EU BUSINESS CLIMATE REPORT AZERBAIJAN 2019

Perceptions of EU Businesses active in Azerbaijan

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KESTUTIS JANKAUSKAS
Ambassador – Head of Delegation
Delegation of the European Union to Azerbaijan

Advancing Public-Private Dialogue

The European Union (EU) is helping to create the best possible business environment for the development of cooperation between the EU and Azerbaijan. As in previous editions, the fourth EU Business Climate Report Azerbaijan surveys the current business climate in Azerbaijan, presenting the perspectives of a large selection of companies that do business in the country. The report's findings are based on the views of no fewer than 130 companies, out of a total of approximately 400 EU companies currently active in Azerbaijan. They range from small and medium enterprises (SMEs) to large companies, and operate across a wide range of industries.

Efforts to improve the business climate lie at the heart of our cooperation with Azerbaijan. We actively support Azerbaijan's endeavours to diversify its economy with extensive technical assistance, peer-to-peer twinning projects and grants. We are currently finalising a new framework agreement to deepen further our cooperation on trade, connectivity and reforms for the direct benefit of the country's citizens. This has an exciting momentum that should raise our partnership – especially in its economic dimension – to a qualitatively new level.

This year we are also celebrating the 10th anniversary of the Eastern Partnership. This is an occasion to take stock of achievements and to reflect on future measures. In this context, the EU Business Climate Report is a constructive tool that provides a snapshot of the improvements and challenges. This knowledge is a key precondition for achieving a further boost to EU-Azerbaijan trade and investment. While the prevailing general sentiment among EU businesses remains positive, the report sheds light on a number of bottlenecks that are still encountered by EU entrepreneurs.

We are pleased to have joined forces with AHK Azerbaijan in publishing this important report. The insights that were gathered – via survey, interviews and focus group discussions – are extremely valuable for the continuing work of the EU and its Member States. This consolidated assessment of the current economic, business and regulatory environment in Azerbaijan, in tandem with our annual EU-Azerbaijan Business Forum, will undoubtedly help to stimulate constructive public-private dialogue and map the best way forward.

The EU will continue to advance reforms to ensure that mutual benefits accrue to the citizens, businesses and economies of the EU and Azerbaijan.

TOBIAS BAUMANN
Executive Director
AHK Azerbaijan

EU Businesses Anticipate Stability in the Near-Term

In a dynamic and ever-changing world, it is essential that the business community, investors and government agencies have access to up-to-date information on the business climate and its drivers. This is why we commit to conducting the EU Business Climate Survey Azerbaijan annually in close, successful collaboration with the Delegation of the European Union to Azerbaijan. It is our pleasure to present the 2019 edition of the EU Business Climate Report Azerbaijan. Since its first release in 2016, the Report has proven to be a valuable tool for those who are eager to learn more about the conditions for doing business and investing in Azerbaijan. We are encouraged by the increasing interest shown by the government and representatives of business.

In the light of economic consolidation, EU businesses assess the current economic situation in the country as satisfactory and they anticipate stability in economic conditions. Noteworthy, too, is the fact that reforms undertaken by the government over the last three years, particularly in the tax and customs sectors, are beginning to pay off. This is reflected in improved investor confidence this year. Nonetheless, the survey's findings highlight that much work remains to improve the country's business and investment climate. Thus, it is important that the government does not rest on its laurels, but implements further reforms to ensure that the remaining economic and structural challenges are properly addressed.

We hope that this report will be a useful tool in providing state authorities and policymakers with deeper insights into the country's business environment and companies' needs. Thus, it will contribute to the government's reform -oriented agenda. Another of this publication's aims is to foster positive business relations between the EU and Azerbaijan. To do this, we will invest further effort to ensure that this report is available every year, providing information that is both pertinent and timely.

On behalf of the AHK Azerbaijan, I express my cordial thanks to the EU Delegation to Azerbaijan for providing financial support for this project and for our long-term cooperation. Acknowledgement is also due to the representatives of EU businesses who gave us their valuable time by participating in our survey and sharing their views with us in interviews and focus group dicsussions. We greatly appreciate your inputs and look forward to a further strengthening of our collaboration!

INTRODUCTION

The EU Business Climate Report is shaped by the findings of an annual business climate survey reflecting the views of EU companies operating in Azerbaijan on the current economic situation, as well as the business and investment climate in the country. There are over 400 EU businesses operating in and cooperating with Azerbaijan, constituting together most of the foreign direct investment in the country and representing the bulk of Azerbaijan's trade. This year's survey was conducted (in January-February 2019) for the 4th consecutive year by the German-Azerbaijani Chamber of Commerce (AHK Azerbaijan), with financial and technical support from the Delegation of the European Union to Azerbaijan.

The primary aim of the survey is to provide insights into the current macroeconomic situation and business and investment climate in Azerbaijan as perceived by EU businesses. It also reveals EU companies' expectations of short-term growth, the challenges they face and problems that remain to be tackled. The annual research highlights economic trends in the country by displaying year-on-year changes in key business indicators and factors relating to investment. The data acquired contributes significantly to this assessment of the current situation in the country, identifying the main factors impeding business operations or expansion and suggesting ways to mitigate or manage them effectively.

130 online responses

As in previous years, the survey comprised 20 questions that were devised to facilitate an assessment of the current economic situation in Azerbaijan and how Azerbaijan's business environment impacted upon individual companies and company demographics. To ensure the acquisition of a set of comparative data over time, most of the key questions remained the same. This year, some questions were amended slightly to account for major updates to the government's reform agenda implemented during 2018, as well as in response to feedback received from EU companies in the previous year. For example, the impact of reforms to the labour market and social protection were added to the question on the effectiveness of reform measures.

In addition, interviews conducted with selected EU businesses in the previous year had revealed that a significant number of companies were not well-informed about the effectiveness of the reforms introduced. Thus, a new option (i.e. "I am not well-informed") was introduced to the assessment of the effectiveness of reforms in this year's survey in order to elicit more precise information from the findings. Cross-tabulation analyses and comparisons of survey findings with those of previous years were conducted where possible to identify any correlations between the data.

Following data quality assurance, 130 completed responses – approximately similar to last year's survey - were selected to represent a valid and statistically significant sample for assessment of the business sentiment within EU companies operating in and cooperating with Azerbaijan.

20 in-person interviews

Following a consistent methodology while drafting the EU Business Climate Report, the quantitative data collected was also supplemented by qualitative research. That is to say, in addition to analysis of responses to the online survey, the report was drafted in the light of feedback received during in-person interviews and focus group discussions conducted with CEOs and senior representatives of EU companies doing business in Azerbaijan. 20 in-person interviews, compared with 17 interviews conducted in 2018, were organised with EU businesses representing 10 major industries within the Azerbaijani economy.

16 represented sectors

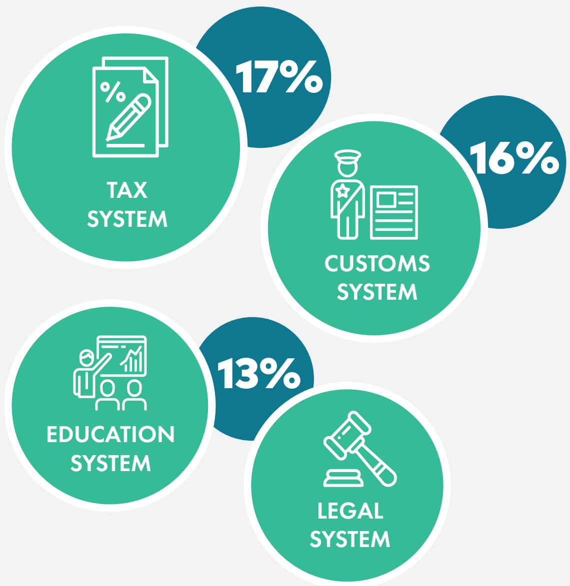
Respondents to the survey represented a wide range of 16 industries, the top 5 sectors being: Wholesale and Retail Trade; Mining, Oil and Gas; Professional, Scientific and Technical Activities; Financial and Insurance Activities; Transportation and Storage. Companies originating in 17 different countries took part in the survey, with 28% representing Germany, 22% being Azerbaijani companies involved in the import of EU goods and services, and 15% being UK companies operating in Azerbaijan.

The companies also varied in size, 38% and 48% respectively representing "micro-enterprises" (with up to 9 employees) and SMEs (with fewer than 250 staff), and 14% were "large enterprises" (with a headcount exceeding 250). As for the positions held by the representatives surveyed, the largest categories of respondents were Directors/CEOs (44%) and General Managers (23%). The annexe presents more detailed information on survey methodology and provides aggregated information on the responses.

KEY SURVEY FINDINGS

ECONOMIC REFORMS

TOP 3 suggested reforms



65% OF EU BUSINESSES **acclaim** the effectiveness of the e-Government Development Centre under **ASAN**

25% OF EU BUSINESSES **regard** the functioning of the Credit Guarantee Fund as **ineffective**

MACROECONOMY & COMPANY

64% OF EU COMPANIES report **stable** economic outlook in 2019

75% OF EU COMPANIES say they would again **invest** in Azerbaijan

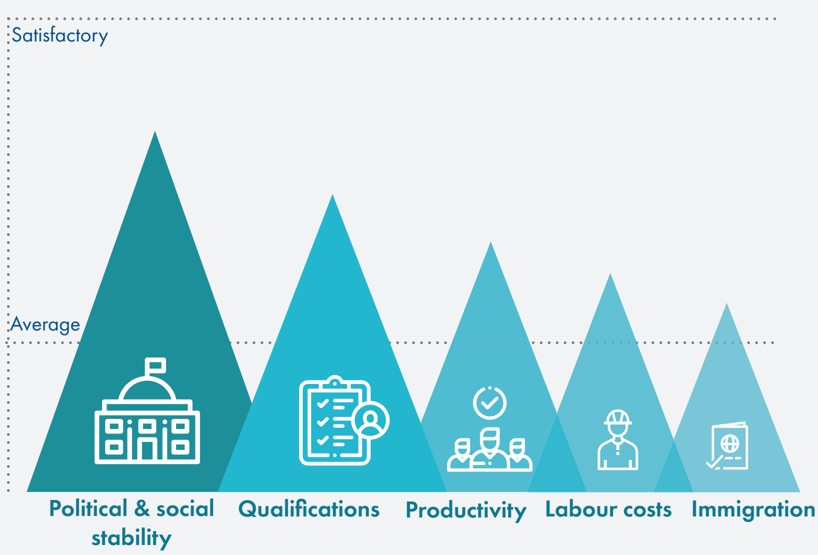
41% expect revenues to increase

45% envisage a stable investment dynamic

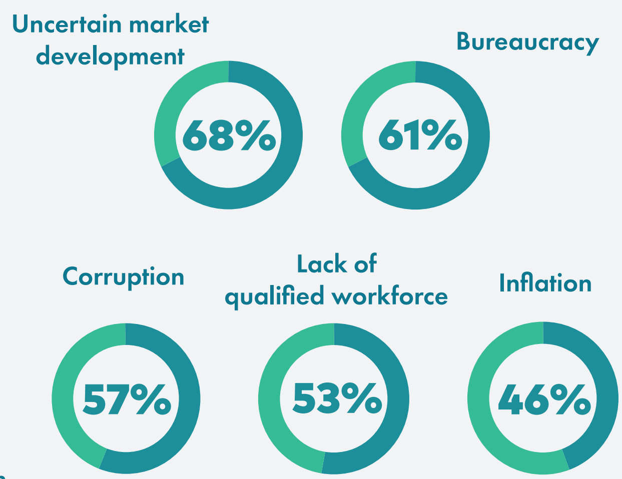
47% plan to maintain headcount

BUSINESS CLIMATE INDICATORS

TOP 5 business climate indicators



TOP 5 business threats



CHAPTER 1

Economic Reforms as Perceived by EU Businesses

Reforms are beginning to exert a positive influence on the business climate, but need to be wider and deeper to transform the economy

A rebound in oil prices and continued stabilisation of the currency, which remains quasi-pegged to the dollar, underpinned a modest cyclical economic recovery in Azerbaijan in 2018. After several years of negative growth or quasi-stagnation following the worldwide slump in oil prices, a surge in public investment and the coming on stream of (part of) the Southern Gas Corridor have brought Azerbaijan's economy into positive growth. Growth was still modest in 2018 (1.4%), but is forecast to expand further, to 3.4% in 2019, while inflation remains firmly under control.[1]

Against this background of a slowly recovering economy, it is interesting to see how EU companies assess the government's record in introducing structural and institutional reforms as for example, proposed in the Strategic Roadmaps adopted in 2016 in response to the 2015 plunge in oil prices. Central to the government's reform agenda in 2018 was an increased emphasis on further improvements to the tax and customs bases, alongside enhancements to institutional frameworks, modernising the education system and strengthening social services.

Key reports paint a mixed picture. On the one hand, the World Bank's "Doing Business 2019" report singles out Azerbaijan for being among the 10 top reformers globally, rising to 25th, from 57th in 2018. This impressive ranking has placed Azerbaijan ahead of most Eastern Partnership countries (except Georgia, which ranks 6th) and several EU member states. The country has made notable improvements in Protecting Minority Investors (2nd), Starting a Business (9th), Registering Property (17th) and Getting Credit (22nd). Modest progress was recorded in Dealing with Construction Permits (61st) and Getting Electricity (74th).

On the other hand, Azerbaijan tumbled to 69th place (from 35th in 2017) in the World Economic Forum's "The Global Competitiveness Report 2018". Azerbaijan's lower ranking here is essentially due to an across-the-board decline in the macroeconomic environment (ranked 126th - a substantial fall of 61 places compared with 2017) and in the financial system (ranked 96th - a notable slip of 17 places compared with 2017). Given these uneven results, the views of EU companies are important to have a better grasp of the reform effect in Azerbaijan.

Tax reforms are encouraging - although more are needed, while ASAN tops the ranking again

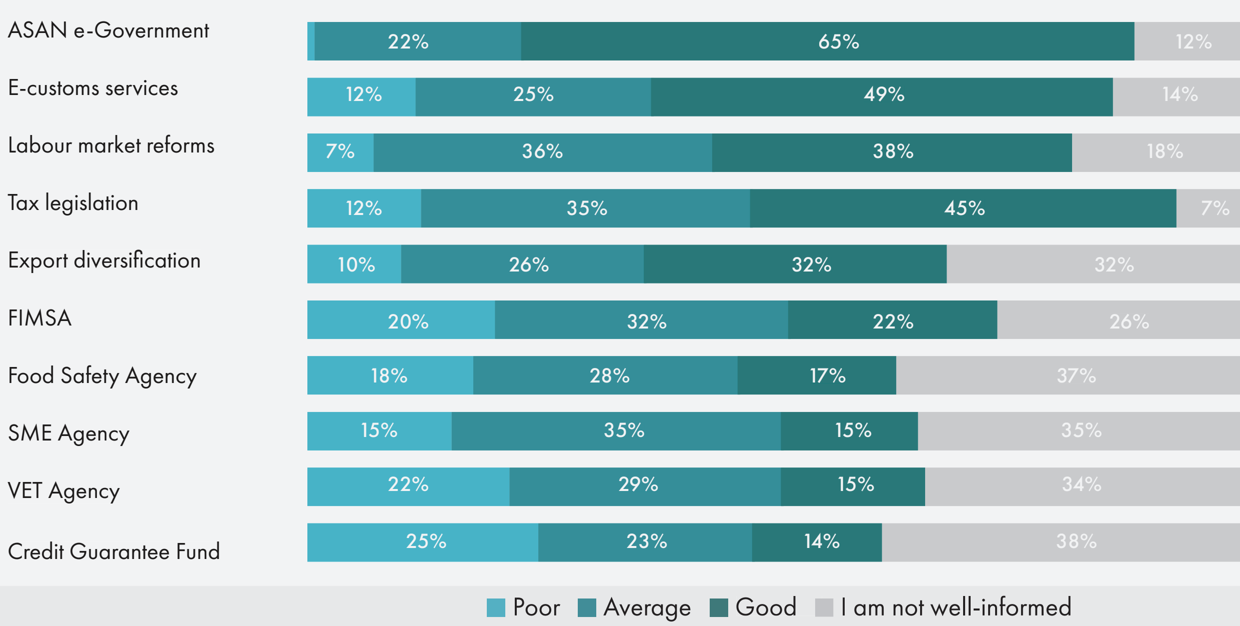
Survey results, further underpinned by interviews and focus group meetings with selected EU businesses, provide evidence that initiatives to reform some core functions are beginning to deliver tangible results. The benefits of a comprehensive package of tax reforms, eagerly anticipated by EU businesses in last year's survey, gradually began to materialise under the new management. This is clearly well received by EU businesses: while last year 29% of them rated the tax system as "poor", the figure dropped to 12% in 2019.

In the wake of the ongoing modernisation and restructuring of customs authorities, the reforms seem to have been responsible for a modest upswing after slower-than-expected progress in 2017: 12% of EU businesses consider e-customs services poor, against 15% in last year's survey. While encouraging, EU businesses equally prioritise further extension and deepening of tax and customs reforms. When asked to identify the most important reforms needed to enhance the country's business and investment climate, respondents' principal concerns are the same as in previous surveys: further improvements to transparency in the tax and customs systems.

The year 2018 was also marked by fundamental change and notable progress in labour and social protection. Reforms, in cooperation with domestic state agencies and international institutions, concentrated mainly on the expansion of e-services in matters relating to employment, the provision of simplified and non-restrictive Ministry services at a single-window, and general improvements to the system's capacity, transparency and effectiveness. Almost three quarters of EU businesses consider these reforms to be average or good.

EU businesses' perceptions of the effectiveness of newly-established institutions is however more muted. Appreciation of the reforming effect of the Agency for Development of SMEs (established in December 2017), the Food Safety Agency (February 2017), FIMSA (February 2016) as well as the Mortgage and Credit Guarantee Fund (December 2017), seems to be fading this year. Discussions confirm that the EU business community expect these new institutions to be more forceful in translating plans and strategies into concrete action and to produce more tangible outcomes. Similarly, EU businesses remain concerned that reforms to vocational education are not yet fully addressing the skills mismatch.

Figure 1. The effectiveness of structural reforms in Azerbaijan



***ASAN has topped the ranking** since 2017, the year we first asked this question.*

Of the reforms hitherto conducted to improve the business climate, ASAN (the State Agency for Public Service and Social Innovations) has topped the ranking since 2017, the year we first asked this question. EU businesses acknowledged the effectiveness of the ASAN e-visa portal in previous surveys, and this year they were invited to assess the work done by the e-Government Development Centre under ASAN, established according to a presidential decree of 14 March 2018. The Centre envisages the centralisation of digital services, including ASAN visa, ASAN payment and ASAN Finance, and the complete integration of all state agencies' information systems into a single electronic platform.

For example, the recently-launched ASAN Finance aims to minimise paperwork and the burden of bureaucracy when using banking services by providing financial organisations with access to state information resources. Extensive work is reportedly underway to increase the number of tax and customs, consular and financial services rendered by ASAN in coming years. In this context, 65% of EU businesses assess the establishment of the e-Government Development Centre under ASAN as effective. Against this positive background, respondents believe that the measures to minimise petty corruption and reduce bureaucracy through the e-governance system continue to bear fruit.

