Impacts of the COVID-19 pandemic on Azerbaijan economy

RESEARCH PAPER

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This research analyzes the impact of the COVID-19 pandemic and the negative implications of oil prices caused by this pandemic over the Azerbaijani economy, including macroeconomic stability, fiscal policy, the revenues of the State Oil Fund and the State Oil Company. The document was produced by experts from the Eurasia Extractive Industries Knowledge Hub with the support of the Natural Resource Governance Institute (NRGI).

Group of experts:

Ingilab AHMADOV
Azer MEHTİYEV
Rovshan AGAYEV
Samir ALİYEV
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Introduction

The COVID-19 pandemic has once again tested the level of commitment of governments around the world to work under exceptional circumstances. Just like in previous crises, this time governments have been forced to take the lead and intervene in the economy. The quality of the public sector, as well as institutional preparedness, was particularly serious challenge to the government. Although the pandemic is an emergency per se, in countries where good governance principles are in place, an effective system of governance carries a significant portion of the burden. The state helps the system by mustering its resources. Where a good governance system works poorly or does not work at all, all the burden falls upon the emergency agencies established by the central government for this purpose. And of course, the situation can not be managed effectively only by administrative resources alone.

In our recent history, Azerbaijan, which has barely survived the economic crises caused by the global financial crisis (2008-2009) and cheap oil (2014-2016), has faced a more severe test in the current "pandemic crisis". On the one hand, the reduction of economic activity in conjunction with the quarantine measures has adversely affected the income of the state and that of the population, on the other hand, the sharp decline in oil revenues due to fall of oil prices on world markets had a double-sided blow effect on the country's economy. Against this background, the IMF forecasts a 2% decline in the Azerbaijani economy, and the World Bank – 2.6% in 2020. The State Statistics Committee has already announced that the gross domestic product in the first half of 2020 decreased by 2.7 percent. After a three-year hiatus, the country's balance of payments turned negative again in the first quarter of 2020, which increased the sensitivity of the exchange rate of the national currency, which is the main guarantor of macroeconomic stability in Azerbaijan.

On March 19, 2020, the Government of Azerbaijan approved the Action Plan1 to reduce the negative impact of the coronavirus (COVID-19) pandemic on the country's economy, macroeconomic stability, employment and business entities. The support provided under the Action Plan covers 3 areas: 1) Support for economic growth and business; 2) Employment and social welfare support; 3) Macroeconomic and financial stability. It was initially planned to allocate up to 1.5 billion Manats from the 2020 state budget to the Cabinet of Ministers in connection with the implementation of the Action Plan, and in the first half of the year funding has been already provided in the amount of 752 million Manat.

1 http://www.e-qanun.az/framework/44791
According to the Action Plan, part of the salaries of employees in the areas affected by the coronavirus (COVID-19) pandemic was paid by the state, and financial support was provided to individual (micro) entrepreneurs. According to the Ministry of Economy, as of July 28, 2020, there were paid 97955.9 thousand Manats to 215689 employees, and 106765 individual entrepreneurs were provided with financial assistance in the amount of 63499.9 thousand Manats. In order to improve access of entrepreneurs to credits, measures have been launched to provide state guarantee to 60% of loans in the amount of 500 million Manats and subsidize 50% of interest rates on guaranteed loans from the state budget.

Experts of the Eurasia Extractive Industries Knowledge Hub have prepared a research document assessing the negative effects of the COVID-19 pandemic on the Azerbaijani economy. The study was conducted in 4 areas: 1) Macroeconomic situation; 2) State budget; 3) State Oil Fund; 4) State Oil Company. The experts assessed the impact in each area and made recommendations at the end.

Key findings

The following results were obtained from the impact analysis of the pandemic and the steep plunge in oil prices on the Azerbaijan's economy:

1. **Regarding the effects on the macroeconomic situation:**

   a) The high economic growth rates observed in the first two months of the year were replaced by a concurrent countrywide downturn due to the introduction of pandemic quarantine measures, and in the first half of the year decreased by 2.7 percent compared to the same period of the last year. The economy declined in both the oil and gas sector (-2.9 percent) and the non-oil and gas sector (-2.5 percent). However, research shows that the 2.7 percent drop does not fully reflect the real impact of the pandemic on economic growth in the country: *the growth that was initially projected for this year, but hasn't taken place due to the pandemic should be taken into account in order to assess the real decline;*

   b) According to the results of the first half of the year, the adverse effects of the pandemic have been greater felt in the following areas:

   * accommodation of tourists and public catering - decreased by 47.9 percent, including hotel revenues decreased by 61.6 percent, catering turnover decreased by 45.6 percent;
   * trade - retail trade turnover on markets and fairs decreased by 17.3%, provision of paid services to the population by 19.2%, total volume of consumer market by 6.4%, retail trade turnover decreased by 1.9% in real terms;
   * passenger transportation - decreased by 60.4 percent for air transport, 45.0 percent for metro transport, 26.4 percent for road transport and 16.1 percent for railways;
   * Rapid drop is observed in the scope of services of recreation and art spheres (no precise statistics)
   * freight traffic - by road decreased by 22.1 percent;
   * there is a sharp decline in the volume of services in the field of recreation, entertainment and art (no exact statistics)
   * although there was a 14.5 percent decline in the construction sector in the first half of the year, this drop cannot be attributed entirely to a pandemic, as the construction crisis, which started in 2016, is still ongoing;
   * in some sectors of the economy (eg. agriculture, processing industry, information and communication, etc.), the negative effects of the pandemic have manifested
themselves in the form of **declining high growth rates** observed in previous years, etc.;

c) the **positive effects** of the pandemic include the rapid development of distance education and services in the fields of education, vocational, scientific and technical activities, on-line sales and home delivery services in the areas of trade and catering;

d) The Ministry of Economy updated its forecast made in May for GDP decline by 3.8 percent by the end of this year, forecasting a decline of around 5.0 percent in July. Based on an assessment of the factors affecting economic growth in the country, especially the government's support measures and fiscal expansion, we assume that the **economic downturn** may be in the range of 4-4.5 percent if the country does not experience another wave of pandemics by the end of the year. In the event of another wave of the pandemic, the level of economic contraction may be **as high as 5.5 percent** at its worse, depending on its scale.

d) According to official statistics, during the 4 months of the pandemic (March-June), the number of unemployed in the country increased by 85.9 thousand people or 34.1 percent, and the **unemployment rate** increased from 4.8 percent to 6.5 percent, i.e. increased by **1.7 percentage points**;

e) An analysis of employment statistics and government support measures shows that the government has not clearly defined the number of people at risk of losing their jobs and incomes as a result of the pandemic. According to our estimation the number of such people could be at least **1.3 million**; the government's aid package covered about half of that in April-May;

f) Although the nominal income of the population increased by 0.6% in the first half of the current year, compared to the same period last year, the real income of the population **decreased by 2.4% compared** to the same period last year, if to take into account the inflation rate. At the same time, despite a **6.8 percent** increase in nominal incomes in the first quarter of the year, the decline to **0.6 percent** at the end of the first half of the year reflects the adverse impact of quarantine measures applied in the second quarter on incomes. As the pandemic continues, it can be said that the nominal income of the population will continue to decline in the following quarters of the year;

g) In the first half of this year, the volume of investments in fixed assets in the economy decreased by **2.7 percent** compared to the same period last year: the decrease was due to investment processes in March-June. The volume of investments in the non-oil and gas sector of the economy decreased by 15.5 percent, and the investments in the non-oil and gas industry decreased by **25.7 percent**;

h) After a 3-year break (2017-2019), the country's balance of payments turned negative again: in the first quarter of this year, the balance of payments amounted to 1.4 billion. There is a deficit equal to the US dollar;
i) In the first six months of this year, the country's total imports (excluding gold imported for monetary purposes) decreased by 5.2 percent. The lowest imports were recorded in April and May;

j) Despite the annual inflation of 3.0 percent in the first half of 2020, the deflation of 0.5 percent and 0.3 percent respectively has taken place in May and June compared to the previous months due to the decline in the purchasing power of the population;

k) The monetary and exchange rate policy of the Central Bank in the first half of 2020 was aimed at eliminating pressure on the exchange rate of the Manat and maintaining the exchange rate stability of the Manat in the context of a drastic decline in world oil prices;

l) In the first half of the year, the Manat appreciated against both the nominal and real effective exchange rates of major foreign trade partners. In fact, this is an element that exacerbates the trade conditions for Azerbaijan's non-competitive non-oil products. At the same time, the increase in the nominal effective exchange rate (6.0%) in the non-oil sector is slightly higher than the increase in the real effective exchange rate (5.4%), which can be noted as a positive development: this difference indicates that inflation in Azerbaijan is lower than that experienced by its foreign trade partners.

m) According to our calculations, the economic and social losses of devaluation are greater than the resources that the government will spend to maintain the exchange rate of the manat in the current state of the country's economy. Therefore, the government is interested in maintaining exchange rate stability, which we expect to be secured by the end of the year. With strict administrative control over capital inflows and foreign exchange purchases, maintaining oil price stability between $35 and $40 by the end of the year could cost the government $3-4 billion from the State Oil Fund reserves.

2. Regarding the impacts on the state budget:

• Transfers from the State Oil Fund are the only source of income of the state budget insured against risks

• If the average annual global market price of oil is around $35, the deficit of projected tax revenues from the oil sector is expected to be 390 million manat.

• If the rate of decline of the foreign trade turnover, especially in the volume of imports, recorded in the first half of the year remains until the end of the year, the projected budget revenue through the SCC is expected to be implemented with a deficit of 4.2% (170 million Manats);

• The economic downturn will reduce non-oil tax revenues to 300 million Manats;
• Extention of pandemic and strict quarantine rules significantly increases health, social protection and business support costs

• In times of crisis, the need for budget support from state-owned companies is growing

• The suspension of the budget rule as a result of the increase in state budget spendings reduces the importance of the "fiscal rule"

3. In connection with the activity of the State Oil Fund of the Azerbaijan Republic:

• The State Oil Fund still has a fairly convincing effect against the background of the expected losses. The relative stabilization of oil prices on the world market since June has strengthened this confidence. During this period, the Fund's stewardship focuses on a conservative approach, abandoning risky operations in its investment activities.

• Most likely, there are no changes will be made to the rules governing the Fund's activities and its investment policy during the year. This is not only due to the relatively high price of oil. This is confirmed by the behavior of the government as a whole during the pandemic. The government does not consider any form of budget transfers, changes in investment instruments, support for external borrowing or additional stimulus in the domestic economy, as well as a review of the fiscal regulations. This is confirmed in the questioner answered by the Fund during the preparation of the current report. Adjustments made to the state budget in August do not promise any direct changes for the Fund, except for an increase in transfers to the budget

• The State Oil Fund's assets are not intended to be used in any form other than liquidity in the economy to cover the balance of payments deficit or in accordance with existing rules and practices in economic stimulation. If there is no change in this approach during the year, the Fund's assets are expected to decrease by about 8-10% by the end of the year due to falling oil prices, in the worse-case scenario. The government's recent behavior also shows that if it is faced with a dilemma, it will prefer foreign borrowing in the more painful version of the pandemic for the country's economy. The main goal is to protect the assets of the Oil Fund.

• The main conclusion we have drawn from the pandemic is that the Oil Fund and the country's economy as a whole should not put as a target just the recovery from the losses caused by the pandemic and restoration of the previous situation. Because the pandemic revealed shortcomings in almost all areas. Observations have shown that the main gap lies in the governance. Identification and move towards flexible and inclusive governance is more important than the recovery.
4. In connection with the impact on the activities of the State Oil Company of the Azerbaijan Republic (SOCAR):

- According to estimates, a $10 drop in the price of Azeri Light brand oil on the global market reduces SOCAR's dividends from Shahdeniz and SCP by 27 million Dollars. Compared to 2019, the decrease was up to 27 million Dollars in the first half of the year. Due to $38 per barrel price of oil in the first half of 2020, SOCAR’s dividend from this source in the first half of this year was $27 million less than in 2019.

- In order to minimize the adverse impact of quarantine measures carried out within the COVID-19 pandemic on SOCAR's financial capabilities, the company has opted for a cost-cutting policy. Under this policy, employee benefits have been reduced, jobs have been cut, and the company's procurement activities have been limited.

- SOCAR's “Azneft” Production Union reduced daily production by 17.000 barrels in May-June reaching 100.000 barrels per day, as part of the initiative to reduce production of OPEC+ countries, which Azerbaijan Government is a part of. It was decided to gradually increase the total production to 5.000 barrels per day in the second half of 2020 and 6.000 barrels per day from 2021, bringing the total crude oil production to 111.000 barrels per day in 2021.

- Construction of a new petrochemical complex (Mercury project) planned by SOCAR and BP in the Aliaga region of Izmir, Turkey, has been postponed until the end of 2021 due to falling oil prices.

- Due to the ban on air traffic in connection with the spread of the COVID-19 pandemic, SOCAR's STAR refinery in Turkey has switched from jet fuel to diesel fuel since March.

- SOCAR has diverted the export route of its petrochemical products in Turkey from the European market, which constitutes 50% of exports to the eastern markets.

- The volume of crude oil exported by SOCAR in the first 6 months of 2020 decreased by **0.76 million tons** compared to the same period last year. Unlike oil, exports of gas and oil and petrochemical products have been increased.
Policy recommendations

To minimize the damage of the COVID-19 pandemic to the country's economy, including macroeconomic stability, fiscal policy, the activities of the State Oil Fund and those of the State Oil Company, and to reduce the sensitivity to such effects in the future, we offer the following recommendations:

**In the field of macroeconomics:**

- When assessing the impact of the pandemic, it is deemed expedient to include the economic losses that occurred in comparison with the forecasts for the current year in the calculations, in addition to the calculated economic contraction compared to the same period of the last year;

- Ensure that the macroeconomic forecasts for the year are reviewed and that the government's new macroeconomic expectations made public bearing in mind the effects of the pandemic;

- The government should refrain from administrative redundancies in order to prevent staff reduction and prioritize compensation measures so that businesses affected by the pandemic can retain their employees; it is expedient to increase the amount of compensation provided by the government to entrepreneurs for the maintenance of jobs and to cover the entire quarantine period;

- To ensure the immediate improvement of employment statistics to clarify the number of people to be included in the risk group affected by the pandemic, to clarify the employment structure of the working population working without an employment contract and to make it public;

- In order to prevent further deterioration of the social situation of the population in the context of the of the ongoing quarantine, the government should develop real support programs that meet the needs of different social groups, assessing the real level of impact;

- The legal-institutional base and infrastructure building process in these areas must be accelerated to ensure the rapid development of distance education, e-commerce and home delivery services, which emerged as the positive effects of the pandemic.
In order to minimize the negative impact on the state budget:

- It is important to improve the accountability of tax authorities, to publish monthly and quarterly reports on the sectoral and property structure of tax incomes;
- There is a need to ensure transparency of information on budget costs, especially investment costs. The list of investment projects should be available to the public with an indication of the sources (credit, budget, extra-budgetary funds, etc.) for each project;
- Public participation in the budget processes should be boosted. In the current context, professional "think tanks" and civil society should be also involved in discussions over budget changes;
- Budget hearings should be organized with the participation of parliamentary committees before the initial draft of changes to the budget is prepared;
- Additional costs incurred during the pandemic and a monthly review of their functional and economic structure should be prepared and presented to the public;
- It is worthwhile to make a decision on the transition to a result-based budget mechanism covering all functional areas of the state budget no later than 2022;
- There is a need to revise the "budget rule", to tighten the conditions for its suspension to the maximum, to revise the rule on the basis of restrictions on oil revenues, not budget costs.

In the direction of the activity of the State Oil Fund of the Azerbaijan Republic:

- The extraordinary role of the Oil Fund in ensuring macroeconomic balance may be reconsidered. In this respect, it is expected that changes will be made to the practice of large-scale transfers to the state budget and its implementation as the sole currency seller at auctions;
- As the scale of the pandemic is not yet clear, the Fund's monitoring practice of the process as an outside observer should be changed in the near future. In such emergency situations, it makes more sense to revitalize the economy by making relevant changes to the existing activities of sovereign wealth funds and using part of its assets. It makes sense for the government to consider appropriate steps in this direction;
- Although the Fund's investment policy is generally considered to be satisfactory in the current situation, it is possible to show a more aggressive approach by considering the situation on the world stock market. To do this, the Fund should think about investing in the stock market, rather than government bonds with minimal risk. Investing in relatively low-value stocks will pay dividends in the medium term;
- The Oil Fund's policy of transparency and accountability needs to be reconsidered. This seems especially necessary in the context of the transfer of activities of the Transparency in the Extractive Industries to the State Statistics Committee;
- The issue of ensuring public representation in the Supervisory Board may be considered.

**In the direction of the activity of the State Oil Company of the Azerbaijan Republic (SOCAR):**

- Implement comprehensive measures to reduce SOCAR's quasi-fiscal activities;
- Limiting the company's vertical integration goals. Withdrawal of Azerigas PU from SOCAR and its transformation into an independent entity, which sells natural gas to the population and non-population groups within the country, in order to strengthen mutual control and ensure transparency between the production entity and the sales entity.
- Adoption of relevant norms and rules regulating financial flows between SOCAR and the state
- Develop a unified Development Strategy for the medium and long term to define the company's future goals;
- Ensuring the transition of the organizational and legal form of the company from the existing "state-owned enterprise" to joint stock company, which is a business company where shares belong to the state
- Application of international corporate governance standards by the company.
- Amendments to the relevant legislation to establish clear and unambiguous frameworks for transparency and accountability obligations. The Law on Access to Information should be amended to include SOCAR in the category of information owners (Article 9) and to include financial and operational information related to the company's activities in the list of information that must be disclosed (Article 29).
- Posting and publication in the Internet the reports of the Audit Chamber regarding its audits of state-owned companies, including SOCAR
Impact analysis of the coronavirus pandemic and that of cheap oil

1. Analysis of the impact on macroeconomic processes

Initial quarantine measures in connection with the pandemic in our country were launched in early March (restriction of border crossings, suspension of education in schools, etc.), but a strict quarantine regime was imposed throughout the country in April. Although the lock-down was eased in mid-May, a tougher quarantine measures were introduced in the Baku-Absheron zone and several other cities in early June, and in mid-June in Baku and 16 other cities and regions of the country.

