



CAPITAL FLOWS ACROSS BORDERS IN AZERBAIJAN

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Introduction

In developing countries, private investment and entrepreneurship is a common determinant of long term growth. Considering that a developing country lacks capital, it is crucial for such a country to attract foreign investments. Many economists believe that Foreign Direct Investment (FDI) is more effective than simply investing in the financial sector. It is also clear that developing countries do not have an appropriate financial market for such investments. Thus FDI might be more helpful as a type of foreign investment. There is a vast range of literature on the determinants of FDI attraction. In this study, we will not discuss each of these determinants in depth. However, we can state that the political and economic credibility of the country plays significant role in attracting FDI. In brief, if a country's institutions do not function properly, the country might struggle to attract foreign investments.

In this paper, the individual legal framework for foreign investment and investment protection in Azerbaijan will going to be analysed. There is a special law associated with foreign investments, called the Law of the Azerbaijan Republic on protecting foreign investment. The present Law determines the legal and economic principles of realization of foreign investments on the territory of the Azerbaijan. The Law is aimed at the attraction and efficient use of foreign material and financial resources in the economy, modern foreign equipment and technology and managerial experience, and guarantees the rights of foreign investors¹. According to this law, foreign investors can make investments at the territory of the Azerbaijan through:

- a) *participation in enterprises, organizations established together with legal entities and citizens of Azerbaijan Republic on the sharing basis;*
- b) *establishment of enterprises fully owned by foreign investors;*
- c) *purchase of enterprises, proprietary complexes, buildings, structures, shares in enterprises, other shares, bonds, securities and also other property which according to legislation of the Azerbaijan Republic might belong to foreign investors;*

¹¹http://www.azpromo.az/domains/azpromo/assets/file/Protection_of_Foreign_Investments.pdf

- d) acquisition of rights for use of land and other natural resources and also other proprietary rights;*
- e) conclusion of agreements with legal entities and citizens of the Azerbaijan Republic providing for other forms of realization of foreign investments.*

Beyond this law, foreign investment activities are also regulated by other national laws and articles. The Law of the Azerbaijan Republic on Investment Activity also includes elements relating to foreign owned investments². This law indicates that persons without citizenship can be investors in Azerbaijan and the protection of their investments is guaranteed by the state. Additionally, Azerbaijan has signed contracts with various countries to prevent double taxation. All barriers related to the conversion of profit into different currencies, transferring to other countries or reinvesting have been removed, and a single exchange rate was formed based on market economy principles. Currently the government is implementing an “open door” policy to attract foreign investments to the economy. Recently, the integration process of the Azerbaijan economy with the world economy has accelerated. While the volume of FDI was 9 billion USD between 1995 and 2004, in 2003-2011 this figure reached 54 billion USD - six times higher than in the previous period.

Control of Capital Flows

Azerbaijan is the largest recipients of Foreign Direct Investment (FDI) in the South Caucasus region, mainly to its natural resource sectors. But as it is shown in the Chart 1, foreign investments to the non-oil sector also increased after 2010.

Table 1 describes that while the volume of FDI was 9 billion USD between 1995-2004, in 2003-2011 this figure was 54 billion USD, which is six times more than previous period. Private foreign direct investment is one of the common determinants of long run growth where credibility and economic attractiveness of the country plays significant role in attracting FDI.

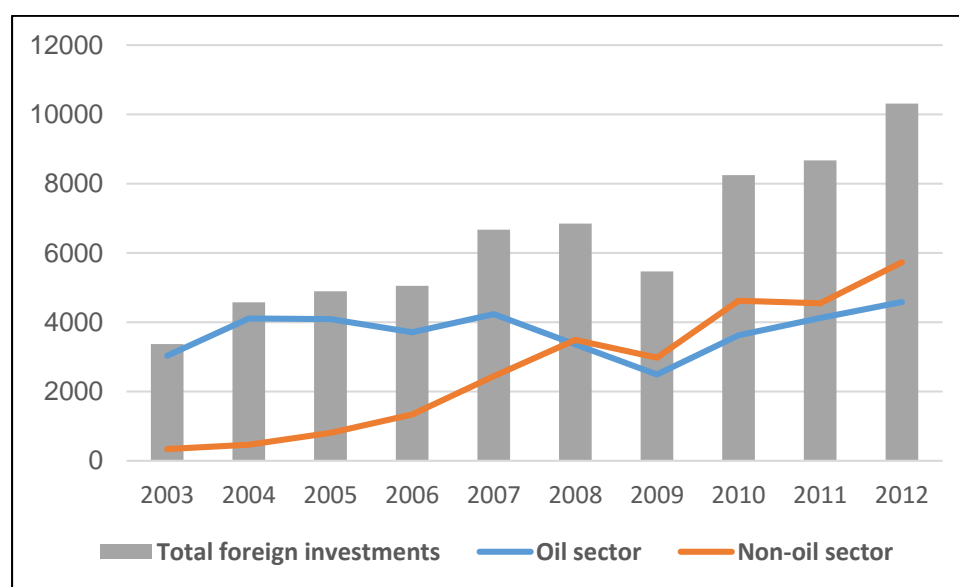
²<http://aic.az/pdf/investment.pdf>

Table 1. Foreign investments to the Azerbaijan's economy (Million US dollars)