*The proportion of EU companies grading the **tax system** as **effective** increased to **45%**, up from **33%** in 2018.*

As fundamental restructuring and management changes took place within the tax authorities, last year's survey witnessed sanguine hopes that deepening and consolidating tax reforms would ensure greater transparency in tax inspections and establish a more dynamic tax administration. This optimism seems to have been justified in 2018, as evidenced by a corresponding climb in respondents' assessment of tax reforms this year. The proportion of EU companies grading the tax system as effective (in the wake of the new tax legislation coming into force from 1 January 2019) increased to 45%, up from 33% in 2018. This is the most notably positive shift in perception by EU businesses this year.

The new legislation introduces stimulating tax incentives and considerable tax exemptions in an endorsement of the private sector and entrepreneurship. A prominent aim is to reduce the scale of the "shadow economy", one of the primary impediments to ultimate transparency in the economy, through improved taxpayer compliance and an expanded tax base.

While welcoming these efforts, EU companies believe that supportive measures were still insufficient to ease the faster-than-expected enforcement of change and to facilitate a smoother transition by companies to the new economic realities. Therefore, the feedback underlines the need for more time and support to adapt to massive changes, for more accurate information sharing as well as for coherent and consistent coordination of action.

The law "On Amendments to the Tax Code of the Republic of Azerbaijan" dated 30 November 2018 was approved on 20 December 2018 with effect from 1 January 2019. Although changes are both positive and promising, businesses were not given enough time and technical support to adjust. In future, there should be more communication and collaboration with the business community on these issues.

Interviews and Focus Group discussions

The encouraging assessments of tax reforms voiced by EU businesses this year have some strings attached. They remain adamant about the need for a series of far-reaching tax reforms to improve the country's business and investment environment. According to the feedback, despite some recent amendments to current regulations on the reimbursement of taxes and double taxation, companies still face serious challenges when exercising their rights. Often the challenges reported concern artificial and bureaucratic barriers, unclear arguments and biased decisions from the tax authorities. Hence, taken as a whole, the EU business community sees further potential and need for improvement and, accordingly, again this year places tax reforms at the top of the government's agenda.

There is a serious need to address existing gaps and challenges in double taxation procedures. Similarly, tax reimbursement is a very complicated process, which does not really work in practice.

Senior Manager from the Professional Activities sector

TOP 5
SUGGESTED REFORMS

17% Further improving transparency in the tax system

16% Further improving transparency in the customs system

13% Ensuring that the education system matches company needs

13% Ensuring transparency in the legal system

11% Strengthening transparency and stability of the fincancial sector

Momentum resurgent as customs appears to overcome reform fatigue and social reforms start to unfold

With Azerbaijan aspiring to become an international trade and logistics hub, seamless trade with, for example, simplified and harmonised customs procedures, is more critical than ever. In this context, the digitalisation of customs procedures is a key area for customs reform from the perspective of the EU business community. Progress in improving the e-declaration system and the advance (pre-arrival) declaration service is highly appreciated by EU companies this year, as almost half the respondents express their content. These have clearly simplified customs clearance processes to some extent and limited the role of human agency, successfully minimising instances of corruption and bribery.

However, despite the considerable success of these mechanisms, interviews and focus group discussions reinforce the necessity of additional adjustments to simplify e-declarations, especially to improve functionality and user-friendliness. The complicated language and complex requirements of electronic forms often force companies to hire customs brokers to ensure the accuracy and compliance of their documents. At the same time, many companies note that the provision of voluntary, advance declarations to customs control, which is supposed to expedite the release of goods, is, in practice, not effective in speeding up customs clearance.

Other pressing needs signalled by European businesses this year include action to ensure that the Green Corridor regime introduced in 2016 (launched on 1 February 2019) will be fully functional, and the development of a resilient anti-counterfeiting strategy. Although some steps were reportedly taken to enhance the system and increase the number of companies entitled to benefit from this regime, interview discussions suggest a lack of awareness and information about the rules and procedures that apply to this initiative. Therefore, moving forward, customs administrations should endeavour to work together with businesses to better understand their needs and priorities, as well as to ensure that the private sector is aware of new customs rules and the latest changes to legislation.

Border enforcement against goods infringing intellectual property rights is another area requiring closer cooperation between customs and business. This year, even more EU companies highlight counterfeiting as a major threat, jeopardising not only brand reputation, but also customer safety and loyalty. With these issues in mind, when asked what reforms they consider most important to further improve the business and investment climate in Azerbaijan, EU businesses mark reform of the customs system as an immediate priority, second only to taxation.

Substantial improvements have been made in minimising corruption, ensuring transparency and digitalising customs services. Further steps are necessary to speed up clearance procedures, eliminate artificial bureaucracy and create a genuinely competitive environment at the borders. With this in mind, the effectiveness of Green Corridor remains to be seen.

Interviews and Focus Group discussions

Among the sobering concerns for us are counterfeit goods and fake products. Control systems at the borders are still weak, and cannot be compensated for by creating additional legal restrictions. Customs needs to take more resolute steps to prevent counterfeit goods from entering the country.

CEO from the Electricity and Gas supply sector

International practice suggests that a progressive customs system, with a consequent facilitation of trade, appears to have significant potential to help promote the diversification of exports. With the various incentives (the creation of online export portals, export subsidies and the establishment of industrial and agro parks) introduced by the government to support local production and non-oil exports, these measures have stimulated mainly the agriculture, chemical and metallurgical industries over recent years. In 2018, the country's non-oil exports grew by 10%. However, the oil and gas sector still accounted for the lion's share (91.2%) of the country's total exports. Export incentives worth 15 million AZN were provided to entrepreneurs within the framework of the programme to promote and stimulate exports of non-oil products. In addition, subsidies and concessional loans to agricultural sector amounted to 370 million AZN according to reports.[2] The effectiveness of these steps, however, is not wholly supported by EU businesses' perceptions of export-oriented measures.

*Moderate **enthusiasm** is observed for recent reforms to the **labour market and social protection**.*

This year, 58% of respondents rate institutional support for export diversification as average or good, down from 82% in 2018. Only 32% of respondents assess the reforms as effective, with another 32% answering, "I am not well-informed". A fairly even distribution of sentiment between "good" and "I am not well-informed" suggests that the government should reach out to entrepreneurs to raise their awareness of improvements and to stay informed about their common problems.

Broad-based work is underway to reform the labour market, enhance the social system and increase pensions. Thus, this issue was included for the first time in this year's survey. Respondents express moderate enthusiasm for recent reforms to the labour market and social protection, with 38% deeming them already effective. Appreciated is the introduction of the e-social portal simplifying access to social services and increasing transparency, along with the faster-than-expected completion of legal and institutional work on the DOST (Sustainable and Operative Social Security Agency) project. This one-stop-shop agency, established following a presidential decree of 9 August 2018, was opened in Baku in May 2019 and is expected to expand across the regions until 2025.

What you see is not (yet) what you get: EU businesses expect recently emerged institutional forms to improve and deliver more tangible outcomes

Small and medium sized enterprises (SMEs) are the backbone of Europe's economy. They represent 99% of all businesses in the EU and provide two-thirds of private sector employment. Moreover, they are key to ensuring economic growth, innovation, job creation and social integration. The proportion of SMEs in the Azerbaijani economy is among the lowest in the Eastern Partnership. According to the scheme laid out in the roadmaps, SMEs contribution to GDP is envisaged to rise to 15% by 2020, and to 35% by 2025. After 2025, the figure is projected to be around 60%.

Progress over the past two years in designing the necessary institutional and organisational structure to enhance the role and competitiveness of SMEs is commendable. In last year's survey, 32% of EU businesses rated the creation of the Agency for Development of SMEs as good, with another 53% assessing it as average. This year, however, the EU companies seem to express concern about the effectiveness of this newly-created institution: only 15% deem the agency to be effective in assisting SMEs and 35% say that they are not well informed about its actions.

In fact, the agency is believed to have strong potential and solid intentions to strengthen the sector; however, discussions suggest that the continuing technical works have not (yet) yielded significant results on the ground. This may be partially due to delays in implementing reforms. For example, the planned establishment of further units operating under the agency, such as SME Houses, is still pending. In addition, survey findings suggest that the agency should consider communicating its longer-term strategy to the business community and strengthen further the public-private sector dialogue platform to generate awareness among entrepreneurs, while ensuring that its proposals and measures for reform are relevant.

*The proportion of **SMEs** in the Azerbaijani economy is among **the lowest** in the Eastern Partnership.*

The same applies to the Food Safety Agency, which began its operations in January 2018. Since then, the agency's improvement agenda has mainly included expanding cooperation with taxes, customs and ASAN, inter alia, facilitating the exchange of information and strengthening the legislative basis for import and export activities. Although last year's survey was conducted immediately following its establishment, still 40% of EU businesses lauded the agency's launch. This time, however, there is reduced enthusiasm from EU businesses about its effectiveness. While most EU businesses consider its establishment to be a pivotal step in stimulating the agricultural sector and supporting non-oil exports, only 17% assess it as effective (down from 40% in 2018), with 37% saying that they are not well-informed about the activities of the agency.

***The education system** is still one of the **most alarming** causes of concern for EU businesses.*

Turning to the needs for immediate reform, this year the education system is still one of the most alarming causes of concern for EU businesses; this stems largely from a surging demand for qualified workforces. The government has acknowledged the importance of modernising the Vocational Education and Training system (VET) and accordingly endorsed the establishment of the State Agency on Vocational Education in April 2016, which was tasked with upgrading the VET system and producing a highly skilled workforce for the labour market. It has also put in place a new legislative framework for VET, within which the role of the private sector can be substantially enhanced.

Nevertheless, most reform measures taken by the VET Agency since then seem to have produced only minor results. 34% of respondents highlight that they are not sufficiently informed about reforms in this area, with 22% assessing the agency's performance as poor. However, change in the education system is generally recognised to be the result of long-term processes. Therefore, even when they seem reasonably promising, the companies surveyed believe that the true effectiveness of VET reforms can only be fully assessed over a period of time.

When considering the education and VET systems, EU businesses believe that technical and material modernisation is not sufficient to achieve transformational change; strengthening private sector involvement in building a comprehensive education system and vocational training programmes that correspond more effectively with companies' needs must be considered equally important for the reform agenda. In this context, the agency should build a participatory platform to increase awareness of the outcomes of recent changes, while at the same time promoting social and public-private partnerships towards successful implementation of the VET roadmap.

There is lack of information about the VET Agency and its activities among businesses. The agency should consider greater involvement for the private sector, so that it is aware of ongoing projects and positive developments.

Interviews and Focus Group discussions

Recent achievements may dissipate over time if not reinforced further by financial and legal reforms

The 2016 recession has left deep scars, particularly in the Azerbaijan's financial sector. On the back of slumping oil prices and two rounds of devaluation, dollarisation reached 82.5% of all deposits in January 2016[3], non-performing loans grew to 24%[4] and inflation surged into double digits, to 12.9% in 2017. The government has taken a sequence of remedial actions. After banks came under substantial siege in meeting capital requirements, FIMSA (Financial Market Supervisory Authority) revoked the licences of 11 banks, and the International Bank of Azerbaijan (IBA) was recapitalised as part of the government's consolidation programme. A Mortgage and Credit Guarantee Fund was established in 2017 to expand access to financial resources and the private Credit Bureau was created in early 2018 to improve the flow of information and transparency within the sector.

Three years on, with the earlier storms partially weathered, business confidence in the banks is gradually being restored. Inflation has fallen substantially since early 2018, down to 2.3%, in response to the government's prudent monetary policy, a stable exchange rate and higher-than-expected oil prices. This has allowed the Central Bank to ease its monetary policy and to cut interest rates from 15% in 2018 to 8.75% in April 2019. Although dollarisation remains high, with 60% of bank deposits held in foreign currencies in April 2019, manat deposits rose to 33.9% in March 2019, from 27.6% in 2017.[5] Going forward, the recent presidential decree on problem loans (28 February 2019), which addressed the increased loan burden on physical persons following the devaluations, is likely to further restore public confidence in the banking system and create little new momentum for deeper changes in the sector.

The banks' overall general health has improved to some extent since the crisis. Yet, the sector remains extremely weak and vulnerable to potential external shocks, as has been highlighted by the international rating agencies (e.g. Moody's, Fitch). Moreover, growth in private sector credit has been at a slower-than-expected pace. The sector remains uncompetitive, fragmented and very small vis-à-vis the size of the economy. Azerbaijan is still hampered by a large stock of non-performing loans (17% of total loans in 2018).[6]

Discussions point to the ***high interest rates*** *on credit and low maturity as the* ***main difficulties*** *faced by businesses.*

Discussions point to the high interest rates on credit and low maturity as the main difficulties faced by businesses. It goes without saying that inadequate access to financial resources weighs particularly heavily on SMEs. This may explain why the majority of respondents (38%) appear to be unaware of initiatives by the Mortgage and Credit Guarantee Fund, while 25% view its activities as ineffective. Interestingly, these results differ from those of the previous year, when EU companies expressed notable enthusiasm about the establishment of the Credit Guarantee Fund. They believe that, alongside competitive financial institutions, credit expansion requires stronger financial intermediation, new financing tools, and more effective governance.

The criteria and conditions identified by the Credit Guarantee Fund are very demanding. Businesses believe that the National Fund for Entrepreneurship Support under the Ministry of Economy could do better and more effective work to support entrepreneurship and create opportunities for access to financial resources.

CEO from the Financial sector

Moreover, interviews and focus group discussions stress that restrictive measures and excess bureaucracy impinge on the development of the financial sector. In addition to exercising control and oversight of the sector, FIMSA should establish more collaborative and solid partnerships with banks to provide them with the necessary support and to address the problems in a more productive and effective manner. Only 22% deem the measures taken by FIMSA as effective this year, with another 26% saying that they are not well-informed about its actions. EU companies believe that more results-oriented, consistent and time-bound measures are necessary in order to continue the clean-up in the banking system and increase its resilience to future external shocks, to diversify the banks' portfolios, and to address the obstacles that impede access to finance. In this context, attracting more foreign commercial banks into the sector, together with the privatisation of the IBA, are other key priorities in lowering risk and creating a beneficial environment in the banking system.

The vision currently presented by the financial institutions is mainly concerned with control, bureaucracy and strong regulative restrictions, rather than liberalisation of the sector. Decisions are delayed and their execution is generally very tardy. These factors, as well as the lack of a sustainable strategy, continuity and long-term vision for the sector, leave no room for innovative tools or new financial instruments.

Managing Partner from the Financial sector

These observations are strongly in line with findings and analyses by international institutions such as the IMF, World Bank and EBRD. In this context, the ADB's November 2018 project "The Development of Nonbank Finance and Alternative Financial Instruments for Economic Diversification", as well as the EBRD's 2019-2024 country strategy for Azerbaijan (approved in April 2019) should be noted. These, as well as other joint projects and agreements on strategic cooperation with international institutions, is expected to accelerate the meeting of targets set for deepening the development of the financial sector and amplifying its role in economic growth. Thus, this year, measures to strengthen transparency and stability in the financial sector have been moved further up the list of priorities, following reforms to ensure transparency in the legal system.

*Calls for **radical reform** of **the legal system** are strenuously expressed in this year's survey.*

Turning to the latter issue, with the ever-growing importance of foreign investment inflows to the state's economy, the establishment of a reliable legal system, transparency of court decisions and their timely, just enforcement, are more decisive than ever. Calls for radical reform of the judiciary and legal system are strenuously expressed in this year's survey, echoing the President's direct communication of 1 March 2019. 41% of the companies surveyed rate legal certainty as unsatisfactory (see more on this in Chapter 3). Their feedback suggests that problems in this field – courts' inefficiency, low productivity and digitalisation, lack of transparency and objectivity - are critical issues requiring immediate action. Furthermore, the training and education of judges and lawyers is considered vital to increased trust in the system.

***The presidential decree** "On Deepening Reforms in the Judicial-Legal System" is of crucial importance in **setting a new stage** of development.*

Here, the presidential decree "On Deepening Reforms in the Judicial-Legal System" of 3 April 2019 - at the time of drafting this report - is of crucial importance in setting a new stage of development in the country's general business environment and investment climate. The across-the-board reform programme set out by the President embraces the legislative, institutional and practical issues that are raised with some urgency by the European business community in this year's survey and face-to-face discussions. Of particular note are: the envisaged establishment of a specialist court to deal exclusively with cases involving tax and customs, the creation of a mediation institute, as well as the promotion of alternative mechanisms for the enforcement of court decisions. These measures, along with planned improvements to judges' social welfare and the development of courts' infrastructure, will contribute to the country's investment climate by boosting business confidence.

Businesses will not be able to benefit fully from ongoing tax and customs reforms unless Azerbaijan establishes a reasonable, transparent and fair legal system.

Senior Manager from the Oil and gas sector

To summarise the implications, progress is visible on many fronts this year, but there is still a long way to go to transform the business and investment climate in the country. Economic diversification and improved business sentiment will require, among other things, that there are firm plans in place to push reform initiatives forward, to monitor their effective execution and timely implementation, as well as to actively address the impediments to their progress.

CHAPTER 2

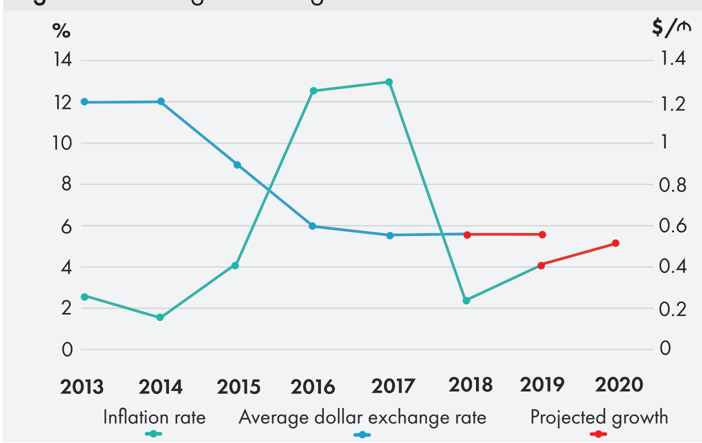
The Macroeconomic and Sectoral Contexts: EU Business Perspectives

After some turbulent years, which saw two rounds of devaluation and then the first economic contraction (-3.1% in 2016) in two decades, Azerbaijan's GDP growth rate accelerated to 1.4% in 2018. With oil production and oil exports picking up marginally, the oil sector has reversed a four-year slowdown to grow by 0.6%. Although growth in the non-oil sector constituted 1.8%, the sector's share of GDP continued to shrink in 2018; it accounted for 58.5% of GDP, compared with 65.8% in 2016. Industry grew by 1.5%, reversing a 4.2% decline in 2017, largely by gains in the mining (0.4%) and manufacturing sectors (7.9%). The commencement of commercial gas deliveries from the Shah Deniz 2 field spurred an increase in gas production of 7%, while reduced capital investments this year (-4.4%) led to further stagnation in the construction sector, which declined by 9% (-1.5% in 2017). This drop, however, was offset by subsequent rises in agriculture (4.6%), tourism (7.6%) and transportation (7.8%).[7]

The IMF projects growth to increase to 3.4% in 2019 and hover around 3.1% in 2020. This reflects strengthening public investment and increasing domestic consumption, as the exchange rate remains stable and the government continues to rely on fiscal measures. The outlook for medium-term growth is mainly supported by a relatively stable trend in oil prices and accelerating gas production from the Shah Deniz 2 field. Construction is also expected to reverse this year's fall and expand by 3% with increasing government investment in infrastructure modernisation in the agriculture, transport and tourism sectors, among others.[8] The Ministry of Economy projects non-oil GDP to increase by 3.9% in 2019.