The economic situation, which broke out in March 2020 with price wars on the global oil market and then worsened with the effects of the Covid-19 global pandemic, seemed to hit the Azerbaijani government with a triple blow:

- **on the one hand**, there has been a sharp decline in oil revenues, a key driver of economic growth in the country, but there is also the possibility of a long-term downturn;
- **on the other hand**, there is a danger of a reduction in economic activity in the non-oil sector of the country due to pandemic and quarantine measures, as well as a decrease in state budget revenues from this sector;
- **And the third blow is that there was a need to allocate funds from the state budget to support them in order to reduce the negative impact of the pandemic on households and businesses.**

The sharp plunge in the price of world oil and the country's plummeting oil revenues have threatened the Manat. The downturn in economic activity as a result of quarantine measures in the light of a pandemic, threatened economic growth in the country. In the face of declining revenues from both the oil sector and the non-oil sector, the government's financial support for businesses and households affected by the pandemic could be ensured either by increase of the budget deficit or reduce some of the existing budget costs directions (eg investment expenditures), or this could be possible by increasing transfers from the Oil Fund.
According to the IMF's April 2020 forecast, the Azerbaijani economy is expected to shrink by 2 percent this year\textsuperscript{3}. According to the World Bank's June forecasts it is expected that Azerbaijan is to face a 2.6 percent decline by the end of the year, the lowest rate in the region\textsuperscript{4}.

**1.1. Economic growth**

1.1.2. *Economic growth by sectors of the economy*

According to the State Statistics Committee of the Azerbaijan Republic in the first half of 2020 the country's gross domestic product (GDP) decreased by 2.7 percent compared to the same period last year. The level of decline was 2.9 percent in the oil and gas sector and 2.5 percent in the non-oil and gas sector\textsuperscript{5}. The GDP per capita decreased by 3.4 percent.

Although there positive dynamics was observed in the first 2 months of the year (GDP growth by 2.4 and 2.8 percent, respectively), the downward trend started in March, and the growth in May and June was negative (Figure 1).

![Real GDP growth rates by sectors in the country's economy in January-June 2020, compared to the same period of the previous year in percentage](https://www.imf.org/en/Publications/WEO/Issues/2020/04/14/weo-april-2020)

(Source: State Statistics Committee)

\textsuperscript{3} https://www.imf.org/en/Publications/WEO/Issues/2020/04/14/weo-april-2020


\textsuperscript{5} https://www.stat.gov.az/news/macroeconomy.php?page=1
GDP in the oil and gas sector of the economy grew positively only in April, while growth through all other months was adverse. In contrast, although the non-oil and gas sector of the economy grew significantly in January and February (2.4 and 2.8 percent, respectively), the growth rate slowed down from March and was negative in May and June.

For comparison, the GDP generated in the economy in the first six months of the year decreased by 1.3 percent in 2017 compared to the same period last year, and increased by 1.3 percent and 2.4 percent in the next two years, 2018 and 2019 respectively. In the non-oil and gas sector of the economy, positive growth rates occurred in the first 6 months of the previous 3 years: 1.7 percent in 2017, 2.0 percent in 2018, and 3.2 percent in 2019. This year, the growth trend in the non-oil and gas sector was replaced by a 2.5 percent decline due to the pandemic.

In the first half of this year, the value of GDP generated in the country's economy using current prices (nominal) was 33.8 billion Manat, of which 23.0 billion Manat (or 68.2 percent) was generated in the non-oil sector, and the remaining 10.8 bln. Manat (31.8 percent) in the oil and gas sector. Looking at the dynamics of GDP production using current prices by months of the year, it is clear that the lowest level of monthly GDP production (for total of economy and for two sectors) was recorded in April: monthly GDP was 4.08 billion Manat, of which 2.9 bln. Manat was generated in the non-oil sector, the remaining 1.15 bln. manat in the oil and gas sector (figure 2).

Figure 2. Dynamics of GDP production by sectors of the economy for the first half of 2020, in current prices, mln. Manats (Source: State Statistics Committee)
As shown in figure, in contrast to the first three months of the year, in the first month of strict quarantine measures across the country which was April, GDP using current prices in the non-oil sector fell drastically compared to previous months, falling down to 2.9 billion Manats compared to 4.0 billion Manats in March, ie decreased by 27.7 percent. There was a nominal increase of 26.3 percent and 30.2 percent, respectively in May and June compared to the previous month. The month-to-month downward trend in the creation of new value in the oil and gas sector is evident from January to April: this is mainly due to lower oil prices on global markets, as well as reduced oil production in April. With the rise in oil prices on world markets in May and June, there is a slight increase in the new value creation in this sector at current prices.

1.1.2. Economic growth by sectors of the economy

The impact of the pandemic related quarantine measures on the economy varies. According to the State Statistics Committee, in the first half of the year, growth in the new value creation in agriculture, forestry and fisheries, processing industry, electricity, gas and steam production, water supply and waste processing, transport and storage, information and communication, mining industry, construction, trade and repair of vehicles, accommodation of tourists and catering, as well as in the group of other areas decreased (Table 1). As can be seen from the table, accommodation of tourists and public catering are the most affected by the pandemic areas in our country: compared to the last year’s first half, there was a 47.9 percent decrease in the newly created value.

For comparison, the value creation in this area went up by 3.3 percent in the first half of 2019 and 7.4 percent in the first half of 2018 compared to the same period last year.

The main reason for the decline in this area this year is the restrictions on the operation of public catering facilities in the country to prevent the spread of coronavirus infection, as well as a sharp drop in the number of tourists visiting our country due to the restrictive measures at the state border. According to the State Statistics Committee, the number of tourists visiting the country decreased by 2.6 times in March 2020, 12.1 times in April, 9.9 times in May and 12.0 times in June compared to the same period last year. In January-June 2020, compared to the same period last year, the number of overnight stays in hotels and hotel-type enterprises, which are key elements of the tourism infrastructure, decreased by 55.9 percent, and hotel revenues decreased by 61.6 percent compared to the same period last year\(^6\).

In June 2020, the turnover of public catering in the country decreased by 4.3 times compared to June last year, and during the first six months of the year by 45.6 percent compared to the same period last year.

Table 1. Comparison of GDP production by areas in 2019 and the first half of 2020

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<tr>
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<tbody>
<tr>
<td>Total GDP production, by areas:</td>
<td>33803,9</td>
<td>38402,6</td>
<td>97,3</td>
</tr>
<tr>
<td>Agriculture /forestry/fishing</td>
<td>2360,3</td>
<td>2125,0</td>
<td>102,2</td>
</tr>
<tr>
<td>Industry</td>
<td>12081,8</td>
<td>16875,8</td>
<td>98,4</td>
</tr>
<tr>
<td>Inter alia: mining industry</td>
<td>9531,9</td>
<td>14376,5</td>
<td>96,6</td>
</tr>
<tr>
<td>processing industry</td>
<td>2086,0</td>
<td>2038,1</td>
<td>108,2</td>
</tr>
<tr>
<td>electricity, gas and steam production</td>
<td>395,2</td>
<td>389,4</td>
<td>112,1</td>
</tr>
<tr>
<td>water supply, waste treatment</td>
<td>68,7</td>
<td>71,8</td>
<td>100,5</td>
</tr>
<tr>
<td>Construction</td>
<td>1896,7</td>
<td>2213,9</td>
<td>85,5</td>
</tr>
<tr>
<td>Trade, repair of vehicles</td>
<td>3806,1</td>
<td>3748,6</td>
<td>98,1</td>
</tr>
<tr>
<td>Transport and warehousing</td>
<td>2541,0</td>
<td>2357,9</td>
<td>106,2</td>
</tr>
<tr>
<td>Tourist accommodation and catering</td>
<td>511,2</td>
<td>972,3</td>
<td>52,1</td>
</tr>
<tr>
<td>Information and communication</td>
<td>690,1</td>
<td>660,9</td>
<td>104,4</td>
</tr>
<tr>
<td>Other areas</td>
<td>6442,9</td>
<td>6124,1</td>
<td>99,1</td>
</tr>
<tr>
<td>Product and import taxes</td>
<td>3473,8</td>
<td>3324,1</td>
<td>98,2</td>
</tr>
</tbody>
</table>

(Source: State Statistics Committee)

According to the table, construction is the second area where the effects of the pandemic are most notable: the new value created in construction in the first half of this year, compared to the same period last year, decreased by 14.5 percent. However, it would not be correct to attribute the decline in construction to the effects of the pandemic alone. Thus, based on the analysis of the State Statistics Committee data for the relevant periods, we can conclude that the crisis in the construction sector, which started in 2016, is still ongoing: compared to the same period of the
previous year, the new value created in construction decreased by 33.6 percent in the first half of 2016, 3.6 percent in the first half of 2017, 10.5 percent in the first half of 2018, and 11.2 percent in the first half of 2019.

According to the State Statistics Committee, the new value created in the first six months of this year in the field of trade and repair of vehicles decreased by 1.9 percent compared to the same period last year. For comparison, the growth rate in this area in the first half of 2018 was 2.4 percent, and in the first half of 2019 - 2.8 percent.

In the first half of this year, the total volume of the consumer market in the country amounted to about 22.0 billion. Manats, which is a decrease of 6.4 percent compared to the same period last year. During this period, retail trade turnover decreased by 1.9 percent in real terms, and the volume of paid services provided to the population decreased by 19.2 percent.

Sales of food, beverages and tobacco products in retail trade increased by 3.1 percent in real terms compared to the same period of the previous year, and decreased by 6.9 percent on non-food products. The decrease was 19.4 percent for textiles, clothing and footwear, 0.5 percent for electrical goods and furniture, 5.9 percent for computers, telecommunications equipment and printing products, and only 0.2 percent for gasoline and diesel fuel. Retail trade turnover at markets and fairs decreased by 17.3 percent compared to the first six months of last year.

Another area where the pandemic has had an adverse impact on value creation is industry: compared to the first half of last year, the value added in industry fell by 1.6 percent. However, as can be seen from Table 1, the decline in the creation of new value in industry was due to the mining industry: there was a 3.4 percent decrease. However, there were increases in the new value creation in other industries: 8.2 percent in the processing industry, 12.1 percent in the production of electricity, gas and steam, and 0.5 percent in the water supply and waste treatment.

The decline in the mining industry's added value is mainly due to oil production. Thus, in the first six months of this year, the country produced 4.9 percent less than the first six months of last year, or 17.8 million tons of marketable crude oil. During the same period, commercial natural gas production was 13.8 billion cubic meters, which is 14.9 percent more than the same period last year. In the first half of this year, the production of metal ores also increased: 30.5 percent in copper ores and concentrates, and 12.3 percent in precious metal ores and concentrates.

According to the State Statistics Committee, the total volume of industrial production in the first six months of this year amounted to 18.4 billion Manats: 5.7 bln. Manats (or 31%) in the non-oil and gas industry, the remaining 12.7 bln. Manats (69.0%) was produced in the oil and gas industry. In terms of fixed prices, the total volume of industrial production in the first half of this year was 1.5 percent less than the same period last year. However, the volume of production in the non-oil and gas industry increased by 11.2 percent in stable prices compared to the same period last year. Although it seems to be a good result at first sight, it should be noted that the increase in growth rates observed in the corresponding period of previous years has been
replaced by a decrease in the growth rate. Thus, the level of this indicator was 4.4 percent in the first half of 2017, 8.8 percent in the first half of 2018, and 15.7 percent in the first half of 2019.

The value creation in the processing industry increased by 8.2 percent compared to the same period last year. According to the State Statistics Committee, the production of petroleum products in the first half of this year, compared to the same period last year, from the refining industry (26.3% of total industrial output) increased by 0.8 percent, chemical industry (7.2%) by 20.5 percent, metallurgy (3.4%) for 2.2 times, the production of tobacco products (2.6%) 16.3 percent, production of rubber and plastic products (2.5%) 4.1 percent, production of machinery and equipment (2%) 16.2 percent, production of electrical equipment (1.4%) 3.8 percent, paper and Cardboard production (0.9%) increased by 21.3 percent. At the same time there was 1.1 percent drop in food production (32.7%), 10.4 percent in construction materials (5.5%), 3.8 percent in beverage production (3.6%), 44.7 percent in installation and repair of machinery and equipment (2.5%), 0.5 percent in textile industry (2.4%), 13.1 percent in production of finished metal products (2.1%), 5.5 percent in furniture production (1.2%) and 6.2 percent in production of printing products (0.9%).

According to the State Statistics Committee data, in the first half of 2020, the new value creation in the "other areas" group decreased by 0.9 percent compared to the same period last year. These include financial and insurance activities, real estate transactions, professional, scientific and technical activities, education, health and social services, public administration, defense and social security, recreation, entertainment and arts activities, and other services. Although there are no official statistics, the following areas should be mentioned in connection with pandemic and quarantine:

- **An increase in health and social services is expected**;

- **It can be said that the activities in the field of public administration and defense are mostly in full swing**;

- **Although activities in the field of education, as well as vocational, scientific and technical activities (such as teaching in schools, etc.) have been suspended, the distant operations have been carried out via the Internet, and distance education and services have been rapidly introduced throughout the country. It can be said therefore that the activities envisaged in these areas are mainly implemented**;

- **activities in the field of recreation, entertainment and art were severely restricted after the introduction of the lock-down.**

According to the table above, in the first half of this year, the creation of new value in transport and warehousing increased by 6.2 percent compared to the same period last year. In fact, transport is one of the areas directly affected by the pandemic. Thus, according to the State Statistics Committee, in the first half of this year compared to the same period last year:
• **Cargo transportation** by all transport means in the country decreased by **14.1 percent**, and **passenger transportation by 28.7 percent**;  
• There was a 3.1 percent increase in freight transportation by rail and a 16.1 percent decrease in passenger transportation;  
• There was a decrease of 22.1 percent in freight transportation by road and 26.4 percent in passenger transportation;  
• The number of passengers using the services of metro decreased by 45.0 percent;  
• Passenger transportation by air decreased by 60.4 percent, while cargo transportation increased by 2.2 times;  
• The volume of gas transported by main gas pipelines increased by 12.2 percent;  
• The amount of crude oil transported by main oil pipelines was 1.4 mln. tons or decreased by 7.0 percent.

The new value added in the **field of information and communication** in the first half of this year increased by **4.4 percent** in constant prices compared to the first half of last year. For comparison: the level of this indicator was 3.7 percent in the first half of 2017, 4.9 percent in the same period of 2018, and 15.8 percent in the first half of 2019.  
A similar situation is observed in agriculture, forestry and fisheries. The new value creation in this area in the first half of this year increased by **2.2 percent** compared to the same period last year. In the first half of 2017, 2018 and 2019, this figure was 2.2 percent, 7.6 percent and 13.1 percent, respectively. In both cases, we see a slowdown in growth though recent years.

To see how the pandemic related quarantine measures impacted sectors of the economy over the months, the dynamics of new value creation in the sectors of the economy in the first half of the year can be tracked in the table below (Table 2).
As can be seen from the table, the lowest volume of the newly added value in the country's economy by months in current prices - 4.1 billion Manats - was registered in April. The amount of new value creation in most sectors of the economy in April, including mining, trade, tourist...
accommodation and catering, transport and other (education, financial services, management, etc.) was at its lowest, and some increases took place in May and June. Although production positions that were observed in many areas have been restored in the first quarter of the year in May or June, there is no significant revival has been seen in the area of tourist accommodation and catering. The introduction of online sales and home delivery services in trade and catering in May and June allowed the partial resumption of activities in this area.

The drastic decline in April was also due to the fact that people and workplaces were not yet ready for the new conditions under the lockdown, and do not have the experience to operate under quarantine. In May, along with the easing of the quarantine regime, the gradual development of skills to work under new conditions has resulted in some progress in almost all areas. It can be concluded that the statistical results (losses) of the introduction of the quarantine regime in 16 cities and regions of the country in the second half of June and in July, which will be officially announced for July, may not be as deep as in April.

Another noteworthy point in Table 2 is the amount of taxes on products and imports. Compared to the same period in 2019, in the first six months of this year, there was a decrease of 0.8 percent in fixed prices, and 149.7 million Manats increase in nominal terms. Given that taxes on products and imports are calculated at face value (ie based on current prices), at the same time, if the new value creation in the first half of this year decreased by 4.6 Manats or 12.0 percent in nominal terms compared to the same period last year, it is interesting to see how occurs this kind of increase in product and import taxes. Minister of Economy M. Jabbarov and Chairman of the State Customs Committee S. Mehdiyev in their presentations at the meeting of the Cabinet of Ministers upon the results of the first half of 2020 socio-economic development and the tasks ahead (July 15, 2020), noted the increase in tax revenues, as a result of the steps taken by the government in recent years in the field of legalization of the shadow economy.

If we proceed from this approach, we can conclude that such legalization should also be reflected in the size of GDP, ie a certain amount of new value that was actually created in the first half of the previous year, but not included in the official real GDP data due to being part of shadow economy, was already included in real GDP size in the first half of this year.

This means that, given the scale of the shadow economy in the country, the 2.7 percent decline announced for the first half of this year does not fully reflect the real decline in the country's economy, ie the real decline is expected to be greater. The fact that more than half of the employed population in the country belong to the self-employed group, and the lack of accurate information about the results of their activities, only increases this probability. Therefore, it would be appropriate for the government to take this factor into account in its policy to reduce the implications of the pandemic.

