

EU BUSINESS CLIMATE REPORT AZERBAIJAN 2018

Perceptions of EU Businesses active in Azerbaijan



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EU Business Climate Report Azerbaijan 2018

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Forewords



Setting the stage to enhance Azerbaijan's business environment

I welcome and strongly support the 2018 edition of the EU Business Climate Report on Azerbaijan. This annual publication has become a key document for an understanding of opportunities and challenges for EU companies doing business in Azerbaijan. It has worked in the past as a catalyst for debate and a vehicle to convey concerns and recommendations for change from the EU business community to the authorities of Azerbaijan and I am confident this year's edition will be no different.

The publication is highly relevant to the continuous work we, the EU and EU Member States, engage in - in constant dialogue with the government of Azerbaijan, EU companies and business associations in the country - to attract more EU businesses to Azerbaijan. There are currently 20 EU Member States with a business presence in Azerbaijan: about 385 EU companies that are represented in part by a number of bilateral business associations. The survey report comprises the voices of a large and representative number of these companies and their in-depth comments are certainly a guide to a better understanding of what can be done to further increase EU business presence in the country.

While the first two EU Business Climate Reports, in 2016 and 2017, were launched during years of recession - witnessing the ambitious implementation of structural reforms in a drive towards economic diversification - this current edition arrives against the more favourable backdrop of a stabilising economy and a more optimistic

economic outlook. It is also launched in the context of the recently renewed and intensified engagement between the EU and Azerbaijan as evidenced, for example, by the ongoing negotiations on a new, comprehensive agreement that will modernise and revitalise the EU-Azerbaijan partnership in many areas, including trade and economic relations. Last November's Eastern Partnership Summit gave further positive impetus to our relations in setting out a number of business-related actions.

The EU, Azerbaijan's key economic partner and source of a major share of Azerbaijan's foreign investments (in both the oil- and non-oil sectors) and trade, stands side by side with Azerbaijan in this endeavour. The collective findings, collated by the German-Azerbaijani Chamber of Commerce in this new edition of the EU Business Climate Report, will be invaluable in indicating constructively where positive steps may be taken in the clearly improving, yet - as the report shows - often still challenging business and investment environment in Azerbaijan.

A handwritten signature in black ink, consisting of a stylized 'K.' followed by a cursive name.

Kestutis Jankauskas

Ambassador - Head of Delegation
Delegation of the European Union to Azerbaijan



Increased business confidence – Time to seize the opportunity

This is already the 3rd successive presentation of the EU Business Climate Report Azerbaijan, the result of reliable and fruitful cooperation between the German-Azerbaijani Chamber of Commerce and the Delegation of the European Union to Azerbaijan. Since the first survey was issued in 2016, we have seen increased attention and have received positive feedback from various sources: the government of Azerbaijan and diplomatic missions, as well as local and international business communities. Another sign of stronger interest in the study this year is the number of respondents. Compared with last year 31% more companies participated in this year's survey.

The government of Azerbaijan has implemented substantial measures of reform over the last three years to address shortfalls and vulnerabilities in the market. One major finding of this survey is that the reforms are assessed positively by EU businesses. We can state that there is a notable upward trend in evaluations of the current economic situation, allowing some optimism about the prospects for development in the Azerbaijani economy this year. This is also supported by a rise in investor confidence. However, the EU companies' current moderate optimism is no reason to relax. It should rather encourage the government to continue the implementation of reforms. According to EU businesses, the government should pursue further determined and consistent action plans to tackle structural problems and the challenges that remain.

The data presented in this report reveal current shortcomings and the extent of impediments to doing business in Azerbaijan. In addition, the data also help to identify the sources of these obstacles and thus may support the government in its further development of an improved regulatory framework. Therefore, we hope that the results of our study will contribute to the identification of the potential for improvement in the country's market. AHK Azerbaijan intends to proceed in creating a vision for policy direction that supports a reform-oriented agenda and provides a brighter future for EU businesses active in Azerbaijan.

I extend my gratitude to the EU Delegation to Azerbaijan for funding this project and for its productive cooperation. On behalf of AHK Azerbaijan, I would also like to acknowledge and express our appreciation to the EU businesses for taking part in the survey and sharing their valuable insights with us in the interviews and focus group discussions.

A handwritten signature in black ink, appearing to read 'T. Baumann', written in a cursive style.

Tobias Baumann

Executive Director
The German-Azerbaijani Chamber of Commerce



Introduction

The EU Business Climate Report is shaped by the findings of an annual business climate survey that reflects the perceptions of EU companies doing business in Azerbaijan of the current economic situation and the business and investment climate in the country. This year's survey was conducted (in February-March 2018) for the third 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 report not only draws insights into the current economic conditions and business and investment climate in Azerbaijan, but also sheds light on the expectations for short-term growth of EU companies active in the country, focusing on the challenges they face and the opportunities available. The study sets a benchmark for economic trends that describe the pattern of changes in key business factors and areas of the economy since 2016, the year of the first business climate survey. The consolidated views of EU companies determine a way forward in evaluating the current situation, defining the major hurdles faced in doing business in the country, and highlighting suggestions to tackle them.

131 online responses

The survey incorporated 20 questions in total, as in previous years, focusing on the current economic situation in Azerbaijan, the impact of Azerbaijan's business environment on individual companies and company demographics. This year 3 new questions were introduced to evaluate factors discouraging companies from sourcing from local suppliers and the forces driving investment / doing business in Azerbaijan, as well as to reveal the proportion of company input that is imported. Most of the key questions, however, remained the same, to facilitate a set of comparative data over time. Comparisons of the survey's results with those of previous years and cross-tabulation analyses have been conducted to examine possible correlations between the data.

After data quality assurance, 131 completed responses, 31% more than in the previous year's survey, were considered to represent a valid and statistically significant sample for assessing the business confidence of EU companies operating in and cooperating with Azerbaijan.

17 in-person interviews

In addition to the completed questionnaire, in-person interviews and focus group discussions were conducted with CEOs and other senior representatives of 17 EU companies, representing 9 main sectors of the economy, in order to enhance the quantitative data collected with qualitative information. We express our appreciation to the company representatives who engaged in the face-to-face interviews and focus group discussions, adding value to this report with their vast experience and significant commentaries.

16 represented sectors


The respondents represent a comprehensive spectrum of 16 industries, the top 5 sectors being: Professional, Scientific and Technical Activities; Mining, Oil and Gas; Wholesale and Retail Trade; Transportation and Storage; and Construction. The companies surveyed have headquarters in 22 countries: 23% representing Germany, while 20% and 11% respectively are Azerbaijani companies involved in the import of EU goods and services, and UK companies operating in Azerbaijan. The companies also vary in size, i.e. 38% and 50% respectively represent "micro-enterprises" (with up to 9 employees) and SMEs (with fewer than 250 staff), while 12% are "large enterprises" (with a headcount exceeding 250). It is worth mentioning that the majority of respondents are Directors/CEOs (47%) and General Managers (23%). The annexe provides more detailed information on survey methodology and presents aggregated information on the responses.

Key Survey Findings

Economic Reforms

TOP 3 SUGGESTED REFORMS

 Tax system **20%**

 Customs system **17%**

 Legal system **12%**

 Education system **12%**

82%

of EU companies
acclaim the effectiveness
of ASAN e-visa portal

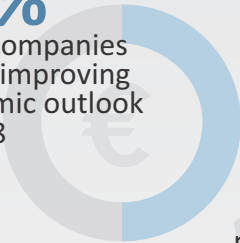


31%

of EU businesses regard
the policies by FIMSA as
ineffective

50%

of EU companies
report improving
economic outlook
in 2018



53%

plan to expand their
business activities
in the country



Macroeconomy & Company



48%

expect revenues
to increase



36%

plan to
increase capital
expenditure



35%

consider a staff
expansion

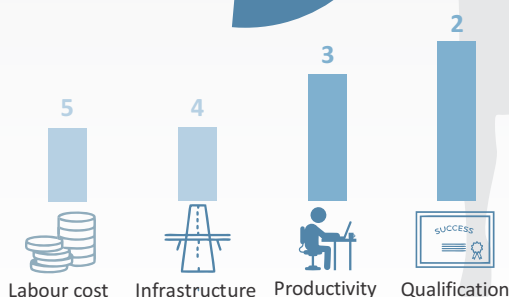
Business Climate Indicators

TOP 5 BUSINESS CLIMATE INDICATORS



Political
stability

51%



TOP 5 BUSINESS THREATS

Uncertain market
development

74%



Chapter 1

Economic Reforms as Perceived by EU businesses: Room for Policy Improvements

Azerbaijan's economy was hit hard following the sharp drop in global oil prices witnessed since 2015. The country entered a recession in 2016 and had quasi-zero growth in 2017, while its financial sector came under substantial stress in adjusting to two rounds of devaluation. The difficult economic situation has, however, created a renewed momentum for the country's agenda of structural reforms and economic diversification. Azerbaijan adopted ambitious Strategic Roadmaps in December 2016, defining short-term (2020), medium-term (2025) and long-term agendas to diversify its economy and improve non-oil competitiveness and exports. The roadmaps target certain key sectors such as agriculture, industry and tourism, as well as strengthening cross-sectoral issues such as SME development, logistics and trade networks and modernisation of the country's vocational and education training (VET) system.

Central to the Strategic Roadmaps is an increased understanding that the key to developing a path towards sustainable economic growth is economic diversification; changing the country's economic model to new sources of non-oil, private sector-led growth. EU businesses - responsible for the lion's share of Azerbaijan's foreign investment (both in the oil and non-oil sectors), as well as being Azerbaijan's largest group of trade partners - can play an important role in this economic transformation.

Against the backdrop of a clearly stabilising economy, the *"sense of urgency"* for undertaking structural reforms outlined in the Strategic Roadmaps may be fading. Is Azerbaijan showing signs of *"reform fatigue"* or is the country pressing forward boldly with structural reforms? The key reform indicators from the World Bank and the World Economic Forum suggest on the one hand that modest recent progress in improving the business climate has been achieved but, on the other hand, that several key reforms are still required to enhance the country's attractiveness and competitiveness as an investment destination.



ASAN remains a key reformer, while the moratorium on inspections continues to be well received

The survey findings, further underpinned by interviews and focus group meetings with selected EU businesses, largely corroborate the glass half full / half empty findings of the World Bank and the World Economic Reform reports.* Some progress has been made in carrying out important business climate reforms; notably the ASAN e-visa and the prolonged moratorium on business inspections are regarded as highly positive by EU businesses. However, the reform agenda remains long, requiring time and sustained, coordinated effort to achieve desirable results and hence to be truly experienced as a genuine improvement on the ground by EU business executives.

For example, the first important steps taken to address the environment for SMEs were the recent creation of the SME Agency (in December 2017) and establishment of the Food Safety Agency (in February 2017) that can play a key role in enhancing the country's competitiveness in exporting food products. While these are new initiatives that should be given time to deliver results, the EU business perception of customs is becoming somewhat grey. Following the encouraging reforms implemented in 2016 to introduce e-declaration, some concerns are cropping up among EU businesses as to whether momentum for the reform of customs is waning. Thus customs, together with tax reforms, appear as the most pressing requirements for reform in this year's survey. The third EU business priority for reform - addressing the rule of law and establishing legal certainty - also features prominently as a concern.

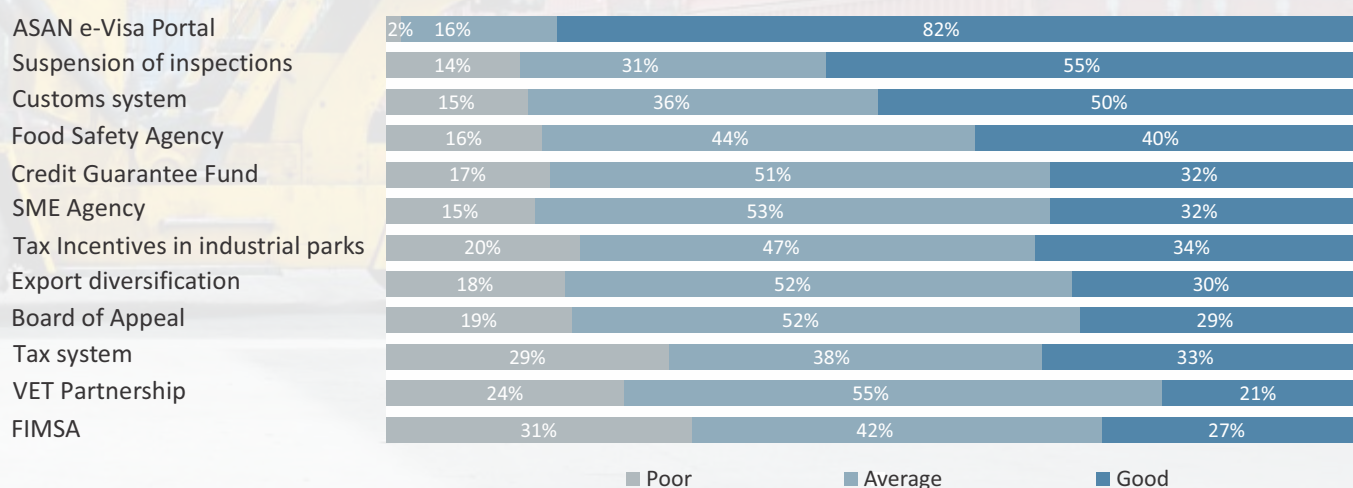
EU businesses continue to perceive ASAN (the State Agency for Public Service and Social Innovations) as the

reform implemented most effectively by the government to date. Although last year's survey was conducted very soon after its launch in January 2017, still 77% of EU businesses lauded the introduction of the ASAN e-visa portal. The e-visa system is valid for all EU nationalities and allows EU citizens and businesses to obtain a visa within 3 days after application, without having to physically apply at an Azerbaijani embassy. As ASAN has further facilitated its e-visa procedure over the year by introducing a visa issuance and payment service to foreigners at the country's airport (as of 31 January 2018), as well as an urgent visa that can be obtained in three hours (as of 30 August 2017), it is no surprise that even more EU companies (82%) acclaim its effectiveness this year.

Given the success of the ASAN e-visa system and the provision of an increasing number of business licences through ASAN services, much valued by EU businesses in last year's survey (67% of EU businesses assessed it as effective), as of 1 February 2018 the process of issuing permits was expanded to include the energy sector. Following the recent decree (14 March 2018) mandating ASAN to ensure the implementation and regulation of state policy on e-government, its centres are expected to expand their range of activities by rendering more tax and customs services in 2018.

Following the presidential decree dated 1 November 2015, business activity inspections were suspended until 30 October 2017. The moratorium has had a significant effect on the number of inspections carried out in Azerbaijan. Only 127 inspections (excluding tax inspections) of

Figure 1: The effectiveness of the structural reforms in Azerbaijan



*Refer to annexe C for more detailed results of the reports.

business entities were conducted over this two-year period¹, compared to 60,000 in 2015.² In view of the further positive assessment by EU businesses voiced in last year's business climate survey, the moratorium on business inspections was extended until 2021.

