

Varazdin Development and Entrepreneurship Agency
in cooperation with
Azerbaijan State University of Economics (UNEC)
University North
Faculty of Management University of Warsaw
Faculty of Law, Economics and Social Sciences Sale - Mohammed V University in Rabat



Economic and Social Development

37th International Scientific Conference on Economic and Social Development –
"Socio Economic Problems of Sustainable Development"

Book of Proceedings

Editors:

Muslim Ibrahimov, Ana Aleksic, Darko Dukic



ISSN 1849-7535



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Publisher ■ Design ■ Print ■ Varazdin Development and Entrepreneurship Agency, Varazdin, Croatia / Azerbaijan State University of Economics (UNEC), Baku, Azerbaijan / University North, Koprivnica, Croatia / Faculty of Management University of Warsaw, Warsaw, Poland / Faculty of Law, Economics and Social Sciences Sale - Mohammed V University in Rabat, Morocco

Printing ■ Online Edition

ISSN 1849-7535

The Book is open access and double-blind peer reviewed.

Our past Books are indexed and abstracted by ProQuest, EconBIZ, CPCI (WoS) and EconLit databases and available for download in a PDF format from the Economic and Social Development Conference website: <http://www.esd-conference.com>

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FEATURES OF ATTRACTING FOREIGN DIRECT INVESTMENT TO THE INDUSTRY OF AZERBAIJAN

Lala Hamidova

Azerbaijan State University of Economics, Azerbaijan
lala_hamidova@unec.edu.az

ABSTRACT

According to this article, attracting of foreign investment is a central issue of reconstruction of foreign economic policy and reforming of economic system of the republic. The purpose of this issue is to study the features of attracting foreign direct investment to the industry of Azerbaijan. In the course of the study, the following tasks were settled: investment environment of Azerbaijan was described, investments were analyzed and the direction of foreign investment in the country's economy was determined, and ways to stimulate investment in industry were identified. The research methodology is based on the works of foreign scientists to attract foreign direct investment. The study period covers the period of 1995-2017. The results of the study indicate that the oil sector has been and still remains as the main direction of attracting foreign direct investment in industry. Oil in Azerbaijan is the most attractive area of the national economy for a foreign investor. Due to the fact that the majority of companies engaged in the oil sector are foreign, mostly foreign investments are attracted to this sector. The main direct foreign investors in the economy of Azerbaijan are residents of the UK, USA, Turkey, Japan and Norway. With regard to the signing of international gas agreements, an increase is expected in foreign investment in the energy sector of Azerbaijan. It was revealed that the state investment policy focuses on creating a favorable investment climate in the country, on stimulating the attraction of private capital, as well as finding new forms of joint investment in promising projects.

Keywords: *foreign direct investment, investment environment, oil sector*

1. INTRODUCTION

Attracting foreign direct investment (FDI) is an important issue of reforming the economic system of Azerbaijan. First of all, this is explained by the fact that Azerbaijan needs foreign investments, which are necessary for fundamental changes in the structure of the economy. Another important reason for attracting investment is the fact that every year it becomes more and more difficult to extract and develop rich local natural resources. Thus, in the Azerbaijani sector of the Caspian Sea, with the help of traditional technologies, only 10% of all oil and natural gas can be opened (Trend, 2009, p. 12). This also applies to other deposits of Azerbaijan, especially in the production of iron ores, non-ferrous metals. Azerbaijan has the huge resource potential, which is, certainly, attractive for foreign investors. The territory of Azerbaijan has rich oil and gas fields, polymetals, raw materials for the chemical industry and construction. There is also a sufficient raw material base for the development of processing industries. Besides the rich natural conditions, the foreign investor is also attracted by a highly skilled cheap labor force. Azerbaijan has a favorable geographical position in the Middle East, it is located at the junction of two parts of the world - Europe and Asia. A reliable legal framework secured by the Law of the Republic of Azerbaijan "On the Protection of Foreign Investments" (1992) is also of great importance, according to which foreign investors making investments into the most important sectors of the economy are provided with certain additional benefits. According to the World Bank's Doing Business-2019 report, Azerbaijan ranked 25th out of 190 countries. The best indicator was the Protecting Minority Investors indicator, according to which the country ranked second in the world. Starting a Business Azerbaijan ranks 9th among the countries of the world.

