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IMF Country Report No. 05/19

Azerbaijan Republic: 2004 Article IV Consultation, Fourth Review Under the Poverty Reduction and Growth Facility, Requests for Waiver of Performance Criteria, Extension of Arrangement, Reduced Access and Rephasing of Disbursements—Staff Report; Staff Statement; Public Information Notice and Press Release on the Executive Board Discussion; and Statement by the Executive Director for the Azerbaijan Republic

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of a combined discussion of the 2004 Article IV consultation with the Azerbaijan Republic, fourth review under the Poverty Reduction and Growth Facility, requests for waiver of performance criteria, extension of arrangement, reduced access and rephasing of disbursements, the following documents have been released and are included in this package:

- the staff report for the combined 2004 Article IV consultation, fourth review Under the Poverty Reduction and Growth Facility, requests for waiver of performance criteria, extension of arrangement, reduced access and rephasing of disbursements, prepared by a staff team of the IMF, following discussions that ended on October 27, 2004, with the officials of the Azerbaijan Republic on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on December 9, 2004. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a staff statement of December 22, 2004 updating information on recent economic developments.

- a Public Information Notice and Press Release, summarizing the views of the Executive Board as expressed during its December 22, 2004, discussion of the staff report on issues related to the Article IV consultation and the IMF arrangement, respectively.

- a statement by the Executive Director for the Azerbaijan Republic.

The documents listed below have been or will be separately released.

Supplementary Letter of Intent sent to the IMF by the authorities of the Azerbaijan Republic*
Selected Issues Paper
Statistical Appendix
*May also be included in Staff Report

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to publicationpolicy@imf.org.

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AZERBAIJAN REPUBLIC

Staff Report for the 2004 Article IV Consultations, Fourth Review Under the Poverty Reduction and Growth Facility, Requests for Waiver of Performance Criteria, Extension of Arrangement, Reduced Access and Rephasing of Disbursements

Prepared by Middle East and Central Asia Department
(in consultation with other departments)

Approved by Lorenzo Pérez and Juha Kähkönen

December 9, 2004

- The staff discussions for the 2004 Article IV consultations and fourth review under the Poverty Reduction and Growth Facility (PRGF) were held in Baku during October 13–27, 2004.
- The team consisted of Messrs. Wakeman-Linn (head), Hobdari, Gvenetadze (all MCD), Joshi (PDR), Le Borgne (FAD), and Surin (BLS). Mr. Kramarenko, who will replace Mr. Wakeman-Linn as mission chief for Azerbaijan following completion of the 2004 Article IV consultations, joined the mission for a few days. Mr. Zavoico, the resident representative assisted the mission. Mr. Mammadov, advisor to the Swiss Executive Director, participated in policy discussions.
- The mission met with government officials, as well as representatives from parliament, the business, banking and diplomatic communities, and members of civil society. The mission held a press conference.
- Azerbaijan's economic reforms have been supported since July 6, 2001 by an arrangement under the Poverty Reduction and Growth Facility (PRGF) in the amount of SDR 80.45 million (50 percent of quota). As of October 31, 2004, total Fund credit and loans outstanding to Azerbaijan amounted to SDR 139.2 million (86.5 percent of quota).
- The authorities have communicated that they consent to the publication of the staff report, supplementary letter of intent, selected issues paper, and statistical appendix.

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LIST OF ACRONYMS

ANB	National Bank of Azerbaijan
BSL	Banking Systems Law
BTC	Baku-Tbilisi-Ceyhan
COM	Cabinet of Ministers
EBRD	European Bank for Reconstruction and Development
EITI	Extractive Industries Transparency Initiative
FAD	IMF's Fiscal Affairs Department
FDI	Foreign direct investments
FSAP	Financial Sector Assessment Program
FSSA	Financial Sector Stability Assessment
IBA	International Bank of Azerbaijan
JSA	Joint Staff Assessment
MDGs	Millennium Development Goals
MOT	Ministry of Tax
MTEF	Medium-Term Expenditure Framework
NBL	National Bank Law
NGOs	Non-governmental organizations
PIP	Public Investment Program
PRGF	Poverty Reduction and Growth Facility
QFS	Quasi Fiscal Subsidies
ROSC	Report on Standard and Codes
SCC	State Customs Committee
SDDS	Special Data Dissemination Standards
SDR	Special Drawing Rights
SLOI	Supplementary Letter of Intent
SOCAR	State Oil Company of the Azerbaijan Republic
SPF	Social Pension Fund
SPPRED	State Program for Poverty Reduction and Economic Development
VAT	Value added tax
WEO	World Economic Outlook
WTO	World Trade Organization

Azerbaijan: Basic Data

Social and demographic indicators (2003)	
Area (in sq. km)	86,600
Population (in thousands)	8,266.0
Percent urban	51.0
Percent rural	49.0
Population growth rate (in percent)	0.8
Life expectancy at birth (in years)	72
Infant mortality rate (per 1,000 population)	12.8
Physicians (per 1,000 population)	3.6
GDP per capita (in U.S. dollars, at average 2003 exchange rate)	862.5

	1999	2000	2001	2002	2003		2004
					First half	Year	First half
				(In percent of GDP)			
Structure of GDP							
Industry and construction	39.1	42.5	43.5	46.2	51.1	49.9	53.3
Of which: Oil and gas sector	20.1	30.5	32.0	31.0	33.7	31.1	32.6
Agriculture	18.2	15.9	14.8	14.0	4.3	13.1	4.1
Other	42.7	41.5	41.7	39.9	44.6	36.9	42.6
			(Annual percentage change, unless otherwise indicated)				
Output and employment							
GDP (in billions of manats)	18,875	23,591	26,578	30,312	16,171	35,054	18,520
Real GDP	7.9	10.3	9.6	9.7	10.1	10.8	10.6
Employment	0.1	-0.1	0.3	0.3	...	0.5	0.4
Prices and wages							
Consumer price inflation							
Average	-8.5	1.8	1.5	2.8	2.7	2.2	4.2
End of Period	-0.5	2.2	1.3	3.3	1.9	3.6	5.5
Average nominal manat wage	9.5	20.2	17.3	21.2	...	22.8	19.4
Real manat wage	19.6	18.1	15.5	18.0	...	20.1	14.6
Average nominal dollar wage	2.8	10.7	12.7	16.1	...	21.5	19.0
Real dollar wage	12.3	8.7	11.0	13.0	...	18.9	14.2
			(In millions of U.S. dollars, unless otherwise indicated)				
External sector							
Exports of goods	1,025	1,799	2,046	2,305	1,254	2,625	1,679
Imports of goods	1,433	1,539	1,465	1,823	1,164	2,723	1,553
Current account balance	-600	-187	-50	-769	-800	-2,021	-1,266
(In percent of GDP)	-13.1	-3.6	-0.9	-12.3	-24.3	-28.3	-33.6
				(In percent of GDP)			
Consolidated government							
Total revenue /1	18.5	21.2	18.7	27.3	27.7	27.1	28.6
Total expenditure (including net lending) 1/	23.6	20.8	18.7	27.7	29.9	28.9	26.9
Fiscal balance (- deficit) 2/	-4.7	-0.6	-0.4	-0.5	-1.7	-1.2	2.4
			(Annual percentage change, unless otherwise indicated)				
Financial markets							
Manat reserve money, end of period	7.0	18.2	9.4	11.1	19.8 3/	23.7	38.8 3/
Manat broad money, end of period	5.3	11.1	7.7	15.5	31.6 3/	28.0	30.9 3/
Manat velocity relative to non-oil GDP (ratio) 4/	10.6	11.4	11.3	11.6	...	10.9	...
Exchange rate (manat/US$)							
End of period	4,378	4,565	4,775	4,893	4,913 3/	4,923	4,905 3/
Period average	4,120	4,474	4,657	4,861	4,907 3/	4,911	4,923 3/

Sources: Azerbaijan State Statistics Committee; Azerbaijan National Bank; Ministry of Finance; and Fund staff estimates.

1/ Starting from 2002 revenue and expenditure include tax credits to SOCAR for energy-related subsidies.
2/ Calculated from below the line data.
3/ For nine months.
4/ Defined as non-oil GDP divided by average manat broad money.

Executive Summary

A three-year arrangement under the PRGF, in an amount equivalent to SDR 80.45 million (50 percent of quota) was approved on July 2, 2001. Four disbursements under this arrangement have been made through December 2003. Staff held discussions on the fourth review, as well as on the 2004 Article IV consultations, in Baku from October 13–27.

Macroeconomic developments remain broadly in line with program objectives. Real GDP grew 9.9 percent in the first nine months of the year, and the real effective exchange rate has remained broadly stable. Inflation has been higher than targeted. The non-oil deficit for 2004, as a percentage of non-oil GDP, is projected to be one percent lower than targeted, as a result of a favorable impact of tax administration reforms and tax policy changes.

Over the medium-term, the key challenge facing the authorities is to efficiently manage the forthcoming massive but temporary surge in oil revenue. A long-term oil revenue management strategy has been adopted by the authorities, targeting a path of non-oil deficits over the medium-term that seeks to preserve macroeconomic stability and also avoid overstretching implementation capacity. To ensure coherent fiscal policy, annual budgets will need to start from the poverty reduction strategy, and incorporate the public investment and regional development programs. Other key challenges include improving governance and accelerating structural and institutional reforms to support growth in the non-oil sectors, hopefully contributing to reducing poverty. Azerbaijan maintains an exchange system free from restrictions on the making of payments and transfers for current international transactions, except for restrictions maintained for security reasons which have been notified to the Fund in accordance with Executive Board Decision No. 144-(52/51).

Performance under the program has been satisfactory. All quantitative performance criteria under the program were met. The reserve money indicative targets were missed by significant margins, and the indicative limits on unpaid government bills were exceeded by small amounts. While several structural performance criteria were missed, policies subject to most of them have now been implemented, following acceleration of structural reforms in recent months.

Understandings were reached on a Supplementary Letter of Intent for 2005. Real GDP is projected to grow by more than 20 percent, and the current account deficit to improve sharply following completion of the Baku-Tbilisi-Ceyhan oil export pipeline. The program targets a 2.4 percent increase in the non-oil fiscal deficit relative to non-oil GDP, which will remain well under the long-term sustainable level, as well as a decline in inflation. To ensure the latter is achieved, the program envisages utilization of ANB bills as an instrument for sterilization, and acknowledges the possibility of modest nominal appreciation of the exchange rate of the manat. The government's structural reform agenda focuses on fostering competition in the banking sector, in part by tendering all financial services of the treasury, improving fiscal management through better budget preparation, and strengthening financial discipline in the public sector by closer oversight of large state-owned companies.

I. Introduction

1. The Executive Board completed the 2003 Article IV consultation with Azerbaijan on May 14, 2003, and approved the request to complete the third review under the PRGF on December 19, 2003. On both occasions, Directors commended the authorities for implementing prudent financial policies, and urged them to develop a long-term strategy for the use of oil revenues and to continue aggressive implementation of structural reforms. Directors also stressed the importance of completing bank privatization and accelerating energy sector restructuring.

2. In the attached Supplementary Letter of Intent (SLOI), the authorities describe their performance under the PRGF arrangement and their planned economic program for 2005, and propose performance criteria and indicative targets for end-December 2004, end-March 2005, and end-April 2005. The authorities also request several waivers, an extension of the PRGF arrangement through July 4, 2005, and cancellation of the previously planned sixth review and correspondingly reduced access under the arrangement.

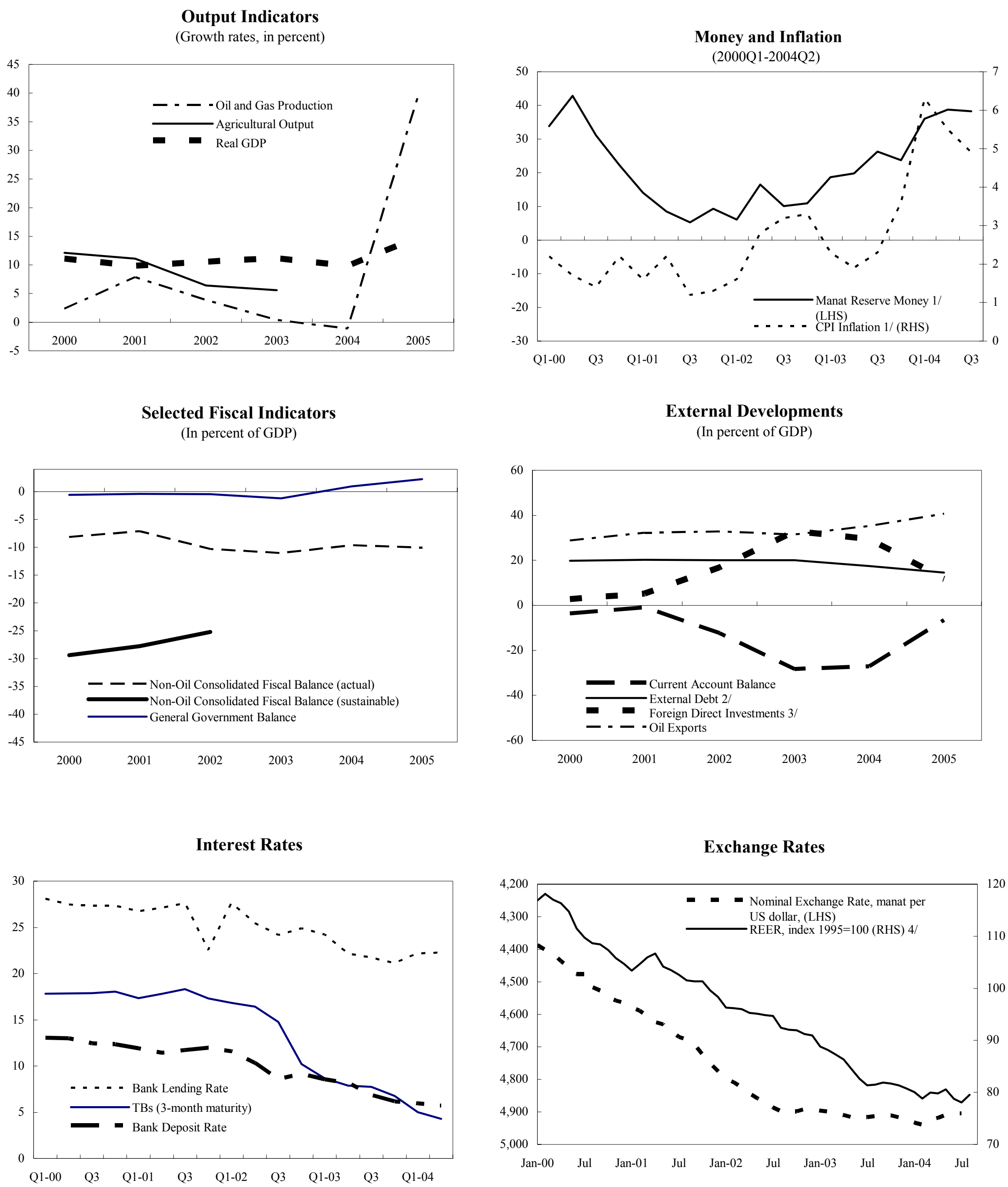
3. Azerbaijan accepted the obligations of Article VIII, Sections 2, 3, and 4 effective November 30, 2004, and is committed to maintain an exchange system free of restrictions in making payments and transfers for current international transactions. Summaries of Azerbaijan's relations with the Fund and World Bank are provided in Appendices I and II, respectively, and statistical issues are reviewed in Appendix III.

II. Overview

4. **Azerbaijan's economy has been, and will continue to be, dominated by oil.** Oil and oil products comprised 86 percent of total 2003 exports; 2004 is expected to be similar. In addition, massive oil and gas projects—in 2004, foreign direct investment (FDI) in these projects will be equivalent to almost 40 percent of GDP—have played a major role in Azerbaijan's economy in recent years. Starting in 2005, as the first of these projects is completed, oil exports will increase dramatically—from around 175,000 barrels per day now to 1.25 million barrels per day by 2010. However, this surge will be temporary; by around 2024 exports will return to current levels. The management of this oil wealth presents the key medium- and long-term challenge for the government of Azerbaijan.

5. **Azerbaijan's macroeconomic performance in recent years has been impressive**, with strong growth, low inflation, and a stable exchange rate (Figure 1). **Real GDP** grew by an annual average of over 10 percent during 2000–03, driven by oil-sector FDI and related spillover effects in the construction and transportations sectors, substantial gains in agriculture following land reform in the mid-1990s, and robust growth in non-oil exports (primarily agriculture and chemical products). Except for the acceptance of the obligations of Article VIII, Sections 2, 3, and 4, there have been no major developments in Azerbaijan's exchange system since the conclusion of the 2003 Article IV consultations.

Figure 1. Azerbaijan: Recent Economic Developments, 2000–05



Sources: Azerbaijan authorities; and Fund staff estimates.
1/ 12-month growth rates.
2/ Includes only public and publicly-guaranteed external debt.
3/ Excludes capital repatriation from foreign investors.
4/ Decrease means depreciation.

6. **The National Bank of Azerbaijan (ANB) has continued its policy of informally targeting the manat/U.S. dollar exchange rate to anchor the price level**, allowing for movements in this rate within a narrow band. Until recently, it targeted a gradual depreciation in the nominal manat/U.S. dollar rate (2-4 percent a year), a policy that was consistent with low, single-digit inflation. Starting in late 2003, however, foreign exchange inflows increased considerably, due to higher FDI and exports, and the ANB has allowed for modest nominal appreciation to counter increasing inflationary pressures (see below).

7. **Fiscal policy has been prudent since the start of the stabilization program in 1996, and the composition of expenditures has improved**. The non-oil consolidated deficit increased from more than 10 percent of non-oil GDP in 2001 to an average of about 15 percent during 2002-04—still well below the long-run sustainable level, as estimated in the IMF Country Report No. 03/130. The authorities are paying increasing attention to infrastructure investment, with domestically financed investment spending as a share of total government spending (net of foreign financed spending and energy subsidies) increasing from less than 5 percent in 1998 to over 17 percent in 2004. Fiscal and quasi-fiscal energy subsidies have also been reduced sharply, from about 22 percent of GDP in 2000 to an estimated 10 percent in 2003. The share of wages in total spending is relatively high and rising, reflecting excessive government employment, but the level of public sector wages is still low.

8. **Progress in structural reforms has been mixed**, with periods of fast progress followed by gridlock. In early 2001 the authorities embarked on a comprehensive structural reform program, which was supported by a PRGF arrangement starting in July 2001. During most of that year, the authorities aggressively pursued reforms designed to (i) improve transparency of government spending, including by establishing clear rules for the operation of the Oil Fund, creating a supreme audit institution, and including in the budget previously quasi-fiscal energy-related subsidies (QFS); (ii) reform the Ministry of Tax (MOT) and State Customs Committee (SCC); and (iii) start financial sector restructuring (IMF Country Report No. 02/40). During 2002, key structural reforms in the energy and banking sectors were delayed, and a number of ad-hoc decisions on spending Oil Fund assets were made. Following an acceleration of reforms for most of 2003—enhancing financial discipline in the energy sector, strengthening the budget preparation and implementation process, and improving the business environment (IMF Country Report No. 04/9)— reforms stalled again in late 2003. The authorities have recently resolved internal disputes on outstanding issues, and the pace of structural reforms has picked up.

9. **The authorities face the challenge of managing the coming oil boom,** with government revenues from oil exports projected to grow about 65 percent in 2005, and by an average of over 128 percent per year during 2006–09. Despite the recently adopted oil revenue management strategy, designed to ensure the revenue windfall is managed effectively, policy coordination remains weak and progress on energy and banking sector reforms has been slow.

10. Over the last few years, the Fund has supported Azerbaijan's economic reforms through the PRGF and Article IV consultations, and has provided technical assistance on a wide range of issues. The authorities have continued their track record of effective use of this assistance, although at times they have implemented the advice more slowly than recommended. In recent years, this assistance has contributed to further development of the Treasury system, a more modern and comprehensive Budget Systems Law, improved tax and customs administration, strengthened banking supervision, improvements in national accounts statistics, and most recently substantially improved banking sector legislation.

III. Recent Developments and Performance Under the Program

11. **Macroeconomic developments remain broadly in line with program objectives** (Tables 1–6). **Real GDP** grew 9.9 percent during January–September relative to the same period of 2003, driven by oil-related FDI and strong growth in non-oil exports. The **real effective exchange rate** has remained broadly stable, following a depreciation of about 8 percent in 2002 and 11 percent in 2003.

12. **However, inflation has been higher than targeted under the program**. Foreign exchange inflows increased considerably toward the end of 2003, due to greater domestic expenditures of oil-related FDI and higher than projected oil and non-oil export revenues. This created pressure for appreciation of the manat. Initially, the ANB increased unsterilized purchases of foreign exchange to resist nominal appreciation. This led to a sharp acceleration in reserve and broad money growth. Together with the impact of strong government wage increases in the second half of 2003, this contributed to an acceleration in inflation from 1.9 percent at end-June 2003 to 3.6 percent at end-2003, and further to 6.8 percent at end-April 2004. To slow the growth in monetary aggregates, starting in March the ANB allowed the nominal exchange rate to appreciate modestly, and began selling ANB bills in August. While these steps helped slow reserve money growth, growth in monetary aggregates has continued. Despite this growth, inflation declined, with 12-month inflation of 4.9 percent at end-September, reflecting rapid remonetization.

13. Reversing this trend, **inflation accelerated sharply in October**, with monthly inflation of 4.4 percent. This acceleration seems to have been largely due to one time and temporary factors: (i) the elimination on October 1 of the VAT exemption for imported grain; (ii) price increases in advance of the expected increases in domestic energy product prices; and (iii) the border closing by Russia due to security concerns (now reopened), which resulted in temporarily higher prices for products imported through this border, primarily meat products.

14. **Monetary and credit aggregates expanded rapidly in 2003 and the first nine months of 2004.** Following the purchases of foreign exchange by ANB noted above, the 12-month growth rate of **manat reserve money** accelerated from 11 percent at end-2002, to 24 percent and 38 percent, respectively, at end-2003 and end-September 2004. Deposit growth was also strong, growing by nearly 70 percent in the 12 months through

end-September 2004, contributing to an increase of about 50 percent in **bank lending**, albeit from a low base.