Reduced enthusiasm among EU businesses regarding measures to simplify the customs system

Efforts by the government to modernise the chronically non-transparent and bureaucratic customs system were very much welcomed by EU companies in last year's survey. Appreciable progress has been made in the implementation of e-declarations for customs clearance and improvements to the Customs Code, as well as in reforms that simplified and streamlined customs procedures to a certain extent. This year, exactly half of respondents express their content with the simplification of the customs system.

Nevertheless, the survey results, as well as interviews and focus group discussions, suggest that amid increasing expectations of reform placed on the customs authorities, the year 2017 has largely gone by without significant changes to address still existing imperfections. Progress has been slower in the integration of new technologies and procedures to shift from traditional physical inspections and towards paperless operations. Also in this context, the intention to channel certain customs services through the ASAN pay portal, initially planned for 2017, is still pending.



Interviews and Focus Group discussions

Setbacks in the implementation of the customs reforms dampen the confidence of businesses in positive change. Hence the customs authorities are expected to maintain their commitment to reforms.

Thus when asked what reforms they considered most important to further improve the business and investment climate in Azerbaijan, EU businesses mentioned reforms in the customs system as the second priority to be achieved by the government, immediately after improvements to the tax system (see more on this below).

Discussions underscore the importance of further modernisation of management policies and control systems to better counter smuggling and cases of corruption. Along with the modernisation of procedures, the EU businesses' feedback also calls for increased training and professional development programmes for customs administrators to help improve cooperation between companies and officials.

EU businesses strongly concur with this prolongation of the moratorium. In this year's survey, the proportion of EU companies marking the moratorium as effective increased to 55%, from 49% in 2017.

It is also worth mentioning that this year's survey marks improvement in the effectiveness of the e-governance system. To elucidate, while last year e-governance was the 2nd priority (26%) for EU businesses of the reforms necessary to further improve the business and investment climate in the country, the figure this year is 11%. This suggests that the measures to minimise petty corruption and reduce bureaucracy through the e-governance system and ASAN, have started to yield good results.

TOP 5 SUGGESTED REFORMS



20%

Further improving transparency in the tax system



17%

Further improving transparency in the customs system



12%

Ensuring transparency in the legal system



12%

Ensuring that the higher and vocational education systems match company needs



11%

Further promoting e-governance to minimise petty corruption and to reduce bureaucracy

Recent institutional reforms are encouraging but need time to deliver on-the-ground results

In compliance with the relevant action plans underlined in the Strategic Roadmaps, the SME Agency and the Credit Guarantee Fund (in September 2017) were established to assist the sustainable development of SMEs and to expand their access to financial resources. One of the most frequently cited obstacles impeding the development of SMEs in Azerbaijan was the difficulty in finding the necessary funding. Both the Agency and the Fund are expected to increase financial inclusiveness, improve the financial services available to entrepreneurs and ensure better access to information. EU businesses assess these recent reform measures as moderately effective.



Senior Manager from the Professional Activities sector

Although the psychological effect of the recent reforms creates confidence, weaker than expected implementation of measures announced, delays their effectiveness.

Given the continuing technical and organisational work, and the envisaged establishment of further units operating under the SME Agency (e.g. SME House) in 2018, the companies surveyed believe that the true effectiveness of these frameworks can only be fully assessed over a period of time. The respondents express slightly more enthusiasm about the newly created Food Safety Agency (established in January 2018) with 40% deeming it already effective. Following international practice, the Agency will provide services that are currently offered by a number of state structures, from one centre and is expected to provide further result-oriented reforms to stimulate the agricultural sector and its orientation towards export.

Although the country's non-oil exports grew by 24% in 2017, only 30% of EU businesses assess the institutional support for export diversification (i.e. the Azexport portal and Export Support Centre) as effective, with another 52% rating it average. Further measures are underway to digitalise more services, and are expected to expedite export procedures for entrepreneurs. While welcoming the progress made with export-oriented measures, EU companies also believe that coordination between the relevant supervisory bodies remains insufficient. They underline the need for more accurate information sharing, as well as more coherent and consistent coordination of actions within a single framework of export diversification.



52% of EU companies assess institutional support provided for export diversification as **average**

Another broad-based framework introduced by the government in support of local producers and non-oil exports is the creation of industrial, high-tech and agro-parks. As of January 2018, five industrial parks, two high-tech parks and two agro-parks with special tax and customs privileges and simplified administrative procedures, have been established. 47% of EU businesses assess this initiative as average. The discussions, moreover, suggest that creating a competitive advantage in attracting investment from the EU business community requires a broader range of opportunities and more flexible criteria for residence permits.

The credibility of the tax authorities is expected to increase in the light of recent changes, while the legal system remains a concern

Since the publication of the first EU Business Climate Report in 2016, the tax system has been consistently reported as the main obstacle for EU companies considering investment in the country. Despite some effective measures and improved electronisation of tax services under the previous management, non-transparent and arbitrary tax collection, as well as increased tax burdens, as perceived by EU businesses continued to

impede the development of the private sector. However, following the structural and senior management changes within the taxation authorities implemented since December 2017, EU businesses are remarkably optimistic about impending tax reforms and expect 2018 to be a year of genuine reform and greater transparency. They accordingly place it at the top of the government agenda.



EU businesses are remarkably optimistic about impending **tax reforms** and expect 2018 to be a year of genuine reform and greater transparency

Recent communications from the newly appointed Tax Minister suggest that extensive work is underway to modernise and simplify tax legislation based on dialogue with the private sector that has been encouraged to make concrete proposals for amendments to the Tax Code, to establish a more dynamic tax administration and to ensure transparency in tax inspections. Reforming the incentive structure within the tax administration and achieving trust in relations between the private sector and tax authorities are obviously challenging tasks that will require solid strategic planning and strong political commitment.

This year, even more EU companies emphasise the importance of a transparent and fair legal and judicial

system in attracting foreign investment to the country, and place it as the next priority to be addressed, after the tax and customs systems. In this context, EU companies perceive an often biased, non-transparent and lengthy legal framework as one of the main risks jeopardising the implementation of necessary structural reforms, thus dampening investor confidence.

The government has been taking steps to address business confidence in the country's rule of law, as witnessed, for instance, in the establishment of the Board of Appeal under the President of Azerbaijan in February 2016. This state body works like a "business ombudsman", to some extent allowing companies believing themselves to be mistreated by the country's administration to address their concerns to the Board before (or instead of) seeking legal redress. However, only 29% of EU businesses deem the Board of Appeal to be an effective resource, outside the legal system, for the protection of the rights and legitimate interests of the business community.

Prospects for the financial sector remain bleak, while the education system requires serious reforms

One of the key concerns in last year's survey, as perceived by EU businesses, was the vulnerability of the country's financial sector, obstructing its natural role as a catalyst for private sector-led growth. Credit to the economy has declined by half since 2014 in nominal terms, in real terms by two thirds.³

Since 2015-16, progress has undoubtedly been achieved in cleaning up the banking system, with the closure and merger of, respectively, 11 and 2 banks, as well as the financial restructuring of the International Bank of Azerbaijan (IBA). This process removed much of IBA's external debt and transferred it to the government. Debt maturities were extended, interest rates lowered and IBA bondholders forced to take a "haircut" of 20% in terms of net current value.⁴ At the same time, the government absorbed the IBA's non-performing loans, placing them in Aqrarkredit, the non-banking, state-owned credit organisation.

The restructuring of the IBA did much to stabilise the banking sector, while the exchange rate peg to the USD may also have helped. Due to capital injections, provisions and higher profits, the capital to asset ratio reached 9% in the first quarter of 2017, up from 6% in 2016, but still

below the pre-crisis level of 15%.⁵ Although dollarisation remained high, with 66.5% of bank deposits in 2017 held in foreign currency, that was still down from a high of 80% in 2016.⁶ Another positive sign was that while the sector as a whole produced losses in 2016, the banking sector ended the past year in profit.

However, while the banks' general health has improved to some extent, results are uneven and some structural weaknesses remain. For instance, although the sector as a whole is making profits, 11 of 30 banks still reported losses in 2017. Azerbaijan remains hampered by a large stock of non-performing loans (NPL-23.7% of total loans in June 2017).⁷ Overdue loans continued to increase in number throughout 2017. A further weakness is the banking system's persistent exposure to exchange rate fluctuations.

This, as well as the loss of FIMSA's (Financial Market Supervisory Authority) independence, may explain why 31% of EU businesses (up from 26% in 2017) continue to regard the policies and measures taken by FIMSA as ineffective.*

*In June 2017 FIMSA's charter was amended to restrict its operational independence, with bank closures now requiring the consent of higher authorities.



31% of EU businesses continue to regard the policies taken by FIMSA as **ineffective**

Indeed, the crisis at the IBA has left deep scars in Azerbaijan's banking sector. Further sustainable and results-oriented measures are necessary, in the opinion of EU companies, to reduce the banking sector's vulnerability to external shocks, to diversify the portfolios held by banks and to address the obstacles impeding access to finance. Following the stabilisation of the local currency and rising business confidence in 2017, further support should come from the reforms anticipated in 2018 to curb the double-digit rate of inflation, to switch to risk-based supervision, and to improve information flow within the sector.



CEO from the Financial sector

Long-term measures should be communicated to all stakeholders, and joint action plans should be prepared with respect to regulation of the financial sector.

However, the modest stabilisation described above is evidenced by the fact that compared with last year, when EU companies noted financial sector vulnerability as a top priority for reform, this year saw stabilisation and transparency in the financial sector further down the list, following reforms to improve the tax and customs systems and measures to tackle skills mismatch.

Turning to the latter issue, with an increasing demand for a highly trained workforce, the availability of skilled people to meet the requirements of a rapidly-changing labour market is becoming a decisive condition for sustainable economic development. For the third consecutive year, EU businesses clearly underscore that further improvements to the higher and vocational education systems in Azerbaijan are essential prerequisites for attracting (and retaining) foreign investment. To this end the EU, together with other international donors, has been supporting the government's efforts to strengthen the VET system so that it can contribute to the development and diversification of the economy - as outlined in the Strategic Roadmap for VET development. Here, although modest progress was noted since the previous survey, EU companies believe that there is still the potential to enhance cooperation between VET schools and companies. In the same area, there is a stronger focus on the issuing of residence permits in this year's survey and this warrants further investigation into causes and possible solutions.



EU businesses underscore that further improvements to the **higher and vocational education** systems in Azerbaijan are essential prerequisites for attracting foreign investment



Chapter 2

The Macroeconomic and Sectoral Contexts: EU Business Perspectives

Following the sharp decline (3.1%) in the Azerbaijani economy in 2016, the year 2017 recorded slight growth (0.1%) as the adverse effects of the earlier collapse of oil prices and exchange rate vulnerability began to recede. The subsequent decline in industry (4.2%) in 2017, reflecting the diminishing oil sector (5%), was offset by advances in agriculture (4.2%) and services (3.5%). Following a sharp (27.6%) plunge in 2016, stagnation in the construction sector decelerated to 1.5% in 2017, mainly due to work on the Shah Deniz gas field and the Southern Gas Corridor pipeline, as well as to state capital expenditure in the agriculture and education sectors.⁸

In line with a modest rebound in the price of oil and an upbeat regional (and global) economic outlook, Azerbaijan's GDP is expected to grow by 2% in 2018 and to pick up to around 4% in the medium term, driven essentially by the non-oil sector, which is projected to grow by 4% in 2018.⁹

In 2018, the increase in non-oil economic growth is mainly driven by construction. This sector has suffered in the last few years due to tight fiscal policies and has recorded negative growth rates since 2015. However, with the government plans to increase public investment by 40% in 2018, the Ministry of Economy expects the construction sector to expand by 15% in 2018.

Despite the stabilisation of the economy (with single-digit inflation also expected for 2018) and a more positive economic outlook, the legacies of the 2015-2016 recession, particularly vulnerabilities in the banking sector, still await government attention.

Figure 2: Average exchange rate and crude oil price
Sources: CBAR; EIA (accessed 17 April 2018)

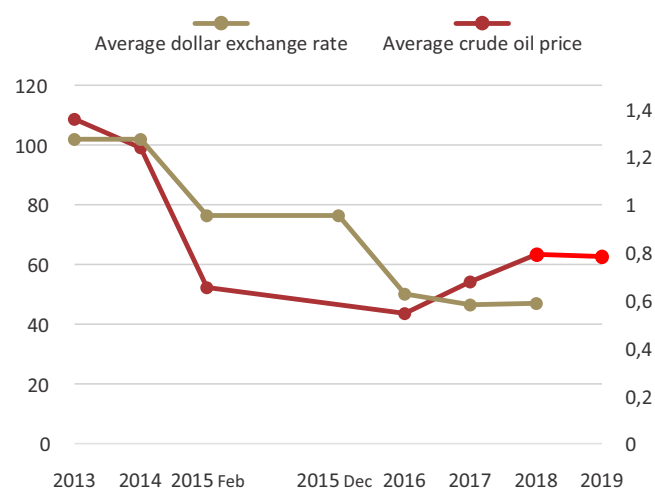
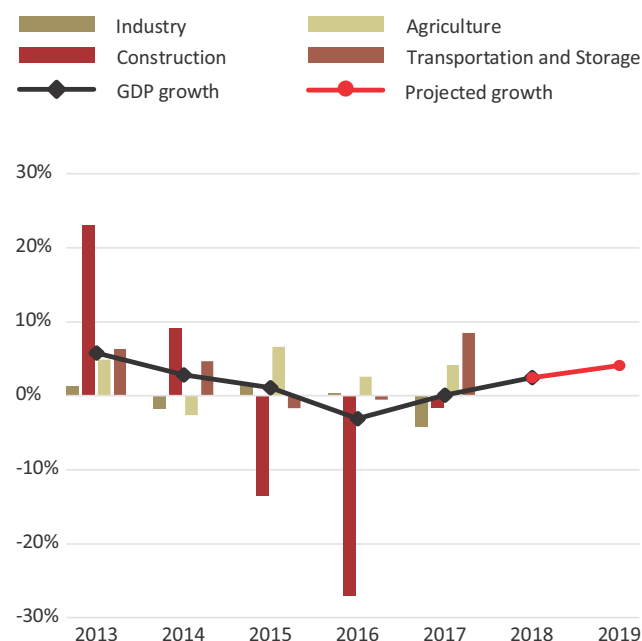


Figure 3: GDP growth by sector
Source: State Statistical Committee of the Republic of Azerbaijan; IMF (accessed 17 April 2018)



Cautious optimism from EU businesses: real recovery or a short-term blip?

Spurred by firming oil prices and the modest economic upswing reported above, the EU companies' perception of the national economy has improved considerably since the previous two surveys. This year, 51% of respondents deem the current economic situation to be satisfactory, up from a low 28% and 17% respectively in 2017 and 2016. EU business optimism was highest for the economic outlook this year, as exactly 50% of respondents expect the overall economic perspective to strengthen; only 11% anticipate a deterioration in 2018.