The worst indicators were the construction permit (61st place) and Trading across Borders (84th place) (Doing Business, 2018). According to the Global Competitiveness Index for 2017-2018, Azerbaijan improved its position, rising to 35th place among 137 countries and taking the 1st place among the CIS countries (World Economic Forum, 2017-2018, p. 25). Attracting foreign investment is one of the priorities of the economic policy of the country's leadership. This is not surprising, since Azerbaijan, with a relatively small population, has an impressive economic potential, the realization of which requires investments many times greater than the available domestic investment opportunities. In addition, foreign investment entails not only capital inflows, but also advanced technologies, modern management experience and access to foreign markets, that is, their positive impact on the economy is diversified.

2. REFERENCE REVIEW

World Investment Report (UNCTAD, 2008) defines FDI as “investments directed to long-term relationships and sustainable income and control by a resident of one country (foreign investor) in enterprises of another country”. A similar definition is given by the United Nations: FDI as “investments made to acquire sustainable income or effectively control over an enterprise operating abroad” (Eurostat, 2014, p. 3). In 1966, Vernon developed the Theory of Product Life Cycle to explain the FDI types invested by American companies in Western Europe after World War II. Vernon believed that there were four stages of the production cycle: innovation, growth, maturity and recession. In the first stage, US multinational companies created new innovative products for local consumption and export surplus in order to serve foreign markets (Vernon, 1966). Vernon's theory was not recognized as a general theory of FDI, as it explained only one reason for investment, and not all aspects of this process. Among all the concepts associated with direct investment, Flying Geese Paradigm by K. Akamatsu is of particular interest. He believed that FDI allowed developing countries and countries with economies in transition to reach the level of developed economies with less time. Therefore, the state was faced with the task of maximally easing restrictions for foreign investors (Akamatsu, 1962). Another theory that attempted to explain FDI is the theory of exchange rates in imperfect capital markets. Itagaki (1981) and Cushman (1985) analyzed currency risks in international trade. Cushman conducted an empirical analysis of currency risks for the first time. He found that an increase in the real exchange rate stimulated FDI made in US dollars, while a rise in foreign exchange lowered the US FDI. Hymer's theory of oligopolistic behavior suggests that the investor is a monopolist in his market. In other words, direct investments are made to curb competition and protect their own interests (Hymer, 1982). Hymer refers to the potential deterrence of domestic producers, which is contrary to the interests of the recipient country of FDI (Dunning & Pitelis, 2008). The theory of internalization explains the growth of transnational companies and their motivation to achieve foreign direct investment. It was developed by Buckley and Casson (1976). According to Buckley and Casson (2009), large firms with an integral internal structure can expand their activities. R. Caves takes into account the FDI direct impact on the recipient country in the form of tax payments, the creation of new industries, the creation of additional jobs. The FDI effect, in his opinion, is reflected in increased competition in the market and the promotion of more technological products among domestic firms (Caves 1974, 1993). The eclectic theory (OLI) developed by Dunning (1979) represents a synthesis of all the existing theories of foreign direct investment. Dunning suggested that the company would benefit from entering the foreign market only if it has the following three advantages:

1. “O” (Ownership advantages) - availability of market entry, ownership of patents and trademarks, international arbitration;
2. “L” (Location advantages) - advantages in transportation costs, production costs, investment incentives;

3. "I" (Internalisation) - effective control of management, ensuring quality control, price discrimination, avoiding violation of property rights (Dunning, 1979, 2000, Janton-Drozdowska & Majewska, 2016).

3. METHODOLOGY

The study used the following methods: a comparative analysis designed to compare the ratio of foreign and domestic investment, investment in the oil and non-oil sector; the method of induction and deduction that allowed to combine individual conclusions on the studied problem and formulate the author's point of view; the method of pair linear regression, with the help of which the dependence of investments on world oil prices was studied. Special methods were also used: absolute and relative statistical indicators, dynamics indicators, factor analysis. The study period covers the years 1995-2017. The information basis for this study consisted of published reports and statistical databases of international organizations UNCTAD, World Bank Group; State Statistical Committee of the Azerbaijan Republic database.