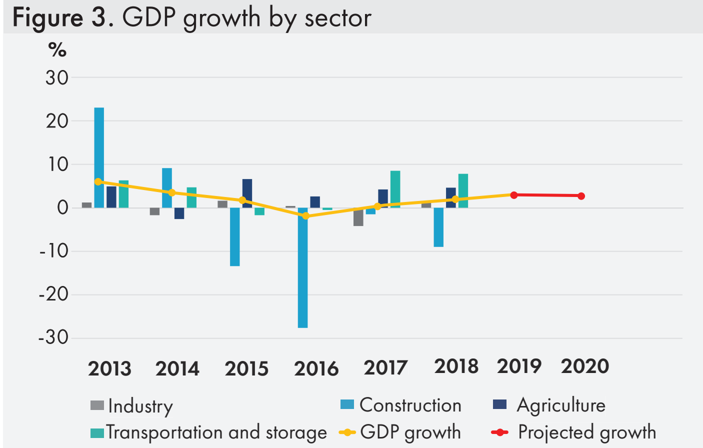
In view of the curb on inflation and a benign economic outlook for the near term, the government seeks to increase budget expenditure to foster economic growth. With recovering petroleum revenues, oil and gas incomes will be strongly predominant in the state budget in the years to come. While the adoption of new fiscal rules and a medium-term expenditure framework (e.g. a nominal 3% limit for yearly consolidated expenditure growth) should enable a more prudent and predictable fiscal policy, looking further ahead, key downside risks remain: the vulnerabilities in the still-fragile financial system and possible delays in implementation of reforms.

Figure 2. Average exchange rate and inflation rate



Source: CBAR, ADB (accessed 15 April 2019)

Figure 3. GDP growth by sector



Source: SSC, IMF (accessed 15 April 2019)

Stabilising EU business sentiment is a notable indication of economic consolidation

Last year marked a record jump in optimism, particularly about near-term economic perspectives, and this momentum was apparent across the sectors. As many as half of the respondents anticipated a strengthened economic outlook, while 51% of EU companies deemed the situation in 2018 to be satisfactory. The positive shift in EU business sentiment continues this year, albeit at a slower pace. The vast majority of EU businesses, i.e. 64% of companies, anticipate stable economic prospects, with only 10% expecting economic deterioration in 2019; roughly similar to last year's survey and clearly better than 2017 (47%) and 2016 (86%). In the same vein, 74% of respondents believe that the current economic situation is satisfactory or strong, marginally up from last year (65%) and substantially up from 2017 (33%) and 2016 (19%).

There is a certain stabilisation of enthusiasm among EU businesses about the current situation in their own sectors and in organisations too. While there is a slight increase in the number of EU companies assessing the current situation as satisfactory/strong (77% in 2019 against 67% in 2018), only 16% of respondents rate the current situation in their respective sectors as strong; it was 21% in 2018. The same narrative unfolds at the company level. On the one hand, an overwhelming majority (90%) of EU businesses consider the current situation to be positive (satisfactory/strong), a slight increase over last year's response (84%). However, a mere 24% of EU companies assess the current situation in their company as strong, and this is markedly down from 2018 (37%).

Figure 4. Assessment of the current situation, 2016-2019

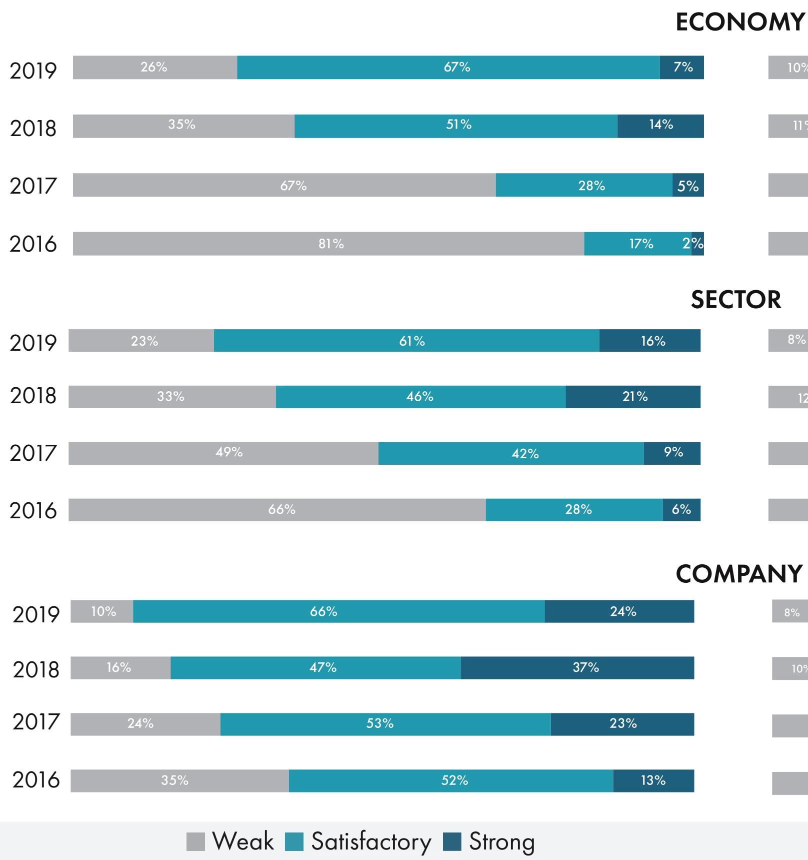
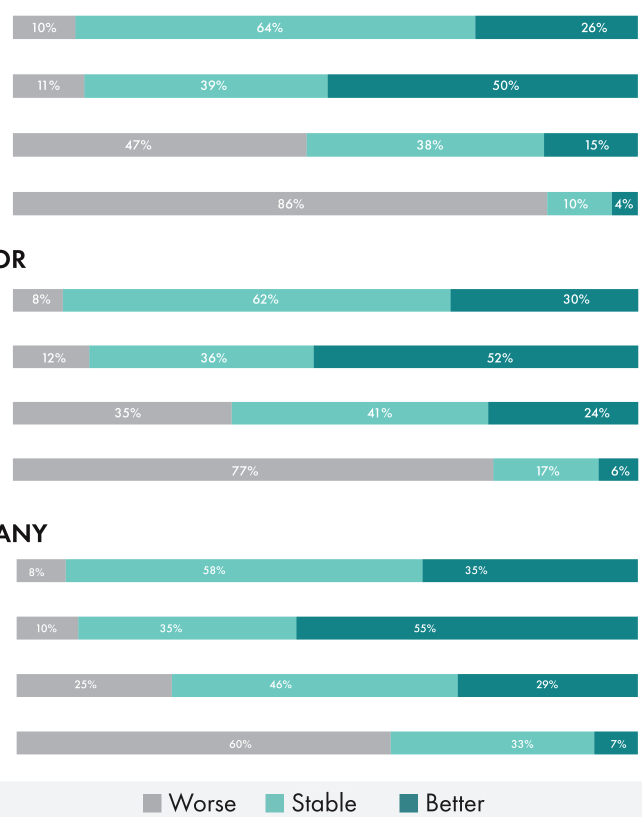


Figure 5. Evaluation of prospects, 2016-2019



Following stabilisation of the economy, there appears to be a consequent consolidation of business prospects, which are positive but subdued. Indeed, notably fewer respondents (30%) expect their sector to perform better in 2019, as opposed to 52% in 2018. This reduced vibrancy in the sectors translates into a correspondingly conservative assessment of their own companies' perspectives. A mere 35% of European companies surveyed this year are optimistic in outlook, whereas a majority (55%) of respondents in 2018 expected their companies to perform better. Having said that, slightly fewer EU businesses expect worsening sector and company performance than was the case last year.

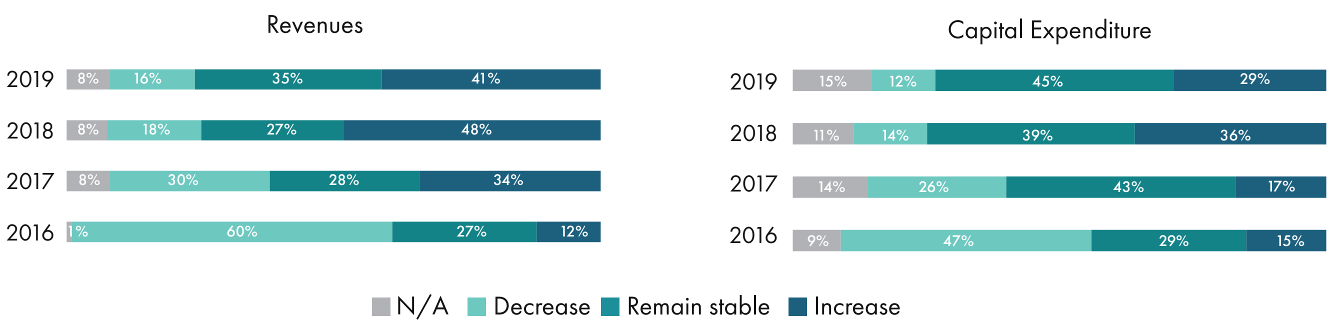
To a large extent, this stabilising outlook mirrors expectations of revenue and investment outlays. Each year from 2016-2018, EU companies grew more confident of increased revenues. In this year's survey we see for the first time, a 7% drop, although 41% of EU companies surveyed still expect an increase and slightly fewer expect a fall in revenues. Of those best-represented in this year's survey, the Water Supply, Sewerage, Waste Management and Remediation sector is least confident about prospects: 4 of the 8 companies from this sector expect revenues to decrease in 2019.

The moderate economic prospects this year are primarily driven by firming oil prices and a steady exchange rate. The huge oil and gas projects with foreign companies will keep the economy stable, but still dependent on petroleum revenues. Therefore, in the long-run, the government should consider adopting more practical plans to create alternative and sustainable sources of growth.

Senior Manager from the Oil and gas sector

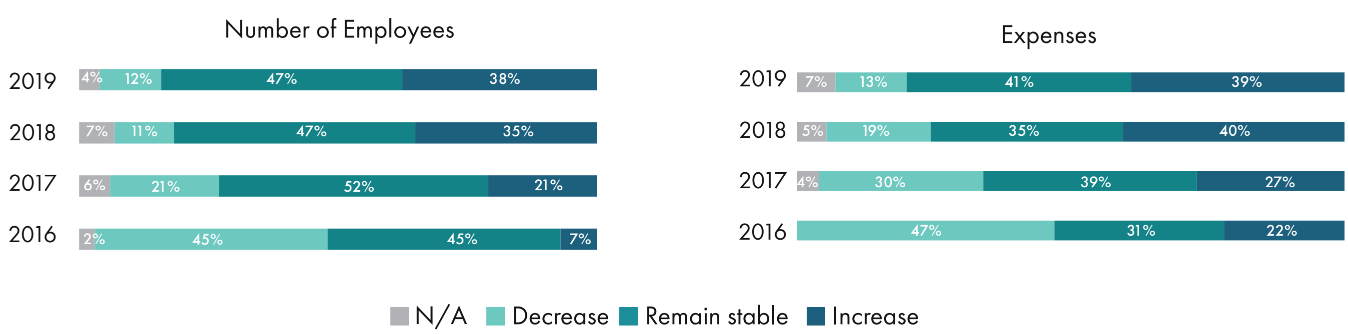
Similarly, slightly fewer EU companies plan to expand their capital expenditures than in the last survey, while 45% envisage a stable investment dynamic in 2019. One exception is the Mining, Oil and Gas sector, which displays a relatively greater propensity to invest (9 out of 18) in light of huge projects for extraction, development and production. New programmes and initiatives also established the frameworks for investment in the Electricity, Gas, Steam and Air Conditioning Supply sector over the next three years. Hence, 4 of the 8 companies from this sector plan to increase capital expenditure in 2019.

Figure 6. Key perfomance indicators



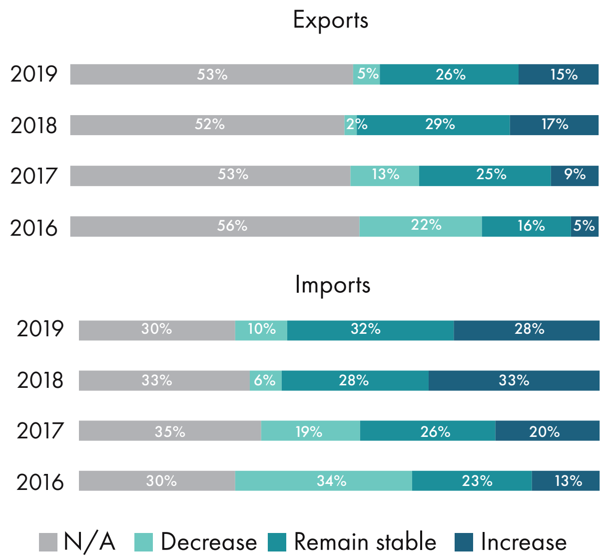
Despite tempered performance expectations and capital expenditure plans, the companies surveyed are not experiencing major cutbacks in their employment strategies this year. Given that the shortage of skilled workers remains a prominent concern (see more on this in the next chapter), EU companies record a strategic interest in finding and retaining good employees. The survey results suggest a moderate increase in the number of EU businesses intending to recruit more staff this year (38% - a 3 percentage point increase compared with last year's survey). Yet, and similar to last year's survey, many EU companies (47%) plan to maintain current numbers of employees, with only 12% anticipating staff reductions. Interestingly, companies engaged in Professional, Scientific and Technical work seem more optimistic about hiring: 13 of 18 businesses surveyed might be looking for new personnel.

Figure 6.1 Key perfomance indicators



Export prospects are clearly determined by how export-oriented EU businesses in Azerbaijan are. Survey findings suggest that EU investments in Azerbaijan are driven largely by access to domestic markets (27%) and less by exposure to export markets (only 7%). Thus, as in previous years, around half of the EU companies surveyed are not engaged in exports. Similarly, 30% of respondents say that they do not import. This year, EU companies' expectations of imports do not hinge on the levels of imports in their inputs. Some one third of them (32%) expect their imports to remain stable in 2019, another third expect an increase (28%); roughly similar to last year's reported outlook.

Figure 6.2 Key perfomance indicators



EU perception across sectors

Unsurprisingly, the generally stabilising economic and business sentiment observed in this year's results translates into a similarly tempered mood across the sectors. These findings only partially correspond to those of the previous year, when the sectors mainly reported a satisfactory current situation and a strengthening outlook for their respective sectors, following difficult years of downturn. The Financial and Insurance sector, however, remains an outlier; here the mood of EU businesses is still largely subdued. A detailed analysis of the findings suggests that this is the least confident sector in 2019, with 6 of the 11 respondents working in this sector rating it as weak (in 2018, 6 of the 8 EU businesses from this sector assessed it as weak), with only 1 company assessing it as strong.

In the wake of a firm exchange rate and stabilising inflation this year, however, the near-term prospects for the financial sector are noticeably more optimistic than in 2018. The percentage of "stable" and "better" responses rose to, respectively, 46% (from 38% in 2018) and 36% (from 25% in 2018).

Overall this year, EU businesses across most sectors are less polarised in their views on the current situation; more companies take the neutral stance that their sector's performance is satisfactory, with somewhat tempered expectations of the future, than in 2018.

EU businesses representing the ICT sector appear more positive about the current situation in their own industries compared with 2018. Most companies (5 out of 7) report satisfactory performance, while last year 3 of the 7 companies considered their sector's performance to be weak. In view of this year's stabilised economic outlook, the mood among ICT companies regarding short-term perspectives has also cooled slightly: 5 of the 7 respondents expect the sector to remain stable in 2019 (in 2018, 4 of the 7 companies expected it to perform better).

Figure 7. Assessment of the current situation across sectors

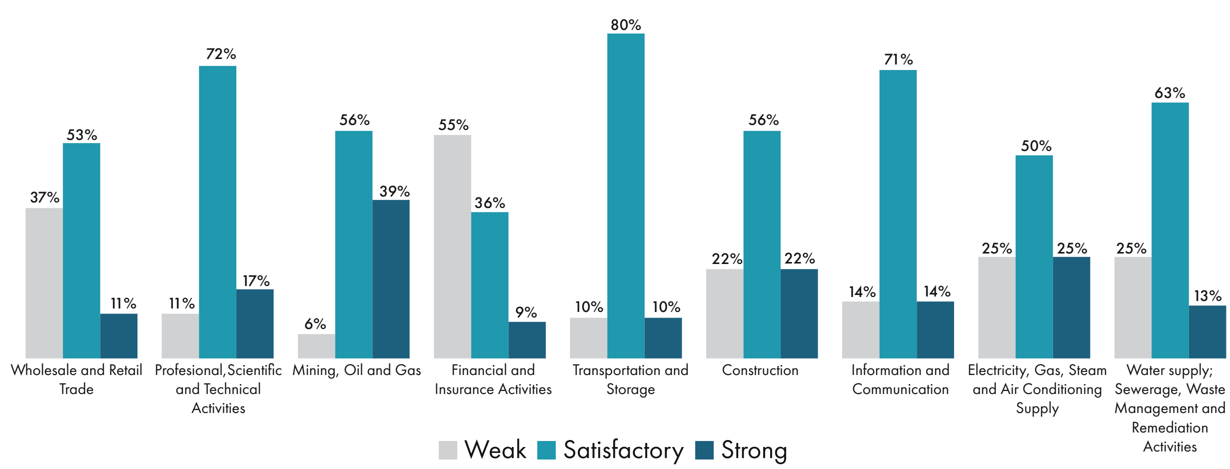
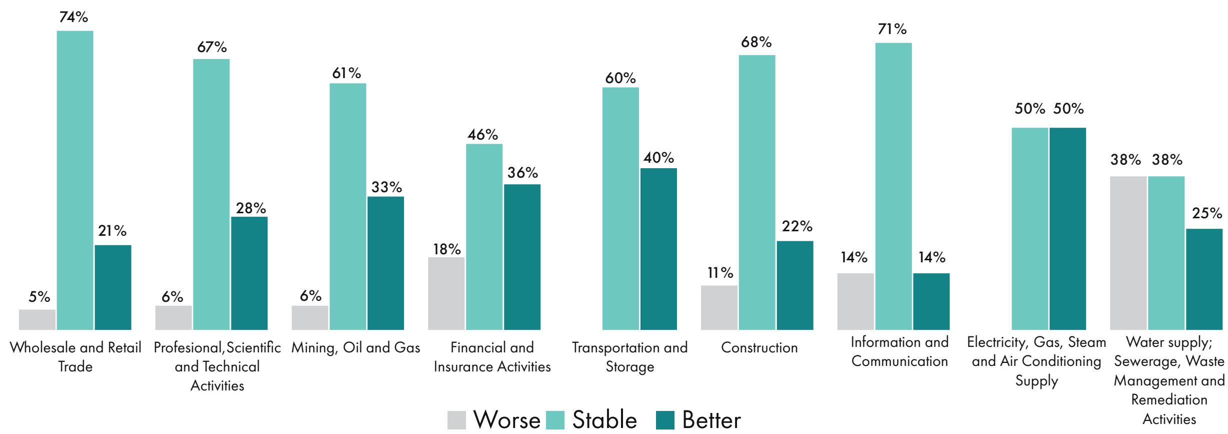


Figure 7.1 Evaluation of prospects across sectors



The mood in the Construction sector has improved steadily since the modest economic rebound in 2017. Similar to last year, most of the construction companies surveyed (7 out of 9) report satisfactory/strong performance and 6 of the 9 companies anticipate stabilisation in 2019. 13 of the 18 EU companies engaged in Professional, Scientific and Technical work remain confident about their own sector this year (in 2018, 14 out of 22). However, this sector is relatively more sceptical about their prospects in 2019 compared to 2018: the percentage of "stable" responses rose to 67% (from 41% in 2018) with a fall in the number of "better" responses (to 28%, from 45% in 2018).