Figure 4: Assessment of the current situation

Weak Satisfactory Strong

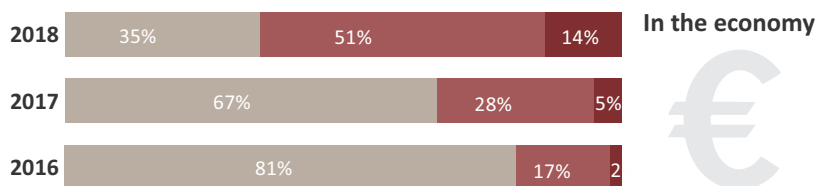
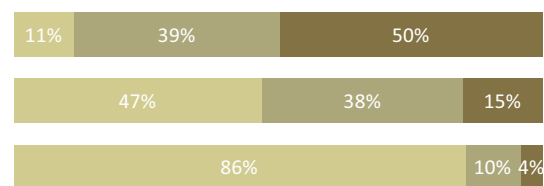
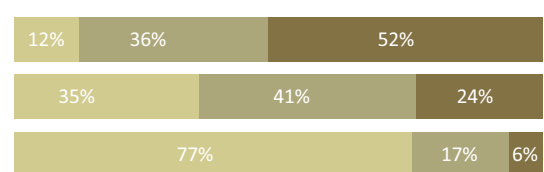
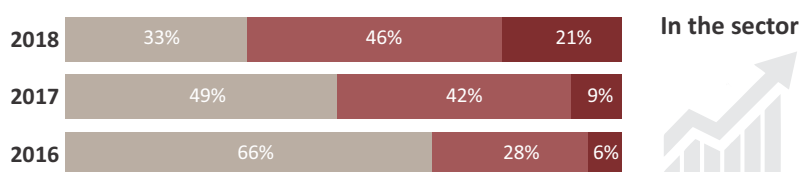


Figure 5: Evaluation of prospects

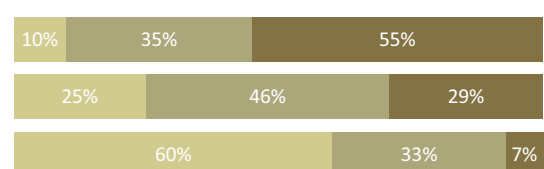
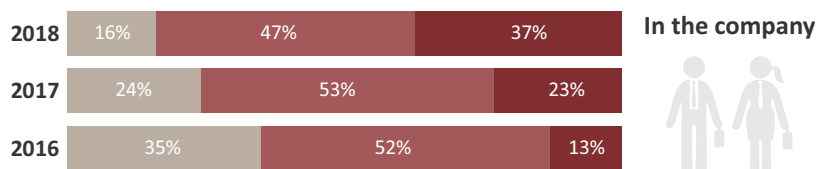
Worse Stable Better



Similar to the previous surveys, EU companies' optimism is even more buoyant in regard to their own sectors and organisations. For example, 46% of EU businesses believe that the current situation in their respective sectors is satisfactory, while 21% (up from a low of 9% in 2017) think that it is strong. With respect to their own company's performance, 47% of EU businesses remain satisfied, while 37% (up from only 23% in 2017) say they are confident.



As many as 52% of the EU businesses surveyed expect their sector to perform better in 2018, a substantial rise from 24% in 2017 and only 6% in 2016. This jump in positivity translates into a corresponding climb in respondents' optimism about their own business prospects. 55% of EU businesses expect their companies to perform better, while a mere 10% remain pessimistic.



Nevertheless, the encouraging assessments of the current situation and future prospects do not indicate that the earlier storms have been successfully weathered or that recovery is permanent. Looking more closely at this year's findings, while increasingly optimistic in their outlook, EU companies remain adamant about the need for a series of reforms to improve the country's business environment. While the first steps towards these reforms have been taken, the key messages of this year's survey are: avoid complacency now and push through the reforms necessary for the country to diversify its economy and become a sustainably more attractive investment destination.

To further reinforce this message, it should be noted that one of the reasons for the remarkable optimism witnessed from EU companies compared with previous years may well relate to the fact that the first surveys were conducted right in the middle of economic turbulence that exposed the country's vulnerability to oil price shocks and led to a twofold depreciation of the

national currency, escalated inflation and a damaged financial sector. Two years on, when businesses appear to have become adept at coping with uncertainties and adjusting to changing configurations, many more companies believe that this cyclical momentum will

continue to drive growth in the country. Therefore, the government should seize this opportunity to sustain recovery through more comprehensive and broad-based policy measures.

EU Perception across Sectors

Interestingly, encouraging signs of optimism among EU businesses for economic growth this year are reflected in their perceptions of the current situation as well as near-term prospects across sectors. This represents a remarkable improvement compared to 2017, when hardly any sector reported a strong current position or positive outlook for their respective industries. However, the financial sector is clearly an outlier here, where the mood among EU businesses remains subdued.

Indeed, the survey results suggest that Financial and Insurance Activities is the least confident sector in 2018, with 6 out of 8 EU businesses working in this sector assessing it as weak; roughly similar to perceptions in this sector in last year's survey (in 2017, 6 out of 9 respondents from this sector assessed it as weak).

The comparatively weak performance of the financial sector, as perceived by EU companies, is followed by the ICT sector (3 out of 7 consider its performance as weak); a substantial change from last year's survey when still 6 out

of 9 EU companies working in the ICT sector noted a satisfactory situation. The interviews and focus group discussions suggest that as international companies, particularly in the high-skill technology sector, may be able to offer better salaries and new opportunities, the result may be a brain drain from the country. This may put Azerbaijan at risk of losing out in this domain, unless remedial measures are undertaken.

On the other hand, compared with 2017, EU business optimism has increased notably in the Professional, Scientific and Technical Activities, and Construction sectors. In the light of the reviving construction projects and higher infrastructure spending this year, 6 out of the 10 construction companies surveyed report satisfactory and/or strong performance, while as many as 9 out of 13 EU companies assessed it as weak last year. Similarly, 14 out of 22 EU businesses engaged in Professional, Scientific and Technical Activities remain confident about their own sector this year (in 2017, 6 out of 13 companies reported it as weak).

Figure 6: Assessment of the current situation across sectors

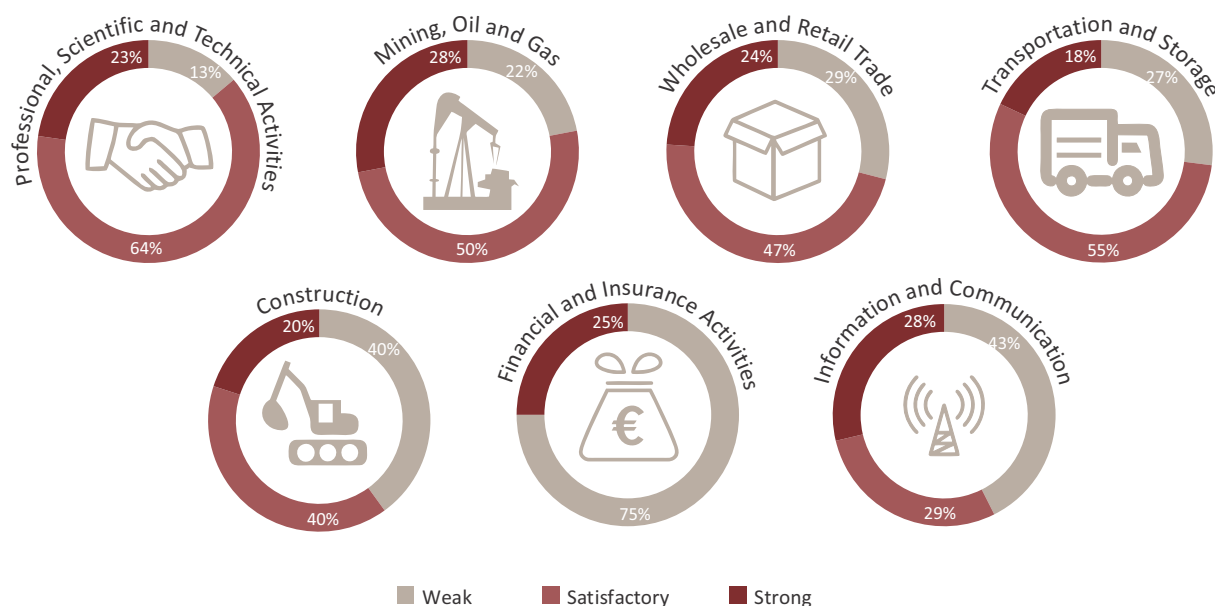
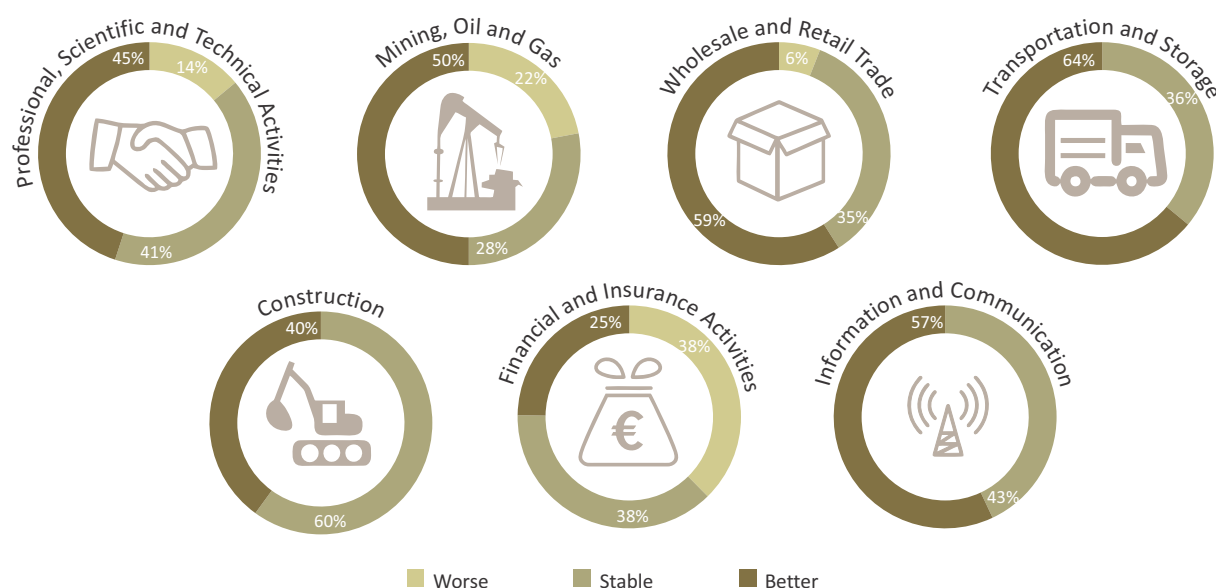


Figure 6.1: Evaluation of prospects across sectors



The EU companies surveyed appear to be more positive about the near-term outlook this year. Despite the long-standing challenges, most companies representing the ICT (57%) and Professional, Scientific and Technical Activities (45%) sectors are confident in their perspectives on 2018. The EU companies representing the Financial and Insurance Activities and Construction sectors have a more positive view of near-term future prospects compared with last year: the percentage of “stable” responses rose to 38% (from 22% in 2017) for the former and to 60% (from 38% in 2017) for the latter.

These upgraded expectations reflect the macroeconomic projections of most international institutions in 2018 and are propelled by higher government spending, particularly in the non-oil sector and on infrastructure as well as improved exchange rate stability, which is expected to boost private sector activity.

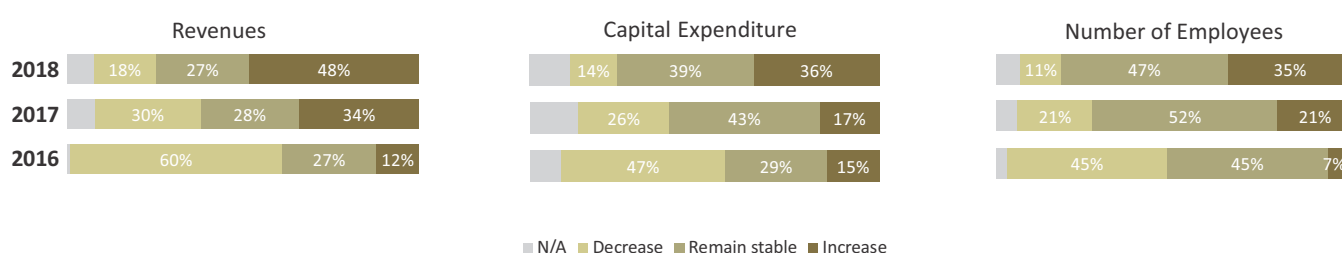
The overall optimism observed in this year's results, translates, albeit in a more tempered way, into a similar leap in confidence in their own companies' performance. Thus, it is not surprising that 48% of companies surveyed expect an increase in revenues, up from 34% in 2017. It is notable, too, that one year later, more companies

plan to increase capital expenditure (36%). Of the best represented sectors in the survey this year, the ICT and Transport sectors are the most confident about growth in their revenue and capital expenditure: 57% of companies in the former and 55% in the latter sector expect both revenues and capital expenditures to increase in 2018.

Similarly, more EU companies are planning to either maintain or increase the number of employees, whereas only 11% of businesses anticipate staff reductions this year. This is significantly down from 21% in 2017 and from a high of 45% in 2016. As a consequence, more EU companies project increased expenses in 2018.

The survey results also show a close correlation between assessments of the national economy and companies' business indicators. Among the EU companies that expect deterioration in the national economy in 2018, 53% also expect their own revenue growth to reduce. And vice versa: 63% of respondents who believe in a promising economic outlook for 2018 also expect their revenues to increase. Albeit relatively tempered, the same applies to companies' capital expenditure and employment plans this year.

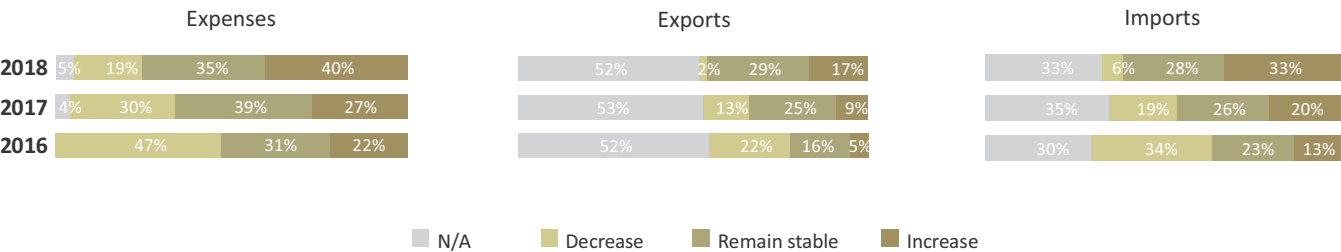
Figure 7: Key performance indicators



Export prospects naturally depend heavily on how export-oriented EU businesses in Azerbaijan are. As in previous years, slightly more than half of EU companies surveyed say that they do not export. 17% of those who do export, however, expect increases (up from a low 5% in 2016) as export growth moderates following last years' rebound.

With respect to imports, EU companies' expectations rise proportionally to the increasing levels of imports in their inputs. 60% of the businesses that import more than half of their inputs (50%-100%), report a further increase this year. Most (61%) of those that depend less on imports (<50%) expect them to remain stable in 2018.

Figure 7.1: Key performance indicators



Chapter 3

Key Local Business Climate Indicators: Performance and Challenges

Azerbaijan has clearly accelerated reforms to improve the business and investment environment since the country was hit by the oil plunge in 2015 and made some progress in easing the doing of business in the country. However, the structural reforms needed to enhance the country's competitiveness and attractiveness as an investment destination would require long-term effort to address existing institutional bottlenecks and systemic challenges.