4. INVESTMENTS IN THE ECONOMY OF AZERBAIJAN

In 1995-2017, investments in the economy of Azerbaijan were invested in the amount of 247,3 US dollars (State Statistical Committee, 2018a, p. 405). The main direction of attracting foreign investment in the industry remains the oil industry. Oil in Azerbaijan is the most attractive area of the national economy for a foreign investor.

*Table 1: Investments in the economy of Azerbaijan, mln. dollars
 (State Statistical Committee of the Azerbaijan Republic, 2018a)*

Year	Total investment	Foreign investments	Internal investments	Year	Total investment	Foreign investments	Internal investments
1995	544,1	375,1	169,0	2007	12066,1	6674,3	5391,8
1996	932,1	620,5	311,6	2008	16222,0	6847,4	9374,6
1997	1694,5	1307,3	387,2	2009	13033,5	5468,6	7564,9
1998	1932,2	1472,0	460,2	2010	17591,4	8247,8	9343,6
1999	1571,0	1091,1	479,9	2011	21588,9	8673,9	12915,0
2000	1441,1	927,0	514,4	2012	25777,8	10314,0	15463,8
2001	1561,8	1091,8	470,0	2013	27340,0	10540,9	16799,1
2002	2796,6	2234,9	561,7	2014	27907,5	11697,7	16209,8
2003	4326,3	3371,0	955,3	2015	19547,2	10719,1	8828,1
2004	5922,8	4575,5	1347,3	2016	14228,0	10161,1	4066,9
2005	7118,5	4893,2	2225,3	2017	13851,2	9120,5	4730,7
2006	8300,4	5052,8	3247,6				

As a result of the "Contract of the Century" on the joint development of the Azeri-Chirag-Guneshli oil field as signed in 1994, it became possible to attract foreign investments to the country's economy. According to table 1, over the analyzed period, the growth of investments in the economy of Azerbaijan continued until 2015. The rapid decline in world oil prices in the second half of 2014 and in 2015 led to a sharp decline in oil and gas revenues. Revenues of the State Oil Fund of the Republic of Azerbaijan (SOFAF) decreased 2,1 times in 2015, and 5,4 times in 2016 as compared with 2014 (Oil Fund, 2014, 2015, 2016). Such a rapid decline in oil revenues led to a number of negative processes in the country's economy: the national currency depreciated, foreign exchange reserves declined, the Central Bank's discount rate increased and interest rates on loans, and there was a significant reduction in government spending (Mehtiyev, 2017). The decline in oil revenues also had a negative impact on investments in the economy, especially domestic ones (Figure 1). All this led to a sharp slowdown in economic growth in the country. For the first time since 2000, real GDP growth rates in the country were negative (-3,1%) in 2016, despite the fact that in 2000–2009, annual real growth rates in Azerbaijan were

always about 10 percent or more. After 2010, the growth rate of real GDP in the oil and gas sector also declined due to a decrease in oil production.