15. **Nonperforming loans** increased slightly at end-2003 relative to end-2002, before declining in the first half of 2004. Due to increased provisioning by banks, the ratio of nonperforming loans net of provisions declined to 18 percent of capital at end-2003, from 28 percent at end-2002. **Dollarization of the economy remains high**, with the share of foreign currency deposits to broad money at end-September 2004 increasing to 53 percent, from 47 percent at end-2002, and the share of lending in foreign currency increasing from 67 percent to 76 percent by end-June 2004.[1]

16. **While interest rates have continued to decline, real lending rates remain well above 10 percent**. The spread between deposit and lending rates has increased, due primarily to an increase in the share of lending going to small and medium-sized enterprises, which are perceived to be riskier customers. The recently adopted Accounting Law, which mandates the implementation of International Accounting Standards, should help in assessing risks. The interest rate on treasury bills declined from 10.2 percent at end-2002 to 3.9 percent at end-September 2004, reflecting a sharp decline in the stock of treasury bills outstanding, while the interest rate on recently introduced ANB bills stands at 4.3 percent.

17. **Fiscal policy was modestly expansionary in 2003**, but tightened in 2004 due to lower-than-budgeted expenditures and buoyant revenue. The latter reflects the positive impact of tax administration reforms, as well as tax policy changes (the broadening of the VAT base and simplification of the personal income tax schedule). A non-oil deficit of 14.4 of non-oil GDP is projected for 2004, 1.3 percent lower than targeted under the program.

18. There has been little improvement in SOCAR’s financial discipline. Despite much higher-than-budgeted oil prices, its cash tax payments through the first three quarters of 2004 were below the budget target, as a larger share than projected was paid through tax credits related to unpaid fuel deliveries to Azerenergy and Azerigas.

19. **Balance of payments developments remained positive in 2003 and the first half of 2004**. While the **current account deficit** increased to nearly 30 percent of GDP in 2003, from just over 12 percent in 2002, and is expected to decline only modestly in 2004, this is due to oil-related imports financed by FDI. Net of oil-related imports, the current account remained in surplus (over 8 percent of GDP in 2003, up one percent from 2002), in part due to growth in **non-oil exports** of nearly 45 percent.

20. **Performance against the quantitative targets under the program was satisfactory, while performance against the structural targets was mixed**. Most

[1] Reasons for this dollarization are discussed in IMF Country Report No. 03/130.

end-2003, and end-March, end-June, and end-September 2004 **quantitative targets** were met. Indicative reserve money targets were missed as money demand exceeded projections, and the indicative limits on unpaid government bills were exceeded by modest amounts due to small pension arrears (less than 0.1 percent of GDP, Table 7). While seven end-December 2003, and end-January, end-March and end-June 2004 **structural performance criteria** were missed (Table 8), policies related to five have since been implemented through adoptions of the Banking System Law (BSL), National Bank Law (NBL), revenue and expenditure plans of key state-owned enterprises, and an oil revenue management strategy.[2]

21. Policies called for in two structural performance criteria have not been implemented. First, talks on selling a 20 percent government share in IBA to EBRD continue, albeit slowly. As the authorities have been following a strategy of selling a stake in IBA to EBRD, and only then selling the remaining government shares, it was impossible to meet the end-June 2004 performance criterion calling for the tendering of those remaining shares. Second, the authorities have reversed their plans to introduce an automatic adjustment mechanism for domestic oil product prices, as discussed below.

22. **The first annual report of Azerbaijan's State Program for Poverty Reduction and Economic Development (SPPRED) was completed in May 2004**. As noted in the JSA (EBD/04/104), the report reflects extensive consultation with civil society. The authorities have made progress toward a number of SPPRED goals, including the preparation of a PIP and an MTEF in support of the SPPRED, a strengthening of the links between the SPPRED and MDGs (Table 9), and the introduction of a new household budget survey to improve poverty analysis. However, the report's impact on policy appears limited, and the links between SPPRED objectives and the allocation of budget resources is weak. Some progress has been made in **alleviating poverty** and reducing the disparities in income distribution. However, with about 45 percent of the population below the poverty line at end-2002, combating poverty remains a key challenge.

23. The authorities' **anti-corruption efforts** have focused on public sector management and energy sector reforms, including enhancing the transparency of budget spending, introducing a new tax code (2001), restructuring the MOT and SCC,[3] and enhancing the independence of the supreme audit institution. In addition, Azerbaijan is a pilot EITI country (Box 1). While these reforms have increased transparency and reduced small-scale corruption, progress in reducing large-scale corruption has been limited, and Azerbaijan's

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[2] Only the end-December 2003 performance criteria apply to the fourth review; the others apply to the fifth review.

[3] In late 2002, the number of tax officials was reduced by 40 percent, and the salaries of the remaining employees substantially increased.

ranking on corruption and governance indicators remains among the worst in the world.[4] The most recent manifestation of these problems is the reported monopolization of imports for many goods.

Box 1. Azerbaijan and the Extractive Industries Transparency Initiative (EITI)

The EITI, put forth by the British Prime Minister in September 2002, aims to increase transparency in payments and contributions made by companies to governments and government-linked entities for natural resource extraction. Upon acceptance by Azerbaijan of the Initiative's principles in June 2003, a national committee was formed—with the participation of ministries, NGOs, and state and foreign oil companies—to lead its implementation.

On November 24, 2004, a memorandum of understanding was signed by the EITI committee, NGOs, and oil companies, according to which oil companies are expected to disclose payments. The memorandum also forms a joint commission—with two representatives each from the national committee, NGOs, and oil companies—to select an independent auditor to aggregate the data for the report, which is to cover 2003 and the first half of 2004, and is expected to be released by the end of the year. If so, Azerbaijan will be the first country to release such a report.

IV. Article IV Discussions

24. Against the backdrop of solid macroeconomic performance but slow progress in structural reforms, the Article IV discussions focused on medium-term challenges facing Azerbaijan: (i) ensuring an effective management of the forthcoming increase in oil-related revenues; (ii) accelerating structural and institutional reforms aimed at supporting sustainable growth of the non-oil sectors and reducing poverty; and (iii) tackling governance issues. The challenge facing Azerbaijan is daunting: no country as dependent on oil revenues as Azerbaijan is today—before the forthcoming oil boom—has succeeded in managing that revenue in a way that allowed for sustained, substantial growth of the non-oil sectors.

25. The mission also discussed the authorities' track record of implementing Fund advice, and sought their views on improving the effectiveness of such advice. Key areas of Fund policy advice, which the authorities have implemented in recent years, include the design of the Oil Fund, the development of a new Budget Systems Law, and the incorporation into the budget of what previously were quasi-fiscal subsidies, as a first step toward their elimination. Two areas where the authorities have moved slower than recommended by the staff include increasing domestic energy product prices and financial sector reforms. The authorities emphasized that Fund policy advice and technical assistance had been crucial to their success in achieving and maintaining macroeconomic stability, improving the efficiency and transparency of their budgetary process, and strengthening

[4] For example, Transparency International's 2004 Corruption Perception Index (October 20, 2004) rates Azerbaijan as one of the seven most corrupt countries in the world.

macroeconomic statistics. They noted that while some policies based on Fund advice with which they agree had been implemented more slowly than recommended, this reflected the need to reach broad consensus within the government and civil society.

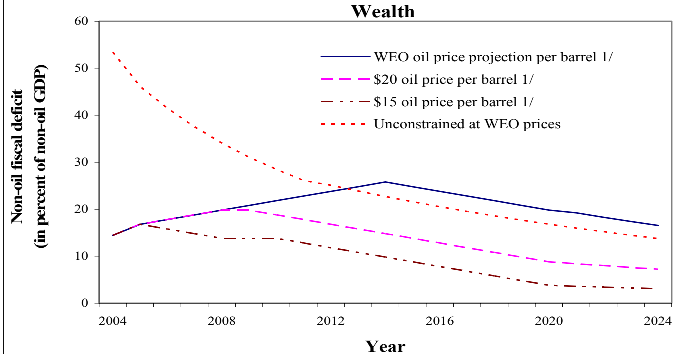
A. Medium-Term Macroeconomic Framework

26. In light of the higher WEO medium-term forecast for oil prices, the mission discussed a revised **medium-term macroeconomic framework** (Tables 1–6, and 10). It was agreed that, consistent with the adopted long-run strategy for the use of oil revenue, the non-oil fiscal deficit would increase by 2.4 percent of non-oil GDP in 2005,[5] and 1 percent per year through 2009, and gradually decline thereafter. There was consensus that this targeted path of non-oil fiscal deficits would need to be revised—generally on an annual basis during the budget preparation process—to reflect changes in oil export volumes and prices, and also the need to maintain macroeconomic stability and avoid overtaxing implementation capacity.

27. While based on a constant real annual spending of the oil wealth, the staff estimates the sustainable level of non-oil fiscal deficit to be over 50 percent of non-oil GDP in 2004, based on current WEO oil price projections, **the authorities' oil revenue management strategy appropriately sets annual limits on the change in the non-oil deficit**. Such limits are needed to smooth fluctuations in the expenditure program, minimize Dutch disease repercussions, and reduce waste of government resources given the limited institutional capacity of the government.[6]

28. The mission worked with the authorities on a **sensitivity analysis**, examining how higher or lower oil prices would affect the sustainable path of non-oil deficits (Figure 2). At current WEO projections, which are significantly higher than the baseline scenario of US$20 per barrel, the authorities can afford to increase the non-oil deficit by 1 percent annually through 2014, or by 2 percent through 2013. Even if oil prices fell to US$15

Figure 2. Azerbaijan: Sensitivity Analysis of Use of Oil Wealth



1/ Annual fluctuations are capped at 1percent of non-oil GDP.

[5] The increase is 1.8 percent of GDP if the increases in domestic excises and VAT taxes on oil products are not included in oil revenue.

[6] In the IMF Country Report No. 03/130 and in its extension ("Managing the Oil Wealth: The Case of Azerbaijan," Special Issue paper, 2004), the staff argued to cap fluctuations in the non-oil fiscal deficit in the range of 1-2 percent annually.

per barrel—just over one-third of the current 2005 WEO projections—there would still be room to increase the non-oil deficit through 2006.

B. Exchange Rate and Financial Sector Policies

29. **There was consensus that the use of the exchange rate as a nominal anchor has served Azerbaijan well, contributing to achieving and maintaining low inflation while protecting the competitiveness of the non-oil sector**. Going forward, the staff noted that, as the use of oil revenues increases, the government will be selling increasingly large amounts of foreign exchange to the ANB. While the ANB should be able to sterilize some of these foreign exchange purchases through sales of treasury bills and/or central bank bills, the stock of such instruments is very limited and the market undeveloped. Sterilization also carries a risk of crowding out the private sector. Given this, and the fact that the ANB is likely to be able to sterilize only a modest portion of these foreign exchange purchases, the result will be real appreciation pressure. Indeed, real appreciation will be the natural result of the substantial increase in oil exports.

30. **The authorities will thus be confronted with the challenge of managing this real appreciation. Staff strongly recommended that the authorities continue to target low inflation, and allow the real appreciation to take place via nominal appreciation.** To protect the competitiveness of the non-oil sectors in the face of this real appreciation, staff advised an acceleration of structural reforms, as well as gearing fiscal expenditures financed by these oil revenues toward improving Azerbaijan's economic infrastructure. The authorities agreed with this recommendation, but noted that the change in policy to allow nominal appreciation would need to be explained effectively to the public.

31. The staff welcomed the ongoing remonetization, but noted that this process creates two challenges for the ANB. First, a counterpart of this money growth has been a rapid growth in credit, which could overwhelm banks' ability to evaluate credit risk. The staff emphasized the importance of strengthening banking supervision to ensure this growth does not adversely affect the quality of banks' portfolios. The officials agreed, but noted that this increase in credit was from very low levels, and that they had started to implement the recommendations of the recent FSAP missions to enforce prudential standards and improve them over time (Box 2, FSSA and SLOI, paragraph 19). Second, as continuation of this remonetization—particularly at the pace of recent years—cannot be assured, the ANB will have to maintain a close eye on inflation pressures. The authorities emphasized their commitment to maintain macroeconomic stability, and noted they are prepared to tighten monetary policy if the remonetization process slows.

C. Medium-Term Fiscal Issues

32. Given the understandings reached on the path of non-oil deficits over the medium term, discussions focused on the composition of those deficits. As the spending of oil revenues will result in real appreciation, with adverse consequences for the competitiveness of non-oil sectors, staff emphasized that the increased deficit should come about through

policies that increase competitiveness. The authorities agreed and noted that (i) on the spending side, in addition to poverty-alleviation expenditures, their priority will be to improve infrastructure and human capital; and (ii) they will continue to reduce taxes on non-oil sectors.

Box 2. Azerbaijan: Key FSAP Recommendations

- Continue to strengthen the supervisory capacity of the ANB as recommended by the Basel Core Principles Assessment and strictly enforce prudential requirements for all banks.
- Strictly adhere to the scheduled privatization of state-owned banks.
- Liberalize the market for the provision of all banking services to the government, by contracting these services solely on the basis of transparent competitive tenders.
- Amend the Law on Anti-Monopoly Activity to include: (i) provisions consistent with international best practice covering all sectors of economic activity, including the financial sector; and (ii) provisions to endow the ANB with approval/rejection and implementation powers regarding the banking sector.
- Establish an interagency committee with the responsibility to take measures to develop the government securities market, including the conversion of the existing portfolio of long term government securities on the ANB's books into new government securities bearing market-based interest rates.
- Implement reform on corporate governance and accounting and auditing standards supported by investment in training.
- Improve the selection mechanism of judges and strengthen sanctions for illegal behavior.
- Complete investment in the payment systems infrastructure for small payments and in rural areas.

33. The staff also discussed **priority fiscal reform measures over the medium term**. There was consensus that to effectively manage the forthcoming surge in revenues, it is essential to develop a coherent medium-term fiscal policy that starts from the poverty reduction strategy, which should incorporate their regional development and oil revenue management strategies. From this should come the medium-term expenditure framework and public investment program, leading to the annual budget. The authorities agreed, but stressed their need for technical assistance to accomplish this objective. The authorities requested a new fiscal ROSC, to provide input into the development of the fiscal reform agenda, and also expressed interest in receiving technical assistance to review their institutional regime for collecting social pension fund contributions. Finally, the authorities agreed on the need to

reform public sector employment (streamline the government sector and decompress wage scales), and continue to reduce energy-related QFS.[7]

34. The staff urged the government to reconsider its **handling of oil revenues**. Currently, oil revenue related to joint venture activities goes into the Oil Fund, while oil revenue from SOCAR's own activities goes to the state budget. While most SOCAR tax payments are used to finance expenditures in the state budget, taxes due to higher oil prices than assumed in the budget are earmarked for a stabilization account. The authorities acknowledged that this treatment of oil revenues complicates efforts to focus fiscal policy on the non-oil deficit, but noted that achieving a consensus on a more coherent approach would take time. In the meantime, the rules for the operation of the stabilization account have been spelled out for the first time in a Cabinet of Ministers' instruction.

D. Other Article IV Issues

35. **The mission discussed the authorities' plans to strengthen governance and reduce corruption**, in the context of the recent Law on Fighting Corruption and Anti-Corruption Decree. Understandings were reached on measures to accelerate these efforts: completing the separation of regulatory and economic functions of the government; embarking on a comprehensive civil service reform; adopting international accounting standards for all firms; and accelerating the restructuring of the major state-owned companies (SLOI, paragraphs 37–39). Some officials expressed concern about the slow progress in SCC reforms, including on improving the transparency of customs operations, particularly in light of the reported recent monopolization of imports of numerous goods. However, no understandings were reached on how to address these challenges.

36. **The authorities reiterated their commitment to a liberal trade and exchange regime**. While they have continued their negotiations for WTO membership, early accession does not appear to be a high priority for the authorities. Outstanding WTO issues include low domestic energy prices, which are regarded as subsidies to domestic production, and regulation of natural monopolies. Azerbaijan's Trade Restrictiveness Index is 1, or fully open, and there have been no significant changes in trade policy in 2004.

37. Finally, the mission discussed the **economic benefits of a possible peace agreement with Armenia**. While the direct benefits might be limited, and delayed by the need to clear mines, the indirect impact on investment from reduced uncertainty could be significant (Box 3).

[7] After requesting technical assistance on their reform program from FAD in mid-2004, SCC inexplicably withdrew this request.

Box 3. Azerbaijan: Economic Implications of a Possible Nagorno Karabakh Peace Agreement

Azerbaijan and Armenia were at war over Nagorno Karabakh from 1988 through 1994. While a cease fire has prevailed since then, there has been no peace agreement. Assessing the economic impact for Azerbaijan of a possible peace agreement, in the absence of its terms, is difficult. However, some observations can be made with reasonable confidence.

First, a peace agreement would create **a more attractive environment for investments in the non-oil sectors, and also lead to increased regional trade.** A 2001 World Bank study estimated that a peace agreement would increase Azerbaijan's exports by 11 percent of 1999 levels, and raise its GDP by 5 percent.[8] However, this may be optimistic, as the prolonged dispute has prevented the establishment of market-based economic links between the neighboring countries in the post-Soviet period, and infrastructure connecting the countries has been damaged or destroyed.

Second, conflict resolution could improve access to the Nakhchivan Autonomous Republic (NAR), a part of Azerbaijan with around 367,000 people that is separated from the main territory by Armenia. A peace agreement could enable Azerbaijan to use the southern railroad to deliver goods to NAR—replacing the current expensive practices of delivering supplies by airplane or by truck through Iran—and to supply gas through the existing pipelines through the territory of Armenia, reducing the need for imported electricity.

However, resettlement or development of the region would have to await **clearance of mines**. According to the Azerbaijan National Agency for Mine Action (a joint project of the Government of Azerbaijan and UNDP), it may take 30 years to clear all mines in the territory. The economic returns from peace, for both countries, could thus be substantially delayed.

38. Azerbaijan provides **core data** to the Fund, and the information is adequate for surveillance purposes and program monitoring. While the authorities have made significant progress in improving the quality and timeliness of macroeconomic statistics, a number of weaknesses need to be addressed in national accounts and price statistics. In these areas, technical assistance continues to be provided by the Fund. Given Azerbaijan's generally strong record of implementing Fund technical assistance recommendations, continued assistance is justified.

39. The authorities have started the process of **SDDS subscription**, and are expected to complete it in early 2005. The authorities have implemented all but one of the 2002 **safeguards assessment** recommendations (Appendix I).

[8] Evgeny Polyakov, *Changing Trade Patterns after Conflict Resolution in the South Caucasus*, Policy Research Working Paper, World Bank, 2001.

V. Program Discussions

A. Macroeconomic Framework for 2005

40. Understandings were reached on a revised **macroeconomic framework** for 2005, taking into account the WEO-projected higher oil prices and much better than forecast performance of non-oil exports in 2003 and 2004. Although higher prices and volumes will lead to significantly higher oil exports in 2005, and the non-oil deficit is projected to increase significantly relative to 2004, there was agreement that the impact on aggregate demand will be moderate, as most of the additional oil revenue will be sterilized in the Oil Fund or stabilization fund, or transferred abroad in the form of capital and profit repatriation, there will be a significant reduction in FDI next year, and the increases in oil product prices will reduce QFS by an estimated 0.5 percent of non-oil GDP.

B. Exchange Rate and Financial Sector Policies

41. While 2004 inflation is projected to be close to 10 percent, in large part due to recent energy price increases and other temporary or one-time factors, it was agreed that the underlying inflation was closer to 5 percent. Consistent with this, and with the authorities' continuing commitment to control inflation, the agreed 2005 monetary program targets inflation of 5 percent, and assumes a moderate decline in velocity. There was consensus that a moderate nominal appreciation of the exchange rate will be needed in 2005, as well as a further increase in the stock of ANB bills, to help slow the growth of monetary aggregates, and thus achieve the inflation objective under the program.

42. The authorities and staff will closely monitor inflation developments over the next few months, and the ANB is committed to tightening monetary policy if necessary, in close consultation with Fund staff.

43. The staff expressed disappointment regarding the continued delay in **privatizing IBA**, and urged the authorities to act aggressively to sell the remaining government shares in that bank. The authorities noted their continued commitment to this privatization, and indicated that EBRD was partly to blame for the prolonged discussions. To curb IBA's monopoly and create a level playing field in the banking sector, understandings were reached on a comprehensive package of measures, including: (i) reversing the monopolization of key financial sector activities by IBA, (SLOI, paragraphs 21 and 34); (ii) adopting a timetable to bring IBA into compliance with all prudential requirements (SLOI, paragraph 20); (iii) initiating steps for the privatization of BUS Bank (SLOI, paragraph 22); and (iv) enhancing opportunities for other banks, (SLOI, paragraph 21). In view of the missed performance criterion on the tender for IBA, understandings were reached that the actions reversing IBA monopolies would be prior actions.

C. Fiscal Issues and 2005 Budget

44. **The 2005 budget targets a non-oil deficit of 16.8 percent of non-oil GDP, 2.4 percentage points higher than the expected 2004 outcome**.[9] The main fiscal policy initiatives for 2005 include a 4 percentage point reduction in the social security contribution rate to 25 percent; an increase in the wage bill of 36 percent, including a 25 percent increase in the minimum wage;[10] and a 45 percent increase in domestically financed investments.

45. The mission expressed concern about the rapidly increasing wage bill, which follows a 34 percent increase in the wage bill in 2004. As a result, as a share of total government expenditures, wages and associated pension contributions have increased from roughly 30 percent in 2003 to 34 percent in the 2005 budget, despite the continuing low government salaries.[11] The authorities agreed that the high number of employees constrained their flexibility to increase salaries, and intend to adopt in 2005 a comprehensive medium-term strategy to reduce the size of public sector labor force (SLOI, paragraph 30). The mission, while noting the need for capital improvements, also cautioned the authorities not to increase capital expenditures too rapidly, for fear of overstretching their ability to monitor and control these expenditures.

46. Concurring with the staff's position that the SPF revenue forecast in the budget is optimistic, the authorities decided to postpone a planned pension increase until the SPF revenue collections in the first quarter have been analyzed, and there are assurances the annual revenue projections are indeed realistic (SLOI, paragraph 35).

