



EU4Business

COUNTRY REPORT

# AZERBAIJAN

May 2017

 Armenia  Azerbaijan  Belarus  Georgia  Moldova  Ukraine

## INVESTING IN SMEs IN THE EASTERN PARTNERSHIP



Azerbaijan



EU4Business

# STRATEGIC PRIORITIES



1

Improving  
access to  
finance



2

Strengthening policy  
and regulatory  
frameworks



3

Improving  
knowledge base  
and business skills



4

Improving  
access to  
markets





# EU4BUSINESS ON THE WAY TO ECONOMIC GROWTH

Reinforcing economic resilience and promoting stabilisation at the EU's borders are key goals of both our new Neighbourhood Policy and of our Eastern Partnership initiative. Citizens across the Eastern Partnership countries aspire to economic development and greater prosperity. They are awaiting concrete and tangible results, such as getting a good job or growing their businesses.

It is in this spirit that the European Union launched the EU4Business initiative. The objective is to support our partner countries' commitment towards improved business climates and to support their SMEs and entrepreneurs in investing in their skills, in their ideas and reach-out to new market opportunities.

Our Eastern neighbours have all made considerable progress in promoting SMEs. Most have also made substantial progress in the design and implementation of business and investment climate reforms. This includes the simplification of business-related legislation, streamlining technical barriers to trade and upgrading quality infrastructure, and the improvement of the legal and regulatory environment in the financial sector. Partner countries are also increasingly aware of the need to support SMEs not only financially, but also by creating dedicated SME agencies and assistance programmes, and specific instruments to encourage SME access to finance and stimulate exports.

Under EU4Business, the EU and its partners have also achieved a lot, supporting countries in the design and implementation of SME policies, encouraging public private dialogue, reinforcing the role of business support organisations, as well as providing access to finance to SMEs. Through our DCFTA facility for example, the EU provided €200 million of grants which will unlock at least €2 billion of new investments. As a result of our joint efforts, more than 90 000 enterprises received already increased access to finance while about 93 000 jobs have been supported! You will read even more of our achievements in this report.

However, there are still important challenges ahead. Access to finance is often limited to foreign currencies exposing SMEs to currency risks. Many SMEs in the region remain tied in low valued-added sectors. Enhancing SME capacities to become more innovative, and to connect to new markets is especially pertinent today as some SMEs have been cut off from traditional markets. We should therefore consider additional support to realise quick commercial wins while fully benefiting from the opportunities offered by closer economic cooperation with the EU. I know that the three DCFTA signatories face a particular challenge in that respect. We have already achieved a lot. Let us now keep the momentum to further improve EaP countries' economic resilience, to support SME trade with the EU and to deliver concrete and positive impact for the life of all people.

**Johannes Hahn**

Commissioner for European Neighbourhood Policy and Enlargement Negotiations

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## CHAPTER 1:

# COUNTRY OVERVIEW

### 1.1. Economic situation

The Azerbaijan economy is largely dominated by the oil industry. Plunging oil prices in 2015 cut export earnings, and sharp currency depreciation reduced household consumption and public investment. Continued weak oil prices helped to cause Azerbaijan's GDP to contract by 3.8% in 2016 and its current account to fall into deficit. This makes the country vulnerable to fluctuations in oil production and prices. The decline reflected weak oil prices and lower oil production, but also a decrease in domestic demand, including less public investment, which caused the economy outside of the large oil sector to shrink by 5.4%. The inflation rate accelerated to 12.4% from 4.0% in 2015.

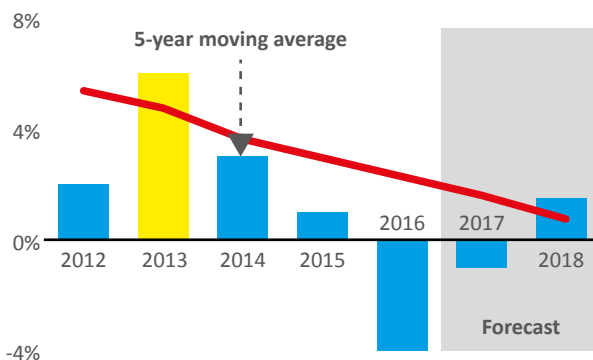
On the supply side, industry declined by 7.1%, much more than the 1.9% decline in 2015, mainly because construction fell by 27.6% as the government cut public investment in response to diminishing revenues. In February 2015 and December 2015, Azerbaijan announced devaluations of the manat against the dollar, which meant a 98% decrease in the value of the manat. After the central bank adopted a floating exchange rate at the end of 2015, the manat depreciated by a further 12.0% against the US dollar in 2016. Dollarisation increased as foreign exchange deposits reached 82.5% of all deposits in January 2016, compared to 51.6% a year earlier. The number of unemployed rose by 2.5% in 2015 and 14.5% in 2016.

Azerbaijan has made significant progress against global competitiveness benchmarks. It currently ranks 37th in the World Economic Forum's Global Competitiveness Index, up from 40th in 2015. The country has implemented reforms in key areas of the World Bank's Doing Business report, such as 'Starting a Business' (5th) and 'Registering Property' (22nd), although it still ranks only 65th overall due to poor performance in other areas. The government has also developed an extensive e-government infrastructure and envisages a further review and simplification of business regulations under the Presidential Decree on Additional Measures for the Development of Entrepreneurship of 3 March 2014.