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https://president.az/articles/39645
Although the quarantine regime was relaxed in May, a steep rise in contracting the Covid-19 virus forced the government to reintroduce a strict quarantine measures in 16 cities and regions in June and July, including Baku. Areas with the re-applied lock-down measures are considered to be the most economically active regions of the country: more than 80 percent of the country's GDP is generated in those areas. Therefore, the Ministry of Economy renewed its forecast for a 3.8 percent decline in GDP by the end of this year in May, now in July forecasting a decline of around 5.0 percent.

High levels of uncertainty about how the pandemic will unfold in the world and in the country by the end of the year make it particularly difficult to forecast economic growth. However, the factors affecting economic growth in the country, the expected situation in the oil market, the sectoral structure of the country's economy and GDP, the results of the first half of the year, economic recovery opportunities, government support measures and fiscal expansion behavior, etc. Based on the analysis of factors such as: However, in the event of another wave of the pandemic, the level of economic contraction, depending on its scale, could be as high as 5.5 percent.

However, based on the analysis of the factors affecting economic growth in the country, the expected situation in the oil market, the sectoral structure of the country's economy and GDP, the results of the first half of the year, opportunities for economic recovery, government support measures and fiscal expansion behavior, we assume that the economic contraction can be in the range of 4 to 4.5 percent, if the country doesn't not experience another large wave of pandemic by the end of the year (such a probability is very low). Nonetheless, in the event of another wave of the pandemic, the level of economic downturn, depending on its scale, could be as high as 5.5 percent.

1.2. Employment and unemployment rates

In order to reduce the negative effects of the pandemic, the government's employment support measures focused on two areas:

1) protection of jobs of employees with employment contracts and prevention of the rise of unemployment. There have been taken both support and administrative measures this direction:

1.a) In order to obviate redundancies of the wage labourers working in pandemic-affected areas during the quarantine period, the support measures covered government support for the payment of a portion of their salaries, as well as state financial support to individual and micro-entrepreneurs. According to the Ministry of Economy, as of July 28, current year, there about 98 million Manats was paid to 215.689 employees of 24,525 taxpayers as part of compensation for the salaries of wage labourers. In addition, 63.5 million Manats

8 http://maliyye.gov.az/static-page/page/184
was allocated to 106,765 taxpayers under the financial support package for individuals, including micro-entrepreneurs\(^9\). At the same time, the salaries of all public sector employees, regardless of whether or not they attend the work, are paid in full during the quarantine period.

1.b) As an administrative control measure, the State Labor Inspection Service under the Ministry of Labor and Social Protection (MLSP) carried out daily control in the frames of the “Employment Contract Notification” subsystem in order to protect jobs during the special quarantine regime and prevent unjustified dismissal of employees. According to the Service, in April alone, there more than 700 employees whose employment contracts were terminated during the quarantine period were reinstated\(^10\).

2) measures taken in connection with the jobless persons. The government's Action Plan to Reduce the Negative Impacts of the Pandemic\(^11\) provides for a lump sum payment of 190 Manats per month for the unemployed and 200,000 informal workers who lost their income during the special quarantine regime, as well as it was planned to create 50,000 two-month paid public jobs (according to the State Statistics Committee, the number of unemployed in the country was 251,000, as of March 1, 2020). However later, the number of people to be paid a lump sum was increased to 600,000, and the number of public jobs was increased to 90,000\(^12\) by a directive of the President. According to the MLSP, a one-time assistance of 190 Manats was paid to 600,000 people in April-May, and then to 283,000 people in 16 districts and cities under lock-down regime in June and July\(^13\) (unfortunately, the Ministry did not specify the age, social status and the structure of the territory across the country of the recipients). According to the ministry, the number of new paid public jobs exceeded 65,000 in July\(^14\).

Another element of the unemployment support program is the self-employment program. It is planned to involve 12,000 unemployed people in this year through the mentioned program. It is supported by the United Nations Development Program and the World Bank\(^15\). According to the decision\(^16\) of the Cabinet of Ministers of the Azerbaijan Republic dated July 25, 2020


\(^11\) [https://cabmin.gov.az/media/files/ff0145806a54cfbe10603cda6d837b7a.pdf](https://cabmin.gov.az/media/files/ff0145806a54cfbe10603cda6d837b7a.pdf)

\(^12\) [https://president.az/articles/36654](https://president.az/articles/36654)


in connection with the current pandemic, persons registered as unemployed and job-seekers at the local branches of the State Employment Agency under the MLSPP, as well as those involved in the self-employment program in 2020 are expected to be provided with materials, equipment and other property in kind.

These people will receive the materials, equipment and other property on the basis of business plans developed by the local employment agencies.

According to the State Statistics Committee, as of July 1, 2020, 4883.1 thousand of the 5220.6 thousand economically active population in the country were engaged in various sectors of the economy. Compared to March 1, when pandemic related quarantine measures were launched in the country, the number of economically active population increased by 32.2 thousand people, while the number of employed population decreased by 53.7 thousand people. As a result, as of July 1, the number of unemployed in the country was 337.5 thousand people, which is about 6.5 percent of the economically active population. At the beginning of March, the number of unemployed in the country was 251.6 thousand people. Thus, according to official statistics, during the first 4 months of the pandemic (March-June), the number of unemployed in the country increased by 85.9 thousand people or 34.1 percent, and the unemployment rate rose from 4.8 percent to 6.5 percent or 1.7 percentage points.

However, the very high number of self-employed people in the country makes it difficult to determine the number of those who actually lost their jobs and income during the quarantine. Thus, according to the State Statistics Committee, as of June 1.2020, the number of wage laborers in all sectors of the economy was 1681.7 thousand people: this is about 34.3% of the total employed population for that period. There are 930.0 thousand (or 55.3 percent) of wage employees working in the public sector and 751.7 thousand (44.7 percent) in the private sector (the number of wage employees for the period of March-June has increased in the public sector by 18.6 thousand (2.0 percent), and by 21.6 thousand in the private sector (3.0) percent) increased.

So, according to the State Statistics Committee, 3.2 million people in the country's economy (65.7 percent of the total employed population) are engaged in other forms of employment without a contract, but the structure of such employment is not disclosed. By the way, according to international labor statistics, the number of employees without an employment contract includes employers (business owners), self-employed people, family members who provide assistance to family companies (but do not receive a salary), members of production cooperatives.

The structure of employment by sectors of the economy is disclosed in the statistical database of the State Statistics Committee. According to the data, there are 1.77 million people employed in agriculture (including forestry and fishing), of which only 51.3 thousand (or 3.0
percent) are employed on a contract basis, and the remaining 97.0 percent are self-employed (according to the law, each with a share of land is considered self-employed, which is a separate issue).

Excluding agriculture, there are about 1.5 million people without employment contracts in all other sectors of the economy. According to the State Statistics Committee, the areas with the highest number of employees without an employment contract in the total number of people employed in the field are: in the field of real estate transactions- 79.2%; in construction- 70.0%; in tourism and public catering- 70.1%; in transport and warehousing - 64.6%; in trade- 59.3%; in the processing industry- 57.2%; in information and communication- 57.6%, etc. The vast majority of those employed in areas such as education, health, financial and insurance services, professional, scientific and technical activities are working on a contract basis.

According to the State Statistics Committee, by the end of 2019, the number of people registered as individual entrepreneurs in all sectors of the economy in the country was 914.6 thousand (about 240 thousand in agriculture, 221.5 thousand in trade, 42.1 thousand in accommodation of tourists and public catering, etc.)\(^\text{18}\). The State Tax Service under the Ministry of Economy stated that the number of active (tax-paying) individual entrepreneurs was about 200.000. This raises the issue of registration of people who are unable to operate despite being registered as employed individual entrepreneurs. The government's Action Plan to reduce the impact of the pandemic is based on the assumption that 300.000 individual and micro-entrepreneurs will be affected\(^\text{19}\).

According to the State Statistics Committee, in June 2020, there were 133.6 thousand state-registered commercial organizations in all sectors of the economy\(^\text{20}\), but not all of them were actually operating.

In such a way, if we assume that the number of active individuals is 300.000 and the number of family members working in the business sphere (employer), owner, shareholder and family companies is about 250.000, then there is a need to **clarify the form of employment of approximately 1 million people, that are indicated as employed.** It is impossible to determine how pandemic and quarantine measures could affect their jobs and incomes until the form of their employment is clarified. The experience of the past months has shown that the employment of these people should be cleared up in order to assess the real impact of pandemic and quarantine measures on the population.

As mentioned above, although the government's Action Plan provided for 200.000 people to receive one-time assistance (according to official statistics, this was in line with the number of unemployed in the country at the time), the president later increased the number up to 600.000

\(^{18}\) [https://www.stat.gov.az/source/st_units/](https://www.stat.gov.az/source/st_units/)

\(^{19}\) [https://cabmin.gov.az/media/files/ff0145806a54cfbe10603cda6d837b7a.pdf](https://cabmin.gov.az/media/files/ff0145806a54cfbe10603cda6d837b7a.pdf)

\(^{20}\) [https://www.stat.gov.az/source/st_units/](https://www.stat.gov.az/source/st_units/)
(ie 400,000 individuals more), in order to include in the scope of assistance those who lost their jobs and incomes as a result of quarantine. However, it has not been clarified yet why the number of people receiving assistance has increased by 400,000 and how this figure is justified. As noted above, it is not possible to say that the government's aid package will cover the entire population affected by the pandemic, until the form of employment and the area of activity of those estimated as 1 million employed people is clarified. The point is that according to the official statistics, in addition to the more than 300,000 unemployed in the country, there 1.0 million people that are indicated as employed individuals whereas the form and scope of employment are not clear, which puts 1.3 million people in a risk group. However, the one-time assistance provided in the past has covered 600,000 people in April-May, and 283,000 people in June-July.

The longer the pandemic and quarantine regime lasts, the more likely it is that this risk group will expand. Because in this case, companies that have partially or completely ceased operations due to quarantine will inevitably go redundant, as well as bankruptcies in small and medium-sized businesses are possible. Prohibiting redundancies in crisis-hit firms and preventing this kind of job-cuts through administrative measures is unacceptable from the standpoint of a normal business environment. Unjustified dismissals however, must always be prevented. This can be achieved through the organization of the normal functioning of independent trade unions and civil society in the field of labor protection, as well as an independent and fair judiciary.

Civil servants working in the relevant field may protect the rights of employees by monitoring compliance with the requirements of the Labor Code in the workplace. Only the courts, not the officials, should decide whether a dismissal is justified or not. When enterprises are not able to sack employees from job as a result of administrative pressure, in most cases those employees are still seen as employed in the official register, but lose their jobs and income in practice. Such situations lead to actual neglect of people at risk. Therefore, the government should abstain from preventing redundancies by administrative measures and instead prioritize compensation measures for businesses affected by the pandemic to enable them to retain their employyes.

1.3. Aggregate demand factors

1.3.1. Incomes and expenses of the population

According to the State Statistics Committee, the nominal income of the country's population in the first half of 2020, amounted to 27.4 billion Manats, which is 0.6 percent or 159.1 mln. Manats more compared to the same period of the previous year. 13.5 billion Manats of total revenues fall to the share of the first quarter and 13.9 billion Manats to the second quarter of the year. Although the nominal income of the population increased by 6.8 percent in the first quarter compared to the first quarter of 2019, the 0.6 percent increase in the population's income at the
end of the first half of the year reflects the adverse impact of quarantine measures on income growth in the second quarter.

According to the State Statistics Committee, after all mandatory and voluntary payments in the first half of 2020, the population will have 24.7 billion manats left. This is 0.9 percent less compared to the same period last year.

Calculations based on the data of the State Statistics Committee show that in the first half of this year, the amount of all types of mandatory and voluntary payments from the income of the population was in amount of 2670.9 million Manats, which is 381.8 million Manats or **16.7 percent more** compared to the same period last year. *Interestingly, the nominal income of the population increased by only 0.6 percent compared to the same period last year, while the compulsory and voluntary payments of the population increased by 16.7 percent.*

According to the State Statistics Committee, the increase in prices in the country's consumer market exceeded the growth of incomes by 2.4 percents in the first half of 2020. That is, taking into account the 103.0 percent inflation recorded in the first half of the year, the **real income** or **purchasing power** of the population **decreased by 2.4 percent** compared to the same period last year.

### 1.3.2. Government spending

A detailed analysis of the impact of the pandemic on the execution of revenues and costs of the state budget for 2020 is presented in a separate section below. We briefly note here that the government's support measures to combat the pandemic, reduce its negative impact on the country's economy, especially to prevent the deterioration of the social situation in certain segments of the population, are mainly funded from the state budget. For this purpose, at the initial stage, it is planned to allocate 1.4 billion Manats from the state budget. When speaking at the meeting of the Cabinet of Ministers on the results of socio-economic development over the first half of 2020 and the tasks ahead, Finance Minister S. Sharifov said: “In order to combat the pandemic and reduce its negative impact on the country's economy, the relevant decrees of the President of the Azerbaijan Republic provided funding of **752 million Manats** out of **1 billion 409 million Manats** allocated from the state budget for 6 months. From this source, 149 million Manats out of 250 million Manats allocated for health, 281 million manats out of 570 million Manats allocated for socio-economic support measures, 244 million Manats out of 309 million Manats allocated for social security support measures and 118 million Manats out of 280 million Manats allocated for financial support to state owned companies has already been spent.\(^2\) At the same time, the Minister stressed that the "features of the qualitatively new social and economic environment created by the pandemic, the need to continue providing state support to vulnerable

\(^{2}\) [https://president.az/articles/39645](https://president.az/articles/39645)
social groups, state companies, businesses, small and medium-sized businesses” require revision and adjustment of the 2020 state budget. The 2020 state budget was adjusted and budget costs increased by 597.5 mln Manats due to the pandemic. As part of measures to reduce the negative effects of the pandemic, the State Social Protection Fund under the MLSP also allocates funds to provide additional social assistance to certain segments of the population affected by the pandemic. Speaking at the meeting, Minister of Labor and Social Protection S. Babayev said that 280 million Manats was paid to citizens in the framework of "one-time assistance in the amount of 190 Manat to those who lost their jobs and income." The payments of 210 million Manats of these funds turned possible at the expense of the reserve funds of the State Social Protection Fund.  

1.3.3. Investment costs

According to the State Statistics Committee, the country's fixed capital in the economic and social spheres in the first half of 2020, amounted to about 6.0 billion Manats, which is 2.7 percent less compared to the same period last year. Compared to the same period of the previous year, the amount of funds directed to fixed assets decreased by 5.5 percent in the first half of 2019 and 14.1 percent in 2018. In other words, compared to the previous two years, we see a slowdown in the amount of funds allocated for capital investment in the first half of current year. At the same time, according to the State Statistics Committee, in the first half of this year, the amount of investments in the oil and gas sector of the economy increased by 17.5 percent, fixed assets in the non-oil and gas sector decreased by 15.5 percent, and funds in the non-oil and gas industry decreased by 25.7 percent. Whereas, the amount of investment in the non-oil sector increased by 5.1% in the first half of 2019 and 21.5% in the first half of 2018 compared to the same period previous years. The volume of investments in the non-oil and gas industry increased by 72.8 percent in the first half of 2018, but decreased by 19.8 percent in the first six months of 2019.

It turns clear from the State Statistics Committee data that the growth rate of fixed capital investment in the first two months of the year exceeded 10% compared to the same period last year. Although the growth rate started to sharply fall in March, at the end of the first quarter there was a positive growth rate of 6.5 percent. However, in the second quarter of the year there was a negative growth rate (Figure 3).

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22 [https://president.az/articles/39645](https://president.az/articles/39645)
According to the State Statistics Committee, 39.7 percent of the total investment in the first six months fell to the state and 60.3 percent to the private sector. Of the fixed assets investment, 3.7 billion Manats (61.6% of total investment) came from enterprises and organizations, 324.0 mln. Manats (5.4%) bank loans, 1.3 bln. Manats (22.2%) from the state budget, 142.0 mln. Manats (2.4%) from extra-budgetary state funds, 369.3 mln. Manats (6.2%) from the population's personal funds, and the remaining 127.6 mln. Manats from other sources. Compared to the same period last year, investments of enterprises and organizations increased by 5.4 percent, bank loans decreased by 22.7 percent, state budget investments decreased by 22.2 percent, and capital investment decreased by 9.5 percent.

### 1.4. Foreign trade and foreign sector indicators

**Foreign trade.** According to the State Customs Committee, the country's foreign trade turnover in the first half of 2020 was in amount of 12.7 billion USD, which is 4.3 billion USD or **25.3 percent less** than in the first half of 2019 (17.0 bln. USD). In the first half of the current year, the country's exports amounted to 7.7 billion USD, and the volume of import to the country came up to 5.0 billion USD (Table 3).
Table 3. Dynamics of export and import operations in 6 months of 2020 (mln. USD)
(Source: State Customs Committee)

<table>
<thead>
<tr>
<th></th>
<th>January</th>
<th>February</th>
<th>March</th>
<th>April</th>
<th>May</th>
<th>June</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Export</td>
<td>2130,2</td>
<td>1118,8</td>
<td>957,4</td>
<td>2100,0</td>
<td>665,5</td>
<td>714,4</td>
<td>7686,3</td>
</tr>
<tr>
<td>Import</td>
<td>721,0</td>
<td>1066,7</td>
<td>850,3</td>
<td>745,3</td>
<td>782,6</td>
<td>823,7</td>
<td>4989,5</td>
</tr>
<tr>
<td>Balance</td>
<td>1409,2</td>
<td>52,2</td>
<td>107,1</td>
<td>1354,7</td>
<td>-117,1</td>
<td>-109,3</td>
<td>2696,7</td>
</tr>
<tr>
<td>Circulation</td>
<td>2851,2</td>
<td>2185,5</td>
<td>1807,7</td>
<td>2845,2</td>
<td>1448,1</td>
<td>1538,1</td>
<td>12675,8</td>
</tr>
<tr>
<td>Monthly increase in exports</td>
<td>-1011,4</td>
<td>-161,5</td>
<td>1142,6</td>
<td>-1434,5</td>
<td></td>
<td></td>
<td>48,9</td>
</tr>
<tr>
<td>Monthly increase in imports</td>
<td>345,7</td>
<td>-216,3</td>
<td>-105,1</td>
<td>37,4</td>
<td></td>
<td></td>
<td>41,1</td>
</tr>
</tbody>
</table>

Compared to the same period last year, exports amounted to $2.3 billion (23.0 percent) and imports to $2.0 billion dollars (28.9 percent). According to the chairman of the State Customs Committee S.Mehdiyev: “The country’s total imports decreased by **5.2 percent** in the first six months of this year, if not to take into account the gold brought by the State Oil Fund in 2019\(^{23}\).