One of the main objectives of the EU Business Climate Survey is to capture the views of EU businesses with respect to the business and investment climate in Azerbaijan in order to identify both progress made so far on the road to reform and the scope for further improvement. To this end, the survey aims to shed light on the views of EU businesses on 25 local business factors categorised into three major aspects of the business environment:



Conditions in the labour market



Operational business environment



Economic policies and institutions

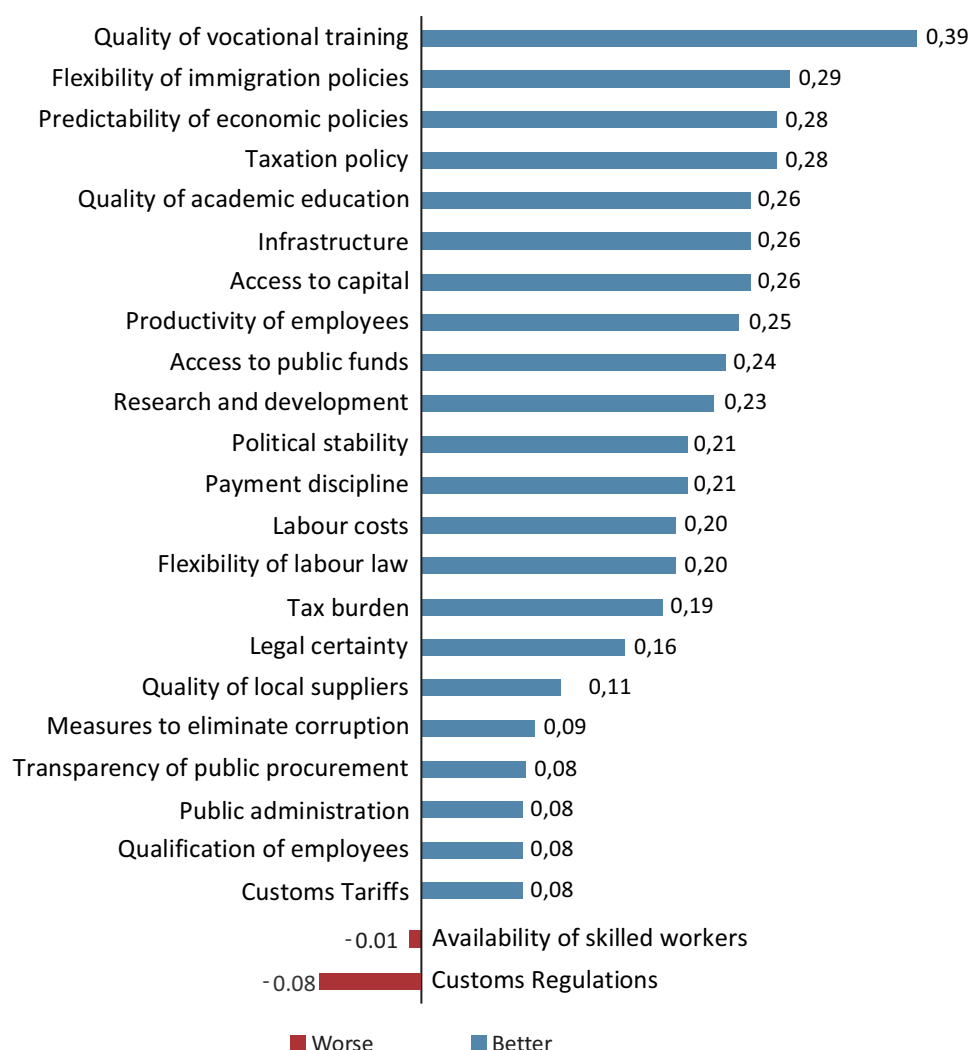


Business climate indicators as perceived by EU companies

This year, and for the first time since the first edition of the report in 2016, the overall rating of conditions in the labour market appears to be slightly above average. Taking a closer look at individual business indicators in all three aspects of the survey (labour market, business environment and economic policies), EU companies report a generally positive improvement in all factors this year, with the exception of the availability of skilled workers, and customs regulations. These are the only two local indicators of the business environment that note a deterioration compared to 2017.

While this EU business perception of improvement across-the-board in local business climate indicators is very welcome, it should be noted that most indicators started from a low base and are in most cases at a level that is far from satisfactory. Noteworthy also is that the positive gains on customs regulations recorded in last year's survey seem to be melting away. This backsliding is a clear reminder of the importance of not only embarking on reforms (as was the case with customs last year) but also of sustaining and furthering the reforms to make a truly lasting impact on the ground.

Figure 8: Change in business climate indicators as perceived by EU businesses, 2017-2018



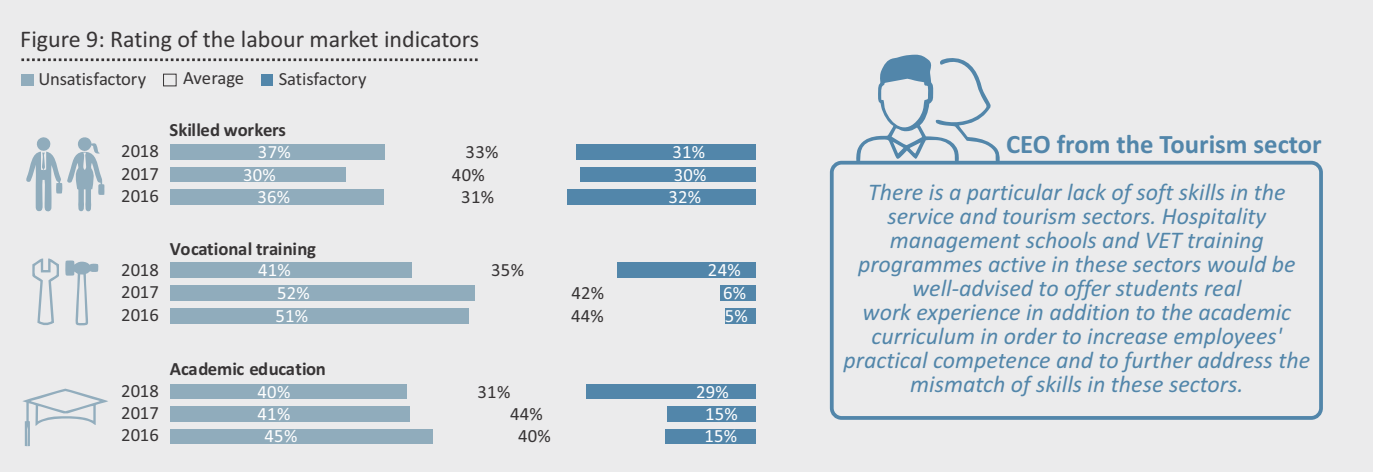
Conditions in the labour market

One factor influencing investment decision-making is the country's labour potential. The shortage of skilled labour can significantly hamper investment, as highlighted in the discussions with European companies. Against a background of EU businesses' relatively expansionary employment plans for this year, upskilling the workforce is more important than ever.

Of all labour market indicators, employee qualification and productivity, in tandem with labour costs and immigration policies, are rated slightly better than average this year. Although the perceived quality of education and vocational training shows some positive movement as compared with 2017, they come from a very low base and are therefore still receiving a low rating overall from EU companies active in Azerbaijan.

The shortage of skilled workers is an increasing bottleneck

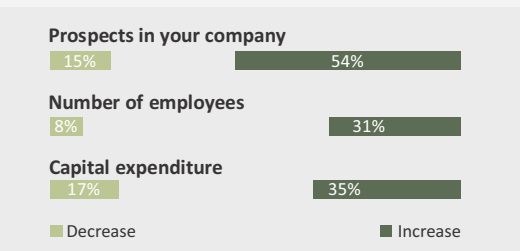
The availability of skilled workers is the business indicator with the second most notable negative shift in 2018. Overall, 37% of EU companies say that lack of skilled workforce is one of the less favorable conditions that their businesses experience. Similar to last year, EU companies fulfilling Professional, Scientific and Technical activities are the least content about the availability of skilled workers (11 out of 22) in the market whereas the oil and gas sector appears to be the least dissatisfied with only 2 out of 18 companies expressing discontent.



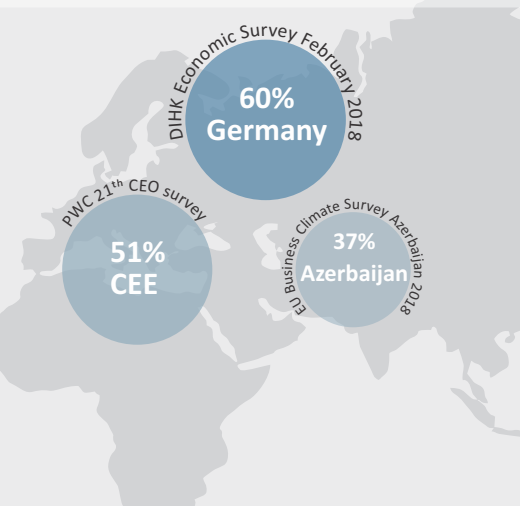
It is, however, reassuring that from cross-tabulation analysis, the adverse effects of the skilled labour shortage do not seem to weigh on investment decisions, employment plans or the near-term company prospects for growth in EU businesses; at least for the time being. This can partly be explained by the fact that the availability of key skills is also an increasingly dire issue in alternative locations for investment within the region.^{10 11}

Vocational training and academic education programmes are often not aligned with the needs of European companies operating in Azerbaijan. Despite an encouragingly positive shift in perception among EU businesses this year of the quality of vocational education (24% of EU companies consider VET training to be satisfactory against only 6% in 2017) and higher education (29% of EU businesses are satisfied with the quality of higher education compared with 15% in 2017), much remains to be done, with 41% and 40% of respondents remaining dissatisfied with the quality of, respectively, vocational training and academic education within the country. The one positive exception is the ICT sector where, respectively, 6 and 5 out of 7 respondents rate the quality of vocational training and academic education as satisfactory.

Shortage of skilled labour vs. other factors



Lack of skilled labour is perceived as a main business threat regionally



Levels of education and specialisation are the key factors determining the quality of the labour market. As acknowledged by the government, this is a long term process before reforms that have been introduced start to bring tangible results. As foreseen in the Strategic Roadmap for the development of VET, moving it forward is essential in strengthening private sector involvement in

building a high-quality and comprehensive education system and vocational training programmes that respond better to the needs of the business. In this respect, European companies voice their readiness to support the public-private dialogue towards successful implementation of the VET roadmap.

Optimism apparent in EU businesses' assessment of employee productivity and qualifications

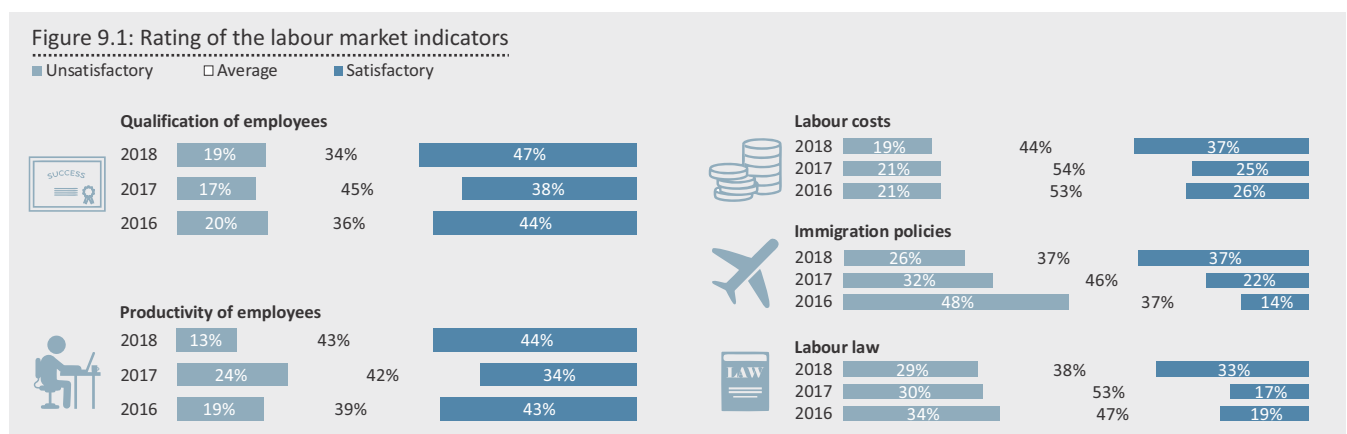
In 2017, employee productivity was the factor receiving the most strikingly negative decline. Workers' qualifications were also poorly rated. One year later, motivated by the rising tide of prospects for growth, employees are found to be more productive. Respectively, 47% and 44% of EU businesses are confident of their employees' qualifications and productivity. Interestingly enough, while expressing their dissatisfaction with all other labour market indicators, the majority of Finance and Insurance companies participating in the survey this year appear to be more positive about the productivity (63%).

Unlike last year, this time the EU companies report improvement in terms of labour costs, presumably reflecting the delayed effects of the steady devaluation of the local currency in 2015. Still, when analysing individual sectors, only Oil and Gas companies assess labour costs as satisfactory (56%), whilst all the other sectors rate them as average. Notably more companies are satisfied with the

law on labour flexibility this year, although it is still rated average.

The flexibility of immigration policies is the second most notable area of improvement of labour market indicators in 2018, rated slightly above average for the first time in three years. The fraction of EU companies marking it as satisfactory increased from 22% in 2017 to 37% in 2018.

The year 2017 was not characterised by cardinal changes in the immigration system or work permit regulations. The main reform of last year – the introduction of the ASAN e-visa portal was expanded further to include an emergency visa, as of August 2017. One principal amendment has been that all foreign nationals travelling to Azerbaijan for work purposes are now required to apply for a work/labour visa before entering the country. Several EU companies believe that this has increased the paperwork and bureaucracy in hiring highly-skilled expat workers and call for simpler, faster and more transparent procedures.



Operational business environment

The country's overall performance and competitiveness are largely driven by a well-functioning physical infrastructure: greater transport connectivity coupled with broad-based digitalisation and innovation. It is therefore crucial that the government gives close attention to factors determining the operational business environment, while keeping an eye on wider socioeconomic goals.

Going forward: public-private collaboration is needed for sustainable modernisation of the infrastructure

The previous two fiscal years saw capital investments reduced substantially to adjust the budget to the new reality of lower oil prices. Yet EU businesses are already reporting a modest improvement in infrastructure in this year's survey, with 37% of respondents rating it satisfactory (28% in 2017). Benefiting from the pickup in commodity prices, the government plans to expand public spending this year, particularly on transport infrastructure and public housing.

