

**THE MINISTRY OF EDUCATION OF THE REPUBLIC OF AZERBAIJAN**

**AZERBAIJAN STATE UNIVERSITY OF ECONOMICS**

**INTERNATIONAL GRADUATE AND DOCTORATE CENTER**

**MASTER DISSERTATION**

**ON THE TOPIC**

**“THE ROLE OF FOREIGN DIRECT INVESTMENT IN AZERBAIJAN”**

**MAMMADOVA GULUSTAN NURADDİN**

**BAKU – 2019**

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**“THE ROLE OF FOREIGN DIRECT INVESTMENT IN AZERBAIJAN”**

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# Xarici birbaşa investisiyaların Azərbaycanda rolu

## Xülasə

**Tədqiqatın aktualığı:** Birbaşa xarici investisiya bir ölkənin iqtisadi fəaliyyəti üçün çox əhəmiyyətli bir komponent və ölkənin iqtisadi inkişafı üçün mühüm bir qaynaqdır. Azərbaycan cavan ölkə olaraq hələ də iqtisadi islahatlarla üzləşir və birbaşa xarici investisiyalar iqtisadi artım prosesinin sürətlənməsinə təsir göstərən əsas amillərdən biri hesab olunur. Həm də bu tədqiqatda Azərbaycanın xarici investorlar üçün cəlbedici bir yer tutan amilləri müzakirə olunmuşdur.

**Tədqiqatın məqsəd və vəzifələri:** Tədqiqatın əsas məqsədi Azərbaycanda milli iqtisadiyyata yönəldilən xarici birbaşa investisiyaların iqtisadi effektivliyinin artırılması yollarını və xarici investisiyaların inkişaf potensialının müəyyənləşdirilməsinə kömək edən tövsiyələrin hazırlanmasıdır.

**İstifadə olunmuş tədqiqat metodları:** Bu tədqiqatda kəmiyyət və keyfiyyət metodlarından istifadə edilmişdir. Metodlar tədqiqat məqsədi ilə seçilmiş və Azərbaycan Respublikasının Dövlət Statistika Komitəsi tərəfindən hazırlanmış və təsdiq edilmiş metodoloji normativ materiallardan geniş şəkildə istifadə edilmişdir. Tədqiqatın nəzəri hissələrinin işlənməsində təsvir üsulu istifadə edilmişdir. Analiz metodu Azərbaycanda xarici investisiyaların inkişaf prosesini qiymətləndirmək, xarici investisiyalarla bağlı problemləri və dəyişkənliyi araşdırmaq üçün istifadə edilmişdir. Əvvəlki illərlə Azərbaycanın iqtisadi məlumatlarını müqayisə etmək üçün müqayisəli analiz üsulu da istifadə edilmişdir.

**Tədqiqatın informasiya bazası:** Bu araşdırmada Azərbaycan Respublikası Dövlət Statistika Komitəsi, Azərbaycan Respublikası İqtisadiyyat Nazirliyi, Azərbaycan Mərkəzi Bankı, iqtisadi ədəbiyyat, kütləvi informasiya vasitələrinin məlumatları və digər internet resurslarının veb saytlarındakı statistik məlumatlardan istifadə edilmişdir.

**Tədqiqatın məhdudiyyətləri:** Bəzi statistik məlumatların olmaması və bəzi nəzəriyyələrin Azərbaycana tətbiq oluna bilməməsi bu tədqiqatda məhdudiyyətlər yaratmışdır.

**Tədqiqatın nəticələri:** Xarici investisiyaların Azərbaycanın yenidən dirçəlişi üçün əhəmiyyət kəsb etməsindən savayı, onun iqtisadi artımı və iqtisadiyyatına necə müsbət təsir göstərdiyi bu tədqiqatın nəticəsində öz əksini tapmışdır.

**Nəticələrin elmi-praktiki əhəmiyyəti:** Xarici birbaşa investisiyaların Azərbaycan iqtisadiyyatı və iqtisadi artım üçün əhəmiyyəti gələcəkdə də bu sahədə atılacaq addımların zəruriliyini təsdiq edir.

**Açar sözlər:** Xarici birbaşa investisiya, İqtisadi inkişaf, Azərbaycanın investisiya siyasəti

## **ABBREVIATIONS**

<b>AZPROMO</b>	Azerbaijan export and investment promotion foundation
<b>AIC</b>	Azerbaijan Investment Company
<b>CIS</b>	Commonwealth of Independent States
<b>CSPI</b>	State Committee on Property Issues
<b>FDI</b>	Foreign Direct Investment
<b>GDP</b>	Gross Domestic Product
<b>IMF</b>	International Monetary Fund
<b>LLC</b>	Limited Liability Company
<b>NFES</b>	National Fund for Entrepreneurship Support
<b>PSA</b>	Production Sharing Agreement
<b>TNC</b>	Transnational Corporation
<b>UNCTAD</b>	United Nations Conference on Trade and Development
<b>USA</b>	United States of America
<b>UAE</b>	United Arab Emirates
<b>UK</b>	United Kingdom
<b>UN</b>	United Nations
<b>VAT</b>	value-added tax
<b>WB</b>	World Bank
<b>WTO</b>	World Trade Organization

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## **1. INTRODUCTION**

After achieving independence, the main task of government of Azerbaijan was to build a real democratic legal state based on different, equal property and economic forms and market relations that are consistent with growing trends in the development of the world states.

The process of the market economy in Azerbaijan is connected with specific difficulties and contradictions, and it is reflected in all spheres of socio-economic and cultural life.

Re-establishing economic relations, abandoning the regulatory and business system, requires rational use of economic factors and transition to market relations everywhere. The main objective here is to remove the country from crisis, to end the commodity scarcity, to balance the demand and supply, to create a standard financial and credit system, and to achieve socio-economic progress in all areas.

The role of the state is particularly significant during more profound economic, social, and political changes. In our modern society, the process of innovation in all spheres is open, and the country is utilizing magnificent, large-scale and comprehensive tasks and responsibilities in the contemporary era in which the governance system has gradually been abolished. It is more likely to study the experience of different countries in this area, its positive and negative aspects. In this case, the country develops its economy in line with the possibilities it has and occupies the right place in the world community and dramatically improves people's living standards.

Modern conditions created in the global economic system, in particular, the rapid development of international economic integration, strengthening of mutual economic relations between countries, increasing the role of transnational corporations in the world economy, strengthening of competition in the world market, etc. requires a careful and creative approach to these or other

considerations related to the regulation of foreign economic activity of various economic theories.

Also, it should be noted that all countries need investment, regardless of the level of economic development and geographical location. In other words, investments in the country play a catalytic role in the economic development of that country. It should be an investment instrument put into the national economy. By attracting investment in the country, it can be used more efficiently than ever before with badly used natural, production and labor resources. If it is used efficiently by foreign capital, this capital can be combined with national resources to create a chain reaction and achieve a high impact.

It should be noted that it is impossible to form real market relations without the state's active regulatory policy in transition. Therefore, after achieving independence, one of the first steps Azerbaijan has made in the transitional period was the formation of the fundamental legal and economic basis for attracting foreign investment. The purpose of this policy was to create a favorable investment climate in the country and to increase attractiveness for foreign investors. In general, the investment policy should be taken into account in the interests of both the state and the investors.

In the transition economies, as well as in Azerbaijan, some processes are essential for attracting foreign investment, one of which is privatization. There is no legal barrier to foreign investors' participation in the privatization process in Azerbaijan, but the somewhat favorable legal environment for foreign investors.

It should be noted that foreign investors are also interested in the non-oil sector along with the oil sector. At the same time, they keep the privatization process in focus. Because foreign investors take part in the privatization of enterprises that can give them a great deal of profit in the future, and take up most of their shares and invest in large amounts. It must be noted that the opening of the privatization of enterprises operating in metallurgy, chemistry, energy, machinery,

communications and other sectors, especially attractive for foreign investors, contributed to the flow of foreign investments.

Successful advancement of our country through dynamic development has increased the interest of international organizations to Azerbaijan. In this regard, the measures taken in the field of international cooperation with the involvement of foreign investments in our country have gained considerable scope in recent years. By organizing part of the investment in the country's economy, foreign investment helps to revive and develop the country's economy, especially the transition economy.

In order to attract foreign investments to the Republic of Azerbaijan, the government has made substantial steps in the country: Protecting the rights and interests of investors in the Republic, the inviolability of property in all forms, as well as the creation of equal working conditions for local and foreign entrepreneurs and the legal basis for their unimpeded access to profits.

One of the reasons for the growing interest of foreign investors in the Azerbaijani economy is the elimination of some obstacles. Examples of these obstacles are double taxation linked to some countries. Barriers to complete removal of contracts, the transfer of profit to other currencies, and the transfer of benefits to other countries have been abolished. Along with these, the formalized investment environment serves not only to attract foreign investment but also to encourage reinvestment. All this increases not only the interest of foreign investors in the Azerbaijani economy but also the interest of international financial institutions and economic organizations.

The modern world economy is characterized by liberalization and globalization. Under these circumstances, firms are particularly interested in the development of infrastructure, social business, and privatization programs when looking for countries and territories to ensure the profitability of the capital investment.



Azerbaijan has favorable conditions for the effective development of foreign economic relations with its natural resources and relatively high economic potential. Conditions affecting the flow of foreign investment to the country depend on several complex factors, and these factors make the investment climate. Also, these conditions should include the country's economy, social stability, culture, and other factors.

After gaining independence, there was a need for economic reforms in Azerbaijan. This necessity was due to the change of the social form in the country and to the transition to a market economy. The primary purpose of economic reforms was to shape and develop free-market relations, to open vast opportunities for free and independent entrepreneurship.

The goals of economic reforms in Azerbaijan were to build a healthy economy based on market economy, to achieve a diversity of ownership in the economy, to form a competitive national economy, to improve the well-being of the population and integrate into the system of international economic relations.

The fertile investment environment created in the economy of the Republic of Azerbaijan has increased the interest of foreign investors in the country's economy. Transnational companies, specifically, intend to take advantage of these conditions. These conditions are the result of systematic investment policy pursued by the Azerbaijani government consistently. Azerbaijan's economic potential, as it is known, is more concentrated in the fuel and energy complex. In that case, the government has taken all necessary steps to ensure sustainable development by investing in other areas along with the fuel and energy complex to protect the proportions of the economy and achieve sustainable economic growth. However, it is known that FDI is focused on the fuel and energy complex of the Republic and that many agreements concluded in this sphere in recent years confirm that. FDI attracted to the country is not a foreign debt problem for the state, but instead, creates additional sources of funding for its cover, creating favorable conditions for the effective integration of the national economy into the international economy

through production and scientific and technical co-operation. As a logical continuation of this, domestic capital reserves increase, and the ability to invest in other areas is formed.

If we look at the investment attracted to oil and non-oil sectors, we see that the share of investment in the non-oil sector has been increasing year after year.

Thus, successful economic policy, which has ensured the substantial development of the Azerbaijani economy, and foreign investments attracted to the country in the previous years have already created such an environment in the country's economy that investments are directed to the real sector. In short, the country's economic climate has fostered the development of the real sector.

### **1.1. Research background**

In the current conditions of Azerbaijan's economy, the demand for foreign investment is excellent to improve the production process and apply new technology. For the involvement of the FDI, foreign investors should have sufficient information about the country and its prospects for development, business and investment climate in the country, and changes in the environment.

Dunning and Lundan (2008) differentiate four types of such investments, depending on the FDI's motivation source included in one or another country: the country has natural resources, scale and availability of the market in the destination country, the firm's strategic assets in the domestic market, and intention to save costs by increasing productivity.

The authors state that, depending on the source of motivation and the type of investment, investors react differently to government policy decisions in the country of destination and the overall investment environment in the country. Investors investing in natural resources and strategic assets are not sensitive to the changes in the investment climate. Investors who are motivated by cost-savings are very vulnerable to any changes that can hinder their expenditure or create barriers

to free exchange. The processing industry and other manufacturing areas are areas where the cost savings and markets can be of interest to investors.

Since mid-2015, the Government of Azerbaijan has been undertaking measures to improve business and investment climate in the country:

- (licensing and permits, simplification of procedures, etc.), partial suspension of inspections in entrepreneurship up to 2021,

- promoting investment (e.g., application of the document and the issuance of tax deductions for those who received this document for seven years, as well as the taxation of imported technology and technology within the framework of the project),

- creation of industrial parks (7 years tax rebates are applied to parks as well as for their production purposes imported machinery and technology are exempt from VAT and duties),

- protection of domestic production and security of the local market, stimulation of non-oil export (export introduction of progressive mechanisms in the field of import-export operations (green corridor, electronic declaration, etc.),

- subsidizing the production of some agricultural products and so on many decisions were made, and measures were taken.

Investors are more interested in the future development of the country than the current situation in the host country, as such information enables investors to evaluate their future expectations.

