

## Foreign Direct Investment in Azerbaijan—the Quality of Quantity

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### Abstract

Azerbaijan is one of the largest recipients of Foreign Direct Investment (FDI) in the Eastern European/South Caucasus Region. Its success comes from its attractiveness as a resource-rich country. These investments were an important catalyst for the start of the country's impressive economic boom. But investments outside the oil sector remained very low. Hence, FDI could not produce its full potential: a broad transfer of international know-how, management and technology combined with sufficient funds for other sectors of the economy. The country underperforms in these areas and is only able to cover its losses with huge transfers from oil profits. The time is ripe for Azerbaijan to break new ground.

### Introduction

Azerbaijan was one of the fastest growing economies in the world over the first decade of the 21<sup>st</sup> century. This growth was, and remains, linked to the fact that Azerbaijan has significant amounts of hydrocarbon reserves and the interest to exploit and sell these resources on the world markets. The country's leaders viewed the oil resources as a sheet anchor and buried treasure to be salvaged to ensure a prosperous future for their country.

As the Soviet Union focused its hydrocarbon exploitation activities in the decades before its collapse on the huge reserves in Siberia, it neglected extraction and infrastructure development in the Caspian Basin. In order for Azerbaijan to take advantage of its resources after gaining independence, it needed three things: sufficient capital, technology, and know-how to properly manage investments in this segment of the economy. But the country lacked all three in both the state and private domestic sectors. As a consequence, it had to attract international investors—a typical approach for a resource-abundant developing or transition country. And this is where foreign investments, and especially Foreign Direct Investments (FDI), came to play a sizeable role in Azerbaijan.

Before we look into the facts and figures and the FDI environment in Azerbaijan, we will briefly outline what FDI is and explain the underlying motives and determinants for FDI in general. We will also define the constraints on investment abroad and in Azerbaijan respectively. And finally, we will examine what role FDI can play in an economy like Azerbaijan's and investigate what the country can do to attract an economically diversified portfolio of foreign investments.

### FDI—Definition, Motives and Determinants

All of the key international organisations, such as the International Monetary Fund (IMF), the Organisation for Economic Cooperation and Development (OECD),

and the United Nations Conference on Trade and Development (UNCTAD) define FDI as: the long-term financial participation by an investor from one country in an enterprise from another country, thereby having a significant degree of influence on the management of the enterprise (at least a 10% share of capital plus technology and know-how transfer indicating a “significant” degree of influence).

But why would a company take the high risk of directly investing in another country? It would do so if the investment advantages are considered to be higher than the anticipated risks and would outweigh costs. The literature employs the concept of “OLI” (first introduced by John Dunning in the late 1970s). According to this concept, an investor's decision to invest in a foreign country is determined by the existence of three different types of advantages or preconditions: Ownership, Localisation and Internalisation advantages. Ownership advantage refers to a product or production process that no domestic company already controls. Such ownership includes patents, technology, but also intangible assets, such as reputation, brand name, knowledge and management skills. Internalisation is derived from a company's interest in maintaining its knowledge assets internally. It prevents host country companies from copying (if they have the ability to do so) and entering into direct competition with the foreign investor. If the foreign investor lacks such an advantage, he would prefer to use licensing to serve demand in the foreign market. These two advantages are more or less location-independent. The third aspect is the set of location-specific advantages, which determine the attractiveness of a country.

There are three main location-specific determinants of a country's attractiveness for FDI:

- Market-seeking (or horizontal) investment: the investing company wants to tap a new sizeable market with growth potential, which makes investment more attractive than exporting to the market. These investments aim at penetrating the local market of the host country.

- Efficiency-seeking (or vertical) investment: this category of investments is production-cost minimizing. Companies seek to produce in lower cost locations to increase their (global) competitiveness. They look for cheaper labour resources and factory costs (taxes, trade barriers, transportation costs).
- Resource-seeking investments: Here, usually non-renewable natural resources attract investors. These investments are often also combined with “strategic asset-seeking investments”, where the investors are global players and—with the support of their home governments—seek to work up their international market position and get a strategic advantage. Resource-seeking investments (in conjunction with strategic asset-seeking) were the first that Azerbaijan attracted on a large scale.