47. The 2005 budget law stipulates that SOCAR should pay in cash its full 2005 tax liability, with credits related to fuel provided to Azerenergy and Azerigas applied to its accumulated tax arrears.[12] However, it appears SOCAR will clear its arrears by early 2005. The staff advised the government that credits to SOCAR after its arrears have been cleared

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[9] This increase in the non-oil deficit includes 0.8 percent of non-oil GDP which is due to increases in domestic excise and VAT revenue coming from the increase in domestic oil prices (see below). While for program purposes oil revenue includes all revenue from SOCAR, FAD's general guidance on non-oil deficits calls for excluding domestic taxes from oil revenues, since these are sustainable.

[10] Minimum wages were increased a cumulative 270 percent in three steps, on October 1, 2003, January 1, 2004, and July 1, 2004. The current minimum wage is 100,000 manat, or about US$20, per month.

[11] Roughly one-third of government employees reportedly will be receiving the new minimum wage of approximately US$25 per month.

[12] SOCAR is obligated to provide the electricity and gas utilities sufficient fuel to meet their needs, even though these companies cannot pay in full for that fuel. Since 2002, the government has reflected these underpayments as subsidies from the budget to the utility companies, and has granted tax credits to SOCAR for the value of these subsidies. In 2003 and 2004, SOCAR paid taxes in cash equal to the difference between these subsidies and its legal tax liability.

should take the form of mandatory dividends; a final decision on this issue will be taken in early 2005.

D. Energy Sector Reforms and Financial Discipline in State-Owned Enterprises

48. The government noted it is not prepared to adopt an **automatic oil product pricing mechanism**—a missed end-2003 performance criterion—due to concerns that such a mechanism would lead to manipulation and hoarding in advance of effectively pre-announced price changes. At the same time, acknowledging that domestic energy product prices being significantly below world market levels is a problem, including due to the implicit subsidies on these products by an estimated 3.7 percent of GDP in the first half of 2004, it agreed that a gradual increase in energy prices is necessary.

49. The staff emphasized the value of an automatic pricing mechanism—one which takes politics out of the price setting process—but recognized the legitimacy of the concerns about the potential for artificial shortages. The authorities were considering significant increases in selected products, including 50 percent for diesel fuel. The staff noted that the agriculture sector was not sufficiently cushioned against the proposed diesel fuel price increase, and urged increases in jet fuel and naphtha prices as well. The authorities considered these concerns, and on November 2 announced 10-12 percent increase in the prices of virtually all oil product prices, and a 120 percent increase in the price of natural gas for households (SLOI, paragraph 13). As a result, natural gas prices will be roughly 85 percent of average cost, gasoline prices will be close to import parity, and prices of other oil products will be about 40-50 percent of reference prices. It was also agreed that, going forward, the authorities will review, and revise as appropriate, domestic energy prices at least once a year; this strategy has been made public.

50. The authorities agreed that strengthening financial discipline in state-owned enterprises is essential, but noted the difficulty they have had in monitoring and enforcing their revenue and expenditure plans in 2004. Recognizing that failure to bring discipline into these enterprises will undermine efforts to reduce QFS, but lacking clear ideas on how to accomplish this goal, they committed to review the 2004 financial performance of these enterprises—adding SOCAR to the list of enterprises being monitored (SLOI, paragraph 37)—and, based on that analysis, take steps during the first quarter of 2005 to strengthen their performance.

VI. Balance of Payments Outlook and Capacity to Repay the Fund

51. The **current account balance** is expected to improve modestly in 2004 relative to 2003, as higher oil-related imports will be more than offset by higher oil exports. Non-oil exports are also expected to grow, by almost 30 percent, led by agricultural and chemical products. The current account deficit is expected to decline sharply in 2005, due to increased oil export volumes and significantly lower oil-related imports, as major oil-related projects are completed.

52. **Azerbaijan has serviced its debt to the Fund in a timely manner, and the staff expects this to continue** (Table 11)**.** Domestic debt of the government is close to zero, and external government and government-guaranteed debt is less than 20 percent of GDP, with a significant portion on highly concessional terms.[13] Azerbaijan's risk of debt service difficulties is thus low, with external debt service payments expected to amount to 3.7 percent of exports of goods and services in 2004, and projected to decline to an average of 1.1 percent during 2005–10, as oil exports increase.

53. **Azerbaijan has debt disputes with Kazakhstan, Turkmenistan, and Uzbekistan**. While the status of debt negotiations with these countries is unchanged from what was reported in IMF Country Report No. 03/154, a Turkish company obtained a judgment in Turkish courts that led to the seizure of three freighters and two aircraft operated by Azeri state-owned companies earlier in 2004, to force repayment of what they regarded as a state-guaranteed debt. Agreement has been reached on settling this debt.

VII. Risks to the Program

54. With the Baku-Tbilisi-Ceyhan (BTC) pipeline expected to start operations in 2005, and oil prices expected to remain high in the near future, short-term risks to the program are low. Over the medium-term, the economy remains vulnerable to a sharp and sustained drop in oil prices, as continued high non-oil growth rates are predicated on removing existing bottlenecks to growth through substantial investments in infrastructure and human capital, financed by oil revenue. On the other hand, if the expected oil revenue materializes, there is a risk of a relaxation of the steadfast implementation of the structural and institutional reforms needed to support sustained, significant non-oil growth, and reduce poverty. Finally, failure to improve governance would seriously undermine non-oil growth prospects.

VIII. Program Modalities

55. Structural performance criteria and benchmarks for end-December 2004, and end-March and end-April 2005 are summarized in Table 8 and described in the SLOI (paragraph 44). Quantitative performance criteria for end-March 2005 and indicative targets for end-December 2004 and end-March 2005 are specified in the SLOI, Table 1. The updated disbursement schedule is presented in Table 12.

56. The program contains a number of structural conditions, which the staff and authorities believe are critical to the program's success as explained in Box 4.

[13] This makes it unnecessary to apply standard Fund templates for debt sustainability analysis.

Box 4. Structural Conditionality Streamlining Assessment

1. Coverage of Structural Conditionality in the Program

Structural Conditionality under the proposed program includes prior actions for the fourth review of the PRGF, and performance criteria and benchmarks for end-December 2005, and end-March and end-April 2005 as follows:

- **Fiscal policy,** through one performance criterion and one benchmark aimed at improving the annual budget process, strengthening links between SPPRED, MTEF, PIP and annual budgets, and increase the efficiency of the government;

- **Banking sector reform,** through two prior actions and one performance criterion to help improve competition in the sector that is dominated by IBA, as well as a prior action on the adoption of the NBL; and

- **Enterprise restructuring,** through one prior action on domestic energy product pricing and one benchmark to strengthen financial discipline in key state-owned enterprises and reduce further energy-related subsidies.

2. Status of Structural Conditionality from Earlier Programs

See Table 8 for performance under the program so far.

3. Structural Areas Covered by Bank Lending and Conditionality

The World Bank is currently negotiating a three-year Poverty Reduction Strategy Credit. The program includes conditionality on (i) public, social and financial sectors; (ii) reduction of implicit subsidies, privatization, and regulatory reform of the utilities sectors; and (iii) private sector development.

IX. Staff Appraisal

57. **Azerbaijan's macroeconomic performance remains strong, and economic prospects are promising**. Real GDP growth is expected to remain robust, driven by oil, oil sector FDI, and associated spillover effects. Over the medium term, planned increases in infrastructure and human capital spending, together with ongoing structural reforms aimed at improving the business climate, increasing competition in the financial sector, and strengthening financial discipline in the energy sector, are expected to reduce bottlenecks to private sector investment and growth.

58. **The long-term oil revenue management strategy adopted recently is consistent with a sustainable use of oil wealth and growth in non-oil sectors, as well as maintenance of macroeconomic stability.** The staff welcomes the fact that the 2005 budget has been drafted based on this strategy. The authorities are encouraged to follow the path of

non-oil deficits in the strategy, resisting inevitable pressures for more rapid spending, not only to conserve assets for the future, but also to avoid overstretching implementation capacity. In this context, staff urges the authorities to limit increases in capital expenditures to levels they can effectively monitor and control. A careful balance also needs to be struck between increasing spending and reducing the non-oil tax burden. In addition, it will be important for the authorities to begin the process of reducing the size of the civil service, so that wage levels can be increased while containing the aggregate wage bill.

59. **The use of the exchange rate as a nominal anchor has, so far, served Azerbaijan well, and the mix of financial policies has been broadly appropriate in recent years.** Looking forward, the use of the oil wealth will bring pressures for real appreciation which, given the limited sterilization capability, should be accommodated by allowing a nominal appreciation of the exchange rate. Such an accommodation should help the authorities achieve their inflation objective, in particular by ensuring that the recent one-time and temporary price pressures are not embedded in underlying inflation.

60. **The staff welcomes the authorities' decision to participate in EITI. However, governance weaknesses remain a serious concern, despite improvements since the adoption of the PRGF-supported program in 2001.** The staff urges the authorities to accelerate progress in this area by completing separation of commercial and regulatory functions, and improving the functioning of the courts. In addition, the staff urges the authorities to aggressively tackle the governance problems in import markets.

61. **The incidence of poverty remains high, despite the strong real GDP growth and macroeconomic stability of recent years.** The staff is concerned that, unless the benefits of economic reforms and increasing oil revenue are distributed across the population, support for reforms will wane. The staff urges the authorities to increase pro-poor government spending, speed up the identification of vulnerable groups, and design an efficient safety net to cushion these groups against the adverse impact of reforms.

62. **While the pace of structural reforms has been slower than targeted under the program, the recent acceleration in reforms is encouraging.** Adoption of the new BSL and NBL has created a legal framework that should enhance financial sector development. In addition, the recent adjustment of domestic energy prices is important, although higher increases in gasoline, jet fuel, and naphtha may have been warranted. The authorities are urged to follow through with their commitment to review and adjust these prices as necessary, at least once a year. The approval of 2004 revenue and expenditure plans of key state-owned enterprises, and the commitment to add SOCAR to the list of companies monitored in 2005, is a good start. The authorities are encouraged to review periodically their performance, and take necessary steps to ensure improvement in their financial discipline, which will be key to a further reduction in energy-related QFS.

63. **Although the staff is encouraged that steps have been taken to reduce the IBA monopoly of segments of Azerbaijan's financial sector, lack of progress in privatizing IBA is disappointing**. The staff urges the authorities to accelerate discussions with EBRD

for the sale of 20 percent of IBA shares, and to tender its remaining shares without delay, and to quickly bring IBA into compliance with all prudential standards. The authorities are also encouraged to continue BUS Bank restructuring, with a view to announce a tender in 2005 for the privatization of this bank, and to press ahead with reforms that will further reduce IBA's monopoly grip on financial markets in Azerbaijan.

64. **The staff welcomes the authorities' intention to subscribe to SDDS in 2005. In addition, in light of the authorities' strong track record in effectively implementing technical assistance recommendations, the staff supports continued technical assistance to Azerbaijan.** Priority areas for technical assistance should be budget preparation, tax administration, implementation of the FSAP recommendations, and further improvements in national accounts statistics.

65. Going forward, **the main risks facing Azerbaijan stem from the challenge of managing the rapidly growing oil revenue in a manner that allows sustained and substantial non-oil growth**. Excessively rapid expenditures could result in waste, rising governance problems, and real appreciation that undermines competitiveness of other sectors. In addition, this rising revenue could undermine commitment to needed reforms, particularly to improving governance and the business environment.

66. **The staff recommends completion of the fourth review under the PRGF arrangement.** Although there were delays in implementing targeted structural reforms, policies subject to most missed performance criteria have now been implemented. While actions on domestic energy prices were not as ambitious as programmed, they represent a substantial step toward market pricing. Thus staff supports the authorities' request for waivers related to these performance criteria. Given the delay in completing the fourth review, staff also supports the request to extend the arrangement to July 4, 2005, rephase the fifth review to March 31, 2005, and cancel the sixth review and correspondingly reduce access under the PRGF.

67. It is proposed that the next Article IV consultation with Azerbaijan be held in accordance with the provisions of the decision on consultation cycles approved on July 15, 2002.

Table 1. Azerbaijan: Selected Economic and Financial Indicators, 2001-05

	2001	2002	2003		2004		2005	
	Act.	Act.	Prog.	Act.	Prog.	Rev. Prog.	Prog.	Rev. Prog.
	(Annual percentage change, unless otherwise specified)							
GDP at current prices	12.7	14.1	15.7	15.6	6.3	20.5	14.7	27.7
GDP at constant prices	9.6	9.7	9.3	10.8	8.1	7.8	14.0	21.6
Of which: Oil sector	7.9	3.9	0.7	0.4	-2.1	-1.1	53.4	39.7
Other sectors	10.4	12.3	11.3	15.5	10.3	12.1	6.5	10.3
Implicit GDP deflator	2.8	4.0	5.9	4.4	-1.7	11.8	0.6	5.0
Consumer price index (end-period)	1.3	3.3	2.5	3.6	2.5	10.0	2.5	5.0
Consolidated government finance 1/								
Total revenue	0.8	34.1	15.2	14.6	12.1	25.2	12.7	38.4
Total expenditure	0.9	36.8	24.7	21.1	6.6	12.1	12.5	30.5
Of which: Current expenditure	5.0	15.3	24.2	19.5	13.0	21.0	11.7	28.4
Investment expenditure	-23.2	210.3	26.1	26.1	-12.3	-13.1	15.6	38.6
Investment expenditure (net of BTC)	-23.2	163.2	8.8	8.7	20.0	18.2	15.6	33.6
Money and credit 2/								
Net foreign assets	31.0	4.7	6.6	16.4	9.5	21.9	…	19.9
Net domestic assets	-1.5	8.4	19.0	12.9	11.4	17.7	…	2.2
Domestic credit	0.1	11.7	18.1	17.6	9.0	22.4	…	4.8
Of which: Credit to the economy	-14.8	9.1	16.0	21.4	14.4	30.5	…	9.9
Manat broad money (average, annual changes)	9.7	18.8	36.4	36.6	38.8	44.8	…	44.3
Foreign currency deposits (level, as a ratio to broad money)	48.0	46.9	46.0	47.4	44.7	50.8	…	46.5
Income velocity of average manat broad money (M2) 3/	11.3	11.6	10.8	10.9	9.7	9.9	…	9.0
External sector (in U.S. dollars)								
Exports f.o.b.	13.7	12.7	8.9	13.9	-6.9	41.7	29.4	36.6
Of which: Oil sector	21.1	11.1	8.0	10.0	-9.4	34.7	33.0	47.4
Imports f.o.b.	-4.8	24.5	40.7	49.3	34.7	26.6	-12.8	6.6
Of which: Oil sector	-5.5	142.7	209.3	230.1	70.9	43.6	-32.9	-1.4
Export volumes	31.8	15.2	-4.0	2.8	5.4	15.8	47.3	34.9
Import volumes	-2.4	20.7	35.9	39.4	34.4	20.1	-12.7	6.6
Terms of trade	-12.1	-5.1	9.7	3.4	-11.8	16.1	-12.1	1.2
Real effective exchange rate (- deprec.)	-6.1	-7.5	…	-11.3	…	…	...	…
	(In percent of GDP)							
Gross fixed investment	22.9	34.1	53.0	50.8	58.3	54.5	46.1	39.9
Consolidated government 4/	2.1	5.6	4.6	6.1	5.2	4.4	5.2	4.8
Private sector	20.8	28.5	48.4	44.7	53.2	50.1	40.9	35.2
Of which: Oil sector	14.6	26.9	39.5	42.2	45.0	40.5	32.4	26.9
Gross domestic savings	24.3	24.8	30.0	27.2	24.1	33.1	31.0	41.1
Gross national savings	19.8	19.8	25.6	22.7	20.5	27.3	25.8	33.4
Consolidated government	1.6	5.1	4.3	4.9	4.0	5.3	4.1	6.9
Private sector	18.2	14.7	21.3	17.8	16.5	22.0	21.7	26.4
Consolidated government finance 1/								
Total revenue and grants	18.7	22.0	22.4	21.7	23.6	22.6	23.2	24.5
Total expenditure	18.7	22.4	24.7	23.4	24.8	21.8	24.3	22.3
Overall fiscal balance	-0.4	-0.5	-2.0	-1.2	-1.2	0.9	-1.1	2.2
Overall fiscal balance (net of BTC, in percent of non-oil GDP)	-0.6	0.5	-0.4	0.6	-1.6	1.3	-1.6	3.8
Statistical discrepancy	0.4	0.1	-0.3	-0.5	...	...	...	...
Nonoil deficit 5/								
As a share of GDP	-7.1	-10.3	-12.1	-11.0	-11.8	-9.7	-11.7	-10.4
As a share of non-oil GDP	-10.4	-14.9	-17.4	-16.0	-15.7	-14.4	-16.5	-16.8
External sector								
Current account (- deficit)	-0.9	-12.3	-27.4	-28.3	-37.8	-27.1	-20.2	-6.6
Foreign direct investment (net)	5.1	16.8	29.1	32.1	36.1	29.4	20.2	11.7
Public and publicly guaranteed external debt outstanding	20.2	20.1	20.8	20.1	20.9	17.5	19.4	14.6
External debt service ratio (including IMF) 6/	4.9	4.4	5.8	5.2	5.5	3.7	3.6	2.5
Memorandum items:								
Gross official external reserves (US$ millions) 7/	725	721	732	803	815	923	890	1,181
Nominal GDP (in manat billion)	26,578	30,312	34,252	35,054	36,410	42,246	41,752	53,929
Nominal GDP (US$ millions)	5,708	6,236	6,977	7,138	7,415	8,598	8,504	10,988
Nominal non-oil GDP (in manat billion)	18,072	20,901	...	24,139	...	28,415	...	33,217
Nominal GDP per capita (in U.S. dollars)	701	760	843	862	889	1,031	1,011	1,307
Oil Fund Assets (US$million, end-period stock)	493	693	817	821	862	981	952	1,322
Population (midyear, in million)	8.1	8.2	…	8.3	…	8.3	…	8.4

Sources: Azeri authorities; and Fund staff estimates and projections.

1/ Excludes the increased revenues and expenditures from including SOCAR's quasi-fiscal activities in the budget.

2/ In percent of beginning of the year broad money (M3) stock, unless otherwise specified.

3/ In terms of nonoil GDP.

4/ For 2002 and 2003 includes investments of US$50 million and US$121.5 million, respectively, for the government's share in BTC, equivalent to 0.8 percent and 1.7 percent of GDP, respectively.

5/ Calculated by deducting Oil Fund, AIOC and SOCAR revenue from the consolidated government budget balance.

6/ In percent of exports of goods and services.

7/ Excluding Oil Fund assets.

Table 2. Azerbaijan: Monetary Survey, 2001-05 1/

(In billions of manats)

	2001 Dec. Act.	2002 Dec. Act.	2003 Dec. Prog.	2003 Dec. Act.	2003 Dec. Adj. Act. 2/	2004 Mar. Prog.	2004 Mar. Act.	2004 Jun. Prog.	2004 Jun. Act.	2004 Sep. Prog.	2004 Sep. Act.	2004 Dec. Prog.	2004 Dec. Rev. Prog.	2005 Mar. Prog.	2005 Jun. Prog.	2005 Sep. Prog.	2005 Dec. Prog.
Net foreign assets	2,431	2,590	2,842	3,214	3,165	2,828	3,510	2,892	3,832	3,131	4,461	3,313	4,294	4,542	4,994	5,332	5,663
Net international reserves of the ANB (convertible)	1,969	2,130	2,347	2,681	2,632	2,361	2,819	2,458	3,078	2,669	3,555	2,813	3,396	3,735	4,137	4,400	4,707
Net foreign assets of commercial banks (convertible)	454	464	499	533	533	471	691	438	753	467	909	504	902	811	861	935	960
Other	8	-4	-4	1	1	-4	0	-4	0	-4	-4	-4	-4	-4	-4	-4	-4
Net domestic assets	943	1,224	1,947	1,718	1,766	2,018	1,652	2,251	1,698	2,316	2,062	2,508	2,590	2,286	2,381	2,462	2,738
Domestic credit	2,232	2,625	3,312	3,295	3,353	3,352	3,278	3,557	3,345	3,595	3,862	3,756	4,401	4,143	4,283	4,408	4,730
Net claims on general government	405	493	573	346	406	475	80	542	-198	402	-357	305	-54	-267	-304	-336	-409
Credit to the economy	1,826	2,132	2,741	2,949	2,949	2,879	3,198	3,017	3,543	3,195	4,219	3,453	4,455	4,410	4,587	4,745	5,138
Other items (net)	-1,289	-1,400	-1,365	-1,577	-1,587	-1,334	-1,626	-1,306	-1,648	-1,278	-1,800	-1,248	-1,812	-1,857	-1,902	-1,947	-1,992
Broad money	3,373	3,814	4,787	4,933	4,933	4,843	5,162	5,140	5,530	5,446	6,523	5,819	6,884	6,828	7,375	7,793	8,401
Manat broad money	1,753	2,026	2,587	2,592	2,592	2,585	2,504	2,760	2,871	2,941	3,044	3,219	3,385	3,248	3,578	3,812	4,499
Currency outside banks	1,469	1,669	2,033	2,041	2,041	2,008	1,857	2,119	2,014	2,231	2,117	2,413	2,346	2,199	2,468	2,633	3,193
Manat deposits	284	357	554	551	551	577	648	641	858	710	927	806	1,039	1,049	1,110	1,179	1,306
Foreign currency deposits	1,620	1,789	2,200	2,341	2,341	2,258	2,657	2,380	2,658	2,504	3,479	2,599	3,499	3,580	3,797	3,981	3,902
(Changes in percent of beginning of year total broad money stock, unless otherwise specified 3/)																	
Net foreign assets	31.0	4.7	6.6	16.4	...	-0.3	6.0	1.0	12.5	5.9	25.3	9.5	21.9	3.6	10.2	15.1	19.9
Net domestic assets	-1.5	8.4	19.0	12.9	...	1.4	-1.3	6.1	-0.4	7.5	7.0	11.4	17.7	-4.4	-3.0	-1.9	2.2
Domestic credit	0.1	11.7	18.1	17.6	...	0.8	-0.3	5.0	1.0	5.7	11.5	9.0	22.4	-3.8	-1.7	0.1	4.8
Credit to the economy	-14.8	9.1	16.0	21.4	...	2.8	5.1	5.6	12.1	9.2	25.7	14.4	30.5	-0.7	1.9	4.2	9.9
Broad money (M3) (percentage change)	29.4	13.1	25.5	29.3	...	1.2	4.6	7.4	12.1	13.8	32.2	21.6	39.6	-0.8	7.1	13.2	22.0
Average broad money (M3) (percentage change)	23.9	22.4	24.2	25.1	...	15.1	19.8	19.3	26.9	26.5	43.1	34.6	37.8	18.1	22.3	30.6	28.4
Average manat broad money (M2) (percentage change)	9.7	18.8	36.4	36.6	...	16.5	14.8	20.4	21.1	28.5	33.2	38.8	44.8	15.2	18.5	28.3	44.3
Currency as a ratio to broad money	43.6	43.7	42.5	41.4	...	41.5	36.0	41.2	36.4	41.0	32.5	41.5	34.1	32.2	33.5	33.8	38.0
Foreign currency deposits as a ratio to broad money	48.0	46.9	46.0	47.4	...	46.6	51.5	46.3	48.1	46.0	53.3	44.7	50.8	52.4	51.5	51.1	46.5
Memorandum items:																	
Gross international official reserves (US$ millions)	725	721	732	803	...	715	814	735	860	774	952	815	923	985	1,077	1,121	1,181
Net international official reserves (US$ millions)	427	462	509	582	...	512	612	533	668	579	772	610	737	811	898	955	1,022
Velocity of total broad money (M3) 4/	6.5	6.1	5.7	5.8	...	…	…	…	…	…	…	5.2	4.9	…	…	…	4.4
Reserve money 3/	1.7	13.7	18.9	23.4	...	-2.2	6.7	6.1	18.3	10.7	34.5	14.4	37.8	-3.4	6.2	13.4	20.6

Sources: Azerbaijan National Bank; and Fund staff estimates.