Companies representing the Mining, Oil and Gas, and Transportation and Storage sectors were comparatively buoyant about their near-term prospects in 2018: there were 9 out of 18 "better" responses from the former, and 7 out 11 from the latter sector. This was a reflection of the new exploration and development projects in the oil and gas sector and work to develop new trade routes and transport corridors in 2018. In view of ongoing projects, the majority of companies engaged in the oil and gas and transport sectors, respectively 61% and 60%, expect a stable outlook in 2019.

Unlike 2018, when EU business optimism about the short-term economic outlook surged, this year the tone is noticeably tempered: the companies surveyed anticipate relatively moderate dynamism. They appear more realistic this year about the structural problems that remain to be tackled and the challenges they face. As EU companies are now better adjusted to the new realities and more conscious of what is happening in their immediate vicinity, they await greater clarity in the government's longer-term strategic vision. These findings may appear sobering at first sight, but they also provide grounds for countering complacency and pushing through the reforms necessary to transform the country's economy and become a sustainably more attractive destination for investment.

The stabilising expectations of growth from EU businesses this year is a good sign, particularly given the unsustainable cycle of booms and busts that the economy experienced in previous years. However, maintaining stability should not be the country's long-term strategy.

Focus Group discussions

CHAPTER 3

Key Local Business Climate Indicators: Performance and Challenges

Many of the reforms so far have successfully addressed, or may be in the process of addressing, some of the immediate challenges to doing business voiced by the EU business community in previous surveys. However, the creation of a favourable business climate conducive to investment requires across-the-board measures and long-term commitment to reform. As Azerbaijan is competing globally to attract EU and other investors, one of the key challenges that remains is to outpace its peers, by the provision of competitive incentives to invest and a broader range of long-term business opportunities.

One of the main objectives of the EU Business Climate Survey is to capture the views of EU businesses with regard to business and investment climate indicators in Azerbaijan. This enables us to acknowledge progress made so far on the road to reform, to reveal shortcomings and the extent of impediments to doing business in the country, as well as to identify the scope for further improvement. To this end, the survey aims to shed light on the perceptions of EU businesses on 25 local business factors, categorised by three major aspects of the business environment:

Conditions in the labour market

Operational business environment

Economic policies and institutions

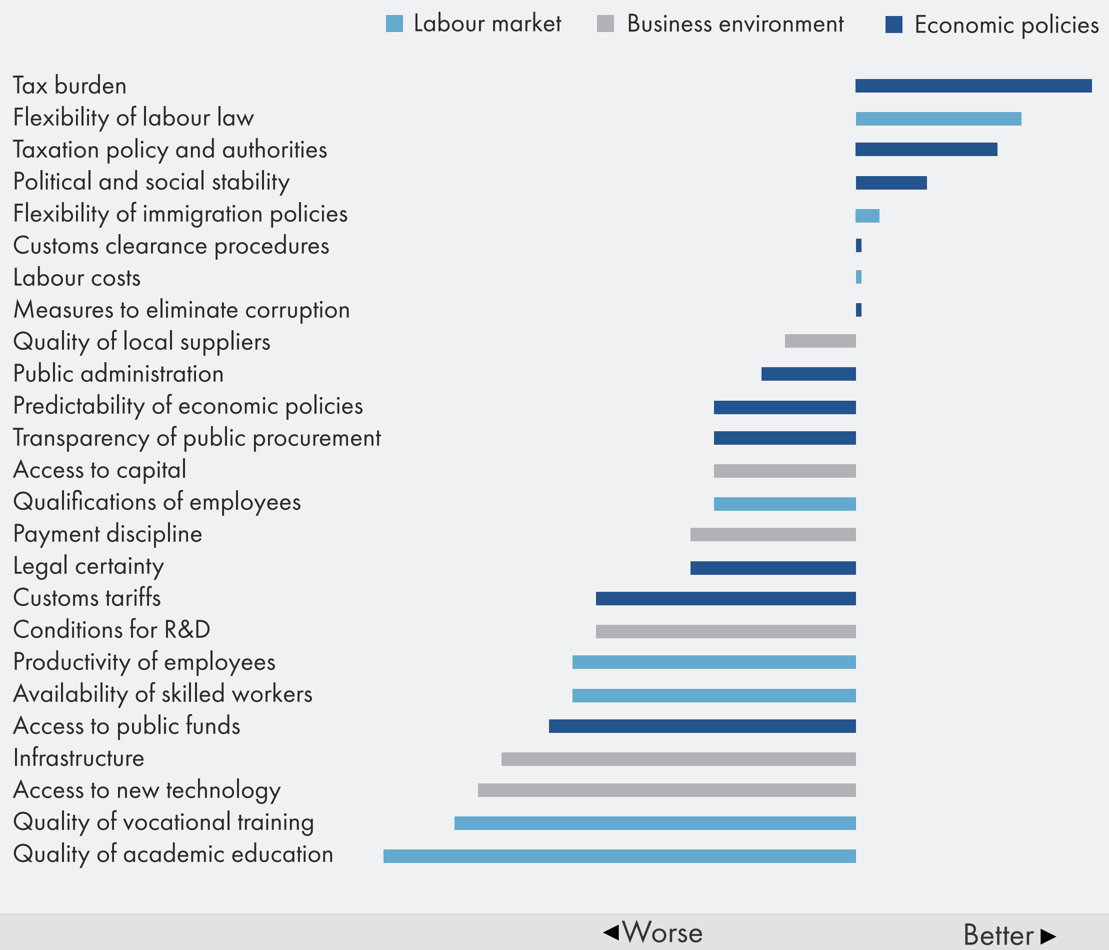
Changes in business climate indicators as perceived by EU businesses

Detailed analysis of this year's findings reveals somewhat mediocre ratings by EU businesses of the business climate indicators. In fact, while in last year's survey, of 25 business climate indicators, only 2 were rated as "changed for the worse" (the availability of skilled workers and customs regulations), this year EU companies identify 17 indicators as having slightly deteriorated.

What is perhaps most notable about the rankings below is that for the first time since the first edition of the report in 2016, tax burden and taxation policy and authorities, record the most markedly positive shift. While this is a clear consequence of recent reforms, it should be noted that these indicators started from a very low base and are still at a level that is far from satisfactory. The quality of academic education is the factor receiving the most strikingly negative decline in rating and the quality of vocational training is also poorly marked this year. These contrast significantly with last year's results, when they were the indicators recording the most positive upswing, although still below average

In fact, increasing concerns may be observed across all other aspects of business this year, with the exceptions of political and social stability, labour law and migration policies, alongside customs clearance procedures and labour costs. This rather reduced enthusiasm from EU businesses concerning the business indicators is a lucid reminder that embarking on reforms is not sufficient; reinforcing and sustaining them is more decisive in producing positive effects on the business and investment climate.

Figure 8. Changes in business climate indicators as perceived by EU businesses, 2018-2019



Conditions in the labour market

The underdeveloped labour market and shortage of skilled workers may well act as brakes, not only on attracting foreign investment, but also on executing and monitoring the reform agenda. Therefore, good quality education and, more importantly, supplies of skilled workers matching labour market demand are pivotal to strong and knowledge-based economic development.

The EU businesses' assessment of the labour market appears to be less robust this year. Of all labour market indicators, only labour law, together with immigration policies, evince somewhat positive movement compared with 2018. Although still above average, the qualification and productivity of employees experienced slight deterioration this year. For the fourth consecutive year, the quality of academic and vocational education, together with the shortage of skilled workers, are reported to be an increasingly significant bottleneck for EU businesses active in Azerbaijan.

Poor quality education and the shortage of skilled workers darken the horizon

Amidst the rapidly rising expectations and standards of European companies, the gap between the existing labour force and the requirements of business is widening every year. The number of EU businesses grading the availability of skilled workers as satisfactory declined from 31% in 2018 to 21% in 2019. Hiring highly skilled workers is challenging across all sectors, yet relatively more concern appears to be expressed by EU companies representing the Financial and Insurance sector (5 out of 11) this year. Discussions suggest that the key employability skills most frequently found wanting in young workers include not only job-specific and technical capabilities, but also socio-behavioural and soft skills, such as communication, leadership, digital and language skills.

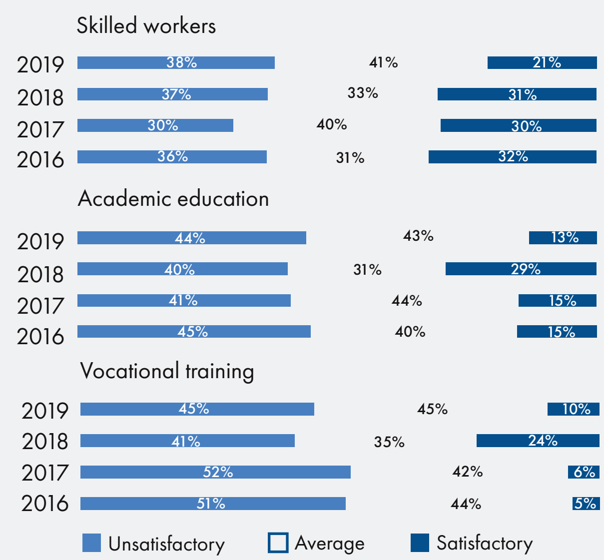
On the other hand, the Mining, Oil and Gas sector is least worried about the shortage of skilled employees, with only 3 of the 18 companies expressing discontent and 10 respondents rating it average.

In fact, in "The Global Competitiveness Report 2018", Azerbaijan ranks 31st of 140 countries for ease of finding skilled employees. This favourable ranking can partly be explained by recent labour market reforms, as well as by the fact that the shortage of skilled employees is among the top threats keeping CEOs awake at night everywhere in the world.[9]

Skilled workers are in search of more competitive jobs abroad, as the labour market in Azerbaijan lacks competitiveness in terms of opportunities and benefits. Tax exemptions and higher salaries are supposed to improve this situation in coming years.

Focus Group discussions

Figure 9. Rating of the labour market indicators



The education system in Azerbaijan is very much theoretically oriented, not much hands-on practical experience or know-how is taught to students. Therefore, young workers on the job market are not well-equipped with up-to-date knowledge and practical skills.

CEO from the Oil and gas sector

This year, many EU companies remain critical of the quality of academic education and vocational training. This should not come as a surprise, given that they also report difficulties in recruiting suitable candidates with the necessary skills. As many as 44% of respondents register dissatisfaction with the quality of academic education in the country. The most frequently cited concerns are about the lack of practical and modern methods and the low level of digitalisation in the education system.

The one positive exception this year is the Mining, Oil and Gas sector, from which 12 of the 18 companies rate academic education as average. In a similar vein, they seem less worried about the quality of vocational training: 11 respondents assess it as average. However, in all, 45% of EU businesses deem vocational training to be unsatisfactory this year. Further enquiry across the sectors reveals that the Financial and Insurance sector is the most dissatisfied with the quality of vocational training, with 8 out of 11 rating it as unsatisfactory.

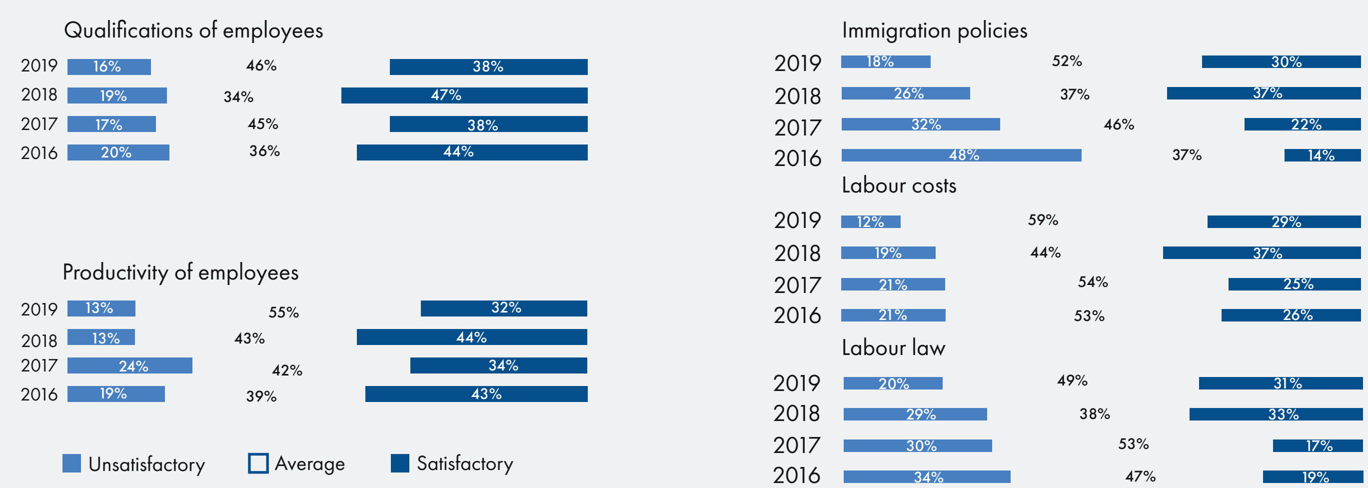
Summarising the interviews and focus group discussions, the education system needs to be more responsive to labour market requirements in order to modernise the economy and foster foreign investment inflows to the country. Tapping into these expectations and demand, the European Union is currently investing € 19 million in education-related projects. The EU assists a range of initiatives, including projects to upgrade standards in higher education and improve the regulatory and policy framework for VET. Other projects support work to increase the institutional capacities of the VET Agency and the Ministry of Education to ensure that the National Qualifications Framework is implemented effectively. These programmes also operate in several of the country's regions (Ganja, Jalilabad, Barda, Gakh, Gabala, Ismayilli) to enhance the impact of VET and its relevance to the private sector. According to EU companies, current projects point in the right direction, but their benefits would only be apparent following full implementation.

Employees' qualifications and productivity, as well as immigration policies and labour law, are among the best-rated indicators

Despite the poorer results already mentioned, overall conditions in the labour market remain the most favourable indicators, as perceived by EU businesses in this year's survey. In the 2018 survey, the improving prospects for growth stipulated a similar leap in employee productivity. Despite the modest decline in optimism this year, employees' qualifications and productivity are regarded as broadly adequate and above average: the proportion of "satisfactory" responses is 38% (down from 47% in 2018) for the former and 32% (down from 44% in 2018) for the latter. Companies from the Mining, Oil and Gas (61%), and the Transportation and Storage (50%) sectors appear to be more satisfied respectively with the qualifications and productivity of their employees.

Although the percentage of satisfactory responses declined from 37% in 2018 to 29% in 2019, labour costs are still rated as average across all sectors and overall by 59% of respondents. This also applies to labour law and the flexibility of immigration policies. Despite a slight reduction in the level of satisfaction this year, labour law and immigration policies are rated as average - by 49% and 52% of EU companies respectively. It is, moreover, reassuring that from cross-tabulation analysis this slight backsliding in the ratings do not seem to weigh on companies' intentions for employment and investment, nor on their near-term company prospects.

Figure 9.1 Rating of the labour market indicators



Particularly notable are the constantly improving ratings for immigration policies, mainly triggered by the launch of the ASAN e-Visa portal in 2017, as well as by the changes of management in the State Migration Service in 2018. The trend towards reduced dissatisfaction among EU companies continues in 2019. The number of EU companies concerned about immigration policies has declined remarkably from 48% in 2016 to 18% this year and this is, in fact, one of the few factors recording a slight positive shift this year. Appreciated is the optimisation of e-services to facilitate procedures for obtaining work permits and ensure accurate exchanges of information with businesses.

Since July 2018, applications for work permits for foreign citizens have been handled by the simplified ASAN Visa system. Finally, the State Migration Service has placed several services online, established a work permit hotline and also established structured dialogues with the private sector.

Given the local shortage of skilled and experienced workers, the government should consider eliminating hurdles to immigration (i.e. paperwork, bureaucracy) for narrow niche specialities and highly-skilled expat workers.

Interview discussions

Operational business environment

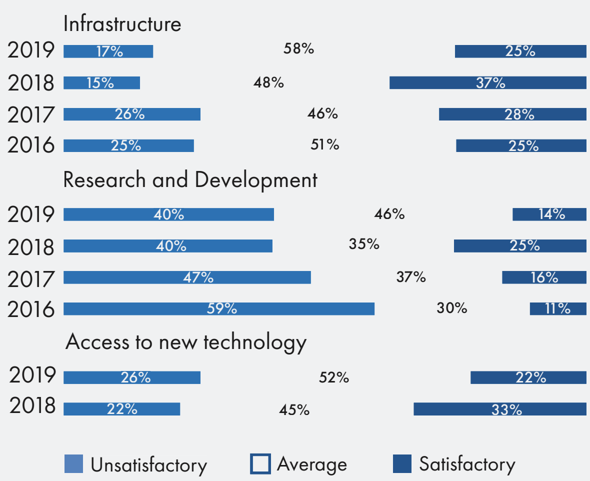
The survey findings reveal that Azerbaijan still has a substantial gap to be closed in the operational business environment. Since 2016, the main weaknesses have been identified to be payment discipline, access to capital and R&D. These points are confirmed once more in 2019. Of all operational business environment indicators, only infrastructure appears to be slightly above average this year.

Sustaining and modernising connectivity is a continuing challenge

In order to re-route foreign investments from the traditionally dominant oil and gas industry to the non-oil sector, the government has so far focused on investing in the reconstruction and modernisation of road and railway networks, ports and electricity generation plants. Most investment has gone into expanding road and railway routes along the country's north–south and east–west transport corridors towards making Azerbaijan an attractive transit and trade hub. To this end, investment of nearly $7 billion (4.7% of GDP) is envisaged for 2017–2020.[10]

With respect to infrastructure, Azerbaijan improved its ranking from 51st in 2017 to 46th in 2018 in "The Global Competitiveness Report". Yet, in this year's survey, EU companies record a noticeable deterioration in their appreciation of the country's infrastructure, with only 25% of respondents rating it satisfactory, against 37% in 2018. The majority (58%), however, marks it as average and only 17% express outright discontent. Benefiting from rising oil prices, the country plans to increase public spending to upgrade infrastructure, particularly that of rail transport, tourism, digitalisation and agriculture this year. Predictably, this will generate new economic momentum, after two years of reduced capital outlays.

Figure 10. Rating of the operational business environment indicators



The EU should show more commitment to supporting the development of transport, roads and connectivity projects in Azerbaijan and the region.

