



**BLACK SEA TRADE AND DEVELOPMENT BANK**

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**AZERBAIJAN**

**Country Strategy**

**2019-2022**

# **AZERBAIJAN COUNTRY STRATEGY**

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**Table 1: Basic Macroeconomic Indicators at a Glance for AZERBAIJAN**

Key Long Term Foreign Currency Sovereign Risk Rating at 31 July 2019

**Moody's: Ba2 | S&P: BB+ | Fitch: BB+**

		2015	2016	2017	2018	Proj. 2019	Proj. 2020
1	Population (Million)	9.7	9.8	9.9	10.0	<b>10.0</b>	<b>10.1</b>
2	Avg Exch. Rate (Manat/ US\$)	1.03	1.60	1.72	1.70	<b>1.70</b>	<b>1.69</b>
3	Inflation (CPI Avg.)	4.0%	12.4%	12.9%	2.3%	<b>3.5%</b>	<b>3.7%</b>
4	Average monthly wages (US\$)	455	313.2	307.1	320.4		
5	GDP (Manat million)	54,380.0	60,425.2	70,337.8	79,797.3	<b>84,581.6</b>	<b>89,722.3</b>
6	GDP US\$ million	52996.8	37862.8	40867.9	46,939.6	<b>49,753.9</b>	<b>53,121.6</b>
7	GDP per capita (US\$)	5561.5	3928.6	4198.5	4780.1	<b>4,970.4</b>	<b>5,259.6</b>
8	Real GDP growth, %	1.1%	-3.1%	0.2%	1.4%	<b>1.8%</b>	<b>2.1%</b>
9	Official Unemployment (end of period) %	5.0%	5.0%	5.0%	4.9%	<b>6.7%</b>	
10	Industrial Production Growth, %	2.4%	-0.5%	-3.4%	1.5%	<b>2.2%</b>	<b>2.1%</b>
11	Agricultural Production Growth %	6.6%	2.6%	4.2%	4.6%	<b>3.0%</b>	<b>3.5%</b>
12	Domestic Credit Growth %	37.4%	21.6%	-15.8%	4.3%	<b>6.0%</b>	<b>7.4%</b>
13	Domestic Credit/ GDP	40.7%	44.5%	32.2%	29.6%	<b>29.6%</b>	<b>29.9%</b>
14	Foreign Direct Investment - \$US million	4,047.6	4,499.7	2,867.5	4,100.0	<b>7,200.0</b>	<b>7,400.0</b>
15	FDI/ GDP	7.6%	11.9%	7.0%	14.9%	<b>14.5%</b>	<b>13.9%</b>
16	Consolidated Budget Balance/ GDP, %	-4.8%	-1.2%	-1.6%	5.6%	<b>4.0%</b>	<b>5.3%</b>
17	Total External Debt- US\$ million	13,215.3	13,270.0	16,796.2	17,930.9	<b>17,911.4</b>	<b>17,742.6</b>
18	Total External Debt/ GDP	24.9%	35.0%	41.1%	38.2%	<b>36.0%</b>	<b>33.4%</b>
19	Public External Debt/GDP	19.8%	20.4%	22.8%	19.0%	<b>19.0%</b>	
20	Private External Debt/ GDP	11.9%	16.8%	12.2%	7.8%	<b>4.6%</b>	
21	Exports- \$US million (Goods)	16,592.3	13,107.5	15,480.5	20,290.9	<b>16,768.8</b>	<b>16,776.3</b>
22	Imports- \$US million (Goods)	9,216.7	8,489.1	8,783.3	11,465.0	<b>9,559.0</b>	<b>9,745.0</b>
23	Trade Balance \$US mn (Goods)	7,375.6	4,618.4	6,697.2	8,825.9	<b>7,209.8</b>	<b>7,031.3</b>
24	Trade Balance/ GDP	13.9%	12.2%	16.4%	18.8%	<b>14.5%</b>	<b>13.2%</b>
25	Current Account Balance \$US mn	-222.5	-1,363.4	1,684.6	6051.1	<b>2,557.4</b>	<b>1,922.7</b>
26	Current Acct. Bal./ GDP	-0.4%	-3.6%	4.1%	12.9%	<b>5.1%</b>	<b>3.6%</b>
27	Forex Reserves (end period- exc gold) US\$ m	5,016.7	3,974.4	5,334.6	5,625.7	<b>6,999.2</b>	<b>7,069.2</b>

Sources: Central Bank of Azerbaijan Republic, State Statistical Committee of the Azerbaijan Republic, IFS –IMF April 2019.