1/ Accounts are valued at program exchange rates of 4,606 manat per U.S. dollar and 1.26 U.S. dollar per SDR.

2/ Takes into account the following temporary transactions by the ANB in which one side of the transaction took place in late Dec. 2003 and the other side on Jan. 2, 2004: (i) sales of US$10.8 mln. to a commercial bank; (ii) repurchase of 40 bln. manat REPOs; and (iii) repurchase of 60 bln. manat treasury bills.

3/ Quarterly figures are cumulative changes year to date.

4/ Velocity is defined as nominal non-oil GDP divided by average broad money.

Table 3. Azerbaijan: Summary Accounts of the Azerbaijan National Bank , 2001-05 1/

(In billions of manats)

	2001	2002	2003						2004								2005			
	Dec.	Dec.	Mar.	Jun.	Sept.	Dec.			Mar.		Jun.		Sept.		Dec.		Mar.	Jun.	Sep.	Dec.
	Act.	Act.	Act.	Act.	Act.	Prog.	Act.	Adj. Act. 2/	Prog.	Act.	Prog.	Act.	Prog.	Act.	Prog.	Rev. Prog.	Prog.	Prog.	Prog.	Prog.
Net foreign assets	1,967	2,124	2,000	2,283	2,426	2,345	2,677	2,628	2,359	2,815	2,456	3,075	2,667	3,551	2,811	3,391	3,730	4,132	4,396	4,703
Net international reserves (convertible)	1,969	2,130	2,003	2,285	2,431	2,347	2,681	2,632	2,361	2,819	2,458	3,078	2,669	3,555	2,813	3,396	3,735	4,137	4,400	4,707
Gross international reserves (convertible)	3,339	3,320	3,124	3,393	3,463	3,366	3,697	3,648	3,292	3,750	3,386	3,961	3,563	4,387	3,756	4,249	4,535	4,961	5,163	5,438
Foreign liabilities (convertible)	-1,371	-1,190	-1,121	-1,108	-1,032	-1,019	-1,016	-1,016	-930	-930	-928	-883	-894	-832	-943	-854	-800	-824	-762	-731
Other	-1	-3	-3	-2	-5	0	-4	-4	0	-4	0	-3	0	-4	0	-4	-4	-4	-4	-4
Net domestic assets	-174	-85	-20	-127	-133	80	-160	-11	9	-129	114	-99	17	-165	-36	76	-379	-449	-464	-520
Domestic credit	233	240	275	207	221	349	314	374	261	230	338	230	213	159	130	396	-60	-127	-190	-293
Net claims on general government	132	154	163	91	-6	112	75	135	0	-12	53	-26	-95	-117	-202	167	-279	-337	-391	-484
Net claims on central government	678	457	345	246	65	233	78	294	0	-9	53	-24	-95	-114	-202	170	-276	-334	-388	-481
Of which: Stabilization Fund	0	0	-49	-74	-74	...	-74	-74	-269	-126	-337	-141	-398	-65	-445	-175	-471	-629	-779	-996
Pre-2000 oil bonus deposit	-546	-304	-182	-3	-3	0	-3	-3	0	-3	0	-3	0	-3	0	-3	-3	-3	-3	-3
World Bank counterpart funds	0	0	0	-152	-68	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Claims on banks (excluding ANB bills)	101	86	110	114	225	235	237	237	259	239	283	254	306	299	330	327	342	358	373	389
ANB bills	0	0	0	0	0	0	0	0	0	0	0	0	0	-26	0	-100	-125	-150	-175	-200
Other items (net)	-407	-325	-295	-334	-354	-268	-474	-385	-252	-359	-223	-329	-196	-324	-166	-319	-320	-322	-274	-226
Reserve money	1,793	2,039	1,979	2,156	2,294	2,425	2,517	2,617	2,368	2,686	2,570	2,976	2,683	3,386	2,775	3,468	3,351	3,683	3,932	4,183
Manat reserve money	1,684	1,872	1,806	1,989	2,101	2,231	2,316	2,416	2,146	2,456	2,340	2,761	2,451	2,905	2,588	3,162	2,987	3,237	3,467	3,708
Currency in circulation	1,534	1,756	1,676	1,804	1,904	2,050	2,169	2,169	2,029	2,087	2,201	2,241	2,297	2,368	2,373	2,818	2,673	2,903	3,107	3,392
Bank reserves	145	110	122	185	197	181	147	248	117	369	139	520	153	536	214	343	314	334	360	315
Reserves in foreign currencies	109	167	173	166	193	194	201	201	222	230	230	215	232	481	188	306	364	446	465	475
Other deposits	5	6	8	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0

Sources: Azeri authorities; and Fund staff estimates and projections.

1/ Accounts are valued at program exchange rates of 4,606 manat per U.S. dollar and 1.26 U.S. dollar per SDR.

2/ Takes into account the following temporary transactions by the ANB in which one side of the transaction took place in late Dec. 2003 and the other side on Jan. 2, 2004: (i) sales of US$10.8 mln. to a commercial bank; (ii) repurchase of 40 bln. manat REPOs; and (iii) repurchase of 60 bln. manat treasury bills.

Table 4. Azerbaijan: Consolidated Government Operations, 2003-05

(In billions of manats)

	2003		2004				2004		2005				2005 2/	
	Year		Q1	Q2	Q3	Q4	Year	Year	Q1	Q2	Q3	Q4	Year	Year
	Prog.	Act.	Act.	Act.	Prel. Act.	Proj.	Prog.	Proj.		Prog.			Budget	Prog.
Total revenue and grants	9,719	9,506	2,438	2,852	2,920	3,216	10,473	11,426	3,226	3,488	3,592	4,358	12,202	14,663
Total revenue	9,669	9,477	2,438	2,852	2,920	3,166	10,423	11,376	3,226	3,488	3,592	4,308	12,152	14,613
Tax revenue	5,457	5,494	1,454	1,507	1,740	1,962	6,244	6,663	1,948	2,264	2,329	2,605	8,399	9,146
Income tax	1,514	1,644	574	429	549	603	1,691	2,156	661	654	673	707	2,695	2,695
Individual income tax	685	752	189	245	319	322	742	1,075	257	290	310	343	1,200	1,200
Enterprise profits tax	829	891	385	184	231	281	950	1,080	404	364	364	364	1,495	1,495
Social security contributions	718	745	179	223	216	230	848	848	206	264	253	259	982	982
Value added tax (VAT)	1,942	2,049	522	567	602	696	2,199	2,386	596	670	739	826	2,754	2,831
Excise taxes	356	335	22	103	131	122	350	377	144	163	169	187	655	663
Taxes on international trade	659	463	86	111	162	222	795	581	250	416	395	522	920	1,583
SOCAR additional revenue	187	126	7	15	65	98	258	184	85	158	151	216	0	610
Other taxes	268	258	71	75	81	89	361	316	90	98	100	104	393	393
Nontax revenue	2,164	2,088	291	792	913	834	2,297	2,830	868	894	938	1,298	2,283	3,997
Of which: Oil Fund revenues 1/	1,187	1,211	109	364	549	673	1,179	1,695	598	600	628	966	1,078	2,792
Tax credits for SOCAR energy subsidies	2,049	1,895	693	553	266	370	1,882	1,882	410	330	325	405	1,470	1,470
Total grants (current)	50	28	0	0	0	50	50	50	0	0	0	50	50	50
Total expenditure	10,508	10,114	2,256	2,730	2,641	3,472	10,901	11,099	2,749	3,264	3,390	4,092	13,495	13,495
Current expenditure	8,366	7,972	2,073	2,291	2,029	2,844	9,021	9,238	2,320	2,648	2,731	3,217	10,917	10,917
Primary current expenditure	6,101	5,995	1,364	1,716	1,742	2,434	7,012	7,257	1,875	2,282	2,372	2,786	9,315	9,315
Wages and salaries	1,604	1,579	418	496	467	734	2,125	2,115	610	717	654	896	2,876	2,876
Goods and services	2,110	2,012	365	533	640	966	2,270	2,503	522	743	887	945	3,098	3,098
Transfers to households	2,140	2,192	548	608	608	673	2,435	2,438	706	771	793	896	3,166	3,166
Of which: Social protection	1,808	1,855	438	490	489	554	1,971	1,971	551	606	625	696	2,479	2,479
Subsidies	163	162	21	59	18	42	120	139	27	27	28	28	110	110
Oil Fund (operating expenditures)	5	4	0	1	1	2	4	4	1	3	4	6	14	14
Other	80	46	12	20	8	18	58	58	8	20	7	15	50	50
SOCAR energy related subsidies	2,049	1,895	693	553	266	370	1,882	1,882	410	330	325	405	1,470	1,470
Interest	122	82	15	22	21	39	126	98	34	36	34	26	130	130
Current balance (-, deficit)	1,354	1,534	365	561	891	372	1,451	2,188	906	839	861	1,140	1,285	3,747
Investment expenditure and net lending	2,142	2,142	182	439	612	628	1,880	1,861	429	616	659	875	2,578	2,578
Domestically-financed	1,457	1,522	130	347	384	407	1,148	1,267	256	415	490	673	1,834	1,834
Without BTC loan	881	946	130	347	384	407	1,148	1,267	256	415	490	568	1,729	1,729
Foreign-financed	686	620	53	92	228	221	732	593	173	201	169	201	744	744
Statistical discrepancy	-113	-184	55	-201	110	0	0	-36	0	0	0	0	0	0
Consolidated government balance, cash basis (-, deficit)	-675	-425	127	323	169	-256	-428	363	476	224	202	266	-1,293	1,168
Excluding foreign project loans	10	195	180	415	397	-35	304	956	650	425	371	467	-549	1,912
Non-oil balance	-4,157	-3,865	-374	-620	-1,156	-1,955	-4,288	-4,105	-979	-1,373	-1,442	-1,796	-5,727	-5,590
Financing	675	425	-127	-323	-169	256	428	-363	-476	-224	-202	-266	1,293	-1,168
Domestic (net)	-426	-611	-188	-407	-395	-72	-382	-1,062	-649	-410	-371	-551	481	-1,980
Banking system	90	-73	-269	-278	-151	303	-268	-396	-214	-37	-33	-72	392	-355
Of which: Treasury bills	12	-34	-61	-19	1	20	46	-60	21	21	21	21	85	85
Oil Fund	-632	-640	24	-140	-292	-424	-259	-833	-459	-398	-361	-502	-6	-1,721
Nonbank sector	2	5	2	1	2	2	10	7	2	2	1	1	6	6
Privatizations and other sale of assets	115	98	53	27	44	36	160	160	23	23	23	23	90	90
Other	0	0	2	-16	3	12	-25	0	0	0	0	0	0	0
External (net)	1,101	1,035	61	84	226	328	810	699	173	186	168	285	812	812
Loans	1,196	1,123	82	101	247	346	886	776	206	202	202	300	910	910
Project loans	739	666	74	101	247	228	788	650	206	202	202	202	812	812
Oil bonuses	288	288	8	0	0	20	0	27	0	0	0	0	0	0
World Bank PRSC	169	169	0	0	0	98	98	98	0	0	0	98	98	98
Amortization due	-95	-88	-21	-16	-21	-18	-76	-77	-34	-15	-34	-15	-98	-98
Financing gap	0	0	0	0	0	0	0	0	0	0	0	0	0	0

Sources: Azeri authorities; and staff estimates and projections.

1/ Includes profit oil, acreage fees, and income earned on Oil Fund assets. Oil bonuses also enter in the Oil Fund, but these are treated as a financing item.

2/ The budget column reflects the draft 2005 budget submited to the Cabinet of Ministers (based on a US$25 per barrel oil price); the projection column reflects the staff estimates of the submited budget on the basis of (i) latest WEO oil price projections (US$42.75 per barrel), and (ii) staff's revenue estimates of the proposed policies in this budget.

Table 5. Azerbaijan: Selected Fiscal Indicators, 2001-05
(In percent of non-oil GDP, unless otherwise indicated)

	2001	2002	2003		2004		2005 5/	
	Act.	Act.	Prog.	Act.	Prog.	Proj.	Budget	Prog.
Total revenue and grants	27.5	39.6	40.7	39.4	38.4	40.2	36.7	44.1
Total revenue	27.3	39.3	40.5	39.3	38.3	40.0	36.6	44.0
Of which: Tax revenue	21.5	21.9	22.9	22.8	22.9	23.5	25.3	27.5
Nontax revenue	5.8	9.8	9.1	8.7	8.4	10.0	6.9	12.0
Tax credits for SOCAR energy subsidies	...	7.7	8.6	7.9	6.9	6.6	4.4	4.4
Of which: Oil revenue 1/	9.8	21.9	23.2	22.1	21.1	21.4	17.8	24.8
Nonoil revenue	17.5	17.4	17.3	17.2	17.2	18.6	18.8	19.2
Total grants (current)	0.2	0.3	0.2	0.1	0.2	0.2	0.2	0.2
Total expenditure	27.4	40.1	44.0	41.9	40.0	39.1	40.6	40.6
Primary expenditure	27.1	32.1	34.5	33.7	32.6	32.1	35.8	35.8
Primary current expenditure	24.0	23.9	25.6	24.8	25.7	25.5	28.0	28.0
Of which: Wage bill	6.6	6.1	6.7	6.5	7.8	7.4	8.7	8.7
Goods and services	6.6	6.5	8.8	8.3	8.3	8.8	9.3	9.3
Transfers	9.2	9.3	9.0	9.1	8.9	8.6	9.5	9.5
Domestically financed investment and net lending 2/	1.6	4.2	6.1	6.3	4.2	4.5	5.5	5.5
Foreign-financed investment	1.5	3.9	2.9	2.6	2.7	2.1	2.2	2.2
SOCAR energy related subsidies	...	7.7	8.6	7.9	6.9	6.6	4.4	4.4
Interest on public debt	0.4	0.4	0.5	0.3	0.5	0.3	0.4	0.4
Wages/primary current expenditure (in percentage)	27.3	25.5	26.3	26.3	30.3	29.1	30.9	30.9
Transfers/primary current expenditure (in percentage)	38.3	38.8	35.1	36.6	34.7	33.6	34.0	34.0
Wages/non-oil revenue (in percentage)	37.5	35.2	38.7	38.1	45.4	40.0	45.0	45.0
Transfers/nonoil revenue (in percentage)	52.7	53.4	51.7	52.9	52.0	46.1	49.6	49.6
Expenditure in education and health	6.3	6.5	6.4	6.0	6.8	6.8	7.1	7.1
Education	5.1	5.2	5.1	4.8	5.5	5.4	5.4	5.4
Health	1.2	1.3	1.3	1.1	1.3	1.4	1.7	1.7
Military expenditure	2.7	2.9	2.9	2.8	2.8	3.2	3.6	3.6
Current expenditure	24.4	32.0	35.1	33.0	33.1	32.5	32.9	32.9
Investment expenditure (net of BTC)	3.0	6.9	6.6	6.5	6.9	6.5	7.4	7.4
Current balance (+, surplus)	3.0	7.6	5.7	6.4	5.3	7.7	3.9	11.3
Primary balance (+, surplus)	-0.3	-0.3	-2.3	-1.4	-1.1	1.6	-3.5	3.9
Primary balance, excluding oil (+, surplus)	-10.1	-14.6	-16.9	-15.7	-15.3	-13.2	-16.8	-16.4
Primary balance (excl. externally financed investment)	1.2	3.6	0.6	1.1	1.6	3.7	-1.3	6.1
Consolidated government balance, cash basis (+, surplus)	-0.6	-0.7	-2.8	-1.8	-1.6	1.3	-3.9	3.5
Non-oil Balance 3/ 4/								
In percent of total GDP	-7.1	-10.3	-12.1	-11.0	-11.8	-9.7	-10.6	-10.4
In percent of non-oil GDP	-10.4	-14.9	-17.4	-16.0	-15.7	-14.4	-17.2	-16.8
Memorandum items:								
Total external assistance, excluding IMF	1.6	4.8	3.9	3.5	3.3	2.6	2.7	2.7
Project financing	1.6	4.1	3.1	2.8	2.9	2.3	2.4	2.4
Program financing	0.0	0.7	0.8	0.7	0.4	0.3	0.3	0.3
Financing gap	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0

Sources: Azeri authorities and Fund staff estimates and projections.

1/ Starting from 2002 includes SOCAR tax credits for energy subsidies.

2/ Investment expenditure increases by 1.2 percent of non-oil GDP (0.8 percent of GDP) in 2002 and by 2.4 percent of non-oil GDP (1.7 percent of GDP) in 2003 due to an equity investment by the government in BTC Azerbaijan.

3/ Calculated by deducting Oil Fund, AIOC and SOCAR revenue from the consolidated government budget balance.

4/ In 2005, part of the increase in the non-oil deficit (0.8 percent of non-oil GDP) is due to the increase in domestic petroleum products. This is because our program definition for oil revenue include both domestic and export revenue. Taxation of domestic petroleum products is, however, a sustainable source of revenue.

5/ The budget column reflects the draft 2005 budget submited to the Cabinet of Ministers (based on a US$25 per barrel oil price); the projection column reflects the staff estimates of the submited budget on the basis of (i) latest WEO oil price projections (US$42.75 per barrel), and (ii) staff's revenue estimates of the proposed policies in this budget.