Recent reforms include the adoption of the Law on Protection of Interests of Entrepreneurs and Regulation of Inspections in 2013, which prompted the creation of an online inspection registry to make this area more transparent. However, despite improvements to the business environment, doing business in Azerbaijan continues to be challenging, particularly outside the oil sector.

The financial sector continues to be dominated by banks, and the non-banking sector still offers limited opportunities. Banks hold about 95% of total financial sector assets.

Figure 1: GDP growth <sup>(1)</sup>

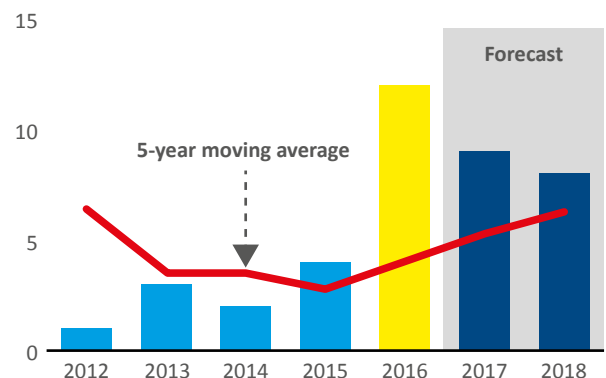


Source:

<sup>(1)</sup> Central Bank of the Republic of Azerbaijan, ADB estimates

<sup>(2)</sup> Idem

Figure 2: Azerbaijan inflation rate <sup>(2)</sup>





The leasing industry is very small but gaining in popularity; insurance services also remain small but are experiencing high growth. Venture capital and private equity are at a nascent stage. Government securities and corporate bonds dominate capital markets. The private capital market is rapidly developing, with more issuers recorded in 2013-14.

International trade in Azerbaijan is dominated by large, often state-owned enterprises with only 2.1% of small and 1% of medium-sized enterprises exporting directly or indirectly. The World Bank's 2017 Doing Business report ranks the country in 83rd place for ease of trading across borders due to the number of documents required and the length of the export process. The EU is Azerbaijan's main trading partner, accounting for around 42.4% of Azerbaijan's total trade. EU imports from Azerbaijan chiefly consist of mineral fuels, machinery and transport equipment, chemicals, food and livestock. The EU supports closer trade and economic integration with Azerbaijan through the European Neighbourhood policy and its Eastern Partnership dimension. Azerbaijan applied to join the WTO in 1997 and the process is ongoing. Azerbaijan is receiving technical assistance from the EU to help it to prepare for WTO membership. Among other Eastern Partner countries, Azerbaijan has the lowest share of export sales by SMEs and of exporting SMEs (1.2% and 3.7%), as well as the lowest percentage of exports by large enterprises in the EaP region (9.2%), partly due to the importance of hydrocarbon products in the export basket.

Currently AZPROMO is the leading agency in charge of promoting international trade opportunities among local businesses, including SMEs. Despite the progress in export promotional initiatives, there is a notable lack of financial support mechanisms for exporting SMEs in Azerbaijan.

The flows of foreign direct investment (FDI) to the Republic of Azerbaijan are mainly directed towards the energy sector. Russia is one of the main sources of direct investment in the Azerbaijan economy, and due to the economic downturn that occurred in Russia in 2014 this has had negative spillover effects on EaP countries, including Azerbaijan. The President of the Republic of Azerbaijan, Ilham Aliyev, has signed a Decree endorsing 'Strategic roadmaps for the national economy and main economic sectors'. The strategic roadmaps cover almost all sectors of the economy, including the development of the oil and gas industry, the manufacture and processing of agricultural products, the manufacture of small and medium entrepreneurship-level consumer goods, the development of heavy industry and machinery, tourism, logistics and trade, vocational education and training, financial services, communication and information technologies and utilities.

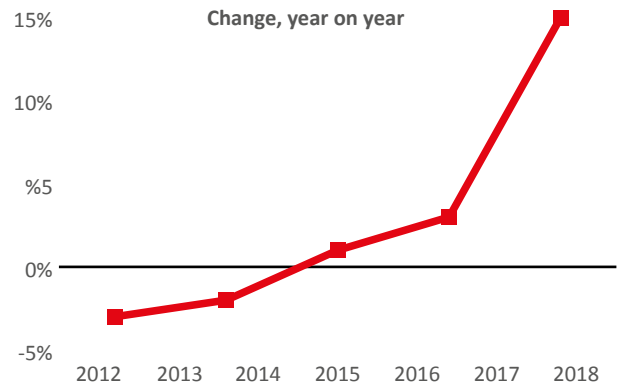
## 1.2. Political situation

Azerbaijan is located at an important crossroads between Asia and Europe, with the country declaring its pro-European aspirations and pursuing policies aimed at integration with European structures. In this respect, Azerbaijan's membership of the Council of Europe and its obligations under the European Neighbourhood Policy (ENP) and Eastern Partnership (EaP) initiative provide the government with a platform to demonstrate its commitment to political and economic reforms to bring the country's legal framework and practice into line with European standards. The latest ENP progress report on March 2015 stated that despite recent progress, Azerbaijan needs to respect and implement its commitments as a member of the Council of Europe on fundamental rights and freedoms, improve democracy and human rights in the country, continue the reform of the judiciary and ensure the full independence of the judiciary.