Foreign investments	1995-2002	1995-2012
<i>Oil sector</i>	6105.3	43464.6
<i>Non-oil sector</i>	3014.4	29773.6
Total	9119.7	73238.2

Source: Ministry of Economy and Industry of Azerbaijan

There are three main location-specific determinants of a country's attractiveness for FDI³: (a) market-seeking (or horizontal) investment; (b) efficiency-seeking (or vertical) investment: this category of investments is production-cost minimizing; (c) resource-seeking investments: usually nonrenewable natural resources attract investors. Resource-seeking investments were the primary sources that Azerbaijan attracted on a large scale till mid 2000's.

Cart 1. Foreign investments to the Azerbaijan's economy in 2003-2012 (Million US dollars)

Source: Ministry of Economy and Industry of Azerbaijan

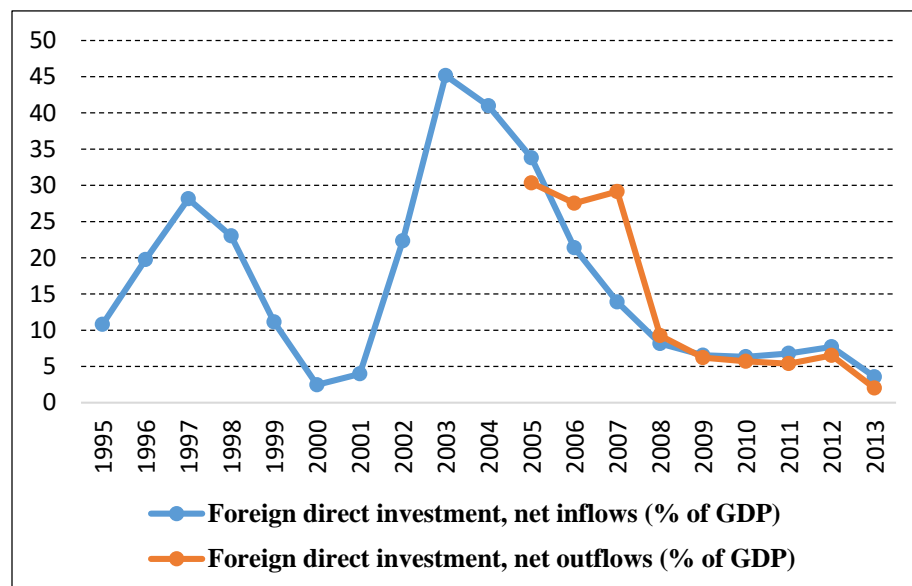
Total amount of FDIs was \$6.3 billion in 2013 and the share of the oil-and-gas sector in the structure of these investments was 82.4%. Attracted investments were channeled to the domestic economy to finance huge oil-and-gas projects. According to estimations, total amount of FDIs to the non-oil sector equaled to \$1107.7 million in 2013, which comprises 17.6% of total FDIs⁴.

³ <http://www.css.ethz.ch/publications/pdfs/CAD-28-2-6.pdf> (CAD No.28)

⁴ <http://en.cbar.az/lpages/statistics/external-sector-statistics/>

Turkey, USA, UK, Netherlands, Germany, Russia and UAE are main sources of FDI in Azerbaijan economy.

Chart 2. Foreign direct investment in Azerbaijan economy



Source: World Bank Meta-data

Main challenge for the country is how to attract foreign investment to the non-oil sector. Important determinants of FDI flows to non-oil sector are market size, the opportunities to access bigger markets using that particular market, trade openness, the ease of doing business, the quality of infrastructure, sound institutions, taxes, and custom regime. In case of Azerbaijan, a weak court system, monopolistic attitudes in the domestic market and corruption, weak protection of property rights are main barriers to attract FDI to the non-oil sector.

Additionally, Azerbaijan has significantly increased its own capital investments abroad, both state-run and private companies of Azerbaijan have significantly improved capital investing abroad⁵. Azerbaijan's state energy company SOCAR, which is keen on expanding its presence in the oil and gas market abroad, invested \$2.9 billion overseas in 2013. These funds were particularly invested in projects being realized in Turkey, Georgia, Ukraine, Switzerland and other countries where the company owns assets⁶.