## **AZERBAIJAN COUNTRY STRATEGY 2019-2022**

### **I. Summary of Recent Economic Developments and Outlook**

Azerbaijan experienced nearly two decades of extraordinary growth, averaging annual real GDP growth of 10.5% between 1996-2014. Azerbaijan has had the fastest growing economy in the Black Sea Region, by far, although its growth rate slowed considerably in the post 2009 global financial crisis period, falling to 3.2% per annum during the 2010-2014 period. This growth was driven by energy production and the global prices of oil and natural gas. The entry into operation of numerous energy development projects led to a large increase in energy receipts, which in turn passed through to the economy and fueled growth in other sectors- particularly construction and non-tradeable services. The extended period of growth transformed Azerbaijan, and raised incomes and living standards substantially, while reducing poverty rates. However, it also increased social and regional income disparities and has increased the economy's dependence on receipts from oil and gas. The need for diversification of the economy has become a top developmental priority, with Azerbaijan trying to develop non-energy sectors of the economy.

#### *Recent macroeconomic trends*

Following a 3.1% contraction in 2016, Azerbaijan's economy returned to low growth, with real GDP rising by 0.2% in 2017 and by 1.4% in 2018. Overall, the GDP growth rate was down from an annual average of 2.7% in the 2011-2014 period to an annual average of -0.1% during the 2015-2018 period. During both periods it was non-oil GDP that drove growth, while oil GDP remained in negative territory in annual average terms. Key positive contributions to growth came from domestic trade and agriculture, while the construction sector was down by an annual average of 11.6% per year.

In US\$ terms, Azerbaijan's GDP declined sharply as a result of the manat devaluations that occurred in 2015. It hit a low of US\$ 37.9bn in 2016, and then rose to US\$46.9bn in 2018, a figure which was significantly smaller than the pre-devaluation US\$ 75.2bn recorded in 2014. Similarly, GDP per capita, which peaked at US\$ 7,991 in 2013-14, fell suddenly to a low of US\$ 3,929 in 2016, before recovering somewhat, and reaching US\$ 4,780 in 2018.

#### *External sector*

Azerbaijan's current account surplus retreated from an annual average of 19.7% of GDP in 2011-2014 period to 3.2% of GDP in 2015-2018 period, as the country faced deficits in 2015 and 2016 as a result of the fall in oil prices. As oil prices recovered, the external balance returned to surplus in 2017 and reached 12.9% of GDP in 2018. Against a volatile oil balance, the non-oil current account deficit in 2015-2018 compared to 2011-2014 remained broadly stable at an annual average of 22.1% of non-oil GDP, as a minor worsening in the goods deficit relative to non-oil GDP was more than compensated by an improvement in the non-oil balance in services and primary income, and improved remittances inflows. Worsening in the oil balance resulted not only from the fall in the price levels of oil and gas exports, but also due to higher oil and gas related service imports.

As net foreign direct investment inflows and net portfolio and other investment outflows remained broadly flat relative to GDP, the rate of reserve accumulation declined from 9.2% of GDP in the 2011-2014 period to -2.6% of GDP during 2015-2018; the main reason for this, along with low oil prices, was a large rise in outflows in 2015. Since then reserves accumulation returned to positive territory once again and reached 7.5% of GDP in 2018.