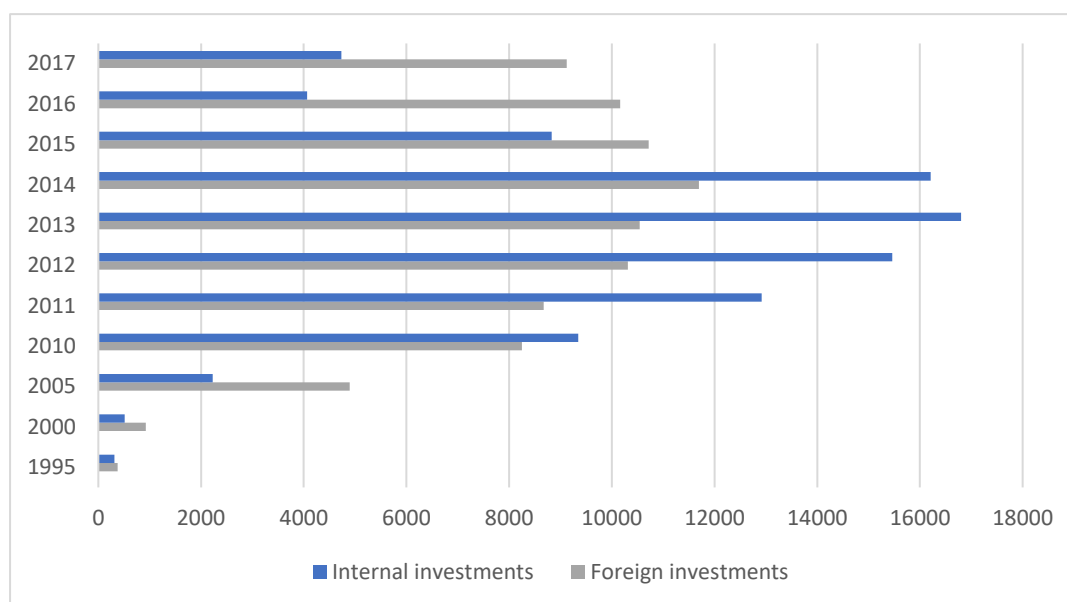


Figure 1: The ratio of foreign and domestic investments in the economy of Azerbaijan, mln. dollars (State Statistical Committee of the Azerbaijan Republic, 2018a)

According to Figure 1, over the period 1995-2017, the volume of investments from all sources of financing increased more than 25 times. Despite the fact that during 2008-2014, the volume of domestic investment outpaced the volume of foreign investment, in subsequent years there was a tendency for the predominance of foreign investment in the country's economy. The main direct foreign investors in the economy of Azerbaijan are residents of the UK, USA, Turkey, Japan and Norway. Their capital is directed to the country's oil sector. The rest of the foreign investment comes from joint ventures and enterprises with foreign capital. In such enterprises (according to 2016), the capitals of Switzerland (\$ 370,5 million), Russia (\$ 363,2 million), Turkey (\$ 307,5 million), Great Britain (\$ 174,4 million), The Netherlands (\$ 127,9 million) are prevailing (State Statistical Committee, 2018b). The structure of foreign investment in the economy of Azerbaijan is shown in Table 2.

Table 2: Foreign investment, mln. dollars
 (State Statistical Committee of the Azerbaijan Republic, 2018a)

	1995	2000	2005	2010	2013	2014	2015	2016	2017
Total foreign investment	375,1	927,0	4893,2	8247,8	10540,9	11697,7	10719,1	10161,1	9120,5
Of which:									
Financial credits	220,4	262,9	698,4	3405,9	2655,8	1880,6	2210,2	2197,8	1783,3
FDI, including:	154,7	664,1	4030,4	3614,9	5976,2	8049,2	7483,1	7323,6	5713,8
oil sector	139,8	546,1	3799,9	2955,3	4935,2	6730,7	6622,7	5617,4	4900,8
non-oil sector	14,9	118,0	230,5	659,6	1041,0	1318,5	860,4	1706,2	813,0
Oil bonus	-	-	1,0	2,0	2,4	17,0	2,0	0,1	1,4
Other investments	-	-	163,4	1225,0	1906,5	1750,9	1023,8	639,6	1622,0

According to Table 2, most foreign investment comes from FDI. In 2000 – 71,6%, in 2005 – 82,4%, in 2015 – 69,8%, in 2017 – 62,6% of all foreign investment are FDI. According to World Investment Report - 2018 (UNCTAD, 2018) FDI in Azerbaijan's economy in 2017 amounted to \$ 2,8 billion. The largest inflow of FDI in 2017 to countries with transitional economies was in Russia, Kazakhstan, Azerbaijan and Ukraine. Among the 18 countries in transition, the top 5 countries that received 81% of all FDI are distinguished: the Russian Federation, Kazakhstan, Azerbaijan, Serbia and Turkmenistan (UNCTAD, 2018, p. 75). As noted in this Report, investments in Azerbaijan in 2017 decreased compared to 2016 by 36%. This was due to the continuing decline in the extraction of natural resources, especially oil. 73% of all FDI is still invested in the oil and gas sector. The ratio of FDI investments in the oil and non-oil sectors is shown in Figure 2.