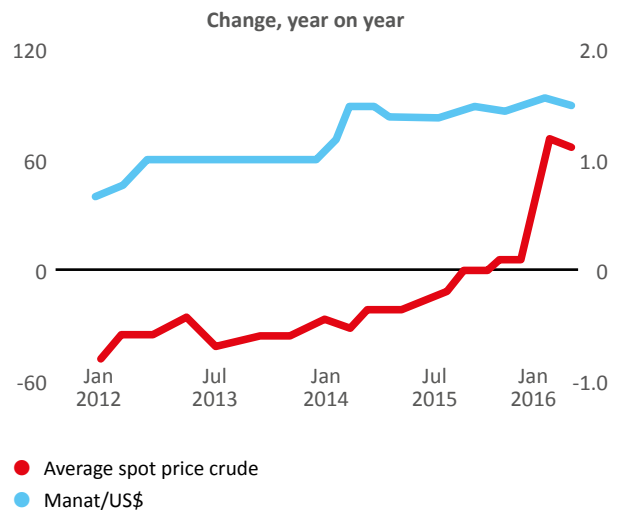
According to its constitution, the Republic of Azerbaijan has a presidential form of government. President Ilham Aliyev has been in office since October 2003. Since coming to power, President Aliyev has steadily consolidated his political authority, and has been re-elected twice, in 2008 and 2013. On 26 September, a referendum was held in Azerbaijan on draft amendments to the constitution, including extending the presidential term from five to seven years.

The ruling presidential party (Yeni Azərbaycan Partiyası – YAP) retains a dominant position in the legislature and in the political system. The conflict with Armenia over Nagorno-Karabakh is still unresolved despite continuing efforts at international mediation by the OSCE Minsk Group, co-chaired by France, Russia and the United States. The escalation in April 2016 between Armenian and Azerbaijani troops in the Nagorno-Karabakh conflict zone has been a cause of concern for major international organisations.

**Figure 3: Growth in total unemployment, 2013-2016** <sup>(3)</sup>



**Figure 4: Exchange rate and average crude oil price** <sup>(4)</sup>



**Source:**

<sup>(3)</sup> The State Statistical Committee of the Republic of Azerbaijan

<sup>(4)</sup> Central Bank of the Republic of Azerbaijan, Haver Analytics

Note: An increase in the exchange rate indicates a depreciation





**Table 1: SWOT Analysis of SME sector for Azerbaijan**

STRENGTHS	WEAKNESSES
<ul style="list-style-type: none"> <li>• Stable macroeconomic environment</li> <li>• Significant progress in global competitiveness benchmarks (37th in Global Competitiveness Index after steady progress)</li> <li>• Extensive e-government infrastructure, strong track record in business environment reforms (one-stop shops, e-government); favourable environment for business registration and ongoing reforms in other areas (credit bureau, collateral registry, RIA)</li> <li>• Comparatively good infrastructure and service provision (cf. BEEPS data on electricity, water)</li> <li>• Increased attention to targeted support in business support infrastructure, innovation (ICT fund)</li> <li>• New SME definition in June 2015 with segmentation by size</li> </ul>	<ul style="list-style-type: none"> <li>• SME policy fragmentation among several state programmes without formal coordination and lack of comprehensive strategy</li> <li>• Lack of public-private consultations; lack of structured institutional set-up beyond informal cooperation; limited SME involvement</li> <li>• Limited access to bank finance (high collateral, low levels of access, cf. BEEPS; other sources are underdeveloped (banking sector holds 95% of total assets); growth in credit mostly to households, consumer credit)</li> <li>• Absence of M&amp;E for government support tools</li> <li>• Corruption perceptions are still cited as an obstacle to business (cf. BEEPS, Global Competitiveness Index)</li> <li>• Low levels of SME internationalisation despite relatively low customs barriers (new legislation in 2014 and 2015) and AZPROMO's existing activities</li> </ul>
OPPORTUNITIES	THREATS
<ul style="list-style-type: none"> <li>• Adoption of strategic roadmap for development of the national economy, which determines the economic development strategy and action plan for 2016-20, long term vision till 2025 and target vision after 2025</li> <li>• Major infrastructure projects will help galvanise new growth opportunities</li> <li>• New export programme in development, with a focus on boosting exports of non-oil products</li> <li>• Ongoing preparation stage for private credit bureaus and registry of movable assets</li> <li>• WTO membership prospects likely to boost trade</li> <li>• Untapped potential in non-oil sectors, e.g. agriculture and manufacturing</li> <li>• FDI in non-oil sectors with potential for SME linkages</li> <li>• Innovative approaches to SME training design and delivery</li> </ul>	<ul style="list-style-type: none"> <li>• Pressure on the banking sector due to the devaluation of the Azerbaijani manat; banks are facing a decline in capital</li> <li>• Dependence on natural resources in times of economic volatility</li> <li>• Exposure to regional dynamics, particularly in the non-oil sectors</li> <li>• Lack of independent implementation agencies in key areas such as innovation and entrepreneurship</li> <li>• Non-oil exports hindered by delays in defining national standards and technical regulations, limited international quality certification (12.8% vs 22.6% ECA average – cf. BEEPS)</li> <li>• Existing initiatives in innovation lacking strategy, focused largely on ICT</li> <li>• The Nagorno-Karabakh conflict that threatens the political and economic stability and absorbs significant financial resources</li> </ul>

### 1.3 General overview of the SMEs sector

Azerbaijan has adopted a number of legislative acts aimed at regulating the development of small and medium-sized enterprises, including a system of economic and legal relations. Examples include the Law on Entrepreneurship, the Law on State Support for Small Business, the Law on State Registration and State Registry of Legal Entities, etc. At the same time, much work has been done to institutionalise relations between state and businesses thus giving birth to the establishment of the Azerbaijan Export and Investment Promotion Foundation (AZPROMO), the Council of Entrepreneurs, and other bodies.