According to the OECD, investments in the first two categories were the main drivers of the “first wave” of FDI in Central European countries in the 1990s and the “second wave” since the beginning of the new millennium in South East Europe. These countries do not possess large-scale natural resources which would have attracted a significant influx of FDI. They were attractive due to their market (demand for goods) and efficiency potential. They competed among themselves with smart economic development policies, which were also targeted at FDI. These countries combined large-scale privatisation with corporate taxation measures, incentive schemes, free trade zones and direct investment promotions. They opened up their financial markets for development and competition, demonstrated a relatively low level of corruption, and benefited from a highly skilled, low-cost labour force that could be employed in a variety of positions.

On average, the countries of the CIS lacked such an enabling environment. But since 2000 the region started to show a continuously growing local demand for goods, especially in the bigger countries (Russia, Ukraine, and prospering Kazakhstan). Even though the environment for FDI was, and is, much more challenging due to slower transition processes, high level of corruption, lower qualified labour forces and low levels of labour productivity (Figure 1), investors began to move eastwards and invest in the region beyond the natural resource sector. The “third wave” was just about to take off in the CIS region, when it was suddenly interrupted by the global financial crisis. After several years of an upward FDI trend, the net inflows declined by roughly 50% between 2008 and 2009 (Figure 2).

### The Case of Azerbaijan: High FDI Inflows but Low Diversification

How does Azerbaijan compare against these criteria? Azerbaijan shows a different path of development than

the CIS average due to the attractiveness of its hydrocarbon reserves. First of all, since Azerbaijan gained independence, the country was able to attract significant inflows of foreign investment, 70% of which were FDI. This influx began in the second half of the 1990s (the first influx of foreign money to re-/build the Baku–Supsa pipeline for the so-called early oil from the Caspian to the Georgian port of Supsa) and peaked between 2005 and 2007. Between 1993 and 2010 total foreign investments amounted to 54.2 billion USD, out of which 37.6 billion USD was FDI. (Figure 4). Investments into fixed capital developed almost congruently. They made up half of total foreign investments (27.7 billion USD).

According to its capital account classification, Azerbaijan recorded positive FDI flows of 4 billion USD on a netted basis (gross inflows minus dividends and profits which were not reinvested into the local economy minus real FDI outflows, which are investments from domestic companies abroad). (Table 5) With a population of around 9 million, Azerbaijan accumulated net FDI per capita of 450 USD through year-end 2010. This is more than twice the CIS average and lies in the same range with Central Europe.

At first glance these figures and ratios look quite impressive. The high FDI inflow definitely contributed to the highest GDP growth rates in the world during 2005–2009. The huge influx of foreign capital also acted like a catalyst for the overall economic recovery and development of the country. But we need to be careful here. As was already mentioned, the huge investment appetite in Azerbaijan stemmed mainly from the global oil industry. Resource-seeking advantages were and still are the prime investment motive in Azerbaijan. As we can see in Figure 5, 88% of total FDI between 1993 and 2010 went to the oil-extracting industry. With British Petroleum having a lead in the biggest oil-extracting projects, UK is the lead FDI contributor, followed by the USA (Exxon, Amoco, Unocal), Turkey (Turkish Petroleum), Russia (Lukoil), Norway (Statoil) and Japan (Itochu).<sup>1</sup>

Total non-oil FDI inflow stood at 4.4 billion USD since 1993 and showed a stronger increase only over the last four years (2.2 billion USD or 50% of total non-oil FDI). Non-oil FDI is also rather concentrated, both country-wise and sector-wise. The top three countries, Turkey, USA and UK, count for almost two thirds of all investments (Figure 6). This reflects to a significant extent their hydrocarbon-related up- and downstream investments in the country. The concentration would

<sup>1</sup> Unfortunately, there is no publicly available information on the exact distribution of total FDI by countries (of investors) for the last decade. Even Azpromo, the Azerbaijan Investment Promoting Agency was not able to provide such information on enquiry.

certainly also explain the 52% share of industry-related investments among non-oil FDI (Figure 7). Investments in additional non-oil segments cover areas with local market potential and with non-tradable goods, such as telecommunication services (mobile phone operators with overseas investments from Turkey and the USA), local food and beverage industry (e.g. Coca-Cola Turkey), tourism infrastructure (hotels with foreign ownership) or construction (with investments from Turkey, but also Germany).