CEO from the Transport sector

The advances of the digital age are powerful in unprecedented ways, and the country's competitiveness is increasingly driven by extensive digital business models and innovations. The number of companies satisfied with access to new technology amounted to only 22% this year, and this is down by 11% compared with 2018. It is, however, reassuring that public investment in the ICT sector is on the rise. In coming years, funds will be directed primarily to digital payment systems and expanding the broadband network.[11] As for local conditions for R&D, 40% of respondents remain dissatisfied, while slightly more EU businesses (46%) take a neutral stance this year.

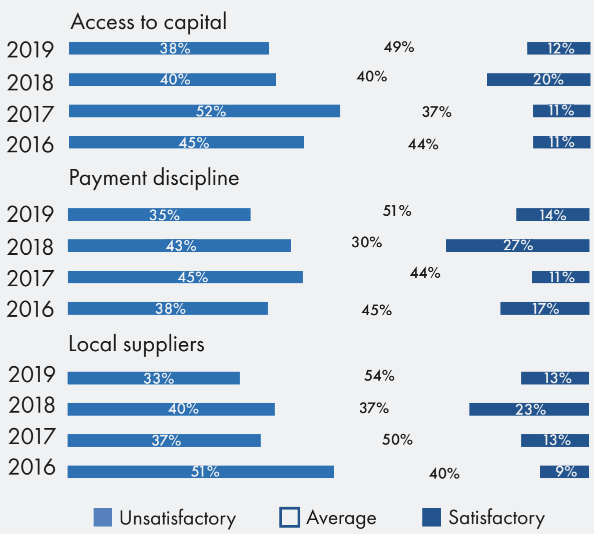
International ratings suggest that Azerbaijan should consider increasing expenditure on R&D (ranked 90th of 140 countries) and the quality of research institutions (ranked 86th) to enhance capabilities for innovation.[12]

Going forward, the EU companies surveyed feel a need for European Union support for further modernisation and digitalising infrastructure in Azerbaijan, as well as for developing general regional connectivity. The recently launched EU-Azerbaijan transport dialogue, held at high level in Baku in February 2019, is seen as a step in the right direction.

Vulnerabilities developing around access to capital and payment discipline weaken the competitive advantage of local suppliers

Access to capital and payment discipline have consistently received poor ratings from all sectors since 2016. Following a short blip last year, 35% of EU businesses think that payment transactions have again become very difficult. Likewise, 38% of the companies surveyed believe that access to capital is constrained. The findings also highlight that, albeit relatively tempered compared with last year, barriers to access to capital continue to weigh on the payment discipline. More precisely, 56% of the companies that lack confidence in access to capital are similarly dissatisfied with payment discipline.

Figure 10.1 Rating of the operational business environment indicators



The regulatory measures against offenders need to be tighter in order to enforce payment on time. More importantly, government agencies and state-owned companies should constitute a good example for the private sector in this regard.

CEO from Waste Management and Remediation Activities

Stimulating the SME sector is also decisive in developing competitive local supply chains. SMEs often operate as suppliers to large international companies and can thus further enhance the country's reliability and attractiveness for foreign investors. This year, slightly fewer (13%) companies are satisfied with the quality and availability of local suppliers (the figure was 23% in 2018). However, 54% of EU businesses rate their local partners as average for quality, with 16% saying they are not discouraged from working with local suppliers. One competitive advantage of local suppliers commonly mentioned by EU businesses is the relatively cheaper pricing, as compared with international companies.

Analysing this issue further in this year's survey, it appears that the main causes of dissatisfaction are: lower quality standards (17%), a shortage of reliable local production input (16%) and a lack of relevant skills (15%). These three discouraging factors also figured prominently in the 2018 rankings, the year we first asked this question. Interestingly enough, suppliers of Electricity, Gas, Steam and Air Conditioning services are relatively more polarised in their views on the quality and availability of local suppliers: 4 of the 8 companies remain dissatisfied, whilst 3 respondents rate them average.

TOP 5 DISCOURAGING FACTORS

17% Local suppliers do not meet our product quality standards

16% The inputs we rely on are not produced locally

16% We source from local suppliers

15% Local suppliers lack the relevant skills or capabilities

12% Local suppliers lack professionalism

Economic policies and institutions

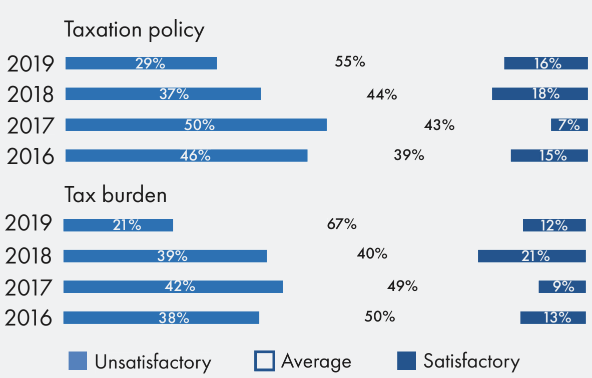
Overall, ratings for economic policy hover at the not-too-bright level of the 2018 survey. Transparency in public procurement, access to public funds, and customs tariffs continue to be rated as clearly inadequate. Encouragingly, a positive shift in perceptions among EU businesses of the tax burden and taxation policy and authorities is particularly noteworthy this year. Political and social stability has gradually improved its rating since the first issue of this survey in 2016, and this trend continues in the 2019 survey. It also remains the only indicator rated above average in this domain.

Taxation policy and the tax burden are rated as most improved of all business climate indicators

With the notable reduction in pessimism (from 37% in 2018 to 29% in 2019) almost equalling the rise in neutral ratings, more respondents (55%) rate taxation policy and authorities as average this year. The same stance applies, to a greater extent, to the tax burden. As pessimism declined (by 18%), considerably more EU companies (67%) assess the tax burden as average this year, and this is irrespective of sector or size of company. Indeed, taxation as a whole enjoyed a successful year of reform in 2018, also drawing on EU business expectations.

Specific steps taken by the tax administration to cut taxes and introduce tax incentives, alongside increased mutual trust and transparency between taxpayers and tax authorities, have clearly given new impetus to EU businesses active in Azerbaijan. Particularly appreciated is the tax authorities' commitment to productive interaction with the business community and international institutions over the past year while modernising tax administration. However, it should be noted that both indicators are still far from satisfactory, signalling the need for further determined and consistent action plans to address the challenges that remain.

Figure 11. Rating of the economic policy indicators



Arbitrary and unnecessary tax inspections have now been eliminated. Equal treatment of taxpayers based on legislation has been one of the most important recent advances towards ensuring transparency.

Interview discussions

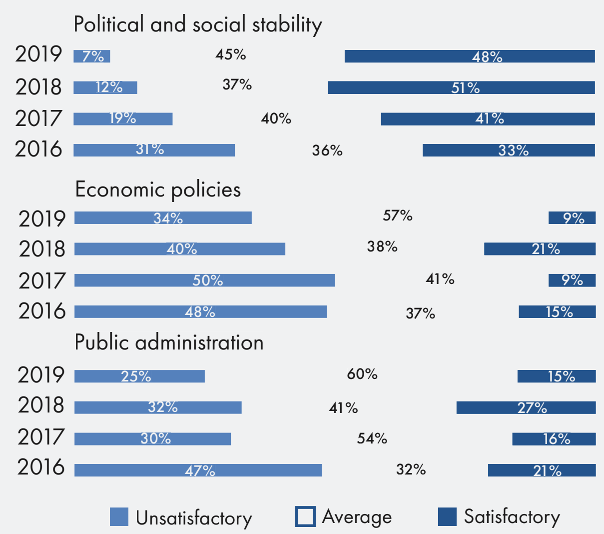
Political and social stability continues to shine out as the best-rated indicator

Political and social stability is clearly one of the most essential conditions for inflows of foreign direct investment (FDI) and findings this year reveal that it continues to be a credible anchor for EU businesses. Of all the business climate indicators, political and social stability stands out as the best-rated indicator for the third year in succession: 48% are satisfied with the country's stability, with another 45% rating it as average. Feedback from EU businesses indicate that effective public administration is equally vital to the implementation and execution of the reform agenda that would secure foreign investment. The number of companies marking public administration as satisfactory fell by 12% over the year, but a majority (60%) still rate it as average.

The findings highlight moreover that EU companies' perceptions of stability and the predictability of economic policies are strongly linked. In other words, from the European businesses' perspective, the more stable the country, the more predictable its economic policies.

This year, a total of 57% of the companies surveyed said that economic policies are moderately predictable, but only 9% (down from 21% in 2018) of respondents rate it satisfactory. That is to say, the mood among EU businesses is good this year, but question marks remain over the future. The most worried sector appears to be the Financial and Insurance sector, with 6 of 11 respondents expressing dissatisfaction with the predictability of economic policies. Concerns about the predictability of economic policies discussed in interviews and focus group meetings are tied closely to a lack of certainty and continuity in some policy measures. Reforms often have a short-term horizon and their longer-term benefits appear elusive from the perspective of the EU business community. Thus, moving forward, the government should capitalise on the reform agenda, strengthen the processes of execution and take additional longer-term measures to boost business and investor confidence.

Figure 11.1 Rating of the economic policy indicators



The government's efforts to optimise the system and improve management is well received. For example, dissolving the agencies whose tasks overlapped with other institutions' duties, was the right decision. However, these decisions require longer-term planning and smoother transformation processes. Otherwise, precipitous changes redefine the focus and priorities of bodies affected, which, in turn, dampens EU businesses' trust.

Interviews and Focus Group discussions

Going forward Azerbaijan may consider revising its tariff policies

Voices for more coherent tariff policies are clearly louder in this year's survey. Many (46%) of the EU companies surveyed are dissatisfied with current customs duties and call for an in-depth analysis of trade tariffs to avoid possible distortions of trade and export. Interview discussions confirm that imposing high customs duties on raw materials and products imported from the EU and that are not locally available, may stifle local manufacturing and eventually neutralise the benefits of export-oriented measures. This feedback is in line with "The Global Competitiveness Report 2018" in which, in respect of trade tariffs, Azerbaijan ranks 90th of 140 countries.

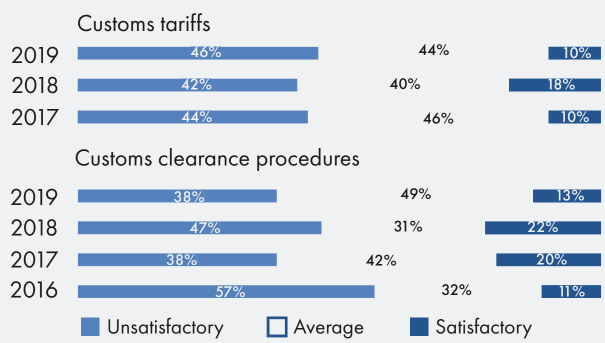
What emerges as we look more closely at the data is that this year high customs duties adversely affect all companies, irrespective of size. Although EU businesses do not regard accession to the WTO as an immediate priority for Azerbaijan amidst other pressing needs (only 3% did so), the country's non-accession is a great surprise to EU businesses and is still mentioned as a stumbling block on the path to a sustainable, innovation-based economy.

In outlining the gaps to be bridged, EU businesses also acknowledge the government's success in carrying out some reforms. Following a short reverse in EU companies' perceptions last year, this year customs clearance procedures are marked as average by 49% of respondents (up from 31% in 2018). However, 38% express dissatisfaction and the need to pursue further measures to optimise clearance procedures. According to the comments, the customs administration requires the submission of a large number of documents and excessive amounts of information (certificate of origin, phytosanitary, sanitary controls and laboratory tests) that have no value for the clearance process but create delays at the border. In fact, this feedback is in line with the "Doing Business 2019" report in which, for trading across borders, Azerbaijan ranks 84th, below the regional average. It is worth mentioning that in EU countries customs clearance takes less than 5 minutes in 67% of cases and exceeds 1 hour in only 7% of cases.[13] This can be achieved by sustaining and furthering the automation of customs procedures (including the certification process) and risk management measures.

Figure 11.2 Rating of the economic policy indicators

There is no duty on goods imported from CIS countries, while the maximum tariff plan is applied to goods imported from Europe. CIS countries cannot meet a quality that complies with world standards. Europe offers that quality; however, our customs procedures do not allow us to benefit from it.

General Manager from the Wholesale and Retail sector



Fair Play: Strengthening transparency and establishing a robust legal framework

Legal certainty, together with transparency of public procurement and access to public funds are more immediate concerns tied to the ease of doing business in this year's survey. Respondents report deterioration in all these areas, with access to public funds receiving the poorest ratings amid all business climate indicators: 48% of EU businesses express discontent here.

A perceived unfairness in the judicial system, in particular a noticeable bias, discourages foreign investors from investing in the country and causes existing companies to leave.

Managing Partner from the Professional Activities sector

For the fourth consecutive year, a majority of EU businesses say that they still tend to avoid the courts in settling economic disputes; this is due to a perception of biased and lengthy procedures, with enforcement processes being even more problematic. In view of the very low level of satisfaction, 12% (against 21% in 2018), with 41% of respondents expressing discontent with legal certainty this year, it is clear that the judiciary system represents a major obstacle to foreign investment in the country. The recently adopted presidential decree on "Deepening Reforms in the Judicial-Legal System" is thus timely, and may affect responses to next year's survey. Particular dissatisfaction with legal certainty is expressed by two sectors: Financial and Insurance (8 of 11 respondents) and Professional, Scientific and Technical Activities sectors (10 out of 18).

Similarly, 42% of EU businesses assess measures to eliminate corruption as insufficient, while 44% remain neutral. While this is a slight improvement on last year's survey, fewer EU companies rate measures to eliminate corruption as satisfactory. Interviews suggest that corruption (and "connections") is the main factor obstructing transparency in public procurement. In fact, cross-tabulation analysis reveals that of the companies rating measures to eliminate corruption as unsatisfactory, 69% also deem public procurement to be non-transparent. Further problems highlighted include the paucity of publicly available information on the criteria and procedures for tendering (requirements are often vaguely set out) and the general obscurity of assessment and selection processes.

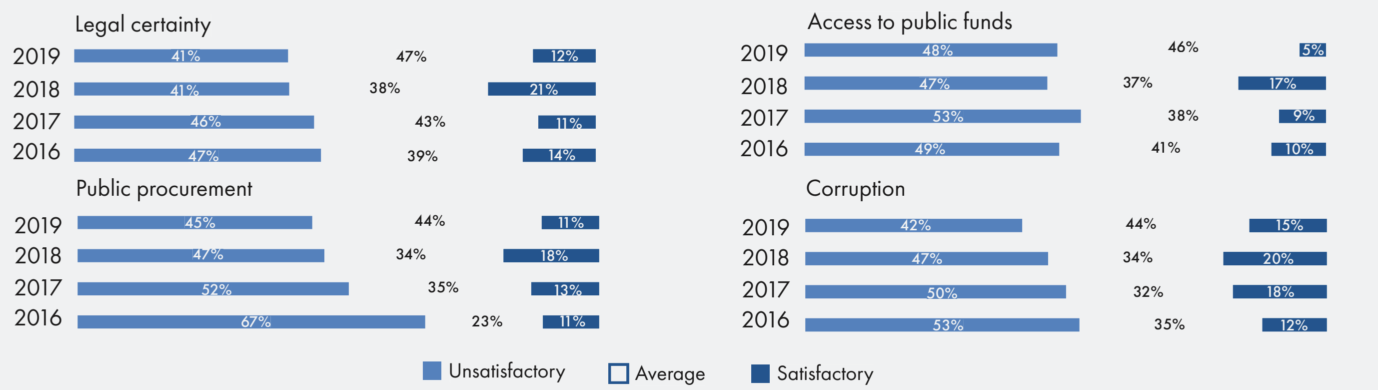
Hence, although there has been slightly improved competition, with more companies participating in procurement procedures over recent years, the lack of transparency constitutes a serious cost for all EU companies.

A first step towards ensuring transparency has been this year's launch of a website (etender.gov.az) to fully automate public procurement processes for all state agencies on one online platform. However, judging by this year's survey results, its effectiveness remains to be seen.

Despite slight improvements in recent years, procurement procedures are not yet entirely transparent. As a European company, we face serious challenges (including tailor-made criteria, lack of information, delays in communications and corruption) in trying to stay ethically compliant.

General Manager from the Water supply and Waste Management sector

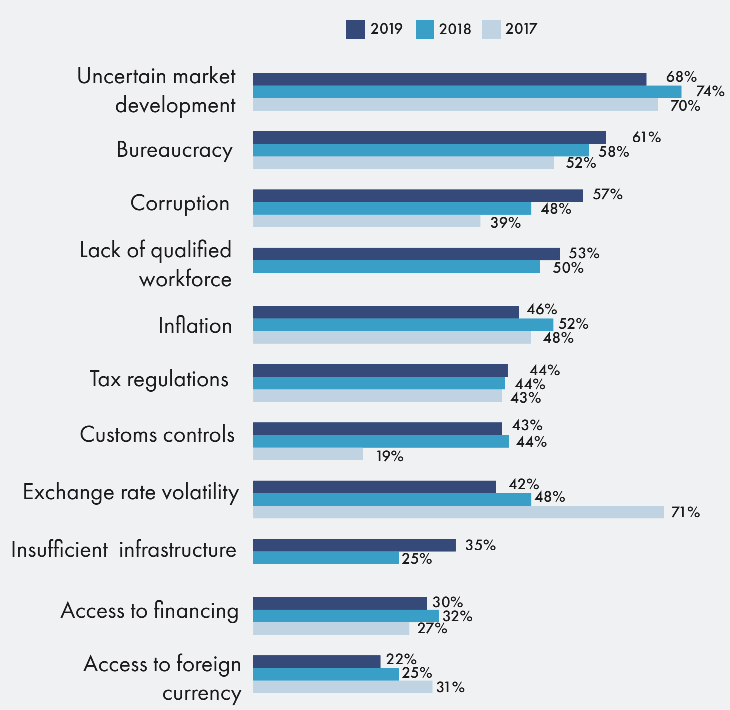
Figure 11.3 Rating of the economic policy indicators



EU businesses' perceptions of business indicators are partly reflected in their rankings of conditions most unfavourable to business in 2019. Uncertain market development, the main threat in 2018, tops the poll again this year, although selected by slightly fewer EU companies. It is joined in the top five unfavourable conditions by: bureaucracy (seen as a serious obstacle by increasing numbers of EU businesses since 2017); corruption (ditto); the shortage of qualified workers; and inflation. Interestingly, corruption is rated one of the top three major risks for the first time since the first survey in 2016. The increased concern about bureaucracy and the continuing shortage of skilled labour are no lesser obstacles to expansion by EU businesses in the country.

Further, the rankings indicate that while EU businesses value the ongoing customs and tax reforms, they still have concerns about customs controls and tax regulations. As was the case last year, the stabilising exchange rate has reduced companies' concerns about inflation and access to foreign currency. Similarly, the companies seem less preoccupied with issues of infrastructure this year.

Figure 12. Ranking of the current economic conditions affecting EU companies



CHAPTER 4

Azerbaijan as an Investment Destination

Towards diversifying its economy, Azerbaijan actively seeks long-term FDIs for large-scale infrastructural projects. Relevant in this context is the indicative Trans-European Transport Network (TEN-T) Investment Action Plan developed by the EU and the World Bank. The projects included in the plan, estimated at almost €13 billion, envisage the construction and rehabilitation of new and existing roads, rail, ports and airports, as well as logistical centres and border crossing points. The project aims to bring forward key reforms to the transportation sector and to improve regional road safety. Plans for Azerbaijan include the creation of five logistics centres (€369 million) and a free trade zone in Alat (€410 million), as well as modernisation of the East-West Railway (€328 million). The two former projects are to be financed by public-private partnership, and the last by international financial organisations.