In US\$ terms, Central Bank reserves declined from a high of US\$ 14.2bn at end 2013 to US\$ 4.0bn in 2016 before recovering to US\$ 5.6bn by the end of 2018, a figure which corresponds to nearly nine months of imports. Unlike the Central Bank reserves, the State Oil Fund reserves experienced a minor decline, from US\$ 37.1bn in 2014 to US\$ 33.1bn in 2016 and by the end of 2018 they had reached a historic high of US\$ 38.5bn. Relative to GDP, Azerbaijan's gross international reserves, which include reserves of the Central Bank, State Oil Fund and Ministry of Finance, reached US\$ 44.7bn or 95.3% of GDP at year end 2018.

Exports of goods from Azerbaijan, according to the State Statistical Committee, averaged US\$16.4bn in 2015-2018 period, down from US\$ 32.9bn in the previous four year period, while excluding mineral fuels, they were down from US\$ 1.6bn to US\$ 1.4bn. Imports, on the other hand, declined marginally from US\$9.8bn in the 2011-2015 period to US\$ 9.5bn during 2015-2018. In terms of destinations, Italy continued to dominate exports, followed by Turkey and Israel. However, excluding crude oil and natural gas, Russia continued to top the list, followed by Turkey and Georgia. Unlike exports, Azerbaijan's imports are widespread with most coming from Russia, Turkey and China.

Azerbaijan's exports to BSTDB member countries fell to a low of US\$ 2.1bn in 2014, before recovering and reaching a high of US\$ 3.9bn in 2018. As a share of total exports, BSTDB member countries' share increased from an annual average of 13.5% in the 2011-2014 period to 20.0% in the 2015-2018 period. Imports from BSTDB member countries, on the other hand, steadily increased to reach a high of US\$ 4.1bn in 2018, while their share in total imports remained broadly flat at 37.0% over the 2015-2018 period.

#### Public finances

As consolidated budget revenues in Azerbaijan relative to GDP declined after 2014 and expenditures remained broadly flat, the budget balance went from a surplus of 2.8% of GDP in 2014 to a deficit of -4.8% of GDP in 2015. The consolidated budget returned to near balance in 2016, but then experienced another deficit of -1.6% of GDP in 2017 before posting a large surplus equal to 5.6% of GDP in 2018. As a result, the annual average budget surplus of 4.9% of GDP during 2011-2014 declined to -0.5% of GDP deficit in the 2015-2018 period. Despite the recent pick up, the share of oil revenues declined from an annual average of 73.2% of total revenues in 2011-2014 to 57.3 % in 2015-2018. It was driven in part by the fall in oil prices, but also by improvement in the collection of non-oil revenues. Consolidated non-oil revenues relative to non-oil GDP increased from 20.0% in the 2011-2014 period, to 23.2% in the 2015-2018 period.

Unlike revenues, expenditures remained broadly flat at around 36.0% of GDP from 2011 to 2018. However, the composition of the expenditures changed in the 2015-2018 period compared to the previous years. In annual average terms, the share of current expenditures in total state budget expenditures increased from 49.2% in the 2011-2013 period, to 58.4%, while the share of debt service related expenditures rose from 2.4% to 8.1%. These increases occurred at the expense of the fall in capital expenditures from 48.5% of total state budget expenditures in 2011-2013 to 33.5% during 2015-2018. Interestingly, the trend reversed somewhat in 2018 as current expenses fell back to 50.8% of total expenses, retreating to pre-crisis previous levels. While the share of capital expenses remained low, debt related expenses increased to 9.8% of total state budget expenses.

As a result of the double devaluations in 2015, Azerbaijan's external public debt increased from 8.6% of GDP in 2014 to 19.8% of GDP in 2015, while in nominal US\$ terms debt increased marginally from US\$ 6.5bn to US\$ 6.9bn. In the later years, following debt restructurings of the major publicly owned

bank, nominal external public debt increased further to US\$ 9.4bn in 2017 before retreating to US\$ 8.9bn in 2018. As a share of GDP, external public debt reached a high of 22.8% of GDP in 2017, before dropping to 19.0% of GDP in 2018.

#### Inflation, exchange rate, and monetary policy

Inflation in Azerbaijan surged to 12.4% in 2016 as the two devaluations in 2015 fed a rise in price levels. Inflationary pressures remained high in 2017 with prices increasing by another 12.9%. However, as the value of the manat stabilized, inflation dropped sharply to 2.3% in 2018.