The World Bank's Global Competitiveness Report 2017-2018: Investor Perspectives and Policies Outcomes is a useful way to find out what the environment needs in the country. The results of the poll conducted by World Bank researchers from among 754 international companies across the world include the following factors affecting direct investment decisions:

- political stability and security in the country (50% of respondents are essential, 37% marked as necessary);

- legal and regulatory environment (40% and 46%, respectively);
- the size of the domestic market (42% and 38%);
- macroeconomic stability and exchange rate (34% and 44%).

The next places in the ranking are employees' skills and abilities (28% and 45%), good physical infrastructure (25% and 46%), low tax rates (19% and 39%), little labor and material costs (8% and 35% land and real estate accessibility (14% and 28%) and access to financial resources in the domestic market (16% and 28%).

The company's managers believe that it is crucial for the country to have predictable and predictable regulations (legislation practice). In this regard, transparency, and predictability of the behavior of public authorities (37% are significant, 45% are essential), guaranteeing investment in legislation (45% and 36%, respectively), easy access to business and protection of property 36% and 41%). Factors such as investment incentives (21% and 35%), preferences in trade agreements (14% and 40%) and bilateral (inter-country) investment agreements (15% and 36%) remain below the order.

In the WB Doing Business index, Azerbaijan is ranked 57th out of the 80 countries (among 189 countries) in 2018, with 57th place (among 190 countries), although it is worth mentioning that construction permits (161th place) it seems that there is a need to seriously improve the country's position on factors such as joining the electricity supply network (102), lending (122) and foreign trade (83).

According to the Global Competitiveness Index of the World Economic Forum, Azerbaijan ranks 35th in 2018 (among 137 countries) in 51st place in 2010. Nevertheless, financial market development index (79th place), health and primary education (74th place), higher education and vocational training (68th place), macroeconomic environment (65th place), domestic market (63rd place) and technological readiness (56th place) reflects the country's subindex positions that need severe changes in the relevant fields.

In the Economic Freedom Index of The Heritage Foundation, Azerbaijan was able to move from 49.8 points in 2000 to 64.3 points in the group of "moderately free" countries from the "regressive" countries. However, the scores that the country has collected on subindexes such as legal effectiveness (36.8 points), Government Integrity (39.9 points), investment freedom (55.0 points) and property rights (53.6 points) are.

The Fragile States Index, annually published by Foreign Policy magazine and The Fund for Peace, is based on 12 criteria. In the 2018 Index, Azerbaijan rated 74.6 points (maximum 120 points) in 78 countries with 178 out of 178 countries. While Azerbaijan's position improved by 3.6 points compared to 2013, there was no change in the group of countries where it was located.

In the Legatum Prosperity Index, calculated from the Legatum Institute analytical center in the UK since 2006, 104 subtypes are subdivided into nine subindexes. The overall rating of Azerbaijan in the index of 2017 was a 106th place (53.33 points) among 149 countries. The position of Azerbaijan in subindexes was 138th place on natural resources, 137th on social capital, 128th on public administration, 123th for individual freedoms, 98th on economy quality, 81st in the business environment, health 71st, the 70th on security and the 46th place in education.

Thus, both based on the analysis and the position of the country on international ratings, we can say that there is a need for serious reforms to improve the investment climate in Azerbaijan to increase the FDI involved in the country's non-oil sector. These reforms should focus not only upon expanding tax incentives and subsidies, but also primarily for issues that are more sensitive to investors. Such problems include:

- increasing transparency and accountability in public administration and eliminating corruption;
- ensuring the protection of property rights;

- Establishing an independent and fair judicial system;
- to expansion of economic freedoms;
- improvement of legal and regulatory environment (ensuring the rule of law, ensuring equality before the law, predictable behavior of public authorities, refusal from the practice of public decision-making on business expenses and income, and at least six months after the entry into force of the agreement, etc.);
- Preparation and adoption of single government policy on the involvement of CSOs;
- Adoption of the new Law "On Competition," "On Protection of Foreign Investments," etc.

## **1.2. Research objective**

The objective of the research is based on an analysis of the past and present state of the area of FDI in Azerbaijan, with a specific focus on oil and non-oil industry, to identify significant effects of the impact of FDI on the development of the economy of the Republic of Azerbaijan.

The primary aim of this thesis is that examines and studies the effect of FDI on economic growth in the Azerbaijan's economy. This dissertation also attempts to offer a better understanding of the relationships between FDI and economic growth.

## **1.3. Significance of the study**

Under the conditions that Azerbaijan gains independence and chooses the market economy as an economic system, it is necessary to deepen further the investment activity, in particular, foreign investment activities, based on the interests of foreign countries and their economic entities and the development of the national economy. In such a real situation, the reality of state regulation and management of investment activity is evident.

The foreign investment policy is an essential part of the overall investment policy of the Azerbaijani state, plays a specific role in the growth of the national economy, its sustainable development and the efficient employment of the population. Specific investment programs should be developed to implement this policy, and the features of the national economy in these programs should be carefully considered and studied in terms of the transition period and international experience. At that time, special attention should be paid to the areas of strategic importance for the development of the country's economy.

While formulating the investment policy, the national interests of the state should be ensured, taking into account the interests of the foreign state and their representatives. Also, the interests of different subjects of the country's economy should also be taken into account. In short, the formation of investment policy should be coordinated within national interests, individual interests, and interests of external factors.

Under current conditions, the investment policy implemented in the country should gradually be improved and substantiated. To this end, measures to encourage entrepreneurs should be developed, and effective investment policy should be applied. It is advisable to implement these measures for the investment policy: formation of the favorable investment climate, preparation and implementation of state investment programs, development of national investment legislation, development of the infrastructure of the investment market, and increasing the volume and effectiveness of investments and improving the structure of investments by providing broader investment in innovation investments.

The Government of Azerbaijan has completed the transitional economy and aims to determine the course of economic reforms in line with the requirements of a new era of quality and quantity. At the start of the long-term development phase, the government of Azerbaijan envisages the preparation of a concept paper on diversification of the economy. In the upcoming years, the key targets of the

economic strategy will be to deepen the diversification policy in non-oil sectors. The forecasts and scenarios based on the socio-economic development indicators of our Republic also include the application of a new economic model in Azerbaijan.

Great development prospects of the non-oil sector in our Republic are one of the main incentives for diversifying the economy and thanks to the new strategic line, Azerbaijan should have a great reputation as an exporter of non-oil products shortly. Naturally, the volume of oil inputs will play a unique role in accelerating the economy diversification at the initial stage. The government of Azerbaijan has been able to create favorable conditions for the dynamic development of all sectors of the economy by effectively spending its foreign exchange reserves from the sale of abundant oil resources, and now the non-oil industry has become a strategic division that can generate substantial revenues. As a result of the implementation of purposeful investment programs, non-oil fields are a currency-based basis for more profound future economic development.

#### **1.4. Research questions**

In the previous section, it was emphasized what factors are considered by investors when trying to invest in any country, and what situation is essential for the country. When attracting foreign investment in our country, it is necessary to examine the interests of foreign investors and the importance of which factors to attract them to the country.

Also, the impact of foreign investment in our country is very important because the state's national interests are above all else. Foreign investment should not hurt the national interests of the state and should not only negatively affect the country's current economy but also contribute to economic development.

Given all this, we are facing questions about foreign investment, and by answering these questions, we will try to determine whether foreign investment is vital to our country. This thesis is focused on finding answers to the following questions:



- 1) What are the significant factors that would determine the FDI attraction of Azerbaijan?
- 2) How FDI impact on Azerbaijan's economy?

### **1.5. Data and Methodology**

The required statistical data on FDI inflows of The Republic of Azerbaijan were sourced from the websites of The State Statistical Committee of the Republic of Azerbaijan, The Republic of Azerbaijan Ministry of Economy, The Central Bank of Azerbaijan, economic literature, pieces of information of mass media and other internet resources.

In this research will be used quantitative and qualitative methods. Methods were selected according to the purpose of the study. The methodological normative materials developed and approved by the State Statistical Committee of the Republic of Azerbaijan have been widely used.

In the second chapter, to explain FDI, the description method was carried out as well as, the descriptive method was used in the processing of theoretical parts of the study.

In the fourth chapter, analysis methods have been used. In this chapter, the economy of Azerbaijan was divided into three parts and analyzed by descriptive methods and compared the trends of FDI by using the secondary data in these years. The analysis method has been used to evaluate the development process of FDI in Azerbaijan, and to investigate problems and variability related to FDI.

The comparative analysis method was also used to compare Azerbaijan's economic data with previous years. Economic data from 1995 until the present day is derived from the website of the State Statistical Committee of the Republic of Azerbaijan and comparative analysis has been made, and FDI's trends have been revealed.

## 2. LITERATURE REVIEW

As mentioned above, the purpose of this thesis is to investigate the impact of FDI in Azerbaijan's economy and economic growth. In recent years, FDI has become the central economic policy in developing countries, and Azerbaijan is no exception. As the main reasons, it does not just provide the benefit of own investment but also benefit of society and the host country, and the environment. FDI increases economic growth through a rise in human capital, and this is done through the development of the education infrastructure of the host country, thus making a skilled labor force for the FDI to utilize. Having increased the labor force, the FDI would also enhance employment opportunities and create many jobs for the host country.

In this section will be mentioned about the definition of FDI, the main differences of FDI from other investments, the relation of FDI with economic growth, FDI theories and other essential factors.

### 2.1. Definition of FDI

FDI is the financial participation of an investor in a company from a foreign country. Resource seeking, market seeking, efficiency seeking and strategic asset seeking are the motives for direct investments. *Resource-seeking motive* is represented by the worldwide search for cheap natural resources in the production industries. This motive can be observed in monopolies that need an intermediate good to manufacture the final goods. Thus, they take part in another foreign country to benefit from more efficient sourcing. *Market-seeking motive* arises that firms want to protect and expand their market share through FDI. *Efficiency-seeking motive* is applied in firms that have front high trade barriers, tariffs, taxes, transportation costs or high local labor costs. Thus, to avoid these costs, they produce in a foreign country. *Strategic asset seeking*- these firms want to promote their strategic objectives- sustaining and developing competitiveness through FDI. Strategic asset seeking is the main reason why many investors have joined

resource-rich countries, such as the Caspian Sea countries. (Sumati Varma and Rishika Nayyar, 2014)

In economic literature, a great deal of definition is given to the FDI. According to one of these, FDI caused global production financial flows.

“FDI is the category of international investment in which enterprise resident in one country (the direct investor) acquires an interest of at least 10 % in an enterprise resident in another country (the direct investment enterprise)” (UNCTAD, 2010: Abdulghader Ali, 2014: p.31).

FDI as a long term relationship between the source country's companies (the investor) and the host country's company (state of investment) (UNCTAD, 2008: Abdulghader Ali, 2014: p.31). Hence as indicated by this definition the source company (foreign investor) is characterized as the company that claims resources in another company or creation unit that has a place with a country other than its native country.

FDI implies capital mobility from one country to a host country. This process happened with courses as the making of a subsidiary of an organization (Greenfield investment) or the augmentation of effectively existing organizations (mergers and acquisitions). FDI, for the most part, includes a long-term connection between the direct investor and the outside company, furthermore the potential control access to the direct investor on the top managerial staff of the organization. The direct investor can be an individual or lawful substance from general society or individual segment, a gathering of individuals, an organization or gathering of organizations, a legislature or an administration association, or some other association, for example, a global financing association.

FDI is of considerable significance to these reasons that first, in quantitative terms, FDI has a high share among other types of foreign investment. Second and, most importantly, FDI is an alluring movement of capital, because FDI is located in a foreign country for a long time, where it has increased the investment reserve, has created new job areas.

## **2.2. The main differences that distinguish FDI from other investments**

During the last 20 years, there has been a noticeable increase in both the flow and stock of FDI in the world economy. Some officials see FDI as a way of overcoming future trade barriers. The globalization process of the world economy is additionally positively affecting the volume of FDI. Some large firms now see the whole world as their market, and they are embraced FDI trying to ensure they have a substantial presence in each region of the world. It is a significant fact that numerous firms now want to have production facilities close to their customers. All these privatizations lead to the fact that FDI differs from other investments. Different classifications are used to distinguish between direct investment in the global portfolio and foreign direct investment. The main differences between the two foreign capital types are as follows, and the same variations can be made between short-term private international capital movements and direct foreign investments.

*Diversity in terms of time*-FDI covers long-term investments (longer than 5-10 years). Thus, acquisition of foreign direct investment, start, and end of fixed investment, a transition to production, changing to profitability may require a medium-term shift. A long-term stay in the country of the FDI makes these investments delicate to long-term real interest rates.

*Diversity in terms of control*-In FDI, a parent company has an all the time controlling capacity, although a piece of a subsidiary (branch, distributor, delegate office, etc.) perceives independence. Specifically, a parent company acts conservatively in the identification of quality and standards.