According to the State Customs Committee, the number of legal entities participating in foreign economic activity in the first half of this year decreased by 112 units, compared to the same period in 2019, while the number of individuals increased by 4781 units.

The lowest levels of exports in the first half of 2020 were recorded in May and June, and the lowest rates of imports were recorded in April and May. Compared to the first half of last year, in the first half of this year, imports of food products increased by $37.9 mln., imports of pharmaceuticals by $46.3 mln., imports of ferrous metals and their products by $45.7 mln., and imports of vehicles and spare parts by $66.6 mln. Imports of clothing and accessories decreased by $21.0 million, while imports of machinery, equipment, electrical appliances and parts decreased by $82.2 million. In the first half of this year the share of the oil and gas sector in total exports decreased by 1.9 percentage points compared to the same period last year and amounted to 88.1 percent (in the first half of last year it was 90.0%).

Compared to the first half of the last year, the main products that increased exports in the first half of the current year were fruits and vegetables: there was an increase in amount of $9.6 million. Exports of all other products (in terms of value) decreased to some extent.

\[^{23}\] [https://president.az/articles/39645](https://president.az/articles/39645)
**Balance of payments.** The main indicators of the balance of payments for the first half of 2020 have not yet been announced. According to the data released by the Central Bank for the first quarter of 2020, after a three-year hiatus (2017-2019), the country's balance of payments turned negative again: in the first quarter of this year, the balance of payments showed a deficit of $1.4 billion.

According to the reports, the current account balance amounted to $646.3 mln. in the first quarter of this year, which is $957 mln. decrease compared to the first quarter of the last year (surplus of $1.6 billion). This decrease is mainly due to increase of the surplus in the foreign trade balance in $613 million and the increase of deficit in the balance of services is $326 mln. (increase from -500.0 million to -826 million dollars) this year ($1.9 billion) when compared to the first quarter of previous year ($2.5 billion), and the deficit in the balance of services is $326 mln. (increase from -500.0 million to -826 million dollars).

In the I quarter of this year, the country's balance of payments amounted to 1.4 billion Manats. There is a deficit of $6.5 billion, which is 6.5 times more than last year ($215 million). At the same time, this is 3 times less than in the first quarter of 2015, when there was recorded the highest level of the financial account deficit ($4.4 billion). According to the Central Bank, the country had an unregistered foreign currency outflow of $596 mln. in the first quarter of this year (for comparison, an unregistered foreign exchange inflow in the first quarter of the previous year was in amount of $633.0 mln).

Consequently, the country's official reserve assets decreased by $1.34 billion, in the first quarter of 2020 (in the first quarter of last year there was an increase of $2.0 billion).

In the second quarter of the year, the rise in oil prices on the global market, on the one hand and the low level of imports on the other hand, did not pass unaffected by the balance of payments. According to the Central Bank, in the first six months of this year, the foreign trade balance showed a surplus of $2.7 billion, an increase of 42.1 percent compared to the first quarter of the year.

5. **Inflation**

1.5.1. **Consumer Price Index (CPI)**

According to the State Statistics Committee, the annual consumer price index was 103.0 percent in the first half of 2020, compared to the same period last year, i.e., annual inflation reached 3.0 percent. Observation of the change in the consumer price index by months shows that albeit slightly, prices tended to increase in the first 3 months of the year, and starting from April, prices tended to fall. In May and June, deflation was recorded at 0.5 percent and 0.3 percent, respectively (Figure 4)

The May and June deflation was attributed\textsuperscript{25} by the Central Bank to a contraction in aggregate demand, i.e., a decline in the purchasing power of the population, which is a direct result of declining incomes due to the pandemic.

According to the State Statistics Committee, in May and June of this year, despite the fact that the annual consumer price index for food products was 105.5 percent, food prices fell by 5.7 and 5.3 percent compared to previous months.

The basic consumer price index, calculated without taking into account state-regulated products and services, as well as seasonal agricultural products and accepted as core inflation, in January-June 2020 amounted to 102.2 percent compared to the same period last year.

1.5.2. Manufacturer price indices

According to the State Statistics Committee, in January-June 2020 compared to January-June of the previous year, producer price indices for industrial products were 69.6 percent, including 61.7 percent in the mining industry and 99.1 percent in the processing industry, in other words, production prices for industrial products fell by 30.4 percent, as well as in the mining industry by 38.3 percent and in the processing industry by 0.9 percent. There were no price changes in the production, distribution and supply of electricity, gas and steam, as well as water supply, waste treatment and processing.

\textsuperscript{25} https://www.cbar.az/press-release-2688/on-interest-rate-corridor-parameters
In the first half of 2020, compared to the same period last year, the annual producer price indices for agricultural products were 108.8 percent, including 111.4 percent for crop products and 106.3 percent for livestock products. During this period, the annual price index for transport services was 101.5 percent, the annual price index for communication services was 100.0 percent, and the annual price index in the housing market was 100.0 percent.

1.6. Monetary and exchange rate policy

1.6.1. Foreign exchange market and manat exchange rate

As global oil prices fell in March, demand for the US dollar rose sharply and pressure on the national currency intensified. According to the Central Bank, the volume of cash dollar sales in banks in March amounted to 1163.4 million. This is 4.4 times more than in February and 2.7 times more than the combined sales in January and February (Figure 5).

Figure 5. Dynamics of cash sales of the US dollar by banks in the first half of 2020, mln. USD

(Source: Azerbaijan Republic Central Bank)

As a result of administrative measures taken by the Central Bank to tighten the regime on cash foreign exchange sales, there was a sharp decline in cash dollar bank sales in April: the volume of cash dollars sold in April decreased by 3.8 times compared to March. In January-June 2020, banks sold $2.32 billion in total, of which almost half fell to March. For comparison, in March 2020 alone, banks sold slightly more US dollars than they sold in the first six months of 2019.
In March, the State Oil Fund (SOFAZ) had to surge the volume of currency issued at foreign exchange auctions to meet the growing demand for cash dollars and, accordingly, the growing demand of banks for dollars: the Fund sold $ 1.9 billion at scheduled and off-schedule foreign exchange auctions in March, which was 3.6 times more than in February. With the reduction of speculative demand for the dollar in April, the volume of dollars sold by SOFAZ at auctions also decreased by 3.6 times to 531.3 billion Manats. fell to the level of manat. The decline in demand and stabilization in the foreign exchange market have been observed since April.

The population's supply of cash currency to banks fell from $129.2 mln. in January and $127.9 mln. in February, to $86.1 mln. in March and $42 mln. in April. But supply has increased effective from May: the offer rose to $71.2 mln. In May, and to $103.5 mln. in June.

Along with cash transactions, the volume of transactions in the non-cash foreign exchange market increased by 26.1 percent compared to the same period last year and amounted to 7.7 billion. 87.7% of non-cash foreign exchange transactions were conducted in US dollars and 12.3% in other currencies. 43.1% of foreign exchange transactions were carried out in the interbank foreign exchange market, and 56.9% in the intra-bank foreign exchange market (data on the second quarter of the year have not yet been disclosed by the Central Bank). According to the Central Bank, there $4.0 billion was sold at 50 currency auctions with the participation of the State Oil Fund in January-June 2020. Of this, $2.8 bln. were sold in the first quarter and $1.2 bln.- in the second quarter. As a result, the Central Bank was able to keep the manat stable (Figure 6).

**Figure 6. Exchange rate of manat against foreign currencies in the first half of 2020**
At the same time, the Central Bank managed to protect and even increase its foreign exchange reserves: if the Central Bank's foreign exchange reserves were $6,258.0 mln. Manats at the beginning of the year, they rose up to $6,436.0 mln. Manats by the end of June, which means an increase by $178.3 mln. or 2.8 percent. As a result of foreign exchange auctions held by the State Oil Fund, its foreign exchange reserves decreased from $43.3 billion at the beginning of 2020 to $41.3 billion at the end of March, but then the reserves were restored and increased to $43.2 at the end of June.

According to the Ministry of Finance, the country’s strategic foreign exchange reserves amounted to 51.1 bln. US dollars at the end of the first half of 2020.

During the period of high tension in the foreign exchange market, the Central Bank was able to maintain a stable exchange rate of the Manat, both through the supply of additional dollars and administrative means. However, in the first half of the year, the Manat appreciated against both the nominal and real effective exchange rates of major foreign trade partners:

- The total nominal effective exchange rate of Manat against foreign currencies increased from 73.4% in January to 78.6% in April, i.e., increased by 5.2 percentage points, and decreased to 76.3% in June, compared to January an increase in June was of 2.9%;
- The real effective exchange rate of Manat against foreign currencies increased from 109.0% in January to 118.9% in April, i.e., increased by 9.9 percents, then decreased slightly and was 115.5% in June, in other words, the real effective exchange rate increased by 6.5 percentage points in the first half of the year;
- In the non-oil sector, the nominal effective exchange rate of the Manat against foreign currencies increased from 99.6% in January to 107.4% in April, i.e., increased by 7.8 percentage points, then decreased and settled at 102.8% in June (increase by 3.2 percentage points compared to January);
- The real effective exchange rate of the Manat against foreign currencies in the non-oil sector rose from 93.3% in January to 102.6% in April - an increase of 9.3 percentage points, and then slightly decreased, but in June it was 98.3%: an increase of 7.8 percents compared to January.

In fact, that's a factor that worsens the trade conditions for Azerbaijan's non-competitive non-oil products.

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29 [https://www.cbar.az/page-41/macroeconomic-indicators#page-1](https://www.cbar.az/page-41/macroeconomic-indicators#page-1)
Another noteworthy point is that the increase in the nominal effective exchange rate (6.0%) in the non-oil sector is slightly higher than the increase in the real effective exchange rate (5.4%): this difference indicates that inflation in Azerbaijan is lower than that of its foreign trade partners.

However, the high level of devaluation expectations in the society when oil prices fall, as well as the structure of Manat deposits in banks show that the confidence in the Manat has not yet been fully restored among the population since the events of 2015. If the Central Bank's administrative steps weaken, pressure on the rate of Manat may continue to rise.

In any situation when the global market price of oil is below $35 for a long time, the exchange rate risk of the manat will remain high. It is also important how the government regulates the balance of payments needs within the financial account, especially how the amount of foreign currency leaving the country in various forms (deposit, investment, capital flight) is being limited. Nowadays the debt of Azerbaijan state, businesses and the population in foreign currency is not that high, both in terms of amount and level of risk. However, the level of dollarization of the banking sector's debt to the population and business remains high (60%)\(^\text{30}\). In this respect, the devaluation may cause some complications, although not at the level of 2015. On the other hand, we have a high dependence on imports: according to our calculations, at least 60 percent of our consumer market is formed by foreign goods. In this situation, devaluation poses very serious inflation risks. However, the psychological effects of devaluation on both investors and society as a whole, and the short- and long-term losses of the economy can be huge. In particular, this could lead to a further loss of public confidence in the national currency (Manat), which has not yet been restored. Therefore, the government is interested in retaining exchange rate stability and we expect to ensure this by the end of the year. With tight administrative controls over capital inflows and foreign exchange purchases, maintaining oil price stability between $35 and $40 by the end of the year could cost the government $3-4 bln. from the State Oil Fund's reserves.

\subsection*{1.6.2 Monetary policy instruments}

The Central Bank discussed the parameters of the interest rate corridor 5 times in January-July 2020, during which the discount rate was reduced several times from 7.5% at the beginning of the year to 6.75% on July 30. At present, the lower limit of the interest rate corridor is set at 6.25% and the upper limit at 7.25%\(^\text{31}\).

In order to prevent threats to macroeconomic stability and retain a balance in the foreign exchange market in the context of the growing adverse impact of the coronavirus pandemic on

\begin{itemize}
\item [30] https://uploads.cbar.az/assets/24b708836ab1958be0eb2ef83.pdf
\item [31] https://www.cbar.az/page-134/monetary-policy-decisions
Since March, the Central Bank has adopted adequate decisions on the terms of sterilization tools. The terms of the tools included in the sterilization portfolio were reduced: instead of 28-day deposit auctions, it was decided to hold only 14-day deposit auctions, and instead of 84-day, 168-day and 252-day note auctions, there were placed only 28-day notes.

In January-June 2020, the Central Bank actively continued deposit auctions to attract free funds in the national currency held by banks. 24 such auctions were held in the I quarter and 12 in the II quarter. A total of 5.0 bln. Manats was raised at 12 auctions in the second quarter of the year. With minor exceptions, funds were raised mainly for a period of 14 days and at 6.76%.

In the I quarter of 2020, the Central Bank held 7 long-term note auctions (2 of them included 84-day notes, 3 – 168-day and 2 - 252-day notes respectively), and in April-June there were auctioned 12 notes- all of them took 28 days.

In the first half of 2020, the mandatory reserve requirements remained unchanged (the last time the reserve requirements were set on March 3, 2016).

### 1.6.3. Money supply

The monetary policy of the Central Bank in the first half of 2020, was aimed at maintaining the exchange rate of the Manat and financial stability. The monetary base in Manat amounted to 12.15 billion manat in the beginning of January. manat, while in March it was 10.06 bln. manat, ie decreased by 17.3 percent, which was due to an increase in cash purchases by the population in March.

While the monetary base equaled 12.15 bln. Manats it the beginning of January, it fell to 10.06 bln. Manats in March, i e dropped down to 17.3 percent, which was due to an increase in cash purchases by the population in March.

The monetary base rose to 11.25 bln. Manats by the end of June- an increase of 11.8 percent. So, the monetary base in Manat has decreased by 7.4% down by the end of the period compared to the beginning of the mentioned period. The temporary decline in the money supply served to maintain stability in the foreign exchange market.

The amount of cash in circulation decreased from 10.4 billion Manats in early 2020 to 9.46 billion Manats in March (i e 10.0 percent), and was restored to the level of the beginning of the year by the end of June. Similarly, the amount of funds in the correspondent accounts fell from 2.7 billion Manats in early January to 1.9 billion Manats in March, and then increased again to 2.7 billion Manats in June.

By the beginning of January 2020, the M1 aggregate was 15.4 billion Manats, of which 9.5 billion Manats consisted of cash outside banks (M0), and 5.9 billion Manats in demand deposits in Manat. The amount of cash outside banks decreased to 8.5 billion Manats (10.5 percent) in March and rose to 9.2 billion Manats at the end of June. Although the amount of Manat deposits fell to 5.3 billion Manats in March, it rose to 5.7 billion Manat at the end of June.
While term deposits in Manat amounted to 2.8 billion Manats at the beginning of the year, they fell by 2.2 billion Manats at the end of June, i.e. by 14.3 percent.

Decreases and increases in the above-mentioned components of the broad money supply (M2) in Manat had a similar effect on its volume: the amount of aggregate M2 decreased from 18.2 billion Manats in early January to 16.4 billion Manats (about 10 percent) in March and increased to 14.9 billion Manats by the end of June.

The volume of deposits in freely convertible currencies decreased by 14.7 percent by the end of June (9.04 billion Manats) compared to the beginning of January 2020 (10.6 billion Manats).

As a result of all the above changes, the broad money supply (M3) decreased from 28.9 billion Manats in early January to 26.2 billion Manats by the end of June, i.e. down by 9.3 percent.

The changes in monetary aggregates mainly reflect the pressure on the exchange rate of the national currency in March, and the restoration of the stability of the Manat in the following months with the reduction of devaluation pressures.

In January 2020, the total amount of deposits in commercial banks was 24.8 bln. Manats, of which 9.6 bln. Manats (38.7 percent) was in Manat and the remaining 15.2 bln. Manats (61.3 percent) in foreign currency. At the end of June, the total amount of deposits amounted to 2.3 bln. Manats (or 9.1 percent) decreased by 22 bln. Manats, of which 8.9 bln. Manats (38.1 percent) and 13.6 bln. Manats (61.9 percent) consisted of deposits in foreign currency. The decrease in the amount of deposits is associated with the withdrawal of Manat deposits due to an increase in the likelihood of devaluation of the Manat and the return of deposits to the population in April due to the revocation of licenses from 4 commercial banks. In the first half of this year, there were no significant changes in the currency structure of deposits. This means that, unlike in 2015, in March of this year the Central Bank was able to prevent the conversion of deposits in commercial banks into foreign currency during the increase in pressure on the Manat.

However, in the structure of deposits, it is noteworthy that while the share of demand deposits in Manat deposits is always high (between 65-70 percent), the share of time and demand deposits in foreign currency deposits is very close to each other (for example, in January) or the share of time deposits was slightly higher than the other (for example, in June, 60% of total foreign currency deposits were time deposits). This may be due to the fact that the population's confidence in the Manat has not yet been fully restored since the events of 2015.