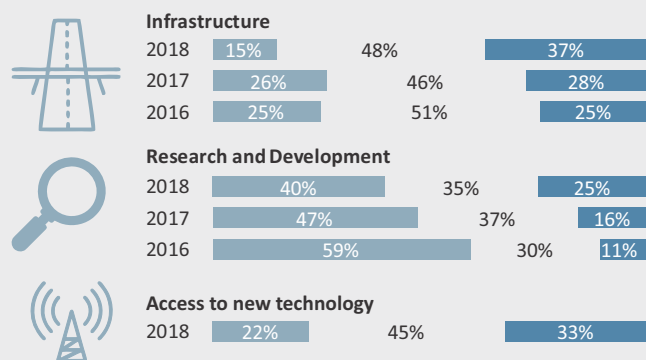
In the rapidly advancing world of technology, the creation of a business climate conducive to investment is also spurred by an efficient digital infrastructure and benign conditions for research and development and adaptation of new technologies. And so this year the companies surveyed were also invited to rate access to new

technology as an indicator of the operational business environment. Albeit moderately above average, the number of companies satisfied with access to new technology amounted to only 33%. As for local R&D conditions, 40% of EU businesses still signal dissatisfaction (a slight improvement compared to the 47% dissatisfaction in 2017).

Historically, the public sector has shouldered a greater burden of infrastructure investment in the country, and, according to EU companies, this needs to change, too. To address the gaps in infrastructure investment, the government should mobilise larger funds from the private sector and foreign investors with clearer policies and attractive investment opportunities.

Figure 10: Rating of the operational business environment indicators

■ Unsatisfactory □ Average ■ Satisfactory



CEO from the ICT sector

Sharing European experience in digital transformation, which is the foundation of a digital economy, will ignite new topics for the Azerbaijani authorities to engage with.

Local suppliers lack competitive advantage over international companies

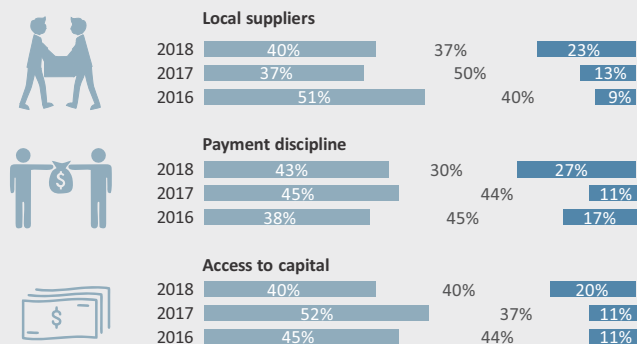
In this year's survey, we also introduced a new question to acquire more detailed insight into the EU businesses' perceptions of local suppliers; this has been a recurring issue with EU companies since the conduct of the first survey in 2016. While outlining moderate improvement with respect to the quality of local suppliers, 40% of respondents deem it unsatisfactory (the figure was 37% in 2017).

Analysing this issue further in this year's survey, it appears that the main reasons for dissatisfaction stem from a clear lack of reliable local production inputs (22%). Among other reasons are lower quality standards (19%) and lack of relevant skills (16%). Interestingly enough, following the Professional, Scientific and Technical Activities sector (11 out of 22 companies), companies from the Oil and Gas sector are most dissatisfied (8 out of 18 companies) with the quality of local suppliers.



Figure 10.1: Rating of the operational business environment indicators

■ Unsatisfactory □ Average ■ Satisfactory



Senior Manager from the Oil and Gas sector

One competitive advantage of local suppliers is the relatively cheaper pricing compared to international suppliers. However, they often do not meet the quality and compliance standards of European companies

Difficulties in accessing capital continue to weigh on companies' payment discipline

The EU businesses report some modest positive change in payment discipline and access to capital over the past year. While this is certainly encouraging, it should be noted that 43% and 40% of EU businesses remain dissatisfied, respectively, with payment discipline and access to capital in 2018.

The findings highlight furthermore that, as in previous years, barriers to access to capital continue to weigh on companies' payment discipline. 69% of the companies that are not confident about access to capital are also dissatisfied with payment discipline this year. This, coupled with insufficient regulatory measures against offenders, is indicative of the underlying reasons for delays in payment.

Economic policies and institutions

Starting from a low base, positive shifts are reported in all indicators of the economic framework this year, with the exception of customs regulations. The greatest risks still lie in transparency of public procurement, access to public funds and corruption, while political stability continues to be a credible anchor for businesses for the third consecutive year.

Political stability is a necessary condition for FDI inflows and economic growth

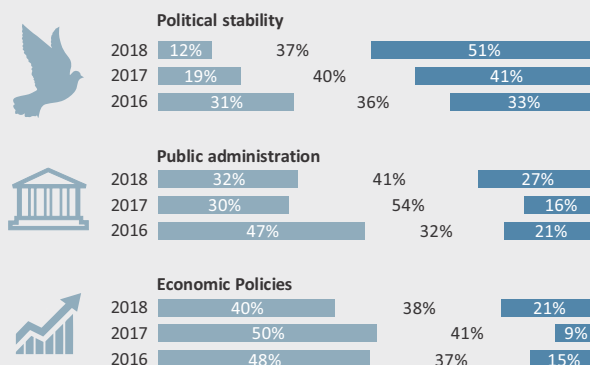
Of all the business indicators, political and social stability continues to stand out as the best-rated factor this year: 51% of EU businesses rate this as satisfactory, up from 41% in 2017. In a similar vein, the proportion of companies satisfied with public administration increased from 16% in 2017 to 27% in 2018. According to EU businesses' feedback, political stability, together with effective public administration, remains vital to the implementation of the reform agenda and thus securing foreign investment inflows.

Moreover, the survey findings reveal that the companies' perceptions of political stability and the predictability of economic policies are deeply interconnected. That is to say, the more politically stable the country is, the more predictable the economic policies are, in the views of EU

businesses. Overall, 21% of companies surveyed indicate satisfaction with the predictability of economic policies; up from a low 9% in 2017.

Figure 11: Rating of the economic policy indicators

■ Unsatisfactory □ Average ■ Satisfactory

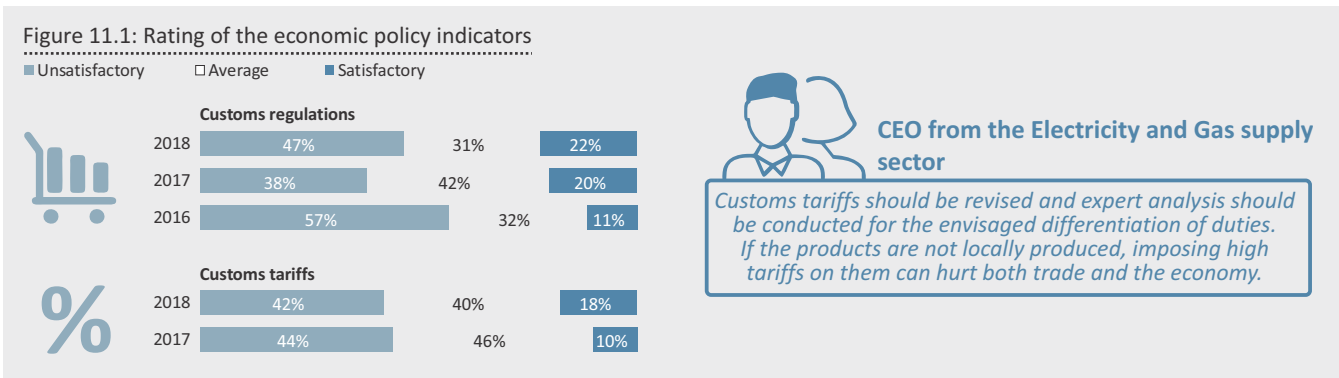


Further modernisation of customs administrations requires additional impetus

47% of EU companies rate customs regulation unsatisfactory this year. This contrasts markedly (and unfortunately) with last year's findings when the most positive shift was reported in the customs regulations. Increasing concerns may also be observed over customs tariffs. Overall, 42% of companies surveyed remain dissatisfied with current customs duties and suggest further analysis and differentiation of trade tariffs. This feedback is in line with the "2017-2018 Global Competitiveness Report" where, in terms of trade tariffs, Azerbaijan slid back from 89th place in 2017 to 94th in 2018.

What emerges as we look more closely at the data is also concern from an SME perspective: customs procedures and duties appear to be a greater burden for smaller companies than for larger ones.

Therefore, sharpened global economic competition makes the adaptation of coherent tariff policies and establishment of a well-designed and transparent regulatory framework essential to simplify customs procedures, minimising time and cost for enterprises.

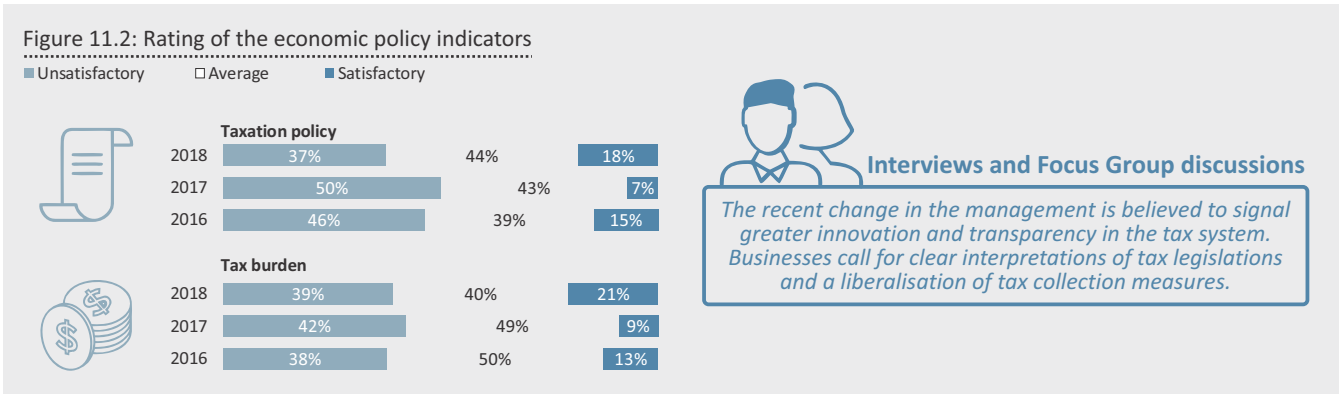


A promising path to genuine, broad-based reforms to the tax system in 2018

Any contemplation of investment must take into consideration not only the formal tax system and tax regulations, but also the way the administration system works. The tax authorities in Azerbaijan have long been perceived as arbitrary and predatory, particularly in the enforcement and collection of taxes. This year, however, taxation policy is assessed positively by EU businesses, who are optimistic that recent changes in the administration will pave the way for more genuine and far-reaching tax reforms. Despite slight progress since last year, 39% of

respondents remain dissatisfied with the overall tax burden and this is irrespective of sector and size of company.

Appreciated is the new tax management's readiness to develop changes in cooperation with the business community and international institutions. Moving forward, European companies also expect the relevant financial and tax authorities to improve coordination and flows of information between themselves, to avoid contradictions and miscommunication in their approach.



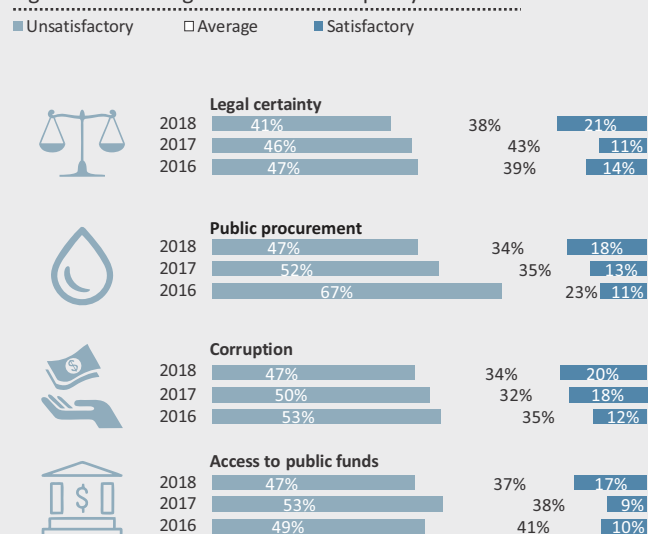
The legal system should work its way out of impasse

International practice suggests that the lack of legal certainty and an inconsistent judiciary system, coupled with corruption, significantly impedes foreign investment in the country. Given this, EU businesses believe that the legal framework is one of the serious issues yet to be addressed. 41% of companies surveyed express discontent with the rule of law in the country.

While outlining moderate improvement with respect to transparency in public procurement, 47% remain

dissatisfied and call for further measures to improve tender procedures and criteria. The findings suggest moreover that the lack of transparency in public procurement weighs on smaller firms to a greater degree than on larger ones, while legal uncertainty constitutes a serious risk for all companies. Therefore, failure to create a fair legal framework and to ensure its accountability and transparency may jeopardise the government's plans for diversification and development.

Figure 11.3: Rating of the economic policy indicators



CEO from the Oil and Gas sector

PSAs are very strong tools in the event of the company facing challenges and disputes. The legal framework established for companies operating in the oil and gas sector is considerably more favourable than that for other sectors.



Managing Partner from the Professional Activities sector

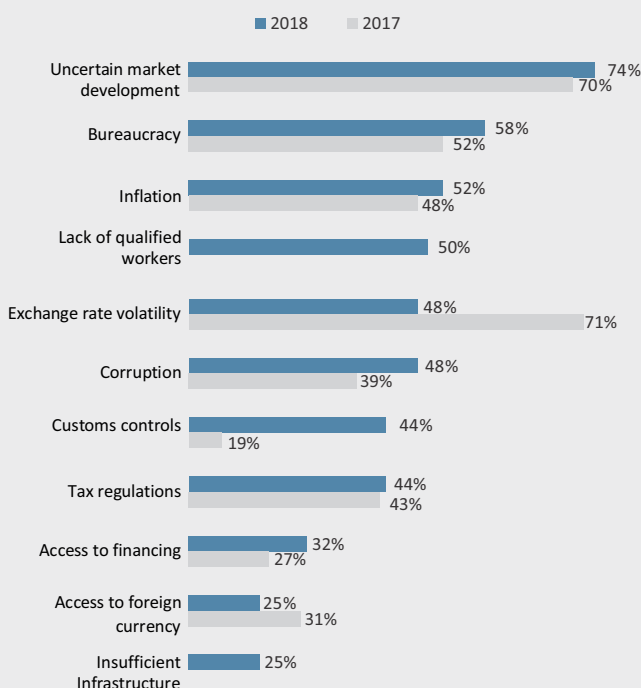
Improvements are needed in the area of the rule of law, particularly in the transparency and professionalism of the local courts.

The feedback suggests that legal uncertainty may also be driven by corruption. Corruption, in tandem with access to public funds, creates additional costs for EU businesses. Both indicators are marked with slight improvements compared to 2017, with 47% of respondents deeming both factors as unsatisfactory this year.

EU businesses' perceptions of the current economic situation and business indicators are also reflected in their ranking of unfavourable conditions affecting their businesses most this year. Against the background of a stabilised exchange rate in 2017, the companies appear to be less concerned about access to foreign currency and exchange rate volatility. It is notable that 44% of this year's respondents say that customs control affects their businesses to a great extent; this is considerably more than in 2017 (19%).

Not surprisingly, the lack of qualified workers is reported to have one of the greatest adverse effects on European companies, following uncertain market development, bureaucracy and inflation.