Since 2008, the registration of individual enterprises has been conducted according to the single-window principle. Since the single-window (one-stop shop) system has been applied, the time for the registration of new enterprises has decreased from 53 days to 3-7 days and the number of procedures from 13 to 5. Moreover, despite the proactive work on the reform of the business environment, the introduction of one-stop shop company registration and a best practice e-government portal, there is a lack of a strategic framework for financial and institutional support measures for SMEs in Azerbaijan.

While small enterprises accounted for 83% of all companies in 2013, their contribution to added value was only 3% (although this is better than in 2010, when it was just 1.7%). Their contribution to total employment has also increased, from 5.9% in 2010 to 7.9% in 2013.

Access to finance remains a key obstacle to SME growth in Azerbaijan. According to the Business Environment and Enterprise Performance Survey (a firm-level survey conducted among 390 enterprises in Azerbaijan in 2013), only 14.6% of surveyed firms had a loan or a line of credit, down from 19.9% in 2009. This was the lowest share of among the 30 countries included in the survey. In addition, only 4.7% of companies reported financing their working capital through banks, while 92.8% financed it through internal funds. This was the highest in the region (EBRD, 2014). Therefore, SMEs remain dependent on higher bank credit rates. Such bank rates and strict conditions for guarantees and pledges required for loans issued by banks challenge SMEs when accessing financial resources.

**Table 2: Definition of SMEs in Azerbaijan <sup>(4)</sup>**

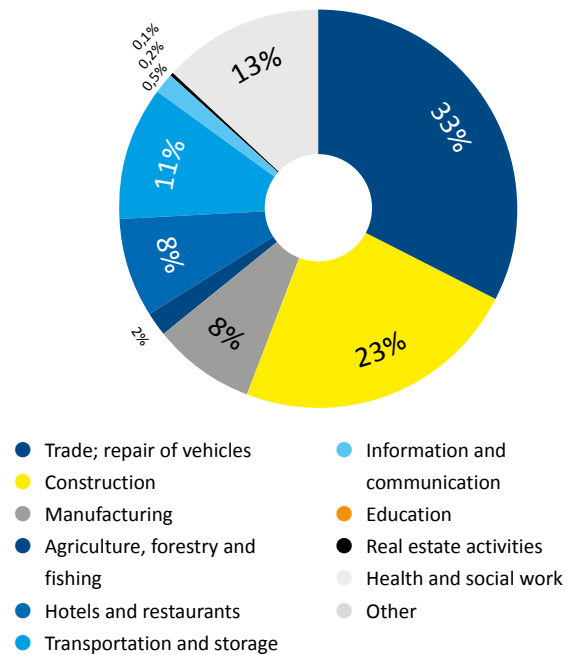
DEFINITION	EMPLOYMENT		TURNOVER	
	1	2	1	2
<i>Small</i>	< 25 employees	Self-employed	< AZN 120 000 (EUR 101 500)	< AZN 120 000 (EUR 101 500)
<i>Medium</i>	< 125 employees		< AZN 1 250 000 (EUR 1 057 500)	

Azerbaijan has two separate SME definitions, one that was included in the general legislation in June 2015 (Definition1) and the other used only for tax purposes (Definition2). The Tax code does not define small and medium enterprises per se, but distinguishes between individual entrepreneurs and legal entities. Individual entrepreneurs are defined as physical persons who are engaged in business activities. The majority of small enterprises are registered as individual entrepreneurs (94.5% in 2013). The turnover threshold used in the lax legislation for individual entrepreneurs is currently aligned with that of small enterprises in the general legislation, following the June 2015 amendment.

Azerbaijan also has been working toward a secured transactions legal framework (a framework that gives creditors the right to enforce claims against their debtors making it easier for creditors to collect debts) for many years, but the reform is not yet complete.

The country is in the process of digitising the registry of the quantity, value and ownership of land and real estate.

**Figure 5: Distribution of SMEs in Azerbaijan by sector, 2013 <sup>(5)</sup>**



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**Source:**

<sup>(4)</sup> Decision of the Cabinet of Ministers No. 215 of 5 June 2015, Tax Code of Azerbaijan; exchange rates as of June 2015

<sup>(5)</sup> Azerbaijan State Statistical Committee



## CHAPTER 2:

# EU4BUSINESS PROJECTS UNDER IMPLEMENTATION

### EBRD WOMEN IN BUSINESS PROGRAMME IN THE EASTERN PARTNERSHIP

<i>IMPLEMENTING AGENCY</i>	EBRD
<i>START DATE</i>	2015
<i>DURATION (YEARS)</i>	7
<i>COUNTRIES COVERED</i>	Armenia, Azerbaijan, Belarus, Georgia, Moldova, Ukraine
<i>TARGET BENEFICIARIES</i>	Women-led SMEs
<i>PURPOSE AND DESCRIPTION</i>	<ul style="list-style-type: none"><li>• The programme promotes women's entrepreneurship and supports small and medium-sized enterprises (SMEs) led by women through access to finance and know-how solutions required for business growth. The EBRD is currently implementing the Women in Business programme in 16 countries. The programme is funded by the EBRD, the European Union, Sweden and the Early Transition Countries Fund. The EU contributes to the risk-spreading component (10% of first loss guaranteed to banks).</li><li>• Belarus became one of the first countries to launch the Women in Business programme implemented by the EBRD.</li></ul>