*Diversity in terms of capital structure*- in FDI, foreign investor additionally creates production technology, management information, initiative, risk, and organizational structure. Therefore, in these investments, the only benefit of a host country, not to meet financial needs, but also to cover the technological divide.

*Diversity in terms of legal status*-in FDI, the investor is regularly a foreign legal entity. Consequently, in such investments, decisions are taken in a group at each stage, and the amount of investment is reaching large volumes.

*Diversity in terms of earnings profits*-in FDI, transfer of profits to the country where the leading company is located, depends on the state of the company's earnings and their behavior on the subject.

### **2.3. Factors affecting FDI**

Many factors are affecting FDI, and their impact on FDI is different. These factors provide profit and profit transfer and define the existence and future security of foreign capital. We will review some of these factors are as follows: (Sabiroğlu N., 2006)

*Economic factors:* There are significant economic factors as market size, purchasing power, abundant labor, costs saving for attracting FDI. The FDI wants to have a real purchasing power and a stable economic growth potential where it will go. Investment discount, exempt from customs taxes and the cheap loan is essential for FDI. As well, abundant and cheap production factors attract foreign investors. Moreover, quality features are as important as quantitative features.

*Political factors:* FDI is generally a risky activity. If a country has an uncertain political situation, it will be a significant disincentive. Political stability is the most important factor for foreign investors, to political stability ensures economic security. Investors avoid investing in countries where they have unstable political conditions.

*Exchange rate:* A weak exchange rate can attract more FDI in the host country because it will be cheaper for investors to purchase assets. But exchange rate volatility may discourage investment.

*Transport:* The transport costs are a substantial factor in the desirability of investment. A country may have low labor costs, but if there are high transport

costs for getting the goods onto the world market, this is a disadvantage, and as a result, investors will refrain from investing.

*Moral and spiritual values:* The country's social structure, standard features, moral and spiritual values ought to not negatively affect foreign capital investments. Although in economic theory are emphasized that moral values should not affect investment decisions, and economic rationality needs to be decisive, it is well known that in practice, foreign investors prefer to work in an environment where they will not feel alien.

#### **2.4. Positive and negative effects of FDI on the economy**

When discussing FDI, it is essential to distinguish between the positive and negative effects of FDI. It can affect both countries in terms of benefits and costs, from the perspective of a host country and of the home country.

*The following are the positive effects for the host country:*

- **Competitive economy:** FDI in the economy of a host country helps to make it focus competitiveness. Global partnerships while setting up workplaces bring in cutting edge technologies that assistance to assist the business and provide employment to a large number of people, to a country can't generate huge investments on its own to improve the infrastructure in development and power enterprises. It ought to be sourced from different countries that have substantial foreign exchange reserves.

- **Elimination of monopoly:** When the government invites FDI to state, then it can do away the monopoly of local companies and benefit to clients because in this situation companies produce quality products.

- **Human resource:** The foreign company prepares the local human resources to improve their ranges of abilities, along these lines conquering any hindrance among instruction and recruitment capacity. It plays a specific role in enhancing the efficiency of the workers. It helps to reduce unemployment by increasing employment.

- Revenue to the host country: The host country obtains FDI benefits from the technology transfer of the foreign company. Also, it pays taxes to the host country. The international company uses cost cutting too, so it uses local employees because they are practical and give quality output. In this way, it upgrades the balance sheet by eliminating the production overheads as high wages.

- FDI positively affects the host country's foreign economic integration and finishes becoming a closed society.

- FDI increases financial resources and investments, and determines the source of funds and positively affects stability. Consequently, this reduces the country's foreign debt needs.

- It takes know-how, technology, and management systems, providing a new technology transfer, and carries out essential functions in the economic development of countries with difficulties in manufacturing technology.

- Provide economic growth by increasing the national income level of the country.

*The following are the positive effects for home country:*

- Transfer of foreign investment income to the investor's country (home country).

- Providing a high level of management and technical staff of foreign investment from the home country, if the capability to find the right quality in a host country in which the foreign capital goes, or if the investor applies specific incentives to that country.

- It makes foreign capital a tool for foreign policy. Investor country can use its direct foreign capital policy as a tool of foreign policy to strengthen its political reputation, thus increasing the political and economic impact of these countries.

*The following are negative effects for host country:*

- Exploitation: FDI leads to exploitation of employees in developing countries by multinational companies to save money.

- When foreign companies come to the country often create an unfair competition climate, they want to eliminate local rivals and break the resolve of small business people who wish to develop local industries.

- One of the biggest criticisms associated with FDI is the fact that foreign companies have an essential right to vote on the host country's economy. In particular, the key concern of the key sectors of the country's economy is the oversight of foreigners. This situation is a problem of the country's political and economic national hegemony.

- Global companies can increase their earnings by going to transfer estimates. However, this will increase the host country's foreign currency output.

- The host country will be deprived of potential foreign currency earnings when global companies choose to pursue domestic demand-oriented production instead of exports.

*The following are negative effects for home country:*

- As a result of FDI, the country may experience a decline in exports.

- The country's capital exports negatively affect the balance of payments, even in the medium term.

- If there is political and economic instability in the country where the investment is made, this is a risk for the investor and its country. This level of instability in the host country indicates the degree of systemic risk. This situation also means the loss of capital in terms of the investing country, as the investor creates a negative impact on the company's profitability, growth, and sustainability.

- Since foreign investment in the country enters global markets, local monetary and fiscal policies, and consequently, the government's control over the economy can become more difficult.



## 2.5. FDI theories

The FDI theories clarify the reason why FDI happens and the determinants of FDI. The theories have generally emphasized market imperfections. These days the issue of foreign direct investments is being given careful consideration, both at national and international level. Numerous theoretical researches examine issues of foreign direct investments, and fundamental researches on FDI were produced by J. Dunning, S. Hymer or R. Vernon.

Financial specialists trust that FDI is an important component of monetary advancement in all countries, particularly in developing ones.

On the connection between FDI and economic development is that the effects of FDI are complex. From a macro perspective, they are frequently viewed as generators of business, high efficiency, competitiveness, and innovation overflows. Particularly for the least developed countries, FDI implies higher exports, access to worldwide markets and global monetary forms, being a vital source of financing, substituting bank loans.

The World Investment Report additionally portrays some econometric models for deciding the effect of FDI on development. Numerous investigations point out that FDI and development relationship relies upon the internal factors of the recipient countries. Lee and Mansfield (1996) brought up that these variables are trade policies, legislative environment, and law enforcement. Buckley (2002) introduced that countries would profit by FDI in their country, if there is a high rate of savings, open trade regime, and high technological knowledge.

“The competition generated by these cross-border investments and trade has been highly influential in shaping the innovative activities of firms (Jacquemin 1982; Cave 1985; Kumar and Siddharthan 1994; Bertschek 1995; Coe and Helpman 1995; Wagner 1995)”.

Commonly, there are two sorts of competition: One is produced by the entrance of household firms into foreign markets and the other by the entry of international firms into the domestic market. The former takes the form of outward FDI and exports, while the latter kind of internal FDI and imports.

Numerous studies have analyzed the impact of internal FDI and imports on firm innovation, for example, those of Zimmermann (1987), Veugelers and Houtte (1990), Scherer and Huh (1992), Bertschek (1995), Co (2000), and Lofts and Loundes (2000).

The creators of these examinations locate that internal FDI and imports can improve rivalry and quicken the procedure of development in the neighborhood producing industry. However, only a couple of studies talk about the impact of outward FDI and exports on innovation activities. Lin and Yeh (2004) locate that outward FDI and exports have a positive correlative effect on the research and development (R&D) of assembling firms, even though they don't determine a relating testable model. (Lin, 2010)

“A depreciation of a country’s currency increases the relative wealth of foreign firms hence their capacity to invest in the context of imperfections of the capital market (Domar, 1997).” Comprehensively, FDI is an exchange of capital and hence can be translated in the form of a comparison of expected returns on alternative decisions of investment. Accordingly, there are two effects of exchange rates on investment decisions: the level and the volatility of the exchange rate. The level is characterized dependent on the condition of the exchange rate, for example regardless of whether it is commonly considered as depreciated or not, and volatility refers to the gap in the trading range of the currency over some time. Initially, the level of the real exchange rate influences FDI in different ways depending on the destination of the goods produced. FDI and trade become substitutes when the investor aims at serving the local market, and various systems at that point can be considered. It is normal that an appreciation of the domestic currency extensions FDI inflows (particularly as imports) because of the higher purchasing power of host countries’ consumers. Conversely, with depreciation in the real exchange rate the recipient country extensions FDI through diminished costs of capital.

Alternatively, according to Jayaratnam (2003), if FDI aims at producing for re-export, it complements the exchange rate, and appreciation of host countries' currency reduces FDI inflows through lower competitiveness. Exchange rate depreciation in actual terms is generally shown to induce more FDI inflows.

Corden (1990), and Barrell and Pain (1998) emphasize the negative impact of an appreciation of the real exchange rate on FDI. A foreign firm confronting significant exchange rate volatility will manufacture in the host country if it plans to sell on the local market but will avoid doing so if it expects to re-export.

**The eclectic model** (otherwise called the OLI model) articulates that FDI comes about when a company in a sending state has a competitive edge as a trademark, creation strategy or entrepreneurial ability, and returns to scale or speculates that the expected investment location has specification advantages as the presence of crude materials, low wages, individual taxes or tariffs. In such a case the company prefers to internalize these advantages, without selling licenses or entering into joint ventures, as a method for creating in the receiving or host country.

The eclectic model or OLI paradigm was developed by Dunning (1988) at the University of Reading (UK) and Rutgers University (US). The model is a mix of three different theories of FDI = O + L + I, each piece concentrating on a various question.

O (ownership advantages) - The advantages create higher income as well as lower costs that can balance the expenses of operating at a distance in a foreign location. A portion of these O advantages can be found with new firms (for example, first-time foreign investors); others originate from being an established affiliate in a large far-flung multinational enterprise.

L (Location advantages) - Location advantages are significant in making decisions such as the products one should make or sell. According to Location Theory, global companies, they prefer to produce in their own country of production in a foreign country, to realize their production with lower costs, to

avoid the adverse effects of tariffs and trade barriers. For example, in the United States, promoting investment in the oil sector abroad is prevented by avoiding double taxation on foreign interests and with extra discounts.

I (Internalization advantages) - emerge as an answer to market failure, as which regards that purchasers and sellers have asymmetric information, what makes vulnerability around the quality of the transactions and the decent price. Dunning clarifies that there ought to be an internalization advantage in that the firm trusts that its owner advantages are best misused internally rather than sold specifically through spot markets or offered to different firms through some legal arrangement, for example licensing, the foundation of a joint venture or management contracting.

**Product life cycle theory** – was developed by Vernon (1966). This model introduces trade and FDI as different stages of a sequential development process. According to this theory, a commodity carries three life cycles, including novelty, competence, and standardization between the first inventive stage and the mass production phase.

At the stage of novelty, the quality of the goods has not yet been standardized. Where production technology exists only in the hands of the inventor, production is more focused on the domestic market.

At the stage of mature, other firms are also starting to get technology related to the firm. With the increase in the number of manufacturers in the market, the monopolistic profits of the inventor company begin to decline. At this stage a certain level of standardization has been attained, demand for the product expands. The extension of the foreign market likewise extends the engaging quality of setting up production facilities there rather than exporting from the home country.

The last stage is a standardized product in the product life cycle, in which a product becomes highly standardized, the production process becomes familiar, and the price is the main factor determining the competitive result. At this stage, the demand in the developed countries is fulfilled mainly by outward imports. In

entirety, Vernon's product life cycle predicts that production is at first located in the U.S., subsequently relocates to other developed countries to meet the market demand there and eventually moves to develop countries where the work costs are the lowest.

**Internationalization theory-** the internationalization of a company has been expressed as a procedure where a company is progressively participating in the international context. This theory depicts the stages of a company's development through knowledge development and increasing obligation to a foreign market into international participation. Companies' access to the global market is being implemented through these stages. Companies that no prior international presence, often start internationalize through exporting. These international activities are later sold through agents in the foreign market. After sales increase, the companies would generate sales subsidiaries and subsequently start their production in the overseas market. Thus, this process creates access to the international market. (Rebecka Andersson, Jennie Wang, 2011)

**LLL framework-** is the framework of firm internationalization, and was developed by John A Mathews (2002, 2006). This framework recognizes the fact that firms utilize international expansion to find non-existent resources. According to this framework, emerging markets are considered as a source of innovation. Mathews (2006) proposed the LLL framework, which is firmly connected to the company's particular advantages from multinational companies in the emerging country. In this framework, the international expansion of multinational organizations is governed by resource linkage, leverage, and learning.