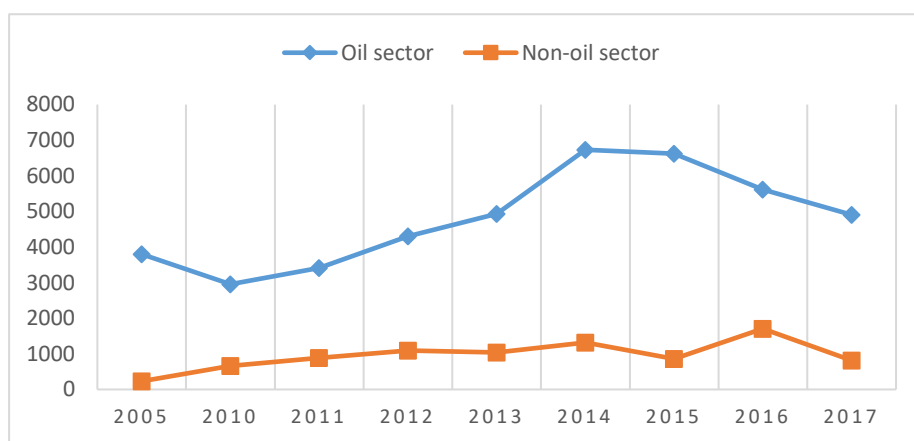


Figure 2: Foreign direct investment in the oil and non-oil sector, mln. dollars (State Statistical Committee of the Azerbaijan Republic, 2018a)

According to Figure 2, the largest share of foreign investment is directed to the oil and gas sector. Nevertheless, one of the main priorities of the government of Azerbaijan is to diversify the country's economy and attract foreign investors. The main directions of development of the non-oil sector are as follows: agriculture, transport, tourism and information and communication technologies.

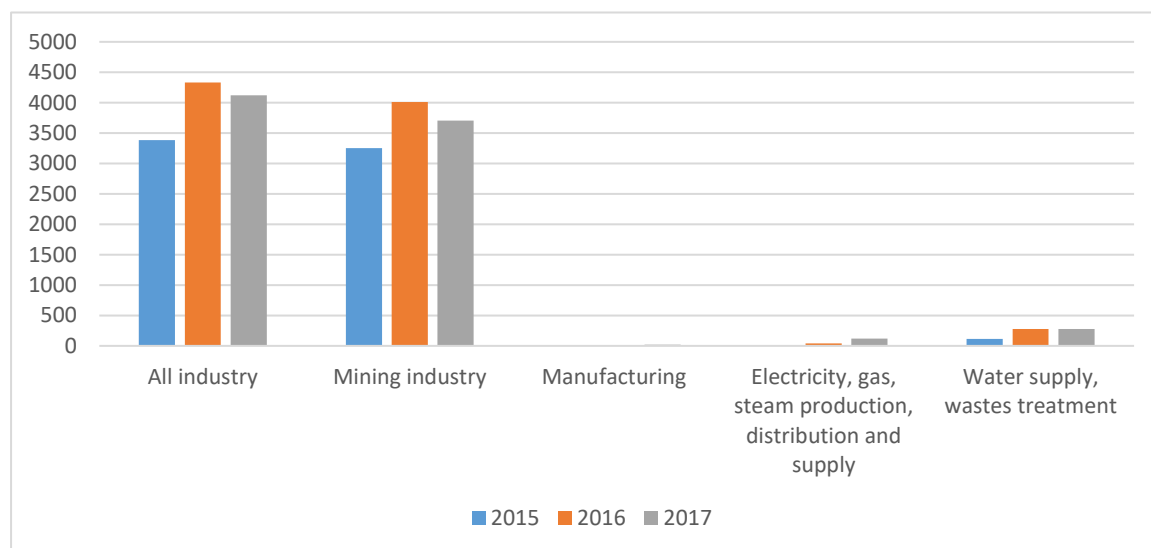


Figure 3: Foreign investment in fixed capital of the industry for 2015-2017, at actual prices, mln. dollars (State Statistical Committee of the Azerbaijan Republic, 2018c)

According to Figure 3, a significant share of foreign investment is in the mining industry. In 2015 – 96,0%, in 2016 – 92,6%, in 2017 – 90,0% of foreign investment in fixed assets of industry is invested in the mining industry. Another interesting fact is that in 2016 there was no foreign investment in Azerbaijan's processing industry at all. This structure of investment suggests that a foreign investor is attracted mainly by raw materials, especially oil and gas. Let's review the dependence of the volume of investments in the economy of Azerbaijan (y) on the world oil prices (x) by using the paired linear regression method.