Thus, based on the analysis of the Central Bank's monetary and exchange rate policy in the first half of 2020, it can be concluded that during the reporting period, this policy was aimed at relieving pressure on the Manat and maintaining the exchange rate stability in the face of a steep drop in world oil prices.
2. Analysis of the impact on the state budget

The Covid-19 coronavirus pandemic, which was announced worldwide in March 2020, has created problems for Azerbaijan's economy, especially for the government's budgetary commitments. On the one hand, the closure of the economy, on the other hand, a sharp plunge in prices for natural resources in the global markets created risks of lower budget revenues.

The level of dependence of the state budget of Azerbaijan on oil revenues is very high. About 58% of the 2020 budget should come from oil and gas revenues, including 50.5% from transfers from the Oil Fund and 7.5% from taxes paid by oil and gas companies. In the approved version of the state budget for 2020, the average annual price of crude oil was set at $55 per barrel, and the revised budget at $35, in order to keep oil revenues at projected levels. Following the results of 6 months of this year, the average selling price of Azerlight oil amounted to about $38 per barrel.

The risks associated with the sharp drop in oil prices are not limited to revenues to the state budget through the Oil Fund and oil companies. At the same time, the risk of declining revenues through the customs line, which accounts for about 16% of the state budget, remains high due to limited international trade, falling economic activity and declining foreign trade turnover.

Finally, after the oil sector and foreign trade relations, the main share in the budget belongs to the service sector, especially tourism and catering, wholesale non-food trade and transport. At present, the government has declared these sectors at risk of the pandemic and an economic support package is being implemented therefore. From this point of view, there is a high risk that budget revenues from these sectors will be lower than expected.

In the situation of mentioned risks in the formation of budget revenues, the increase in budget expenses, for rescuing businesses whose operations were limited due to strict quarantine measures and for supporting the rapidly growing poor and unemployed population, becomes inevitable. In this reality, ensuring macroeconomic stability and fiscal balance leaves the government facing a difficult choice. Compensating the declining revenues and finding sources for the rising cost liabilities is not an easy task in the short term.

One of the intricacies for Azerbaijan is that the budget does not only meet the social needs of households. The significant role of the public sector in the economy, the monopoly of a number of important services (especially in the utilities and energy sectors) by state-owned companies, and the continued dependence of these economic entities on financial support from the state budget increase the budget burden.

In this conditions, the implementation of the state budget without reducing the approved commitments in a number of areas has been identified as one of the main priorities for the government. This is why, the draft budget amendment for 2020 submitted to the parliament envisages not only the full implementation of the approved general budget commitments using
the reserves of the State Oil Fund, but also a decision to increase the total state budget costs by about 600 million Manats.

2.1. Impacts on the execution of state budget revenues

The prolongation of the pandemic is a double blow for natural resource dependent countries: on the one hand, the economic contraction caused by health care reasons, and on the other hand, the decline of demand resulted in plunge of the resource prices at the world stock markets.

According to the State Oil Fund, while the weighted average price for crude oil in the first quarter of 2020 was $59\textsuperscript{32}, in the first six months of this year it fell down to $38.7\textsuperscript{33}. In this situation, the government decided to change the approved state budget for the current year and re-forecast the structure of revenues\textsuperscript{34}.

According to the amendment, there is a very little adjustment in the amount of total budget revenues: if the approved budget was 24134.5 mln. Manats, this figure was reduced by 10.5 mln. Manats (0.04%) to 24124 mln. Manats, as a result of the revision. The decrease in budget revenues from the non-oil sector was compensated by an increase in transfers from the State Oil Fund. The state budget has projected the oil prices at $55 for 2020 and forecasted share of oil sector in state budget was 56%, 84% or 11.350 mln. Manats of these revenues were to be formed through transfers from the State Oil Fund, and 16% or 2.180 mln. Manats were to be formed at the expense of taxes paid by the oil sector. Two-thirds or 1.450 mln. Manats of tax liabilities in the oil sector were set for the State Oil Company, and one-third or 730 mln. Manats for the companies included in foreign oil consortia.

\textsuperscript{32} \url{https://oilfund.az/fund/press-room/news-archive/1441}

\textsuperscript{33} \url{https://oilfund.az/fund/press-room/news-archive/1454}

Despite the severe economic losses caused by the pandemic, the government has decided to meet its planned fiscal commitments, at least in the short term (by 2020), albeit through the use of available resources.

For this reason, it is envisaged that the expected losses in tax revenues of both the oil and non-oil sectors will be compensated by increasing the transfers of the State Oil Fund to the state budget. According to the revised budget document, tax liabilities in the oil sector were reduced by 390 mln. Manats, including SOCAR's tax liabilities by 210 mln. Manats from 1.450 mln. Manats to 1.240 Manats, and liabilities for foreign oil companies by 180 mln. Manats from 730 mln. Manats to 550 mln. Manats.

Instead, the Oil Fund's budget transfers increased by 850 mln. Manats or 7.5% to 12.200 mln. Manats. The possibility of increasing the Fund's support to the budget was voiced in a media interview with the head of the Audit Chamber in early April\(^{35}\). The chairman of the agency suggests that the repayment of foreign debts through transfers from the State Oil Fund to the budget reduces the risks for the fiscal system.

As can be seen, a significant part of the state budget's oil revenues - the Oil Fund's transfers - are "insured" revenues. Because at any price of oil, there are no problems in the fulfillment of obligations to the budget, even at the expense of the Fund's reserves that were formed in previous years.

World oil prices also have less of an impact on SOCAR's budget liabilities, as 80-85% of the company's taxable turnover comes from sales in the domestic market. Domestic market prices are not free and are set by the state, not pegged to world market prices. Therefore, despite the fact that in 2015 and 2018 the difference between the average annual price of oil was about twice, SOCAR paid the same amount of tax to the state budget (slightly more than 1.4 bln.

Manats). Under the current amendment, the approved liabilities for SOCAR are reduced by about 14%. However, the tax liability of the foreign oil consortium has been reduced by about 25%.

One of the main consequences of the budget change is that the dependence of the state budget on oil revenues has increased from 56% to 58%. This increase was mainly due to the transfers growth from the State Oil Fund. While the share of the Fund's transfers in the approved budget was 47%, in the revised budget the volume increased up to 50.6%. After the budget change, the share of tax payments from the oil sector in the state budget fell from 9% to 7.4%.

Among the non-oil revenues of the state budget, there has been a significant increase in customs revenues in recent years. According to the approved budget for 2020, 4.0 bln. Manats of the projected income of 10.605 mln. Manats in the non-oil sector was expected to come via the State Customs Committee. In the revised budget document, the budget liabilities of the customs authorities were reduced by 170 mln. Manats or 4.3% to 3.830 mln. Manats. As export operations in Azerbaijan are completely exempt from customs duties with very few exceptions, customs duties are formed at the expense of import operations. In the first half of 2020, compared to the same period last year, there was a decrease of 29% in import turnover, including more than 5%, excluding tax-exempt monetary gold imports. As a result of the reduction in import turnover, customs duties decreased by 46 million Manats in the first half of this year compared to the same period last year.
The approved budget identified a budget liability of 7.875 mln. Manats for the State Tax Service, of which 2.180 mln. Manats was to be provided by the oil sector and 5.695 mln. Manats by the non-oil sector. According to the new amendment, the liabilities of this institution were reduced by 685 mln. Manats or 8.7% to 7190 mln. Manats. There 390 mln. Manats decrease was due to oil sector, while 295 mln. Manats was due to non-oil sector.

The main reduction in revenue through the tax authorities will be related to income tax. In the new version of the budget, the profit tax forecast was reduced by 388.8 million Manats (14.6%) to 2.268 million Manats. In turn, the forecast for tax authorities was reduced by 100 million Manats for VAT, 45 million Manats for personal income tax, 39 million Manats for simplified tax, 25 million Manats for property tax and 12.6 million Manats for excise tax.

In the first half of 2020, the volume of revenues through the State Tax Service has not decreased compared to last year. However, both the replacement of economic growth by
economic contraction from the second quarter and the fact that a number of pandemic-affected businesses have been eligible for tax breaks since May due to changes in tax legislation have had a negative impact on tax payments in the second half of the year, is known to show.

However, it is clear that both the replacement of economic growth by the economic contraction in the second quarter and the fact that a number of businesses affected by the pandemic will receive tax breaks from May onwards, will have a negative impact on tax payments in the second half of the year.

As tax revenues of the Azerbaijan state budget are formed mainly due to indirect (turnover) taxes (VAT, excises, customs duties), nominal indicators affect the dynamics of tax collection more than real indicators of economic growth. For example, if the updated version of the 2020 budget does not take into account the transfers of the State Oil Fund, about 69% of state budget revenues, or 7,000 Manats are taking place due to taxes levied on turnover or applied to the price of the product. As can be seen from the chart above, there is a direct link between the nominal growth of non-oil GDP in 2014-2019 and the increase in tax revenues from this sector. Even in 2016, when the sector recorded a real 4.4% contraction, nominal economic growth of 5.3% provided a 13.8% increase in budget revenues for the sector. In the first half of 2020, with non-oil GDP plummeting by 2.5% in real terms and severe economic restrictions caused by the pandemic, revenues from the State Tax Service (about 4 billion Manats) not only decreased compared to last year, but also increased by about 10%. oil was accompanied by a nominal 3.3% increase in GDP. In the coming period, there is a risk of a decline not only in real GDP, but also in nominal GDP, which is an important source for justifying the forecast of turnover taxes. Because in the first 6 months of 2020, the nominal volume of GDP in non-oil sectors, which account for more than 40% of GDP - construction, trade, transport, tourism and catering - is

about the same as in the same period last year. It decreased by slightly more than 1.000 million Manats or 12%.\textsuperscript{37}

It should be noted that the continuation of the severe quarantine regime in the third quarter of the year and the expansion of unemployment and poverty as a result of the ongoing Covid-19 pandemic is expected to further weaken economic growth by reducing consumer demand. At the same time, the fact that both small and medium-sized businesses and households spend more resources as the strict quarantine regime lasts is one of the serious risk factors for economic contraction.

In addition, incentives for businesses have an impact on reducing tax forecasts. According to the amendments to the Tax Code, from May 1, 2020, tax breaks and exemptions will be applied to a number of businesses affected by the pandemic\textsuperscript{38}. Tax benefits include domestic (inter-city and inter-district, intra-city and intra-district) passenger transport by road (including taxis), hotel and other hotel-type facilities, tour operators and travel agents, goods on orders, including transportation and (or) delivery of food, food and non-food products from sellers to buyers, catering activities, organization of exhibitions, stage, recreation and entertainment (games), cinema, theater, museum and concert halls, activities of sports and recreation facilities, training (education) and refresher courses, out-of-school educational institutions, psychological centers have the opportunity to benefit. The tax exemptions provided for the mentioned areas of activity include the following:

- are fully exempt from property and land taxes;
- 75\% of the profit (income) is discounted;
- 50\% of the tax amount is reduced if the entities engaged in passenger and cargo transportation by road are simplified taxpayers;
- the amount of withholding tax on real estate leased from individuals is reduced by 50 percent;
- the amount of this simplified tax is reduced by 50 percent for those who exercise the right to be a payer of the simplified tax.
- in order to ensure the health and needs of the population with the necessary food products, the import of products, the list of which is approved by the relevant executive authority, is exempt from VAT.

Unfortunately, the documents released on budget changes do not provide information on sectors where main tax forecast reductions will happen. The last time the Audit Chamber opinion on the implementation of the 2015 state budget revealed the sectoral structure of tax revenues\textsuperscript{39}. If no significant changes have taken place in this structure since that period, at best 10-15\% of

\begin{itemize}
  \item \url{https://www.stat.gov.az/news/macroeconomy.php?page=1}
  \item \url{http://www.e-qanun.az/code/12}
  \item \url{http://sai.gov.az/1/reyler/}
\end{itemize}
tax revenues are generated by businesses that receive tax benefits, such as those affected by the pandemic.

2.2. Impacts on the execution of state budget expenditures

The effects of the pandemic highlighted the need to increase the expenditure burden of the state budget. Expenditures of the state budget for 2020 are projected at 26894.7 mln. Manats, which is 2478.8 mln. Manats or 10.1% more than the actual expenditures in 2019.

As a result of the budget amendments, total expenditures increased by 597.5 mln. Manats (2.2%) to 27497.2 mln. Manats. Despite of the declining revenues, the government was expected to increase spending by all available resources. This is because the further weakening of economic activity due to the pandemic makes it much more difficult to reduce budget costs.

At the last government meeting, the President also stressed that the budget should be fully implemented, regardless of oil prices.

It should also be taken into account that over the past 15 years, fiscal instruments, primarily budget investments, have been the driving force of economic growth in Azerbaijan. In this respect, the government has not ignored the side effects of reducing investment costs and the socio-economic consequences. By the way, the head of the Audit Chamber said in a media statement that it is necessary to spend investment costs even through domestic borrowing, as well as to finance projects that will provide only employment (plants, factories, etc.).

According to the changes in expenses, expenditures were increased in 2 directions out of 12 functional expenditure sections of the state budget, costs were reduced in 9 sections, and the amount of expenditures in 1 section was maintained.
Health costs increased by 347.6 mln. Manats or 25.3%, while services not related to the main departments - by 447.9 mln. Manats or 24.9%. The increase in health expenditures is due to the growth in the financial needs of the health system as part of measures to combat the Covid-19.

According to the government meeting with the participation of the President on the results of the first half of 2020, health costs increased by 75.8% in the first six months of 2020 compared to the same period last year. The increase in health care costs was due to the construction of modular hospitals and the expansion of procurement of necessary equipment for medicine and treatment. The increase in non-core service expenditures is due to an increase of 280 mln. Manats (68.3%) in reserve funds and 189.9 mln. Manats (18.1%) in expenditures related to socio-economic reforms. The amount of the President's reserve fund has been increased from 300 mln. Manats to 480 mln. Manats, the amount of the state budget reserve fund from 100 mln. Manats to 210 mln. Manats. However, the explanatory documents released to the public on the justification of the budget change did not provide detailed information on the reasons for the increase in expenditures on reserve funds or "socio-economic reforms" by about 470 mln. Manats. It can be assumed that 238 mln. Manats will be allocated for social protection measures in connection with the pandemic, 136.6 mln. Manats will be provided as financial support to state companies, and 100 mln. Manats will be provided as a package of support to businesses. Expenditure forecasts for 9 functional areas of the state budget were reduced by 434.1 mln. Manats, including public service costs by 170 mln. Manats, education costs by 121 mln. Manats, defense costs by 49.4 mln. Manats, court and law enforcement costs by 33.7 mln. Manats, and agricultural costs by 23.2 mln. Manats. Investment costs did not change and remained at the approved amount – 4909 mln. Manats. By the way, it became clear yet when the budget was approved for 2020, that the main feature of the current year's budget compared to the annual budgets for the last 10 years is a sharp reduction in the investment burden of the budget and instead a significant increase in social capacity.
Compared to 2019, the volume of budget investments in the current year was reduced by 1291 mln. Manats or 21% in absolute terms, and under such circumstances it did not seem realistic that budget changes would reduce investment costs. In fact, the drastic decline in investment costs occurred in the context of an increase in total budget costs by 10% and expenditures in the social sphere by 44.5%. The share of investment costs in the approved budget for 2020 (18.2%) was the lowest in the last 3 years.

In recent years, in order to reduce the negative macroeconomic consequences of declining incomes in times of crisis, the government has always decided to sequester expenditures, and as a rule, expenditures have been offset by reductions in investment expenditures.

For example, the loss of large amounts of resource revenues in 2015 as a result of the steep fall in crude oil prices on world markets forced the government to cut budget costs by 18.6% or 3315 mln. Manats, including investment costs by 1930 mln. Manats or 28%. However, one important point should be noted: the share of investments in the approved budget costs in 2015 was quite high - 33%.

The investment expenses were significantly lower in the approved state budget for 2020, both as an absolute indicator and in terms of specific weight, thus the government's ability to maneuver at the expense of investment costs was very limited. For this reason, 434 mln. Manats is provided for additional needs of the state budget, as well as to compensate the loss of income by cutting a number of expenditures, increasing the budget deficit by 608, mln. Manats and expanding transfers of the Oil Fund by 850 mln. Manats.

The Budget deficit is expected to be covered through foreign debt (951.2 mln. Manats), internal debt (290 mln Manats) and treasury funds (2121.2). The sharp growth in the budget deficit shows that in the current economic environment, the increase in costs is an unalterable priority for the government. The approved budget deficit for 2020 was quite large – 2779.2 mln. Manats or about 3% of projected for the current year GDP. The deficit in the amended budget was increased by 608 mln. Manats to 3368.2 Manats, which is equal to 4.9% of projected GDP. The budget deficit is expected to be covered mainly by foreign borrowing (951.2 mln. Manats), domestic borrowing (290 mln. Manats), treasury reserves (2121.2 mln. Manats).

From the standpoint of the economic structure of expenditures, in comparison with the approved budget for 2020, the amended budget reduced wage expenditures by 61.4 mln. Manats, and increased expenditures for the purchase of goods and services by 645.6 mln. Manats.

The increase in budget spendings has also led to an increase in the budget deficit. While the approved budget envisages a state budget deficit of 2.760 mln. Manats, the revised budget increased the deficit by 608 mln. Manats to 3.368 mln. Manats. The increase in the deficit will be covered by domestic borrowing and the free balance of the single treasury account of the state budget.
2.3. Experience and legal aspects of the suspension of fiscal rule

After the global pandemic of the Covid-19 virus was announced, the risks of growing budget liabilities and declining revenues due to the economic downturn brought up the budget changes in Azerbaijan. For the first time, the initiative to change the budget at the official level came from the Audit Chamber. In the first days of April, the head of the agency told the country's media that it is realistic to reconsider the budget, as the pandemic will not pass unnoticed and likely to reduce revenues.\footnote{https://fed.az/az/dovlet/hesablama-palatasi-budceye-ve-budce-qaydalarina-qanunlara-yeniden-baximaldir-musahibe-77512}

After that, the finance minister said at a meeting in the first half of the year that although budget revenues in the first half of the year were generated by raising forecasts, excess reserves will not be enough to close the expected imbalance between spending and income by the end of the year. For this reason, it was suggested that the 2020 state budget should be revised and adjusted in order to optimize the priority and targeting the state and consolidated budget costs, to finance new needs in accordance with the current situation, to ensure the balance between the state budget revenues and expenditures. In response to this proposal, the President recommended that the government prepares necessary proposals.