*Linkage-* Multinational internationalization of the emerging country seeks to acquire resources and complementary assets which can be obtained on the world market rather than in their home countries. By seeking resources outside of the domestic market, it is a precondition to overcome the limitations of its local market on the market. At the same time, this external orientation is risky than more conservative internal attention. Therefore, joint strategic partnerships in

international markets are strategically essential strategies for accessing external resources and, as discussed, is a common choice for foreign markets for multinational entrepreneurs. These forms of internationalization are used to form international networks that link resources. Thus, multinational companies in emerging countries "turn themselves into periods of exchange and sources of advantage." (Mathews, 2006)

*Leverage-* to effectively manage and use the resources and capabilities across the entire network networks of resource exchange and exploitation can leverage the connections between resources and competitive advantages. In this context, it is crucial to set up structures and processes that enable companies. Emerging country multinationals can leverage these resources by creating a knowledge sharing across the network.

*Learning-* Through linkage and leverage strategies, emerging country multinationals are more conformed to the world markets that are themselves increasingly connected. This is the subsequent learning processes that expedite expansion patterns. Companies use linkage and leverage processes that lead to organizational learning processes.

FDI has played an essential role in the international economy after the Second World War. Theoretical research on FDI resulted in a better understanding of economic mechanisms and behaviors of economic tools, both economic and micro and macro levels, economic theory. To understand the foreign direct investment, first of all it is necessary to understand the primary motivations for the company to invest in international companies or to invest in foreign companies.

## **2.6. Relation between FDI and economic growth**

There is a positive connection between economic growth and FDI. That relationship is significant for both developing and developed countries. FDI straightforwardly influences the economic growth of the host country. New job opportunities, the inflow of innovation, managerial know-how, marketing abilities, and numerous other viewpoints are developed in the host country thanks to

experiences of foreign investors. Also, that amount of massive flow brings about in being a catalyst for some different segments. For instance, finance, transportation, construction, and numerous different sectors are straightforwardly influenced by FDI.

According to neoclassical growth models, FDI only has a short-run growth effect. The production function in the receiving country consolidates the innovative advances from FDI and thereby extends growth. These innovative spillovers make it feasible for a long-run growth to take place by counteracting the impacts of diminishing returns to capital. Beside capital accumulation, knowledge spillovers from FDI can likewise improve economic growth.

It is ordinarily believed that developing countries can have a high growth rate because of the catch-up effect. Since their innovation dimension is much lower than in developed countries, they can execute already open innovation and thereby expand the growth rate. “A large amount of FDI may cause positive spillovers which in turn enables the country to raise the growth rate (Borensztein et al., 1998)”.

In general, FDI contributes directly or indirectly to economic growth. Tax revenues, foreign enterprises' revenues, and tariffs increase government revenues and FDI increases capital formation and constitutes an integral part of capital accumulation. FDI improves the overall productivity of the country, enhances the richness of the new input and idea production function. According to Whalley and Xin (2006), foreign-owned enterprises have labor productivity that is about nine times more likely to be found in local businesses. Foreign investments create many spillovers to domestic firms due to the adoption of advanced technology and know-how from western investors. Thus, in recent years more projects in the high technology sector were promoted. Also, FDI creates various job opportunities and skills for local workers.

According to Borensztein, FDI inflows contribute to economic growth by increasing capital stock in the host country. They stimulate technological progress

that they provide to economic growth. FDI stimulates and develops technological progress by generating knowledge or technological spillovers that increase factor productivity. The knowledge spillovers take place through imitation, competition, linkages, and training (Hermes and Lensink (2003), Lensink and Morrissey (2001), Gorg and Strobl, 2001). Foreign companies have some unique assets, such as advanced technology and organizational skills on local companies. It's cheaper to imitate or copy them than just refreshing new things. Local firms can be more productive by imitating foreign companies. FDI generates positive technological spillover through the channel of imitation and technology spillover through the competition channel when the competition between overseas and domestic firms induces domestic firms to upgrade their technology or adopt new methods of production. Technology or knowledge dissemination originates from a relationship channel where domestic firms deliver raw materials or intermediate goods to foreign companies. This contact may encourage international companies to provide technical assistance to local firms or to improve their technology to meet specific requirements.

By stimulating technological development, empirical studies are confirming the FDI's impact on economic growth. Borensztein (1998) found a positive effect of FDI on growth through technology spillover. This spreading effect is because the trained workforce in the recipient countries is at the regional level.

Hermes and Lensink (2003) proved that the development of the domestic financial system was a necessary condition for creating positive effects that would increase production growth for foreign investment. Carkovic and Levine (2002) have performed the same experiment.

It is true that investments to a country, especially FDI, create widespread increases in GDP labor productivity. FDI may have a positive impact on employment levels in host countries. Greenfield FDI is the creation of new jobs in the home country. M & A FDI does not have the same effect as soon as possible.



The unemployed labor force benefits from local firms employed by foreign companies. FDI can also adversely affect employment. This can happen by more foreign companies as a result of the close down of local companies.

### **3. THE ROLE OF FDI IN AZERBAIJAN ECONOMY**

After gaining independence, one of the most important directions of economic reforms in our country is to increase the efficiency of foreign investment. One of the measures taken in this direction is the liberalization of foreign economic relations. Naturally, liberalization covers both current transactions of the balance of payments and fixed capital accounts. From this aspect, the limitations on current transactions were rejected in a short time. The absence of any restrictions on current currency operations has also been recognized in the appropriate legislation. At present, our country has also joined the VIII Agreement with the IMF. In the procedure of forced sale of foreign currency income to the country was canceled.

Currency transactions related to capital flows under the Law of the Azerbaijan Republic "On Currency Regulation" include: Investments in the entity's charter capital for FDIs, the acquisition of new revenue and the right to participate in the enterprise management; Acquisition of securities; buildings, including land, as well as transfers of property rights as well as other rights over real estate on the other property owned by real estate under the laws of the host country; delivery and receipt of payment delay for goods and services for more than 180 days.

There is no limit on the entry of foreign capital into the country. Our country occupies one of the leading places among the CIS countries, as well as Eastern Europe, for the share of FDI, the most effective form of foreign investment. The state, as well as other economic entities, have established partnerships with leading international commodity lending institutions in the world and have long-term borrowings with large foreign banks.

The increase in proficiency in the banking system of the country has been considerably liberalized by foreign capital. Thus, the foreign bank capital limit has been removed in the banking system. Following the legislation, foreign investors have also been authorized to repatriate profits. At the moment, capital outflows from the country are met in the manner specified in Article 8 of the "Currency Regulation."

Further improvement of the investment climate in the country is one of the primary tasks to ensure the required capacity and quality of investments. For this purpose, the following measures are undertaken:

- Protection of personal property and improvement of corporate governance;
- creating a more convenient competitive environment for all investors regardless of ownership;
- increasing the role of the state to ensure a stable normative-legal regime;
- further enhancement of the regulatory-legal outline of investment activity;
- Improvement of the system of informing investors about enterprises for selection and analysis of investment objects;
- Increasing assistance to the development of modern institutional infrastructure that ensures the efficient transformation of savings into investments;
- To improve business information, bringing accounting and statistics into international standards.

The Republic of Azerbaijan has been among the first in the world in terms of economic growth rates achieved in recent years. The economic stability of potential foreign investors invested country's economy is reflected in the fast and sustained growth of macroeconomic indicators in Azerbaijan. Thus, in comparison with 2003, GDP in 2013 was 3.2 times, strategic currency reserves increased 31 times, and state budget revenues increased by about 16 times. In the World Economic Forum's latest global competitiveness report, Azerbaijan, which ranks 38th in the world, has 9th out of 144 countries in terms of macroeconomic stability. The development of the private sector has played a significant role in achieving these achievements.

The main task of "Azerbaijan Export and Investment Promotion Foundation (AZPROMO), providing various services to local exporters and foreign investors, National Fund for Entrepreneurship Support (NFES), providing concessional loans to entrepreneurs, State Agency for Agricultural Credits under the Ministry of

Agriculture, implemented joint investment projects with local and foreign investors, Azerbaijan Investment Company (AIC) and newly created industrial parks and industrial neighborhoods" is to stimulate the development of the non-oil sector of the country's economy.

Along with the measures taken to improve the investment environment, the country's investment promotion should also be necessary. Regular business forums and other business events are organized in the country and abroad to encourage the country's investment potential and attract foreign direct investment to priority areas. The expansion of participation in prestigious international investment events is underway. Preparation and dissemination of campaign materials and electronic media, promoting the country's economic potential, natural resources, investment climate, opportunities, and projects, as well as priorities in the country, was carried out in the country's prestigious international media.

As the priority directions of foreign investments, the economic zones created on the basis of the President of the Republic of Azerbaijan on the establishment of the Garadagh Industrial Park with the President of the Republic of Azerbaijan, the Decree of the President of Azerbaijan on the establishment of the Mingachevir High Technology Park and the creation of the Mingachevir Industrial Park can be displayed in our country.

Recently, the activation of a free economic zone in Sumgayit is an exclusive event in terms of accelerating the flow of foreign capital into Azerbaijan. In principle, the open industrial area is, in fact, the elimination of economic and non-economic barriers to foreign investment and imposing maximum preferential terms. From this point of view, Sumgayit industrial enterprises, urban infrastructure will become the most widely used object of foreign investment. The UN Development Program has prepared a Sumgait project together with Azerbaijani experts.

Documents on the establishment of these economic zones provide for a seven-year investment of regional investment projects in full, and 50 percent release from

income tax. Additionally, the measures will help minimize the risks invested in the plan and increase future profitability.

There is a great need for FDI in the development of the technical level of the Azerbaijani economy, introduction of progressive management technologies. Therefore, strengthening investment policy is one of the essential tools to overcome the current economic difficulties.

Generally, foreign investment in Azerbaijan's economy is mainly in the form of direct investments. The volume of foreign investments was \$ 5016.2 million in 1994-1999. The bulk of this was directly attributable to FDI (\$ 4248.1 million or 85%). Also, non-credit investments, or, more specifically, investments into concrete enterprises amounted to \$ 3927.8 million or 78.3%. These investments are directly involved in the production process, and they carry out the entire production cycle - from the establishment of the enterprise to the final production. That is why all transition economies, including Azerbaijan, are interested in attracting FDI.

Improvement of the investment climate in Azerbaijan is impossible without the development of tax legislation. According to experts, the massive reduction of taxes to stimulate foreign investment is inaccurate. It is crucial to apply tax incentives and even "tax holidays." It is necessary to pay attention to the differentiation and targeted nature of the taxation of foreign investment through taxation. The joint ventures established with the participation of foreign capital in Azerbaijan are subject to a preferential tax (more than 30% of the charter capital is paid by enterprises with foreign capital, 25% pay income tax, and 35% average profits tax rate).

One of the functions of the state during the transitional period is the formation of the necessary legal and economic base for the attraction of foreign investments into the economy of the country. It tries to attract foreign investment in the country's economy, which forms the necessary economic-legal basis. Based on these principles, Azerbaijan has taken significant steps to attract foreign

investment. The following sections describe and explain separately the economic reforms carried out by Azerbaijan after gaining independence, the measures it has undertaken for the recovery of the economy and the foreign investment activity.

### **3.1. Evaluation of FDI in Azerbaijan**

The Republic of Azerbaijan is a young country that gained its independence after the collapse of the Soviet Union in the early 1990s. Having gained independence, as he was part of the Soviet government for many years, he faced a series of problems in the economy. The country also faced severe problems with the neighbors and the economic shortage, and eventually began to economic reforms to address these problems.

The first economic step taken as independence was a transition to a market economy. The main focus of economic reforms and transformation of the economic system is to ensure the independence of economic entities, to increase the effectiveness of industrial production, to increase and stimulate labor activity. One of the most initial and important steps taken in this direction was the adoption of the Law of the Republic of Azerbaijan "On Privatization of State Property in the Republic of Azerbaijan" defining the principles and organizational and legal bases of privatization of state property in the Republic of Azerbaijan in 1993. Privatization was an essential part of the economic reform and the transformation of the economic system in the transition to a market economy.

But because of objective and subjective reasons, there were severe crises in all the spheres of the public life of the Republic of Azerbaijan in 1990-1993 and this situation did not allow for large-scale and systematic socio-economic reforms in the country.

The most fundamental problems facing the Azerbaijani economy were the decline in production, investment and savings, high inflation levels, and, in other words, the existence of an unfavorable macroeconomic environment, which ultimately led to a sharp decline in many economic indicators.

Thus, Azerbaijan's economy in the years 1990-1994, it can be characterized as a period of the sharp deterioration of the economic situation.

**Azerbaijan's economy in the years 1995-2000:** After achieving state independence, one of the most fundamental problems facing the Azerbaijani economy was the dramatic decline in the volume of investment that defines the country's economic growth potential. The low level of investment activity in the country, the tendency to decrease the volume of investments directed to many sectors of the economy, the high level of investment and credit risks associated with general instability in the Republic, and the economics of Azerbaijan, characterized by severe crises, require a solid foundation.

