privatization of entities which are open for privatization within II State Program as well as determining support measures for the development of entities privatized earlier. The new draft law will also create opportunities to meet the requirements which arose following the implementation of other state programs.

To actualize the ongoing measures that are aimed at further increasing private sector participation in Azerbaijan, and to complement the developments implemented, effective administration of the Strategic Roadmap developed is an important element. In this light, coordination of the overall approach to public sector's role together with ensuring the necessary resources and objectives to accomplish the roadmap, as well as securing the required funding would be the main considerations.

Furthermore, it is of special importance to apply modern corporate governance principles, take necessary measures in making significant structural changes, increase control over privatization process and ensure openness in this area with a view to ensuring the highest level of transparency in financial-economic activities of large state-owned companies and increasing their efficiency. Another important point is to ensure transparency and awareness in state property privatization as well as carrying out relevant procedures electronically.

7.2.1. *Priority2.1: Coordinate the overall approach to improve efficiency of public sector's role in the economy*

Rationale

Strategic Roadmap proposes to consider two important issues related to government shareholding for privatization purposes and identification of its level of involvement in the state owned enterprises. Thus, the decisions on increasing private sector involvement in the assets of state owned enterprises or on maintaining these in their ownership should be made for the purpose of improving the activities of enterprises and their profitability. Furthermore, when specifying the objectives regarding state property privatization. First of all, preference will be given to the enterprises that are not operable but they can make significant contribution to socio-economic development and have a competitive potential in the region.

The Decree of the President of the Republic of Azerbaijan "On certain measures that are related to accelerating state property privatization and increasing efficiency of its management" and Executive Order "On additional measures that are related to increasing efficiency in the activities of legal entities whose control stock belongs to the government"

dated September 5, 2016 have further strengthened the legal framework for ensuring efficiency of privatization in the country.

Actions to be taken

Action 2.1.1: Identify the needs based on state ownership

It is planned to identify the needs for state ownership in the long term based on the following 5 criteria:

- A state company ensures the interests that are important for society but cannot be implemented through private sector;
- National interests related to the area of activity of SOE should be taken into consideration while establishing or supporting SOEs;
- Continued state ownership is required in case these enterprises create significant added value for the country in the long term.
- State ownership is required to be continuous for the purpose of maintaining the competitive environment and preventing natural monopolies;
- Continued state ownership is required to ensure employment.

Action 2.1.2: Conduct state owned enterprise (SOE) reform program to improve governance and efficiency

With the aim of accelerating the efforts to develop entrepreneurship and robust competitiveness within the framework of the economic reforms conducted in Azerbaijan, the President of the Republic of Azerbaijan signed the Decree “On additional measures related to increasing efficiency in the activities of the legal entities whose control stock belongs to the government” on September 5, 2016. The main purpose of this Decree is to improve transparency in the management of the legal entities whose control stock belongs to the government (further called SOE) and eventually achieve the formation of a diversified and competitive national economy. One of the actions taken in this area is to determine the procedure for performance evaluation of SOEs. This procedure will be developed taking account of the characteristics of the national economy and international experience. Corporate governance rules and standards as well as an action plan for staged application of these rules and standards will be developed. In this case, the payment of bonuses to the members of the administrative bodies of SOEs will be made based on the results of their activities (“Performance Based Remuneration System”). The financial reports of these enterprises will be improved by applying international standards in stages.

7.2.2. Priority 2.2: Successfully implement the privatization agenda and carry out privatization in priority sectors

Rationale

During implementation of the Strategic Roadmap, attention will be paid to fully agreeing the privatization agenda and assets classification among all the stakeholders. The outcomes of

the analyses conducted regarding Strategic Roadmap will be based on the information provided from relevant economic divisions

Actions to be taken

Action 2.2.1: Administer the privatization agenda for classified assets that can be offered for privatization in future

Focus areas of the Strategic Roadmap include the main principles of receiving the title over properties, privatization decision and methodology, as well as asset classification based on their size.

To further enhance planning the route ahead for privatization and to ensure the enterprises are at a healthy position, corporate governance including legislation adjustments, transparent financial accounts, and requirements for appropriate legal status for privatization would be considered further within the existing Strategic Roadmap.

Two key areas play an important role in implementation of the Strategic Roadmaps. The first area covers full agreement of the privatization agenda and assets classification among all the stakeholders. The second area is to define the resources to efficiently work with the local and global experts in solving various issues.

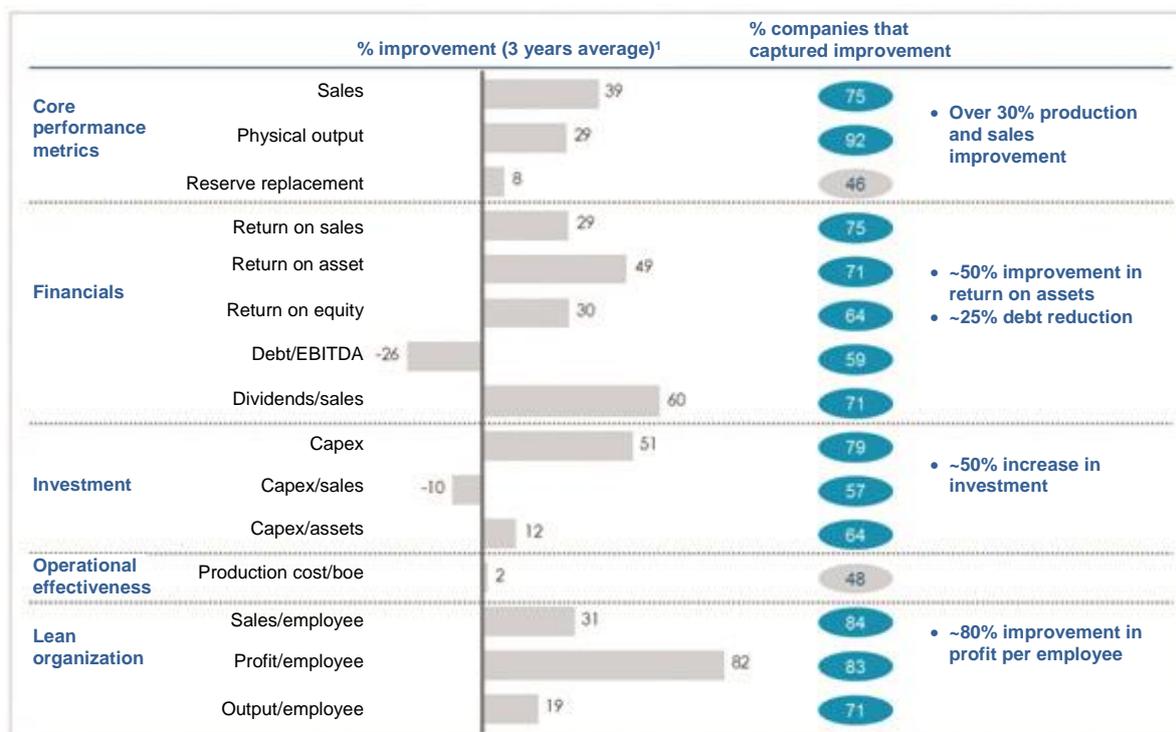
In order to encourage the involvement of foreign investors in the process of developing a new draft law with a view to creating efficient conditions for the attraction of foreign investments and protecting those investments, additional concessions, advantage sand state guarantees will be provided to them.

Action 2.2.2: Apply the established privatization approach in priority sectors

The Strategic Roadmap has also given place to establishing a sectorial based approach in the programs developed (described in more detail in sectorial roadmaps). In this light, the key observations from the analysis conducted for the Strategic Roadmap can provide additional perspectives to further strengthen the ongoing continuous measures. These observations are based on the details available in sector-specific strategic roadmaps such as oil and gas, utilities, heavy manufacturing and machinery, logistics and tourism sectors.

Establishing and developing the required regulatory infrastructure on incentives, taxation and capital markets in the oil and gas sector is highlighted in the respective section on this sector as one of the enablers towards implementing the Strategic Roadmap for development of Azerbaijan's the oil and gas industry (including chemical products). In this direction, effectively leveraging the funding options such as capital markets could promote healthy financials, performance increases and efficiency for national state enterprises in the oil gas sector (see exhibit 30). Therefore in order to increase access to capital, a common practice of national oil companies of issuing debt in domestic or international market or issuing equities on local stock exchanges could be considered. When implementing this approach, it is possible to utilize initial public offering (IPO) of the shares regarding individuals parts of the companies (for example, retail sale of fuel or polymers) and not as a whole.

Exhibit 30: Impact of sales of shares on financial standing and performance of companies



1. After equity issue: % improvement between 3 year average from – 3 to -1, and year +1 to +3; 14-28 IPOs on data set for each metric

SOURCE: Wolf, C and Pollit, M.G., “Privatizing national oil companies: Assessing the impact on firms performance, “University of Cambridge Business School”

As a method for promoting top notch efficiency and quality levels across the value chain in utilities, private sector participation in the utilities sector may be considered. As indicated in the “Strategic Roadmap for the development of utility services in the Republic of Azerbaijan (electricity and heating, water and gas)”, unbundling and liberalization of generation, transfer, distribution and sales in the value chain have already been proved in international practice. This practice shows that liberalization of the electricity sector is carried out based on various methods including 1) “Construct – manage – hand over” (CMH model); 2) full privatization; 3) assign to management; 4) transformation to open joint stock company or 5) concession contract. Privatization in this sector mainly covers the production (except the strategic facilities) and sale areas.

Evaluation process for the efficient realization of the initiatives mentioned in “Strategic Roadmap for the development of utility services in the Republic of Azerbaijan (electricity and heating, water and gas)” will be ensured. In this direction, the application of a systematic approach along with correct prioritization will be taken into consideration. The step-by-step approach outlined in the relevant Strategic Roadmap prioritizes generation assets for selective private sector involvement by focusing on private enterprises to improve efficiency of certain generation assets. Efficient operations and executions by the private sector through

competitive power purchase agreements, auctions for privatization, and new generation licenses are potential areas for assessment in generation portfolio, as well as selective privatization of distribution activities in prioritized regions could be considered.

According to the “Strategic Roadmap for the development of heavy industry and machinery manufacturing in the Republic of Azerbaijan”, the private sector participation in this sector as a method to ensure the best use of the idle assets to further promote efficiency can be taken into consideration. To revitalize the idle assets with potential competitive advantage, and low investment requirement, increasing private sector participation in this sector through selling shares to private companies for income generation, better management and potential to create further growth will be evaluated. In the same direction, the method of selling land and asset for private use to repurpose idle assets that require high investment, and have limited potential competitive advantage could be considered. Privatization in this area should be aimed at import substitution and integration to global value chain in future.

One of the mechanisms of the “Strategic Roadmap for the development of logistics and trade in the Republic of Azerbaijan” is to increase private sector involvement in the logistics sector. Through the sectorial approach proposed in that Strategic Roadmap, it is possible to benefit also from the potential opportunities of this area. Some countries with best practices have privatized many state assets in logistics in the last 30 years. Experience shows that private sector involvement in logistics generally pays off in this sector by contributing to operating margins, communication transparency and openness including higher service level. This provides better returns for governments and sector profitability.