Azerbaijan resorted to two devaluations in 2015 bringing the USD-AZN exchange rate from 0.78 in the beginning of the year to 1.55 by the end of the year. The manat has experienced limited volatility since then and the exchange rate has settled at 1.7 AZN per US\$ since mid-2017, and has remained at that level.

To address pressures on the local currency and inflation, the Central Bank of Azerbaijan increased the main policy rate, from 3.0 in mid 2015 to 9.5% in a little more than a year in 3 steps. Eventually, monetary authority hiked the rates from 9.5% to 15.0% in September 2016 and kept them at the elevated level until February 2018. Since then, as pressures on prices and exchange rates eased, the Central Bank started to relax monetary policy by lowering the refinancing rate step by step and bringing it down to 9.75% by the end of 2018.

#### Banking sector

Following two devaluations in 2015 and a slowing economy, the Azerbaijani banking system faced significant challenges, which resulted in major deleveraging of the whole banking system. As a result, total loans relative to GDP declined from the peak of 40.0% of GDP in 2015 to 16.3% of GDP in 2018. The devalued currency pushed up the share of loans in foreign currency from 27.2% at the end of 2014 to 49.4% by the end of 2015, while overdue loans increased from 5.3% in 2014 to 6.9% in 2015 and jumped further up to 13.8% in 2017 before easing marginally to 12.2% in 2018. Deleveraging was far more significant for state owned banks, whose share in the total loan book declined from 33.1% in 2014 to 16.1% in 2018. At the sectoral level, the most important drop in loans was to construction and real estate, industry, and households.

The funding side of the banking sector was also negatively affected, as devaluations drove a switch to foreign currency deposits from local currency deposits or outright withdrawal from the banking system, in addition to boosting the share of existing foreign currency deposits relative to total deposits. Just before the devaluations, dollarization ratio in deposits in Azerbaijan was at 49.9% in 2014. Following the devaluations, the nominal stock of local currency deposits declined significantly, while foreign currency deposits increased, resulting in the dollarization ratio increasing to 81.6% in late 2015. As the currency stabilized, the dollarization ratio started to decline gradually, retreating to 65.3% by the end of 2018.

With these trends, the loan to deposit ratio declined from 120.0% in 2014 to 59.5% in 2018. The loan to deposit ratio in local currency declined from 174.4% in 2014 to 106.5% in 2018, while in foreign currency the ratio declined from 65.3% to 34.6%.

#### Outlook

According to the official forecasts, Azerbaijan's economy is expected to grow 3.6% in 2019 with the non-oil GDP growth rate at 3.9% and the oil GDP growth rate at 3.1%. Over the 2019-2022 period

growth rate is forecast to average 3.4% per year. During this period non-oil GDP is projected to grow at an annual average 3.7% per year while oil-GDP growth rate is projected to average 3.2% per annum. Assuming a stable exchange rate, GDP in 2022 in nominal US\$ terms will be 28.8% higher than in 2018. The central government budget balance should remain in surplus, although a sudden fall in energy prices may necessitate consolidation in other areas. Public debt, which ballooned in recent years as a share of GDP due to the devaluation, is set to decline by 2-3 % of GDP per annum. The trade balance will remain positive, buoyed by energy receipts, but is forecast to be in the neighborhood of 15% of GDP, down from the extraordinary pre-crisis surpluses of over 25%; this in turn suggests that the current account will remain positive, but at around 5-6% of GDP, barring shocks.

## II. Overview of Current BSTDB Portfolio

As of 31 December, 2018, the active BSTDB portfolio in Azerbaijan amounted to six operations approved by the Board of Directors (BoD), involving an investment of € 88.9 million. All six operations were signed for € 73.2 million and the outstanding disbursements were at € 53.9 million. Azerbaijan ranks ninth as a destination for operations by BSTDB, in terms of BoD approved operations, with 3.9% of the total portfolio, ninth in terms of signed operations, with 3.6% of the total portfolio, and ninth in amounts outstanding, with 4.0% of the total portfolio. The portfolio has been concentrated primarily in the financial sector, which suffered a serious downturn during the 2015-16 recession, and this had as a result the reduction in the Bank's exposure in Azerbaijan.

