



AZERBAIJAN

Highlights

- **The economy has been hit by the twin shocks of the Covid-19 pandemic and a slump in oil prices in 2020.** GDP declined by 3.9 per cent year-on-year in the first nine months of the year. Amid soaring demand for foreign exchange, transfers by the sovereign wealth fund SOFAZ to local banks via central bank auctions kept the currency stable.
- **The authorities deployed a crisis response package of economic and social support.** The cost of the package exceeds 4 per cent of GDP and the widening budget deficit is expected to be financed by the sovereign fund rather than by external financing.
- **The crisis prompted the authorities to rethink their approach to the governance of state-owned enterprises (SOEs).** The establishment of a public holding company to centrally manage SOEs aims to increase the efficiency and transparency of the state sector.

Key priorities for 2021

- **Pursuing further governance reforms in the state sector would bring significant efficiency gains.** The creation of a public company to manage SOEs is an opportunity to introduce best international corporate governance and management practices across the SOE sector.
- **The shift in financial sector regulation back to the central bank is an opportunity to reinvigorate reforms.** The current economic downturn will further accentuate weaknesses in the banking sector, including the regulatory framework and its supervision. Promptly addressing these drawbacks would support a faster economic recovery.
- **Continued implementation of energy sector reforms is needed.** The development of a sustainable and competitive energy market with a sound regulatory framework and institutions will strengthen the economy's resilience to future shocks.

Main macroeconomic indicators %

	2016	2017	2018	2019	2020 proj.
GDP growth ¹	-3.1	0.1	1.4	2.2	-3.0
Inflation (average)	12.4	12.9	2.3	2.7	3.0
Government balance ² /GDP	-1.1	-1.4	5.5	8.1	-6.3
Current account balance/GDP	-3.6	4.1	12.8	9.1	-3.6
Net FDI/GDP [neg. sign = inflows]	-5.1	-0.7	1.7	2.9	-1.0
External debt ³ /GDP	20.4	22.8	19.0	18.9	n.a.
Gross reserves ⁴ /GDP	10.5	13.1	11.9	13.0	n.a.
Credit to private sector/GDP	27.2	16.7	16.3	18.7	n.a.

¹ The GDP forecast for 2020 was determined prior to the flare-up of the conflict over Nagorno-Karabakh.

² Includes central government and main extrabudgetary funds, including operations of the oil fund and the social protection fund.

³ Public and publicly guaranteed external debt outstanding.

⁴ Excluding assets of the State Oil Fund (SOFAZ).

Covid-19: macroeconomic implications

The economy was hit by twin shocks: the Covid-19 pandemic and a slump in oil prices. After the robust growth at the beginning of 2020, output in the non-oil sector turned negative following the introduction in March 2020 of measures to protect public health. Containment measures were extended a few times since then and limitations on regular business activities maintained, particularly in the service sector, although they have been loosened. Output in the non-oil and gas sector reached a trough in June 2020 before slowly recovering. The slump in global demand hit Azerbaijan's export sector, which is dominated by hydrocarbons. With more than one-third of GDP, roughly two-thirds of government revenue and 90 per cent of exports generated by the hydrocarbon sector, the slump in oil prices on top of the Covid-19-induced crisis is taking a significant toll on the economy. Preliminary figures show GDP declined by 3.9 per cent year-on-year in the first nine months of 2020, with the non-oil and gas sector falling by 2.4 per cent. Capital investments were down by 3.8 per cent year-on-year and nominal income of the population remained flat (after many years of continued growth).

Macroeconomic stability is being preserved. Amid soaring demand for foreign exchange, SOFAZ sold US\$ 6.2 billion until October 2020 to local banks, keeping the currency stable. The *de facto* currency peg is supporting low inflation, at 2.6 per cent in September 2020. Low inflationary pressures allowed the central bank to continue cutting the refinancing rate, which declined by 100 basis points to 6.5 per cent in September 2020. However, external and fiscal surpluses are turning negative on the back of significantly lower oil revenues.

Crisis response and the budget financing gap have been financed by reserves from SOFAZ. The authorities responded with a package of economic and social support measures amounting to 4.3 per cent of GDP. Higher expenditures and lower tax revenues are expected to widen the budget deficit to 6.3 per cent of GDP. However, the country prefers to rely on the sovereign fund for financing rather than on external financing. In the first half of 2020, the combined assets of SOFAZ and the central bank amounted to nearly US\$ 50 billion, more than the country's projected GDP.