Table 3: Linear regression (author's calculations)

<i>Regression Statistics</i>	
Multiple R	0,919966
R-squared	0,846338
Standard R- square	0,83902
Standard error	3687,568
Observations	23

Empiric equation of regression: $y = 252,0736 x - 2895,0739$

To determine the relationship between the signs the Cheddok scale has been used. The linear pair correlation coefficient is determined by the b regression coefficient:

$$r_{x,y} = b \frac{S(x)}{S(y)} = 252,074 \frac{32.805}{8988.804} = 0,92$$

The value of this coefficient indicates that the relationship between the y attribute and the x factor is very high and direct.

Coefficient of elasticity is calculated as follows: $E = 252,074 \frac{54,139}{10751.969} = 1,269$

The coefficient of elasticity is more than 1. Therefore, when x changes by 1%, y changes by more than 1%. In other words - x significantly affects y .

Coefficient of determination is as follows: $R^2 = 0,92^2 = 0,8463$

This ratio shows that in 84,63% of cases, the x changes result in the y changes. In other words - the accuracy of the selection of the regression equation is high. The remaining 15,37% of the y changes are due to factors not taken into account in the model (as well as the specification errors).

Figure following on the next page

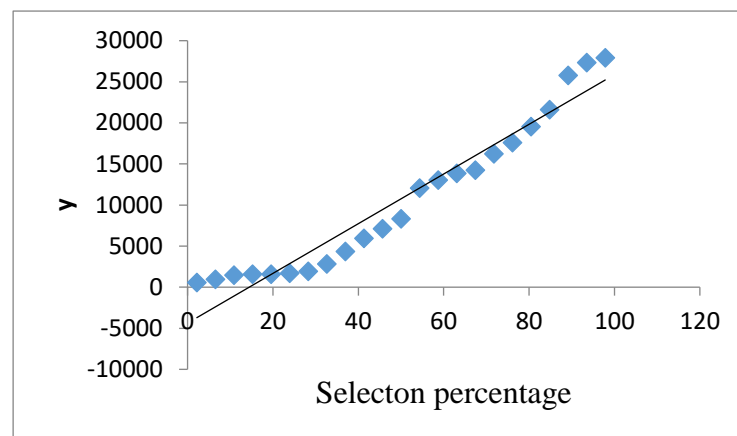


Figure 4: Normal probability graph (author's calculations)

Validation of the regression model is performed by Fisher's F-test. The actual value of the F-test is as follows: $F = \frac{0,8463}{1-0,8463} \frac{23-1-1}{1} = 115,66$

The tabular value of the criterion (F_t) with degrees of freedom is $k_1=1$ and $k_2=21$, $F_t = 4.35$. Since the actual value is $F > F_t$, the coefficient of determination is statistically significant (the estimated estimate of the regression equation is statistically reliable).

5. INVESTMENT ENVIRONMENT IN AZERBAIJAN

The market in the republic provides a great opportunity for those who want to take the risk. But most investors want a 100% guarantee. In addition, the investor can only make direct investments. And the global trend is such that a significant shift in economic policy from providing loans for industrial development to investment by buying shares has occurred. Using the lowest risk strategy, foreign entrepreneurs and their local partners are trying to concentrate their capital in such industries where profits are guaranteed by the product, on the production of consumer goods, on raw materials projects with a relatively short technological cycle, where the turnover is conjugated funds above and their volume of investment is negligible. The most important factor in stimulating investment in the country's economy is legislation. Legislation, as a rule, not only affects the degree of investment risk, but also stimulates investment in certain spheres or industries, determines the procedure for using individual factors of production. To date, the following Laws of the Azerbaijan Republic regulating the activities of investors have been adopted: "Investment activity", "Protection of foreign investments", "Privatization of state property", "Joint-stock companies", "Unfair competition", Tax Code of the Azerbaijan Republic and a number of others. In order to create a favorable investment environment, to facilitate state registration of business entities, the Decree of "On measures to ensure the organization of activities of business entities on the principle of "single window" by the President of the Azerbaijan Republic on October 25, 2007. After the introduction of the "single window" system, the initial procedures for organizing business in Azerbaijan were reduced from 15 to 2, and the time spent on it was reduced from 30 days to 2 days. After the introduction of this system, the number of registered individuals and legal entities increased significantly. The Ministry of Taxes provided the taxpayers with 63 electronic services, and the application of the electronic invoice started from April 1, 2017. The system of online registration of individual entrepreneurs was introduced in 2011, and the registration of local legal entities - in 2012. In order to stimulate investment and to create a favorable business environment, as a result of changes and additions to the Tax Code, the number of tax incentives and exemptions has increased. At present, 129 privileges are provided in the Tax Code of the Republic of Azerbaijan.