### The Economic Potential of FDI: Qualitative and Quantitative Aspects

In a diversified environment, FDI can contribute to broad know-how and technology transfer, inclusion into the global economy, and the development of the financial sector as one of the preconditions for further economic stimulation. It usually contributes to wealth and job creation. And it can have an impact on educational levels and an increase of skills among the working population through training and investments in research and development. Overall, there is a strong correlation between FDI and economic growth. That is what we also see in Azerbaijan, where the huge investments into the oil industry acted as a catalyst for other economic sectors, such as construction, transportation, and finance.

Government officials and the investment promoting agency proudly proclaim over and over again how quickly the economy developed, especially during the first decade of the 21st century, and the large amount of FDI they attracted. They refer to their investment-grade sovereign-rating and to the reduced formal poverty rate of below 10%, down from around 50% ten years ago. Of course, these are achievements, which are not negligible. For ordinary citizens this prosperity is today visible as twinkling sea fronts, well-appointed boulevards and the glamorous skyscrapers of the capital. But this type of quantity-related argumentation does not usually include a qualitative analysis. What they do not mention is the rather low FDI share in the non-oil sector. And here, investors do not choose Azerbaijan as a destination for efficiency-seeking investments, but predominantly as a place to sell goods (market-seeking investments).

It is arguable to what extent the resource-seeking and partly market-seeking investments help the overall development of the economy and the country. For instance, although the share of oil GDP is just below or around 50% and oil-related FDI accounts for as much as 88% of all FDI, the share of employees in the mining industry to the overall Azeri working population is just 1% (41,000 employees). That means that foreign FDI per "mining employee" was one million USD over the last two decades. In contrast, non-oil FDI in agriculture

was just 4.5 million USD (1% of non-oil FDI) in almost two decades of investments. But the sector employs 1.5 million people (40% of the working population). This is a per capita FDI of 3 USD in the agro-sector! Consequently, this sector shows the lowest value added to the economy (10 times less than the construction sector, tourism or transport and 500 times less than the mining industry). These figures provide a good picture of how national wealth is predominantly distributed.

For the time being, it would be highly doubtful to assume that Azerbaijan could survive at its current economic level without its reliance on the oil and gas industry. While no changes are needed immediately, the country cannot count on the fossil fuel sector in the mid- to long-term perspective.

### Constraints and Opportunities for FDI in Azerbaijan

There are several reasons for the limited investment appetite outside of the almost independently functioning oil and gas sector. Azerbaijan is perceived as a tough autocratic system with widespread corruption, high informal market-entry barriers, sector monopolies combined with unfavourable monetary conditions.<sup>2</sup> Independent institutions, accountability, and the transparency needed to maintain an efficient market economy are by and large still in the early stages of development. Transparency and checks and balances of public sector accounts are notably lacking. The domestic market is rather small and regional trade barriers (for selling locally-produced goods) are high. Here, Azerbaijan takes one of the lowest positions according to the Doing Business Report of the World Bank. The banking sector is still underdeveloped, with very few international investors (Figure 8) and a significant share of state-owned assets. The appreciating currency is good for confidence among the population but highly unfavourable for efficiency-seeking investors as it makes production more expensive.<sup>3</sup> Azerbaijan has so far failed to join the WTO, although it started accession negotiations in 1997. And, it is still considered a country with a higher geopolitical risk due to its unresolved conflict with Armenia over Nagorno-Karabakh.