**Table 2: Active BSTDB Portfolio in Azerbaijan as at end December 2018**

All Figures in Euros Million	BoD Approval Date	Approved Amount	Signed Amount	Amount Outstanding
AccessBank (former MFBA) Equity**	14-Oct-01/ 9-Oct-06/ 1-Feb-08/ 18-Nov-16/ 1-Jul-17	16.9	9.0	-
Unibank (TF)*	1-Oct-05	2.6	2.6	-
Equity to ADM CEECAT Recovery	21-Jul-11	0.1	0.1	-
Turan Bank (TF)*	21-Jul-11/ 11-Apr-	12.2	6.1	-
SEAF Caucasus Growth Fund*	2-Dec-11	2.9	2.9	1.3
Shah Deniz Stage 2*	20-Jun-15	54.1	52.4	52.4
<b>Total</b>		<b>88.9</b>	<b>73.2</b>	<b>53.8</b>

\* Financing for Operation provided in USD

\*\* Amount outstanding represents valuation of equity investment

## III. Review of Country Strategy 2015-2018: Post-Evaluation

The current evaluation was performed by the Bank's Evaluation Office as per the respective Evaluation Policy. It reveals the performance of the Bank's 2015-2018 Country Strategy for Azerbaijan. Its goal is to provide accountability to the Board of Directors and Board of Governors as well as facilitate the decision-making by the Bank's Management and Boards on the eventual update of the country strategies.

The evaluation of the respective country strategy compares the stated 2018 targets with actual results as of end of 2018 and provides a country-oriented overview and evaluation rating. The 2015-2018 Country Strategy was approved by the Board of Directors in early 2015, reflecting an in-depth independent evaluation of the implementation of the BSTDB's earlier strategies, conducted by the Evaluation Office. It was aligned with the objectives of the Bank's Business Plan 2015-2018 and was therefore evaluated in that context.

While the implementation of the Country Strategy was consistent with the Business Plan implementation it only covered 72% of the target volume. The Bank's operations covered the energy and financial sectors but remained unable to cover some of the sector priorities of the Strategy, such as agribusiness and construction.

A more comprehensive overview is presented in the table below.

**Table 3: Post Evaluation of 2011-2014 Country Strategy for Azerbaijan**

2011- 2014 TARGETS			RESULTS	
Country Strategy	Sectors/Priorities	Target: approved/ signed (€ million)	Actual: approved/ signed (€ million)	Evaluation Summary
Azerbaijan	<p><b>1. Financial sector:</b> <i>Trade finance/ Micro-SME loan facilities/ private financial sector/ equity / financial intermediaries/leasing</i></p> <p><b>2. Energy/ Infrastructure:</b> <i>energy (supply, downstream), transport and retail networks, petrochemical, power generation, transmission and distribution, municipal and social.</i></p> <p><b>3. Agribusiness:</b> <i>food processing and poultry projects, distribution channels, infrastructure.</i></p> <p><b>4. Construction:</b> <i>transport, cross-border cooperation rail-road-port), office/ co-financing of private sector.</i></p>	10/115	3/83.8	<p><b>1.volume:</b> 72%</p> <p><b>2. Sector coverage:</b> Turan Bank (SME) Garant Holding (Consumer staples) Sha Deniz Stage 2 (Energy) SOCAR (Energy)</p> <p><b>3. Conclusion</b> While actual volume met only 72% of target volume, the Bank covered the energy sector priorities but was not able to reach other targets, particularly in agribusiness and construction. There is no sufficient diversification, intended by the Strategy.</p>



#### **IV. BSTDB Operational Priorities for 2019 - 2022**

The Bank's role and priorities are outlined in accordance with (i) the priorities and targets laid out in its *Medium-term Strategy and Business Plan 2019-2022* and (ii) country needs and objectives, and taking due consideration of (iii) available resources, strategies and policies of BSTDB. BSTDB will seek viable opportunities for operational activity and will continue closely monitoring the developments in the Azerbaijani economy in order to stand prepared to support bankable projects. Where possible, the Bank will seek to leverage its presence by co-financing with international financial institutions (IFIs), public sector institutions and private partners, per its mandate.