Articles 18.4, 18.5, 18.6 and 19.4 of the Law on Budget System provide a number of circumstances for the autonomous replacement of the executive body authorized by the state budget. Those cases are among those indicated below:

- Within the limits of the approved budget allocations, it is changed by the relevant executive authority in the sections of the functional classification, among the sections, sub-sections, paragraphs, items and subtotals of economic classification;

- When revenue and deficit financing are less than the approved amount, the cost of functional and economic classification (excluding protected items of expenditure) shall be reduced proportionally and the cost of administrative classification shall be reduced in the manner determined by the relevant authority;

- The amount of funds provided in the budget for the regulation of local revenues and expenditures can be increased up to 20 percent or reduced to additional revenues relative to the forecast of local revenues;

- In the process of budget execution, the savings obtained in the reporting year on lump sum funds provided for in the relevant section, subsection, paragraph, article and sub-items of the economic classification are sent to the state budget reserve fund and spent in other areas.
If, the executive body is unable to ensure balance in the budget in accordance with these provisions, then the law on the state budget is to be revised in accordance with Article 23 of the mentioned Law. The budget must be revised and amended by the Milli Majlis no earlier than May 15 and no later than October 15.

However, some excessive increases in expenditures due to the budget changes are forcing the suspension of the "fiscal rule". According to Article 11-1.2 of the Law on the Budget System, the consolidated budget costs should not exceed 103% of the previous year's budget costs, taking into account the projected inflation rate. The upper limit of the consolidated budget costs for 2020 was approved in the amount of 29.488 mln. Manats with a conditional protection of 103% with a projected inflation rate of 4.6%. Budget legislation gives the “green light” to suspend the application of the necessary fiscal rules.

So, according to Article 11-1.6 of the Law on the Budget System, in the event of suspension of the application of budget rule, if the consolidated budget costs exceed upper level of the consolidated budget expenses, proposals to set these expenditures in the upper limit calculated according to the budget rules in the medium term are included in the budget package of the next year. Article 23 of the law also defines specific cases of suspension of the budget rule. These cases include:

- if the actual incomes of state budget and financing of its deficit are 10 percent less than the approved rates of the current year's quarterly indicators;
- or if these incomes are less than 5 percent of the approved quarterly rates, with the exception of transfers from the State Oil Fund to the state budget;
- if there is a threat of an imbalance between the incomes and costs of the state budget and these cases cannot be eliminated by introducing amendments provided for in Articles 18.4, 18.5, 18.6 and 19.6 of this Law;
- the authorized body must apply to the Milli Majlis no later than October 25 with a legislative initiative to revise the state budget for the current year, apply sequestration and (or) suspend the application of the budget rule in order to ensure the missing part of the approved state budget costs.

As can be seen from the latter provision, there is a legitimate opportunity to optimize State Oil Fund transfers by suspending the application of the fiscal rule in the event of an increase in spending in exchange for a decrease in revenue.

However, in this case, there is a risk of suspension of the budget rule. Nevertheless, the fiscal rule requires a fairly strict approach and discipline. The use of the practice of the legislature to suspend the application of these rules without the direct involvement of the government in the face of any challenge diminishes the importance of this rule as an important institution.

http://www.e-qanun.az/framework/1126
3. Analysis of the impact on the activities of the State Oil Fund of Azerbaijan

Countries with sovereign wealth funds differ from others in the context of measuring the socio-economic impact of Covid-19, maintaining and restoring the relative stability of the economy. First of all, the presence of an "airbag" is of great psychological importance here. Since the scale and duration of the current pandemic are difficult to predict, unlike a normal cyclical downturns, governments are often on hold and cautious to be prepared for the worst-case scenario. From this standpoint, the existence of the Fund is in itself such a serious confidence factor for the weakest economies, a great advantage to ensuring liquidity.

On the other hand, natural resource funds play a role of depreciation during the crisis, and can insure the state budget, at least in part, by taking on the negative effects. And finally, in the worst-case scenario, the Fund could be a special stimulus tool for the government to overcome the crisis.

The State Oil Fund of Azerbaijan has all these capabilities and that's why the expectations from the Fund are high. At the same time, it should be taken into account that the Azerbaijani economy, based on the model of state capitalism, does not have a strong and sustainable private sector, so the government indirectly implements fundamental macroeconomic balance and regulation through the State Oil Fund. So the Fund carries the investment burden of the economy, it does not allow excessive growth of foreign borrowing and consequently plays the role of an exceptional instrument of intervention in the hands of the state in maintaining the exchange rate of the national currency.

All this gives the ground to say that the State Oil Fund is not an ordinary welfare fund in Azerbaijan, but a basic pillar of economic regulation of the state.

3.1. Synopsis

The State Oil Fund is a sovereign welfare fund established in 1999 to effectively manage Azerbaijan's oil and gas revenues. From the sale of oil and gas resources in 2001-2019, the Fund received a total of about $160 billion, of which $119 billion have been spent. More than $100 billion of the expenditures are transfers to the budget. The Fund currently has $43 billion in assets. By the end of 2019, the Fund's assets amounted to 90.2% of GDP.


The Fund manages its assets on the world market in accordance with the Charter and the Rules, and for this purpose invests in securities, as well as property and gold.

Strategic projects are annually financed from the approved budget of the Fund. However, since 2019 the Fund has minimized its activities in this direction, financing only its traditional activities to improve the socio-economic conditions of IDPs.

At the same time, in accordance with the current practice, since 2003 the Fund has been annually carrying out the bulk of its expenses, transferring them to the state budget.

3.2. Estimated losses of the Oil Fund

The total revenues of the ratified budget of the State Oil Fund for 2020 were approved at 12384088.2 thousand Manats ($7284.8 million) and expenditures at 11589910.3 thousand Manats. State’s share of profit oil (net incomes from the sale of hydrocarbons) made 85.3% of revenues, and transfers to the state budget made 98% of expenditures. For 2020, the oil price was calculated at $ 55, both in the state budget and in the budget of the Oil Fund. However, changes in the budget in early August this year set the oil price at $35 in the state budget and the Fund. As a result of the changes, the Fund's revenues are set at 5041.5 mln. Manats (40.7%) or 7342.6 mln. Manats compared to the approved forecast, and expenses are increased by 850 mln. Manats (7.4%) and amounted to 12.410 mln. Manats, respectively.45

The largest reduction in the revenue structure fell on the sale of oil and gas - 39%! In the new budget, this main source of income has been reduced from 10.6 billion Manats to 6.5 billion Manats.

Thus, against the background of an increase in the fund's expenses, its new budget deficit is 5 billion Manats, which is 68.5% of revenues. The Oil Fund now and even in the post-pandemic period is being hit by a triple blow. On the one hand, a steep plunge in oil prices leads to a decrease in expected revenues. On the other hand, it is necessary to use more resources of the Fund to compensate the deficit of public finances. And finally, in order to maintain the rate of Manat, more dollars must be put up for sale. Here, despite the decline in economic activity, the panic plays an important role.

To estimate the expected losses of the State Oil Fund for 2020 and beyond, it is necessary to consider the following three elements: 1) how would the oil prices behave in the world market and in what range? 2) what will be the total damage caused by the pandemic to the country's economy and when will the government suspend the quarantine measures and return the country to normal socio-economic life? 3) finally, depending on element 1 and 2, will the government be


forced to use the Oil Fund's additional resources in the event of an emergency and will it change the legislation and existing practice?

The behavior of oil prices now depends on several factors. Prices, which have plummeted since February this year, are gradually recovering since June and are currently hovering around $40, contrary to most experts' forecasts. Undoubtedly, the situation is unstable, it can change at any moment, and against the background of a possible second wave of a pandemic, the change may be more downward. The average oil price for 2020 is predicted to be around $37.47

At the same time, it should be taken into account that the country's crude oil production is lower than that in the past, as Azerbaijan joined the production quota by the decision of OPEC+. Thus, in May 2020, production decreased by 18% compared to April and amounted to 557.2 thousand barrels per day. However, in April this figure was 679.8 thousand barrels per day.48

In order to correctly assess the impact of the pandemic and the sharp drop in oil prices on the Oil Fund, the pre-crisis situation in the Fund is of great importance. At the beginning of the year, the State Oil Fund showed good results. Thus, in 2019 the Fund's budget revenues amounted to 19030.6 million Manats, and budget expenditures – 11.588.6 million Manats. During 2019, the Fund's revenues from the implementation of oil and gas agreements amounted to 15404.7 Manats, including 14614.7 million Manats from the sale of profitable oil and gas, bonus payments of 766.4 million Manats, payments for cultivated areas of 4.7 million Manats, and revenues from transit of 18.9 million Manats. Income from the Fund's asset management last year amounted to 3625.9 million Manats, which is 19.1% of total income49.

At the same time, it should be taken into account that, leaving behind the peak period, the Azeri-Chirag-Gunesli (ACG) project is experiencing a steady decline in production from year to year. Thus, if in 2018 the volume of profit oil received by the Fund at ACG was 213.51 mln. barrels, in 2019 this figure was projected at 195 mln. barrels50, and in 2020 at 186.7 mln. barrels.51

“Revenues from oil and gas agreements in January-June 2020 amounted to 4914.7 mln. Manats. Profit from the sale of oil and gas in the structure of these revenues amounted to 4130.1 mln. Manats. The average net profit from the sale of crude oil for these months was $38.7”. In the first half of 2020, the Fund's costs amounted to 5.8 mln. Manats against 4.9 billion Manats.

50 https://azertag.az/xeber/Oten_il_Azeri_CHiraq_Guneslide_hasilat_195_milyon_barrelden_chox_chox_1406435
51 http://sai.gov.az/upload/files/Rey_ARDNS%202020.pdf
As costs exceed the revenues, assets have declined. On the other hand, the Fund sold $4 billion (6.8 billion Manats) in the domestic market in six months. If $2.9 bln. of this amount was Fund’s income, it turns out that $1.1 bln. came from foreign assets.\footnote{https://www.oilfund.az/report-and-statistics/get-download-file/6_2020_2.pdf}

Profits from individual projects for this year are reflected in the review of the Audit Chamber on oil revenues. So that the projected profit oil price for 2020 from ACG, which has the largest source of income, should have been $5.382 billion\footnote{http://sai.gov.az/upload/files/Rey_ARDNF_%202020.pdf}. The fund earned only $115 mln. in May, compared to an average of about $450 mln. a month. This means a reduction of more than \textbf{5.5} times.

In May of the current year, the profit from ACG, the main source of income of the Oil Fund, decreased 5.5 times compared to March of this year and amounted to only $115 mln.\footnote{https://www.turan.az/ext/news/2020/6/subsc/energy%20news/ru/124599.htm}

Of course, it would be wrong to project these losses for the entire year. However, if the current situation continues and the average market price of oil on the world market is expected to be around $37 by the end of the year, the amount of loss by the Oil Fund from oil prices alone may reach more than 3.5-4 billion Manats or $2 billion at best. This means a decrease of about 35% for the year compared to the forecast.

The forecast for oil prices in the world market for 2020 and 2021 varies greatly. So, S&P Global Ratings predicts that in 2021 the price of Brent crude oil will rise to more than $50. Other experts are more careful. According to the US Energy Information Administration (EIA), the world oil price will hit $45 at best.\footnote{https://www.eia.gov/outlooks/steo/report/prices.php}

Forecasts for the rate of GDP decline in 2020 through post-Soviet countries are also different. S&P Global Ratings estimates the largest decline in Azerbaijan - 6.6%. The World Bank estimates the lowest decline in the region in Azerbaijan - 2.6%.\footnote{https://www.worldbank.org/en/publication/global-economic-prospects}

All this is a manifestation of the singularity and uncertainty of the pandemic crisis.

Another problem related to forecasting oil revenues in Azerbaijan and managing the risks in this area is that revenues come mainly from one project. Thus, in 2019, \textbf{92.1}% of the Fund's revenues fall to ACG. However, the Fund received revenues from 11 other projects besides ACG.\footnote{https://www.oilfund.az/report-and-statistics/get-download-file/7_2019_tam.pdf} The small share of other projects in the Fund's revenues, the unrealistic development of new projects during the pandemic means that the Fund can not rely on the growth of revenues from other projects. Dependence on a large project increases the volatility of revenues.
It should be noted that the structure of the Fund's revenues includes annual bonuses totaling **3.6 bln. dollars** and calculated for **8 years** (450 million dollars annually) under the updated ACG project in 2017, which in a sense contributes to the guaranteed incomes of the Fund.

Thus, Covid-19 complicates further diversification of the Fund's profitability. The proposed new agreements are unlikely to be signed under such conditions, investors would avoid uncertainty and delay implementation for several years, as most of oil countries do\(^58\).

**3.3. Asset management**

The structure of the Fund's investment portfolio for 6 months of 2020 was as follows. Bonds and money market instruments - 66.8%, shares - 13.7%, real estate - 5.9%, gold - 13.6%.\(^59\)

Interestingly, but in the first quarter of this year, i.e., at the beginning of the pandemic, the Fund's portfolio was different: bonds and money market instruments - 68.7%, equities - 12.4%, real estate - 6.1%, gold - 12.8%.\(^60\)

As can be seen, in the second quarter, the Fund preferred to invest more in equities, as well as gold, and instead reduced investment in real estate and bonds.

The performance for the first six months of 2020, primarily suggest that the negative impact of the pandemic on the Fund's profitability was not as strong as expected. There was no steep decline in revenues as oil prices fell sharply in a short period of time. As for the structure of assets, according to the Fund's management, the Fund prefers a conservative approach to the risk-profit dilemma right now. However, an increase in the share of equities in the portfolio instead of bonds suggests otherwise. But in the near future, as noted by the Fund's management, preference will be given to government bonds that promise high quality, reliable and stable income. The increase in the share of gold is understandable. Against the background of increasing volatility in the world market over the past 3-4 months, the price of gold demonstrates a stable positive dynamics.

It worth to remind that after the amendments to the “Rules on storage, placement and management of foreign exchange assets of the State Oil Fund of the Republic of Azerbaijan” by the Decree of the President of the Azerbaijan Republic No. 519 dated October 27, 2011, 10% of the total investment portfolio can be invested in gold and real estate, respectively.

It should be noted that as of January 1, 2020, the Fund's assets increased by 12.48% compared to the same period in 2019 (38,515 million dollars) and amounted to 43.323 million dollars. The increase in assets in 2019 was due to SOFAZ budget revenues, including revenues from the asset management. During the relevant period, the highest return was observed on the stock sub-


\(^59\) [https://oilfund.az/storage/uploads/wwfnsts4ng.pdf](https://oilfund.az/storage/uploads/wwfnsts4ng.pdf)

\(^60\) [https://oilfund.az/storage/uploads/q06f4gkbi2.pdf](https://oilfund.az/storage/uploads/q06f4gkbi2.pdf)
portfolio and a positive return was recorded for each component of the investment portfolio. Thus, despite the negative return on the stock sub-portfolio last year (-6.6%), the corresponding figure for 2019 was 21.5% (including private shares)\textsuperscript{61}.

It should be noted that in 2020, revenues from the management of the State Oil Fund's assets are projected at 1.45%\textsuperscript{62}, which is significantly lower than in 2019 (5.29%).\textsuperscript{63}

According to the Fund's management, given the current situation on the world market, the Fund does not make any new investments in any of the shares listed on the stock exchange, as in previous years, and tries not to incur large losses by choosing a conservative position. Instead, it intends to increase investment in secured bonds. ("Trend" Agency)

So, the behavior of the Fund's management is aimed at protecting the Fund's assets with minimal profitability, without resorting to any risky investments until stability in the world market in the near future is maintained.

The Fund's six-month report confirms this trend in some ways, and the Fund is still able to maintain its assets in this regard\textsuperscript{64}. Thus, at the beginning of 2020, assets equal to 43.233 mln. Manats fell to 41.349 mln. Manats at the end of the first quarter of the year, but the 6-month volume was 43.223 mln. Manats\textsuperscript{65}.

Undoubtedly, the above-mentioned effects are still of an initial nature. Thus, the increase in the scale and duration of the pandemic will further increase the adverse effects.

Pandemiyânın qlobal sırayıdə turizm və nəqliyyat sektorundan sonra ön çox neqaтив təsirləri əmlak bazarına olundan, Fonدد bu vəhəddə yatırımları da itki şərq müşaappid olunacaq.

First of all, the negative impact of the pandemic on the stock market can effectively reduce the Fund's earnings per share in the past year. This will also happen due to the depreciation of assets. The heavier result will be reflected on investments in the real estate market. Since the real estate market is the most affected by the pandemic after the global tourism and transport sector, the Fund's investments in this area will also be accompanied by losses. It should be noted that the property owned by the Fund in Paris, London, Milan, Seoul, Tokyo and Moscow brought their dividends mainly functioning as office buildings. We remind that at the end of 2019, the share of real estate in the Fund's portfolio was 5.8\%, at the end of 3 months of this year - 6.1\%, and at the end of 6 months - 5.9\%. Of course these minor changes are not associated with the volatility of real estate investments, but with changes in the value of these assets in the new valuation and an increase or decrease in the share of other instruments. The incomes from the real estate are

\textsuperscript{61} http://sai.gov.az/upload/files/HP_DNF_REY_yekun.pdf
\textsuperscript{62} http://sai.gov.az/upload/files/Rey_ARDNF_%20202020.pdf
\textsuperscript{64} https://www.oilfund.az/report-and-statistics/get-download-file/6_2020_2.pdf
\textsuperscript{65} https://oilfund.az/storage/uploads/wwfnsts4ng.pdf
normally symbolic, and in this case the Fund makes these investments in order to insure part of its assets in the medium and long term. A sharp plunge in demand for office space during and after the pandemic, in exchange for companies choosing to operate online would devalue those assets.