Table 6. Azerbaijan: Balance of Payments, 2002-05

(In millions of U.S. dollars)

	2002	2003						2004						2005				
		Q1	Q2	Q3	Q4	Year		Q1	Q2	Q3	Q4	Year		Q1	Q2	Q3	Q4	Year
	Act.	Act.	Act.	Act.	Act.	Prog.	Act.	Act.	Act.	Proj.	Proj.	Prog.	Rev. Prog.	Prog.	Prog.	Prog.	Prog.	Prog.
Exports, f.o.b.	2,305	658	596	651	719	2,511	2,625	732	946	1,075	965	2,338	3,718	1,206	1,153	1,149	1,570	5,079
Of which: Oil and oil products	2,046	585	522	578	566	2,210	2,250	610	675	931	814	2,003	3,031	1,067	1,000	999	1,403	4,468
Other	259	73	74	74	153	301	374	122	271	144	151	335	688	140	153	151	167	611
Imports, f.o.b.	-1,823	-487	-678	-681	-877	-2,565	-2,723	-712	-840	-933	-961	-3,454	-3,447	-890	-942	-944	-899	-3,674
Of which: Oil and gas sectors	-336	-127	-305	-283	-393	-1,039	-1,109	-265	-350	-483	-493	-1,775	-1,592	-352	-393	-418	-408	-1,570
Other	-1,487	-359	-372	-398	-484	-1,526	-1,614	-447	-490	-449	-468	-1,678	-1,855	-538	-550	-526	-490	-2,104
Trade balance	482	171	-82	-30	-158	-54	-98	20	106	142	3	-1,115	272	316	211	206	672	1,405
Services (net)	-936	-379	-378	-341	-516	-1,550	-1,614	-652	-532	-448	-482	-1,422	-2,114	-366	-333	-290	-290	-1,280
Credit	362	104	98	116	113	407	431	106	121	131	129	453	487	125	133	136	149	542
Debit	-1,298	-483	-476	-457	-629	-1,956	-2,045	-758	-653	-579	-611	-1,875	-2,601	-491	-466	-426	-440	-1,822
Of which: Oil and gas sectors	-868	-383	-351	-318	-454	-1,458	-1,505	-581	-476	-412	-469	-1,252	-1,939	-301	-267	-255	-296	-1,119
Income	-386	-98	-96	-130	-118	-437	-442	-137	-177	-169	-195	-415	-678	-212	-232	-226	-380	-1,050
Investment income (net)	-326	-83	-81	-114	-96	-369	-374	-111	-134	-149	-179	-333	-573	-187	-210	-201	-354	-952
Of which: Profit of oil consortium	-344	-95	-94	-100	-97	-389	-386	-113	-114	-138	-182	-338	-547	-200	-201	-213	-358	-971
Compensation of employees	-39	-11	-10	-13	-17	-45	-50	-22	-27	-11	-10	-47	-70	-18	-16	-17	-19	-70
Interest on public debt (including Fund)	-20	-5	-5	-4	-5	-24	-19	-5	-16	-10	-5	-34	-35	-7	-7	-7	-7	-28
Transfers (net)	70	13	49	30	42	129	134	47	60	36	50	146	191	50	51	42	60	204
Private	15	3	36	19	19	79	77	31	40	19	29	84	118	33	34	34	34	135
Public	55	10	13	11	23	50	57	16	20	17	21	61	74	17	17	8	26	68
Current account balance	-769	-293	-507	-471	-750	-1,911	-2,021	-723	-543	-439	-624	-2,807	-2,328	-211	-304	-268	61	-722
Net direct investment	1,048	428	556	581	787	2090	2,353	820	525	574	613	2,673	2,531	303	469	411	99	1,282
Oil companies	984	422	547	574	771	2060	2,315	815	502	562	605	2,609	2,484	289	454	396	85	1,225
Contracted (net)	1,613	599	673	756	944	2728	2,972	1,011	846	770	811	3,276	3,438	702	756	775	669	2,902
Capital repatriation	-629	-176	-174	-182	-184	-727	-716	-198	-344	-210	-208	-667	-960	-412	-301	-379	-584	-1,676
Bonus	0	0	49	0	11	59	60	2	0	2	2	0	6	0	0	0	0	0
Other	64	6	9	7	17	30	38	5	23	12	8	65	47	14	14	14	14	57
Public sector capital	167	37	63	7	8	126	115	2	4	47	49	131	103	28	28	28	48	131
Medium long-term borrowing	216	47	81	23	25	195	177	16	21	57	73	193	165	44	44	44	64	198
Budget support	30	0	34	0	0	34	34	0	0	0	20	20	20	0	0	0	20	20
Other long-term loans	185	47	47	23	25	160	142	16	21	57	53	173	145	44	44	44	44	178
Scheduled amortization	-48	-10	-18	-15	-17	-69	-61	-13	-16	-9	-24	-62	-63	-17	-17	-17	-17	-66
Other (including short term capital) 1/	-135	-135	17	-3	6	21	-115	-48	102	-26	-36	151	-7	38	-36	-47	-49	-93
Capital account balance	1,080	330	636	586	801	2,236	2,353	775	631	596	625	2,955	2,627	369	461	391	98	1,320
Errors and omissions	-90	-31	-16	-79	30	-165	-96	-36	-4	0	0	0	0	0	0	0	0	0
Overall balance	221	7	113	35	82	160	237	15	84	157	42	149	298	159	157	123	160	599
Financing	-221	-7	-113	-35	-82	-160	-237	-16	-84	-157	-42	-149	-298	-159	-157	-123	-160	-599
Change in net foreign assets of NBA (-, increase)	-35	25	-61	-33	-55	-52	-124	-33	-58	-105	36	-104	-160	-75	-86	-59	-67	-287
Net credit from the Fund	-39	-17	-3	-18	-4	-41	-42	-21	-12	-13	6	-20	-40	-13	7	-15	-7	-29
Disbursements/purchases	10	0	18	0	19	36	37	0	0	0	19	36	19	0	19	0	0	19
Repayments/repurchases	-49	-17	-21	-18	-22	-77	-79	-21	-12	-13	-13	-56	-59	-13	-12	-15	-7	-48
Change in gross official reserves (-, increase)	4	43	-58	-15	-51	-11	-82	-11	-46	-93	30	-84	-120	-62	-93	-44	-60	-258
Change in other foreign liabilities (+, increase)	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Change in arrears (-, decrease) 2/	15	5	3	4	4	15	15	5	5	5	5	0	22	7	7	7	7	29
Change in oil fund assets (-, increase)	-201	-37	-55	-6	-31	-124	-128	12	-32	-57	-84	-45	-160	-91	-79	-71	-100	-340
Financing gap	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Memorandum items:																		
Current account balance (in percent of GDP)	-12.3	…	…	…	…	-27.4	-28.3	…	…	…	…	-37.8	-27.1	…	…	…	…	-6.6
Excluding oil sector imports of goods and non-factor services	7.0	…	…	…	…	8.4	8.3	…	…	…	…	3.0	14.0	…	…	…	…	17.9
Gross official reserves (US$ millions)	721	678	737	752	803	732	803	814	860	952	923	815	923	985	1,077	1,121	1,181	1,181
Gross official reserves (in months of non-oil imports c.i.f.)	4.0	…	…	…	…	3.8	3.8	…	…	…	…	3.9	3.9	…	…	…	…	4.5
Oil fund assets	693	…	…	…	…	817	821	…	…	…	…	862	981	…	…	…	…	1,322
WEO oil price (US$ per barrel)	25.0	…	…	…	…	28.5	29.0	…	…	…	…	25.5	38.5	…	…	…	…	42.8

Sources: Azeri authorities; and Fund staff estimates and projections.

1/ For 2004-2005, includes debt financing of the Baku-Tbilisi-Ceyhan (BTC) pipeline project and the Shah Deniz project by SOCAR.

2/ Arrears are for the nonpayment of electricity imported from Turkey by Azerenergy (a state-owned company) for Nakchivan. The stock of arrears as of May 2004 is estimated at 655 billion manat, approximately US$133 million. These arrears are not an obligation of the government of Azerbaijan.

Table 7. Azerbaijan: Quantitative Performance Criteria and Indicative Targets for the PRGF, 2003-05 1/ 2/

(In billions of manats, unless otherwise indicated)

	2002	2003			2004										2005
	Dec.	Dec.			Mar.			Jun.			Sept.		Dec.		Mar.
	Act.	Prog.	Adj. Prog. 3/	Act.	Prog.	Adj. Prog. 3/	Act.	Prog.	Adj. Prog. 3/	Act.	Prog.	Proj.	Prog.	Rev. Prog. 4/	Prog.
1. Quantitative performance criteria and indicative targets															
Floor on net international reserves of the ANB (end-of-period stock, in US$ million)	462	513	465	582	512	494	612	533	500	668	579	772	610	737	811
Ceiling on net domestic assets of the ANB (end-of-period stock)	-85	-28	194	-160	9	92	-129	114	266	-99	17	-165	-36	76	-379
Ceiling on net credit to the general government from the ANB (end-of-period stock)	154	93	315	75	0	83	-12	53	205	-26	-95	-117	-202	167	-279
Ceiling on the overall consolidated non-oil deficit 5/ 6/	...	4,224	4,176	3,865	968	899	374	2,141	1,959	994	3,192	2,150	4,288	4,105	979
Ceiling on New Nonconcessional External Debt Contracted or Guaranteed by the Consolidated Government or the ANB (excluding the IMF) (flows, in US$ million) 5/															
Less than one year's maturity	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Medium- and long-term debt, one to less than five years	...	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Other long-term debt (maturity five and more years)	...	80	80	0	50	50	0	100	100	0	125	125	150	150	50
2. Continuous performance criterion															
Ceiling on Stock of Outstanding Nonreschedulable External Payments Arrears of the Consolidated Government and the ANB (end-of-period stock, in US$ million)	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
3. Indicative targets															
Ceiling on stock of ANB's manat reserve money (end-of-period stock)	1,872	2,231	2,231	2,316	2,146	2,146	2,456	2,340	2,340	2,761	2,451	2,905	2,588	3,162	2,987
Ceiling on stock of unpaid bills in excess of Manat 50 billion (end-of-period stock)	-36	0	0	-41	0	0	10.1	0	0	19.7	0	...	0	...	...

1/ The program targets are indicative targets for end-March 2004 and end-September 2004, and performance criteria and indicative targets for end-December 2003, end-June 2004 and end-December 2004 end end-March 2005.

2/ Foreign exchange components are valued using program exchange rates of 4,606 manat/US$ and 1.26 US$/SDR.

3/ Program targets are adjusted on the basis of program adjustors as specified in Attachment I, Annex I of EBS/03/57.

4/ The staff expects that end-2004 quantitative targets and/or performance criteria under the program on net international reserves, net domestic assets of ANB, and net credit to general government from ANB to be met, on the basis of preliminary calculations of expected program adjustors.

5/ Cumulative changes during the year.

6/ For 2003, the figure reported in EBS/03/57 was 4,042. However, this figure incorrectly did not exclude AIOC profit tax of 182 billion manat.

Table 8. Structural Performance Criteria and Benchmarks for End-December 2003, End-March 2004, End-June 2004, End December 2004, End-March 2005 and End-April 2005, and Prior Actions for the Fourth Review

Reform Measure	Status	Comments
End-December 2003		
Structural Performance Criteria		
Establish a single uniform enterprise profit tax for all non-oil companies	Observed	Profits tax unified at 24 percent on November 28, 2003
Adoption of a procedure for future automatic adjustments of domestic energy prices	Not Observed	Decree adjusting most domestic energy product prices took effect in November, 2004
Replacement of specific with ad valorem customs duties in continued adherence to timetable adopted in compliance with end-March 2002 structural performance criteria	Observed	Consistent with the timetable under the program, on October 1, 2003 the authorities replaced a number of specific with ad valorem custom duties
Adoption of a Cabinet of Ministers decision reducing list of VAT exemptions and requiring that all future changes be done in the context of annual budget preparation process	Observed	Adopted by Cabinet of Minister's Decision No. 155 dated December 4, 2003
Adoption by parliament of a new Banking Systems Law	Not observed	Adopted in January 2004, but the implementing Presidential decree restricted Central Bank's independence. This issue was resolved with the passage of the Central bank Law
Submission to parliament of the new Central Bank Law	Not observed	The revised draft satisfactory to the Fund staff was submitted to parliament in Nov. 2004
Structural Benchmarks		
Continued adherence of the SCC reform program	Observed	
Allocation of tax credits to SOCAR and subsidies to Azerenergy and Azerigaz related to unpaid fuel consumed by the utilities	Observed	Subsidies calculated and allocated to SOCAR quarterly
End-March 2004		
Structural Performance Criteria		
Approval by Cabinet of Ministers of a long-term strategy for oil revenue management	Not observed	Strategy endorsed by the President on Sept. 27, 2004.
Adoption of the Central Bank Law	Not observed	Expected to be adopted by December 17, 2004.

Table 8. Structural Performance Criteria and Benchmarks for End-December 2003, End-March 2004, End-June 2004, End December 2004, End-March 2005 and End-April 2005, and Prior Actions for the Fourth Review

Reform Measure	Status	Comments
Approval by Cabinet of Ministers of annual expenditure plans and revenue projections for Azerchemia, Azerenergy, and Azerigas for 2004	Not observed	Plans for Azerchemia approved in January, but plans for Azerenergy and Azerigas were approved only in April
End-June 2004		
Structural Performance Criterion		
Issuance of a tender for all remaining government shares in IBA	Not observed	Progress on the sale of 20 percent of IBA to EBRD has stalled, and thus the tender for selling all remaining shares in IBA could not be issued
Structural Benchmark		
Review by Cabinet of Ministers of first quarter 2004 implementation by Azerchemia, Azerenergy, Azerigas and Baku metro of their expenditure plans and revenue projections, and taking any measures to ensure these budgets are adhered to	Not observed	
Prior Actions for the Fourth Review		
Adoption of National Bank Law		
Announcement that all banks have the right to serve as collection points for gas and water bills, and that the respective utilities will cooperate with all participating banks		
Inclusion in a Cabinet of Ministers' instruction of non-oil fiscal deficit path of 2.4 percent of non-oil GDP increase in 2005, and a one percent increase in subsequent years		
Announcement that pensioners are free to choose the payment outlet (including private commercial bank) they wish to receive their pensions through, and that the ATM cards issued to pension recipients can be used at any ATM in the country		
End-December 2004		
Structural Performance Criterion		
Approval by the Cabinet of Ministers of revenue and expenditure plans for Azerchemia, Azerenergy, Azerigas, and SOCAR, consistent with the subsidy allocations in the 2005 budget		

Table 8. Structural Performance Criteria and Benchmarks for End-December 2003, End-March 2004, End-June 2004, End December 2004, End-March 2005 and End-April 2005, and Prior Actions for the Fourth Review

Reform Measure	Status	Comments
End-March 2005		
Structural Performance Criterion		
Issuance of tenders for all financial services to be purchased by the Ministry of Finance		
Structural Benchmarks		
Submission to Cabinet of Ministers of a timetable for the design of a comprehensive medium-term civil service reform program		
Based on a review by the Cabinet of Ministers adoption of decisions to strengthen the financial discipline and oversight of Azerchemia, Azerenergy, Azerigas, and SOCAR		
End-April 2005		
Structural Performance Criterion		
Adoption by the Cabinet of Ministers of a plan to improve the annual budget process, and strengthen connections between the SPPRED, MTEF, PIP and annual budget with this plan to be implemented during the preparation of the 2006 budget		

Table 9. Azerbaijan: Millennium Development Goals
Country Profile

	1990	1995	2001	2002
1 Eradicate extreme poverty and hunger	2015 target = halve 1990 $1 a day poverty and malnutrition rates			
Population below $1 a day (percent)	....	....	3.7	....
Poverty gap at $1 a day (percent)	....	....	1.0	....
Percentage share of income or consumption held by poorest 20percent	....	....	7.4	....
Prevalence of child malnutrition (percent of children under 5)	....	10.1	16.8	....
Population below minimum level of dietary energy consumption (percent)	....	37.0	21.0	....
2 Achieve universal primary education	2015 target = net enrollment to 100			
Net primary enrollment ratio (percent of relevant age group)	....	....	79.8	....
Percentage of cohort reaching grade 5 (percent)	....	....	....	....
Youth literacy rate (percent ages 15-24)	....	...	...	...
3 Promote gender equality	2005 target = education ratio to 100			
Ratio of girls to boys in primary and secondary education (percent)	99.8	107.5	97.5	...
Ratio of young literate females to males (percent ages 15-24)	...	...	...	...
Share of women employed in the nonagricultural sector (percent)	35.0	39.5	45.4	...
Proportion of seats held by women in national parliament (percent)	...	2.0	...	...
4 Reduce child mortality	2015 target = reduce 1990 under 5 mortality by two-thirds			
Under 5 mortality rate (per 1,000)	106.0	102.0	97.0	96.0
Infant mortality rate (per 1,000 live births)	84.0	81.0	78.0	76.0
Immunization, measles (percent of children under 12 months)	66.0	97.0	99.0	97.0
5 Improve maternal health	2015 target = reduce 1990 maternal mortality by three-fourths			
Maternal mortality ratio (modeled estimate, per 100,000 live births)	...	...	94.0	...
Births attended by skilled health staff (percent of total)	...	...	84.1	...
6 Combat HIV/AIDS, malaria and other diseases	2015 target = halt, and begin to reverse, AIDS, etc.			
Prevalence of HIV, female (percent ages 15-24)				
Contraceptive prevalence rate (percent of women ages 15-49)	...	...	0.0	...
Number of children orphaned by HIV/AIDS	...	...	55.4	...
Incidence of tuberculosis (per 100,000 people)	...	...	...	...
Tuberculosis cases detected under DOTS (percent)	...	...	82.0	82.0
	...	4.0	6.0	42.8
7 Ensure environmental sustainability	2015 target = various (see notes)			
Forest area (percent of total land area)	11.1	...	12.6	...
Nationally protected areas (percent of total land area)	...	5.5	5.5	5.5
GDP per unit of energy use (PPP $ per kg oil equivalent)	1.3	1.0	2.0	...
CO2 emissions (metric tons per capita)	6.4	4.2	3.6	...
Access to an improved water source (percent of population)	...	...	78.0	...
Access to improved sanitation (percent of population)	...	...	81.0	...
Access to secure tenure (percent of population)	...	...	...	...
8 Develop a Global Partnership for Development	2015 target = various (see notes)			
Youth unemployment rate (percent of total labor force ages 15-24)	...	...	...	...
Fixed line and mobile telephones (per 1,000 people)	86.3	85.7	199.6	220.3
Personal computers (per 1,000 people)	...	...	...	...

Millennium Development Goals (concluded)
Azerbaijan Country Profile

	1990	1995	2001	2002
General indicators				
Population (in millions)	7.2	7.7	8.1	8.2
Gross national income (US$ billions)	...	3.0	5.3	5.8
GNI per capita (US$)	...	390.0	660.0	710.0
Adult literacy rate (percent of people ages 15 and over)	...	...	...	...
Total fertility rate (births per woman)	2.7	2.3	2.1	2.1
Life expectancy at birth (years)	70.8	69.0	65.2	65.2
Aid (percent of GNI)	0.7	3.9	4.3	6.1
External debt (percent of GNI)	...	10.6	23.4	24.5
Investment (percent of GDP)	26.5	23.8	20.7	32.8
Trade (percent of GDP)	83.1	87.7	78.2	95.0

Source: World Development Indicators database, April 2004.

Note: In some cases the data are for earlier or later years than those stated.
Goal 1 targets: Halve, between 1990 and 2015, the proportion of people whose income is less than one dollar a day. Halve, between 1990 and 2015, the proportion of people who suffer from hunger.
Goal 2 target: Ensure that, by 2015, children everywhere, boys and girls alike, will be able to complete a full course of primary schooling.
Goal 3 target: Eliminate gender disparity in primary and secondary education preferably by 2005 and to all levels of education no later than 2015.
Goal 4 target: Reduce by two-thirds, between 1990 and 2015, the under-five mortality rate.
Goal 5 target: Reduce by three-quarters, between 1990 and 2015, the maternal mortality ratio.
Goal 6 targets: Have halted by 2015, and begun to reverse, the spread of HIV/AIDS. Have halted by 2015, and begun to reverse, the incidence of malaria and other major diseases.
Goal 7 targets: Integrate the principles of sustainable development into country policies and programs and reverse the loss of environmental resources. Halve, by 2015, the proportion of people without sustainable access to safe drinking water. By 2020, to have achieved a significant improvement in the lives of at least 100 million slum dwellers.
Goal 8 targets: Develop further an open, rule-based, predictable, non-discriminatory trading and financial system. Address the Special Needs of the Least Developed Countries. Address the Special Needs of landlocked countries and small island developing states. Deal comprehensively with the debt problems of developing countries through national and international measures in order to make debt sustainable in the long term. In cooperation with developing countries, develop and implement strategies for decent and productive work for youth. In cooperation with pharmaceutical companies, provide access to affordable, essential drugs in developing countries. In cooperation with the private sector, make available the benefits of new technologies, especially information and communications.

Table 10. Azerbaijan: Macroeconomic Framework, 2000-10

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
	Act.	Act.	Act.	Act.	Projections						
GDP and prices (annual percentage changes)											
Real GDP	10.3	9.6	9.7	10.8	7.8	21.6	38.3	36.8	21.6	9.0	3.5
Oil sector	2.4	7.9	3.9	0.4	-1.1	39.7	74.7	62.5	32.6	10.9	1.3
Other sectors	13.7	10.4	12.3	15.5	12.1	10.3	8.0	7.5	7.0	6.5	6.0
GDP deflator	12.5	2.8	4.0	4.4	11.8	5.0	-7.5	-3.7	0.5	0.6	2.1
Consumer price index (end-period)	2.2	1.3	3.3	3.6	10.0	5.0	5.0	5.0	5.0	5.0	5.0
Monetary aggregates (annual percentage changes)											
Broad money (M3)	27.1	29.4	13.1	29.3	39.6	22.0	...	...	...	...	...
Credit to non-government 1/	-1.7	-17.5	16.7	38.3	51.1	15.3	...	...	...	...	...
Savings and investments (in percent of GDP)											
Gross fixed investment	23.1	22.9	34.1	50.8	54.5	39.9	33.4	19.3	13.8	13.3	14.4
Consolidated government	3.0	2.1	5.6	6.1	4.4	4.8	4.8	4.1	4.2	4.2	4.5
Private sector	20.1	20.8	28.5	44.7	50.1	35.2	28.6	15.2	9.6	9.1	9.9
Of which: Oil sector	11.2	14.6	26.9	42.2	40.5	26.9	21.6	10.1	5.6	5.1	6.1
Gross domestic savings	21.3	24.3	24.8	27.2	33.1	41.1	48.6	57.2	62.4	61.8	59.4
Gross national savings	17.1	19.8	19.8	22.7	27.3	33.4	38.5	49.4	57.8	59.0	62.7
Consolidated government	2.4	1.6	5.1	4.9	5.3	6.9	7.2	14.3	40.0	45.3	44.3
Private sector	14.7	18.2	14.7	17.8	22.0	26.4	31.4	35.1	17.9	13.7	18.4
Consolidated government (in percent of GDP)											
Revenue 2/	30.2	27.5	39.6	39.4	40.2	44.1	25.1	28.8	52.7	59.1	59.4
Expenditures 2/	29.6	27.4	40.1	41.9	39.1	40.6	22.7	18.6	17.0	16.8	18.4
Current	18.6	24.4	24.3	25.2	25.9	28.4	15.9	13.3	12.2	12.5	13.8
Of which: Interest payments	0.6	0.4	0.4	0.3	0.3	0.4	0.3	0.2	0.2	0.2	0.2
Investments	4.3	3.0	8.1	8.9	6.5	7.8	4.8	4.1	4.2	4.2	4.5
Overall balance	-0.8	-0.6	-0.7	-1.8	1.3	3.5	2.4	10.1	35.7	42.3	41.0
Non-oil balance 3/											
-As a share of GDP	-8.1	-7.1	-10.3	-11.0	-9.7	-10.4	-9.6	-8.7	-8.5	-9.1	-10.0
-As a share of non-oil GDP	-11.5	-10.4	-14.9	-16.0	-14.4	-16.8	-17.7	-18.7	-19.7	-20.7	-21.7
Balance of payments (in millions of U.S. dollars)											
Trade balance	260	581	482	-98	272	1,405	3,457	7,657	11,218	12,165	11,998
Exports	1,799	2,046	2,305	2,625	3,718	5,079	7,314	11,125	14,498	15,620	15,816
Of which: Oil and gas sector	1,519	1,841	2,046	2,250	3,031	4,468	6,650	10,405	13,711	14,768	14,898
Imports	1,539	1,465	1,823	2,723	3,447	3,674	3,857	3,468	3,280	3,455	3,818
Of which: Oil and gas sector	147	138	336	1,109	1,592	1,570	1,494	860	446	365	472
Services, net	-225	-375	-936	-1,614	-2,114	-1,280	-1,319	-637	-205	-128	-197
Receipts	260	290	362	431	487	542	616	786	918	1,031	1,098
Payments	-485	-665	-1,298	-2,045	-2,601	-1,822	-1,934	-1,423	-1,123	-1,159	-1,295
Of which: Oil and gas sector	-154	-329	-868	-1,505	-1,939	-1,119	-1,169	-632	-315	-312	-400
Income, net	-295	-332	-386	-442	-678	-1,050	-1,650	-1,710	-1,339	-1,000	518
Current account balance	-187	-50	-769	-2,021	-2,328	-722	720	5,565	9,971	11,356	12,663
Capital and financial account balance	496	420	1,080	2,353	2,627	1,320	411	-2,858	-1,153	54	-826
Of which: Net FDI	149	299	1,048	2,353	2,531	1,282	291	-2,972	-1,165	176	-610
Memorandum items:											
Gross official reserves											
- In millions of U.S. dollars	680	725	721	803	923	1,181	1,388	1,457	1,525	1,608	1,728
- In months of prospective nonoil sector imports of GNFS	4.9	4.5	4.0	3.8	3.9	4.5	4.9	4.8	4.7	4.6	4.5
External debt/GDP (in percent)	19.8	20.2	20.1	20.1	17.5	14.6	12.1	9.6	8.3	8.1	8.2
External debt service/exports of GNFS (in percent)	4.6	4.9	4.4	5.2	3.7	2.5	1.4	1.0	0.7	0.5	0.4
Oil Fund Assets											
- In millions of U.S. dollars	272	493	693	821	981	1,322	2,209	4,812	13,541	24,860	36,575
- In percent of non-oil GDP	7.3	12.7	16.1	16.7	17.0	19.5	28.8	55.5	139.1	228.4	301.9
Nominal GDP											
- In billions of manats	23,591	26,578	30,312	35,054	42,246	53,929	69,005	90,929	111,122	121,823	128,767
- In millions of U.S. dollars	5,273	5,708	6,236	7,138	8,598	10,988	14,060	18,527	22,641	24,821	26,236
Nominal non-oil GDP (in billions of Manats)	16,575	18,072	20,901	24,139	28,415	33,217	37,668	42,518	47,769	53,418	59,454

Sources: Azeri authorities; and Fund staff projections.