### SUPPORTING SME COMPETITIVENESS REFORMS IN EASTERN PARTNER COUNTRIES

<i>IMPLEMENTING AGENCY</i>	OECD
<i>START DATE</i>	2013
<i>DURATION (YEARS)</i>	5
<i>COUNTRIES COVERED</i>	Armenia, Azerbaijan, Belarus, Georgia, Moldova, Ukraine
<i>TARGET BENEFICIARIES</i>	Public authorities, the private sector and civil society
<i>PURPOSE AND DESCRIPTION</i>	<p>The initiative aims to:</p> <ul style="list-style-type: none"><li>• improve competitiveness in participating countries through better policy design and implementation</li><li>• support private sector development with a focus on SMEs</li></ul>

### IMPLEMENTATION OF EBRD SMALL BUSINESS SUPPORT (SBS) PROGRAMMES - ENTERPRISE GROWTH PROGRAMME (EGP) AND BUSINESS ADVISORY SERVICES (BAS) IN EASTERN PARTNERSHIP (EAP) COUNTRIES

<i>IMPLEMENTING AGENCY</i>	EBRD
<i>START DATE</i>	2015
<i>DURATION (YEARS)</i>	3
<i>COUNTRIES COVERED</i>	Armenia, Azerbaijan, Belarus, Georgia, Moldova, Ukraine
<i>TARGET BENEFICIARIES</i>	SME's
<i>PURPOSE AND DESCRIPTION</i>	<p>SBS programmes - the Enterprise Growth Programme (EGP) and Business Advisory Services (BAS) - help MSMEs in the region to improve their competitiveness and ability to attract external financing by improving the financial literacy of senior managers and by facilitating their firms' access to high-quality business support services, enhancing managerial capacity in all areas and striving to develop the capacity of the local consultancy market to deliver the services needed. The SBS programme seek to achieve enterprise-level change and the development of a sustainable infrastructure of business advisory services.</p>

**EAST INVEST I-II**

<i>IMPLEMENTING AGENCY</i>	EUROCHAMBRES
<i>START DATE</i>	2010 / 2014
<i>DURATION (YEARS)</i>	3
<i>COUNTRIES COVERED</i>	Armenia, Azerbaijan, Belarus, Georgia, Moldova, Ukraine
<i>TARGET BENEFICIARIES</i>	Business support organisations and SME associations
<i>PURPOSE AND DESCRIPTION</i>	<ul style="list-style-type: none"><li>• The overall purpose of the East-Invest programme is to develop mechanisms encouraging new flows of direct foreign investments and to strengthen the ongoing investment promotion process between the EU and the Eastern ENPI countries as well as between the Eastern countries, which will help to improve trade in the region.</li><li>• East Invest provides training and technical assistance to SMEs in the Eastern Partnership countries, to enhance their networking and trading competences and opportunities.</li></ul>

**SME FINANCIAL FACILITY I**

<i>IMPLEMENTING AGENCY</i>	EBRD
<i>START DATE</i>	2010
<i>DURATION (YEARS)</i>	9
<i>COUNTRIES COVERED</i>	Armenia, Azerbaijan, Belarus
<i>TARGET BENEFICIARIES</i>	SME
<i>PURPOSE AND DESCRIPTION</i>	The facility aims to offer a wide range of financial services and products to SMEs and financial intermediaries throughout the region

**SME FINANCE FACILITY - PHASE I WITH EIB**

<i>IMPLEMENTING AGENCY</i>	EIB
<i>START DATE</i>	2010
<i>DURATION (YEARS)</i>	
<i>COUNTRIES COVERED</i>	Armenia, Azerbaijan, Belarus, Georgia, Moldova, Ukraine
<i>TARGET BENEFICIARIES</i>	SME
<i>PURPOSE AND DESCRIPTION</i>	Emphasis is given to stimulating local currency lending, particularly for MSMEs

**NEIGHBOURHOOD WINDOW OF THE EUROPEAN FUND FOR SOUTH EAST EUROPE (EFSE)**

<i>IMPLEMENTING AGENCY</i>	KFW
<i>START DATE</i>	2009
<i>DURATION (YEARS)</i>	10
<i>COUNTRIES COVERED</i>	Armenia, Azerbaijan, Belarus, Georgia, Moldova, Ukraine
<i>TARGET BENEFICIARIES</i>	SME
<i>PURPOSE AND DESCRIPTION</i>	The Fund aims to foster economic development and prosperity in the Southeast Europe & Caucasus region through the sustainable provision of additional development finance

**FINANCIAL SECTOR INSTITUTION BUILDING AND CRISIS RESPONSE**

<i>IMPLEMENTING AGENCY</i>	EBRD
<i>START DATE</i>	
<i>DURATION (YEARS)</i>	
<i>COUNTRIES COVERED</i>	Armenia, Azerbaijan, Belarus, Georgia, Ukraine
<i>TARGET BENEFICIARIES</i>	SME
<i>PURPOSE AND DESCRIPTION</i>	Rebuild financial intermediaries' confidence following the financial crisis, to extend financing to SMEs, including micro-enterprises