Increasing private sector involvement in logistics could further improve competition in this area, and drive performance to regional and international tourist development initiatives. Conducting reforms in Azerbaijan with regard to cultural tourism, wellness tourism, eco-tourism and rural tourism is connected with the strategy for further developing other tourism sub-sector areas for domestic and regional tourists as well as supporting development of winter tourism. As one of the actions steps taken to expand the private sector involvement in the tourism sector, privatizing winter resorts starting with the state-owned-hotels in Shahdag could be considered. The privatization potential and the deal attractiveness would be assessed to decide on either outsourcing management to professional hotel chains or introducing administrative flexibilities to current administration.

7.2.3. *Priority2.3: Attract most appropriate investors for privatization and foreign direct investment*

Rationale

With the aim of creating favorable conditions for the economic development of Azerbaijan to attract funding and support investor involvement, the new draft law, which is related to the Strategic Roadmap and privatization, reflects legislative conditions and legal protection issues. To increase domestic private sector participation, Azerbaijan can consider assessing small companies as target groups for joint involvement.

Actions to be taken

Action 2.3.1: Apply structural approach to the most suitable investor profiles

The private sector participation program is targeted to channel investment flow into Azerbaijan by actively engaging foreign and local investors. This Strategic Roadmap determines an approach to attract funding for promoting Azerbaijan's economic development, and includes legislative conditions, and legal protection to support investor participation under the agency initiatives. This approach enables to further promote measures taken to attract financial investors interested in capital market development in Azerbaijan, and strategic buyers interested in developing their business.

In this direction, the investors, state investment funds, pension funds, endowments and private sector investors will be kept on focus. The potential investors may be selected among the largest players actively investing in CIS, Eastern Europe, Turkey and Middle East. Moreover, apart from the largest investors in emerging markets, other investors can also be attracted depending on the profile of the enterprise. Additionally, industrial conglomerates with localized operations in the region, and multinational companies targeting to expand local value chains could also be taken into consideration for potential partnerships to increase private sector privatization.

The share of the above mentioned investment organizations in the global institutional assets makes approximately 24 percent (EUR 36 trillion)³⁷. These organizations have become a driving force in development of the countries in the last 5 years. By attracting such investors to Azerbaijan it may be possible to increase investment opportunities in Azerbaijan and foreign capital investing.

With a view to selecting investors more efficiently, these investors will be analyzed and the opportunities for classifying them into various categories by their different characteristics as well as application of individual approach methods to such investors belonging to these categories will be investigated. One of such approaches may be analyzing the funds in terms of suitability (accessibility, intensity of the investments made, complexity of the approach) and attraction (division of assets by equity capital and regions, expected financial resources inflow, time frame of investments). Another approach may be dividing investors into various categories in terms of risks and profitability. During the attraction of investments to the country, the distribution of funds across territories, investment mandates and purposes as well as situations that may hinder investing will be taken into consideration. Detailed information is provided below regarding various investor profiles.

³⁷ Source: Preqin, Towers Watson and Pension & Investments

State investment funds (SIF)

In the near past, the budget surplus and investment indicators caused a significant increase in assets managed by state investment funds. The budget surpluses created as a result of export of oil products to hydrocarbon export markets and non-commodity products to emerging markets further accelerated the development of these funds. Funds based on hydrocarbon resources have high ranks in the ranking of state investment funds while other foundations are those that are based on non-commodity resources (See exhibit 31). Therefore, in order to weaken the relation between oil prices and capital inflow in Azerbaijan, the opportunities for attracting investment funds that are based more on non-commodity resources will be evaluated. However, probable adverse effects on hydrocarbon-based funds as a result of drop in the price of hydrocarbon resources will be taken into account.

Exhibit 31: Top 20 SWFs source their capital not only from commodity exports

Rank	Fund Name	Total Assets, 2014 EUR bn	Country	Source of Capital
1	Government Pension Fund Global	673	Norway	Hydrokarbon
2	Abu Dhabi Investment Authority	636	UAE	Hydrokarbon
3	SAMA Foreign Holdings	550	Saudi Arabia	Hydrokarbon
4	China Investment Corporation	535	China	Non-Commodity
5	State Administration of Foreign Exch.	467	China	Non-Commodity
6	Kuwait Investment Authority	451	Kuwait	Hydrokarbon
7	Hong Kong Monetary Authority	341	Hong Kong	Non-Commodity
8	GIC	263	Singapore	Non-Commodity
9	Qatar Investment Authority	250	Qatar	Hydrokarbon
10	National Social Security Fund China	204	Chine	Non-Commodity
11	Temasek Holdings	132	Singapore	Non-Commodity
12	Abu Dhabi Investment Council	74	UAE	Hydrokarbon
13	Korea Investment Corporation	70	South Korea	Non-Commodity
14	Future Fund	68	Australia	Non-Commodity
15	Samruk-Kazyna National Welfare Fund	64	Kazakhstan	Hydrokarbon
16	Revenue Regulation Fund	64	Algeria	Hydrokarbon
17	Reserve Fund	63	Russia	Hydrokarbon
18	National Wealth Fund	62	Russia	Hydrokarbon
19	National Fund of Kazakhstan	59	Kazakhstan	Hydrokarbon
20	Int. Petroleum Inv. Comp.	56	UAE	Hydrokarbon

SOURCE: Preqin, SWFI

State investment funds (SIF) do not have conservative investment requirements as much as the pension funds and a more varied division of assets may be applied in these funds. Approx. 50 percent of the SIF assets are divided into share capital or alternative investments, for

example private share capital or real estate³⁸. Therefore, investing in Azerbaijan's share capital may be an attractive option for state investment funds in terms of its opportunities.

State investment funds may be divided into three broad categories in terms of attracting a particular asset type: deposit funds, state holding companies and development investors. The mandate of deposit funds is to create stability in material welfare and maximize profitability. The portfolios of these funds are different, characterized by limitation of direct investments in share capital. And the mandate of the state holding companies varies from strategic profitability to capital profitability. In these funds, in addition to other investments, inherited assets are also managed and usually, strategic ownership agenda is applied. And the funds belonging to the third category mainly focus on domestic and foreign strategic sectors and apply the same investment process as the private investment companies, however unlike the above two funds, its vulnerability to risks is lower.

Pension and endowment funds

Pension and endowment funds constitute an important part of the institutional investors operating in the financial markets. In 2014, the total value of the assets managed by these funds was EUR 9,6 trillion³⁹. Azerbaijan may benefit from pension and investment funds not only for investment purposes. Since most of these funds are considered "fund of funds" according to the investing manner, it is likely that they will have mutual relations with other participants. Therefore, successful attraction of such investments may strengthen awareness about Azerbaijan in the community of investors.

In general, though pension funds implement more conservative investment strategy as compared to state investment funds, approx. 20 percent of their assets (EUR 1.8 trillion) are attracted to share capital and alternative investments (Exhibit 32). While it is important to understand individual cases and investment mandates, it is especially necessary to take account of these factors when attracting pension funds by considering the restrictions that are faced by pension funds in investing. Therefore, it is of great importance to properly understand the allocation of financial resources in the plans of pension funds, and the needs for financing their future debt obligations for the reason that those funds can have an impact on the investment strategy. Pension funds may be more interesting in terms of fixed incomes or risk-managed products, depending on the opportunities of fund allocation and other needs.

Proper determination of pension funds is important for Azerbaijan because this creates conditions for attracting more efficient investments. The opportunities for creating a portfolio different from traditional investment opportunities in Azerbaijan may create attractive investment environment for the pension funds. Furthermore, since significant part of the regional pension funds are mainly accumulated in the selected countries, it may be easier for Azerbaijan to define more suitable targets. Finally, another reason why pension funds are

³⁸ Source: Preqin

³⁹ Source: Preqin, Towers Watson, Pension & Investments

suitable for Azerbaijan is that such funds carry out long-term investment strategies and possess domestic labor resources for assessment of such investments.

Exhibit 32: Top pension funds of Europe, Africa and Middle East

Rank	Fund Name	Total Assets, 2014 EUR bn	Country	Source of Capital
1	ABP	344	Netherlands	Contribution of fund members
2	PFZW	177	Netherlands	
3	ATP	100	Denmark	
4	Alecta	73	Sweden	
5	Bayerische Versorgungsk.	62	Germany	
6	Royal Dutch Shell	61	Netherlands	
7	Metaal/tech Bedrijven	58	Netherlands	
8	BT Group	56	UK	
9	Bouwnijverheid	53	Netherlands	
10	Universities Superannuation	53	UK	
11	PFA Pension	53	Denmark	
12	Lloyds Banking Group	49	UK	
13	AMF Pension	45	Sweden	
14	Royal Bank of Scotland Group	44	UK	
15	Keva	41	Finland	
16	Electricity Supply Pension	40	UK	
17	Varma	40	Finland	
18	PME	39	Netherlands	
19	Barclays Bank UK	34	UK	
20	Sampension	34	Denmark	

SOURCE: Towers Watson

Endowments funds are relatively small and are involved in privatization-related investment transactions to small extent; however, since they are reputable, attracting such funds to Azerbaijan may increase overall interest in the country and the existing assets. Generally, the endowment funds make long-term investments and investment strategies, which are carried out by these funds, indicate that these investment funds are suitable for Azerbaijan.

US universities are in the top ranking among the endowment funds (Exhibit 33). Considering the distance between the two countries, it is of great importance to inform these investors of Azerbaijan in order to attract such endowment funds. As other investment funds, the needs of endowment funds and their preferred investments will be analyzed and special strategies will be developed in order to attract these funds.