To attract and stimulate investment in the republic's economy, industrial parks were established in Sumgayit, Balakhani, Mingchevir, Garadagh and Pirallahi, as well as high-tech parks and industrial districts. For residents of industrial parks, a 7-year exemption from income taxes (income), property tax and land tax is provided. Currently, there are two structures to improve the investment environment: the Azerbaijan Investment Company (AIK) and the Export and Investment Promotion Foundation in Azerbaijan (Azpromo). The purpose of the AIK investment activity is to make investments in the authorized capital of joint-stock companies and other commercial organizations operating in the non-oil sector of the country's economy. Azpromo directs foreign investors to priority sectors for investment and facilitates the procedure of their origin in Azerbaijan. In accordance with the Decree of the President of the Republic of Azerbaijan dated January 18, 2016, the Ministry of Economy issued a document on encouraging investments to legal entities and individual entrepreneurs engaged in investment activities. To stimulate investment promotion, starting from 2016, entrepreneurs who received an Investment Promotion Document for 7 years from the date of receipt of this document are exempt from 50% of income (income) tax, property tax and land tax. Legal entities and individual entrepreneurs importing equipment, technological equipment and installations are exempted from value added tax and customs duties for 7 years from the date of receipt of the Investment Promotion Document on the basis of the relevant supporting document. In addition, today, the Republic of Azerbaijan and 47 countries have executed bilateral agreements on the promotion and mutual protection of investments. All this testifies to the positive steps of the government aimed at stimulating and encouraging investment in the economy of Azerbaijan. To attract investments, it is necessary to create an investment infrastructure that meets international standards. Increase investor interest and the level of investment by the state through the provision of state and commercial guarantees.

6. CONCLUSION

Investments are one of the most important tools for the formation and improvement of the structure of the economy. Transformation of the investment sphere and state policy should play a leading role in the further development of the economy of Azerbaijan. State investment policy should be aimed at creating a favorable investment climate in the country, at stimulating the attraction of private capital, both national and foreign, as well as searching for new forms of joint (private and public) investment in promising projects. An analysis of the dependence of investments in the economy (y) on the world oil prices (x) was performed using a pair-wise linear regression. Its parameters are estimated by the method of least squares. The statistical significance of the equation is verified by the coefficient of determination and the Fisher criterion. It has been established that in the situation under study, 84,63% of the total y variability is explained by the x changes. Economic interpretation of the model parameters is possible - an increase in world oil prices by 1 dollar leads to an increase in investment by an average of 252,074 dollars. This study shows the dependence of investment on the world oil prices. With the rise in the oil prices on the world market, an increase in oil production in Azerbaijan becomes profitable. Taking into account that foreign investments prevail in the total volume of investments (in 2017 their share was 65,8%), it can be said that foreign investments mainly depend on the oil prices. As the oil prices rise, so does the government investment. Revenues from oil exports entering the State Oil Fund of the Republic of Azerbaijan continue to invest in infrastructure, social projects, thereby increasing investments for state projects. As a result of execution of international gas agreements, an increase in foreign investment in the energy sector of Azerbaijan is expected. Despite the growth of foreign investments in the oil and gas industry and the growth of revenues from oil export, it cannot be argued that these investments alone will generate the optimal path for economic development. It all depends on how to dispose of them, in which sectors of the non-oil sector they will be directed.

But the fact that they are called upon to play an irreplaceable role in the economic development of Azerbaijan is indisputable.

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