Figure 12: Ranking of the current economic conditions affecting EU companies in 2018 vs 2017



Chapter 4

Azerbaijan as an Investment Destination

Alongside the state policy to diversify the economy, attracting foreign investment to the country remains the government's foremost goal for upcoming years. In order to re-route foreign investments from the traditionally dominant Oil and Gas industry to the non-oil sector, Azerbaijan is currently working to develop new trade routes and transport corridors, as well as large-scale infrastructure projects. In this area, the establishment of the Alat free trade zone and development of the international sea trade port, along with the commissioning of the Baku-Tbilisi-Kars railway, are expected to give further impetus to lure foreign direct investment to the country.



CEO from the Transport sector

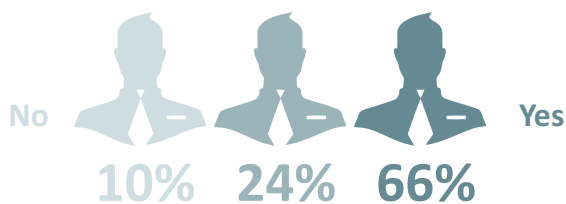
Azerbaijan is aiming to become a transit country, which will stimulate more infrastructure projects. We believe that convenient transport routes are essential for attracting foreign investment.

According to the Central Bank of Azerbaijan, cumulative foreign investments worth \$5.7 billion were made in Azerbaijan in 2017, 86% of which were accounted for by the oil and gas sector. Over the past 10 years, the EU has invested \$21 billion in the Azerbaijani economy, amounting to 24% of total foreign investments. Meanwhile, 35.5% of Azerbaijan's trade turnover is accounted for by EU countries.* The government's current aim is to see \$15 billion invested in the country this year and to continue reforms to improve the investment climate and increase foreign companies' confidence in Azerbaijan.

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

Would you invest again in Azerbaijan?

In the “Doing Business Report 2018” by the World Bank Group, Azerbaijan has strengthened minority investor protection by increasing shareholder rights and their role in major corporate decisions, clarifying ownership and control structures and requiring greater corporate transparency. Moreover, in line with a presidential decree of January 2018, work is underway to create an investment-friendly environment for foreign businesses by developing a new “Law on Protection of Rights of Foreign Investors”.

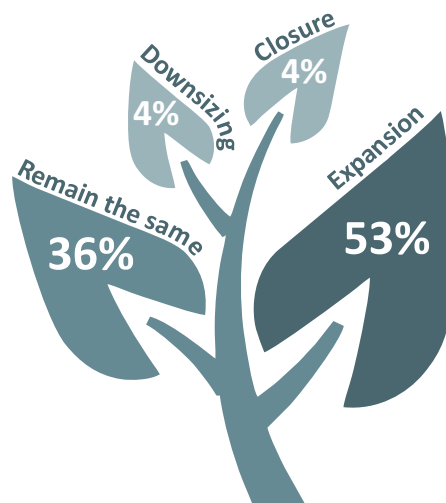


Amid visible optimism about the prospects for growth this year, more EU companies appear to remain committed to Azerbaijan when it comes to investment decisions. More precisely, 66% of EU businesses participating in the survey this year state that they would invest again in Azerbaijan, while only 10% say they would reconsider their investments.

A detailed analysis of the findings also suggests that favourable business conditions are an indispensable prerequisite for EU businesses when reconsidering their investment decisions: the higher the level of confidence in business indicators, the smaller the willingness to reconsider investments.

When further differentiated by sectors, companies within the Oil and Gas industry (following the Transport sector) displayed greater determination in their investment decisions than companies in non-oil sectors, as was the case in 2017. This, in fact, reflects the more favourable conditions for investment and substantial tax exemptions for oil and gas activities in the country.

Not surprisingly, the development dynamics of the European companies surveyed has also forged ahead in line with their generally optimistic outlook. That is to say, this year 53% of EU companies plan to expand their business activities in the country over the next one to two years, which is substantially more than in the previous year (33%). Moreover, 63% of those who say they would again choose Azerbaijan as an investment destination also intend to grow their business.



Sizeable and long-term foreign investments demand a more business-friendly environment

In this year's survey, we also introduced a new question to get more detailed insight into the EU businesses' perception of Azerbaijan as an investment destination. The companies were invited to indicate the factors urging them to invest or do business in Azerbaijan.

According to the survey findings, investment in Azerbaijan is principally driven by easy access to the domestic market (33%). Among the aspects making Azerbaijan an attractive investment location for EU businesses, strategic partnerships and alliances are cited as the second most influential benefit (28%). Other indicators, such as access to technology and export markets, as well as tax incentives, are viewed as less attractive by the respondents.

Top 5 factors driving the investment



Following in the footsteps of many other emerging economies, Azerbaijan is trying to attract FDIs particularly through privatisation of state enterprises and by developing industrial parks and special economic zones. The EU feedback suggests that to encourage foreign firms to invest in the country the terms for privatisation (e.g. ownership rights, facilities provided for investments) should be more favourable and attractive. Similarly, investments in the industrial zones should not be constrained by rigorous qualifying criteria.



Interviews and Focus Group discussions

The government should create a more competitive business environment and introduce more attractive incentives to induce investors to choose Azerbaijan over other developing countries in the region

Furthermore, experience has shown that the existence of these stimuli alone is not enough and it is essential to pursue further structural reforms to address the challenges that remain in the tax and customs systems, to ensure transparency in legal institutions and to minimise bureaucratic interference. EU companies reckon that these measures, coupled with a highly-skilled workforce and well-developed infrastructure, will foster investment confidence in foreign companies in 2018 and will eventually generate new momentum for economic growth.



An offshore oil rig is silhouetted against a vibrant sunset sky with orange and yellow clouds. The rig's complex structure, including cranes and platforms, is reflected in the calm sea below.

Conclusion

In view of the slowly recovering and stabilising economy, EU businesses are clearly more optimistic this year. They assess the national economy remarkably more positively than in the previous two years, although it is still below satisfactory. It should be mentioned that despite the measures taken to ensure stability in the country's financial sector, structural problems and imperfections still remain. On the other hand, a gradual ramp-up of expenditure on infrastructure, as well as simplifying procedures for construction permits, is creating renewed confidence in the construction sector, which has been under pressure since 2015.

This year's survey findings, alongside the interviews and focus group discussions with selected EU businesses, suggest that new and consistent reforms are required in the tax and customs systems, as well as to the rule of law and the education sector. EU businesses are clearly optimistic that the tax system, cited in the previous year as a major hurdle to do and expand business in Azerbaijan, will see substantial improvements following the recent change of management and amendments to the Tax Code.

For customs, on the other hand, the optimism witnessed in last year's survey, following the introduction of e-customs declarations, seems to be waning due to the lack of follow-up reforms. EU businesses emphasise the importance of speeding up the pace of reform implementation, improving customs administration, accelerating transactions into the electronic system and increasing the training and professional development of customs authorities. Ensuring that customs tariffs do not disproportionately burden SMEs is also called for, as they are at the heart of the country's agenda for economic diversification.

Carrying out reforms to the legal system, modernising the implementation of court decisions and ensuring transparency in the judicial system are considered to be principal tasks in support of the development of entrepreneurial activity. Last but not least, EU companies continue to signal the importance of addressing the skills mismatch by investing in and reforming higher education and vocational training and making them more relevant to company requirements. The first steps taken in this domain is acknowledged in this year's survey, with increased satisfaction with higher and vocational education systems, but obtaining tangible results will require a long-term commitment to reforms.

Overall, we can state that some important steps have already been made to stabilise the economy and improve the business environment. However, this year's survey clearly shows that much remains to be done. The EU companies surveyed feel the need of the European Union's support to improve the public-private dialogue and to strengthen work with policy-makers to tackle the challenges that remain in the business environment (most notably by facilitating the implementation of reforms in the tax, customs, legal and education systems, while strengthening particularly an environment in which SMEs can prosper).



Annexe A: Methodology

This is the third consecutive year the German-Azerbaijani Chamber of Commerce (AHK Azerbaijan), with the support of the EU Delegation to Azerbaijan, conducted the EU Business Climate Survey Azerbaijan. The current report aims at drawing a picture of current economic condition and business environment as perceived by EU companies operating in Azerbaijan.

The questionnaire consisted of 20 questions covering 3 sections:

- Economic situation and outlook in Azerbaijan
- Impact of Azerbaijan's economic situation and business environment on the company and their investment decisions
- Company demographics

The structure of the previous business climate surveys has largely been maintained to facilitate a set of comparative data over time. This year 3 new questions (one of them having branching/skip logic feature) were added to questionnaire. The newly introduced questions focused on identifying the problems EU companies encounter while sourcing from local suppliers, analysing factors giving impetus to EU businesses to invest or to do business in Azerbaijan, as well as determining the proportion of company input that is imported.

The questionnaire was shared through an online survey software QuestionPro to around 400 EU companies representing 27 EU countries. In the period from 9 February to 16 March 2018, 149 questionnaires were submitted. After the data verification and elimination of double responses from the same respondents/companies, 131 valid and complete responses, corresponding to a response rate of 31%, were selected to provide a representative and statistically significant sample for analysing the business sentiment of EU companies. The cumulative responses were treated in strict confidentiality and processed anonymously.

Moreover, in-person interviews were conducted with 17 EU companies representing various sectors. Also, insights of selected EU businesses participating in the Focus Group Meeting contributed to the evaluation of the acquired data. Their opinions and comments on the specific points are anonymously quoted throughout the report.

Like in previous years, the statistical data of international financial organisations, including World Bank, Asian Development Bank and 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, have been used to elaborate major findings of the survey. Furthermore, the results of the present year's (2018) survey have been compared to the survey findings from the previous years (2016 and 2017), in order to have a precise analysis of yearly changes in the perception of EU businesses with respect to economic development and business indicators of the country.

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

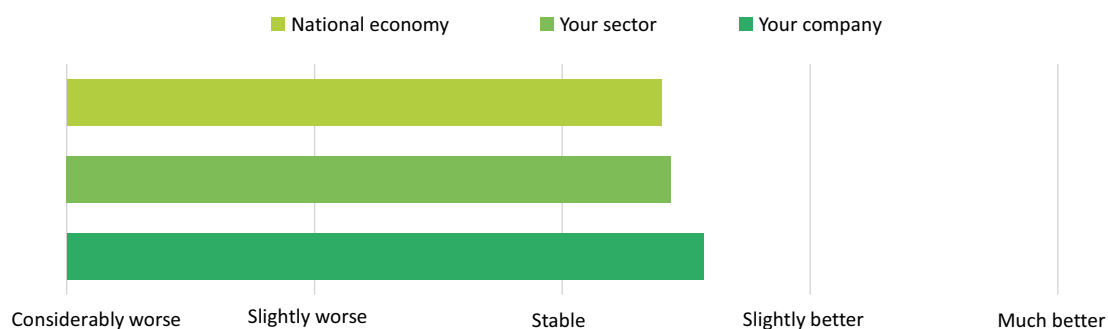
Annexe B: Detailed Survey Findings

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



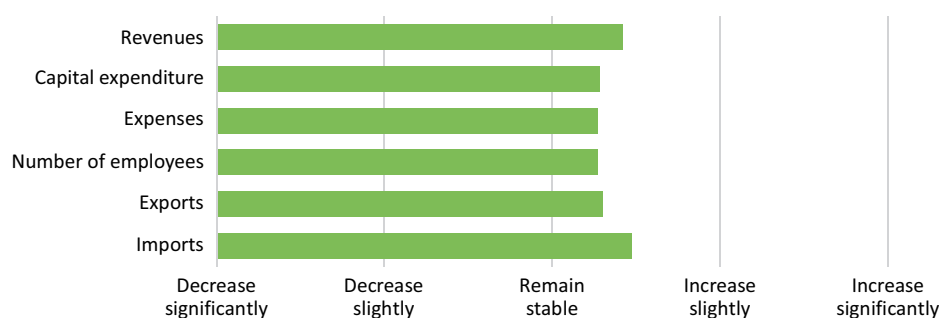
Answer options	Very weak	Weak	Satisfactory	Strong	Very strong	Rating average	Response count
National economy	9	37	67	16	2	2,73	131
Your sector	7	36	60	23	5	2,87	131
Your company	5	16	61	41	8	3,24	131
Total							131

Q2. How do you assess the prospects in Azerbaijan for 2018 compared to the previous year?



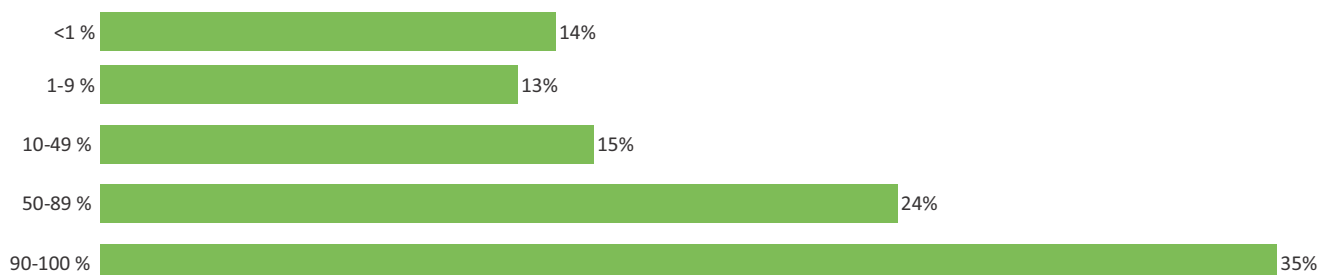
Answer options	Considerably worse	Slightly worse	Stable	Slightly better	Much better	Rating average	Response count
National economy	2	13	51	60	5	3,40	131
Your sector	2	14	47	60	8	3,44	131
Your company	0	13	46	56	16	3,57	131
Total							131

Q3. How do you expect your company to perform in 2018 compared to the previous year?