The Fund's investment in gold can be considered relatively successful compared to other instruments. At the end of 2019, 11.4% of the Fund's assets were invested in gold, at the end of 3 months of 2020 this figure came up to 12.8%, and at the end of 6 months it was 13.6%. 66

Note that since the beginning of the year, gold has risen from $1.517 to $1.881 (July 23) (more than 21%). 67

With regard to government bonds, which are the main investment tool of the Oil Fund, no such drastic change is expected here, although developed countries (the Fund has invested in government bonds of those countries) are trying to minimize the price of government bonds to compensate for the losses in the current situation.

Hence, the new situation will force the Fund to review its investment portfolio and make some changes in its structure.

The share of the State Oil Fund long-term assets in total assets fell to its lowest level in six years - 4.97%. This means that the Fund can convert 95% of its assets into liquid assets within a year. Long-term assets, which last time had the lowest share (3.3%) in 2012, even rose to 15.2% in 2016.

In subsequent periods, it has been declining. The increase in the share of short-term assets last year was due to the growth of gold bullion and securities. On the other hand, “The Fund's investment policy has several important mechanisms to reduce the risks mentioned above. Thus, up to 70% of the Fund's investment portfolio consists of highly liquid investments, including debt obligations and money market instruments. In addition, more than 80% of the investment portfolio consists of fixed-yield securities and gold, which are characterized by high liquidity and less price volatility, which are generally considered more reliable instruments in times of market volatility and uncertainty.” 68

The modification in the structure of the investment portfolio in the second quarter of the year suggests that, in contrast to previous practice, the decision-making mechanism in the management of the Fund has become more flexible, and this is a good thing.

It is very likely that the Fund will not make new investments in this area, in the medium and long term, but will instead prefer to invest in gold and the stock market.

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67 https://tradingeconomics.com/commodity/gold
The Fund's revenue from asset management will fall sharply compared to last year and is expected to be around 0% at best by the end of the year.

Generally, by the end of the year, the Fund's assets are expected to fall by 5-8%, which will be mainly due to lower oil prices than calculated in the budget, as well as the devaluation of shares and property.

In this regard, the Fitch rating agency stands on a tougher position. According to the agency, Azerbaijan's foreign assets (Oil Fund and Central Bank) will be reduced to 38.8 billion dollars by the end of 2020. At the end of 2019, this figure was 49.5 billion dollars, and in the first half of 2020 – 49.7 billion dollars. The Oil Fund's assets must be reduced by at least 7-8 billion dollars for our foreign reserves to fall down to $38.3 billion dollars.69

3.4. Transfers to the state budget

The practice of transferring from the State Oil Fund to the budget dates back to 2003. The Oil Fund, which was established in late 1999 and has been operating since 2001-2002, had no direct relationship with the state budget during that period. The beginning of transfers to the budget is explained by the steep increase in oil revenues and the government's preference for spending in the domestic market, as well as large-scale public investment along with consumption. The highest share of the Fund in the state budget through transfers was in 2013 – 58.2%. The amount of the transfer planned for 2020 was 11350 million Manats. After the amendments to the budget, this amount increased by 850 mln. Manats to 12.200 million Manats, which is 98.3% of the total costs of SOFAZ.

During the first six months of this year, the Fund transferred 5675.0 million Manats to the budget, which is half of the plan. The amount of transfers varied from month to month, and the Fund was forced to make higher-than-average transfers during periods of turmoil to maintain the stability of the manat.

At present, any possible changes related to the transfer of the Fund to the state budget depend on the fiscal situation of the country as a whole and the government's response to the pandemic. The behavior observed so far suggests that the government prefers not to overspend as much as possible, saving as much as possible on the planned expenditure of the pandemic. With this approach, the subsequent course of events may be not aligned. Thus, the prolongation of the quarantine period and the decline in economic activity may force the government to change this behavior at the last moment.

3.5. Currency sales of the Fund

The practice of large-scale transfers to the state budget of the Fund performs simultaneously at least two macroeconomic functions.

1. By covering about half of budget costs, the transfer effectively mitigates the volatility of oil prices for the budget, ensuring actual fiscal stability by taking on negative shocks;

2. By offering a stable currency to the market, it balances the surplus demand that arises from time to time during the year with the relevant supply, thereby preventing a soft devaluation of the Manat.

These seemingly positive features actually carry very serious long-term negative risks. This opportunity of the Oil Fund correctly assesses the macroeconomic risks and, instead of taking appropriate countermeasures, spurs the government to take administrative steps to further distance the economy from market principles. In both the fiscal and monetary spheres, the balance of supply and demand, which is considered the superpower of the market economy, is realized by the state itself, not between the state and market "players". If the sole currency seller in the market is the Oil Fund, it is very convenient to manage the macroeconomic balance through administrative ways. On the one hand, the Fund ensures the sale of currency, on the other, the Central Bank selectively regulates and controls the demand of commercial banks participating in the auction. There is no doubt that such management of the Manat exchange rate minimizes exchange rate risks in the short term, making it much easier to manage. But this practice is very different from the usual intervention, because all the levers to control the exchange rate are concentrated in the hands of the government. So, if market signals are not taken into account gradually, the economy will look in a distorted mirror, and the longer this practice lasts, the more difficult the transition to effective macroeconomic regulation will be. Unfortunately, the previously adopted fiscal rule does not break this circle.

The amount of the Fund's currency sold at the auction for the first 6 months of 2020:

<table>
<thead>
<tr>
<th>Months</th>
<th>Monthly currency sales/ million US dollars</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2017</td>
</tr>
<tr>
<td>January</td>
<td>285</td>
</tr>
<tr>
<td>February</td>
<td>258.4</td>
</tr>
<tr>
<td>March</td>
<td>250</td>
</tr>
<tr>
<td>April</td>
<td>220.8</td>
</tr>
<tr>
<td>May</td>
<td>300.3</td>
</tr>
<tr>
<td>June</td>
<td>373.2</td>
</tr>
</tbody>
</table>
As you can see, the biggest monthly load falls on March, which is actually the beginning of a pandemic in the country.

According to “Fitch” agency, the Fund's recent sale of currency at the auction is disproportionate to its annual plan. In general, out of the 6.7 billion dollars planned for 2020, there was sold 4.1 billion dollars and transferred to the state budget in Manats. And 2.5 billion of this amount was sold in March-April. There is a great risk that this pace will continue until the end of this year, and thus the Fund will sell more currency and transfer to the budget than was planned in the annual forecast 70.

Practice shows that the demand for currency seriously increases during periods of shocks that usually take place in the market for one reason or another. The Fund addresses this problem by increasing the amount of currency to be auctioned during this period. The peculiarity of the pandemic is that, unlike other crises, both demand and supply are declining, as is the case throughout the world. The demand for foreign exchange is also declining as the restrictive measures minimize economic activity, especially that of the services. However, the sharp plunge in oil prices raised fears among market participants of a possible devaluation, which increased the demand for foreign currency. The government, which has not yet fully recovered from the negative effects of the 2015 double devaluation, is still abandoning a new devaluation. It is clear that if the government ignores the gradual devaluation, it will soon have to make a decision to devalue the Manat. This will depend on the level of oil prices during the year, the balance of payments and the socio-economic situation.

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70 https://www.fitchratings.com/research/sovereigns/fitch-affirms-azerbaijan-at-bb-outlook-negative-17-07-2020

<table>
<thead>
<tr>
<th>Month</th>
<th>Manats</th>
<th>Dollars</th>
<th>Euros</th>
<th>Yen</th>
</tr>
</thead>
<tbody>
<tr>
<td>Jule</td>
<td>253.2</td>
<td>536.6</td>
<td>434.9</td>
<td></td>
</tr>
<tr>
<td>August</td>
<td>292.6</td>
<td>733.7</td>
<td>815.4</td>
<td></td>
</tr>
<tr>
<td>September</td>
<td>252.2</td>
<td>394.8</td>
<td>618.95</td>
<td></td>
</tr>
<tr>
<td>October</td>
<td>318.7</td>
<td>489.6</td>
<td>654.85</td>
<td></td>
</tr>
<tr>
<td>November</td>
<td>208.9</td>
<td>654.1</td>
<td>539.81</td>
<td></td>
</tr>
<tr>
<td>December</td>
<td>584.8</td>
<td>677.1</td>
<td>886.35</td>
<td></td>
</tr>
<tr>
<td>TOTAL</td>
<td>3598.1</td>
<td>6460.4</td>
<td>6593.86</td>
<td>4010.2</td>
</tr>
</tbody>
</table>

Source: Monthly Currency Sales Data of the State Oil Fund
3.6. Strategic projects directly funded by the Fund

From 2019, the Oil Fund will not directly finance any other projects, except for the resettlement of IDPs. Funding for any project in 2020 is not reflected in the Fund's budget. It should be noted that the Fund has allocated a total of 20 billion Dollars for projects funded since 2002. Most likely, the Fund will not allocate funds for direct financing of such strategic projects in the near future. Exceptionally, if necessary, the financing of SOCAR's and the state's share in oil and gas sector development projects may be considered. As for the costs of socio-economic development of IDPs, the Fund will continue to develop as its main mission.

The suspension of the Fund's direct funding of strategic projects may be due to several reasons. The main reasons are the slowdown in the growth of oil revenues since 2015, the prevention of a steep decline in the Fund's assets and the preservation of a certain amount of funds for future generations (about 90% of GDP).

3.7. Expected changes in the Fund's regulations and rules, or contribution to the stimulation of the economy

In the 20 years since its establishment, there several significant changes have taken place in the regulation of the Foundation's activities.

These are:

2001 - Rules on storage, placement and management of foreign currency funds were approved;

2003 - The first transfer to the state budget was made;

2011- Was signed the Decree № 519 on amendments to the “Rules on storage, placement and management of foreign exchange assets of the State Oil Fund of the Azerbaijan Republic”. This marked the beginning of the placement of assets in stocks, gold, real estate and other, softer currencies.

Apparently, the government is conservative in its approach to changing the Fund's activities and investment policy.

Most likely, the Fund will continue this approach during the pandemic, and no changes are expected in its activities and management in the near future.

3.8. Fund's accountability and transparency policy and prospects during the pandemic

The Government of Azerbaijan, which joined the EITI in 2003, was one of the first countries to prepare semi-annual and annual reports since 2004, became a full member for the first time in EITI history, and in 2017 was forced to abandon this initiative.

After leaving the EITI, there was established Extractive Industries Transparency Commission by the Decree of the President of the Azerbaijan Republic on 5 April 2017 and chaired by the Executive Director of the State Oil Fund of Azerbaijan (SOFAZ) (Chairman of the Government
Commission and Multi-Stakeholder Group during EITI membership). The commission also included officials from 5 relevant government agencies at the level of deputy ministers\(^71\).

There were prepared three reports by Azerbaijan after it left EITI. The pandemic has not yet begun, and changes in the Foundation's leadership at the end of last year, as well as the resignation of some members of the Commission, have delayed the preparation of transparency reports.

By the Presidential Decree of July 28, 2020 on measures to implement transparency in the extractive industry, the State Statistics Committee was entrusted with ensuring accountability for EIT\(^72\).

The government attributes this change to the fact that EIT has entered a phase of new systematic information openness (EITI mainstreaming) globally. At this stage, accountability will continue with the systematic updating of online data on one portal, which is supposed to be mainly technical.

For more than 17 years, the government of Azerbaijan has been implementing transparency in the extractive industry through the Oil Fund, which was in a sense symbolic. The Fund, in turn, was the most worthy organization in comparison with other relevant institutions. The Oil Fund, which has prioritized transparency as a new institution since its inception, has also established a tradition. As the only government agency, it was perhaps the only one operating in a dialogue with the public. The big question is whether the Statistics Committee will be able to continue this mission at the same pace.

Setting priorities correctly in times of crisis is more important than during the normal times. Globally, this is one of the most frequently discussed issues lately, as transparency and accountability have become more important for the country's public during the pandemic. As mentioned above, the Oil Fund has been a model for government agencies operating in this direction since the very beginning. The Foundation's extensive and accessible information policy on its activities, as well as its multi-stakeholder decision-making practice with civil society organizations, is one of the limited successes of the recent past in this area. The threat of a gradual dissolution of this tradition should be of a primary concern to the government itself.

As for the public oversight over the Fund's activities, this issue turns even more relevant during the pandemic. The need for public representation on the Fund's supervisory board has always been a major challenge for civil society. Taking real steps in this direction now, ensuring the representation of the public on the Oil Fund's supervisory board, would serve to increase the credibility of the Fund's management, as well as the socio-economic reforms initiated by the government several years ago.

\(^71\) [http://az.president.az/articles/23288](http://az.president.az/articles/23288)

\(^72\) [https://president.az/articles/40124](https://president.az/articles/40124)
4. Impacts on the activity of the State Oil Company of Azerbaijan

One of the effects of the COVID-19 pandemic on the world economy was the sharp plunge in oil prices. The steep decline in oil demand against the background of downturned economic activity led to a sharp plummet in revenues of transnational and national oil companies. The fall in oil prices on world markets has put both the oil-dependent economy of Azerbaijan and the State Oil Company of the Azerbaijan Republic (SOCAR), which represents the country's oil sector, in a difficult position. For SOCAR, whose revenues are formed mainly from the sale of crude oil, the fall in oil prices has led to a sharp decline in its revenues.

SOCAR is the largest company and taxpayer in Azerbaijan. By the end of 2018, the number of its employees reached 511,125 people\textsuperscript{73}. Last year, the company paid a total of 1,448,571.3 Manats to the state budget and 173,641 Manats to the State Social Protection Fund\textsuperscript{74}. The share of SOCAR's tax payments in total tax revenues is 18.9 \%.\textsuperscript{75} In 2019, SOCAR accounted for 76.4\% of taxes and other mandatory payments received by state-owned taxpayers.

State participation in the oil and gas industry of Azerbaijan is carried out through SOCAR. SOCAR is the vertically integrated national oil and gas company of Azerbaijan, mainly engaged in production, transportation and processing in the territory of the Azerbaijan Republic. The state owns 100\% of SOCAR shares.

SOCAR also has a stake in ACG and Shah Deniz PSAs, as well as in a number of international pipelines, including the BTC pipeline which is the main oil export route for the oil produced at the Azeri-Chirag-Guneshli (ACG) fields, and SCP pipeline which is the main export route for the oil produced in ACG and Shah Deniz fields.

SOCAR's petroleum products are mainly focused on the domestic market. In 2009, it exported 43.4\% of petroleum products, and in 2018 the share of exports fell to 18\%. In 2019, the volume of assets amounted to 65.4 billion Manats, and total revenues amounted to 83.8 billion Manats. 61\% of revenue came from the sale of crude oil, 26.5\% of petroleum products, 4.7\% of petrochemicals and 4.9\% of natural gas. The company received most of its income from operations in Switzerland. In 2019, through SOCAR Trading and SOCAR Energy Switzerland, the company earned 63.7 billion Manats, which is 76\% of the consolidated revenue for that year. Only 7.3\% of total income is generated in Azerbaijan\textsuperscript{76}.

\textsuperscript{73} Annual Report on Sustainable Development, 2018

\textsuperscript{74} http://www.socar.az/socar/az/news-and-media/news-archives/news-archives/2020/02


\textsuperscript{76} SOCAR’s financial report for 2019. - http://www.socar.az/socar/assets/documents/az/socar-financial-reports/Maliyy%C9%99%20hesabatlar%C4%B1%202019.pdf
On average, SOCAR accounts for 18-20% of oil production and 19-24% of gas production in Azerbaijan. However, in recent years, SOCAR's share in oil production has increased, while gas production has decreased. This is due to a decrease in oil production in the country and a significant increase in gas production.

At the end of 2019, SOCAR's debt amounted to 11.4 billion Dollars. Borrowing will continue in 2020. In January-May 2020, SOCAR attracted new long-term and short-term loans totaling 1 billion 71 million Manats from several local and international banks and repaid 1 billion 82 million Manats.

4.1. SOCAR's activity during the pandemic

Presidential Decree of April 22, 2020 approved the Sustainable Business Development Program in the fight against the coronavirus pandemic (COVID-19) in order to minimize the impact of the pandemic on SOCAR's activities. The purpose of the program is to prevent the spread of the COVID-19 among SOCAR employees and to adapt their working conditions. The program focuses on the protection of workers' health, compliance with hygienic rules and regular testing of COVID-19.

SOCAR and its structures at various times transferred funds to the Coronavirus Fighting Support Fund, established by the presidential Decree of March 19, 2020. They transferred funds in the amount of 50% of the monthly salary of strategic managers of the “Azerigaz” Production Association, which is part of SOCAR (total 180636 Manats). In addition, “Azerigas Project Construction” CJSC transferred 10,000 Manats, “Tamiz Gaz” CJSC – 10,000 Manats, “SOCAR Petroleum” CJSC – 250,000 Manats and SOCAR AQS - 1.5 million Manats.