**SOUTH CAUCASUS SUST. ENERGY FINANCE FACILITY: IMPLEMENTATION SUPPORT**

<i>IMPLEMENTING AGENCY</i>	EBRD
<i>START DATE</i>	2013
<i>DURATION (YEARS)</i>	7
<i>COUNTRIES COVERED</i>	Armenia, Azerbaijan, Georgia
<i>TARGET BENEFICIARIES</i>	SME
<i>PURPOSE AND DESCRIPTION</i>	The Facility provides credit lines to Participating Financial Institutions ('PFIs') for on-lending to private sector borrowers

**FRAMEWORK FOR CAPACITY BUILDING TO SUPPORT FINANCIAL INTERMEDIARIES IN AZERBAIJAN AND GEORGIA**

<i>IMPLEMENTING AGENCY</i>	EBRD
<i>START DATE</i>	2009
<i>DURATION (YEARS)</i>	9
<i>COUNTRIES COVERED</i>	Azerbaijan, Georgia
<i>TARGET BENEFICIARIES</i>	SME
<i>PURPOSE AND DESCRIPTION</i>	The aim is to develop banks' operations and the growth of working assets.

**GREEN FOR GROWTH - EXTENSION TO NIF EAST REGION**

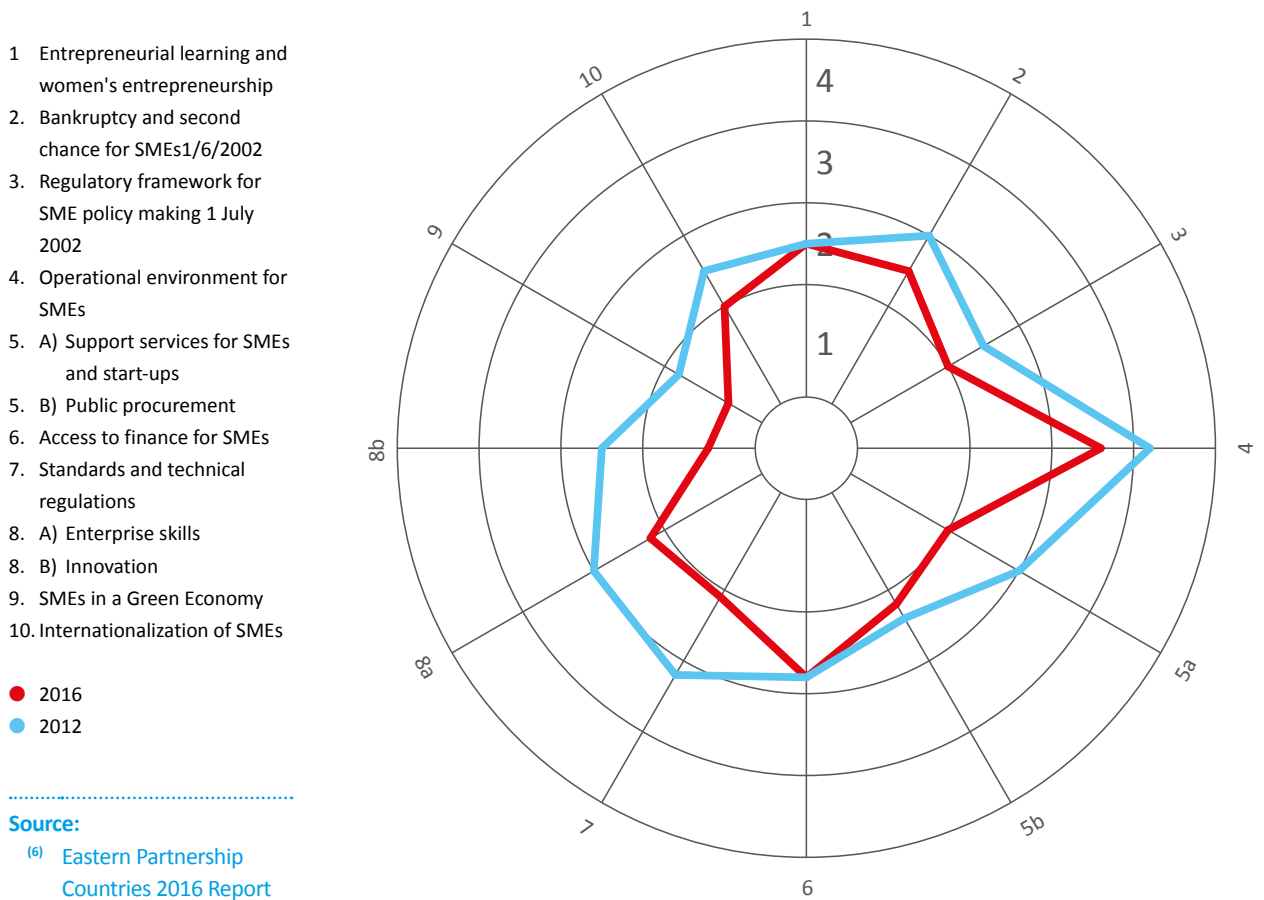
<i>IMPLEMENTING AGENCY</i>	EIB
<i>START DATE</i>	2013
<i>DURATION (YEARS)</i>	5
<i>COUNTRIES COVERED</i>	Armenia, Azerbaijan, Belarus, Georgia, Moldova, Ukraine
<i>TARGET BENEFICIARIES</i>	SME
<i>PURPOSE AND DESCRIPTION</i>	Helps to overcome the lack of sufficient legal, policy and other framework conditions by providing long-term financing instruments

**STAREP - STRENGTHENING AUDITING AND REPORTING IN THE COUNTRIES OF THE EASTERN PARTNERSHIP**

<i>IMPLEMENTING AGENCY</i>	WB
<i>START DATE</i>	2013
<i>DURATION (YEARS)</i>	5
<i>COUNTRIES COVERED</i>	Armenia, Azerbaijan, Belarus, Georgia, Moldova, Ukraine
<i>TARGET BENEFICIARIES</i>	Government/auditors
<i>PURPOSE AND DESCRIPTION</i>	STAREP aims to help the participating countries both to improve their frameworks for corporate financial reporting and to raise the capacity of local institutions.