Exhibit 33: Endowments ranking is dominated by large universities

Global Endowments¹, 2014 values

Rank	Endowment Name	Total Assets, 2014 EUR bn	Country	Source of Capital
1	Bill & Melinda Gates Foundation Trust	30	USA	University fees, donations and private wealth
2	Harvard University	30	USA	
3	Stanford University	21	USA	
4	Yale University	20	USA	
5	Princeton University	17	USA	
6	University of California	11	USA	
7	Massachusetts Institute of Technology	10	USA	
8	The Ford Foundation	9	USA	
9	University of Notre Dame	8	USA	
10	University of Michigan	8	USA	
11	Northwestern University	8	USA	
12	University of Pennsylvania	8	USA	
13	The Robert Wood Johnson Found.	8	USA	
14	Columbia University	8	USA	
15	The William and Flora Hewlett Found.	7	USA	
16	Lilly Endowment Inc.	6	USA	
17	University of Chicago	6	USA	
18	Duke University	6	USA	
19	University of Virginia	6	USA	
20	Washington University in St. Louis	6	USA	

Source: "Pensions and Investments"⁴⁰

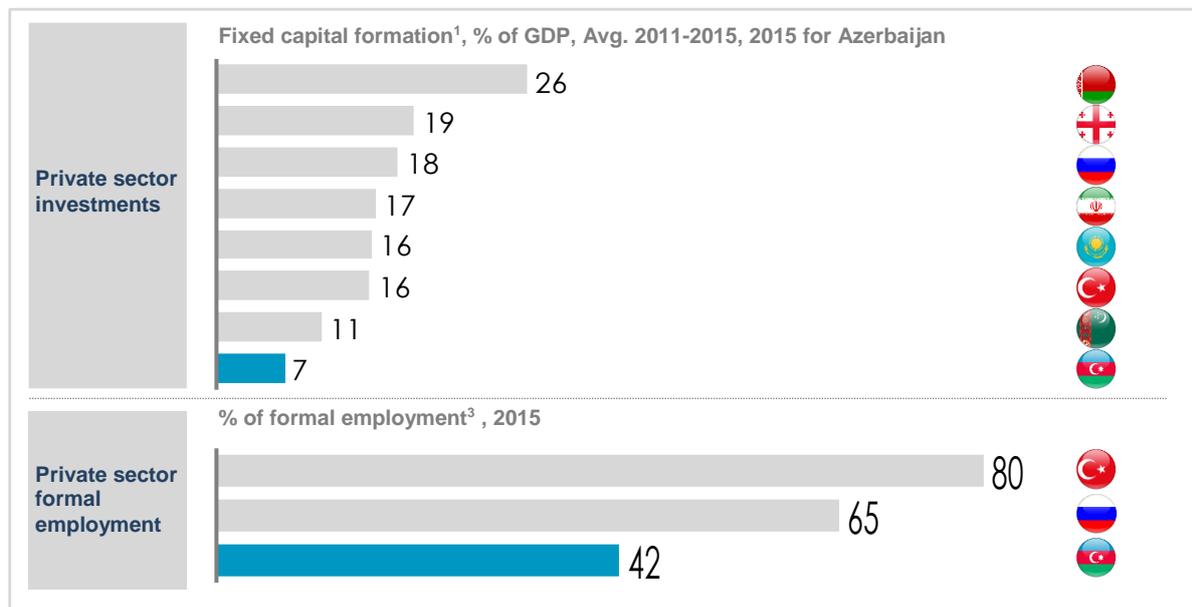
Private sector (domestic and foreign)

As mentioned in the 1st strategic target, the share of private sector in Azerbaijan's economy is small as compared to the developed countries. The share of the private sector in investment and employment once more proves this fact. For instance: while the amount of total fixed capital saving, which constituted 20 percent of GDP, was formed at the expense of the public sector, this indicator amounted to 8,6 percent in the private sector⁴¹. According to these indicators, it should be noted that it is possible to develop private sector in Azerbaijan by considering the opportunities of strengthening privatization and entrepreneurship in Azerbaijan (exhibit 34).

⁴⁰ "Pensions & Investments" –international newspaper for money management (<http://www.pionline.com/>)

⁴¹ Source: State Statistics Committee of the Republic of Azerbaijan

Exhibit 34: Private sector share in GDP and comparison of hired employees



- 1 Note that Fixed Capital Formation does not include all foreign direct investment inflows
- 2 Existing data have been assumed as average indicator since data for 2011 – 2015 are not available.
- 3 “Official employment” means the people classified as “hired employees” in the official statistics

SOURCE: World Bank “World Development Indicators, State Statistical Committee of the Republic of Azerbaijan, Russian Federal State Statistics Service, Turkstat (2005-14), World Bank Indicators

Though foreign investments in Azerbaijan are considered an important element of the country’s economy, greater involvement of domestic private sector in the privatization process should be considered. In this respect the opportunities to attract investments from domestic private sector will be assessed. Small family businesses or wealthy citizens as well as large domestic corporate holdings refer to potential investors operating in these fields.

One of the initial actions to be taken in this area is to make potential domestic investors well aware of privatization opportunities. Therefore, the online list of the privatization assets shall be updated regularly (this actions are already being successfully implemented) and the existing database will be expanded in order to provide more detailed information to potential investors. Furthermore, special promotion documents and presentations will be prepared in order to inform large holding companies of privatization benefits (for example, vertical and horizontal integration with the existing environment). Finally, the enterprises which are pending privatization for a long time but do not generate much interest, will be analyzed and proposals will be presented once the reasons (circumstances affecting privatization) are identified.

In addition, broad communication strategy will be implemented in support of the privatization initiatives. The principles specified within the scope of action 4.2.3 can be used in order to attract foreign private sector to the privatization process.

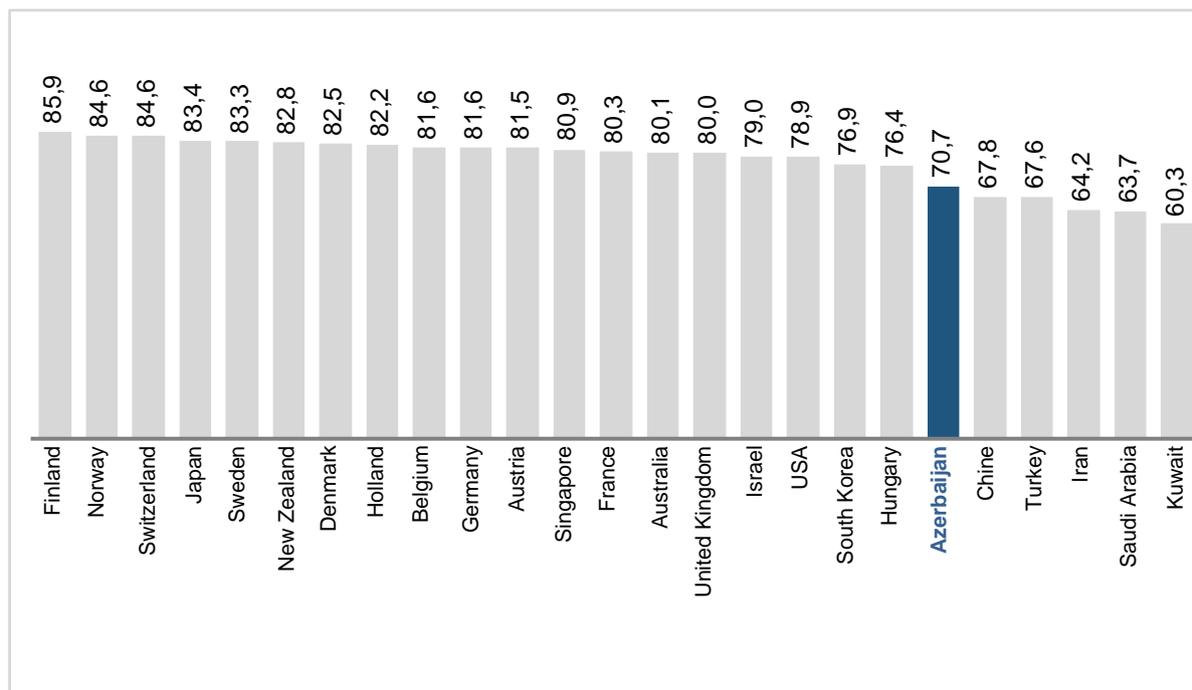
7.3. Strategic target 3: Develop human capital

Human capital plays a crucial role in increasing labor productivity, sustaining economic growth, improving the competitiveness of manufacturing and service sectors and integrating the country in global markets. In order to achieve this, it is required to improve the quality of education at all levels, ensure continuity in developing employee skills and knowledge, adapt qualified personnel training to the requirements of the labor market, stimulate companies to invest in researches and improvement areas and officially use the existing human capital. On this basis, comprehensive support will be provided for actions related to ensuring continuity in the development of human capital, improving labor productivity and increasing knowledge role in economic development as an integral part of the reforms conducted towards the transformation of Azerbaijan's economy. This will be ensured at two levels:

- 1) Improve the quality of education at all stages for the formation and development of human capital;
- 2) Encourage investing in continual development, research and improvement areas to ensure that labor productivity is enhanced.

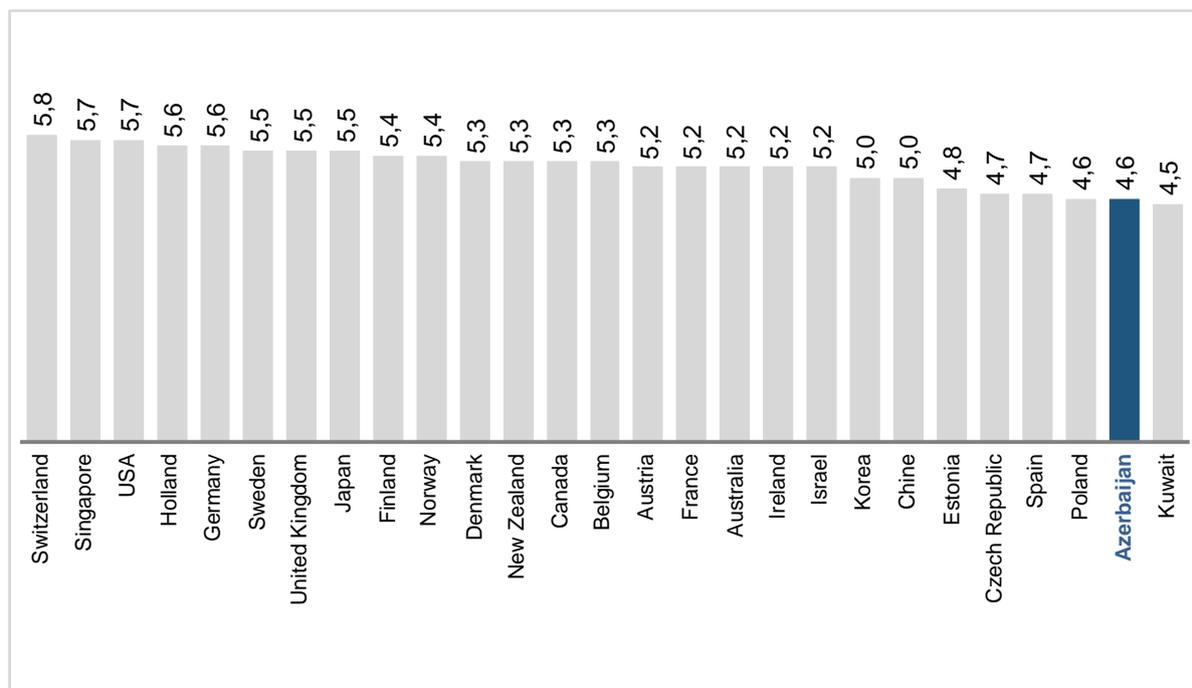
In the report "Human Capital Index" published by World Economic Forum for 2015, Azerbaijan, which holds middle ranks (63th) among 124 countries, has outpaced countries such as Turkey, China, Indonesia and Kuwait (Exhibit 35). According to the Global Competitiveness Report published by World Economic Forum for 2016-2017, Azerbaijan ranked 37th among 138 countries (Exhibit 36). This shows that Azerbaijan has established human capital and opportunities for increasing competitiveness. By efficiently using these opportunities, human capital in the short to medium term can be further developed and its competitiveness can be enhanced.