1/ Negative credit growth reflects the impact of closure of nonviable banks, including the closure of Agrobank in 2001.

2/ Revenue and expenditure prior to 2002 do not include quasi-fiscal activities in the energy sector.

3/ Calculated by deducting Oil Fund, AIOC and SOCAR revenue, as well as government financed BTC investment from the consolidated government budget balance.

Table 11: Azerbaijan: Capacity to Repay the Fund, 2004-10

	2004	2005	2006	2007	2008	2009	2010
			(In millions of SDRs)				
Outstanding use of Fund credit	147.2	127.5	102.7	78.2	64.5	52.5	44.1
IMF obligations	41.7	34.1	25.8	25.0	14.1	12.2	8.5
Purchases and Disbursements	12.9	12.9	0.0	0.0	0.0	0.0	0.0
Repurchases and Repayments	39.9	32.6	24.9	24.5	13.7	12.0	8.4
Charges	1.8	1.5	1.0	0.6	0.3	0.2	0.1
				(In percent)			
Outstanding use of Fund credit as a ratio of							
Exports of goods and services	5.1	3.3	1.9	1.0	0.6	0.5	0.4
External public debt	14.4	11.6	8.9	6.4	5.0	3.8	3.0
Gross official reserves	23.4	15.8	10.8	7.9	6.2	4.8	3.7
GDP	2.5	1.7	1.1	0.6	0.4	0.3	0.2
Quota	91.5	79.3	63.8	48.6	40.1	32.6	27.4
Debt service obligations to IMF as a ratio of							
Exports of goods and services	1.5	0.9	0.5	0.3	0.1	0.1	0.1
External public debt	4.1	3.1	2.2	2.1	1.1	0.9	0.6
Gross official reserves	6.6	4.2	2.7	2.5	1.4	1.1	0.7
GDP	0.7	0.4	0.3	0.2	0.1	0.1	0.0
Quota	25.9	21.2	16.0	15.6	8.7	7.6	5.3
Memorandum item:							
Quota (million SDRs)	160.9	160.9	160.9	160.9	160.9	160.9	160.9

Source: Fund staff estimates and projections.

Table 12: Azerbaijan: Review and Phasing of Disbursements
Under the Proposed PRGF Arrangement

(In millions of SDRs)

Date of Disbursement	Conditions	Disbursement
July 13, 2001	Disbursed upon Board approval of the PRGF arrangement	8.05
February 28, 2002	Disbursed upon completion of the first review under the PRGF arrangement	8.05
May 29, 2003	Disbursed upon completion of the second review under the PRGF arrangement	12.87
December 29, 2003	Disbursed upon completion of the third review under the PRGF arrangement	12.87
On or after December 22, 2004	Completion of the fourth review; end-December 2003 performance criteria	12.87
On or after June 15, 2005	Completion of the fifth review; end-December 2004, and end-March and end-April 2005 performance criteria	12.87

December 6, 2004

Mr. Rodrigo de Rato
Managing Director
International Monetary Fund
700 19th Street
Washington, DC 20431

Dear Mr. de Rato:

1. On December 19, 2003, the IMF Executive Board completed the third review under Azerbaijan's Poverty Reduction and Growth Facility (PRGF) arrangement, which is in support of our economic reform program. We would like to take this opportunity to inform you about our continuing implementation of this program, as well as our policy intentions for 2005, and to request waivers for non-compliance with several structural performance criteria. This letter should be read as additional to our original letter of intent and Memorandum of Economic and Financial Policies, dated June 15, 2001, as well as our letters of February 6, 2002, April 23, 2003 and December 4, 2003.

2. Our performance relative to the quantitative performance criteria and indicative targets for end-2003, as well as end-March, end-June and end-September 2004, and the proposed performance criteria and targets for end-December 2004, and end-March 2005 are presented in Table 1. Performance relative to these targets and criteria should be measured as detailed in Annex I of our April 23, 2003 letter. While the fourth review under our PRGF arrangement was scheduled for completion by May 15, 2004 and the fifth review by August 15, 2004, difficulties discussed below have made adherence to this schedule impossible. Therefore, we would like to request completion of the fourth review under our PRGF arrangement, a rephasing of the fifth review so that it be completed on or after May 15, 2005 based on performance criteria for March 31, 2005. To accommodate this rephasing of reviews, we also request an extension of the program to July 4, 2005, from the current expiration date of March 31, 2005. The delays in completing the fourth review, as well as delays in completing earlier reviews, make completion of the originally planned sixth review impossible within the 4 year maximum life of a PRGF arrangement, and thus we also request cancellation of the sixth review and a corresponding reduction in the size of our PRGF arrangement.

3. Our program policies and objectives described below are fully consistent with our State Program for Poverty Reduction and Economic Development (SPPRED).

Recent Macroeconomic Developments

4. **Macroeconomic developments remain generally favorable,** with strong real GDP growth, a stable exchange rate, and continued accumulation of foreign assets by the National

Bank of Azerbaijan (ANB) and the State Oil Fund of Azerbaijan. **Real GDP** grew 11.2 percent in 2003 relative to 2002, and by 9.9 percent in the first nine months of 2004 compared to the same period a year earlier, reflecting the positive impact of prudent financial policies and comprehensive structural reforms adopted by the government, high oil prices, and continued strong foreign direct investments in the oil sector. **Gross official reserves** of ANB increased to US$952 million at end-September 2004, and are now equivalent to almost 4.1 months of non-oil imports. Given that external debt and debt service remain relatively low—with prospective public and publicly-guaranteed external debt about 17.5 percent of GDP, and debt service at 2.3 percent of projected 2004 exports—these foreign assets provide a comfortable cushion against adverse external shocks.

5. **Inflation remains moderate.** Although there was an acceleration in consumer price inflation late in 2003 that continued in early 2004, 12-month consumer price inflation has recently declined from a peak of 6.8 percent as of end-April 2004, to 4.9 percent at end-September 2004, moderately higher than both the 3.3 percent at end-2003 and the program target for 2004 of 2.5 percent. We believe four factors have contributed to this increase in inflation: the increase in wages and pensions in the second half of 2003; the increase of nearly 20 percent in imported wheat prices; the higher than expected domestic impact of oil-sector FDI; and the significant depreciation of the U.S. dollar vis-à-vis most major currencies in late-2003 which, given our policy of using the manat/U.S. dollar exchange rate as an anchor for monetary policy, has produced a significant real effective depreciation of the manat relative to our trading partners. The acceleration in inflation in October, when monthly inflation reached 4.4 percent, we attribute to a number of one time factors, including increases in advance of the expected upward adjustment in domestic energy product prices and the temporary closure of the border with Russia.

6. We continue our efforts to combat poverty. As detailed in the first annual report on our SPPRED, completed in May 2004, poverty is estimated at 44.7 percent of our total population, while the incidence of extreme poverty is almost 10 percent. While changes in methodology between the two most recent household surveys make comparisons difficult, we believe there has been some reduction in poverty, and are determined to reduce it further in the coming years.

Performance Relative to Program Targets

7. **All end-2003, as well as end-March, end-June and end-September 2004 quantitative performance criteria and indicative targets were met** with comfortable margins, with two exceptions. The indicative reserve money targets were missed by significant margins, in large part reflecting increased money demand, while the indicative limit on unpaid government bills for end-March, end-June and end-September were exceeded by less than 0.1 percent of GDP, due to modest arrears on pension payments.

8. **Our performance relative to our structural commitments under the PRGF program has been mixed.** We met most of our structural performance criteria and benchmarks for end-December 2003: we established a single uniform enterprise profit tax;

replaced specific import duties with ad valorem duties as programmed; reduced the list of VAT exemptions and required that future changes in such exemptions be done only in the context of the annual budget preparation process; allocated tax credits to SOCAR and subsidies to Azerenergy and Azerigas related to unpaid fuel consumed by the utilities on a quarterly basis in 2003; and continued adherence to the reform program for the State Customs Committee (SCC) through end-2003.

9. **However, there were a number of structural reforms that proved more difficult to implement than we had anticipated, with the result that we missed several structural performance criteria under the program.** First, given the importance for our economic future of a **long term strategy for the use of oil revenues**, we have taken time to ensure the development of a strategy that is both well-designed and broadly supported. While we were not able to meet the performance criterion calling for the adoption of such a strategy by end-March 2004, our strategy was formally adopted by a Presidential decree in September, with the resultant path of non-oil deficits presented in the draft presidential decree on the 2005 budget.

10. Second, while we have made serious efforts during 2004 to begin the process of increasing the financial discipline of, and government control over the operations of, large state-owned enterprises, the process has been very difficult. We had committed to **approve the 2004 revenue and expenditure plans of Azerchemia, Azerenergy and Azerigas** by end-March 2004 (a structural performance criterion), but these companies had difficulty producing plans satisfactory to the government, and thus were only able to complete this approval process in April 2004. In addition, we have found it very hard to monitor and enforce the implementation of these plans. However, these plans were approved, and we are making efforts to strengthen our monitoring of the execution of these plans as discussed below.

11. Similarly, the process of **revising the legislative foundation of our banking system has proven more complicated and thus protracted than we anticipated**, as we struggled to balance the need for independence of the ANB with the need to ensure the transparency and effective oversight of the ANB. Deciding how to meet both these needs took longer than expected, and as a result we were not able to adopt the Banking System Law (BSL) by end-December 2003, or to submit the National Bank Law (NBL) to parliament by end-December 2003 (both structural performance criteria). However, as a prior action for completing the fourth review we have adopted a BSL, and will adopt an NBL, that are both consistent with all Basle Core Principles (BCPs). Among other important features, the laws provide for a level playing field in the banking sector, strengthen banks' corporate governance, bolster the central bank's supervisory control, improve our ability to fight money laundering and financing of terrorism, strengthen ANB's independence in the formulation and execution of monetary policy, improve the accountability of the ANB, enhance ANB transparency through an inclusion of two independent members in its Board, and establish a clear mechanism for distributing ANB's profits. On this basis, we request waivers of the relevant performance criteria.

12. Also on the banking sector, **the process of privatizing International Bank of Azerbaijan (IBA)** has gone slower than we had hoped. We had planned to sell 20 percent of IBA to EBRD, and to then issue a tender for the sale of the government's remaining 30.1 percent of the bank. While it was a structural performance criterion to issue this tender by end-June 2004, the discussions on the sale to EBRD have not yet been completed, and thus it proved impossible to meet this commitment. Nonetheless, we continue our efforts to privatize IBA (discussed in paragraphs 20 and 21 below), and are taking steps to develop a competitive banking system.

13. Finally, while we recognize the importance of **ensuring that domestic energy product prices reflect world market prices,** we have reconsidered our plans for how to achieve this objective. We had committed to adopt a mechanism for the automatic adjustment of domestic energy product prices by end-December 2003 (a structural performance criterion). However, we are now concerned that such a process could lead to artificial shortages in advance of what would be effectively pre-announced price changes. Thus, while we remain committed to eventually bringing domestic prices into line with world market prices, we have decided not to adopt such a mechanism at this time. Instead, as of November 1 this year we increased the price of natural gas 127 percent, (bringing the average price to roughly 85 percent average cost), which will be combined with an ambitious program to provide gas meters for all households. We have also increased the price of gasoline, diesel fuel, home heating fuel, kerosene, motor oil, industrial oil, turbine oil, transformer oil, other types of oil, motor fuel, jet fuel, coke, naphtha (primary gasoline), bitumen, and compression gasoline, depending on grade, by 10-12 percent, on average. During the coming year, based on an analysis of the impact of these increases in the first half of 2005, we will consider the next stage in revising these prices.

14. In part to help **cushion the most vulnerable in society against these price increases**, we increased the minimum wage from 60,000 to 100,000 manat per month on July 1, 2004, and plan further increases in both the minimum wage and minimum pension in 2005. We have also included in the 2005 budget 34 billion manat to compensate vulnerable groups for energy price increases.

15. In addition to these one-time price changes, our intention is to review the domestic prices of energy products at least once per year, in the context of the annual budget preparation process, with the goal of first ensuring all prices at least cover production costs, and then over time ensuring these prices more closely align with world market prices. We have publicly announced this pricing strategy. Given the recently announced price increases, and this long-term pricing strategy, we request a waiver of the performance criterion calling for the adoption of an automatic adjustment mechanism.

Monetary and Exchange Rate Policies and Financial Sector Reforms

16. **Our macroeconomic targets and projections for 2005 reflect our continued strong economic growth prospects.** High export prices, the anticipated completion of the Baku-Tbilisi-Ceyhan (BTC) oil export pipeline and the first phase of the Azeri-Chirag-Guneshli oil field, as well the continued investments in the Shah Deniz gas field and South Caucasus gas pipeline are expected to produce roughly 25 percent growth in the hydrocarbon sector of our economy in 2005, at the budgeted export price of oil of US$25 per barrel. At the same time, reflecting the continuing broad-based growth of our economy, growth in other sectors—particularly in agriculture, agro-processing, transport and telecommunications—are projected to lead to a fifth consecutive year of over 10 percent growth in the non-hydrocarbon sectors of our economy.

17. **We also remain committed to macroeconomic stability, and in particular to keeping inflation under control.** While underlying inflation in 2004 is projected to be 5.0 percent, as a result of the increases in energy product prices discussed above, we expect the actual inflation level to be somewhat higher. We are targeting 2005 inflation of 5.0 percent.

18. **The ANB has in recent years used the exchange rate of the manat to help anchor the domestic price level**; we believe this policy has served us well, as it has contributed to low inflation, increasing international reserves and growing external competitiveness, as reflected in the rapid growth of non-oil exports in recent years. Thus, we will continue to use the nominal exchange rate as an anchor for the nominal variables of the economy. However, we recognize that, as our use of oil revenues increases, appreciation of the real exchange rate will be inevitable. We will ensure that this real appreciation does not come about via higher inflation. In part as a result, we anticipate modest nominal appreciation in 2005. We will monitor inflation trends carefully and, if developments indicate our new inflation target is in jeopardy, we stand ready, in consultation with Fund staff, to tighten the stance of our fiscal and monetary policies, as necessary. To enhance our ability to conduct monetary policy, we have recently introduced Central Bank Bills. In addition, the Ministry of Finance and the ANB will review the issue of the long-term government bonds currently held by the ANB, with the aim of converting them into marketable securities. We aim to have a combined total of 500 billion manat worth of Treasury and Central Bank Bills in circulation or held by the ANB by end-2005, but will revise this plan as necessary based on financial market developments.

19. The ANB will continue to follow carefully the developments in the domestic credit market, to **ensure that the recent fast pace of credit growth does not undermine the quality of commercial bank loan portfolios**. While in 2003 the stock of outstanding commercial bank loans increased by nearly 40 percent, the stock of nonperforming loans increased only modestly, and the ratio of nonperforming loans net of provisions declined. In the first half of 2004, there was a modest reduction in the stock on nonperforming loans, despite a further 20 percent increase in the outstanding stock of credit. Notwithstanding these encouraging developments, the ANB's supervisors are paying particular attention during on-

site inspections to ensuring that the reported loan portfolio quality does indeed reflect the underlying financial health of banks. In addition, based on the results of the recent FSAP assessment, we intend to improve regulations related to banking supervision, as recommended based on the detailed BCP assessment. We will also adopt a zero-tolerance approach to violations of prudential regulations and impose stricter penalties for such violations.

20. We remain committed to the **privatization of IBA**. However, as the privatization of IBA has proceeded more slowly than hoped, and as privatization alone will not solve all the problems created by IBA's effective monopoly of key portions of the financial markets, we are embarking on a comprehensive program to improve corporate governance and enhance competition in the banking sector. On corporate governance, as a prior action for completing the fourth review the ANB—having taken into account possible recapitalization opportunities in the future—has approved a timetable for ensuring that the IBA is in compliance with all prudential requirements. In addition, during 2005 we will review the operation of the IBA's supervisory board, with a view to restructuring it so as to make it more effective in light of the demands of the market and the new banking system law.

21. To improve competition in the banking sector, consistent with our broader anti-monopoly program, we have announced as a prior action for completing the fourth review that, effective December 1, 2004, all banks have the right to serve as collection points for gas and water bills, and that the respective utilities will cooperate with all participating banks. In addition, following the experience with limited tendering for government financial services in 2004, we have announced that, during January 2005, the government will issue a tender for all financial services purchased by the Treasury.

22. With regard to **BUS Bank,** the government and the ANB will jointly review, by end-March 2005, the appropriate role for this institution in Azerbaijan's financial markets. We will also take steps to strengthen the management of this institution and issue a tender for its sale during 2005. While we have recently removed the special credit constraints on this bank, we will closely monitor its actions to ensure the bank does not take on excessive risks.

23. Azerbaijan has **accepted the obligations of Article VIII, Sections 2, 3 and 4**, effective November 30, 2004, following the removal of a few economically insignificant restrictions that remained in our exchange system.

24. The government and the ANB are in full agreement with the conclusions and recommendations of the recent FSAP exercise. We are committed to implementing these recommendations, which will help remove impediments to financial sector development in Azerbaijan.

Fiscal Policy

25. As noted above, in light of the importance of proper handling of the oil revenue that Azerbaijan is receiving already, and the much greater oil revenues we will receive in coming

years, the government has designed a **long term strategy for the management of oil revenues;** this strategy has been formally adopted through a Presidential Decree. The strategy includes the following important principles: 1) We will seek to ensure constant real expenditures of oil revenues over time, to enable all generations of Azeris to benefit from this exhaustible resource. 2) Fiscal policy will focus on targeting the non-oil deficit (as a share of non-oil GDP) as the best measure of the pace of spending of oil revenues. 3) While the current non-oil deficit is well below the sustainable level of real expenditures of oil wealth, we will gradually move toward that sustainable level, placing an annual ceiling on the maximum change in the non-oil deficit, seeking to ensure continued macroeconomic stability and efficiency of spending. We have ensured that the draft 2005 budget is consistent with these principles. In addition, as a prior action for completion of the fourth review the Cabinet of Ministers has issued an instruction that lays out a path of non-oil deficits through 2008, targeting a 2.4 percent of non-oil GDP increase in the non-oil deficit in 2005, and a one percent increase in subsequent years. This instruction also clearly defines the important concepts of oil revenue, non-oil deficit, and non-oil GDP. The calculations underlying these targets will be revised at least once a year, in the context of the annual budget preparation process, in light of developments in oil prices and volumes, but will always be based on conservative assumptions of oil prices and volumes; the resulting path of non-oil deficits will be included in the annual budget, along with our Medium Term Expenditure Framework (MTEF).

26. The strategy we have adopted thus provides guidance on how much oil revenue we can afford to spend in any given time period. The strategy also provides guidance on how to spend that money. We will focus our expenditures of oil revenue on our goals of reducing poverty, encouraging growth in the non-oil sectors, and enhancing regional development, all of which is consistent with our State Program for Poverty Reduction and Economic Development (SPPRED). Thus, our expenditures will focus on infrastructure development, improvements in health and education, and tax cuts for non-oil enterprises. Now that we have developed this broad strategy, our next task will be to convert these principles into concrete expenditure and tax plans, including through the further development of the MTEF and our Public Investment Program (PIP).

27. To further strengthen our budget preparation process, and the coherence of our fiscal policies, the Ministry of Finance and the Ministry of Economic Development will conduct a joint review of the process of preparing the 2005 budget, and before end-February 2005 will present to the Cabinet of Ministers recommendations for steps to (1) improve the annual budget preparation process, and (2) strengthen the ties between the SPPRED, MTEF, PIP, regional development program, other programs related to fiscal policy and the annual budget.

28. The oil revenue strategy and goals are reflected in the 2005 budget we have submitted to parliament. On the tax side, the major reform in the 2005 budget is a **reduction in the Social Protection Fund (SPF) contribution rate from 29 percent (27 percent for employers and 2 percent for employees) to a combined 25 percent (22 and 3 percent, respectively)**. This lower rate could encourage job creation and will enhance the competitiveness of our businesses. We have also eliminated the temporary VAT exemption

for grain effective October 1, 2004, and will not reintroduce such an exemption, and we have reaffirmed our commitment not to introduce VAT exemptions outside the annual budget process. On expenditures, we are sharply increasing domestically financed capital expenditures (by almost 37 percent), with these expenditures focused primarily on infrastructure investments.