⁵ <http://www.azernews.az/business/43269.html>

⁶ http://www.azernews.az/oil_and_gas/59636.html

Legal bases of capital flows

Legal conditions of investment activity and capital movement in the territory of Azerbaijan and principles of foreign investment are determined by the Law on "Investment activity" (1995) and on "Protection of foreign investments" (1992). The government gives to foreign investors the following additional legal provisions:

- a) Against deterioration of legislation: the existing law will be valid for 10 years while implementing investment projects;*
- b) Against nationalization and requisition of investments: if requisition or nationalization is implemented, injured foreign investors are provided with emergency and adequate compensation;*
- c) As a result of illegal measures taken by the authorities' injured foreign investors are paid compensations;*
- d) Repatriation of revenue after paying taxes.*

Private entities may freely establish, acquire and dispose of interests in business enterprises. Foreign citizens, organizations, and enterprises may lease, but may not own land. Taxes based on the so-called "One-stop Shop"⁷ principle that greatly simplifies the registration process and reduces waiting times. Country has a liberal exchange rate system and, in general, there are no restrictions on converting or transferring funds associated with an investment into freely usable currency. Disputes arising between foreign investors and enterprises with foreign investment, state bodies of Azerbaijan and enterprises, public organizations and other legal entities of Azerbaijan, are to be solved in the court systems of country or in court of arbitration, including international arbitration bodies. In 2007, Parliament amended existing legislation to eliminate custom duties for cash currency exports. But Azerbaijan has an underdeveloped financial services sector of which banking comprises more than 90 percent. Despite that small economy has around 45 private banks (approximately same number with Turkey), Azerbaijan's banking sector is fragmented; the fragmented structure reinforces oligarchic control of the economy and holds back private sector growth, as smaller firms find it difficult to finance expansion. Foreign ownership in

⁷ A company or a location that offers a multitude of services to a client or a customer (Investopedia).

the banking sector is limited to 50% percent ownership on an aggregate basis. Currently there are around 22 banks in Azerbaijan with some investment by foreign capital. US Department of State's investment climate report indicates that "because banks rarely compete directly against each other for market share, they have little incentive to offer competitive terms". Also, loan or credit interest rates offered by commercial banks in early 2014 varied in the range of 16-34%⁸. Last changes (2013) in the Commercial Secrets Law, discouraging the disclosure of shareholders of companies, raises concerns about open competition for private sector activities and is against international disclosure principles on beneficial ownership.

Azerbaijan's economic freedom score is 61.0, making its economy the 85th freest in the Economic Freedom Index 2015. Azerbaijan's overall score is above the regional and global averages. But its overall score is 0.3 point lower than last year, reflecting declines in the management of public finance, investment freedom, and trade freedom that outweigh improvements in freedom from corruption and regulatory efficiency. Report says that "wide-ranging reforms have resulted in limited progress in regulatory efficiency and economic diversification, improving the overall macroeconomic and entrepreneurial environments. Tax reforms and continued openness to global trade and investment have aided Azerbaijan's gradual transition to a more market-based system. Nonetheless, substantial challenges remain, particularly in implementing deeper systemic and social reforms to strengthen the foundations of economic freedom. Property rights and freedom from corruption remain fragile, and burdensome regulatory requirements continue to undermine the emergence of a more dynamic private sector and long-term economic development"⁹. Policy coordination is the serious institutional challenge partly affecting regulation of capital movement preventing effective implementation of reform plans and programs¹⁰.

⁸ <http://www.state.gov/documents/organization/228976.pdf>

⁹ <http://www.heritage.org/index/country/azerbaijan>

¹⁰ Bertelsmann Stiftung, BTI 2014 - Azerbaijan Country Report, <http://www.bti-project.org>

Recommendations

Azerbaijan is the largest recipients of Foreign Direct Investment (FDI) in the South Caucasus region, mainly to its natural resource sectors. Azerbaijan has significantly increased its capital investments abroad, both state-run and private companies of Azerbaijan have significantly improved capital investing abroad. It established an investment company to attract foreign investors and promotes itself and investment opportunities worldwide through its investment promotion foundation. But existing regulatory shortcomings, feeble court system, monopolistic attitudes in the domestic market, corruption risks, weak protection of property rights are main barriers to attract foreign capital to the non-oil sector in Azerbaijan.

- 1. It is necessary to improve foreign investment climate in the country and eliminate regulatory impediments for foreign investments in non-oil sector.*
- 2. A program of new structural reforms should be designed and implemented to improve institutional effectiveness of the government.*
- 3. Development of a competitive environment in the capital market including commercial banks and non-bank credit organizations.*
- 4. In order to enhance domestic competition between foreign and domestic entities it is necessary to implement restructuring of currently operating state-owned companies.*