Exhibit 35. Human capital index, 2015



Source: World Economic Forum, "Human Capital Report 2015"

Exhibit 36. Global competitiveness index



World Economic Forum, "Global Competitiveness Report " 2016 - 2017

Therefore, special attention will be paid to developing human potential including issues related to the improvement of human capital quality and labor productivity; further improving institutional and business environment; establishing infrastructure; increasing the efficiency of

education process and qualified personnel training, coordination between labor productivity and business sector; enhancing the investment attractiveness of innovation-oriented (science and technology based) manufacturing (service); supporting clustering initiatives and identifying key priorities for labor productivity improvement.

7.3.1. Priority 3.1: Improve quality at all stages of education

Rationale

In developed countries, human capital accounts for a significant portion of the national resources and intellectual labor has special importance in economic growth. It is also considered a primary priority in Azerbaijan to establish and to efficiently use human capital with a view to ensuring sustainable development of the country and initiatives in this field are supported by the government. Over the past years, actions related to human capital development have been identified and reflected in a number of ongoing strategies, state programs and concepts. Human capital development as well as development based on knowledge and innovation are among priorities in the “Azerbaijan 2020: Vision of Future” Development Concept and “State Strategy for the development of education in the Republic of Azerbaijan”. Also, the laws “On education” and “On science” are important state documents serving for the development of human capital in the country.

Quality improvement and efficient use of human capital has a significant impact on the development of science and knowledge-based manufacturing (service) sectors, enhancement of labor productivity and competitiveness. Currently, reforms are underway towards human capital development, non-oil sector development, business environment improvement and diversification of economy. Continuation of these reforms is essential in the medium to long term for improving the quality of education (especially, for qualified workforce training levels), establishing flexible management mechanisms for infrastructure and “science-education-production” relationship as well as for integrating the companies into the world market by joining the value chain.

Azerbaijan will continue developing and implementing targeted programs to ensure continuity (lifelong learning) in human capital development, adapt vocational education and qualified personnel training to the requirements of the labor market including pre-school and secondary education as well as improving “science-education-production” relationship. Establishment of more qualitative human capital will allow receiving more material and spiritual benefits.

Actions to be taken

Action 3.1.1: Improvement of the level of coverage of preschool education and enhancement of training – education technologies

Pre-school education has a positive impact on human capital development, establishment of more qualitative human capital, income of population in the long term, economic growth and sustainable development. Currently, there is a low coverage level by preschool education for children at that age. That is, a total of 14 percent of the children aged 1- 5 are covered by pre-school education. According to official statistic data, 1722 pre-school education institutions

were operated in Azerbaijan in 2015, out of which 1079 were infant schools, 631 kindergartens, 4 school-kindergartens and 8 special kindergartens.

Given the impact of pre-school education on improvement of human capital quality in the long term, incentivizing actions will be taken in this area and educational technologies will be improved accordingly. The establishment of public and private pre-school education institutions as well as the development and adoption of a relevant regulatory framework will be supported, and actions will be taken to train highly qualified teachers based on modern educational and training technologies. The actions to improve the social protection of teacher personnel will be supported in order to ensure that their working practices are more efficient.

The matter of making preschool education compulsory will be taken into consideration. Identifying, developing and supporting talents from an early age is important for Azerbaijan's sustainable development.

The initiatives of large companies to establish pre-school institutions could be encouraged. This may be of importance in terms of improving labor productivity at companies (by reducing the concerns of employees about their children and through the protection of continuity in the knowledge and experience of qualified female employees) and protecting gender equality in the labor market.

To implement the above-mentioned actions, a state program for the development of preschool education could be prepared.

Action 3.1.2: Improve general education and develop specialization

Improving the quality of general education to achieve the medium and long term targets envisaged in the strategic roadmaps for 11 sectors of the economy will play a crucial role. Thus, general education (primary general education, basic and secondary general education) is of strategic importance in forming human capital. In this respect, transparent and democratic management in general education system and establishment of creative and initiative environment aimed at the quality of education are considered to be among key priorities in building a knowledgeable society. Continued actions are being undertaken in Azerbaijan towards the improvement of general education infrastructure and quality. In 2003-2015, a considerable amount of works has been performed with regard to the construction of new school buildings and refurbishment of the existing schools. Despite improving the material and technical base during this period, the quality of education has not yet been developed in line with the requirements of our era. The actions to bring teacher personnel training and education in line with modern teaching and learning technologies and to improve teaching and learning methods in order to increase the quality of education at the secondary education level will be supported.

Actions will be taken towards ensuring transition from the school of "memorizing"-based leaning model to a school of "thinking"-based learning model, developing and implementing education programs (curriculums) based on international best practices, improving the professional level of school directors and teachers and increasing the teacher's prestige in the

society and the reforms will be carried out towards efficiently leveraging the existing resources to form more qualitative human capital.

In accordance with the “State Strategy for the development of education in the Republic of Azerbaijan”, the implementation of the staged transition to 12- year general education system in the country has started. 12-year education envisages specialization in the two final years of general education. Specialization will improve vocational education and higher education coverage as well as help the young people to be protected against the risk of unemployment when joining the labor market and will speed up the integration of Azerbaijan’s education system into European education system.

The activities to improve the material and technical base of the education system and to provide students with teaching aids will further be continued in Azerbaijan.

Action 3.1.3. Adapt basic vocational and secondary trade education to the requirements of the labor market

Basic vocational and secondary trade education plays an important role in the formation of human capital and investment there in. The development of basic vocational and secondary trade education is important in terms of economic growth, improvement of labor productivity, creation of added value, alignment of supply and demand in the labor market and employment provision. Especially, as a result of fast updated technologies and scientific-technological progress in the 21st century, the creation of new professions and specialties further increases the importance of basic vocational education and training. In this respect, basic vocational and secondary trade education will be encouraged as part of the strategic roadmap for the country.

Arrange of actions towards the development of vocational education in Azerbaijan has been taken. Thus, within the framework of the “State Program for the development of technical vocational education in the Republic of Azerbaijan (2007 – 2012)”, a series of actions were taken in the vocational education system; however the expected outcome was not achieved, despite increased enrollment to vocational education institutions. Furthermore, the establishment of the State Agency for Vocational Education under the Ministry of Education of the Republic of Azerbaijan is of great importance in terms of developing vocational education and adaptation to the standards of modern era.

Support will be provided to the adaptation of “Classification of professions for basic vocational education” to the requirements of the labor market; close involvement of employers in personnel training; optimization of the network of the vocational education institutions that carry outwork force training in the same professions in parallel, in the regions particularly in industrial centers; involvement of representatives of enterprises and organizations in the management of vocational education institutions. To this end, the activities to establish close cooperation relationship with key employers from various sectors of the economy and to improve the quality and quantity indicators of vocational education institutions will be encouraged.

In addition to formal education (when a state education certificate is granted upon its completion), the methodology for recognizing the competences that are gained through

informal (learning through self-study) and non-formal education (received in various courses, interest groups and individual tuition and not accompanied by granting a state education certificate) will be developed.

The development of vocational standards for priority areas jointly with the representatives of educational institutions and social partners in order to specify the quality requirements of the labor markets i.e. requirements for knowledge and skills will be supported.

The existing conditions of the basic vocational and secondary trade education institutions will be investigated, and the assessment of their infrastructure, material and technical base as well as the potential of teacher personnel will be assessed.

According to the plan for the rationalization of vocational education school network, the merger of vocational education institutions and establishment of education centers specialized in certain vocations will be encouraged.

Actions towards the appraisal of the existing teacher personnel of vocational education institutions, improvement of their knowledge and skills, involvement of new teacher personnel in the vocational education and training process will be supported. Necessary actions will be taken to assess the potential and professional level of the existing teacher personnel of vocational education institutions and provide relevant re-training, and involve industrial trainers and teacher personnel possessing high professional levels in priority professions. Relevant incentivizing and motivating actions both for employers and their specialists involved in teaching process will be determined.

Furthermore, 2-year sub-bachelor degree (colleges) under the existing universities could be established, which would increase the level of youth coverage by the secondary vocational education.

Action 3.1.4: Promote the development of “education – research – innovation” model at higher education institutions

Higher education is an important stage in the establishment and development of human capital. Its impact on the establishment and development of human capital becomes evident in two aspects: 1) development of qualified specialists directly involved in the establishment of human capital; 2) direct involvement in the creation, application and transfer of new knowledge.

Specialists educated at higher education institutions take an active part in the administration of the government and companies, creation of more added value, economic growth and improvement of labor productivity. Taking this into consideration, the formation of a higher education system in Azerbaijan, which could be more efficient in terms of economy and social issues, will be supported. Therefore, the reforms towards the improvement of the quality of higher education, its integration with the global education spectrum, response to the needs for high education personnel as well as the adaptation of higher education to the requirements of the information society and knowledge-based economy will be accelerated. Currently, there is a low level of coverage of Azerbaijani youth by higher education. This, in its turn, may prevent the country from competitive and sustainable development.

Activities towards adapting the training of highly qualified personnel with the requirements of the labor market and with international classification of professions and preparing a long-term forecasting mechanism will be supported, and, also, mechanisms for creating a differentiated salary and incentivizing system in the labor market will be encouraged.

Establishing university clusters may enhance the efficiency of “education – research – innovation” chain. In this respect, creating clusters in some specialized universities in the country will be encouraged in the first place. As a result of improving higher education quality, more qualitative human capital and intellectual potential will be formed and labor productivity will be increased.

Creating university clusters will stimulate the implementation of researches, improvements and application of scientific findings in the production, and will increase the efficiency of “education – research – innovation” relations. Supporting the regions.

Incentives will be provided in order to enhance the independence of private universities and ensure their development. The adoption of a law on higher education and state programs will be considered.

Action 3.1.5: Support development of scientific – research activities and knowledge – based society building

Development of science is of strategic importance in establishing human capital, improving the competitiveness of products and services produced and enhancing labor productivity. Actions related to the development of science in Azerbaijan, improvement of quality of scientific researches and promotion of applying research results in production will be implemented.

Development of science will be encouraged, and incentives will be provided in order to ensure private sector investments in research and improvement. This may accelerate Azerbaijan’s access to global value chain. Access to the international production chain, in its turn, will positively affect the improvement of “education- research – innovation” relations and enhancement of labor productivity.

The Azerbaijan National Academy of Sciences (ANAS) can make its contribution to participation of Azerbaijan in global production chain by getting involved in “education– research – innovation” chain. Currently, ANAS has taken a number of steps to establish a research university with a view to building the “education- research – innovation” chain.

Improvement of business environment may increase the specific share of private sector in financing the science by encouraging investments made by companies in research and improvements. Currently, GDP share of research and development expenditure (0.2 percent)⁴² is below the global average.

⁴² Source: State Statistics Committee of the Republic of Azerbaijan

Action 3.1.6: Improve the quality of education through innovative teaching methods and technologies

Establishing competition mechanisms and carrying out such competition is of importance for the development of human capital with a view to establishing innovative teaching methods and relevant resources at all levels of education. Actions towards strengthening the potential of the institutions, which provide additional education irrespective of their type of ownership, will be undertaken in order to improve the quality of additional education and shape its competitive environment.

This action will encourage the development of innovative models to improve the professional skills of the teachers of general education institutions, establishment of structural units for additional education under higher education institutions, development and application of the mechanisms for assessing and stimulating retraining results. Furthermore, initiatives will be supported with regard to the competition and grant mechanisms to encourage the development of workbooks, teaching aids and didactic materials based on new curriculums and information technologies.