It is worth mentioning the Law on Protection of Foreign Investments adopted in 1992 and the Law on Investment Activities adopted in 1995. These laws determine the general and social, economic and legal conditions of investment activity in the territory of the Republic of Azerbaijan. The laws are aimed at intensifying the investment in the Republic of Azerbaijan, effectively using it for the development of the country's socio-economic base, as well as for the development of international economic cooperation and integration and ensuring equal protection of the rights of all investors irrespective of the form of ownership.

Azerbaijan, rich in hydrocarbon resources, has historically maintained its reputation. These resources are considered to be the most favorable opportunity for national economic development, and this opportunity has been achieved after gaining independence. To solve economic problems, the country focused on abundant oil reserves. Azerbaijan has begun to produce, and export oil signed essential agreements and created pipeline projects.

Despite severe economic and political crises in this period, the "Contract of the Century" was signed on September 20, 1994, and this event has turned Azerbaijan's oil into one of the country's long-term economic development factors. This agreement was signed with 11 well-known oil companies from 7 countries around the world, and this agreement was about on the sharing of oil, extracting

the deep portion of the Azeri-Chirag-Gunashli (ACG) fields located in the Azerbaijani sector of the Caspian Sea. This agreement, which brought Western capital to the region to extract Caspian energy resources, was of great importance in terms of ensuring social and political stability in Azerbaijan, the country's future economic development and integration into the world economy. In 1995, the project cost was \$ 100 million and \$ 600 million in 1996. So far, \$ 2.5 billion have been invested in this project.

One of the most important steps was the closure of the Century Contract. After that, the economy of Azerbaijan became even more attractive to foreign investors. In 1994-1997, ten contracts with 33 large oil companies from 15 countries of the world and nine contracts in 1998-1999 resulted in significant investments in the country.

The Contract of the Century envisages the joint use of the oil field in the Caspian sector of Azerbaijan (Azeri-Chirag-Gunashli). The contract has been signed with 12 companies from 8 countries:

Amoco (US) - 17.01%; BP (B. Britain) -17.13%; Lukoil (Russia) - 10%; Statoil (Norway) -8,56%; Turkish Petroleum (Turkey) - 6.75%; Unokl (US) - 9.52%; "Itochu Co" (Japan) - 7.45% (McDermant sold part of its shares to Hotch Coin 1996); Ramco (B. Britain) -2.08%; Delta (S. Arabia) - 1.68%; Pennzoil (US) -4.81%; Exxon (US) has a share of -5% and ARDNŞ-10%.

After this agreement, Azerbaijan's reputation in the international arena has significantly increased, and the production of first oil turned Azerbaijan into an oil exporting country. After signing this agreement, socio-political and economic stability has been gained in Azerbaijan, and the other sectors of the economy have also opened the way for domestic and foreign investments.

Generally, as a result of the Contract of the Century, the alliance with Azerbaijan's foreign oil companies has brought many economic benefits. With modern research, oil extraction, utilization, and transportation technology, the



country has allowed building businesses that can help develop the oil and gas industry.

**Table 1: Volume of foreign investments intended for project exploitation of oil fields in the republic**

No	Field name	Volume of oil extraction (mln.ton)	Investment (billion USD)	Azerbaijan's share (%)
1	“Azəri”, “Çıraq”	600	12.0	10
2	“Günəşli”	80-150	1.7-2.0	7.5
3	“Qarabağ”	100	4.0	10
4	“Şahdəniz”	100-150	1.5-2.0	10
5	“Dan Ulduzu- Əsrəfi”	100	1.5-2.0	25
6	“Lənkəran-dəniz” “Talış-dəniz”	100	1.5-2.0	40
7	“Yalama”(D-22)	150-300	3.0-3.5	50
8	“Abşeron”	75-100	5.0	50
9	“Naxçıvan” (keçmiş D3)	75	2.0	50
10	“Oğuz”	90-120	2.0	50
11	“Kürdaşı”	30-60	0.3-0.5	20
12	“Güney-Qərbi-Qobustan”	150-250	3.0-4.0	50
13	“İnam”	50-80	1.0-1.5	50
14	“Muradxanlı”	150-300	9.0	40
15	“Alov”, “Araz”, “Şərqi”	60-90	0.5-0.8	50
16	“Gürsəngi”, “Qarabağlı”	100	2.0	50
17	“Atəşgah”	120-150	2.0	50
18	“Zəfər”, “Məşəl”	100-120	2.0	50
19	“Lerik-dəniz”, “Savalan”, “Padar”	50-100	0.8-1.0	20

**Source:** Dövlətin iqtisadi siyasəti: Dayanıqlı və davamlı inkişafın təntənəsi (2011)

Increased oil production as a result of the signed contracts has led to a significant increase in budget revenues. The rise in oil and gas production has led

to new infrastructure projects, promoting employment and this has helped reduce unemployment by opening new jobs for local people.

With the signing of the contract, Azerbaijan's ownership right over its assets was once again confirmed, and the fact that the Azerbaijani economy was open to the world was once again demonstrated. The closure of the "Contract of the Century" enabled Azerbaijan to be recognized as a state it's joining the world economic system and strengthening its position in the international arena. With the signing of international oil contracts, a solid foundation for the development of effective and mutually beneficial cooperation with the states participating in oil contracts was created, further strengthening of the geopolitical position of the country and acceleration of the integration process into the world economy.

After this contract, the oil industry has already started to play a significant role as a substantial source of foreign investment, which, in turn, has created the necessity of pipelines. Pipelines are also economically important. One of the critical conditions for the efficient utilization of energy resources is the creation of a necessary transport chain to bring supplies to the world market. Thus, the construction of pipelines was laid for the transportation of Azerbaijani oil.

The agreement, signed on January 16, 1996, was the first export of oil via the Baku-Grozny-Novorossiysk line. Oil was exported from this line since November 1997. Through this pipeline, the Azerbaijani oil is transported to the Russian port of Novorossiysk and is carried through tankers to the world market. 2.5 million tons of oil is exported annually through this pipeline.

The agreement, which prescribes the transportation of primary oil from Azerbaijan to Georgia on March 8, 1996, was signed between the AIOC, the Georgian government, and SOCAR. The contract envisages the transportation of oil from the Azeri-Chirag-Gunashli fields to international markets by the Baku-Supsa oil pipeline. This line was built in 1999 and started operating.

Thus, one of the main conditions for economic growth is the creation of a favorable investment climate in the country. It is necessary to have a unique role in

the state in stimulating the investment activity and implementing an active investment policy. From the world experience, it is known that mistakes made in the development of investment legislation lead to the loss of confidence of potential investors for a long time.

The fact that the oil sector is an essential factor for the Azerbaijani economy is undeniable. Direct investment in the oil sector improved the country's economic performance and attracted foreign investors to the country.

"Between 1994-2000, \$ 3.34 billion was invested in the oil industry." (Dr. Osman Nuri ARAS, Elçin Süleymanov, 2010: p.178)

Thus, since 1995, many positive trends have been observed in investment in Azerbaijan's economy. The elimination of political instability in late 1994, the announcement of a cease-fire in the Karabakh war, specifically, in September 1994 the signing of the Production Sharing Agreement (PSA) on the Azeri-Chirag-Gunashli Project, which was the country's first international oil contract, paved the way for FDI in the country.

Since 1994, investment flow has been started in Azerbaijan, and in 1998 it reached its maximum level with \$ 1472 million. However, as a result of strict monetary policy, a stagnant economy, delayed privatization, and non-implement economic reforms, the economy was under pressure from deflation, and after 1998, a decline was observed in the Azerbaijani economy, especially in terms of foreign investment. The 1998 crisis in Russia, the current bureaucracy in the country, bribery, and hidden monopoly in certain areas have contributed to a significant decline in foreign firms in the country and a decline in foreign investment. (Table2)

"Foreign companies invested about \$ 80 billion in Azerbaijan's economy in 1994-2010. Of this, 77.2% were realized through direct investment, and 22.8% utilizing loans. 73% of the direct investments were invested in the oil industry". (Dr. Osman Nuri ARAS, Elçin Süleymanov, 2010: p.234)

**Table 2: Investments directed to economy (1995-2000)**

	1995	1996	1997	1998	1999	2000
<b>Investments by all sources (taking into account foreign investments):</b>						
mln.manats	480.7	800.8	1351.1	1495.1	1293.8	1,289.8
mln.dollars	544.1	932.1	1694.5	1932.2	1,571.0	1,441.40
<b>Foreign investments:</b>						
mln.manats	331.4	533.1	1042.4	1139.0	898.6	829.5
mln.dollars	375.1	620.5	1307.3	1472.0	1091.1	927.0
<b>Internal investments:</b>						
mln.manats	149.3	267.7	308.7	356.1	395.2	460.3
mln.dollars	169.0	311.6	387.2	460.2	479.9	514.40

**Source:** The State Statistical Committee of the Republic of Azerbaijan, [www.stat.gov.az](http://www.stat.gov.az)

### 3.2. Analysis of FDI impact on economic growth in Azerbaijan

**Azerbaijan's economy in the years 2000-2010:** The entry of foreign investment into the country has started to grow again since the last months of 2000. Some changes in the law, partial reduction of the customs and tax rates and the continuation of this, the protection of foreign investment, and the steps taken by the state in this direction have contributed to the increase in foreign investment. The stability of the macroeconomic structure, the changes in the private sector strengthening and the further development of the oil sector have created enormous opportunities for investment flows to Azerbaijan.

1.454.5 Million manats were invested in the economy of Azerbaijan in 2001, 70% of the investments were made in foreign investments and 30% in local investments. In 2002, 80.9% of investments were made by international and 19.1% by local entrepreneurs. In 2003, 80.5% of the investment in the economy of Azerbaijan was foreign investment, and 19.5% were in the form of domestic investment. And, as the following table shows, investments in the economy have grown year by year. (Table 3)

As in the previous years, the basis of the revival of the Azerbaijani economy was the oil industry. As production of oil increased, Baku-Novorossiysk and Baku-Supsa pipelines were not sufficient, and the construction of a new pipeline for the

transportation of Azerbaijani oil to western countries occurred. The ceremony of laying the foundation of the Baku-Tbilisi-Ceyhan pipeline with the participation of the presidents of Azerbaijan, Turkey, and Georgia was held on September 18, 2002. A total of \$ 3.6 billion was spent on this project. Baku-Tbilisi-Ceyhan pipeline started operating in 2006 and has since begun to impact the Azerbaijani economy positively. Since 2005, this pipeline has been exporting 50 million tons of oil for 30 years, which will bring \$ 35 billion to Azerbaijan's economy.

**Table 3: Investments directed to economy (2001-2008)**

	2001	2002	2003	2004	2005	2006	2007	2008
<b>Investments by all sources (taking into account foreign investments):</b>								
mln.manats	1,454.5	2718.0	4249.3	5820.3	6 733.4	7 415.6	10 353.9	13 328.0
mln.dollars	1,561.8	2796.6	4326.3	5922.8	7 118.5	8 300.4	12 066.1	16 222.0
<b>Foreign investments:</b>								
mln.manats	1,016.8	2172.8	3311.0	4496.3	4 628.5	4 514.2	5 727.2	5 625.8
mln.dollars	1,091.8	2234.9	3371.0	4575.5	4 893.2	5 052.8	6 674.3	6 847.4
<b>Internal investments:</b>								
mln.manats	437.7	546	938.3	1324.0	2 104.9	2 901.4	4 626.7	7 702.2
mln.dollars	470.0	561.7	955.3	1347.3	2 225.3	3 247.6	5 391.8	9 374.6

**Source:** The State Statistical Committee of the Republic of Azerbaijan, [www.stat.gov.az](http://www.stat.gov.az)

Also for transportation of Shahdeniz natural gas to Turkey, the construction of the Baku-Tbilisi-Erzurum natural gas pipeline was started in 2004. This pipeline is thought to be parallel to the Baku-Tbilisi-Ceyhan pipeline, and the project is implemented which will allow reducing time and financial costs. In 2004, BP began construction of the excellent South Caucasus natural gas pipeline through natural gas transportation of the Shahdeniz field, and in 2006, natural gas was produced and exported.

Due to the implementation of this strategy (construction of pipelines) and the signing of agreements with international oil companies, multi-billion foreign investments were attracted to the country's oil reserves. Over the years, significant increases have been observed in oil production in Azerbaijan. The closure of

contracts and the commissioning of the pipelines created conditions for this process.