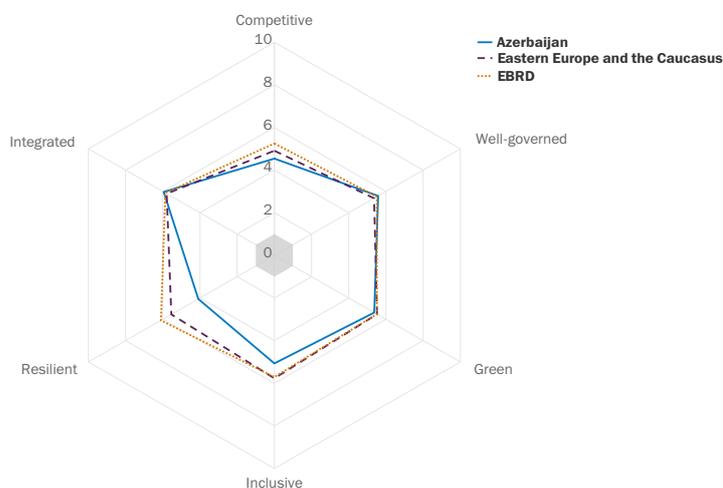
Economic contraction is expected to be followed by a mild recovery. We expect the economy to contract by 3.0 per cent in 2020, recovering by 2.5 per cent in 2021. Key risks to the near-term developments are related to a possible resurgence of the pandemic, continued weaknesses in the oil market and the ongoing conflict over Nagorno-Karabakh. Large liquidity buffers anchor the country's resilience to shocks, but the prolonged duration of the conflict could test the country's macroeconomic stability and have significant economic costs.

Policy response to Covid-19

The authorities prepared a large programme to support the non-oil and gas sector and vulnerable social groups. Support to businesses includes wage subsidies, various tax benefits, financial support to micro entrepreneurs, issuance of state guarantees on new loans with a subsidised interest rate to businesses in the most affected sectors, and subsidising interest rates on existing loan portfolios of companies operating in pandemic-affected areas. The transport sector is receiving significant support from the authorities as well. The Central Bank of the Republic of Azerbaijan adopted a package of measures to relax the regulatory burden and support the banking and insurance sectors as well as capital market participants. It reduced capital requirements, introduced a loan loss provisions holiday and restricted dividend payments until September 2020. To support vulnerable individuals, the state expanded unemployment benefits and introduced a scheme providing preferential mortgage loans, and it expanded the pool of households benefiting from consuming electricity under preferential prices.

The blanket deposit guarantee insurance was extended. The scheme was first adopted in 2016 to safeguard financial stability and boost confidence amid times of macro-financial volatility and an economic downturn. In March 2020, the authorities decided to extend the blanket guarantee for an additional nine months to strengthen confidence in the banks during the pandemic. The scheme covers all depositors' funds irrespective of the amount and currency denomination.

Assessment of transition qualities (1-10)



Structural reform developments

Regional support infrastructure for small and medium-sized enterprises (SMEs) was strengthened. The recently established Agency for the Development of SMEs in Azerbaijan opened the first House of SMEs in early 2020. Based in the Khachmaz region in the north of the country, this platform offers and coordinates services provided by the government and by private entities in a single space. Its offer includes support in launching start-ups via the development of business and marketing plans, improvement of business knowledge, and help in obtaining registration and various licences to access financial resources, logistics and infrastructure networks, internal and external markets and export promotion.

The authorities have partly liberalised the foreign currency operations regime. In February 2020, the central bank extended the period for submission of customs declarations and other documents confirming imports of goods and services from 270 days to two years. Under the new rules, imports with a total cost below US\$ 10,000 are exempt from notifying the currency control authorities.

The central bank has regained its financial sector supervision function. The Financial Market Supervision Authority (FIMSA) was established in early 2016 with the onset of the banking sector crisis and tasked with the licensing, regulation and supervision of banks, the securities market, investment funds, insurance firms, credit organisations and payment systems. During its term, FIMSA implemented a number of reforms including initiating the cleaning up of the banking sector (11 banks closed in 2016), strengthening the monitoring and regulatory framework for the financial system, and setting up a credit bureau. At the end of 2019, the authorities closed FIMSA and transferred all of its functions back to the central bank. Following the transfer of power and following inspection of the banks, the central bank initially appointed temporary administrators in four banks in April 2020 and revoked their licences shortly thereafter.

The authorities initiated reforms to improve management of the SOEs. Recognising the cost of inefficient management, particularly with the budget tightening as the pandemic unfolds, in August 2020 the authorities established the Azerbaijani Investment Holding public company to manage SOEs. The establishment of the company aims to increase the efficiency and transparency of the SOEs to be placed under its umbrella. The governance and management structure of the holding as well as the list of public companies are yet to be determined.

Development of a major gas project advanced. In November 2019, the European segment of the Southern Gas Corridor, Trans Adriatic Pipeline (TAP) was linked to the Trans-Anatolian Natural Gas Pipeline (TANAP) at the Turkish-Greek border. With TANAP becoming operational in 2018, the first gas deliveries from Azerbaijan's Shah Deniz gasfield to Europe via TAP are expected by the end of 2020. The project almost triples Azerbaijan's annual gas production capacity.