29. For stabilization purposes, we have established a special Ministry of Finance account in the ANB, where tax revenues resulting directly from oil prices that are higher than assumed in the budget are deposited, as a cushion against possible declines in oil prices. However, to date there have been no formal rules covering this account. We have prepared such rules and included them in the draft Presidential Decree on the 2005 budget.

30. **The 2005 budget also includes a substantial increase in the wage bill,** largely reflecting both the full year effect of the increase in the minimum wage to 100,000 manat in July 2004 and the effect of the further increase in the minimum wage to 125,000 manat in January 2005. Even at this new level, the minimum wage—which is paid to roughly one-third of all budgetary employees—will remain very low, at around US$25 per month. Average government wages are also low. Despite these low wages, the wage bill for the government—including the associated SPF contributions—has steadily grown as a share of total expenditures, and stands at over 25 percent of total 2005 expenditures. We recognize that, in order for the government to be able to eventually pay more reasonable wage levels, it will be necessary to reduce the number of civil servants. We intend, during 2005, to design a comprehensive medium-term civil service reform program, aimed at achieving this objective.

31. **The main area of reductions in expenditures in 2005 is in subsidies**. Improvements in Azerchemia's financial position means that it no longer requires subsidies from the government budget, while improved collection rates and the increased tariffs for natural gas mean that Azerigas should be able to pay SOCAR in full for its gas consumption, without subsidies. Subsidies to Azerenergy are also being reduced modestly (2.5 percent) in 2005, while the subsidy to Baku Metro has been reduced by 48 percent due to the doubling of metro tariffs as of January 1, 2005. Finally, from April 1, 2005, we will increase tariffs for water supply by 100 percent for households and 30 percent for budget organizations, to enhance the financial position of the water companies and thus reduce their need for subsidies.

32. In 2003, for the first time, **SOCAR paid its full legal tax liability,** rather than a negotiated tax target. However, SOCAR's cash payments in 2003 were precisely what had been assumed in the 2003 budget, and we expect the same outturn for 2004, despite the fact that in both years oil prices were higher than assumed in the budget. The additional tax liability was settled by applying more of SOCAR's tax credits—for fuel delivered to Azerenergy and Azerigas for which SOCAR was not paid by those utilities—to SOCAR's current tax liability, and less to settling accumulated tax arrears. To ensure that the budget benefits from higher oil prices, we have included in the 2005 budget law a requirement that SOCAR pay its full current legal tax liability in cash, using any tax credits to settle its accumulated tax arrears, and we will require SOCAR to pay these outstanding arrears in full.

Once all SOCAR's tax arrears have been cleared, any future credits will be in a form to be determined, in consultation with Fund staff, before the end of the first quarter of 2005.

33. On a related issue, through 2004 we have continued the practice of setting minimum tax payment levels for large state-owned enterprises, to be imposed in the event tax collections fall short of budget levels. Starting in 2005, these minimums have been eliminated; in the future, all enterprises will be required to pay taxes strictly on the basis of the tax laws.

34. The state-owned airline AZAL has recently contracted to purchase four airplanes from Airbus. In the context of the 2005 budget, the government will provide a capital injection to AZAL to assist in paying for these planes. AZAL will be responsible for the remaining cost of these planes; there will be no further budgetary expenditures to assist in paying for these planes, subject to the provision of a government guarantee for credits to finance the remaining cost as foreseen under the terms of the purchase and sales agreement.

35. **The reform of our pension system continues**. Increasing efforts are under way to develop an insurance and pension framework based on individual accounts and establishing a direct relationship between contributions and pensions. The Social Protection Fund (SPF) has arranged for ATM cards to be issued to pensioners, to enable them to receive their pensions through electronic systems and ATMs. While in Baku these cards are being issued to pensioners only through IBA, outside Baku we have opened the tendering process to all banks. We have recently publicly clarified, as a prior action for completion of the fourth review, that pensioners throughout the country—including in Baku—are free to choose whichever payment outlet (including private commercial bank) they wish to receive their pensions through, and that the ATM cards issued to pension recipients can be used at any ATM in the country. We are also working to improve SPF revenue collections, notwithstanding the reduction in SPF contribution rates. We believe that we will be successful in this effort, both as a result of rising wages in the economy—including the increase in the minimum wage—as well as improved administration and enforcement. We recognize the risks inherent in budgeting on the basis of administrative improvements in collections, and we will monitor the situation. The planned increase in minimum pensions will only take place after we have monitored SPF revenues in the fourth quarter of 2004 and the first quarter of 2005 and are confident on that basis that the annual revenue targets will be met, and that the SPF has not only had success in clearing outstanding arrears but will be able to avoid future arrears. The government will take any necessary measures to prevent future accumulation of pension arrears.

36. Our external debt levels remain modest, and we continue our policy of paying all acknowledged government and government-guaranteed debts in a timely fashion. We continue to seek a resolution of our debt disputes with Kazakhstan, Turkmenistan and Uzbekistan, and we have recently resolved a debt dispute with a Turkish company. A **Law on Public Debt** has been prepared, with technical assistance from the Fund, and will be submitted to parliament in 2005.

Other Structural Issues

37. The revenue and expenditure plans for 2004 that we approved for Azerenergy, Azerigas and Azerchemia were consistent with the subsidy allocations to these companies in the 2004 budget. However, the monitoring and enforcement of these plans has proven difficult. The Chamber of Accounts has recently completed, or is in the process of conducting, audits of these companies. Based on the results of these audits, as well as the implementation of their approved revenue and expenditure plans for 2004, the government will take steps to strengthen the financial oversight of these companies. In addition, the Ministry of Finance will, by the end of 2004, prepare reporting forms that these companies, as well as SOCAR, will be required to use in reporting quarterly on the implementation of their approved 2005 revenue and expenditure plans.

38. We recognize the importance of continuing to strengthen **governance** in Azerbaijan. Parliament approved an anti-corruption law in January 2004. This law requires that government officials annually report their sources of income and total wealth, establishes limits on the value of gifts government officials are allowed to receive, and prohibits public officials from benefiting personally through the execution of their official duties. To effectively implement this law, an anti-corruption committee was formed, and we have adopted a comprehensive anti-corruption strategy that was prepared with the active engagement of the international community and NGOs.

39. Despite the steps we have already taken to improve the **business environment,** we recognize the importance of continuing these efforts. While protecting the rights of the ANB to inspect banks, the Ministry of Finance to inspect budgetary organizations, and the Ministry of Tax to conduct necessary inspections to ensure compliance with the tax laws, we will continue our efforts to reduce further any unnecessary and intrusive inspections of businesses. We will also continue the process of simplifying business registration, including by reducing the paperwork requirements and considering the establishment of a one-stop registration process. Finally, during 2005 we will submit to parliament a new Investment Law, which has been prepared in close cooperation with the staff of the World Bank.

40. We are increasingly concerned about the artificial monopolization of domestic markets for a large number of goods. We intend to strengthen our fight against **monopolies** in three ways. First, we will accelerate the preparation of a new Anti-Monopoly Code, and submit it to parliament during the first quarter of 2005, with the aim of strengthening our efforts to create a competitive economy. Second, not awaiting the passage of this new Code, we will review and revise as necessary our procedures for enforcing our anti-monopoly rules and regulations. Finally, we will review developments regarding the apparent monopolization of certain goods on the domestic market.

41. We have started a major reform of the communications sector, aimed at separating the regulatory and commercial functions within the Ministry of Communications and Information Technologies (MCIT), and then privatizing its commercial activities. As a first step, we plan to shift the responsibilities for the regulation of the telecommunications sector

to an independent unit (with its own charter) within the MCIT and then later to establish this unit as an wholly independent government agency. We will also shortly begin the process of privatizing the MCIT's participation in joint ventures and hope to complete this process by end-2005. Next year we will also start the process of restructuring our domestic telecommunications network (Aztelekom and Bakutelekom) with the aim of ultimately privatizing it as well. It is hoped that these measures will materially improve the business climate in the telecommunications sector and stimulate both domestic and foreign investment into this industry, including into the regions.

42. We will continue to implement a liberal **trade policy.** On April 1, 2004, the final stage of the process of replacing specific with ad valorem customs duties was taken; as of this date, only excisable products, cars and a few minor products continue to be subject to specific customs duties, and the weighted average tariff has been reduced to 5.7 percent. The second meeting of Azerbaijan's WTO accession working party met in October 2004 and good progress was made. Work will now focus on issues of market access for goods and services and agriculture. The next meeting of the working party is expected to take place in the second half of 2005.

43. We recognize the necessity of timely and accurate macroeconomic statistics. We will thus continue our efforts to improve our statistical collection, analysis and reporting system. We will review our need for assistance in this effort, and will request appropriate technical assistance including from the Fund. As a result of the progress we have made in this effort, **we are now prepared to subscribe to the reporting standards of the Special Data Dissemination Standards (SDDS) system during early 2005.**

Program Monitoring

44. Quantitative performance criteria and targets for end-December 2004, as well as end-March, are detailed in Table 1.We propose that Cabinet of Ministers approval of revenue and expenditure plans for Azerchemia, Azerenergy, Azerigas, and SOCAR, consistent with the subsidy allocations in the 2005 budget, be a structural performance criterion for end-December 2004. We also propose the following structural performance criterion for end-March 2005: issuance of tenders for all financial services to be purchased by the Ministry of Finance. We also propose one end-April structural performance criterion: adoption by the Cabinet of Ministers of a plan to improve the annual budget preparation process, and strengthen the connections between the SPPRED, MTEF, PIP and annual budget, based on the review conducted by the Ministry of Finance and the Ministry of Economic Development, with this plan to be implemented during the preparation of the 2006 budget. Finally, we propose the following structural benchmarks for end-March 2005: (1) in accordance with the Law "On Public Service" dated July 21, 2000, to prepare legislation providing for the recruitment of citizens to the civil service on a competitive basis and, based on that legislation, setting a timetable for implementing comprehensive civil service reforms. We remain committed to the phased implementation of this law, which foresees the broader reform of the civil service. (2) Based on a review by the Cabinet of Ministers, in conjunction with the Ministry of Economic Development, Ministry of Finance, Ministry of Energy, and

Ministry of Taxes, of the financial performance of Azerchemia, Azerenergy, Azerigas and SOCAR, adoption of decisions to strengthen the financial discipline and oversight of these companies.

45. The fifth review of our PRGF arrangement will focus on three areas: (1) continued progress in energy reforms—particularly enhancing financial discipline of key state-owned enterprises, controlling the subsidies to Azerenergy, and ensuring SOCAR pays its full legal tax liability, consistent with the tax laws and the relevant provisions of the 2005 budget law; (2) enhanced competition in financial markets, including progress toward the privatization of IBA and BUS Bank; and (3) progress on strengthening the MTEF and PIP, as well as the links between the MTEF, PIP, SPPRED, and the annual consolidated budget.

46. The government and the ANB believe that the policies discussed above, combined with the policies described in our previous letters and MEFP, are adequate to achieve the objectives of the program, but we will take any further measures that may become appropriate for the purpose. Azerbaijan will consult the Fund on the adoption of these measures, and in advance of revisions to the policies discussed above, in accordance with Fund policies on such consultation.

Sincerely,

/s/

Artur Rasi-zade
Prime Minister
Azerbaijan Republic

/s/

Avaz Alekberov
Minister of Finance
Azerbaijan Republic

/s/

Farhad Aliyev
Minister of Economic Development
Azerbaijan Republic

/s/

Elman Rustamov
Chairman, National Bank
Azerbaijan Republic

Attachment

Table 1. Azerbaijan: Quantitative Performance Criteria and Indicative Targets for the PRGF, 2003-05 1/ 2/

(In billions of manats, unless otherwise indicated)

	2002	2003			2004										2005
	Dec.	Dec.			Mar.			Jun.			Sept.		Dec.		Mar.
	Act.	Prog.	Adj. Prog. 3/	Act.	Prog.	Adj. Prog. 3/	Act.	Prog.	Adj. Prog. 3/	Act.	Prog.	Proj.	Prog.	Rev. Prog. 4/	Prog.
1. Quantitative performance criteria and indicative targets															
Floor on net international reserves of the ANB (end-of-period stock, in US$ million)	462	513	465	582	512	494	612	533	500	668	579	772	610	737	811
Ceiling on net domestic assets of the ANB (end-of-period stock)	-85	-28	194	-160	9	92	-129	114	266	-99	17	-165	-36	76	-379
Ceiling on net credit to the general government from the ANB (end-of-period stock)	154	93	315	75	0	83	-12	53	205	-26	-95	-117	-202	167	-279
Ceiling on the overall consolidated non-oil deficit 5/ 6/	...	4,224	4,176	3,865	968	899	374	2,141	1,959	994	3,192	2,150	4,288	4,105	979
Ceiling on New Nonconcessional External Debt Contracted or Guaranteed by the Consolidated Government or the ANB (excluding the IMF) (flows, in US$ million) 5/															
Less than one year's maturity	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Medium- and long-term debt, one to less than five years	...	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Other long-term debt (maturity five and more years)	...	80	80	0	50	50	0	100	100	0	125	125	150	150	50
2. Continuous performance criterion															
Ceiling on Stock of Outstanding Nonreschedulable External Payments Arrears of the Consolidated Government and the ANB (end-of-period stock, in US$ million)	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
3. Indicative targets															
Ceiling on stock of ANB's manat reserve money (end-of-period stock)	1,872	2,231	2,231	2,316	2,146	2,146	2,456	2,340	2,340	2,761	2,451	2,905	2,588	3,162	2,987
Ceiling on stock of unpaid bills in excess of Manat 50 billion (end-of-period stock)	-36	0	0	-41	0	0	10.1	0	0	19.7	0	...	0	...	...

1/ The program targets are indicative targets for end-March 2004 and end-September 2004, and performance criteria and indicative targets for end-December 2003, end-June 2004 and end-December 2004 end end-March 2005.

2/ Foreign exchange components are valued using program exchange rates of 4,606 manat/US$ and 1.26 US$/SDR.

3/ Program targets are adjusted on the basis of program adjustors as specified in Attachment I, Annex I of EBS/03/57.

4/ The staff expects that end-2004 quantitative targets and/or performance criteria under the program on net international reserves, net domestic assets of ANB, and net credit to general government from ANB to be met, on the basis of preliminary calculations of expected program adjustors.

5/ Cumulative changes during the year.

6/ For 2003, the figure reported in EBS/03/57 was 4,042. However, this figure incorrectly did not exclude AIOC profit tax of 182 billion manat.

Azerbaijan: Fund Relations
As of October 31, 2004

1. **Membership Status:** Joined: 09/18/1992; Article XIV

2. **General Resources Account:**

	SDR Million	Percent of Quota
Quota	160.90	100.00
Fund Holdings of Currency	202.64	125.94
Reserve position in Fund	0.01	0.01

3. **SDR Department:**

	SDR Million	Percent of Allocation
Holdings	0.49	N/A

4. **Outstanding Purchases and Loans:**

	SDR Million	Percent of Quota
Extended arrangements	31.99	19.88
Systemic Transformation Facility	9.75	6.06
PRGF arrangements	97.41	60.54

5. **Financial Arrangements:**

Type	Approval Date	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
PRGF	07/06/2001	03/31/2005	80.45	41.84
EFF	12/20/1996	03/19/2000	58.50	53.24
ESAF/PRGF	12/20/1996	03/19/2000	93.60	81.90

6. **Projected Obligations to Fund:**
(SDR million; based on existing use of resources and present holdings of SDRs)

	Forthcoming				
	2004	2005	2006	2007	2008
Principal	4.97	32.57	24.86	24.45	13.72
Charges/Interest	0.60	1.50	0.97	0.60	0.33
Total	5.57	34.07	25.84	25.05	14.05

7. **Safeguards Assessment**

Under the Fund's safeguards assessment policy, National Bank of Azerbaijan (NBA) is subject to an assessment with respect to the PRGF arrangement, which was approved on July 6, 2001 and is scheduled to expire on March 31, 2005. A safeguards assessment of the NBA was completed on March 8, 2002. The assessment concluded that risks may exist in the legal structure and independence of the Central Bank, and in its internal audit and control systems.

The authorities have implemented all but one of the 2002 safeguards assessment recommendations. The newly adopted NBL clearly specifies the modalities for the ANB profit distribution, consistent with one of the last two outstanding recommendations, and requires that ANB's internal audit division be responsible only to the chairman of the ANB Board. The latter falls short of establishing an independent audit committee under the Board, as recommended by the safeguards assessment mission.

8. **Exchange Rate Arrangements**

The currency of Azerbaijan is the manat, which became sole legal tender on January 1, 1994. Currently, the exchange rate is allowed to float against all currencies. Noncash exchange rates are determined five times a week at the foreign exchange auctions conducted by the Baku Interbank Currency Exchange (BICEX). Exchange rates for cash transactions are quoted by commercial banks licensed to deal in foreign exchange on the basis of market conditions. The NBA conducts the policy of informal exchange rate targeting and determines an official exchange rate against the U.S. dollar every day, equal to a weighted average of all foreign exchange markets, including the off-auction interbank market, the retail intra-bank market, and the bank note market located in foreign exchange bureaus.

Azerbaijan has been classified by the staff with the group of countries whose exchange rate regimes are managed floating with no pre-determined path for the exchange rate.

9. **Article IV Consultation**

The 2003 Article IV consultation with Azerbaijan was concluded on May 14, 2003.

10. **ROSCs**

A fiscal transparency ROSC module was prepared by FAD (IMF Country Report No. 00/121 and updated in April 2003 (IMF Country Report No. 03/155). A data dissemination ROSC module was completed by STA in March, 2003 (IMF Country Report No. 03/86). The authorities have agreed to publish the ROSC and it is available on the IMF web site.

11. **Resident Representative**

Mr. Basil B. Zavoico, the Fund's fifth Resident Representative took up his duties in Baku in July 2003.

12. **Resident Advisers**

An adviser on the establishment of the Treasury in the Ministry of Finance, Mr. Nurcan Aktürk, was stationed in Baku from December 1994 until September 1996. He was succeeded by Mr. B.K. Chaturvedi, whose assignment was extended twice, first through August 2000, and then through May 2001. Mr. B.K. Chaturvedi was replaced by

Mr. A. Khan whose assignment started May 2001 and ended in August 2002. A technical long-term adviser for tax administration, Mr. Mark Zariski, was stationed in Baku from April 1995 until April 1996. He was succeeded by Mr. Peter Barrand, who was stationed in Baku from January 2001 until December 2002. Mr. Isaac Svartsman was resident advisor in the ANB for bank supervision and restructuring from September 1998 to April 2001.

Azerbaijan: Technical Assistance, 1998-2004

Fund Dept.	Area of Assistance	Mission Dates
FAD	Treasury project inspection	April/May 1998
MAE	Bank restructuring	May 1998
BCS	Book entry system	October 1998
LEG	Tax code legislation	November 1998
FAD	Tax administration	December 1998
LEG	Tax code	Jan./Feb. 1999
STA	Balance of payments statistics	Mar./April 1999
LEG	Tax code	Mar./April 1999
MAE	Bank restructuring	April/May 1999
FAD	Tax administration	Sept./Oct. 1999
MAE	Bank restructuring	Oct./Nov. 1999
STA	Price statistics	November 1999
STA	National accounts statistics	November 1999
FAD	Tax administration	Jan./Feb. 2000
FAD	Customs administration	Mar./April 2000
FAD	Expenditure policy	April/May 2000
LEG	Tax code	September 2000
MAE	Bank restructuring	October 2000
FAD	Treasury computerization	Oct./Nov. 2000
STA	Price statistics	November 2000
STA	National accounts and GDDS	November 2000
STA	Money and banking statistics	Nov./Dec. 2000
STA	National accounts and GDDS	February 2001
STA	Price statistics	February 2001
STA	Balance of Payments Statistics	April 2001
MAE	Banking supervision	May 2001
MAE	Payments system	May 2001
MAE	Central Bank Internal Audit	June 2001
FAD	Customs Administration	June 2001
FAD	Budget systems law	August 2001
MAE	Bank restructuring and monetary operations	June 2001
TRE	Safeguards assessments	January 2002

Azerbaijan: Technical Assistance, 1998-2004 (concluded)

Fund Dept.	Area of Assistance	Mission Dates
LEG/MAE	Banking legislation	January 2002
MAE	Central Bank accounting	January 2002
MAE	Payments system	February 2002
STA	National Accounts	Oct./Nov. 2002
FAD	Tax administration reform	December 2002
MAE	Bank restructuring and monetary operations	December 2002
STA	National Accounts	Jan./Feb. 2003
FAD	Budget systems law	Feb/March 2003
STA	Consumer Price Statistics	June 2003
STA	National Accounts	Jul./Aug. 2003
MFD	Regional Technical Assistance in Public Debt Management	Jul./Sep. 2003
MFD	Payment and Settlement Systems	Sep. 2003
FAD	Revenue Administration	August 2003
FAD	Tax Policy	August 2003
MFD	Payment and Settlement Systems	Jan. 2004
STA	Balance of Payments Statistics	May 2004
MFD	Payment and Settlement Systems	May 2004
MFD	Regional Public Debt management	April 2004
FAD	Customs Administration	September 2004
STA	National Accounts	Sep./Oct. 2004
FAD	Tax administration	Dec. 2004
MFD	Public Debt Management	Dec. 2004

Source: International Monetary Fund

Azerbaijan: IMF-World Bank Relations

Partnership in Azerbaijan's Development Strategy

- The government's poverty reduction strategy, embodied in its first full State Program for Poverty Reduction and Economic Growth (SPPRED) was discussed by the IDA and IMF Boards in May 2003. The strategy comprises six key strategic aims identified as follows: (i) the facilitation of an enabling environment; (ii) the maintenance of macroeconomic stability; (iii) the improvement in the quality of and equity in access to basic health and education services; (iv) the improvement of infrastructure (including roads, delivery of utility services, communications, irrigation); (v) the reform of the current system of social protection to give a more targeted, but effective protection to the vulnerable; and (vi) the improvement of the living conditions and opportunities for the one million refugees and Internally Displaced People (IDP) of the Nagorno-Karabakh conflict. While the PRSP's overall direction is considered appropriate, weaknesses were identified related to costing, prioritizing, and sequencing measures as well as their monitoring and evaluation.