Action 3.1.7.: Improve the material and technological infrastructure involved in the development of human capital

Infrastructural improvements in education and science sectors can have an impact on more efficient activities in these areas, improve efficiency in the formation and use of human capital and ensure innovation- based development. Continuous support will be provided to initiatives towards the development of transport, ICT, building and premises, devices and equipment, laboratories, testing centers, funds, innovation institutions, consulting and engineering services etc. which serve to ensure the mutual, flexible and effective activities of “education – science- production” sectors.

Support will be provided also to the efforts of other mediator organizations in order to increase the efficiency of the mutual activities of information infrastructure (mass media, conduct of specialized exhibitions and conferences, establishment of analytical centers to investigate global and local markets, translation centers, consulting services) and “education – science- production” sectors. At the same time, the activities, which are aimed at improving the access of schools, scientific and manufacturing organizations to internet as well as relevant informational provision, will be encouraged. ICT knowledge allows people and economy to create workplaces with potential to create added value. Furthermore, digital literacy is considered the main element for the future of Azerbaijan and human capital development.

ICT knowledge is one the decisive factors in the establishment and use of human capital. The establishment of modern schools and universities, conduct of investigations and improvements, activities of manufacturing and service enterprise sare all related to ICT to some extent.

Currently, there are regions, areas and schools in the country which have no access to internet. In the short to medium term, in order to efficiently use the global information field and impart ICT knowledge to students at all levels of secondary education starting from primary

education, awareness-building actions will be supported. The creation of electronic libraries and intellectual games at secondary schools will be encouraged. Awareness-building actions related to targeted use of internet resources will be implemented.

For the purpose of promoting digital literacy, it is necessary to improve curriculums at all levels of education by means of digital teaching materials (for instance, e-books, e-seminars, open-access teaching materials, conduct of web-exams etc.). Systematic accessibility to digital education materials developed for teachers and students by using various digital equipment will be ensured.

ICT skills will be identified and the relevant base including professional standards will be developed for all levels of education. ICT skills of students will be assessed (by tests, participation in international comparative questionnaires, and external assessment on particular topics) and the outcomes of these assessments will play a basic role in planning development activities.

The upgrading of material and technical base in scientific, educational and manufacturing sectors to modern requirements, normal functioning of pedagogical and teaching activities in education, conduct of scientific researches, testing and application thereof and optimization of “science-production-market” relationship will be ensured and also establishment of support organizations will be encouraged. This will improve the efficiency of coordinating the governing bodies that develop and implement policies for education, science and production.

Financial and credit infrastructure (budget and non-budgetary funds, commercial banks) will be developed for the purpose of improving financial capabilities in order to optimize “Education – science – production” relationship, prepare qualified personnel for the institutions and organizations that are involved in these “three areas” and carry out market-oriented scientific research and development.

Activities related to the establishment of regional and functional universities and production clusters in order to set up the mechanism for flexible operation of “education – science – production” infrastructure will be encouraged. Support will be provided to the development of manufacturing and service areas that improve the economic efficiency of multi-level lifelong education system, university camps, scientific-research institutions (Azerbaijan National Academy of Sciences and regional institutes) and their activities.

7.3.2. Priority3.2. Stimulate human capital to increase labor productivity

Rationale

The primary requirement established for the competitive, inclusive and sustainable development of Azerbaijan's economy is to ensure that human capital is developed and labor productivity reaches the level of developed countries. Therefore, preference will be given to the creation of sectors that encourage intensive labor in economic growth in the short and medium term and the transition to knowledge-based model in the medium and long term will be ensured. Development of labor productivity and human capital can be considered an

important enabler for two reasons. On one hand, the improvement of labor productivity in development model that requires intensive labor will be the key driver of economic growth by creating direct added value in the country's economy. On the other hand, smooth transition to the development model that requires more intensive knowledge will be ensured only by achieving the enhancement of labor productivity. All this will ensure the competitiveness of Azerbaijani products in the global markets and, at the same time, make human capital investments more attractive.

Accelerated development was achieved in Azerbaijan and labor productivity improved by more than three times in the recent 15 years. The growth of labor productivity in Azerbaijan made 13,6 percent on an average in 2000 – 2008. From 2008, though the growth of labor productivity continued, the growth rate declined by nearly 2 percent on an average.

Considering the development level of the countries in the region, the comparison made shows there are broad opportunities for the improvement of labor productivity in Azerbaijan. Thus, GDP per 1 employed period in 2015 was USD 46 thousand in Russia, USD 57 thousand in Turkey and USD 36 thousand in Azerbaijan⁴³.

Investing in human capital will be encouraged in order to improve labor productivity in 11 sectors covered by the strategic roadmap for national economy and the key sectors of the economy.

Azerbaijan may achieve the growth of labor productivity in the agricultural business sector by promoting the encouragement of support system, production and innovation activities. Education and training centers and agricultural clusters will be established in order to provide training to qualified employees working in various sectors, assist entrepreneurs in generating more profits and help them to develop the activities they need.

Consultation centers aimed at increasing the awareness of entrepreneurs and encouraging production will be organized. By using professional mediators and consultants involved from manufacturing and service sectors, these centers will provide advice and support to small and mid-size businesses regarding the enhancement of competitiveness and productivity. The main target of the centers is to come up with proposals to solve the issues faced by small and medium businesses and improve their access to various networks.

In order to encourage companies in performing research works and simulate innovative development, they may be granted outcome-based concessions and privileges.

As an integral part of the continuous economic reforms conducted in Azerbaijan, investing in labor productivity will be carried on in order to increase labor productivity. To this end, important factors consist in creating and applying mechanisms to achieve training and regulatory changes in the short to long term, increasing production volume and efficiency, incentivizing investments, applying and adapting innovations to value adding sectors.

Actions to be taken

⁴³Source: International Labor Organization

Action 3.2.1: Establish a supportive system

Building a supportive system can include infrastructure improvements, labor trainings, labor regulations, easing and accelerating access to markets through trade agreements, creating conditions for cluster-based development through industrial centers or industry platforms. Azerbaijan is already making efforts in all these dimensions. It has invested heavily in improving its infrastructure in last decade, is launching efforts to improve its vocational education and training provision and has adopted a cluster based development approach in sectors such as agricultural industry, heavy machinery and logistics.

The Republic of Azerbaijan will continue pursuing already launched efforts and start dedicated monitoring efforts to observe their implications on labor productivity. Based on the principles of operation, the future development of the country will be based on the new improvement plans. It is necessary to use efficient international best practices in the process of development and execution of the action plan for the improvement of labor productivity.

Improving and developing human resource skills in operating manufacturing enterprises, training and reskilling workforce for clustered development will be continued as well as various stimulating and encouraging actions will be implemented in order to improve recruitment and training mechanisms. The establishment of a local employment center by the government will be considered in order to facilitate recruitment processes in commercial organizations and flexible mechanisms. The trainings provided by the center may be fully financed by the government for the purpose of developing promising employees to meet the requirements of the labor market.

Action 3.2.2: Encourage manufacturing and investment

Investment encouragement reflects the importance of the activities performed to ensure incentivizing financial resources for increased productivity.

Given that Azerbaijan joins the global value chain, the main focus will be on improving labor productivity and implementation of incentivizing programs will also be carried out in the future.

Promotional actions for the establishment of relationship with transnational companies that operate in the priority sectors will be undertaken. The companies involved may be offered outcome- based concessions and investment subsidies for the purpose of encouraging their activities. Such concessions can enable improving production volumes, establishing a number of small sub-vendor clusters by using state subsidies as well as involving additional companies. These factors, in their turn, will improve labor productivity.

Action 3.2.3: Promote investments in innovation activities

Innovation activity is the main enabler for ensuring continuity in the development of human capital, improvement of labor productivity and competitiveness in manufacturing and management areas. When developing action plans and state programs, which will encourage the promotion of innovation in Azerbaijan, the importance of such activities will be taken into account. In order to encourage innovation activities, the country has a number of opportunities to establish a large-scale knowledge network by granting awards and credits to the scientific

researches and improvements, production of high technology products. It is important to maintain focus on the performance of these provisions in a consistent, staged and continuous manner in order to obtain suitable and optimum results.

Action 3.2.4: Implement sector-based labor productivity initiatives

In parallel to the previous action steps that are aimed at labor productivity at the sectorial level, exploring improvement areas will be continued in an inclusive manner. The main goal is to effectively coordinate with the responsible bodies in each sector, including governmental bodies and sectorial associations, to support them in building up the required mechanisms for increased labor productivity.

It is reasonable to conduct additional analyses on labor productivity in the future for 11 sectors covered by the strategic roadmaps.

7.4. Strategic target 4: Develop a suitable business environment

Azerbaijan has been implemented programs in order to achieve both macroeconomic and sectorial targets specified. Consequently, Azerbaijan ranked 63rd out of 189 countries in the “Doing Business” report developed by the World Bank in 2016. Azerbaijan is among the top 40 countries in the world against 5 out of 10 indicators reflected in the report. Attracting foreign investments in oil-gas sector and investing through direct and indirect participation of the government was the key enabler of the economic development in 2004 – 2014. The new economic approach requires further improvement of the business environment in order to encourage investing by private sector in non- oil economy. In this respect, the economic reforms will cover further improvement of the business environment, continuation of the promotion policy and institutional reforms. By supporting macroeconomic stability and infrastructure development, the government will continue making its contribution to the improvement of business environment. This Strategic Roadmap also reflects conceptual issues covering 11 sectors in terms of business environment improvement. Detailed action plans have been provided in the Strategic Roadmap for each sector.

7.4.1. Priority4.1. Further strengthening the leading role of the government in creating a suitable business environment

Rationale

The most important issues are to develop entrepreneurship in the country, improve government regulation in enhancing its competitiveness, establish attractive business and investment environment in line with the international best practices and have an advanced regulatory and legal framework in this area. In order to achieve these targets, the government has consistently implemented comprehensive actions towards the development of government-entrepreneur relationship, elimination of unlawful interventions and artificial barriers in entrepreneurial activities, expansion of competitiveness and export capabilities, formation of mechanisms for state support and entrepreneurship promotion, provision of electronic public services in line with international standards. It has established a commission for the purpose of ensuring sustainability of the accelerated development which has been

achieved in the recent years in the area of entrepreneurship and strengthening of its competitiveness as well as for further improvement of Azerbaijan's position in the international ratings.

Within the framework of this priority, Azerbaijan will strengthen the institutional basis of the business environment. In particular, the main dimension will be the development of competition mechanism, reduction of human capital in government – business relations and improvement of accountability and transparency. Another role of the government is to ensure the conclusion of free trade agreements for access to foreign markets, establishment of technical regulation and national standardization system in line with the international requirements. The government will also continue its activities with respect to further improvement of mutual trust and transparency between taxpayers and tax authorities and improvement of business environment efficiency through optimum tax burden policy.

Actions to be taken

Action 4.1.1: Develop a free competition environment

Azerbaijan has implemented important reforms which enable free competition in order to ensure a suitable business environment in support of the private sector development.