**Figure 6: Key challenges for ongoing EU4Business programmes and planned activities <sup>(6)</sup>**



**SME Competitiveness**

The 2016 SME Policy index report was published in November 2015. The report presents in-depth analysis, recommendations, and a roadmap for policy reforms or the development of SMEs in Azerbaijan.

The Ministry officials did not appreciate some scores in the report in comparison with other CIS countries. However, this publication could play the same role as 'Doing Business', where the government is interested in improving its scores.

<b>EBRD SBS</b>	The project is active in Azerbaijan, supporting local consulting companies as well as providing direct support to companies.
<b>East Invest</b>	In comparison with other EaP countries, Azerbaijani organisations are not so active in this project, the aim of which is the economic development of the Eastern Neighbourhood region.



**CHAPTER 3:**

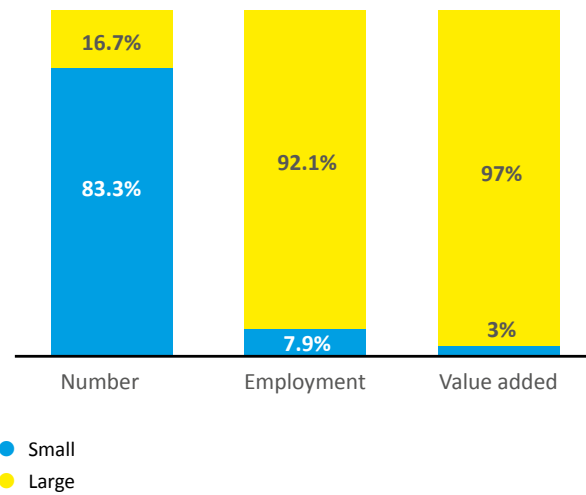
# PRESENT NATIONAL POLICIES AND FUTURE MEASURES PLANNED IN THE NATIONAL STRATEGY FOR SMES

Azerbaijan has taken a number of steps to strengthen the institutional, regulatory and operational environment for SMEs, particularly by easing company registration and developing e-government services. The institutional support for SMEs has also been improved with the establishment of the Department of Entrepreneurial Development Policy under the Ministry of Economy and Industry. However, a comprehensive SME strategy has yet to be adopted to address policy fragmentation, improve inter-agency coordination and enhance public-private dialogue. An inadequate insolvency legal framework and a cumbersome licensing and permit regime are other outstanding challenges.

The ‘Azerbaijan 2020 Vision’ which lays out the country’s medium-term strategic framework, highlights the role of entrepreneurship and SMEs in economic development. Entrepreneurial development and related aspects are included in several state programmes such as the Programme on Social-Economic Development of Regions 2014-18), Poverty Reduction Programme (2008-15), Food Security Programme (2008-15), Azerbaijan 2020 Development Concept and ‘Strategic roadmaps for the national economy and main economic sectors’ signed by the President of the Republic of Azerbaijan. Currently there is no coordination between government agencies and departments involved in SME policy. A joint coordination platform could therefore improve the effectiveness of SME policy making.

The centralised agency and centre for small and medium enterprises are expected to be established under the ‘Strategic roadmaps for the national economy and main economic sectors’. The creation of the centralised agency for small and medium enterprises will increase the effectiveness of policy implementation in this sector.

**Figure 7: Business demography indicators in Azerbaijan, 2013 <sup>(7)</sup>**



Source:  
<sup>(7)</sup> Azerbaijan State Statistical Committee

TITLE OF THE MEASURE	IMPLEMENTING BODY	DURATION, YEARS
1. State Programme on Socio-Economic Development of Regions of the Republic of Azerbaijan	Government	2014-18
2. Strategic roadmaps for the national economy and main economic sectors	Government	2016-N/A

# GENERAL CONCLUSION

### **Main challenges for SME development**

Compared with other EaP and EU countries, the level of SME development in Azerbaijan is lower. According to the 2016 OECD SME Policy Index, Azerbaijan has made substantial improvement over the last 4 years, but still needs improvement in dimension 3, 8b (regulatory framework), dimension 6 (access to finance), dimension 10 (SME internationalisation)

The main challenges that SME development in Azerbaijan faces are:

- The absence of a coordination structure, implementation body and public-private dialogue
- High costs of borrowings, a lack of a legal framework for both bank and non-bank sources of finance
- The absence of a comprehensive innovation strategy and an enabling environment for trade finance (export promotion)

### **The absence of a coordination structure and implementation body**

The absence of a definition of micro-enterprises and the existence of an overlap between the two SME definitions (one specified in legislation and applicable to nearly all policy areas and another used exclusively for taxation) due to use of different employment criteria, thereby affecting the quality of statistics on SMEs. As the data do not differentiate micro-enterprises, it is difficult for policy makers to design policies.