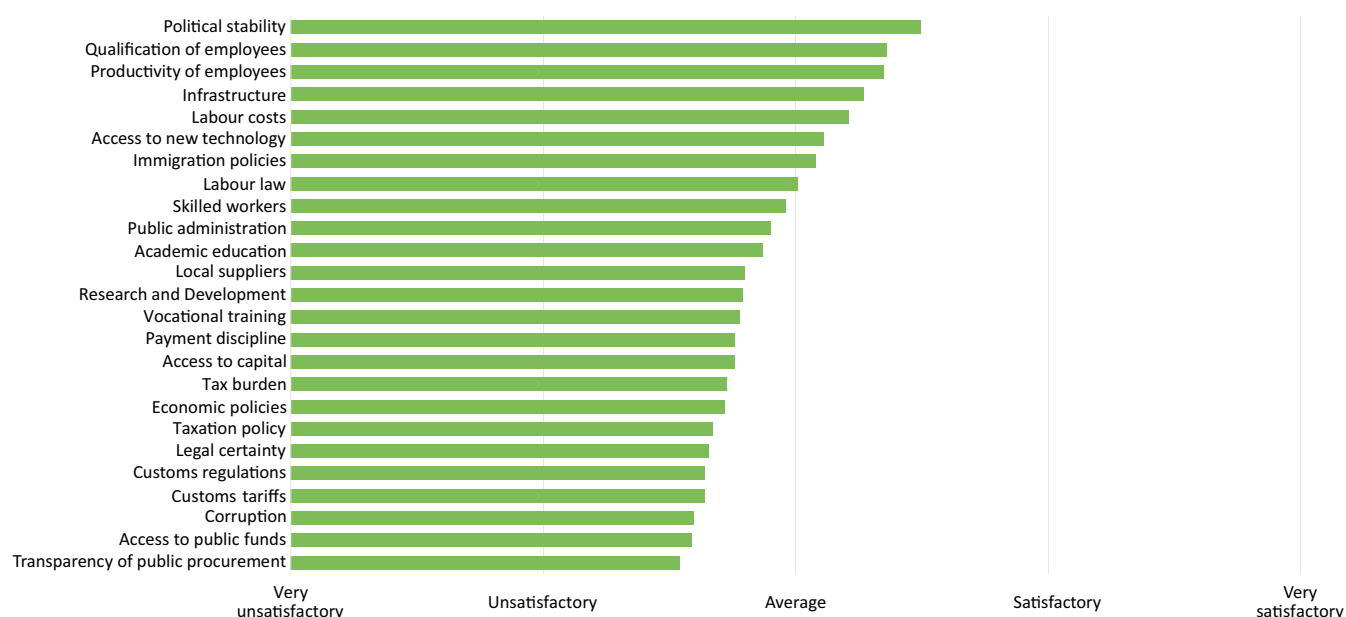
Answer options	Decrease significantly	Decrease slightly	Remain stable	Increase slightly	Increase significantly	Not applicable	Rating average	Response count
Revenues	3	20	35	49	14	10	3,42	131
Capital expenditure	4	14	51	39	8	15	3,28	131
Expenses	3	22	46	44	9	7	3,27	131
Number of employees	3	12	61	41	5	9	3,27	131
Exports	1	2	38	21	1	68	3,30	131
Imports	2	6	37	35	8	43	3,47	131
Total								131

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



Answer options	Response count	Response rate
<1 %	12	14%
1-9 %	11	13%
10-49 %	13	15%
50-89 %	21	24%
90-100 %	31	35%
Total	88	

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



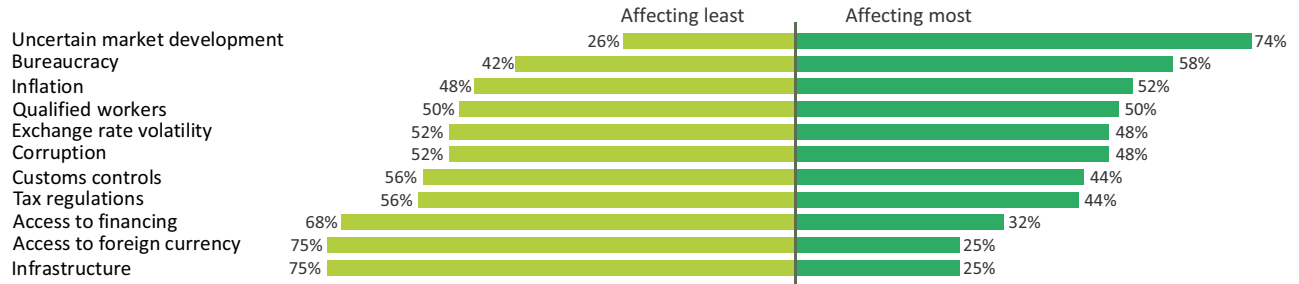
Answer options	Very unsatisfactory	Unsatisfactory	Average	Satisfactory	Very satisfactory	Rating average	Response count
Political and social stability	7	9	48	46	21	3,50	131
Qualification of employees	3	22	44	49	13	3,36	131
Productivity of employees	2	15	56	51	7	3,35	131
Infrastructure	3	16	63	41	8	3,27	131
Labour costs	4	21	57	42	7	3,21	131
Access to new technology	7	22	59	35	8	3,11	131
Flexibility of immigration policies	9	25	49	43	5	3,08	131
Flexibility of labour law	11	27	50	36	7	3,01	131
Availability of skilled workers	6	42	43	31	9	2,96	131
Public administration	13	29	54	28	7	2,90	131
Quality of academic education	10	43	40	30	8	2,87	131
Quality of local suppliers	7	45	49	27	3	2,80	131
Research and Development	12	40	46	30	3	2,79	131
Quality of vocational training	12	42	46	25	6	2,78	131
Payment discipline	16	40	39	31	5	2,76	131
Access to capital	13	39	53	19	7	2,76	131
Tax burden	16	35	53	23	4	2,73	131
Predictability of economic policies	17	36	50	23	5	2,72	131
Taxation policy authorities	23	26	58	19	5	2,67	131
Legal certainty	23	31	50	22	5	2,66	131
Customs procedures and regulations	22	39	41	22	7	2,64	131
Customs tariffs	21	34	53	17	6	2,64	131
Measures to eliminate corruption	24	37	44	20	6	2,60	131
Access to public funds	22	39	48	15	7	2,59	131
Transparency of public procurement	26	36	45	20	4	2,54	131

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



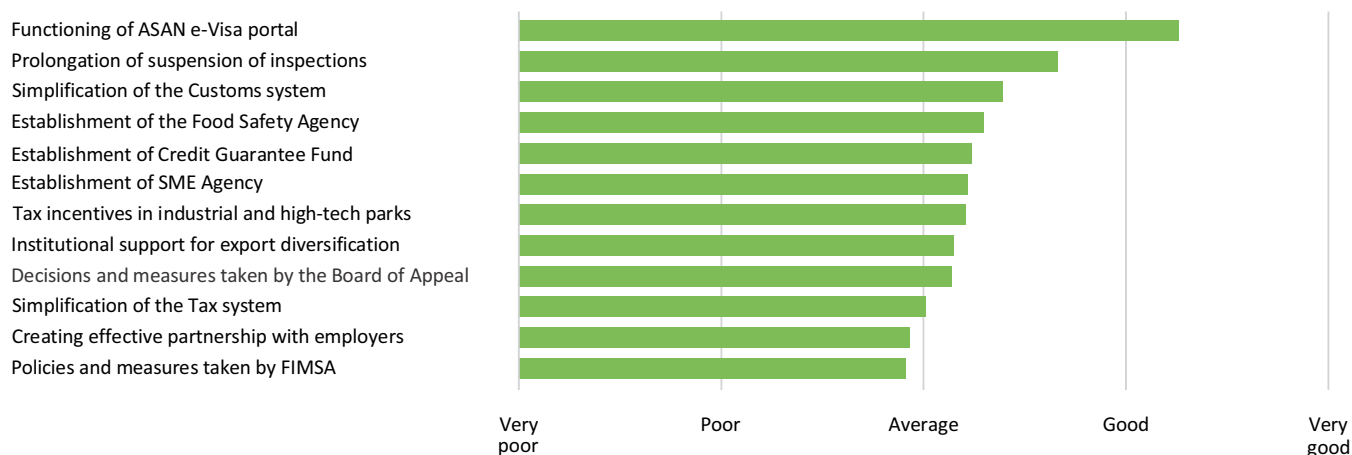
Answer options	Response rate	Response count
The inputs we rely on are not produced locally	22%	66
Local suppliers do not meet our product quality standards	19%	57
Local suppliers lack the relevant skills or capabilities	16%	50
Local suppliers lack professionalism	11%	35
Local suppliers are unreliable	11%	35
Local suppliers do not meet our ethical standards	7%	22
Local suppliers do not respect intellectual property rights	6%	18
Local suppliers do not meet our environmental standards	5%	15
Other	2%	6
Total	100%	304

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



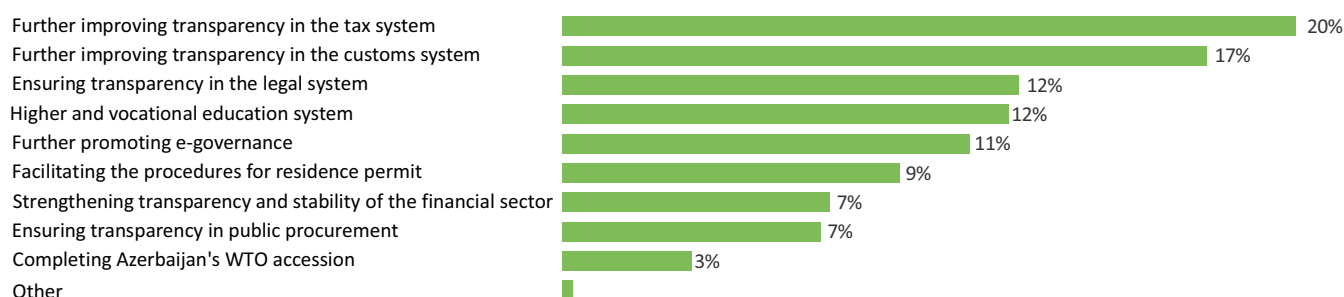
Answer options	11	10	9	8	7	6	5	4	3	2	1	Response rate	Response count
Uncertain market development	4	4	9	5	5	7	22	19	19	15	22	100%	131
Bureaucracy	4	10	7	8	11	15	13	13	15	12	23	100%	131
Inflation	6	3	8	16	17	13	15	14	12	14	13	100%	131
Lack of qualified workers	11	11	9	12	13	10	16	17	12	14	6	100%	131
Exchange rate volatility	4	13	7	14	12	18	8	8	18	14	15	100%	131
Corruption	19	15	8	10	9	7	10	8	8	18	19	100%	131
Customs controls	14	11	13	16	9	10	13	13	11	11	10	100%	131
Tax regulations	5	10	14	16	11	18	8	14	11	15	9	100%	131
Access to financing	16	24	12	14	9	14	10	8	8	8	8	100%	131
Access to foreign currency	30	17	20	8	18	5	10	7	8	6	2	100%	131
Insufficient Infrastructure	18	13	24	12	17	14	6	10	9	4	4	100%	131

Q7. In 2017 Azerbaijan undertook several reforms to address vulnerabilities in the financial sector and to ensure economic growth. How effective do you think the following reform measures have been in improving the business and investment climate in Azerbaijan?



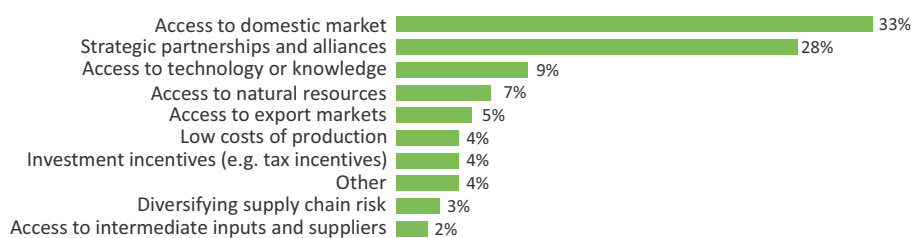
Answer options	Very poor	Poor	Average	Good	Very good	Rating average	Response count
Functioning of ASAN e-Visa portal	0	2	21	49	59	4,26	131
Prolongation of suspension of inspections related to entrepreneurial activities until 2021	5	13	41	35	37	3,66	131
Simplification of the Customs system	8	11	47	52	13	3,39	131
Establishment of the Food Safety Agency	6	15	58	38	14	3,30	131
Establishment of Credit Guarantee Fund	2	20	67	29	13	3,24	131
Establishment of the SME Agency	2	18	69	33	9	3,22	131
Tax incentives in industrial and high-tech parks	6	20	61	28	16	3,21	131
Institutional support for export diversification (e.g. One-stop-shop Export Support Center, Azexport portal)	3	21	68	32	7	3,15	131
Decisions and measures taken by the Board of Appeal under the President of Azerbaijan	4	21	68	29	9	3,14	131
Simplification of the Tax system	14	24	50	33	10	3,01	131
Creating effective partnership with employers as outlined in the VET Roadmap	9	23	72	22	5	2,93	131
Policies and measures taken by Financial Market Supervisory Authority to stabilise the financial sector	10	31	55	31	4	2,91	131
Total							131

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)



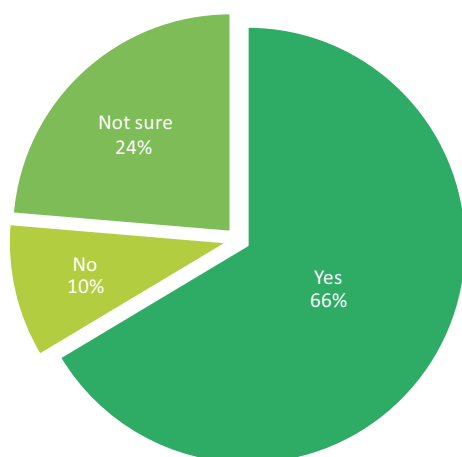
Answer options	Response rate	Response count
Further improving transparency in the tax system	20%	74
Further improving transparency in the customs system	17%	65
Ensuring transparency in the legal system, particularly with regard to contract enforcement and settlement of economic disputes	12%	46
Ensuring that the higher and vocational education system in the country match company needs	12%	45
Further promoting e-governance to minimise petty corruption and to reduce bureaucracy	11%	41
Facilitating the procedures for residence permit and work permit for foreign entrepreneurs and investors	9%	34
Strengthening transparency and stability of the financial sector	7%	27
Ensuring transparency in public procurement	7%	26
Completing Azerbaijan's WTO accession process	3%	13
Other	0,27%	1
Total	100%	372

Q9. What are the most important factors that drove your company to invest/to do business in Azerbaijan? [Select max. 2 that apply]



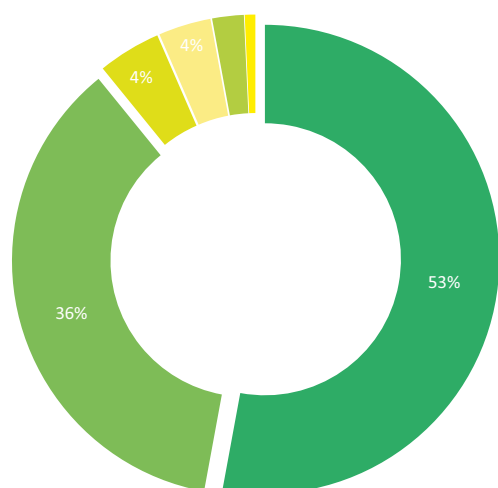
Answer options	Response rate	Response count
Access to domestic market	33%	76
Strategic partnerships/alliances	28%	64
Access to technology or knowledge	9%	21
Access to natural resources	7%	15
Access to export markets	5%	12
Low costs of production	4%	10
Investment incentives (e.g. tax incentives)	4%	10
Other	4%	7
Diversifying supply chain risk	3%	7
Access to intermediate inputs and suppliers	2%	5
Total	100%	227

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



Answer options	Response rate	Response count
Yes	66%	87
No	10%	13
Not sure	24%	31
Total	100%	131

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

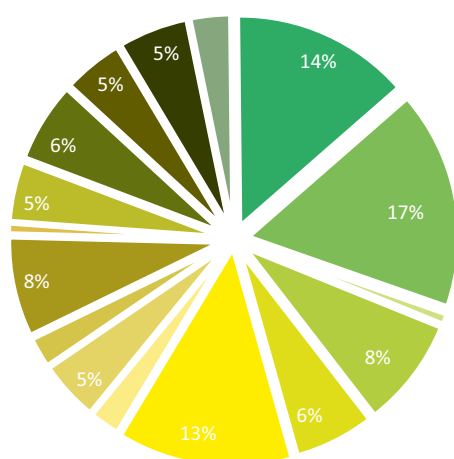


Answer options	Response rate	Response count
Expansion	53%	73
Remain the same	36%	50
Downsizing	4%	6
Closure	4%	5
Localisation of production	2%	3
Move to a third country	0,72%	1
Total	100%	138

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

Answer options	Response count
Malta	1

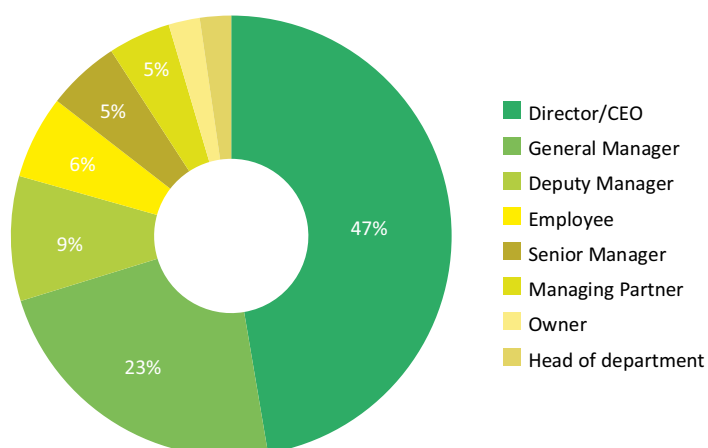
Q12. What is the main area of your operations?