The government is also exploring the potential for engaging the private sector in power generation and distribution, as well as projects in renewable energy and water supply, currently managed by state agencies with weak capacity. Together with modernising infrastructure and developing concepts to boost agriculture and tourism, there are several initiatives to encourage greater private sector investment, including the establishment of special economic zones and industrial parks. So far, more than $2.6 billion have been invested in the creation of industrial parks in Azerbaijan, with plans for a further $1.1 billion in the next stage.[14]

Statistics suggest, however, that these incentives have done little (thus far) to attract long-term foreign investment. As reported by the Central Bank of Azerbaijan, FDIs estimated at $4.1 billion were pumped into the Azerbaijani economy in 2018, 28.1% down on the previous year. According to the balance of payments for the year 2018, 76.5% of FDIs went into the oil and gas sector. Compared with 2017, FDIs in the non-oil sector increased by 18.9%, amounting to $967.1 million in 2018. Over the past five years, EU countries have invested more than $15 billion in Azerbaijan's economy.[15] In addition, the EU remains Azerbaijan's main trading partner and the largest export and import market. According to the State Customs Committee of the Republic of Azerbaijan, EU countries accounted for 41.7% of Azerbaijan's foreign trade turnover in 2018.*

**Refer to annexe C for more information on investment and EU trade with Azerbaijan*

Would you invest again in Azerbaijan?

Turning to investment intentions, the proportion of EU businesses committed to Azerbaijan rose gradually from 40% in 2016 to 66% in 2018. This year, even more European companies recognise potential for still untapped investment opportunities when asked if they would invest in Azerbaijan again. As many as 75% of the companies surveyed state their confidence in choosing Azerbaijan as a preferred investment location for 2019, while only 7% are inclined to reconsider their investment plans. The main driver of this year's upturn in investment intentions appears to be the Construction sector, from which all 9 companies surveyed express their firm plans to invest in Azerbaijan again. This represents the highest upswing compared with 2018, when only 4 of the 10 companies from this sector declared a commitment to the country. Further analysis across the sectors reveals that oil and gas companies also display greater continuity (17 of the 18 respondents) in their investment decisions, compared with last year (14 of the 18 companies). This is, in fact, a reflection of historically favourable conditions for investment in Azerbaijan's oil and gas sector.

Figure 13. Would you again invest in Azerbaijan?

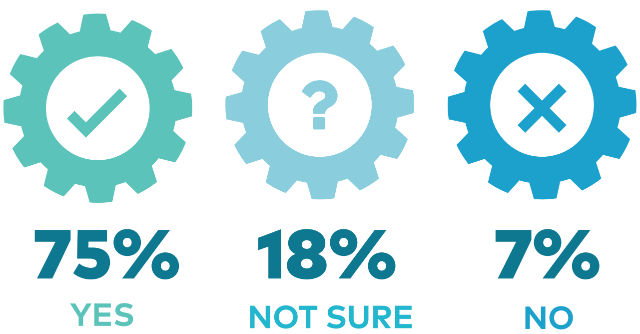
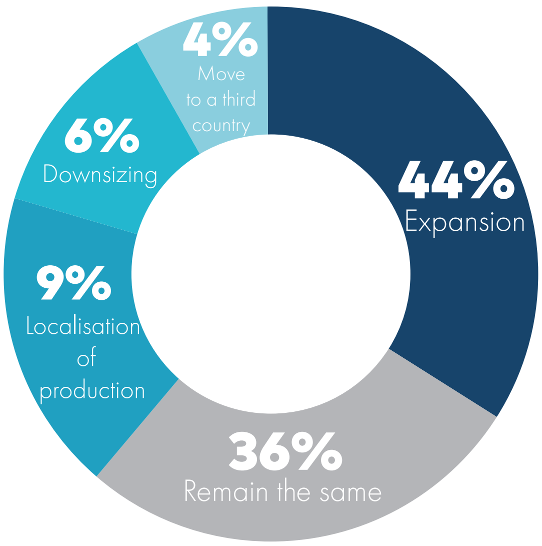


Figure 14. What is the direction of your company's development?

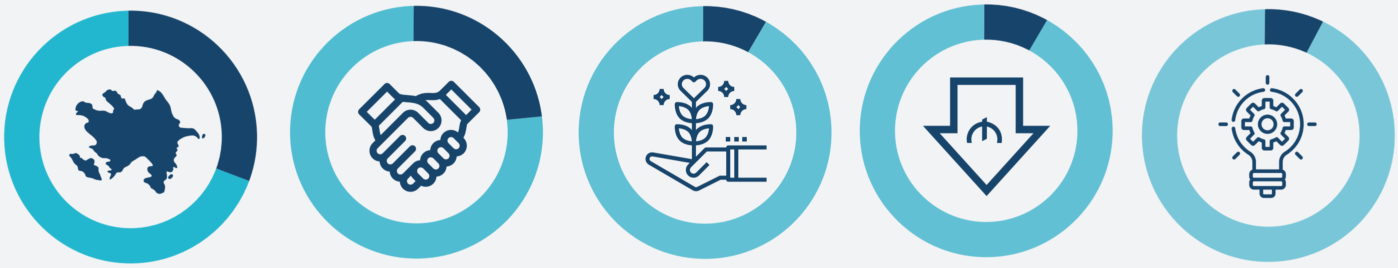


In contrast, the Financial and Insurance sector remains relatively conservative. That is to say, when asked if they would again invest in Azerbaijan, 5 of the 11 providers of financial and insurance services do not say "Yes". However, these negative responses do not necessarily mean that the companies are planning to leave the country, only that they would prefer to invest in another country under existing circumstances. Georgia, Uzbekistan, Russia and Malta are cited as alternatives by 6 companies who say they are planning to move to a third country over the next one or two years. Changing market conditions and needs may change business preferences, but the local business climate undoubtedly plays an equally important role. This implies that in order to outperform the competition, Azerbaijan needs to increase efficiency and competitiveness in its economy, with beneficial effects for long-term sustainability.

As with last year, the development dynamic of companies surveyed has advanced in line with their commitment, albeit in a somewhat tempered way. 44% of the EU companies declare that they plan to expand their business activities over the next one to two years. This is a 9% drop since last year. On the other hand, exactly 9% of companies envisage localising production this year. As for motivations to invest, access to the domestic market and strategic partnerships and alliances (mentioned by 27% and 24% respectively) remain the most significant driving forces among the companies surveyed. Other indicators, such as investment incentives (e.g. tax incentives), low costs of production and access to technology or knowledge are among the least influential benefits.

TOP 5

FACTORS DRIVING THE INVESTMENT



27% Access to domestic market

24% Strategic partnerships & alliances

9% Investment incentives

9% Low cost of production

8% Access to technology or knowledge

Looking further ahead, sustainable and longer-term economic growth will depend increasingly on greater levels of private sector investment. Azerbaijan displays a promising appetite for reforms, and this is perceived by EU businesses. Yet the country apparently faces some challenges in restructuring institutions and implementing principles of good governance to ensure that those institutions are managed effectively. Now, when institutional frameworks are mostly in place and several reform initiatives in practice, the government needs the stamina to implement those challenging reforms effectively across a wide range of sectors, with particular emphasis on banking and finance, the judiciary and education. Success along the road to a more vibrant business and investment climate depends on strong commitment to close cooperation with the business community to design workable, long-term solutions that will attract businesses and foreign investors to the country.

Lack of affordable credits and the absence of transparency in the judicial system reduce the country's attractiveness as a destination for investment.

Interviews and Focus Group discussions

Azerbaijan needs to clarify its long-term vision for the sectors and foreign investment to gain a strong competitive advantage in the region and to convince international companies to invest in the country for the long-term.

Interviews and Focus Group discussions

Way Forward and Recommendations

When comparing the results with last year's, no clear picture emerges. EU businesses appear to be more cautious in their assessments of the business climate; the reforms are appreciated, however, their implementation has not fully lived up to expectations. While the reform agenda for taxation and customs raise great optimism, the EU businesses believe that further supportive measures are necessary if companies are to benefit fully from the initiatives implemented. The delivery of user-friendly solutions and further procedural simplifications could be helpful in this respect.

Responses to the impacts made with long-awaited reforms by the new managements in the Ministry of Labour and Social Protection and the State Migration Service are almost unanimously positive. Optimism might easily disappear if not fuelled by substantial reforms. As for the recently established agencies (i.e. Agency for Development of SMEs, Food Safety Agency, Mortgage and Credit Guarantee Fund) that are crucially important to the reform agenda, their honeymoon period during institutional setup has expired and they are called upon to deliver. These responses discern one clear message: EU businesses expect further timely and effective implementation of measures to complete the initial momentum for reform.

The subdued perceptions of the education system and VET send an alarming signal. The shortage of skilled workers is again raised as a top priority for reform, this time in an even stronger voice. This is one of the top five most important reforms, alongside those necessary in the legal system and financial sector. Considering that the recent decree by the President will lay out a new vision to address the rule of law in the country, the legal system will warrant further detailed investigation into its challenges and solutions in next year's survey. Moving ahead, the government should capitalise on the reform agenda, strengthen its implementation and take additional longer-term steps to boost business and investor confidence.

1. The ongoing reforms to taxation and customs need to be supported with accurate information and consistent coordination of action to ensure effective and smoother transition by companies to the new economic realities. Moreover, the EU businesses call for more reforms to address existing barriers to the implementation of double taxation and tax reimbursements. Similarly, additional adjustments are required to further improve customs clearance processes and avoid artificial delays at the border. To this end, the customs authorities should endeavour to work with businesses to ensure the effectiveness of the Green Corridor system, as well as to prevent counterfeit imports.

2. Clearly, reforms to education and the vocational education sector do not happen overnight. EU businesses stress that the State Agency on Vocational Education should not relax its efforts to modernise the system (i.e.with more practical and modern methodology, up-to-date know-how, digitalisation). They encourage the establishment of a participatory platform to raise awareness of the outcomes of recent changes, while at the same time promoting social and public-private partnerships for successful implementation of the VET roadmap.

3. The financial sector is viewed as lacking liberalisation and flexibility, thus creating serious obstacles to innovation and introduction of new financial instruments. The companies remark that EU expertise and practices are essential to the elimination of bureaucracy and the creation of a sustainable strategy and longer-term vision for the country's financial sector. Following stabilisation of the local currency, further support should come from the reforms anticipated in 2019 to improve resilience and transparency in the banking sector (banks lacking transparency and reliability continue to operate) and to address the bottlenecks restricting access to finance (i.e. high interest rates, low loan maturity, unsystematic supervision of the financial sector). These are essential if businesses are to reap the full benefits of recent reforms to taxation and customs.

4. The EU businesses expect newly established bodies to strengthen and become more visible in delivering tangible outputs. The agencies should consider communicating their long-term strategy with the business community and develop public-private sector dialogue further, thus raising awareness among entrepreneurs while ensuring that proposals and measures to reform are also relevant.

5. With all this in mind, the principal threat to the ease of doing business, according to the majority of EU companies this year, is the uncertain direction of market development. Hence, the companies surveyed and interviewed this year call for long-term vision and the translation of plans and strategies into concrete action that would yield effective results.

It is important to remember that the EU businesses still hold a positive view of the economic diversification agenda. The efforts made are recognised and appreciated, but further steps are expected. While the economy has stabilised significantly, it is still essential to maintain the pace of reform. Delays or ineffective implementation may limit the potential for positive outcomes.

ANNEXE A: Methodology

For the fourth time in a row, the EU Business Climate Survey was conducted by the German- Azerbaijani Chamber of Commerce (AHK Azerbaijan) with the support of the EU Delegation to Azerbaijan. Based on the findings of the survey, the EU Business Climate Report Azerbaijan 2019 was drafted to present an overall economic situation, business environment and investment climate in Azerbaijan as perceived by EU companies doing business in the country.

The questionnaire included 20 questions focusing on 3 sections:

1. Economic situation and outlook in Azerbaijan
2. Impact of Azerbaijan's economic situation and business environment on the companies and their investment decisions
3. Company demographics

While small amendments were made to particular questions to keep pace with the reform updates, the overall format of the survey and the quantity of questions remained unchanged. This year, a new answer option (i.e. I am not well-informed) was added to the question on assessing the effectiveness of the reforms in order to enable more accurate deduction from the results and to reveal the areas which require delivering enhanced information and communication to businesses by the government.

The questionnaire was disseminated through an online survey platform QuestionPro to around 400 EU companies representing 23 EU countries. A total of 221 responses were submitted during the period from 15 January to 22 February 2019. After data control, incomplete responses were eliminated and double responses were excluded. As a result, 130 valid and complete responses, corresponding to a response rate of 33%, were selected as a representative and statistically significant sample. Strict confidentiality and anonymity of the responses was ensured while analysing and presenting the survey results.

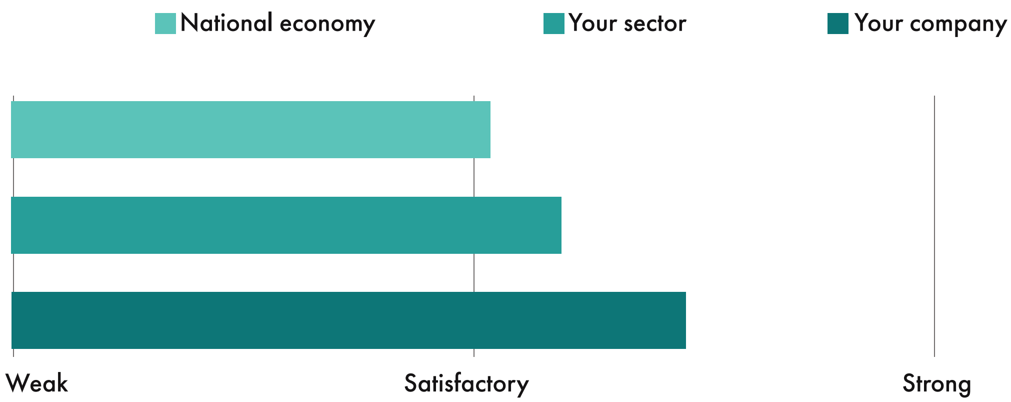
In addition, this year 20 face-to-face interviews, 3 more compared to last year, were conducted with the selected EU companies representing 10 various sectors. Also, additional remarks mentioned in the Focus Group discussions by EU company representatives were considered while drafting the report, which facilitated further elaboration of the findings. The commentaries made by interviewed companies and participants of the Focus Group discussions on the specific issues are anonymously quoted throughout the report.

For the purpose of providing more detailed analysis of the survey findings, the statistical data of international financial organisations, including the World Bank, Asian Development Bank, European Bank for Reconstruction and Development and the International Monetary Fund, as well as the State Statistical Committee of the Republic of Azerbaijan, the Central Bank of Azerbaijan and the State Customs Committee of the Republic of Azerbaijan, was referred to in the report. Furthermore, comparative data analysis on the current and previous years' survey findings was conducted in order to shed light on changes of the EU businesses' perceptions of the economic situation, business and investment climate in the country over years.

The overall "mean values" and average rates were calculated by using the arithmetic mean. Moreover, cross-tabulation analyses between the relevant variables were carried out to find out the correlation between the data, where possible.

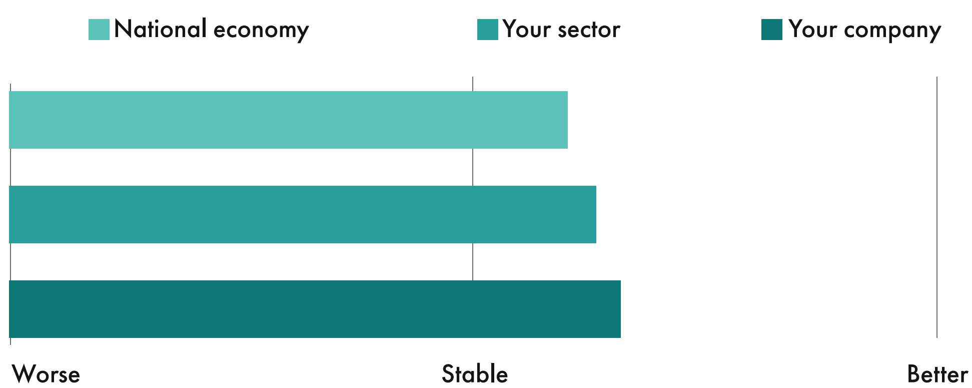
ANNEXE B: Detailed Survey Findings

Q1. How do you rate the current situation in Azerbaijan?



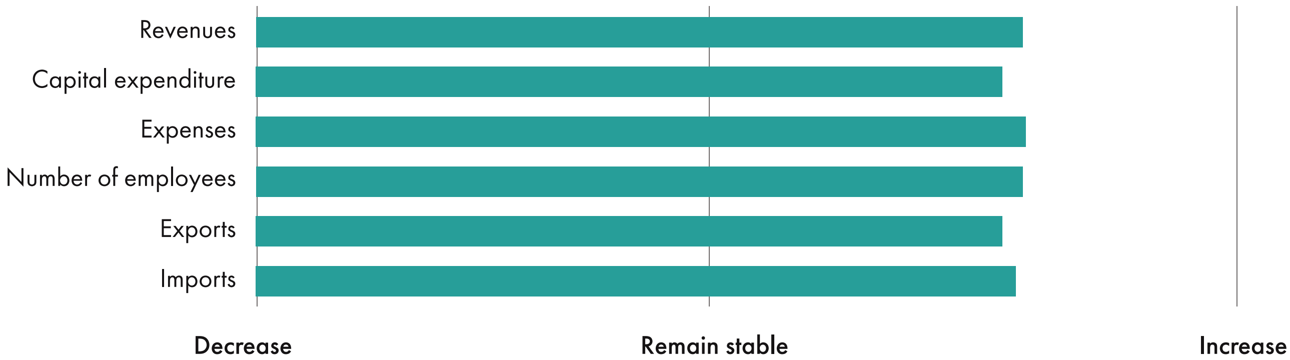
Answer options	Weak	Satisfactory	Strong	Rating average	Response count
National economy	34	87	9	1.81	130
Your sector	30	79	21	1.93	130
Your company	13	86	31	2.14	130
Total					**130**

Q2. How do you assess the prospects in Azerbaijan for 2019 compared to the previous year?



Answer options	Worse	Stable	Better	Rating average	Response count
National economy	13	83	34	2.16	130
Your sector	11	80	39	2.22	130
Your company	10	75	45	2.27	130
Total					**130**

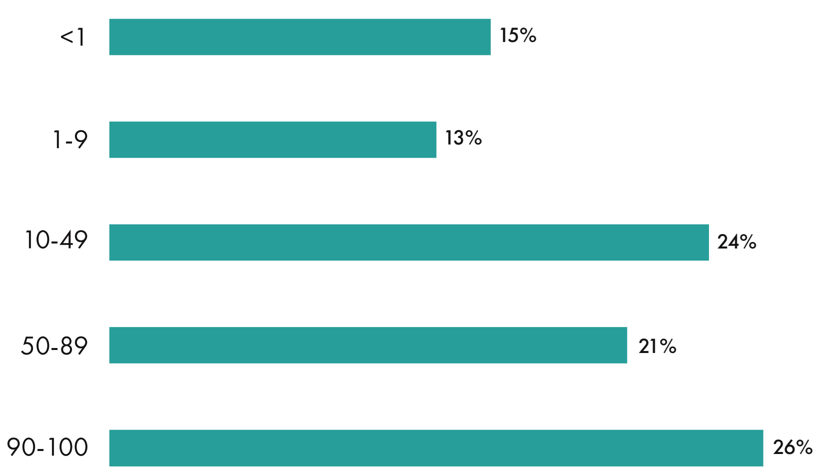
Q3. How do you expect your company to perform in 2019 compared to the previous year?