The resolution of the issue regarding the balance point between financial sector and real sector is possible through the improvement of competitive environment in Azerbaijan. Thus, it is possible to improve competitiveness of the domestic products and services only by providing incentives to the economy under free competition conditions. The improvement of competition environment requires the existence of robust and improved competition legislation, the application of this legislation by a competition regulator that operates efficiently and independently, and realization of an economic policy which complies with competition principles, eliminates the barriers for the development of competition and prevents monopoly in general. Since preliminary investigation of the violations of competition legislation and adoption of decisions regarding the identified violations are two different fields of activity, these fields are required to be specialized. In this respect, establishing a competition authority which will independently operate in line with the international best practices (US, Austria, Latvia, Lithuania, Hungary, and Czech Republic etc.) will be taken into consideration and the Competition Code will be adopted in line with the international practices.

Action 4.1.2: Encourage an efficient taxation system

The target is to achieve compliance with international standards and to provide most of the tax services applied in the leading countries of the world.

Therefore, the reforms are underway towards the introduction of efficient and fair tax and execution system that encourages the development of private sector and formalization of business entities and includes carefully specified and real tax rates.

Since taxation system and its management are an important part of the suitable business environment, Azerbaijan has conducted reforms that facilitate making tax payments by

business entities. Further reforms will be implemented to improve the taxation system and its administration in order to strengthen mutual trust between taxpayers and tax agencies through increased transparency, and to specify the tax potential while encouraging a sustainable development. For the purpose of advancing in this direction, tax burdens of companies in other countries as well as taxes on all operations along the value chain will be taken into consideration and fair tax levels will be assessed accordingly. Thus, with a view to expanding the tax base and encouraging official registration of business entities, initiatives for the reduction of tax compliance costs will be taken into consideration within the framework of these reforms. In addition to the reforms conducted, the stimulation of economic activities, encouragement of priority sector development and impact of differentiated tax rules to attract foreign investments will be continuously assessed. In order to ensure efficient conduct of the reforms, the role of other factors such as tax administration will be analyzed and considered accordingly in addition to respective in-process accountability. By incentivizing companies (through government programs), which contribute to economic growth and creation of new workplaces, analysis will be made to identify the opportunities to invest funds, which are obtained from the taxation system, into the areas that support economic development.

Action 4.1.3: Increase the flexibility and efficiency of public services

To develop the business environment, the improvement of electronic government services will be continued by expanding the application of modern technologies and easing their usage options. The government will support the development of digital economy by expanding the provision of electronic services such as e-payment, e-tax, e-intellectual management etc. and, this way, the improvement of public administration will ensure the improvement of overall economic efficiency.

The coverage of the “ASAN” service centers, which provide public services under the principle of “single space” and are recognized as “made in Azerbaijan” brand in the world, will be expanded. In general, by integrating the information systems of the public bodies, the flexibility, efficiency and transparency of the electronic services will be ensured so that business entities can save their resources as well as mutual relations will be improved on an international level and investment inflow into the country will increase by expanding the access to markets and resources. Regular measurements of consumer satisfaction index will ensure that the quality of public services is further increased and business environment is continually improved.

Considering the large volumes of public procurements in Azerbaijan, the improvement of procurement procedures for products and services including increasing the acceleration and efficiency of public procurement processes will be ensured. In addition to benefiting from the large volumes of public procurement, the establishment of a certain regulation for public tenders will provide further support to the domestic companies as well as small and medium business entities operating in the country.

It will be ensured that the actions to further develop public-private partnership and to improve business environment in Azerbaijan are executed in time and efficiently, the attraction of

private investment for the development of infrastructure areas will make an additional contribution to business development.

Action 4.1.4: Conclude free trade agreements

Azerbaijan has been continuously concluding suitable trade agreements benefiting from economic benefits that arise out of free trade agreements.

The export activity will be encouraged by concluding bilateral and multilateral trade agreements hereafter as well, and the suitability of the business environment will be ensured by increasing the trade margin. The established transport-logistic infrastructure will be further developed in order to strengthen country's foreign trade, and also improvement will be made for the trade logistics in order to further enhance the country's ranking in "Logistic Transport Index" developed by World Bank.

The new free trade agreements being developed will be based on the analyses of the markets and assessments conducted for the strengthening of standing in the value chain. In addition to traditional CIS markets, activities will be continued to enter markets such as European Union, Gulf countries, China for the purpose of increasing non-oil export. Feasibility studies and risk analysis for the construction of logistic centers in the export markets with government support will be carried out and the real value of these projects in ensuring the country's export will be forecast.

The access of domestic products and services to foreign markets through electronic trade will be promoted by ensuring the development of infrastructure and legal base of the electronic trade which is an important part of global information society in the country in line with international regulations.

Possible economic, social and political outcomes of the decisions to conclude trade agreements and participate in international agreements will be analyzed. When considering the opportunities for bilateral agreement with Turkey and Iran, the potential impacts assessment for various sectors is also important.

It is necessary to specify preparatory actions to be taken in this direction, including performing improvement works for risk mitigation, and to identify special actions in the event that such agreements are concluded.

Action 4.1.5: Establishment of technical regulation and national standardization system in line with international requirements and its application in support areas for business environment

Most products in the country, including domestic food products, are mandatorily certified based on standards. According to the current legislation, the central executive authority responsible for the governance and regulation of the national standardization system is the State Committee for Standardization, Metrology and Patents (SCSMP). In addition to this Committee, other respective state bodies also carry out the preparation and evaluation of standards, certification, and control over the conformity of products in the market with standards and safety requirements.

Azerbaijan's national standardization system has a number of different features as compared with the national standardization systems which are available in some developed countries and are established based on the requirements of the World Trade Organization (WTO). A number of CIS countries, including Russian Federation, Kazakhstan, Ukraine and Georgia are adapting their national standardization systems with the international requirements as per the WTO requirements and European Union model in order to eliminate the above differences and to allow free circulation of the products, which they produce, in international trade.

It is reasonable to take a number of actions in order to ensure free turnover of Azerbaijani products in international trade and simplification of the import-export operations. These actions cover the processes from the establishment of the legal base to the adoption of a relevant action plan related to adapting national standards with international and European Standards. Thus, adopting the technical regulation law will solve the issues of limiting the state control of products to safety requirements, adaptation to quality requirements on a voluntary basis, removal of control over food products from technical regulation and standardization system, conduct of product certification as per the risk level. In addition, the enactment of the new revision of the standardization law, which regulates quality issues, will fully adapt the legal base of the system with international requirements. All the existing standards will gradually become voluntary during the process and entirely new technical regulations will be adopted instead. And the existing directives of the European Union may be assumed as a model and adopted as national technical regulations. There are reference standards in the European Union adopted as per relevant international standards which can ensure the fulfillment of the main requirements in these directives. Following the adoption of technical regulations, namely these international standards will also be accepted as national standards. At the same time, the existing standards which comply with the international standards will be applicable as reference standards and those which do not comply therewith or those which are old will be cancelled. The mentioned actions will be conducted based on a gradual transition principle. Thus, until new technical regulations and their referenced standards are adopted, the existing standards will remain in force and the old ones will be cancelled as new technical regulations and their referenced standards are adopted.

On an institutional level, when conducting these reforms, a number of important criteria will be assumed as a basis: balance between ensuring product safety and establishing liberal business environment; limitation of regulation measures to ensuring product safety as well as transformation of the standardization, which serves for quality improvement, to the activities contributing to the enhancement of product competitiveness; establishment of management system based on market economy principles and transparency; avoiding conflicts of interests and basing upon liberality; rationalization of public administration expenditures; ensuring minimum intervention which is necessary for entrepreneurial activities; substitution of public control over production with public control over market and assignment of public control over production to conformity assessment bodies; ensuring more active participation of private sector in the operation of the national standardization system; reduction of expenditures incurred by the private sector in applying regulatory documents as much as possible and simplification of procedures.

7.4.2. Priority4.2. Strengthen business sustainability by improving promotional environment

Rationale

Currently, competition is growing in attracting investments on global and regional scales and business promotion mechanisms are being improved. It is planned to bring the country to a more favorable ranking in attracting investments on a regional scale by speeding up the reforms in this area. Thus, by attracting more investments, the pressure in the balance of payments will be eliminated, gradually optimized public investments will be replaced with private investments and sustainable economic development will be ensured. In particular, attracting foreign investments will pay the way for Azerbaijan to join value chain on global and regional scales. At the same time, encouraging mechanisms, which are necessary for investing the domestic savings potential, will be developed. It is of special importance to reflect the business promotion environment in Azerbaijan in international rankings.

Actions to be taken

Action 4.2.1: Accelerate the ongoing reforms to improve ease of doing business and improve positioning in international rankings

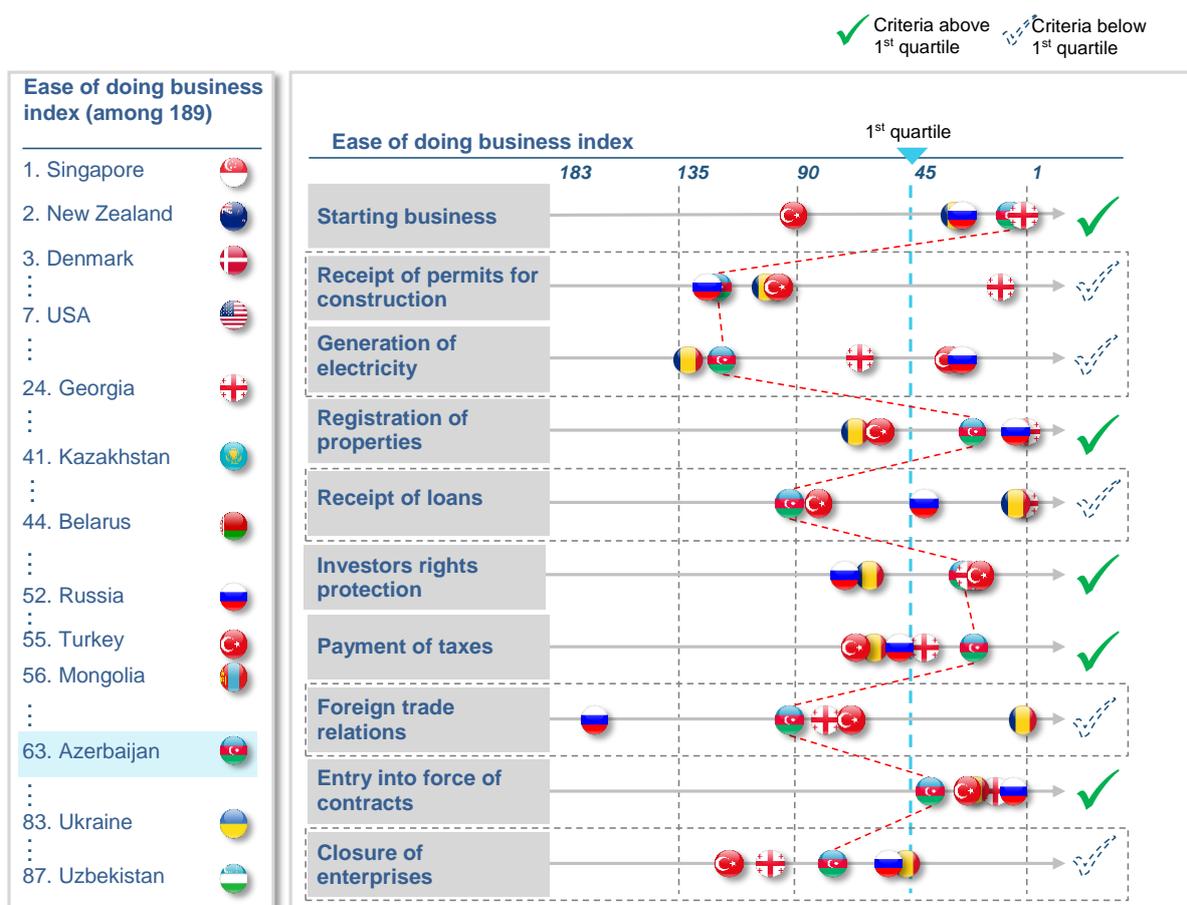
One of the most important dimensions to attract the investments is the availability of projectable and stable business environment. The main factor establishing the investment reputation of the country is the position of the country in international rankings. Thus, these rankings have indicators in most factor that are important for investors (such as macroeconomic stability, investment environment, judicial system etc.) and investors may form opinion about the country just by reviewing these rankings.