The informal economy remains a challenge for the authorities, with 'practices of the informal sector' identified as the biggest obstacle to doing business. Public-private consultations are still conducted on an ad-hoc basis and lack a formal framework. There is also no detailed information about PPCs conducted with the participation of SMEs.

### **High costs of borrowings, a lack of a legal framework for both bank and non-bank sources of finance**

Access to finance continues to be the main obstacle for SME growth in Azerbaijan. The current economic situation exhibits very high interest rates for borrowings in the local currency. Due to high inflation rates and economic uncertainty, banks find it disadvantageous to provide long-term loans or grace period loans that are important for new businesses.

As a rule, access to credit is on the banks' terms, which include interest rates, securitisation of credits and period of borrowing. Such conditions seem unfavourable for SMEs to take loans from the banks.

One of the main reasons for refusal of commercial lending is the demand for credit guarantee requirements. In-depth analysis shows that the banks prefer real estate as collateral to secure crediting. The fact that approximately 60% of entrepreneurs conduct their businesses on leased premises, means that they can only use their living accommodations as collateral, which does not satisfy the banks. Also, because SME operations are not transparent, due to not keeping financial records, the banks cannot evaluate companies' operations, which in turn limits banks' ability to assess the creditworthiness and possible loan issuance.

Although in 2014 the government took a step towards the establishment of a legal framework for secured transactions it has yet to be completed. Credit guarantee schemes with private sector participation is underdeveloped in Azerbaijan.

Letters of credit, trade insurance, leasing, and factoring are also limited by both supply and demand factors. At the same time, stronger legal frameworks are required to create an enabling environment for venture capital activities.

### **Visibility of the EU4Business initiative in Azerbaijan**

The current level of awareness of the authorities and the business community regarding the EU4Business initiatives is rather low. Therefore, measures should be undertaken to increase the visibility of the EU4Business initiative and promote the opportunities it offers in Azerbaijan.

### **Establishing the SME policy implementation agency**

Separating SME policy design from policy implementation is crucial to promote transparency and accountability in the policy-making process. An autonomous agency or special department separate from the Ministry of Economy needs to be established for translating strategic directions into operational programmes and implementable measures.

### **Addressing the limited availability and quality of SME statistical data**

The existence of an overlap between the two SME definitions and the absence of a definition of micro enterprises affect the quality of statistics on SMEs. The government must intensify its efforts to increase the level of detail and quality of SME statistics, improve the accessibility of the data (e.g. by publishing regular updates on the websites of the national statistical offices), improve international comparability and use firm-level surveys of active companies to expand the information available on certain topics.

### Adoption of legal requirement to conduct regulatory impact analysis (RIA)

Currently there is no legal requirement to conduct regulatory impact analysis (RIA) in Azerbaijan. The Ministry of Justice has developed draft legislation for the introduction of RIA as part of the national action plans on open government and corruption. Its final adoption is still pending.

### Reform of the legal framework for both bank and non-bank sources of finance to address the obstacles in SME access to finance

Completing key pieces of legislation (e.g. on facilitating the establishment of a private credit bureau, a movable collateral registry and legal reforms regarding secured transactions) would fill the gaps in the country's financial structure. Innovative approaches could encourage banks to lend to SMEs, including the establishment of a credit guarantee scheme and improvements to current schemas.

### Establishment of a Development Bank for the consolidation of all existing funds and support to entrepreneurs on a centralised basis

Although Azerbaijan has attempted to fill finance gaps in the private sector by launching various special lending and loan subsidy programmes, including through the National Fund for Entrepreneurship, access to finance is still the main obstacle for SMEs.

The government has requested that the World Bank analyse the possibilities of establishing a development bank to support SMEs, and the development and improvement of collaboration with international organisations involved in SME financing.

### Increasing SME competitiveness by improving the monitoring and assessment of the existing initiatives on innovation, capacity building and export promotion

A more strategic approach is needed to ensure that innovation support measures being introduced by the government are coherent and effective. The narrow focus on the ICT sector should be broadened to take in the full framework for innovation, including developing institutional links between academia and the private sector. The government could also strengthen general support to SMEs by promoting private advisory services for businesses.

Table 3: SME Policy Development Index Dimensions for Azerbaijan, 2016 <sup>(8)</sup>

POLICY DIMENSION	SME POLICY INDEX AZERBAIJAN			
	2012*	2016*	EaP average, 2016	Azerbaijan rank among EaP countries, 2016
1. Entrepreneurial learning and women's entrepreneurship	2.45	2.59	2.52	5
2. Bankruptcy and second chance for SMEs	2.50	2.87	2.71	5
3. Regulatory framework for SME policy making	1.95	2.47	2.95	6
4. Operational environment for SMEs	3.70	4.23	4.01	3
5a. Support services for SMEs and start-ups	2.12	2.98	3.13	4
5b. Public procurement	2.29	2.42	3.12	3
6. Access to finance for SMEs	2.74	2.70	3.28	5
7. Standards and technical regulations	2.13	3.32	3.76	6
8a. Enterprise skills	2.19	2.94	2.66	6
8b. Innovation policy for SMEs	1.29	2.47	2.57	1
9. SMEs in green economy	1.20	1.54	1.99	4
10. Internationalization of SMEs	2.07	2.50	2.79	4

#### Source:

<sup>(8)</sup> OECD Policy Index EaP countries, 2016

\* \*Score range 1-5, with 1 being the weakest, 5 being the strongest



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