The intention of the Bank is to provide support for the implementation of Government economic priorities, while being responsive to market demand. The Bank will consider undertaking activities and providing services as may advance its purpose, paying special attention to activities that promote regional cooperation, development of infrastructure, increased and diversified export of goods and services, and new employment creation. The Bank will seek to maintain consistency with the UN's Sustainable Development Goals in the context of Azerbaijan and its priorities and needs.

Based on the updated 2019-2022 BSTDB Medium Term Strategy and Business Plan, the Bank would expect on average to sign two to three new operations each year, for approximately € 65-75 million. Over the four year period, this implies ten new commitments (signed operations) for approximately € 290 million (a range of € 270-310 million).

These indicative targets are based on the Base Case Scenario of Growth of the MTSBP 20109-2022, and given appropriate circumstances and sufficient operational opportunities, the Bank would exceed this level in order to continue meeting client needs. In case of higher regional economic growth rates, an improved situation in financial markets, and above all, increased demand for Bank funding coming from private and/ or public entities active in the Azerbaijani market, the Bank will welcome the prospect to exceed the projected scenario and achieve higher operational results.

A key consideration for the Bank is to increase its relevance in each Member State. Achievement of such greater prominence has both quantitative and qualitative aspects- how much the Bank plans to do, but also where it plans to do so. In line with the MTSBP 2019-2022, the Bank intends to increase its presence in key infrastructure sectors since on the one hand regional investment rates are low while country needs are high, and on the other hand such operations usually have high cooperation and development impact, and positive economic and social returns that exceed the financial returns of the particular operation. The willingness to provide sovereign guarantees for such operations (or equivalent undertakings) would greatly increase the ability of BSTDB to provide support in these high priority areas.

The Bank will insist that all operations meet criteria of sound banking principles on the one hand, and financial viability/ economic sustainability on the other hand. Within these parameters, and in line with the Bank's continuing strategy to sustain higher operational activity in smaller shareholder countries, the Bank will explore the possibility of taking on additional risk- or risks- in order to facilitate the undertaking of additional operations. The greater 'reward' that justifies the acceptance of more risk is that the Bank would participate in a larger number and volume of operations in smaller countries, and thus better fulfill its mandate to promote economic development, especially where needs are greatest.

#### ***Areas for BSTDB Financing:***

Development bank activity in a country such as Azerbaijan is needed in sectors which are relatively underdeveloped and/ or in need of better access to financing. Given the need to promote diversification of the economy and to promote the non-oil/ non-energy portion of the economy, the Bank will pay particular attention to operations which promote diversification, including the promotion of small and medium scale projects in the non-oil sector which generate new employment creation and development impact. In line with the increased strategic emphasis of the Bank to help countries to boost investment and to invest in infrastructure in particular, BSTDB will prioritize such infrastructure investment activities where possible. Given the great need, however, for development of the non-energy related portion of the economy, BSTDB will be open to provision of support for bankable operations that support private sector development, with emphasis on high potential sectors as outlined below.

#### *Trade Finance and Financial Sector*

BSTDB's Trade Finance and Financial Sector Strategy have been created in order to develop a network of financial intermediaries, through which to deliver trade finance, SME finance and mortgage products. It is particularly important for accessing the many small and medium sized enterprises that often face difficulties in obtaining access to affordable financing.

Prior to the recession and banking crisis of 2015-16, BSTDB had developed a number of operations through selected financial intermediaries in Azerbaijan for the purpose of trade finance, mortgage finance and SME development:

- Combined Trade Finance (export/import) product;
- Medium-term Multiple Buyer products;
- Medium –Term Micro and SME Finance product;
- Medium –Term Mortgage product.