SOCAR's subsidiary “SOCAR Polymer Investment” LLC issued bonds worth 200 million Dollars for the domestic market on July 9, where only the banks participated in placement of the

77 Regulation of SOCAR's financial relations with the state and its agencies. Baku, 2020, Khazar Knowledge Hub
78 http://www.socar.az/1/Maliyy%C9%99%20hesabatlar%C4%B1%202019.pdf
81 https://report.az/energetika/azeriqaz-dan-koronavirusla-mubarizeye-20-min-manat/
bonds. Under the terms of the issue, “SOCAR Polymer” OJSC bonds were issued in dollars for a period of 5 years with an annual yield of 5%. Interest on the bonds will be paid quarterly. «PAŞA Bank» acted as a consultant for the sale of “SOCAR Polymer” bonds. In total, the bonds were sold to 8 banks. These are the International Bank of Azerbaijan, Xalq Bank, Bank of Baku, Bank Respublika, Kapital Bank, Rabita Bank, Ziraat Bank and PAŞA Bank. So far, only the International Bank has announced the amount of bonds received - 65 million Dollars. “SOCAR Polymer” will repay part of the loan received from “Gazprombank” at the expense of proceeds from the sale of bond.

On January 21, 2020, SOCAR acquired a 16.3% stake in SOCAR Energy Georgia with a payment of 65 million Manats ($ 38 million). As a result, the Group's controlling stake in SOCAR Energy Georgia went up from 75.5% to 91.8%.

Despite the plummeting oil prices on world markets, SOCAR's international credit rating has not deteriorated significantly. Only Fitch Ratings agency in its statement dated April 17, 2020 downgraded the rating outlook for the state-owned company from “stable” to “negative”. Long-Term Issuer Default Rating (IDR) and unsecured rating remained unchanged at BB+. As SOCAR is a state-owned company, its rating is adjusted to the country's overall rating. The agency believes that SOCAR's Standalone Credit Profile (SCP) is rated "b +" and that lower oil prices on world markets in 2020-2021 due to the COVID-19 pandemic will limit the company's leverage reserves. Continued deterioration of the SCP may have a negative impact on SOCAR's rating. According to the agency, lowering the country's rating and reducing state support could have a negative impact on the company's rating. In its assessment on January 28, 2020, Fitch Ratings also kept the forecast “stable” by maintaining SOCAR's overall rating of BB+. At that time, the price of oil on world markets was over $60.

The last time Moody's reviewed SOCAR's rating at the beginning of the year on January 22 and kept the country's rating at Ba2. Since the pandemic did not fall during a period of negative

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84 https://fed.az/az/birja/dovlet-sirketi-sakitce-200-milyon-istiqraz-buraxdi-yalniz-banklara-satdi-84435?fbclid=IwAR0k-oGZ0yW82hZjxCsJ1dkv3ozMf80mJCbU_M0LflLTJZCqiVY4ZZzE00

85 http://www.socar.az/1/Maliyy%C9%99%20hesabatlar%C4%B1%202019.pdf


impact on global markets, the assessment did not deteriorate\textsuperscript{88}. SOCAR has not used the services of “Standard and Poor's” Rating Agency since 2017.

4.2. State support to reduce the impact of the pandemic on SOCAR's activities

In order to minimize the damage caused by the pandemic to the country's economy, the President of the country has issued a Decree “On a number of measures to reduce the negative impact of the coronavirus (COVID-19) pandemic and, as a result, sharp fluctuations in global energy and stock markets over the economy, macroeconomic stability, employment and entrepreneurship in Azerbaijan Republic” on March 19, 2020\textsuperscript{89}.

Although the order provides for the allocation of 1 billion Manats from the state budget to the Cabinet of Ministers in 2020, these funds apply to legal entities operating in the private sector and individuals engaged in entrepreneurial activities without creating a legal entity. At the first stage of the pandemic, state-owned companies, including SOCAR, did not receive significant financial support from the state. However, in the second half of the year, the government took certain steps to reduce the damage to SOCAR in an amendment to the 2020 state budget. According to the new amendment\textsuperscript{90}, SOCAR's tax liabilities to the state budget for 2020 were reduced by 14.5% or 210 million Manats to 1.240 million Manats.

In the explanation of the draft law of the Azerbaijan Republic “On amendments to the Law of the Azerbaijan Republic on the State Budget of the Azerbaijan Republic for 2020” the reduction of crude oil export prices by $20, less than the approved state budget price ($55), reduced production under the OPEC+ agreement, as well as declining domestic demand for oil products due to the coronavirus (COVID-19) pandemic are shown as the reasons for the decline.

By the corresponding resolution\textsuperscript{91} of the Cabinet of Ministers, SOCAR was included in the “List of state bodies and institutions, which executives and, if necessary, employees are engaged in work during the period of special quarantine announced on the territory of Azerbaijan Republic”. This means that the companies were allowed to work during the strict quarantine period.

It would be wrong to link solely with the pandemic the state's annual support to SOCAR for various purposes. So, in the first half of 2020, the additional paid-in authorized capital of SOCAR was increased by government in the amount of 40 million Manats, and in addition there

\textsuperscript{88} \url{https://www.moodys.com/research/Moodys-announces-completion-of-a-periodic-review-of-ratings-of--PR_414808}

\textsuperscript{89} \url{http://www.e-qanun.az/framework/44791}

\textsuperscript{90} \url{http://www.maliyye.gov.az/scripts/pdfjs/web/viewer.html?file=/uploads/news_files/5f2486962c071.pdf}

\textsuperscript{91} \url{http://www.e-qanun.az/framework/44831}
was 62 million Manats invested to the charter capital. Besides, there about 29 million Manats was allocated from the state budget of the company for gasification of a number of territorial units.

4.3. Negative impact of the pandemic on SOCAR's activities

4.3. Pandemiyanın SOCAR-ın fəaliyyətində neqativ təsiri

In accordance with the Protocol to the Agreement on the Management of Revenues from SOCAR's Shah Deniz, South Caucasus Pipeline (SCP) and Southern Gas Corridor projects signed between the Ministry of Finance, the Ministry of Economy, the State Oil Fund and SOCAR, the information on payments to SOCAR in 2020 is shown in the table below:

(per million US dollars)

<table>
<thead>
<tr>
<th>Source of payments intended for SOCAR</th>
<th>Oil price, US Dollar/barrel</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>40$</td>
</tr>
<tr>
<td>Dividends to be paid to SOCAR on Shah Deniz share</td>
<td>28.39</td>
</tr>
<tr>
<td>Dividends to be paid to SOCAR on SCP shares</td>
<td>47.30</td>
</tr>
<tr>
<td><strong>Dividends to be paid to SOCAR on Shah Deniz and SCP, total</strong></td>
<td><strong>75.69</strong></td>
</tr>
<tr>
<td><strong>Expected payments from SOCAR to SOFAZ (55%)</strong></td>
<td><strong>41.63</strong></td>
</tr>
</tbody>
</table>

**Note:** This information is a forecast and may change in the future, taking into account the actual extraction within the project.

As can be seen from the table, the amount of dividends to be paid to SOCAR on Shah Deniz and SCP varies depending on oil prices. Each increase in oil prices by $10 increases the dividends to SOCAR by 59.8 million Dollars. However, according to the Memorandum of Understanding, 55% of the dividends due to SOCAR will be paid by the company to the Oil Fund. In the end, the

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92 [http://www.socar.az/1/Maliyy%C9%99%20hesabatlar%C4%B1%202019.pdf](http://www.socar.az/1/Maliyy%C9%99%20hesabatlar%C4%B1%202019.pdf)


remaining dividend to SOCAR from the price increase is $ 26.9 million. For example, while the average price of oil in 2019 was $64.2, in the first half of 2020 it dropped down to $38. This means that SOCAR's dividends on Shah Deniz and SCP decreased by 27 million Dollars in the first half of the year compared to 2019.

Falling oil prices on world markets as a result of the pandemic has had a negative impact on SOCAR's performance, and these effects can be systematized as follows.

\[ a) \text{Optimization (reduction) of budget expenditures} \]

In order to minimize the negative impact of COVID-19 related quarantine measures on SOCAR's financial capabilities, the company focused on reducing its costs. The cost reduction policy has been implemented in the following areas.

\[ \cdot \text{Reduction of funds paid to employees.} \]

In order to ensure the reduction of salary costs, SOCAR appealed to the National Committee of the Trade Union of Oil and Gas Industry Workers of Azerbaijan (NCTUOGIWA), as authorized representatives of SOCAR employees to comment on the issue of reduction of the amount of monthly additional payments for leading, responsible employees and authorized employees by 50% effective from July 1, 2020.

The committee considered SOCAR's appeal and at a meeting on June 22 agreed to reduce the amount of additional monthly payments. In this regard, SOCAR President Rovnag Abdullayev signed on June 29, 2020, the Order No. SOCAR20100003030004002OA00109 "On revision of the amount of monthly additional payments."

Based on the SOCAR's order dated December 28, 2015 №SOCAR/15-1000/01/SM-04-000099 "On Approval and Application of Standards in the Field of Organization and Labor Rationing" "Management of Labor Categories for Remuneration" (SOCARSS-010.2015)" and Appendix 19 to the "Regulations on the remuneration of employees of the State Oil Company of the Azerbaijan Republic", the amount of monthly additional payments for professionalism and special services, as well as management, officers and regular employees is planned to be reduced by 50% effective from July 2020.

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95 Azərbaycan Respublikasının Mərkəzi Bankı, [https://uploads.cbar.az/assets/00c0a7aa778232c5d5ee04f5e.pdf](https://uploads.cbar.az/assets/00c0a7aa778232c5d5ee04f5e.pdf)

96 [https://president.az/articles/39491](https://president.az/articles/39491)
Ibrahim Akhmedov, deputy head of SOCAR's public relations and events department, confirmed the negative impact of the global pandemic on the company's revenues in response to a Modern.az poll.97

- **Reduction of employees.**

SOCAR's April 30 statement stressed that most of the workers released by SOCAR as a result of the temporary restrictions on production will be involved in the conservation of wells and maintenance of equipment. According to the company, the released employees will be entered to the Personnel Reserve Database (PRD). There will be taken measures to keep them in the list of SOCAR enterprises and organizations within the scope of labor legislation, suspend external recruitment for company vacancies and fill existing vacancies from PRD list. It is also envisaged to involve employees in training centers for retraining and acquisition of new professions.98

By SOCAR's order №SOCAR202000030300040020A002018 dated July 20, 2020 "On necessary measures to reduce the staff", the company started to reduce the Security Office.

The decision was made to close 4 posts in the 15th brigade of the Office ("Oil stones" of PA "Azneft") and 2 day posts in the 22nd brigade (OGPU named after May 28, PA "Azneft"). According to daily post standards, it has become necessary to reduce 21 staff units (4 posts) in the 15th brigade and 10 staff units in the 22nd brigade within annulled posts.

- **Restriction of procurement activities**

The “Azerigaz” Production Association, which is part of SOCAR, decided to revise contracts for the sale of goods and services in case of force majeure circumstances, the results of which were not approved, and the newly announced tenders were postponed. According to the Association, only the implementation of other sales and purchase agreements has been suspended, with the exception of the uninterrupted supply of gas, as well as the required amount of goods, works and services for the prompt implementation of emergency recovery work. This step was taken as part of cost optimization.99

Taking into account Azerbaijan's new obligations under the “OPEC+” agreement, the SOCAR Procurement Committee has prepared Protocol №15 dated April 23, 2020 against the background of certain restrictions on oil production, which will be implemented from May 2020. According to the Protocol, all procurement operations were suspended by the decision of the Procurement Commission. Tenders have been postponed indefinitely, taking into account the

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97 [https://modern.az/az/news/246442?fbclid=IwAR1vXsX9I3GFeQZWq3-4_rJeGm0q5eEe_FUxs6bzTx9_Qu5swwfYoUZOFI](https://modern.az/az/news/246442?fbclid=IwAR1vXsX9I3GFeQZWq3-4_rJeGm0q5eEe_FUxs6bzTx9_Qu5swwfYoUZOFI)


requirements of the current legislation and the company's internal regulations, including the signed procurement contracts for conducting out-of-competition procurement procedures. The decision also provides for the suspension of the execution of the concluded procurement contracts for an indefinite period by agreement of the parties.

Only in exceptional cases, the execution of procurement contracts that cannot be stopped or are inappropriate to be stopped in order to ensure the sustainability of the business, as well as signing of new contracts for urgent needs can be carried out by positive feedback and under the control of the responsible authorities (Procurement and Capital Investment Department of the Head Office) and upon agreement with relevant field vise-president.

a) Decrease in oil production
Declining demand for energy in world markets has prompted OPEC + countries to reduce production. An official statement released to the public in February this year stated that SOCAR plans to produce 7.6 million tons of oil and 7.2 billion cubic meters of gas in 2020. The company said in a statement that it plans to increase gas production this year and reduce oil production due to the condition of existing fields.

At a meeting held on April 9 in the “OPEC+” format, Azerbaijan as one of the 23 participating countries, pledged to voluntarily reduce production. The Ministry of Energy proposed to distribute quotas for a temporary reduction in production in proportion to producers in the country, and the Cabinet of Ministers instructed SOCAR to ensure the implementation of this proposal. According to the terms of the “OPEC+” agreement, daily production in Azerbaijan in May-June 2020 should not exceed 554 thousand barrels, in July-December - 587 thousand, and from January 2021 to April 2022 - 620 thousand barrels.

According to this division, SOCAR's “Azneft” Production Association reduced daily production by 17,000 barrels in May-June to 100,000 barrels. It was decided to gradually increase the total production to 5,000 barrels per day in the second half of 2020 and 6,000 barrels per day from 2021, bringing the total crude oil production to 111,000 barrels per day in 2021.

In the second quarter of 2020, 1.841 million tons of oil and 1.827 billion cubic meters of gas were produced in the fields directly operated by SOCAR. Compared to the second quarter of 2019, oil production decreased by 86.8 thousand tons, while gas production increased by 155.6 million cubic meters. In the second quarter of 2019, SOCAR produced 1.928 million tons of oil and about 1.672 billion cubic meters of gas.

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100 https://report.az/energetika/socar-bu-il-7-2-milyard-kubmetr-qaz-hasilati-planlasdirir/
The decline in oil production occurred in the second quarter, as oil production increased by 75.2 thousand tons in the first quarter. In general, in the first half of 2020, SOCAR's oil production (3.76 million tons) decreased by 11.6 thousand tons compared to the same period last year and gas production (3.64 billion cubic meters) increased by 408.7 million cubic meters.

According to the international Fitch Ratings agency, SOCAR will reduce its oil production by 11% in 2020104.

b) Postponement of repair and construction works

General Director of “STAR Refinery A.Ş.” Mesut İlter, told Anadolu Agency on March 11, 2020 that the construction of a new petrochemical complex (Mercury Project) that was planned in the frames of cooperation between SOCAR and BP in the Aliaga region of Izmir (Turkey) may start in late 2020 or early 2021105.

However, Zaur Gahramanov, CEO of SOCAR Turkey Enerji A.Ş., SOCAR's Turkish subsidiary, told Anadolu Agency on April 10 that the final investment decision on the Mercury project had been postponed to the last quarter of 2021 due to plummeting oil prices. According to the CEO, the investment plans were negatively affected by the fact that the price of a barrel of oil on world markets is in the range of $ 20-30106.

a) Modifications in production plans

In connection with the air travel ban due to the spread of the COVID-19 pandemic, SOCAR's refinery in Turkey switched from jet fuel to diesel fuel in March. Anadolu News Agency quotes Zaur Gahramanov, General Director of “SOCAR Turkey Enerji A.Ş.”'s subsidiary as saying: The consumption of diesel fuel over the past month has decreased by 15%, and if the reduction in consumption is 40%, its production will have to be reduced by 10-15%.107

In connection with the spread of the COVID-19 pandemic, SOCAR redirected the export routes of petrochemicals in Turkey from the European market to the eastern markets. If earlier

107 https://report.az/energetika/koronavirusa-gore-star-zavodunda-mehsul-istehsalinin-novu-deyisdirili/
50% of our petrochemical products were exported to European countries, including Germany, Italy and Spain, later the export route was shifted to eastern markets.108

b) Reduced investment

In January-June 2020, SOCAR drilled 40,727 meters, which is 50.3% less than in the same period of the last year. In January-June 2019, the company drilled 81,896 meters. It happened due to the decline in global demand for oil as a result of the COVID-19 pandemic and the temporary restriction of production under the “OPEC+” agreement. Production has been limited to low-yield onshore fields and the volume of drilling operations has been reduced accordingly.109

As of June 1, "SOCAR AQŞ" has completed drilling of 17 out of 40 wells in Turkey as part of the Salt Lake Underground Gas Storage Expansion Project.110

On October 17, 2019, "SOCAR AQŞ" and “China CAMC Engineering Co. Ltd - İctas Construction Industries & Trade Inc.” signed a drilling contract to expand a gas storage in the region of Duz Gol in Turkey's Aksaray province. The project was launched in 2019 and is scheduled for completion in October 2020.

Over the past seven months there have been drilled 40% of the planned wells. It is difficult to drill the remaining 23 wells within last 4 months. The total cost of the project is 103 million Dollars while the drilling of each well requires 2-2.5 million Dollars.

b) Decline of exports, including the export of non-oil goods.

SOCAR exported about 9.94 million tons of crude oil from Azerbaijan in the first six months of 2020.111 This is 0.76 million tons less than that of the same period last year. While crude oil export in the first quarter of 2020 decreased by 0.4 million tonnes in comparison with the same period in 2019, in the second quarter it increased by 0.14 million tonnes in comparison with the same period last year.

In contrast to oil, exports of gas, oil and petrochemical products have increased. According to the Center for Analysis of Economic Reforms and Communication of the Azerbaijan Republic, in


111 __ SOCAR şirkətinin rəsmi internet saytının xəbərlər bölməsi - [www.socar.az](https://www.socar.az)
January-June 2020, the export of non-oil products by SOCAR's Marketing and Economic Operations Office amounted to 71.1 million Dollars, which is 41.5 million Dollars less than in the same period last year. In January-May 2019, the company's exports stood at 112.6 million Dollars.112

112 http://www.iqtisadiislahat.org/news/ixrac_icmali_nin_iyul_sayi_teqdim_edilib-999