**Table 4: Oil extraction (including gas condensate) in Azerbaijan (thsd. ton)**

Years	Oil extraction (including gas condensate)	of which:	
		on land	on sea
1995	9 161	1 624	7 537
1996	9 100	1 575	7 525
1997	9 071	1 563	7 509
1998	11 424	1 578	9 846
1999	13 807	1 526	12 282
2000	14 017	1 511	12 506
2001	14 909	1 596	13 313
2002	15 334	1 561	13 773
2003	15 381	1 630	13 751
2004	15 549	1 707	13 842
2005	22 214	1 755	20 459
2006	32 268	1 782	30 486
commodity	32 186	...	...
2007	42 598	1 767	40 831
commodity	42 523	1 723	40 800
2008	44 514	1 799	42 715
commodity	44 395	1 746	42 649
2009	50 416	1 781	48 635
commodity	50 364	...	...
2010	50 838	1 716	49 122

**Source:** The State Statistical Committee of the Republic of Azerbaijan, [www.stat.gov.az](http://www.stat.gov.az)

Between the years of 1994-2000, \$ 3.34 billion was invested in the oil industry. Since 2001, there has been a significant increase in foreign investment in the oil sector. As a result, the investment in the oil sector at the end of 2009 is estimated at \$ 30 billion.

Following the Decree signed by our national leader Heydar Aliyev in 1999, the Oil Fund was established. The main objective is to develop state priority areas

and to implement economically essential projects to ensure efficient management of revenues from the sale of profit oils derived from the joint development of oil fields with foreign companies. At present, the Fund's activities and transparency in this area are highly appreciated by international organizations.

The oil and gas sector played a specific role in the development of other areas of the economy. As a result of thoughtful economic policy, macroeconomic stability has been achieved, and the basis of sustainable economic development has been laid, reforms have been started in all sectors of the economy, and serious steps have been taken to improve the living standards of the population.

Attracting domestic and foreign investments through developing entrepreneurship, creating favorable business and investment environment, and achieving non-oil sector development have been one of the typical features of economic policy at this stage. As a result of purposeful measures, the ownership sector has been formed in Azerbaijan, and the role of the private sector in the socio-economic development of the country has increased.

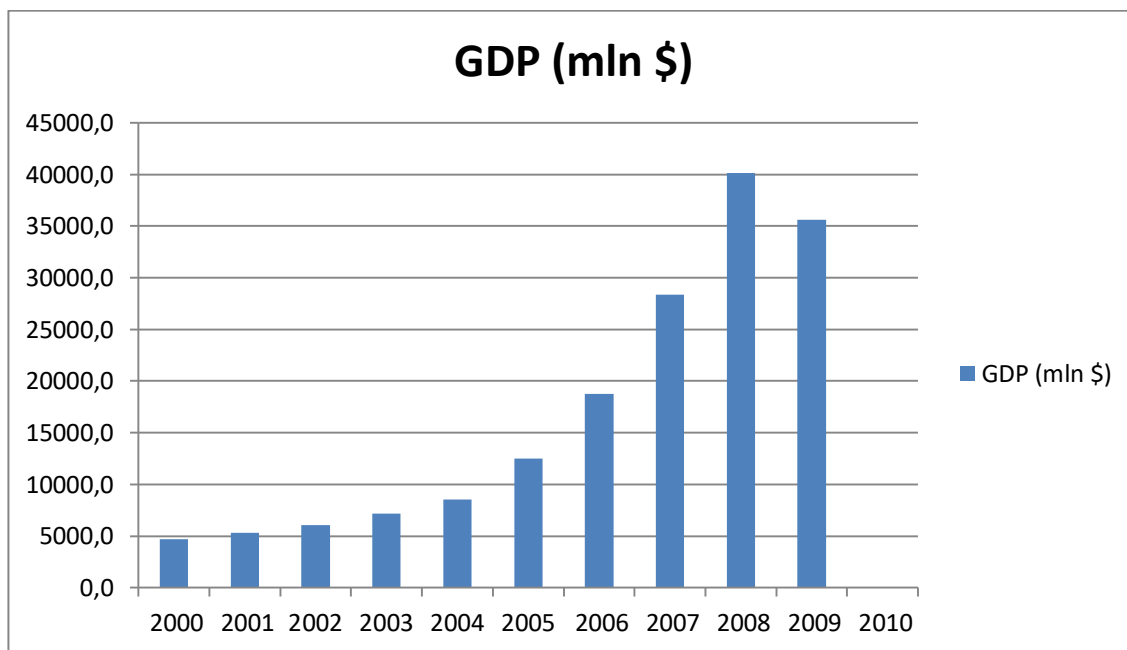
Ensuring the diversity of property in the economy has given a positive result to sustainable economic development. Thus, while the privatization started, the share of the private sector in GDP is less than 10%, while its specific weight has now reached 83%.

Successful policies have also been reflected in the gross domestic product. GDP between the years of 2000 and 2008 was at a steady pace. The growth of GDP in Azerbaijan is known to depend on more oil production and rising oil prices. Before the global financial crisis, Azerbaijan's GDP growth rate was 26.4% in 2005, 34.5% in 2006, and an increase of 25% in 2007, with a 10.8% economic growth in 2008. According to the International Monetary Fund, Azerbaijan's GDP declined by 11.5 percent in 2009.

For the first time in 2009, GDP declined compared to previous years. This was mainly due to the decline in oil prices and the crisis in the construction sector. The decrease in oil prices also led to a reduction in the dynamics of goods and

services produced in the country. This shows that Azerbaijan's revenues depend on oil. Therefore, for the sustainable development of the GDP, it is necessary to minimize the dependence of the economic growth on oil revenues.

**Figure 1: Gross Domestic Product in Azerbaijan (Million \$)**



**Source:** The State Statistical Committee of the Republic of Azerbaijan, [www.stat.gov.az](http://www.stat.gov.az)

State development of non-oil sector as one of the priorities of the state, including the State Program on Poverty Reduction and Economic Development for 2003-2005, on the Development of Small and Medium-Sized Entrepreneurship (2002-2005) State Program ", " State Investment Program for 2004-2007 ", as well as " State Program on Socio-Economic Development of Regions of the Republic of Azerbaijan for 2004-2008 ", once again improved investment climate in the country.

**Azerbaijan's economy in the years 2010-2017:** Recently, the integration process of the Azerbaijani economy into the world economy is accelerating. The growth of the oil and gas industry is of strategic importance in solving many problems. Co-operation with foreign oil companies remains a prerogative for government policy. The attraction of foreign investments is not only stable political and macroeconomic conditions but also ensuring that the currency is



stable, tax systems of corporations and adequate financial services to world standards. In particular, the efficient use of energy resources plays a vital role in the development of the Azerbaijani economy.

**Table 5: Volume of investments directed at country economy (in millions of USD)**

	<b>1995-2002</b>	<b>2003-2011</b>	<b>1995-2011 (total)</b>
<b>Total investments</b>	12473.6	106247.8	118721.3
<b>Domestic investments</b>	3353.9	52443.2	55797.1
<i>Oil sector</i>	902.5	9024.1	9926.5
<i>Non-oil sector</i>	2451.7	43419.2	45870.6
<b>Foreign investments</b>	9119.8	53804.5	62924.2
<i>Oil sector 1</i>	6105.3	31333	37438.3
<i>Non-oil sector 2</i>	3014.4	22471.5	25485.9

**Source:** [https://www.azerbaijans.com/content\\_1614\\_en.html](https://www.azerbaijans.com/content_1614_en.html)

More than 60 percent of the \$ 119 billion invested in the country's economy from 1995 to 2011, \$ 63 billion, was foreign investment. The volume of foreign investments in 1995-2002 was \$ 9 billion, with \$ 54 billion in foreign investment between 2003 and 2011 and \$ 25.5 billion in the non-oil sector and \$ 37.5 billion in the oil sector between 1995 and 2011.

The oil and gas sector of Azerbaijan has always been attractive for foreign investment: \$ 77.8 billion directed to the economy of the country during the years of 2000-2017 and more than 85 percent of the US \$ (\$ 66.8 billion) share in the oil and gas sector. It is possible to state that Azerbaijan did not sufficiently invest in the non-oil sector, which needs significant investments. If we look at picture 1 below, we can see that the amount of FDI in the oil sector has always been more than ever before in the non-oil industry.

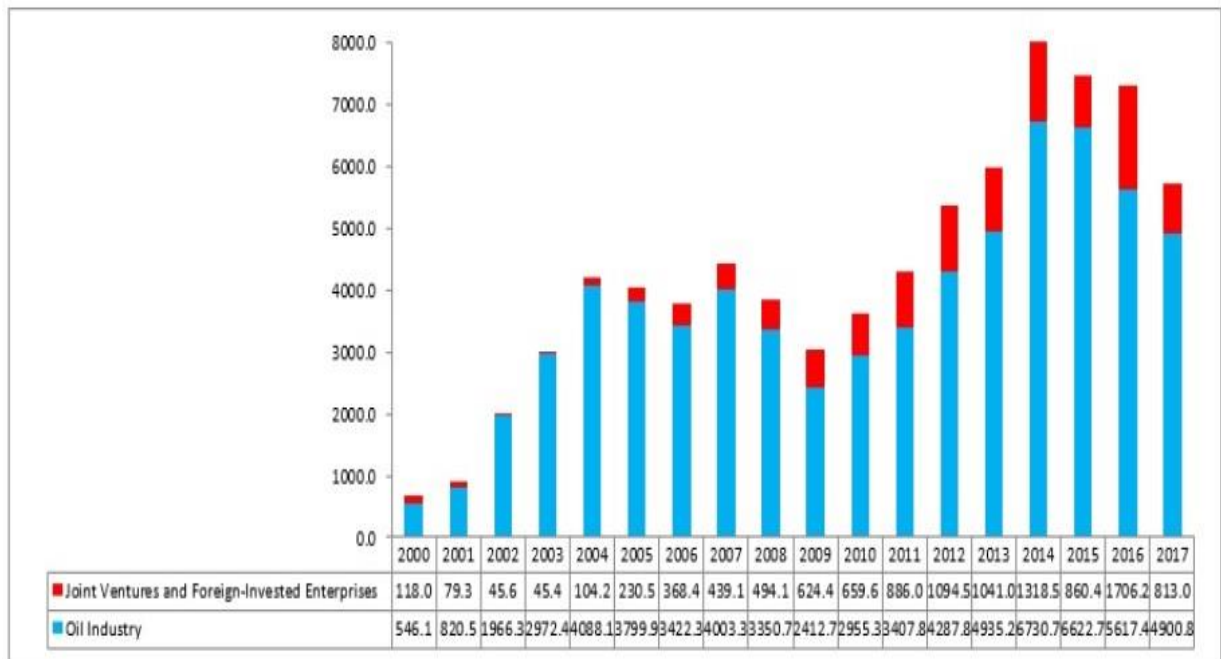
To invest in more oil sector in Azerbaijan and it is dangerous to generate a substantial part of GDP from oil revenues. Due to the unilateral development of the oil sector, price fluctuations in world markets cause changes in GDP, budget and foreign trade.

**Table 6: Volume of investments directed at oil and non-oil sectors of the country economy (in millions of USD)**

	1995-2002	2003-2011	1995-2011(total)
<i>Oil sector</i>	7007.8	40357.2	47364.6
<i>Non-oil sector</i>	5466.1	65890.7	71356.5

Source: [https://www.azerbaijans.com/content\\_1614\\_en.html](https://www.azerbaijans.com/content_1614_en.html)

**Picture 1: Dynamics of Oil and non-oil Foreign Direct Investment (in millions of USD)**



Source: <https://bakuresearchinstitute.org/foreign-direct-investment-in-azerbaijans-economy-current-status-development-trends-and-challenges/>

This process called the "Dutch Disease" can be described as the retreat or collapse of other sectors in the face of the rapid growth of a single industry in a country's economy. This situation points to the excessive economic growth of the state in which it is present. The first signs of the syndrome and the measures to be taken had gained greater importance since the end of 2005, particularly when oil exports began.

It is necessary to mention one issue, as noted above, it is essential for sustainable economic development not only to depend on energy resources but also

to use non-oil resources effectively. And it is necessary to increase the investment interest in this area. The amount of FDI attracted to the non-oil sector of Azerbaijan reached \$ 500.0 million in 2008 and \$ 1.0 billion in 2012. While there has been a gradual rise in the amount of FDI attracted to the non-oil sector during 2003-2014, there has been a sharp fluctuation in the years 2015-2017. The amount of FDI decreased by 34.7% in 2015 compared to the previous year and increased by 98.3% in 2016 (reaching \$ 1.7 billion), and in 2017 it dropped to 52.4 percent (i.e., more than twice).

The ratio of non-oil FDI to non-oil GDP in Azerbaijan is often less than 3% (only 3% for a few years). In 2016 the level of this indicator rose to 7.6%. The sharp decline in non-oil GDP was crucial in this year's abrupt change: in 2016, the amount of non-oil GDP was about 22.5 billion, which is 46.8% more than in 2014 (approximately \$ 42.3 billion), and 32.4% less than in 2015 (roughly \$ 33.3 billion). In 2017, the figure dropped to 3.5% as a result of a decline in FDI.