Activities will be carried out in the following dimensions in order to improve positioning in international rankings:

- 1) Improve legislation based on international best practices;
- 2) Ensure that the decisions made are executed;
- 3) Make the domestic and foreign community aware of the economic reforms by strengthening communication.

The main indicator of ease of doing business is an annual “Doing Business” report prepared by the World Bank Group and focused on the rules and regulations that can help the private sector thrive. According to this report, the ease of doing business in Azerbaijan has improved in recent years. Azerbaijan's ranking improved to 63rd in the world (out of 189) in 2016 as a result of Presidential Decrees in 2007 and 2014 and other reforms aimed at applying a one-window system for entrepreneurs to start their businesses and abolishing the requirement to use a corporate seal with the aim of developing an electronic system for tax and social insurance payments (Exhibit 37).

Exhibit 37. Azerbaijan's rank for ease of doing business



Source. World Bank, “Doing business” report, 2016

An analysis of the *Doing Business* index reveals useful insights: Azerbaijan has a favorable ranking in terms of such indicators as starting a business, registering property, protecting investors, paying taxes, and enforcing contracts. These results show that, due to the ongoing actions, including the recent Presidential Decrees, the reforms in Azerbaijan are being implemented in line with developed world standards in multiple areas. While Azerbaijan is ahead of most post-Soviet countries, Azerbaijan can further improve the initiatives taken towards strengthening the business environment by starting to consider the following areas: obtaining construction permits, getting connected to electrical power supply networks, obtaining credits, trading across borders, and resolving insolvency. These areas focus on rules and regulations that can help the private sector to develop, thus highlighted in detail in “Strategic Roadmap for the production of consumer goods y small and mid-size enterprises in the Republic of Azerbaijan”.

Increased focus on ease of doing business in Azerbaijan can complete the current reforms conducted to support the economic reforms. In this respect, for the purpose of further investigating reform opportunities and the actions to be taken in this area, a relevant commission was established pursuant to the Decree of the President of the Republic of Azerbaijan “On additional measures with regard to the improvement of business environment

suitability and further improvement of the position of our country in international rankings” dated July 13, 2016. The proposals of this Commission may be very important for strengthening the economic development efforts targeted jointly with professional tactical actions. International rankings play a helpful role in identifying the priority actions for development purposes and these should be assumed as an indicator for progress and not just as an objective.

Action 4.2.2: Improve statistic infrastructure:

Targeted reforms are underway with a view to building an environment, which will support the development of business entities in Azerbaijan, and improving the business environment. Possible measures are being continuously considered and developed for the purpose of conducting economic reforms in parallel and eliminating the barriers. In line with the requirements of the sustainable development of reforms, there is a necessity for conducting new actions. In order to provide further support to reforms, the actions to be taken towards making efficient decisions on the existing opportunities also include strengthening statistical infrastructure.

To further enable private investment, strengthen market institutions, and contribute to a more favorable environment for businesses, statistics is a critical governance tool as it enables evidence-based policy, and business decisions. The national statistical system in Azerbaijan aggregates and processes a broad range of data and statistics, and provides access to published statistics through multiple channels of the State Statistics Committee (SSC). In this light, sustaining the ongoing efforts in this area through allocating the required resources and ensuring alignment and cooperation between governmental entities are essential. On one hand, it will decrease duplication of efforts and increase efficiency of data collection and dissemination system, across government entities. On the other hand, it will improve effectiveness of statistics infrastructure, by ensuring accuracy and diminishing data discrepancies, streamlining data updating procedures. By taking into consideration all technical issues, a stronger statistics infrastructure will facilitate critical analyses and ensure effective decision making and citizen engagement.

Action 4.2.3: Implement a foreign direct investment strategy through good management and efficient incentives

There are a number of factors that demonstrate Azerbaijan to the investors in an important and positive light: political stability and security; natural economic characteristics of the country; advanced system in individual elements of business environment (starting business, quality public services, electronic services, liberal licensing, cessation of inspections); material infrastructure. It is expedient to carry on reforms in order to ensure investment inflow into the country due to these advantages.

Investment promotion agencies play an active role in attracting investments and creating business environment and international practices show some examples of their involvement at different levels. Such examples include “one stop shop” model application and reflect the functions of investment promotion agencies, which are active in promotion and negotiations,

and their coverage in joining the value chain. For example, the respective state agencies of Singapore, Ireland and Malaysia in their activities mainly focus on: attracting foreign investors and solving their problems in administrative stages through incentives; supporting investment implementation; efficient subsector-based development of project operating models and achievement of the government's general development objectives. These agencies take actions towards obtaining work permits in support of investors and registration of business entities for the purpose of attracting foreign investments, establishing relations with potential business partners, project financing through reasonable subsidies, performing lobbying activities in various government agencies etc. It is proposed to widely use the mentioned international experiences in the country.

Important initiatives have been implemented in attracting and increasing foreign investments in line with economic growth and development purposes in Azerbaijan.

Establishment of proper management structure and identification of incentives (in regulations, finance or tax) may help Azerbaijan to attract foreign investments. Investor perspective should be adopted by identifying successful incentive structure, general arrangement profile, relevant field or area of activity as well as possible financing and selecting proper tools through other business incentives. The potential impacts of the government policy on regulatory, financial and tax incentives may be assessed in order to facilitate the creation of added value. The time schedule of incentives is also important. Thus, the impact of incentives becomes negative over time and when it is thought that these incentives are permanent.

The format of the potential incentives covers a wide range grouped in 3 main fields: *Regulatory incentives* may cover equal benefits and provisions such as assigning the ownership title of property to foreign investors, which is also available to domestic companies, mitigation of currency control limitation or capital requirements, employment of expats. *Financial incentives* envisage costs related to savings and tax exemption, scientific-research credits, tax on capital discounts, preferential duties. *Tax discounts* cover all the tax exemptions, corporate and local taxes for a specified time and under specified conditions. In order to ensure economic development, these instruments are already being applied in Azerbaijan. The incentives will be continuously revised and updated in the years to come.

There is a necessity for attracting investments and, particularly, successfully continuing the efforts for the development of the securities market. Currently, there is high demand for currency derivatives in the market (futures, forwards, swaps and options). Apart from uncertainties, additional risks for entrepreneurs arise as a result of failure to meet this need and to use the mentioned instruments in the commercial sector. The development of foreign currency derivatives market may create opportunities for attracting foreign investments in Azerbaijan.

The revival of incomplete infrastructure projects, cooperation with international development banks for non-oil sector and public-private sector partnership are of special importance. Under current conditions, it is necessary to establish a market for selling bad assets and attracting international asset management companies to Azerbaijan in order to attract international investors. Therefore, making relevant changes in the legislation, shaping a legal framework

for establishing asset management companies can be considered. It is of great importance to speed up privatization of state institutions and to start initial public offering of shares for the purpose of developing financial markets and attracting foreign investments. This action is also important in terms of improving state-owned bad assets.

The development of Islamic funding in Azerbaijan (especially from Gulf countries) may also give a boost to attracting foreign investments. Islamic financial institutions are considered a good platform for expanding access to financial services in the real sector and for the provision of funding to small and medium enterprises. Their participation in attracting foreign investments will be assessed to support the economic growth and development in the country.

The investment standing and attractiveness of the country are also influenced by membership in international and regional economic organizations. For example, investors perceive WTO membership as the availability of stable and predictable trade and investment environment since titles and investor's rights in that country are protected as a result of the country's commitments to WTO, there by making more investments in that country.

Analyses for the identification of optimum legal base for the purpose of protecting the investors' rights will be carried out.

Considering return on investment factors, the procedures for allocating additional resources, which are required for encouraging the engagement of domestic and global experts, will be implemented and, with a view to expanding the potential opportunities for foreign direct investments, broad investment actions will be encouraged.

8. FINANCING MECHANISMS

To achieve the strategic targets specified, it is estimated that AZN 27 billion investment will be required. This amount includes the total funds required within the framework of the strategic roadmaps for all sectors and will be ensured at the expense of all types of public and private (domestic and foreign) sources. The implementation of the actions envisaged in the Strategic Roadmap will be financed from the below sources:

- Government budget;
- Non-budgetary funds;
- National Entrepreneurship Support Fund;
- Local budgets;
- Funds from local institutions, enterprises and organizations irrespective of their forms of ownership;
- Direct foreign investments;
- Loans and grants from the country's banking system;
- Loans, technical and financial support from international organizations and foreign countries;
- Other sources that are not prohibited by legislation.

To ensure that the funds for the specified strategic targets are spent in the most efficient way, the budgets will be developed within the framework of performance based funding processes. A larger portion of the required funds will be provided through restructuring the current budgets and joint financing efforts of the private sector and different investors.

9. Implementation, monitoring and evaluation

Implementation of Strategic Roadmap

Coordination and governance: Accelerated decision making, clear accountability and additional execution capacity will ensure appropriate coordination and governance.

- A mechanism for accelerated decision making at the highest political level will be set up for the Strategic Roadmap. This mechanism will enable appropriate leadership from key stakeholders for other decision makers for the implementation of the program. Decisions about implementation priorities and concrete targets will be made using this mechanism.
- The main executive organization will appoint responsible persons for each relevant priority and action in order to implement them in a timely and proper manner. With the involvement of other organizations specified in the action plan, working groups under the top management of responsible organizations will also be formed for each priority. Reporting meetings of the work groups will be conducted under the leadership of the main executive organization on a quarterly basis. Quarterly work progress and activities to be performed during the next quarter will be discussed in the meetings. The work groups will carry out their activities based on annual work programs. Daily work schedules and task allocation will be determined by the responsible person. Typically, current work group meetings will be held in the offices of the main executive organization as requested by the responsible person. The main executive organization will ensure that appropriate conditions are created for unimpeded activity of the work group and, when necessary, it will involve external experts to make best use of their technical support.
- An appropriate coordination group (delivery unit) will be established to monitor the implementation of the Strategic Roadmap and provide central execution support in areas such as in problem solving or coordination across institutions. The unit's major work will serve to create organization across the institutions, processes, and technology required for implementation. This coordination unit will oversee teamwork across work groups in line with the action plan, summarizing of quarterly reports and preparation of annual reports. Furthermore, it will be responsible for ensuring that the involved institutions arrange for the required financial and human resources, and empowered to inject additional resources when needed.