Answer options	Decrease	Remain stable	Increase	Not applicable	Rating average*	Response count
Revenues	21	45	53	11	2.27	130
Capital expenditure	15	58	38	19	2.21	130
Expenses	17	53	51	9	2.28	130
Number of employees	15	61	49	5	2.27	130
Exports	7	34	20	69	2.21	130
Imports	13	42	36	39	2.25	130
Total						**130**

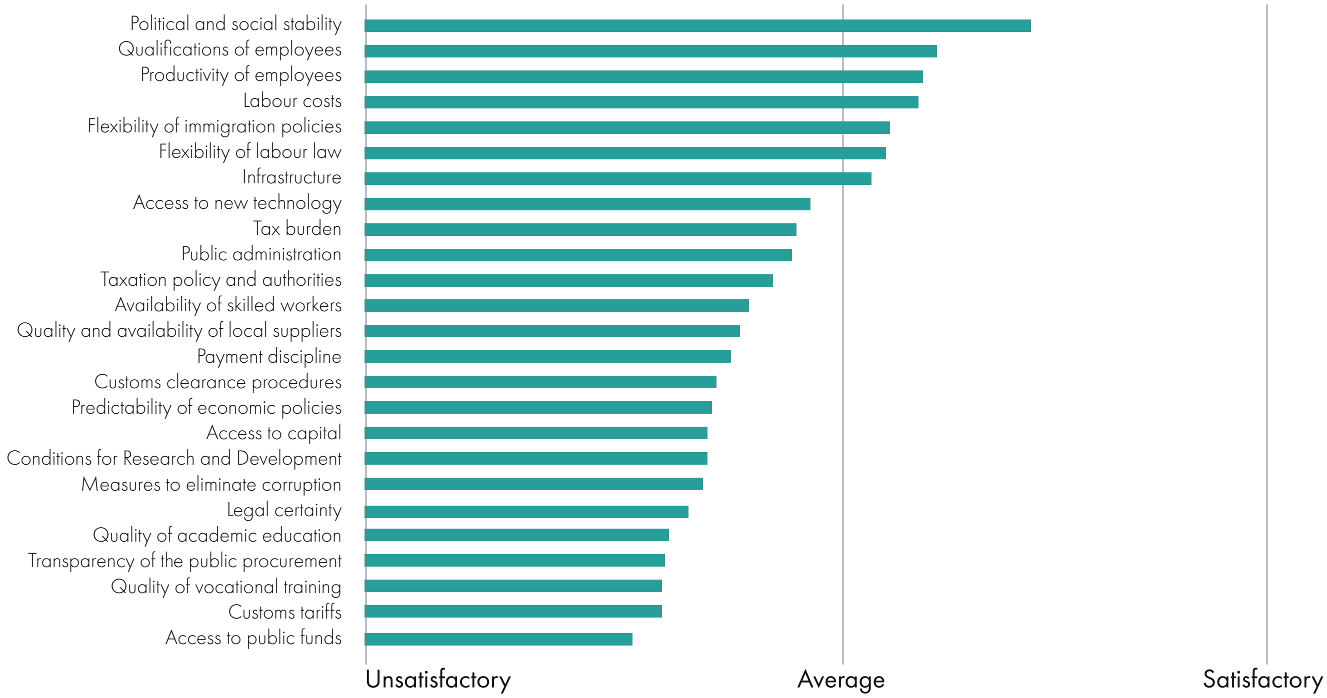
* *N/A options are excluded while calculating rating averages*

Q3.1 What percent of your company's inputs are imported?



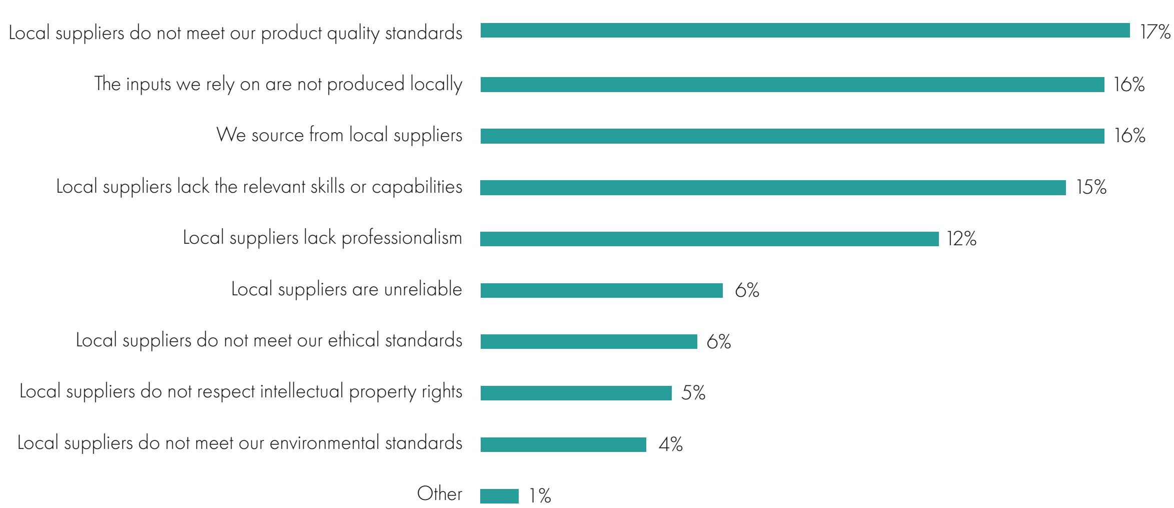
Answer options	Response rate	Response count
<1	15%	14
1-9	13%	12
10-49	24%	22
50-89	21%	19
90-100	26%	24
Total	**100%**	**91**

Q4. How do you rate the following local indicators of business environment for your company/ sector?



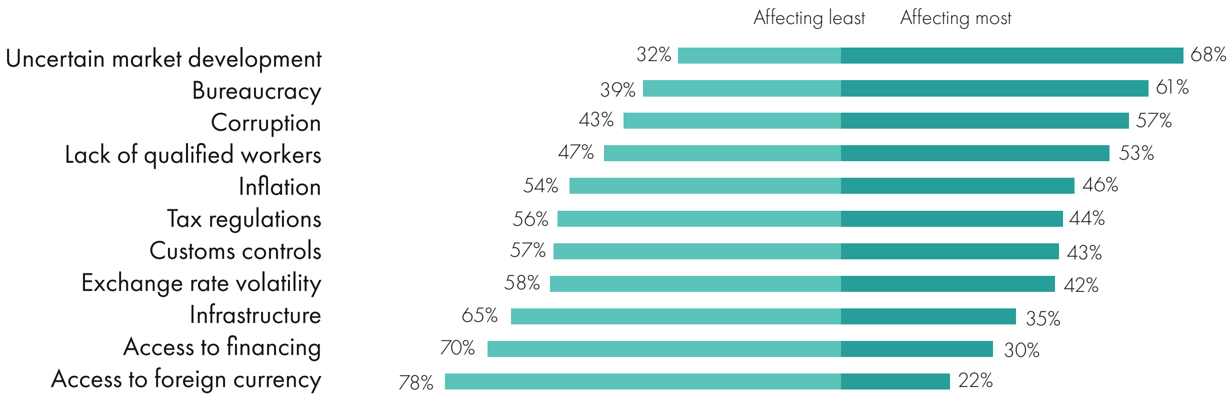
Answer options	Unsatisfactory	Average	Satisfactory	Rating average	Response count
Political and social stability	9	58	63	2.42	130
Qualifications of employees	21	60	49	2.22	130
Productivity of employees	17	71	42	2.19	130
Labour costs	15	77	38	2.18	130
Flexibility of immigration policies	23	68	39	2.12	130
Flexibility of labour law	26	64	40	2.11	130
Infrastructure	22	76	32	2.08	130
Access to new technology	34	68	28	1.95	130
Tax burden	27	87	16	1.92	130
Public administration	32	78	20	1.91	130
Taxation policy and authorities	38	71	21	1.87	130
Availability of skilled workers	50	53	27	1.82	130
Quality and availability of local suppliers	43	70	17	1.80	130
Payment discipline	46	66	18	1.78	130
Customs clearance procedures	49	64	17	1.75	130
Predictability of economic policies	44	74	12	1.75	130
Access to capital	50	64	16	1.74	130
Conditions for Research and Development	52	60	18	1.74	130
Measures to eliminate corruption	54	57	19	1.73	130
Legal certainty	53	61	16	1.72	130
Quality of academic education	57	56	17	1.69	130
Transparency of the public procurement	59	57	14	1.65	130
Quality of vocational training	59	58	13	1.65	130
Customs tariffs	60	57	13	1.64	130
Access to public funds	63	60	7	1.57	130
Total					**130**

Q5. What discourages your company from sourcing from local suppliers? (Select max. 3 that apply)



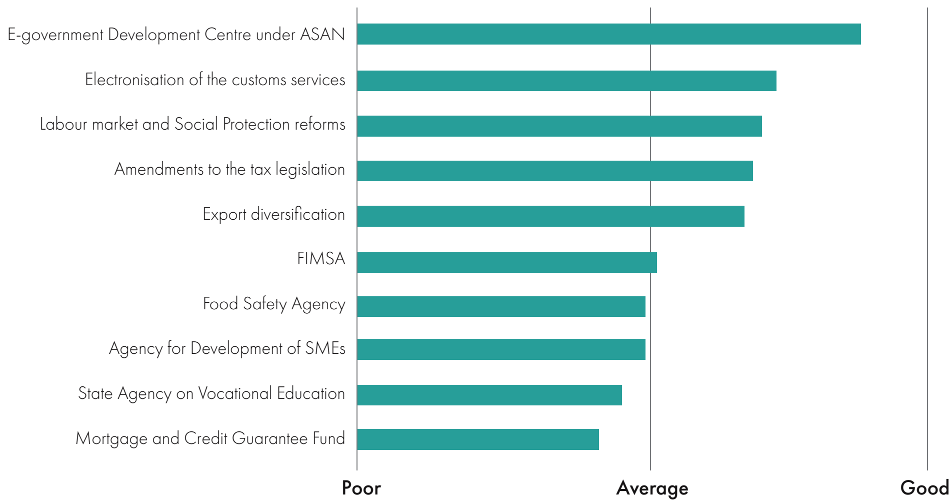
Answer options	Rating average	Response count
Local suppliers do not meet our product quality standards	17%	51
The inputs we rely on are not produced locally	16%	49
We source from local suppliers	16%	49
Local suppliers lack the relevant skills or capabilities	15%	46
Local suppliers lack professionalism	12%	36
Local suppliers are unreliable	6%	19
Local suppliers do not meet our ethical standards	6%	17
Local suppliers do not respect intellectual property rights	5%	15
Local suppliers do not meet our environmental standards	4%	13
Other	1%	3
Total	**100%**	**298**

Q6. Which of the below mentioned current factors are affecting your company/sector most?



Answer options	11	10	9	8	7	6	5	4	3	2	1	Response rate	Response count
Uncertain market development	5	4	4	10	11	8	7	14	18	30	19	100%	130
		32.31%							67.69%				
Exchange rate volatility	9	12	18	11	12	13	6	18	10	6	15	100%	130
		57.69%							42.31%				
Bureaucracy	4	5	9	4	11	18	13	13	16	19	18	100%	130
		39.23%							60.77%				
Inflation	8	8	14	20	13	7	20	15	10	7	8	100%	130
		53.85%							46.15%				
Tax regulations	10	11	6	10	18	18	17	13	10	9	8	100%	130
		56.15%							43.85%				
Corruption	19	12	6	10	6	3	13	15	18	15	13	100%	130
		43.08%							56.92%				
Access to foreign currency	35	28	19	10	3	7	9	3	4	8	4	100%	130
		78.46%							21.54%				
Access to financing	14	21	20	15	10	11	1	6	9	5	18	100%	130
		70%							30%				
Customs controls	12	6	16	12	9	19	15	8	16	8	9	100%	130
		56.92%							43.08%				
Insufficient infrastructure	6	18	9	17	22	13	15	9	8	10	3	100%	130
		65.38%							34.62%				
Lack of qualified workers	8	5	9	11	15	13	14	16	11	13	15	100%	130
		46.92%							53.08%				

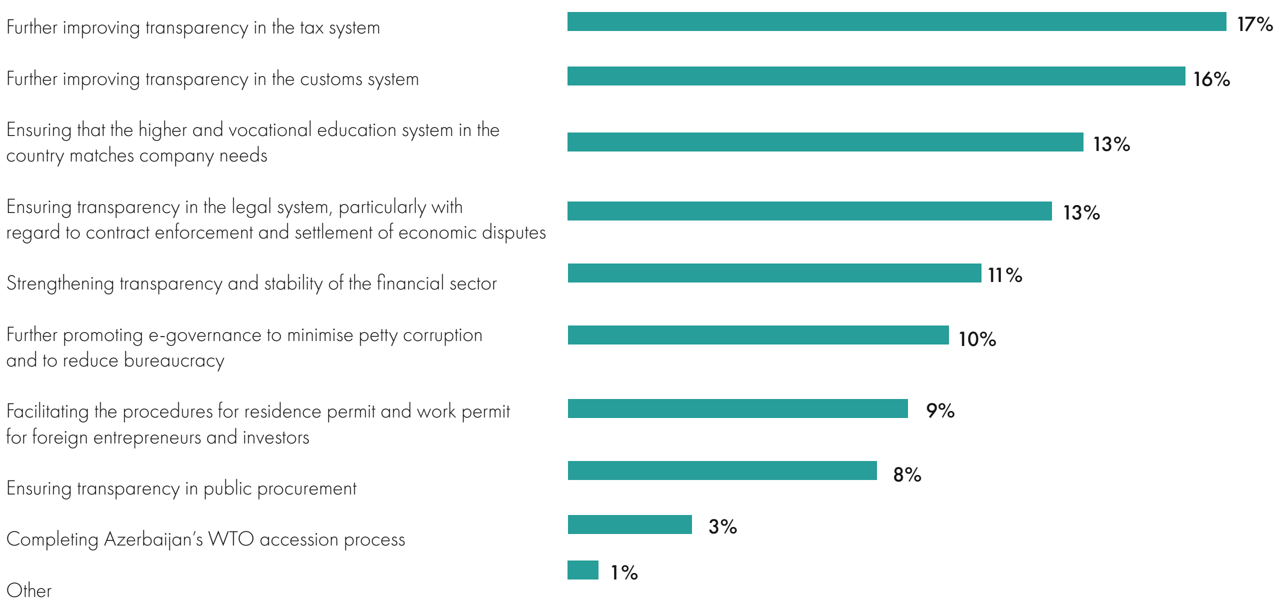
Q7. In 2018 Azerbaijan continued to implement reforms to diversify its economy and to foster business climate in the country, which resulted in improvement of its global rankings. How effective do you think the following reform measures have been in improving the business and investment climate in Azerbaijan?



Answer options	Poor	Average	Good	I am not well informed	Raiting average*	Response count
Establishment of e-government Development Centre under ASAN	1	29	85	15	2.73	130
Further electronisation of the customs services	15	33	64	18	2.44	130
Labour market and Social Protection reforms (e.g. establishment of DOST Agency, introduction of e-social.gov.az internet portal)	9	47	50	24	2.39	130
Amendments to the tax legislation	16	46	59	9	2.36	130
Institutional support for export diversification (e.g. One-stop-shop Export Support Center, Azexport portal)	13	34	42	41	2.33	130
Policies and measures taken by Financial Market Supervisory Authority (FIMSA) to stabilise the financial sector	26	41	29	34	2.03	130
Operation of the Food Safety Agency	23	37	22	48	1.99	130
Measures taken by the Agency for Development of SMEs	20	46	19	45	1.99	130
Measures taken by the State Agency on Vocational Education	28	38	20	44	1.91	130
Functioning of the Mortgage and Credit Guarantee Fund	32	30	18	50	1.83	130
Total						**130**

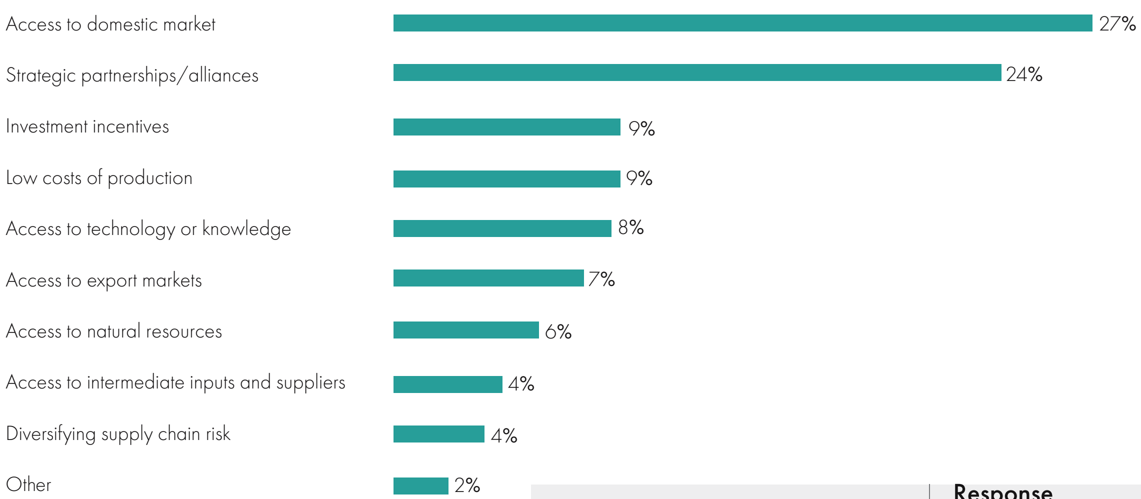
*"*I am not well-informed*" options are excluded while calculating rating averages

Q8. Which of the following reforms do you consider most important to further improve the business and investment climate in Azerbaijan? (Select max. 3 that apply)



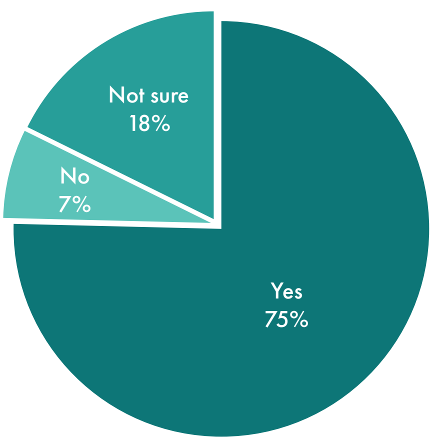
Answer options	Response rate	Response count
Further improving transparency in the tax system	17%	64
Further improving transparency in the customs system	16%	60
Ensuring that the higher and vocational education system in the country matches company needs	13%	50
Ensuring transparency in the legal system, particularly with regard to contract enforcement and settlement of economic disputes	13%	47
Strengthening transparency and stability of the financial sector	11%	40
Further promoting e-governance to minimise petty corruption and to reduce bureaucracy	10%	37
Facilitating the procedures for residence permit and work permit for foreign entrepreneurs and investors	9%	33
Ensuring transparency in public procurement	8%	30
Completing Azerbaijan's WTO accession process	3%	12
Other	1%	3
Total	**100%**	**376**

9. What are the most important factors that drove your company to invest/to do business in Azerbaijan? (Select max. 3 that apply)



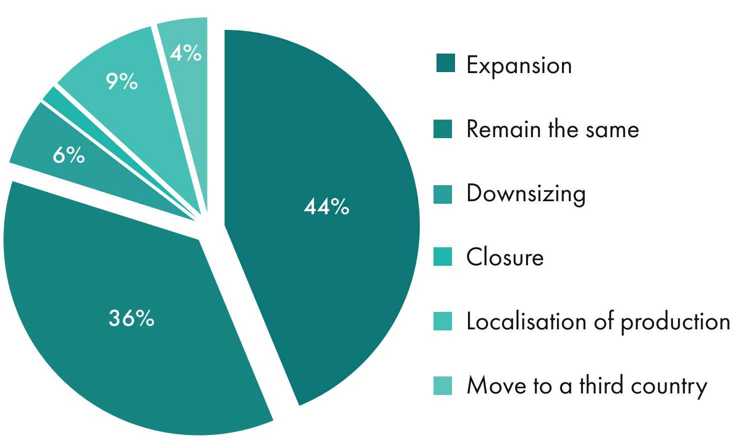
Answer options	Response rate	Response count
Access to domestic market	27%	77
Strategic partnerships/alliances	24%	67
Investment incentives (e.g. tax incentives)	9%	25
Low costs of production	9%	25
Access to technology or knowledge	8%	24
Access to export markets	7%	21
Access to natural resources	6%	16
Access to intermediate inputs and suppliers	4%	12
Diversifying supply chain risk	4%	10
Other	2%	6
	100%	**283**

Q10. Would you again choose Azerbaijan as preferred location for your business?