The Bank also undertook a number of equity investments to facilitate the creation of a micro finance institution in Azerbaijan, and to help banks improve their capital base from which to access additional financing and then on-lend for the benefit of 'real sectors' of the Azerbaijani economy. Most of the Bank's operational presence in Azerbaijan was in the financial sector, and the banking crisis of 2015-16 resulted in losses and reduction of activity, and a consequent reduction in exposure.

The crisis has largely passed, and needs remain as high as ever, in particular to channel money to 'real sectors' in order to promote employment and greater diversification of non-oil related activities. Thus, BSTDB intends to prioritize working with intermediaries in order to support recovery of the private financial sector and to help them fulfill their intermediating function for the benefit of other sectors. To fulfill this important strategic priority the Bank will seek to provide trade finance products where possible, and more generally to support the re-emergence of micro, small and medium enterprise (MSME) medium term lending

The small size of most non-oil sector firms often renders conducting direct operations with these enterprises as uneconomical (due to scale) or too difficult (due to informational difficulties and complexity of reaching out to small firms). The Bank remains committed to a proactive strategy of working with Azerbaijani commercial banks, and as the needs of Azerbaijani banks and SMEs evolve, the Bank will adapt in order to meet the changing needs as effectively as possible.

One of the factors behind the financial crisis was currency mismatches- the fact that Bank's raised funding in foreign currency and then provided financing in local currency. As long as the manat exchange rate remained stable, this business model worked well, but the dual devaluations of 2015 created a need to rethink this model.

While the Azerbaijani financial sector needs to continue to attract foreign currency to help private firms develop, there is also a need to develop and deepen the manat denominated portion of the financial sector. The Bank is thus keen to build upon its successful experience in other countries to help develop local currency lending in Azerbaijan, and during 2019 has already developed one such project, the first local currency loan from a multilateral development bank in Azerbaijan. In addition to making financing for partner banks and their clients easier, and removing foreign currency risks for them, local currency lending also contributes to the development of the domestic financial sector and is consistent with the Government's long term goal to promote 'de-dollarization' and increase confidence in the domestic currency for deposits as well as lending.

#### *Energy and Infrastructure (E&I)*

Given existing E&I needs, so long as projects are 'bankable', the Bank will be offering its support. Azerbaijan has sizeable hydrocarbon energy reserves, and achieving increases in the exports of oil and gas requires substantial financial resources for new investment and maintenance of existing transportation links, including oil and gas pipelines. The Bank will consider projects which intend to increase the supply of energy resources through transport networks with strong environmental and other positive externalities. The Bank also expects that there exist bankable business opportunities to provide financing for 'downstream' operations, particularly for oil and natural gas transportation, expansion of retail networks, the building of storage facilities and industrial parks, and the construction of new and/or modernization of existing petrochemical facilities (including refineries) to improve product quality and environmental acceptability.

BSTDB will be willing to explore whether the Government of Azerbaijan is able to provide sovereign guarantees for E&I projects. Should a sovereign guarantee be necessary and possible, it shall primarily be sought for an extremely high priority activity in which the guarantee would also serve as a signaling mechanism of the Government's commitment to/ ownership of the operation in order to facilitate greater resource mobilization and broader participation.

The Bank will focus on projects that envisage modernization and expansion of conventional energy infrastructure in order to facilitate power generation, transmission and distribution inside and outside Azerbaijan. Alternative energy sources such as hydro-power, wind and solar are enhancing the potential in this field, while also helping to address a number of environmental issues. In particular, the Bank will be looking forward for more "renewable energy" opportunities. The existence of an appropriate competitive environment and regulatory framework will be an important consideration in ascertaining 'bankability' alongside development impact.

Azerbaijan has a need for further development and improvement of its infrastructure including municipal and urban infrastructure. The Bank will focus on projects supporting efficient waste management and rehabilitation of the water sewage and water supply networks.

In terms of financing instruments, the Bank's energy and infrastructure priorities will primarily focus on medium- to long-term debt financing products to both local and international companies operating in Azerbaijan. Such financing may be used for the purpose of financing corporate

development needs, capital expenditures, financing of working capital requirements, re-financing of existing debts, as well as for sound project finance structures.