Strategic alignment and financing: To allow for an efficient implementation process that avoids wasted resources and conflicting objectives, the Strategic Roadmap will be fully integrated into other sectorial plans and existing budgets.

- All related strategic documents proposed by relevant governmental institutions will be harmonized with the Strategic Roadmap and the mandates of existing state agencies will be realigned to the objectives wherever necessary. This alignment work

will include developing transparent, measurable implementation targets, which will be communicated publicly and used to track progress.

- Detailed implementation plans will be developed for all strategic priorities as governance for their execution, based on provided actions, to provide transparency regarding the resources required and expected impact. While the assigned leading group will bear overall responsibility for fulfilling the implementation plan, it will involve all key institutions and private sector organizations in its application.

Stakeholder mobilization platform: Both domestic and international partners from both public and private sectors will be mobilized to join in the execution of the Strategic Roadmap.

- Appropriate actions will be taken to identify and involve key strategic partners. The involvement of multiple organizations and stakeholders is required for the successful implementation of each strategic priority. To ensure alignment of objectives and proper coordination, advisory councils and working committees will be formed to work with the private sector and state owned enterprises as well as with critical international partners, such as international financial institutions.
- Civil society will be mobilized and engaged to generate broad support for the roadmap. Furthermore, active communication, transparency and inclusiveness will help to mobilize the public and private sectors, society as a whole, and other relevant stakeholders.

Monitoring and evaluation of the Strategic Roadmap

The Strategic Roadmap will be monitored and evaluated to ensure successful implementation through required tools, processes and other resources. During monitoring and evaluation, focus will be placed on the implementation of core actions, expected results and indicators versus priorities, and also compliance with the completion schedule will be checked. The monitoring and evaluation will be carried out in accordance with procedures based on international methodologies.

The annual activity programs of the work groups will be agreed with the coordination unit and approved by the main executive organization. Representatives of the coordination unit will participate in the quarterly meetings of the work groups.

The main executive organization will submit quarterly work progress reports to the coordination unit at least 10 days prior to the work group's quarterly meeting. By taking into account extensive analysis and evaluation of quarterly reports including discussions held in the quarterly meeting of the working group, the coordination unit will submit quarterly monitoring results and its recommendations for the next period to the main executive organization within 10 days following the meeting date. The coordination unit and the main executive organization will take actions to ensure that the monitoring results and recommendations are taken into consideration by the working group in its daily activities.

10. Action plan

Item No.	Action	Main responsible entity	Other entities	Time-line
Strategic target 1: Strengthen fiscal sustainability and ensure a robust monetary policy				
1.1: Establish a “golden rule” to regulate the transfers of oil revenues to the national budget				
1.1.1.	Create alignment on golden rule principles	Ministry of Finance	SOFAZ, Ministry of Economy, Financial Stability Council	2017
1.1.2.	Define and adopt “golden rule” mechanism and parameters	Ministry of Finance	SOFAZ, Ministry of Economy, Financial Stability Council	2017
1.2. Create a mechanism to ensure expenditure/investment discipline				
1.2.1.	Establish medium term expenditure framework	Ministry of Finance	Ministry of Economy, SOFAZ, Ministry of Taxes	2017
1.2.2.	Implement outcome based budgeting mechanism	Ministry of Finance	Ministry of Economy, SOFAZ, Ministry of Taxes	2017
1.3. Apply an efficient monetary policy framework for the new economic model				
1.3.1.	Ensure macroeconomic coordination	Financial Stability Council	Ministry of Finance,	2017 – 2018
1.3.2.	Target a new alternative anchor	Central Bank of Azerbaijan	Ministry of Finance, Ministry of Economy	2016 - 2017
1.3.3.	Ensure transition to fully floating exchange regime	Central Bank of Azerbaijan	Ministry of Finance, Ministry of Economy, Financial Market Supervision Chamber	2017
1.3.4.	Improve the activities of interbank market	Financial Market Supervision Chamber	Ministry of Finance, Central Bank of Azerbaijan	2017

Item No.	Action	Main responsible entity	Other entities	Time-line
1.3.5	Form and manage adequate economic expectations	Central Bank of Azerbaijan	Financial Market Supervision Chamber, Ministry of Finance, Ministry of Economy	2017-2018
Strategic target 2. Privatization and state-owned enterprise reforms				
2.1. Coordinate the overall approach to improve efficiency of public sector's role in economy				
2.1.1.	Establish a regulatory framework related to the improvement of efficiency in the activities of legal entities whose control stock belongs to government	Presidential Administration of the Republic of Azerbaijan	Cabinet of Ministers, Ministry of Economy, Center for Analysis of Economic Reforms and Communications	2016
	Identify the needs based on state ownership	State Committee on Property Issues	Ministry of Economy	2017-2020
2.1.2.	Accelerate state property privatization and improve governance efficiency	State Committee on Property Issues	Ministry of Economy	2016 - 2018
	Conduct state-owned enterprise (SOE) reform program to improve governance and efficiency	State Committee on Property Issues		2017 - 2018
2.2. Successfully implement the privatization agenda and carry out privatization in priority sectors				
2.2.1.	Administer the privatization agenda for classified assets that can be offered for privatization in future	State Committee on Property Issues	Ministry of Economy	2017
2.2.2.	Apply the established privatization approach in priority sectors	State Committee on Property Issues	Ministry of Economy	2017 - 2018
2.3. Attract most appropriate investors for privatization and foreign direct investment				

Item No.	Action	Main responsible entity	Other entities	Time-line
2.3.1.	Apply structural approach to the most suitable investor profiles	Ministry of Economy	State Committee on Property Issues	2017 -2020
Strategic target 3: Develop human capital				
3.1. Improve quality at all stages of education				
3.1.1.	Improvement of the level of coverage of preschool education and enhancement of training-education technologies	Ministry of Education	Ministry of Communication and High technologies	2017 -2020
3.1.2.	Improve general education and develop specialization	Ministry of Education	Azerbaijan National Academy of Sciences, Ministry of Labor and Social Protection of Population	2017 -2019
3.1.3.	Adapt basic vocational and secondary trade education to the requirements of the labor market	Ministry of Education	Ministry of Labor and Social Protection of Population	2017 -2018
3.1.4.	Promote the development of “education – research – innovation” model at higher education institutions	Ministry of Education	Azerbaijan National Academy of Sciences, Ministry of Economy	2017 -2018
3.1.5.	Support development of scientific – research activities and knowledge – based society building	Azerbaijan National Academy of Sciences	Ministry of Education	2017 -2020
3.1.6.	Improve the quality of education through innovative training methods and technologies	Ministry of Education	Azerbaijan National Academy of Sciences, Ministry of Communication and High technologies,	2017 -2018
3.1.7.	Improve the material and technological infrastructure involved in the development of human capital	Ministry of Education	Azerbaijan National Academy of Sciences, Ministry of Communication and High technologies, Ministry of Economy	2017 -2019

Item No.	Action	Main responsible entity	Other entities	Time-line
3.2. Stimulate human capital to increase labor productivity				
3.2.1.	Establish a supportive system	Ministry of Economy	Ministry of Education, Ministry of Labor and Social Protection of Population	2017
3.2.2.	Encourage manufacturing and investment	Ministry of Economy	Ministry of Finance	2017-2020
3.2.3.	Promote investments in innovation activities	Ministry of Economy	Azerbaijan National Academy of Sciences	2017-2020
3.2.4.	Implement sector-based labor productivity initiatives	Ministry of Economy	Azerbaijan National Academy of Sciences	2017-2018
Strategic target 4: Develop a suitable business environment				
4.1: Further strengthening the leading role of the government in creating a suitable business environment				
4.1.1.	Develop a free competition environment	Ministry of Economy	Ministry of Justice	2017-2018
4.1.2.	Encourage an efficient taxation system	Ministry of Tax	Ministry of Economy	2017
4.1.3.	Increase the flexibility and efficiency of public services	State Agency for Public Service and Social Innovation under the President of the Republic of Azerbaijan	Ministry of Communication and High technologies	2017-2018
4.1.4.	Conclude free trade agreements	Ministry of Economy	Ministry of Foreign Affairs, State Customs Committee	2017-2020
4.1.5.	Establishment of technical regulation and national standardization system in line with international requirements and its application in support areas for business environment	State Committee for Standardization, Metrology and Patents	Ministry of Economy	2017-2019

Item No.	Action	Main responsible entity	Other entities	Time-line
4.2. Strengthen business sustainability by improving promotional environment				
4.2.1.	Establish a committee for the purpose of increasing business suitability in the Republic of Azerbaijan and improving Azerbaijan's position in international rankings	Presidential Administration of the Republic of Azerbaijan	Ministry of Economy, Ministry of Finance, State Statistics Committee, State Agency for Public Service and Social Innovation under the President of the Republic of Azerbaijan, Centre for analysis of economic reforms and communication, National Confederation of Entrepreneur Organizations	2016 Executed
	Accelerate the ongoing reforms to improve ease of doing business and improve positioning in international rankings	Ministry of Economy		2017-2020
4.2.2.	Improve statistic infrastructure	State Statistics Committee	Ministry of Finance, Ministry of Economy, Ministry of Taxes, Ministry of Labor and Social Protection of Population, Ministry of Agriculture	2017-2018
4.2.3.	Implement a foreign direct investment strategy through good management and efficient incentives	Ministry of Economy	Ministry of Taxes, State Customs Committee	2017-2018
4.3. Implement institutional reforms				
4.3.1.	Establish and ensure the operation of State Examination Centre Public legal Entity of the Republic of Azerbaijan	Presidential Administration of the Republic of Azerbaijan	Cabinet of Ministers, Ministry of Justice, Ministry of Internal Affairs, Ministry of Taxes, Ministry of Communication and High Technologies, Ministry of Labor and Social Protection of Population, State	2016 Executed
4.3.2.	Establish and ensure the operation of Centre for Analysis of Economic Reforms and Communication	Presidential Administration of the Republic of Azerbaijan		2016 Executed
4.3.3.	Establish MIDA agency and "MIDA" LLC and develop the rules for the purchasing of affordable housing, which is at the disposal of this Company, by citizens	Presidential Administration of the Republic of Azerbaijan		2016 Executed

Item No.	Action	Main responsible entity	Other entities	Time-line
4.3.4.	Establish Financial Stability Council	Presidential Administration of the Republic of Azerbaijan	Committee on Property Issues, State Committee for Refugees and IDPs	2016 Executed
4.3.5.	Establish Financial Markets Supervision Board	Presidential Administration of the Republic of Azerbaijan		2016 Executed