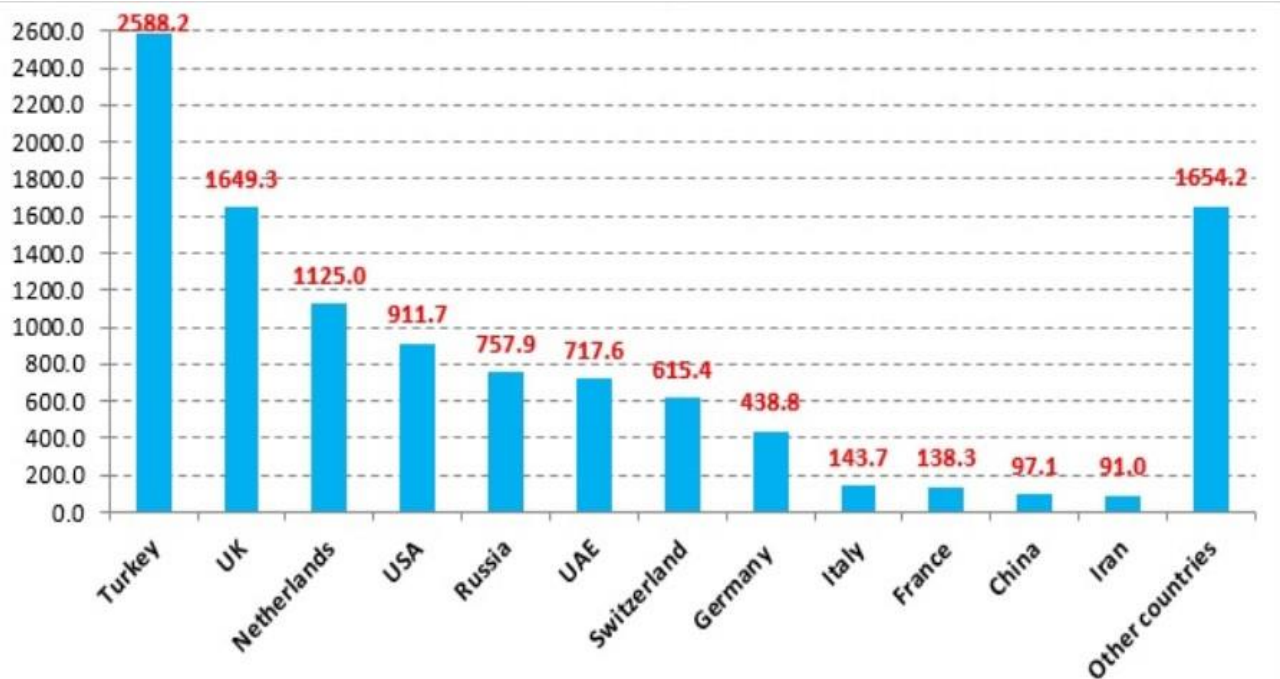
It is not accidental that the goal of the Strategic Roadmap of the National Economy Prospects of the Republic of Azerbaijan is to "increase the ratio of non-oil FDI to non-oil GDP by 4% by 2025". The role of FDI in the diversification of the economy is significant. That is, the contribution of FDI is not just investment; they also bring new skills, technologies and networking capabilities needed to access new sectors and value chains. The diversification of the economy requires more investment in the non-oil sector.

In the 2000-2017 period, a total of \$ 10.9 billion was invested in the country's non-oil sector, with 3.3% of the total GDP in the non-oil sector of the country during that period.

According to the State Statistical Committee of the Republic of Azerbaijan, total FDI in the non-oil sector during in the years of 2000-2017 amounted to \$ 2588.2 mln. (23.7%) in Turkey, \$ 1649.3 mln. (15.1%) in the UK, \$ 1125.0 mln. (10.3%) in the Netherlands, \$ 911.7 mln. (8.3%) in USA, \$757.9 million (6.9%) in Russian Federation, \$ 717.6 mln. (6.6%) in the United Arab Emirates, \$ 615.4 mln.

(6.6%) in Germany, \$ 143.7 million. (1.3%) in Italy, \$ 138.3 mln. (1.3%) in France, \$ 97.1 mln. (0.9%) in China and, \$ 91.0 million (0.8%) fell on Iranian companies (picture 2).

**Picture 2: Countries of the origin of FDI to the Azerbaijan's non-oil sector (2000-2017)**



**Source:** <https://bakuresearchinstitute.org/foreign-direct-investment-in-azerbaijans-economy-current-status-development-trends-and-challenges/>

As seen in Picture 2, Turkey has played a significant role in the non-oil sector of Azerbaijan. Also, the United States, Great Britain, Germany, France, UAE, and Russia have continued to invest in this sector. \$ 1.7 billion was invested in the non-oil sector of Azerbaijan in 2016. And 1.4 billion dollars (61%) of this amount fell on the share of Switzerland, Russia, and Turkey. The largest FDI in the non-oil sector in 2016 came from Switzerland (\$ 370.5 mln.). From Russia to Azerbaijan, it has been invested in the amount of \$ 363.2 million FDI in 2016.

**Table 7: Foreign investment directed to fixed capital by foreign countries (2016-2017)**

Countries	2016		2017	
	thsd. manats	share in total volume, in percent	thsd. manats	share in total volume, in percent
<b>Total</b>	<b>9,282,549.5</b>	<b>100.0</b>	<b>8,665,080.6</b>	<b>100.0</b>
including:				
United Kingdom	2,480,006.4	26.7	2,296,484.0	26.5
USA	447,219.7	4.8	392,385.2	4.5
Japan	541,622.7	5.8	447,271.9	5.2
Norway	198,886.6	2.1	174,483.6	2.0
Turkey	1,241,918.0	13.4	1,163,654.0	13.4
Germany	13,674.5	0.2	103,144.5	1.2
Saudi Arabia	35,965.3	0.4	42,291.5	0.5
France	203,655.0	2.2	714.2	0.0
Czech Republic	227,422.8	2.5	274,265.7	3.2
Iran	571,141.7	6.2	540,087.1	6.2
Italy	356.5	0.0	714.2	0.0
Russia	571,141.7	6.2	540,087.1	6.2
Switzerland	792,823.8	8.5	614,596.1	7.1
Korea Republic	3,001.6	0.0	25,980.1	0.3
India	63,006.0	0.7	57,198.1	0.7
Virgin Islands	-	-	46.1	0.0
Malaysia	885,269.6	9.5	837,134.9	9.7
International organizations	1,005,437.6	10.8	1,154,542.3	13.3

**Source:** The State Statistical Committee of the Republic of Azerbaijan, [www.stat.gov.az](http://www.stat.gov.az)

### **3.3. What are the significant factors that would determine FDI attraction of Azerbaijan?**

First of all, it must be noted that Azerbaijan is a strategic country and has several advantages to attract foreign companies. It is located in the international transport corridor connecting Europe and Asia. The country has significant agricultural potential due to its climate. Azerbaijan has substantial hydrocarbon reserves. In addition to having a favorable geographical position in Azerbaijan, there is also an international transport network of international importance (air, water, railway and motor roads, oil gas pipelines), which facilitates the creation of

intense contacts abroad. Azerbaijan has strong natural-economic potential (abundant mineral resources, productive land, favorable natural and climatic conditions, plentiful and cheap labor, etc.). There are several industrial enterprises, production facilities and infrastructure facilities with some modern technical and economic bases in Azerbaijan. Realization of economic reforms (privatization and de-privatization of property, liberalization of prices, liberalization of foreign economic relations, creation of market infrastructure), on attraction and protection of foreign investments in the country, liberalization and development of international economic relations, adoption of other legal-normative acts and carrying out of organizational-administrative work for their implementation, creation of enterprises dealing with economic activity jointly with foreign business circles in the country plays an attractive role for international companies.

While modern Azerbaijan's oil and gas industry is still a major export destination, it has succeeded in building relatively advanced communications and transport infrastructure, as well as industry, agriculture, education, housing, and healthcare.

Diversification of the economy is the main of the priorities in Azerbaijan's politics, though Azerbaijan's economy is still dependent on oil and gas exports. Some substantial steps have been taken for the development of the non-oil industry and reducing its dependence on the production and export of oil and gas.

Azerbaijan is one of the leading places among CIS and East European countries on indicators characterizing direct foreign investments. The following reasons can explain our leading role in this area:

- The large volume of Azerbaijani market;
- Poor market mastering
- Unlimited Raw Materials;
- Compared to similar transactions in other countries, the ability to earn a more substantial capital gain.

Creating a "closed economy" in the modern world and setting up an economy effectively did not justify itself in world practice. Therefore, the countries of the world prefer to go to an "open market economy," and the Republic of Azerbaijan has put forward its "open market economy" as its strategic task. Orientation to the open market economy suggests that national economies can gain access to the world economy and act as an entity of the current world market. The achievement of an open market economy involves a complex system of measures. Among these measures, the creation of a favorable environment for attracting foreign investment is an essential part of the country because foreign investments play a crucial role in the development of the country's economy at the modern level.

Above all, an entire economic system should be formed to achieve a robust foreign investment flow. Given the experience of countries in the world, productive foreign economic activity and productive attitudes with foreign investors should be taken into account with some principles. The national economy should be an open system, the mechanism of regulation of economic activity in the country must comply with international law and world practice, the structure of the economy and foreign trade relations should be formed following the country's economic potential and domestic demand. Also, favorable conditions for the application of progressive forms of foreign economic relations should be established, foreign economic relations should be conditioned by the logic of economic efficiency and necessity, and must actively participate in and work in international and regional economic associations and organizations that respond to the country's national interests. Foreign economic relations should always take into account strategic objectives and achievements of scientific and technical progress, serve the use of resources, ensure the economic security of the country.

Recently, political stability and economic development in the country have increased the interest of foreign countries in investing in the Azerbaijani economy for a long time. At present, there are two laws regulating investment activity in the Republic of Azerbaijan: Approved by the President of the Republic of Azerbaijan

dated January 13, 1995 , under No 952 and "The law of the Republic of Azerbaijan on investment activity" and under No 57 of the President of the Republic of Azerbaijan dated January 15 1992 "Law of the Republic of Azerbaijan on protection of foreign investments".

Besides, the Azerbaijani government has signed agreements on the avoidance of double taxation, promotion of investments and mutual protection with several foreign countries. All restrictions on the conversion of profit to other currencies, relocation or reinvestment to foreign countries have been canceled, and a single exchange rate has been formed based on market economy principles. These measures have further increased the interest of foreign investors, international financial institutions and economic organizations to Azerbaijan.

If we summarize Azerbaijan's advantages for foreign investors, we can conclude that:

- Flexible conditions for foreign investments: This advantage implies the highest FDI per capita in the region and legal guarantees for investors.

- Rapidly developing an open economy- Annual growth of GDP by 26.4%, annual increase of foreign trade turnover by 19.8%, and average import tariff rate: 5.7%.

- Vast opportunities in the non-oil sector- over the past five years, the highest growth in the areas of economic activity was observed: industry - 7.5 times, construction - 3.8 times, trade - 3.5 times, transport and communications - 2.9 times, social services - 2.8 times farm - 2.1 times and tax concessions to agricultural producers.

- Natural resources-minerals and fertile soil.

- Affordable strategic position- direct access to Central Asia and the Caspian region, participation in international trade initiatives (Silk Road, North-South Corridor) and expanding European factor and joining the New Neighborhood Policy.



- Competitive local workforce.
- Establishing an organizational and management mechanism for the adoption and implementation of several relevant laws and regulations on foreign investment attraction and protection, liberalization and development of foreign economic relations.
- There are some industrial enterprises, production facilities, and infrastructure facilities with a new technical-economic base.
- There is strong scientific and technical potential and qualified personnel reserve.

Also, it was worth mentioning the strong points of Azerbaijan. Azerbaijan has strong prospects such as "competitive production costs, cheap and qualified labor, significant gas potential in the Caspian Sea, prospects for gas exports to Turkey and Europe, linkages between China and Europe, railways with Iran, Turkey, and Georgia."

### **3.4. How FDI impact on Azerbaijan's economy?**

As mentioned above, FDI has had very positive effects on the economy after Azerbaijan gained independence. The volume of investments in the economy of Azerbaijan began to overgrow after the signing of the Century Contract. According to official data, from 1994 to the present, the volume of investments into the economy of Azerbaijan exceeded \$ 100 billion.

FDI is the most effective form of stimulating economic growth. Most investments are related to significant projects in the oil and gas sector. Not only the development of macroeconomic stabilization but also the large volumes of the foreign economy also lead to the growth of the Azerbaijani economy. According to Hubner (2011), there is a positive correlation between FDI and economic growth in Azerbaijan. The author states that there is a vast flow of FDI into the oil sector of Azerbaijan.

Investment companies and government in Azerbaijan are proud to announce that they have made significant progress in terms of economic development. They also wish success in attracting foreign investment. Sharp economic growth in the economy of Azerbaijan in the first decade of the 21st century is affected by the volume of foreign investments in the oil sector. In 2009 the economy of Azerbaijan was positive economic growth. The reason for this optimistic forecast was the right speeches in the oil sector. Despite the global financial crisis and global oil prices, the Azerbaijani economy has seen a relatively significant increase. 2008 and 2009 also succeeded in the Azerbaijani economy. One of the primary reasons for this success was investing in the oil sector.