Answer options	Response rate	Response count
Yes	75%	98
No	7%	9
Not sure	18%	23
Total	**100%**	**130**

Q11. What is the most likely direction of your company's development over the next one to two years in Azerbaijan?

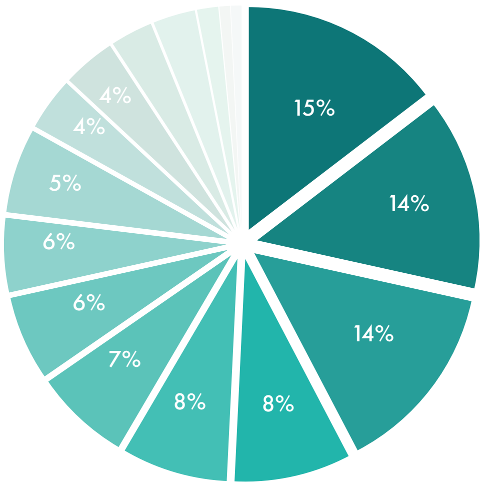


Answer options	Response rate	Response count
Expansion	44%	63
Remain the same	36%	52
Downsizing	6%	8
Closure	1%	2
Localisation of production	9%	13
Move to a third country	4%	6
Total	**100%**	**144**

Q11.1 If you are going to move to a third country, then which country will you choose?

Answer options	Response rate	Response count
Georgia	33%	2
Canada	17%	1
Malta	17%	1
Russia	17%	1
Uzbekistan	17%	1
Total	**100%**	**6**

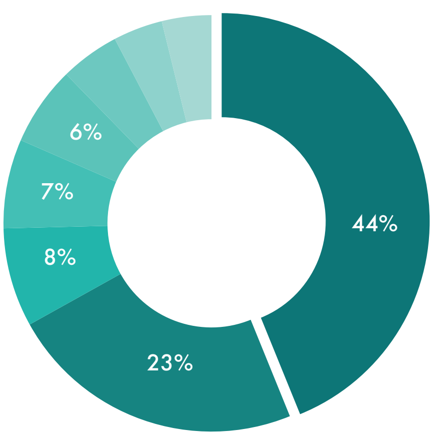
Q12. What is the main area of your operations?



- Wholesale and Retail Trade
- Professional, Scientific and Technical Activities
- Mining, Oil and Gas
- Financial and Insurance Activities
- Transportation and Storage
- Construction
- Electricity, Gas, Steam and Air Conditioning Supply
- Water supply; Sewerage, Waste Management and Remediation Activities
- Information and Communication
- Administrative and Support Service Activities
- Human Health and Social Work Activities
- Education
- Manufacturing
- Accommodation and Food Service Activities
- Agriculture, Forestry and Fishing
- Arts, Entertainment and Recreation

Answer options	Response rate	Response count
Wholesale and Retail Trade	15%	19
Professional, Scientific and Technical Activities	14%	18
Mining, Oil and Gas	14%	18
Financial and Insurance Activities	8%	11
Transportation and Storage	8%	10
Construction	7%	9
Electricity, Gas, Steam and Air Conditioning Supply	6%	8
Water supply; Sewerage, Waste Management and Remediation Activities	6%	8
Information and Communication	5%	7
Administrative and Support Service Activities	4%	5
Human Health and Social Work Activities	4%	5
Education	3%	4
Manufacturing	3%	4
Accommodation and Food Service Activities	2%	2
Agriculture, Forestry and Fishing	1%	1
Arts, Entertainment and Recreation	1%	1
Total	100%	130

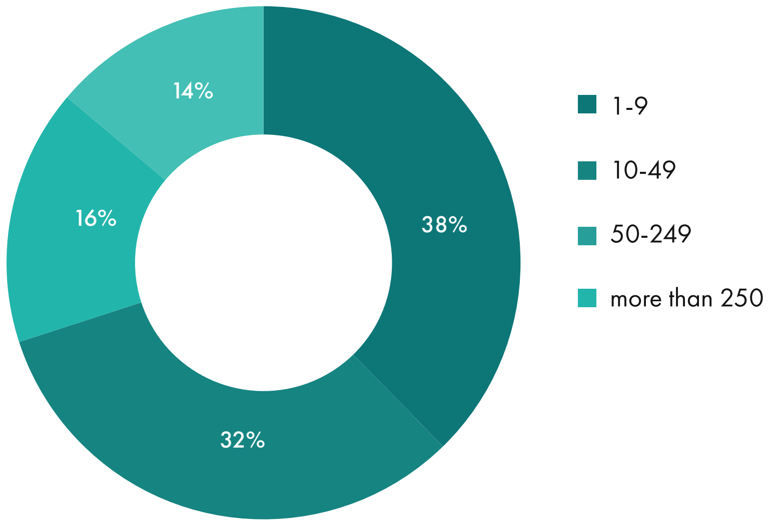
Q13. Please specify your current position within the company?



- Director/CEO
- General Manager
- Deputy Manager
- Employee
- Senior Manager
- Head of department
- Managing Partner
- Owner

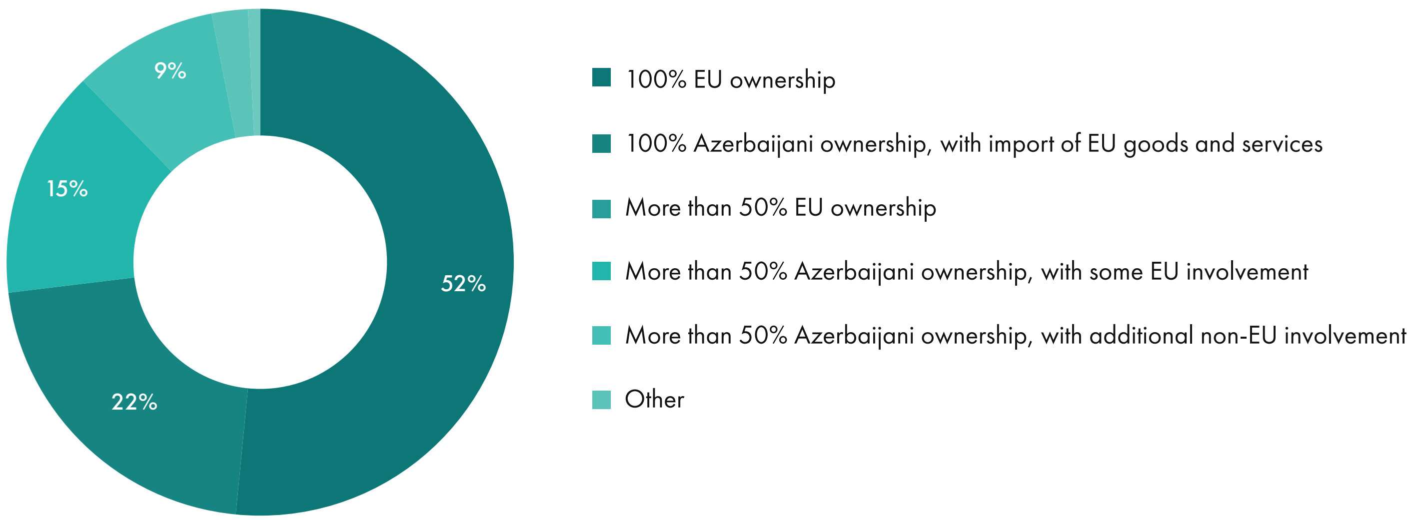
Answer options	Response rate	Response count
Director/CEO	44%	57
General Manager	23%	30
Deputy Manager	8%	10
Employee	7%	9
Senior Manager	6%	8
Head of department	5%	6
Managing Partner	4%	5
Owner	4%	5
Total	**100%**	**130**

Q14. Please specify the number of employees in your company.



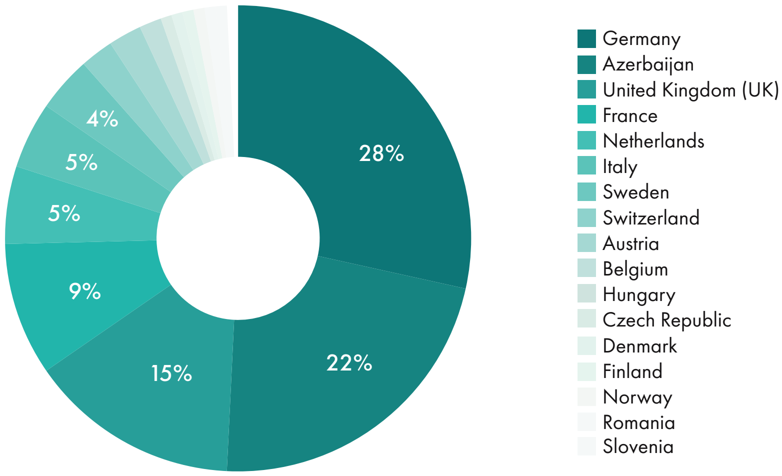
Answer options	Response rate	Response count
1-9	38%	49
10-49	32%	42
50-249	16%	21
more than 250	14%	18
Total	**100%**	**130**

Q15. From the following options, select one which best describes the structure of your company.



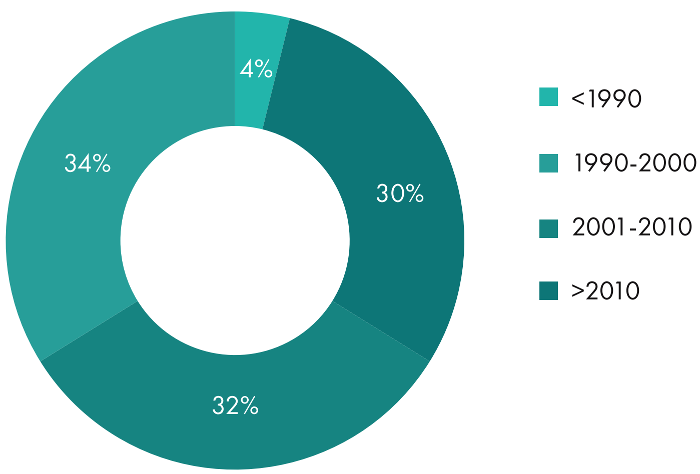
Answer options	Response rate	Response count
100% EU ownership	52%	67
100% Azerbaijani ownership, with import of EU goods and services	22%	28
More than 50% EU ownership	15%	19
More than 50% Azerbaijani ownership, with some EU involvement	9%	12
More than 50% Azerbaijani ownership, with additional non-EU involvement	2%	3
Other	1%	1
Total	**100%**	**130**

Q16. Which country does your company represent?



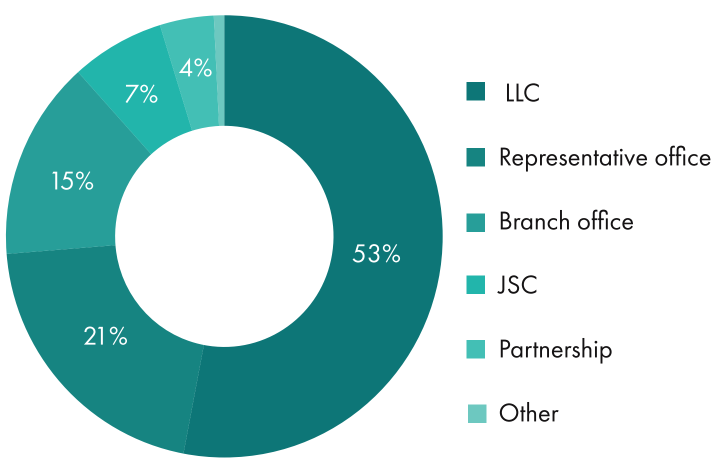
Answer options	Response rate	Response count
Germany	28%	37
Azerbaijan	22%	29
United Kingdom (UK)	15%	19
France	9%	12
Netherlands	5%	7
Italy	5%	6
Sweden	4%	5
Switzerland	2%	3
Austria	2%	3
Belgium	2%	2
Hungary	1%	1
Czech Republic	1%	1
Denmark	1%	1
Finland	1%	1
Norway	1%	1
Romania	1%	1
Slovenia	1%	1
Total	100%	130

Q17. When was your company established in Azerbaijan?



Answer options	Response rate	Response count
<1990	4%	5
1990-2000	30%	39
2001-2010	32%	42
>2010	34%	44
Total	100%	130

Q18. What is the legal set-up of your company in Azerbaijan?



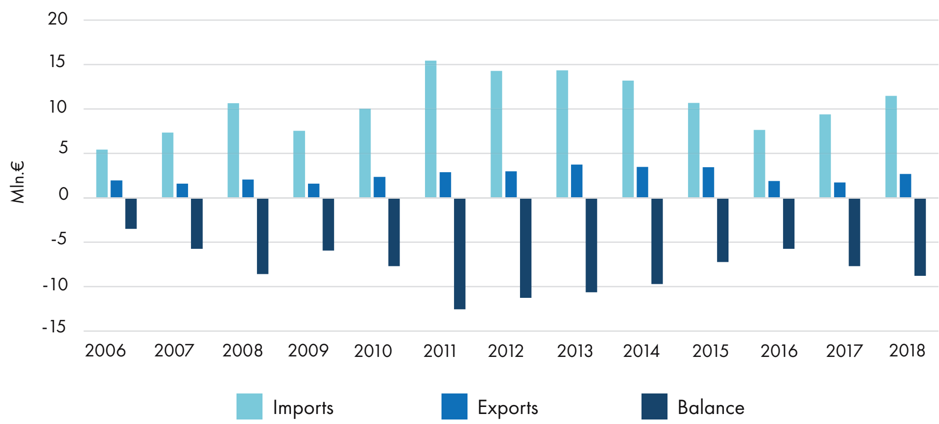
Answer options	Response rate	Response count
Limited liability company (LLC)	53%	69
Representative office	21%	27
Branch office	15%	19
Joint stock company (JSC)	7%	9
Partnership	4%	5
Other	1%	1
Total	100%	130

ANNEXE C: Statistical Information

EU Trade with Azerbaijan

According to the statistics provided by the State Customs Committee of the Republic of Azerbaijan, the foreign trade turnover of the country increased by 27% in 2018, compared to 2017. It is further reflected in the 29% and 23% upturn in exports and imports respectively. The EU countries still remain Azerbaijan's key trade partner accounting for 54.4% of total exports and 20.3% of total imports of the country. The statistical data suggests 30% and 17% increase in the export and import operations by EU countries in 2018, compared to the previous year. The Asian Development Bank forecasts exports to dwindle by 7.5% in 2019 due to lower average oil prices despite higher gas exports and to increase by 1.0% in 2020 given increases in gas production at the Shah Deniz 2 field. Imports, on the other hand, are expected to decline by 19.9% in 2019 owing to increased customs duties on machinery and cars and recover by 11.1% in 2020 to meet rising domestic demand as the impact of these tariffs wanes.

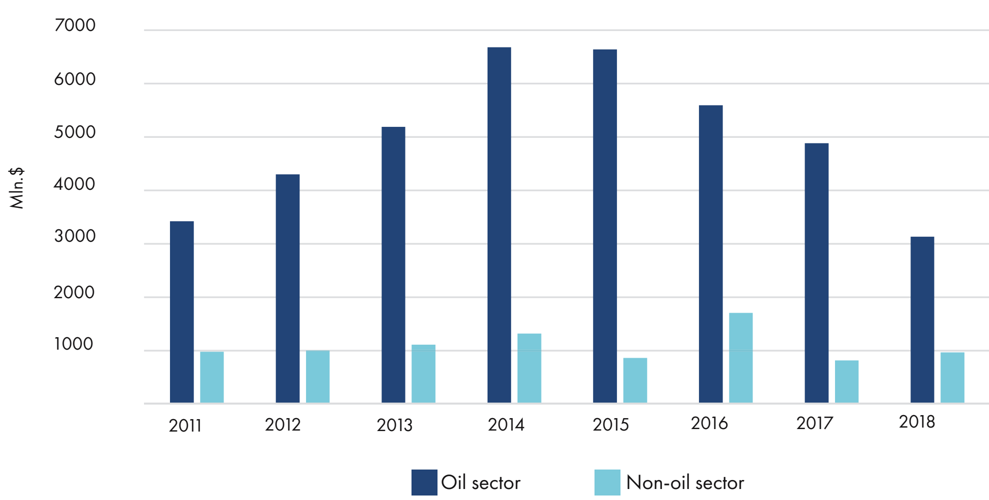
Total goods: EU trade flows and balance, annual data 2006-2018



Source: European Union, Trade with Azerbaijan, https://webgate.ec.europa.eu/isdb_results/factsheets/country/details_azerbaijan_en.pdf

Foreign Direct Investments to the Azerbaijani economy

FDI in million USD, 2011-2018



Source: CBAR, Balance of payments 2018

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About AHK Azerbaijan

The German-Azerbaijani Chamber of Commerce (AHK Azerbaijan), based in Baku, is part of the worldwide AHK network promoting German foreign trade. The AHK Azerbaijan supports companies with business services such as market research, market entry and business partner search. It represents the interests of the German economy and its partners towards politics, administration and the public. The AHK Azerbaijan was founded in 2012 and with 130 members as of May 2019 is the strongest European business association in the country.

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