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

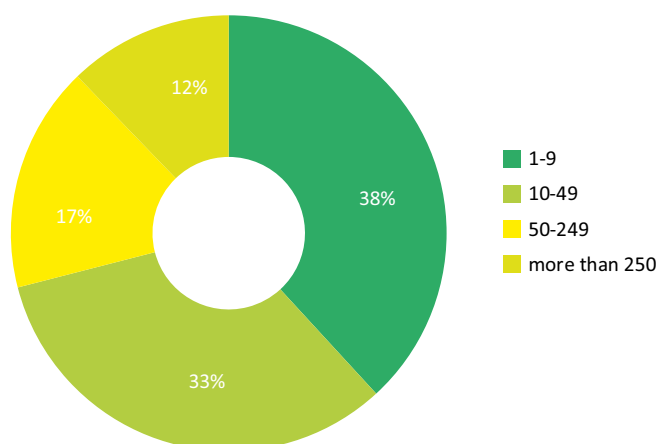
Answer options	Response rate	Response count
Accommodation and Food Service Activities	2%	3
Administrative and Support Service Activities	5%	6
Agriculture, Forestry and Fishing	2%	3
Arts, Entertainment and Recreation	0%	0
Construction	8%	10
Education	1%	1
Electricity, Gas, Steam and Air Conditioning Supply	5%	6
Financial and Insurance Activities	6%	8
Human Health and Social Work Activities	5%	6
Information and Communication	5%	7
Manufacturing	3%	4
Mining, Oil and Gas	14%	18
Professional, Scientific and Technical Activities	17%	22
Public Administration and Defence; Compulsory Social Security	1%	1
Transportation and Storage	8%	11
Water supply; Sewerage, Waste Management and Remediation Activities	6%	8
Wholesale and Retail Trade	13%	17
Total	100%	131

Q13. Please specify your current position within the company?



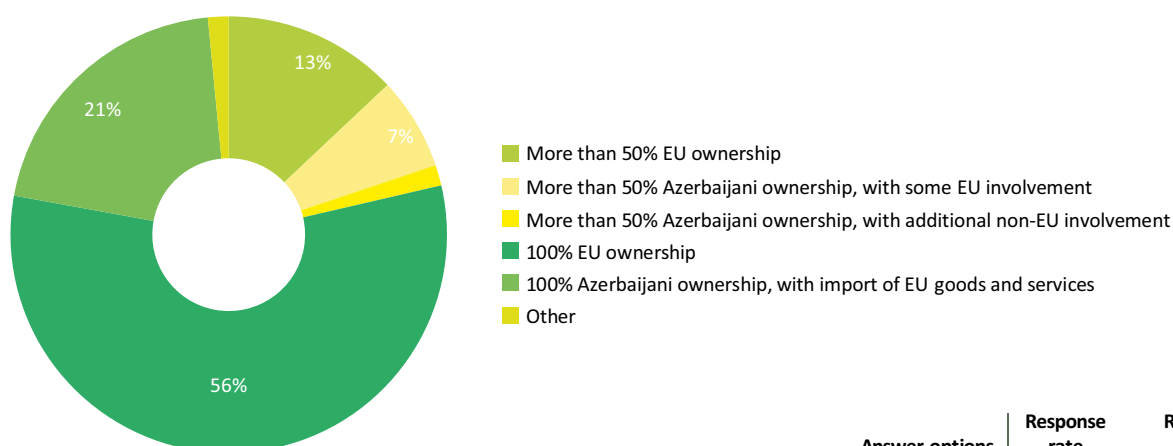
Answer options	Response rate	Response count
Director/CEO	47%	62
General Manager	23%	30
Deputy Manager	9%	12
Employee	6%	8
Senior Manager	5%	7
Managing Partner	5%	6
Owner	2%	3
Head of department	2%	3
Total	100%	131

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



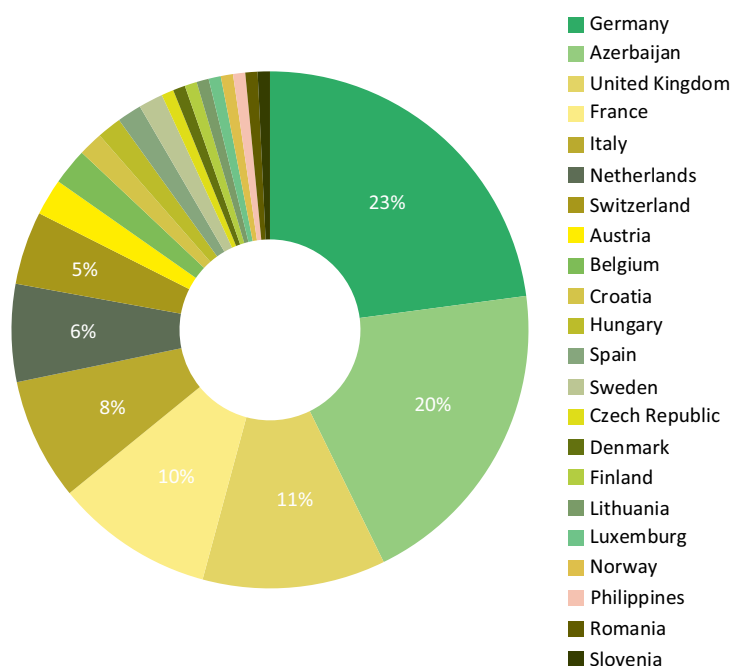
Answer options	Response rate	Response count
1-9	38%	50
10-49	33%	43
50-249	17%	22
more than 250	12%	16
Total	100%	131

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



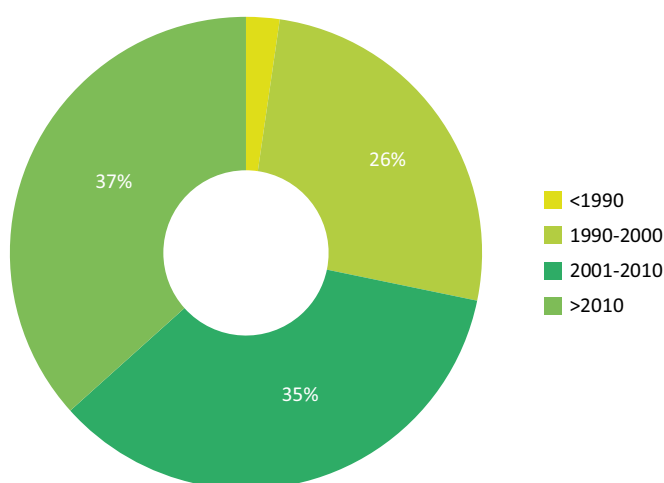
Answer options	Response rate	Response count
More than 50% EU ownership	13%	17
More than 50% Azerbaijani ownership, with some EU involvement	7%	9
More than 50% Azerbaijani ownership, with additional non-EU involvement	2%	2
100% EU ownership	56%	74
100% Azerbaijani ownership, with import of EU goods and services	21%	27
Other	2%	2
Total	100%	131

Q16. In which country are your company's headquarters registered?



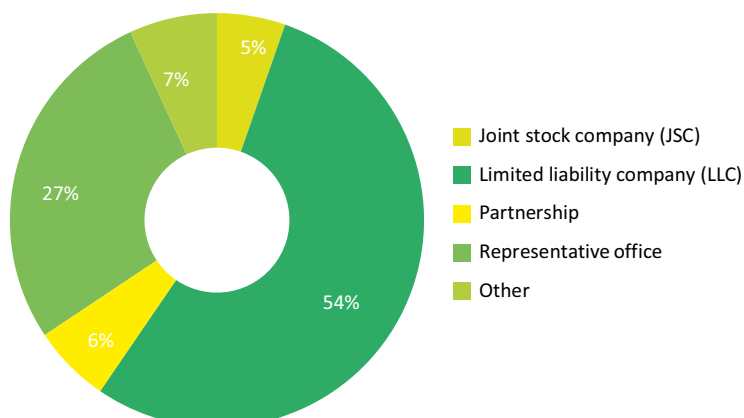
Answer options	Response rate	Response count
Germany	23%	30
Azerbaijan	20%	26
United Kingdom	11%	15
France	10%	13
Italy	8%	10
Netherlands	6%	8
Switzerland	5%	6
Austria	2%	3
Belgium	2%	3
Croatia	2%	2
Hungary	2%	2
Spain	2%	2
Sweden	2%	2
Czech Republic	1%	1
Denmark	1%	1
Finland	1%	1
Lithuania	1%	1
Luxembourg	1%	1
Norway	1%	1
Philippines	1%	1
Romania	1%	1
Slovenia	1%	1
Total	100%	131

Q17. When was your company established in Azerbaijan?



Answer options	Response rate	Response count
<1990	2%	3
1990-2000	26%	34
2001-2010	35%	46
>2010	37%	48
Total	100%	131

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



Answer options	Response rate	Response count
Joint stock company (JSC)	5%	7
Limited liability company (LLC)	54%	71
Partnership	6%	8
Representative office	27%	36
Other	7%	9
Total	100%	131

Annexe C: Statistical Information

Doing Business Report 2018: modest progress towards improving¹²

Azerbaijan has undertaken several reform measures to address obstacles in doing business. Compared to 2017, the country has made some progress in 6 out of 10 doing business indicators of the World Bank's Doing Business Report 2018: I) getting electricity (rank 102 compared to 105 in 2017), II) registering property (rank 21, one step up compared to 2017), III) protecting minority investors (rank 10, an improvement of 22 places compared to 2017), IV) paying taxes (rank 35 – an improvement of 5 places), V) enforcing contracts (rank 38 – 6 places higher than 2017) and VI) resolving insolvency (rank 47, a substantial improvement from its 86 rank the year before). As a result, Azerbaijan could improve its position in the World Bank “Doing Business Report 2018” ranking 190 countries, from 65 in 2017 to 57 in 2018, although still behind the regional average in dealing with construction permits (rank 161 – a substantial regression of 34 places compared to 2017), trading across borders (rank 83, similar to 2017) and getting credit (rank 122, a small decline by 4 places compared to 2017). In “starting a business” - generally seen as a strong feat of the country's business climate - the country dropped from its 5th rank in 2017 to 18th place in 2018. This has mainly been due to good performance of other countries, while Azerbaijan retained its system for starting a business largely intact.

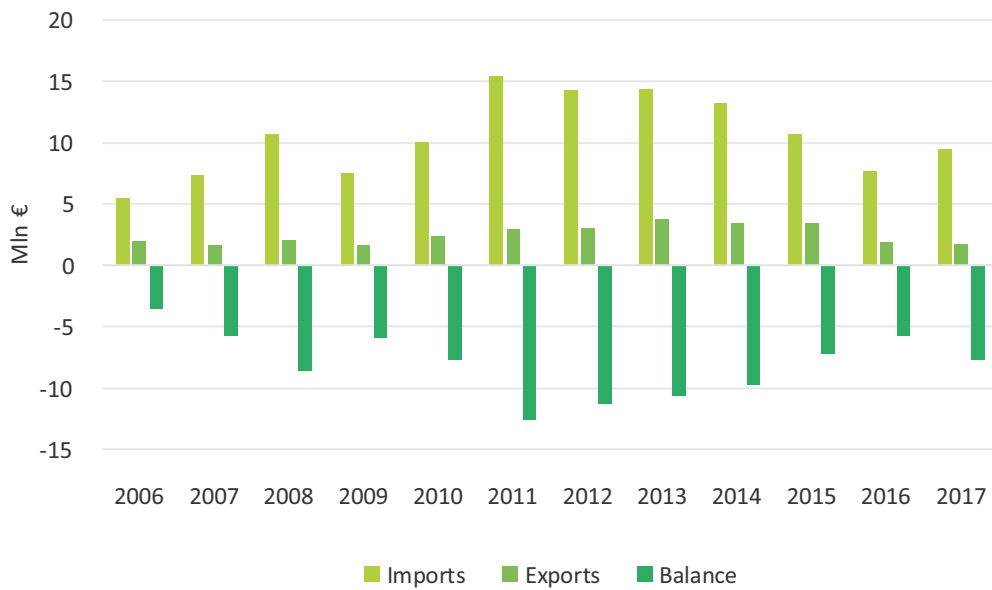
The Global Competitiveness Report: modest progress in improving the country's competitiveness¹³

In the “2017-2018 Global Competitiveness Report” published by the World Economic Forum, Azerbaijan ranks 35th among 137 economies, a modest improvement of 2 places compared to the 2016-2017 report. Noteworthy is that although the country has improved or retained its position with respect to most indicators used for compiling the index (basic requirements such as institutions, infrastructure, health/education; efficiency enhancers such as higher education market size and technological readiness and innovation enhancers such as business sophistication and innovation), it has seen across-the-board regress in the macroeconomic environment where Azerbaijan rolled down to 65th place (from 39th in 2017) owing to a surged inflation rate, increased debt/GDP ratio, and reduced gross savings.

EU Trade with Azerbaijan

The statistics provided by the State Customs Committee of the Republic of Azerbaijan suggests that trade turnover of the country stagnated by 11% in 2017, reflecting dwindled exports and imports by respectively 6.5% and 17.6%. The EU countries, however, continue to be Azerbaijan's key trade partners and account for 46% of total exports and 22% of total imports of the country.

The Asian Development Bank forecasts exports to grow by 13% in 2018 with higher oil prices and then contract by 3.5 % in 2019 with lower oil production and a projected small decline in oil prices. Imports, on the other hand, are projected to contract by 6% in 2018 due to customs duties on machinery and cars.



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About AHK Azerbaijan

The German-Azerbaijani Chamber of Commerce (AHK Azerbaijan) is the institution of German foreign trade promotion in Azerbaijan, which was officially founded in 2012 in Baku. With over 128 German and Azerbaijani member companies on board as of May 2018, AHK Azerbaijan is a part of the worldwide AHK network representing German business interests operating in Azerbaijan and offering its professional business services and experience to German and Azerbaijani companies.

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