On the positive side, Azerbaijan's government has embraced wide-ranging reforms to improve economic freedom. It signed bilateral trade treaties and introduced

2 Compare: Gerald Hübner, "As If Nothing Happened? How Azerbaijan's Economy Manages to Sail Through Stormy Weather," *Caucasus Analytical Digest*, No. 18 (The South Caucasus after the Global Economic Crisis), 05.07.2010, pp 8.

3 Compare: Gerald Hübner and Michael Jainzik, "Splendid isolation? Azerbaijan's economy between crisis resistance and debased performance," *Caucasus Analytical Digest*, No. 6 (The Caucasus in the Global Financial Crisis), 21.05.2009, pp 12–13.

investment stimulating legislation. It established an investment company to attract foreign investors—the Azerbaijan Investment Company—and promotes itself and investment opportunities worldwide through its foundation AZPROMO. The government finally started a one-stop-shop for investors to streamline business processes. It also cut corporate tax to a more favourable level of 20% (from 24% in 2005) and does not limit repatriation of profits. And the banking sector grew very strong, offering better interest rates and collateral requirements than its regional peers (Figure 9). And finally, foreign direct investments in the non-oil sectors grew significantly over the last four years (Figure 4 and Table 4).

The two most famous indices for assessing a country's business potential are the Doing Business Report of the World Bank and the Index of Economic Freedom of the Heritage Foundation and Dow Jones & Company. The Doing Business Report only focuses on the formal aspects of doing business in a country. Here, Azerbaijan was considered a top reformer in 2009 and jumped more than 60 positions up to the 33<sup>rd</sup> rank, but was overtaken by other reformers a year later. According to the 2011 Index of Economic Freedom, Azerbaijan ranks 92<sup>nd</sup> worldwide (which is above the CIS average, but significantly below its neighbours Georgia and Armenia).<sup>4</sup> This index is more realistically founded since it relies on polls among businessmen. Here, Azerbaijan performs well on measures of fiscal freedom, labour freedom and business freedom; but poorly in property rights, freedom from corruption (TI list index 143 out of 180 countries) and monetary freedom (distortion of domestic prices).

Based on this analysis, direct recommendations include:

- Despite the considerable gains in regulatory reform and a growing economic diversification, substantial challenges remain, particularly in implementing deeper institutional and systemic reforms. To

facilitate economic diversification, the country could further promote oil-related upstream and downstream non-oil sectors (manufacturing and services). It would further need to increase both labour productivity and export performance via the import of technology, know-how and managerial expertise.

- Continued transformation and restructuring are needed to capitalize on Azerbaijan's well-educated labour force and tradition of entrepreneurship. Although the literacy rate is high in Azerbaijan, the level of skilled and technically advanced engineers and highly educated specialists in all fields is very low and needs significant investments and curriculum development. At the same time, the EBRD reported in its Transition Report 2010 that Azerbaijan is the country where companies spent less than in all other transition countries on Research & Development (R&D). Therefore, per-capita FDI should be coupled with policies designed to facilitate the transfer of knowledge and technology between firms. The government could also set incentive schemes for companies to invest more in its staff (education and vocational training) and in R&D.
- The government should further support and develop the still weak national banking system in order to create a more competitive environment. It should actively promote mergers and acquisitions among banks, especially with the participation of foreign investors. If such reforms are successful, access to finance for entrepreneurs at all levels (in general and especially in the form of better loan conditions) would improve.

Finally, the government needs urgently to tackle the pervasive culture of corruption. By doing so, many of the above mentioned deficits, such as the lack of monetary freedom as well as governance and transparency, would almost automatically improve. Here, the government took decisive steps since the beginning of 2011. It remains to be seen, whether the country will have the required patience and staying power to implement such reforms fully.

<sup>4</sup> For comparison: Georgia: rank 29; Armenia: 36; Ukraine: 164; Moldova: 120; Russia: 143; Germany: 23.

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*(continued overleaf)*

*Further Reading*

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