Where possible, the Bank will also work in cooperation with international financial institutions (IFIs), commercial banks and export credit agencies (ECAs) as an important source of project co-financing as well as institutional knowledge transfer.

The Bank will continue to ensure that all BSTDB operations in Azerbaijan meet sound banking principles and comply with the Bank's Environmental Rules and Procedures.

BSTDB Energy and Infrastructure strategy in terms of banking instruments:

- Project Finance limited recourse transactions;
- Corporate recourse financing transactions;
- Exploration of financing in the form of Equity;
- Co-financing of transactions with other IFIs, commercial banks and ECAs;
- Participation in syndicated facilities for E&I deals in Azerbaijan

Areas of particular focus in Energy and Infrastructure:

- Oil and natural gas upstream, midstream and downstream projects, including oil and gas transportation pipelines, refineries and storage,
- Energy (conventional and renewable) generation, transmission, distribution and storage,
- Transportation and transport infrastructure
- Telecommunication and Information Technology Services,
- Municipal and Social infrastructure of all kinds

### *Manufacturing*

Consistent with the theme of promoting greater diversification of the economy, the Bank will seek to find bankable projects in the area of manufacturing. This will be a priority area for the Bank in Azerbaijan. The manufacturing sector in Azerbaijan has suffered both (i) from a 'Dutch Disease' situation in which the overwhelming success of the energy sector has increased price levels and wages in other sectors of the economy, thus negatively affecting competitiveness, and (ii) from the 2015-16 economic recession and attendant banking crises which made access to credit even more difficult. Most new investments were postponed while existing businesses were unable to expand. In terms of specific sectors, the Bank will give priority to the investments that benefit from the competitive advantages of the country and demonstrate that they reduce reliance on imports and increase productivity.

### *Agriculture and Agribusiness*

Agribusiness is one sector in which Azerbaijan has great potential which thus far has not been met, and it represents another area of high priority. The reason for the underutilization includes factors such as rudimentary methods of production, outdated machinery and equipment, fragmented agricultural land holding (making achieving scale more difficult), insufficient irrigation facilities and distribution channels etc. The Bank will seek financing opportunities in agribusiness

investments of well-established companies with a proven market track record. The demand for food processing and packaging equipment is also big. BSTDB will finance such investments where feasible.

As the economy recovers from the recession, it is expected that many projects in various non-oil sectors like furniture manufacturing, machine-building, glass production etc. that had been postponed during the recession may revive. The Bank will finance such projects where feasible.

#### *Petro-chemical industry*

The large oil reserves of the country provide it with a significant competitive advantage in downstream activities like the petro-chemical industry, as well as the production of equipment and machinery that are used in oil extraction and transportation. The Bank will be open to opportunities in this area, but given that the size of investments in these sectors are relatively high, BSTDB would likely seek to join with other IFIs and commercial banks to co-finance such projects.

#### *Transport:*

Azerbaijan is well-positioned to be a transportation hub between east-west and north-south trade. To benefit from this position, the Azerbaijani government has implemented several important projects in road, air, port and rail including the Baku-Tbilisi-Kars railway, the Alat Port and a new modern cargo terminal at the Heydar Aliyev International Airport. BSTDB will give priority to projects that help the country develop its transport infrastructure with the aim of becoming a regional hub for trade from Russia to Iran and the Middle East and from Asia to Europe. These investments may include new or extension of existing road and port facilities, investments in free trade zones, storage facilities, warehouses, logistic centers etc.

#### *Real Estate and Tourism:*

The real estate development sector was negatively affected by the economic recession. Although there are signs of recovery in 2019, the Bank will be very selective in financing projects in this sector. Tourism on the other hand keeps growing steadily, thanks to the successful promotional efforts of the government, various international organizations and events hosted by the country and the improvements in tourism infrastructure. Currently Baku, as the main tourism destination in the country, seems to be saturated in terms of five star hotels and accommodation facilities. However, there is a need for lower star facilities and hotels outside of Baku, where the tourism potential for nature tourism is high. BSTDB will finance new investments in tourism where feasible.