**Table 8: Investments directed to economy (2009-2014)**

	2009	2010	2011	2012	2013	2014
<b>Investments by all sources (taking into account foreign investments):</b>						
mln.manats	10 475.0	14,118.9	17,048.8	20,251.0	21,448.2	21,890.6
mln.dollars	13,033.50	17,591.4	21,588.9	25,777.8	27,340.0	27,907.5
<b>Foreign investments:</b>						
mln.manats	4 395.1	6 619.7	6,849.8	8,102.6	8,269.3	9,175.7
mln.dollars	5 468.6	8 247.8	8,673.9	10,314.0	10,540.9	11,697.7
<b>Internal investments:</b>						
mln.manats	6,079.90	7,499.2	10,199.0	12,148.4	13,178.9	12,715.0
mln.dollars	7 564.9	9,343.6	12,915.0	15,463.8	16,799.1	16,209.8

**Source:** The State Statistical Committee of the Republic of Azerbaijan, [www.stat.gov.az](http://www.stat.gov.az)

Investment in the oil sector in the country affects many aspects of the economy. For example, foreign investment in the oil sector increases oil exports. This situation, especially since 2006, has brought Azerbaijan's reserves to a high level. In 2006, there was a significant increase in the country's reserves. In 2008, reserves increased by 51.4 percent to reach \$ 6.5 billion. At the beginning of 2013, the country's reserves reached the State Oil Fund owns \$ 29.1 billion and \$ 22.7 billion of this amount.

In recent years, the process of promoting investment in the non-oil sector has started to accelerate. AZPROMO (Azerbaijan Export and Investment Promotion Foundation) has made significant contributions to this field. AZPROMO-established by the Ministry of Economic Development of Azerbaijan in 2003 and it aims to contribute to economic development through attracting foreign investments in the non-oil sectors of the economy and stimulating the expansion of the country's exports of non-oil goods to the overseas markets. AZPROMO's mission is to support economic growth and diversification by maximizing the inflow of FDI and utilizing effectively export capacities.

According to the data of AZPROMO, Azerbaijan is the most attractive destination for FDI in the Caucasus region. The azerbaijan's economy is the 35th the most competitive marketplace in the world and 1st among CIS countries according to the Global Competitiveness Report 2017-2018 of the World Economic Forum.

In the last decade, Azerbaijan's economic potential has been doubled, enabled and sustained macroeconomic stability and has been undertaking a vast range of economic and regulatory reforms ensuring sustainable business and investment environment.

AZPROMO signed many investment projects in 2018, like agriculture, tourism, heavy industry, construction, machinery, chemicals, etc. Some of those projects are as follows:

#### *Agriculture's projects*

Vineyard (Project's cost \$ 5.4 million) – the purpose is the expansion of grape production through the cropping of new 200 ha of vineyard and development of irrigation system. This project is located in Gakh province.

Expansion of Greenhouse Vegetable Facility (Project's cost \$ 22 million) – the purpose is the construction of an additional 20 ha of greenhouse in Zira village,

and production capacity of tomatoes will reach 5000 tons per year. This project is located in Zira village, Khazar province.

Fruit Orchards (Project's cost \$ 12.6 million) – the purpose is to invest to plant pear, cherry and plum orchards in the area of 274 ha. This project is located in Shamkir province.

Organic Rose Oil Facility (Project's cost \$ 1 million) – the purpose is to increase to production of organic rose oil from the current 4 kg up to 100 kg through cropping of new 100 ha of rose plantations and purchasing of new computerized equipment meeting highest international standards. This project is located in Zagatala province.

Expansion of Agro park (Project's cost \$ 65.3 million) – this project involves an increase of greenhouses from existing 42 ha to 100 ha. This project is located in the Absheron province.

Hazelnut Orchards (Project's cost 15 million AZN) – the purpose is planting of a hazelnut orchard on 1000 ha. This project is located in Shaki province.

Herbal Products Harvesting and Processing Facility (Project's cost 15 million AZN) – the purpose is the production of sea buckthorn plantation, and sea buckthorn oil, which is used herbal medicine. This project is located in Gakh province.

Projects at Mugan Aqropark LLC (Project's cost \$ 12 million) – the purpose is to support the development of production, processing, and exportation of agricultural products in the country. This project is located in Imishli province, Hacalmuradli village.

#### *Tourism's projects*

“Ideal” Tourism and Health Centre (Project's cost 22 million AZN) – is located in Oghuz province.

Construction of a 3 Star Hotel (Project's cost 1.8 million AZN) – is located in Astara province.

### *Heavy industry's projects*

Energy Efficient LED Lamps Production Facility (Project's cost \$ 12.7 million) – the purpose is the mass production of lighting lamps based on the new generation of white LEDs, and this project will involve the renovation of an existing plant. This project is located in Ganja city.

Electric Battery Production Facility (Project's cost \$ 9 million) - As you know, the number of cars in Azerbaijan is increasing year by year, and hence, this situation creates demand for electric batteries. Taking this into consideration, the project will provide the production of vehicle batteries. This project is located in Ganja and Sumgait cities.

Carbon and Glass Fibers Production Facility (Project's cost \$ 3.5 million) - there is a high demand for glass fibers in the construction sector. In 2003, when construction of the Gabala-Baku water pipeline, \$ 330 million of glass fiber was imported from China. As well, the demand for this material is growing every year. This project is located in Baku and Sumgait cities.

Cement Fiber Production facility (Project's cost \$ 100 million) - this project aims to create the first fiber cement fiber production in Azerbaijan. This project is located in Sumgait (Sumgayit Chemical Industrial Park).

Pressure-based cookware manufacturing plant (Project's cost 18.5 million EUR) – The production of under-pressure cookware to meet the demand for these dishes in the domestic market and to gradually be exported and 300 new jobs will be created due to this production. This project is located in Baku city, Garadagh district, Sahil settlement.

### *Chemicals' projects*

Soda Ash Production Facility (Project's cost \$ 50 million) – the purpose is to the production of Sodium Carbonate. Most of the product has always been imported, but after the devaluation of the currency in 2015, the local product has

become more competitive. This project is located in Sumgait (Sumgayit Chemical Industrial Park).

Household chemicals Production Facility (Project's cost \$ 25 million) – The essential products as soap and detergents are imported in most of the time, and they have an annual growth rate of 4-5%. Instead of import, in Azerbaijan, there are sources of plant and animal oils for the production of natural soaps. This project is located in Sumgait (Sumgayit Chemical Industrial Park).

Packaging materials ( LDPE, HDPE, Evon, POP) (Project's cost \$ 35 million) – the purpose is to produce products in line with EU standards to pack food products and to ensure that this product is exported to global markets and beyond the CIS region. This project is located in Sumgait (Sumgayit Chemical Industrial Park).

In Sumgait (Sumgayit Chemical Industrial Park) numerous investment projects, such as the projects as mentioned above, have been implemented.

In addition to these investment projects, investment projects have also been implemented to develop the energy sector and introduce new technologies, as Pellet Production Facility ( \$ 605000), Samukh Agro- Energy Project (\$ 150 million), Pirallahi Wind Power Station (\$ 800 million), PV Siyazan 30 MW Solar Power Station (\$ 60 million), “Wind Island-1” (\$ 408.9 million), Samukh Agroenergy Residential Complex (\$ 165 million), Hybrid Electric and Thermal Power Plant (\$ 96.3 million), Absheron Hybrid Power Station (wind component) (154.4 million AZN), Khizi-2 HEPP(wind component) ( 193 million AZN), Khizi Wind Power Station (377.7 million AZN), Lokbatan Wind Power Station ( 74.7 million AZN).

Additionally, the Azerbaijani government takes significant steps to develop the privatization program. The Government of Azerbaijan launched a privatization program to sell various types of facilities, industrial facilities, businesses and property portfolios. It is intended to invite investors to the necessary skills and capabilities to apply new management methods to these entities. The Government

of Azerbaijan intends to cooperate with foreign investors to attract these facilities, to serve domestic and regional markets, to adopt international standards in business activities and production standards. The privatization program is part of economic reforms; the Azerbaijani government is developing and implementing. This program is based on the international experience of privatization programs in market economies and tries to imitate their successes. It provides the placement, description, and method of privatization. These projects are derived from the State Committee on Property Issues of the Republic of Azerbaijan (SCPI). Below is a list of some of the proposed projects and objects privatization:

- “Daşkəsən Filizsaflaşdırma” -Extraction and processing of iron ore.

- “Azəralüminium”- Production of primary aluminum.

- “Bakı Neftqazmədən Avadanlıqları zavodu,” “B.Sərdarov Adına Maşınqayırma zavodu,” “Balaxanı Maşınqayırma Zavodu,” “Zabrat Maşınqayırma Zavodu,” ▸ “Bakı Fəhləsi Maşınqayırma zavodu,” “Suraxanı Maşınqayırma Zavodu” - Oil industry equipment production facility.

From all of these, it is possible to conclude that significant steps are being taken to develop the non-oil sector in Azerbaijan, and the development is already showing itself.

## CONCLUSION

From the early years of our independence, it became clear that without the help of foreign investors, it would be impossible to build a market economy in the republic. That is why several legal-normative documents have been adopted from the early years of our independence calling for respect for the flow of foreign investment and respecting it ("On Foreign Investments Protection," "On Property" and other laws). All this has led to the arrival of foreign investors to the country, and the development of the market economy.

This research reveals some essential points about FDI and its effect on the Azerbaijan economy considering foreign direct investment seen in oil and non-oil sectors.

First of all, FDI is an activity having significant contributions to the economy of Azerbaijan. It is traditional to see that a country getting the attention of foreign investors and getting a high quantity of FDI is likely to improve in a short period. Large inflows seen during FDI processes support that kind of progress, reduced levels of unemployment, augmented export rates, and augmented revenues. Azerbaijan has had a significant increase in economic indicators. In particular, FDI has contributed to the revival and development of our country's economy, particularly the transitional economy.

Thanks to FDI, although Azerbaijan was an oil-dependent economy years ago, there is an increase at non-oil sectors as agriculture, tourism, construction, trade, service, transport, communication, and financial service as well in the last decade. Foreign investors are also interested in investing in the non-oil sector along with the oil sector in recent years, and the share of investment in the non-oil sector is rising every year. Also, the privatization process is in the center of attention, as it will significantly benefit foreign investors in the future. The privatization of enterprises operating in metallurgy, chemistry, energy, machinery, communications and other sectors, which is particularly attractive for foreign investors, has resulted in an inflow of foreign investments.



Azerbaijan is in a stable economic situation in the Caucasus, and this creates the basis for attracting foreign investment in the future. The favorable geographical position of our country, its location in the international transport corridor, and the availability of abundant hydrocarbon reserves are of interest to foreign investors.

The positive effects of foreign direct investment for the integration of our country into a globalized global market economy have been observed, and our country has developed its economy, taking into account its capabilities, and significantly improving the people's living standards by choosing the right place in the world community.

Given the positive effects of FDI on the economy, it is no coincidence that strategic targets for the promotion of foreign investment in the Strategic Road Map of the Republic of Azerbaijan have been put forward.

FDI has led to an increase in the GDP, which, in turn, has seen economic growth in the Azerbaijani economy. Also, the non-oil sector's share in the GDP has significantly increased.

Finally, the importance of FDI for the Azerbaijani economy should be taken into account, and some steps should be taken to promote it:

- expanding the range of electronic services to increase the quality of services rendered by state bodies and municipalities to entrepreneurs, including foreign investors, to expand their coverage and to increase transparency in this area;
- registration of entrepreneurship subjects, including legal entities with foreign investments, issuance of permits for construction, access to utility networks, state registration of real estate rights, recruitment of labor, international trade and other activities of state regulation of entrepreneurship, reduction of procedures, enhancement of legislative acts aimed at attracting, protecting and promoting investments, including expanding the bilateral contractual framework in the field of mutual protection and promotion of investments with foreign countries;

- Expansion of the types of services provided by the relevant state bodies to entrepreneurship entities, including foreign investors, on the principle of "single window";

- strengthening institutional mechanisms for promoting investment and export promotion to foreign investors and exporters and improving them according to the best international practice;

- Stimulating the involvement of direct foreign investments through the securities market in the economy of the country, especially in the economic subjects, for which the institutional development of the securities market, financial intermediation, and organization of collective investment schemes, support of demand and supply in the securities market, and principles of financial transparency and enhancing corporate governance, improving the regulatory framework for the securities market and raising awareness and professionalism in the securities market;

- accelerating Azerbaijan's accession to the WTO;

- to actively participate in regional integration blocs, as well as to obtain mutual concessions on foreign trade by signing a bilateral agreement with the countries of the region;

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