- Macroeconomic management aims at maintaining a stable economic environment through appropriate fiscal, monetary, exchange rate, and sustainable debt policies. In support of these policies, the authorities are tightening payment discipline, especially in the energy sector, hardening budget constraints for state-owned enterprises, and pursuing enterprise and banking privatization and restructuring. Consistent macroeconomic management has supported the economic recovery since 1995. Nonetheless, maintaining strong growth will depend importantly on accelerating structural reforms to enhance private sector development and to encourage foreign and domestic investment, particularly in the non-oil sectors of the economy.

- The IMF has taken the lead in assisting Azerbaijan in enhancing macroeconomic stability and related structural reform measures. In this regard, the Fund has encouraged the authorities to continue with fiscal reforms and to maintain a prudent monetary policy stance. The government has also been encouraged to enhance governance and strengthen financial discipline in the energy sector, to strengthen the banking sector, and to improve the legal and regulatory environment for private sector development. The Fund has supported Azerbaijan's economic reform program since 1995. The authorities were successful in achieving macroeconomic stabilization under the economic reform program supported by the early IDA and IMF structural adjustment arrangements, which formed the foundation for an ongoing Fund-supported program under the Poverty Reduction and Growth Facility (PRGF), approved by the Executive Board in July 2001, with the first review endorsed by the Board on February 20, 2002, second review completed on May 15, 2003, and the third review scheduled for December 19, 2003.

- The World Bank has taken the lead in the policy dialogue on structural reforms, including poverty reduction measures, public expenditures, agricultural policies, private sector development, institution building and governance. A range of instruments is used to conduct the dialogue. SAC-II, which has been fully disbursed in June 2003 was supporting a wide-ranging structural reform agenda and its accompanying second institution building and technical assistance credit (IBTA II) is assisting institutional capacity building, especially of government budget preparation and execution, privatization and utility reforms. The Bank has initiated discussions with the authorities on the design of a proposed sequence of Poverty Reduction Support Credits based on the reform agenda of the SPPRED and the CAS. The objectives of the proposed PRSCs are to support proper management of public resources, strengthen corporate governance, encourage non-oil trade and investments and enable adequate regulation of utility services, while increasing the efficiency and sustainability of social services. The proposed PRSCs ensure continuity of the progress made with the support of SAC II.

- This broad-based policy reform approach is combined with sector investment projects in agriculture, roads, water, refugees/IDPs, environment, education, health and domestic gas. Recent analytical and advisory assistance has included a Poverty Assessment, a PER, a CPAR (procurement assessment), a CFAA (financial accountability), pension reforms paper and ongoing work on trade facilitation and mitigation of the social costs of utility price increases.

- The next section describes the Bank program and the division of responsibility between the two institutions. In a number of areas—social sectors and safety nets, environment, governance, infrastructure, and agriculture—the Bank takes the lead in the dialogue and there is no cross conditionality with the IMF-supported program. The Bank is also leading the dialogue in private sector development and public enterprise reform and Bank analysis serves as an input into the Fund program. In other areas—energy, financial sector, public expenditure management, public sector, trade and investment policy—both institutions work together and share cross conditionality. Finally, in areas like monetary policy, tax policy and customs, the IMF takes the lead with limited Bank involvement. (see Table 1).

Table 1. Bank-Fund Collaboration on Azerbaijan

Area	Specialized Advice from Fund	Specialized Advice from Bank	Key Instruments
Macroeconomic Framework/ Management	Monetary policy, exchange rate, fiscal and trade policies, economic statistics.	Medium- to long-term public expenditure management of oil windfall, trade reform.	*IMF:* PRGF performance criteria and benchmarks on monetary and fiscal targets. *Bank:* Structural adjustment operation within a proposed PRSC 1, 2 and 3 (previously SAC-II) and IBTA II support of reforms in budget preparation and execution, PER, integrated non-oil trade and investment strategy.
Budget	Consolidated medium-term budget framework, including the Oil Fund's operations, budget systems law, treasury modernization, tax policy and administration, customs, debt management, extra budgetary funds, long-term oil revenue management strategy.	Budget systems law, consolidated medium-term budget framework, integration of the Oil Fund's governance framework, PIP capacity building.	*IMF:* PRGF performance criteria on overall consolidated fiscal deficit, excluding Oil Fund revenues and overall consolidated non-oil deficit including quasi-fiscal activities; performance criteria related to rules and legislation related to ensuring coherent fiscal policy and oil revenue management strategy. *Bank*: Policy conditionality on governance of the Oil Fund, budget systems law, MTEF and PIP within the proposed PRSCs (previously SAC-II), and IBTA-II support of activities for capacity building.
Public Sector Reform	Support to State Customs Committee, Ministry of Taxes, Ministry of Finance.	Support to Ministry of Environment, Ministry of Economic Development and consolidation of Agencies and Departments, State Procurement Agency, Chamber of Accounts.	*IMF:* PRGF performance criteria and benchmarks related to ongoing administrative reforms in customs, taxes and finance. *Bank*: technical assistance supported by IBTA-II.

Table 1. Bank-Fund Collaboration on Azerbaijan

Area	Specialized Advice from Fund	Specialized Advice from Bank	Key Instruments
Energy Sector Reform	Strengthening financial discipline in energy sector by unification of domestic and international prices for natural gas and oil products, allocation of subsidies to Azerenergy and Azerigas, and offsetting tax credits to SOCAR, full payment by budgetary organizations for their utility consumption.	Strengthening financial discipline in energy sector by elimination of implicit subsidies and improved collections and tariff policies, privatization of distribution companies, introduction of regulatory framework and agency, and specialized advice on oil and gas sector development.	*IMF:* PRGF performance criteria and benchmarks related to domestic energy prices, as well as the incorporation of previously quasi-fiscal subsidies into the state budget. *Bank*: Policy conditionality on utility reforms, especially aimed at improving financial viability within the proposed PRSCs (previously SAC-II). PPIAF/ESMAP TA on sector restructuring and regulations. IBTA-I and –II supported assistance for privatization and in analyzing the environmental and social impact of such reforms and designing measures to protect the poor.
Financial Sector Reform	Strengthening the competitiveness and health of the banking system, privatization of state-owned banks, revision and introduction of a new legal framework for the banking sector (banking law, bankruptcy law, central bank law), development of manat financial markets, including the market for T-bills, safeguards assessment of the financial sector, FSAP.	Restructuring and privatization of large State banks, strengthening of ANB's supervisory capacity, introduction of electronic payment systems, credit rating agencies and registries, SME credit, FSAP.	*IMF:* PRGF performance criteria and benchmarks on bank privatization, banking system law and central bank law. *Bank*: SAC-II Policy conditions on the financial sector within the proposed PRSC (previously SAC-II) and the financial sector TA credit.

Table 1. Bank-Fund Collaboration on Azerbaijan

Area	Specialized Advice from Fund	Specialized Advice from Bank	Key Instruments
Social/Poverty		Public expenditure reforms, strengthening of monitoring and evaluation systems, reform strategies for education, health, social assistance and protection as well as pension reform and direct assistance to IDPs.	*Bank*: Policy conditionality in SAC-II the proposed PRSC (previously in SAC-II). Poverty Assessment and TA for Household and other surveys, assistance with design of pension reforms and better targeting of social expenditures. Project to assist IDPs and refugees. Education and Health LILs aimed at improving service delivery to the poor.
Private Sector Development	Trade and investment policy.	Integrated framework for trade and business development, improving and monitoring of the business and investment environment, streamlining procedures for entry and exit, enhancing high-level public/private sector dialogue, trade and transport facilitation, SME support, and privatization of SOEs.	*Bank*: enhanced public-private partnership supported via the proposed PRSC (previously by SAC II) and IBTA II; analytical assistance on the nexus of business environment and governance in cooperation with FIAS; integrated trade and business development framework report. trade and transport facilitation report; SAC II and IBTA II supported TA on privatization and labor redeployment.
Other sectors		Strengthening rural and agricultural infrastructure, transport policy and infrastructure, environmental clean-up and preservation.	*Bank*: investment projects in environment, agriculture and highways.

IMF-World Bank Collaboration in Specific Areas

Areas in which the World Bank leads and there is no direct IMF involvement

- These areas are the social sectors, agriculture, infrastructure and environment. In the social sphere, the Bank has been involved in both improving the data and analyzing poverty as well as in helping design pension reforms, and measures to mitigate the social impact of utility reforms aimed at raising collections and tariffs. In education a LIL is to be followed by an APL to improve quality. There is also an ongoing LIL in the health sector (in partnership with UNICEF) which aims at building capacity of the Ministry to carry out health care reforms and pilot them in selected districts.

- In infrastructure, Bank lending to date has comprised projects for Gas Rehabilitation, water supply and highways. An environment project is being followed by assistance to build the capacity of the new Ministry of Environment and mainstreaming environmental concerns across-the board, especially in the energy sector. In Agriculture the Bank has provided credits for farm privatization, irrigation rehabilitation and credit, extension and other agricultural services.

Areas in which the World Bank leads and its analysis serves as input into the IMF program

- The Bank leads the dialogue on structural reforms through the **proposed PRSCs**. The PRSCs will initially focus on any follow-up reforms to SAC-II and will extend to new reform initiatives. Bank leads in the areas of:

- **Privatization and Private Sector Development.** The Bank is taking the lead in the formulation of an integrated strategy and action plan for trade and private sector development.[14] An important element of the strategy is in providing a framework to better integrate the efforts of key stakeholders—i.e., the government, multilateral and bilateral donors, the private sector, and others—in promoting non-oil trade and investment. The four broad policy components include: (i) Improving the Trade Policy Regime and Market Access—creating a more export-friendly tariff structure, accelerating Azerbaijan's accession to the WTO, increasing access to regional markets and the European Union; improving access to finance; streamlining administrative procedures; (ii) Enhancing Trade Facilitation—streamlining and strengthening customs procedures and improving the quality and capacity of Azerbaijan's transportation infrastructure; (iii) Improving the Macro Business Environment - the macro business environment cover a wide range of issues impacting on private sector development, including improving business registration

[14] See: *Azerbaijan: Building Competitiveness for Increased Non-Oil Trade and Investment—An Integrated Strategy and Action Plan*, World Bank, forthcoming.

and licensing; land acquisition and site development; labor market policies; taxation; access to credit; support for SMEs; contract enforcement and dispute settlement; and public sector governance; and (iv) Developing Competitive Industry Clusters—industry-specific strategies for improving inter-firm cooperation, promoting innovation and quality, encouraging specialization and strengthening supply chains.

- The Foreign Investment Advisory Service (FIAS) has recently conducted a diagnostic study of the investment environment to determine the most important impediments to private sector investments, and this was followed up by the CIS Business Environment Enterprise Performance Survey 2002 (BEEPS) conducted by the Bank and EBRD together.

- **IFC's strategy** emphasizes support to the non-oil sector to help economic diversification. To this end, IFC will help catalyze FDI in non-oil sector projects which focus on exports, help generate foreign exchange earnings and contribute to the modernization of the country's manufacturing base and basic infrastructure. IFC's strategy for the non-oil sectors involves: (i) promotion of competition in the banking sector, establishment of joint ventures in the non-bank financial sector, technical assistance to private local banks for institutional capacity building; (ii) improving access to finance through credit lines to local private banks for on-lending to SMEs; (iii) efforts to improve the business climate and reduce impediments to foreign investments; (iv) support of agri-business and agro-processing; and (v) support for private provision of public services.

- As for **privatization**, the Bank provides support for hiring of financial technical and legal advisors, advises on the transaction processes, and ensures that proper social and environmental mitigation is taken into account. The Bank is also supporting the development of a strategy for further industrial privatization as well as for labor redeployment. Together with the EBRD, and in the context of the new proposed PRSCs, the Bank is also planning to support **financial and corporate restructuring of SOCAR**.

- **Regulatory Reforms,** including approval of draft regulations for electricity, gas, and water sectors, separation of regulatory and commercial functions in utilities, transport and communications sectors, establishing an independent regulator agency assigned with regulatory functions. In particular, all regulatory functions currently exercised by Azal, Azeri Rail, Azeri Road Company and Caspian Shipping Company will be transferred to the Ministry of Transport, the commercial and regulatory functions of the Ministry of Communications will be separated, and remaining regulatory functions of SOCAR will be transferred to the appropriate government institution.

- While the Bank has taken the lead in privatization and in structural reforms in the private sector as described above, the IMF has also a strong interest in these areas since many of these reforms are critical to achieving macroeconomic stabilization and enhancing growth prospects. Accordingly, there is a high degree of consultation and coordination between the two institutions on these matters.

Areas of shared responsibility

- The Bank and the Fund are working jointly in the following three main areas, supported by the Bank's SAC-II, the joint Bank/Fund Financial Sector Assessment Program (FSAP), several investment and technical assistance operations and the Fund's PRGF.

- **Public Expenditure Management.** This area includes public expenditure management reforms aimed at introduction of a medium-term expenditure framework and public investment program a long-term oil revenue management strategy, implementation of a new Budget Systems Law, consolidation of all extrabudgetary resources including the Oil Fund with the state budget, modernization of the Treasury, strengthening the Chamber of Accounts and supporting tax and customs administration. Both institutions are involved in supporting treasury modernization, while the Fund is providing technical assistance in support of tax and customs operations. The governance framework for the Oil Fund is another area in which there is very close cooperation, as well as the elimination of all quasi-fiscal subsidies.

- **Financial sector reforms.** This area includes strengthening the competitiveness and health of the banking system, privatization of state-owned banks, revision and introduction of a new legal framework for the banking sector (banking law, bankruptcy law, central bank law), development of manat financial markets, including the market for T-bills and implementing IMF's safeguards assessment's recommendations. Both institutions have conducted the first joint FSAP mission during September, 2003, while the second and the last joint mission is scheduled to take place in December 2003. In terms of banking supervision, the IMF is monitoring the closure and merger of banks that do not satisfy prudential requirements.

- **Utilities reform,** including measures to reduce implicit subsidies in the electricity, gas, and water sectors, to ensure full payment by budgetary institutions their utility bills, to improve overall utility collections, revision of electricity and gas tariffs to cover the true costs of providing these services. The Fund takes the lead in seeking to ensure that budget organizations and state-owned enterprises pay their utility bills in full and the budget fully funds remaining energy-related subsidies, while the Bank is taking the lead in utility and state-owned enterprise reform, tariff revision and collections from households, regulatory reform and privatization.

Areas in which the IMF leads and its analysis serves as input into the World Bank program

- The Fund leads the dialogue on fiscal matters, setting the overall ceiling on the consolidated budget. In addition to the achievement of overall fiscal targets the Fund-supported PRGF includes performance criteria and structural benchmarks requiring: (i) issuance of a tender for all remaining shares in IBA; (ii) issuance of tenders for all financial services to be purchased by the Ministry of Finance; (iii) adoption of decisions to strengthen the financial discipline and oversight of these companies, and (iv) submission to the Cabinet of Ministers of a timetable for the design of a comprehensive medium-term civil service reform program.

- In the budgetary area the Fund is taking the lead on reforms of budgetary revenues and expenditures to (i) complete the process of subjecting all taxpayers to the tax legislation; (ii) improve procedures for revenue forecasting; (iii) improve tax and customs administration; (iv) eliminate the earmarking of revenues for some extra-budgetary operations of budget organizations. In these areas, as well as monetary policy, the Bank takes into account the policy recommendations of the IMF and ensures that its own policy advice is consistent.

- The Bank plays a central role in advising on development of a Medium Term Expenditure Framework and Public Investment Program.

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Azerbaijan: Statistical Issues

Although the authorities have made significant progress towards improving the quality and timeliness of their macroeconomic statistics, a number of weaknesses need to be addressed, particularly in the areas of national accounts and producer prices. In these areas, extensive technical assistance has been provided by the Fund. It is important for the authorities to persevere with the implementation of the recommendations derived from this assistance.

A data ROSC mission, which took place in May 2002, carried out a review of Azerbaijan's data dissemination practices against the GDDS, as well as an in-depth assessment of the quality of national accounts, consumer price index (CPI), producer price index (PPI), government finance, monetary, and balance of payments statistics. The Data ROSC module is published on the IMF external website. Azerbaijan nominated a National SDDS Coordinator in June 2004 and work towards SDDS subscription is proceeding well.

I. Real Sector

National Accounts Statistics

Peripatetic missions took place in Baku under STA's two-year technical assistance project on national accounts which are compiled by the State Statistics Committee (SSC). Progress was made in a number of areas: (i) the methods for compiling the gross national income were improved and the revised estimates disseminated; (ii) input-output tables for 2001 and quarterly national account estimates at constant prices for 1998-2001 were compiled; (iii) the data on capital investments were revised. The mission identified significant problems related to the calculation of real growth in the construction sector. Due to the lack of a PPI for construction, the SSC uses data on capital investment, which are considered to be more reliable than data collected directly from companies, to calculate real growth of the construction sector. . Fund staff agree with the SSC that the current approach to estimating real growth of the construction sector needs to be seen as a temporary solution. The PPI for construction is planned to be developed during 2004-2005. The national accounts peripatetic project has been extended with two more missions aiming at improving the quality of the quarterly national accounts compiled.

Price Statistics

The price department of the SSC intended to update the consumer basket of goods and services and respective weights used for the compilation of the CPI. A STA mission visited Baku in the middle of June, 2003 to assess the progress with the pilot CPI based on the new weights prepared by the SSC. The mission assisted the staff of the SSC with the specification for data processing for the new CPI and developed a preliminary list of approximately 550 market basket items. Procedures for estimating the market basket weights based on the results of the 2002 household budget survey have been developed and the SSC will shortly publish an updated CPI index based on these weights.

II. Fiscal Sector

The treasury system was overhauled with the assistance of an FAD resident advisor in 1998. Steady improvements were made since then, and the adoption of a new budget classification system in 2002 paved the way for a computerization project currently underway. Since 2001, the government reports on quasi-fiscal activities in the energy sector and an estimate of these operations was included in the 2003 budget. In 2002, for the first time, a consolidated budget balance was produced. In 2003, the government amended its Budget System Law and, as a result, the state budget is now submitted to parliament for approval at the paragraph level. The recently published data ROSC recommends expanding the coverage of government finance statistics by including all operations recorded by the treasury and to publish details on financing and debt outstanding. Over the medium term the government should strive to publish all fiscal data in a single publication showing budget and GFS presentations. Over the medium term, the government should develop a plan for adopting the framework and classification system as recommended in GFSM 2001 and strive to publish all fiscal data in a single publication showing budget and GFS presentations.

III. Monetary Sector

A STA technical assistance mission visited Baku in May 2002 and found the monetary statistics to be in full compliance with the GDDS and SDDS standards in terms of quality, coverage and timeliness, with the following two exceptions. First, the mission recommended that the chart of accounts for commercial banks be revised so as to allow a distinction between commercial banks' holdings of securities issued by residents and nonresidents. Following the mission's recommendation, the Azerbaijan National Bank (ANB) introduced two sub-accounts in the chart of accounts for commercial banks. Second, some changes were recommended to record properly the accounts of the IMF and other international financial organizations in the balance sheet of the ANB. This recommendation has not been implemented since according to the auditor (Price Waterhouse Coopers), the ANB's chart of accounts properly reflects these accounts. The mission also developed new report forms, to reflect the adoption of new charts of accounts for the ANB and the commercial banks that became effective in January 2003 and September 2002, respectively. These forms are now used to generate automatically the analytical tables required for monitoring the PRGF-supported program. The ANB has recently started to issue its notes, which are categorized as "other items net" in the ANB's analytical accounts.

IV. External Sector

Balance of Payments (BOP): While the overall structure of the balance of payments statistics was in broad conformity with the guidelines presented in the *Balance of Payments Manual, fifth edition,* the Data ROSC mission in May 2002 found that there were several weaknesses in the methodology of compilation including (i) an inadequate breakdown between FDI equity and other capital which is necessary to properly record transactions associated with the Baku-Tbilisi-Cayman Pipeline; (ii) undercoverage of nonguaranteed external debt; (iii) poor data on FDI income in the oil sector; and (iv) misclassification of current transfers and other liabilities transactions. A follow-up balance of payments mission in May 2004 provided further assistance in implementing the recommendations of the Data ROSC mission, developing the ITRS reporting system, and improving the methodological soundness of the public external debt data.

The ANB has made steady progress toward implementing the short-term measures recommended by the Data ROSC mission. Almost all short-term measures have now been completed; the methodology for compiling reserve assets has been revised to exclude the Oil Fund assets and reclassify them into other investment assets of the government; a new survey form for oil sector enterprises (IOCs) has been designed and distributed to international oil consortia for their input; and the scope and classification of BOP statistics have been improved. However, the provision of data from reporters, specifically from the IOCs, is inadequate to compile the data on foreign direct investments. The estimations that are based on the variety of assumptions result in inconsistencies arising from differences in timing, coverage, and valuation of the source data.

To date, significant progress has been made in implementing the Data ROSC module's medium-term recommendations on balance of payments statistics. However, while documentation on BOP sources and methods has been completed, its publication may be delayed until later this year due to budgetary constraints. It is STA's understanding that the computerized compilation system recently implemented by the ANB is facing some operational problems due to the lack of collaboration with other data-producing government agencies such as the State Oil Fund of Azerbaijan Republic (SOFAZ).

International Investment Position (IIP): The ANB has initiated compilation of the IIP statistics, but the IIP statement is still at an evolving stage. Starting from data for 2002, the IIP is published in the IMF's *International Financial Statistics* as a comprehensive statement that comprises data on international reserves, FDI, portfolio investment, and other investment assets and liabilities by sectors including the foreign assets of the State Oil Fund.

Reserves and Foreign Currency Liquidity: Monthly data on total official reserve assets and daily ANB net interventions in the foreign exchange market are provided within 15 days of the end of each month. Data on official reserves during the month are provided on request from Fund staff. Azerbaijan does not disseminate the reserves template, but the ANB and the government of Azerbaijan do not engage in any forward or futures transactions that could give rise to contingent short-term net drains on foreign currency assets.

External Debt: External debt statistics for public and publicly guaranteed external debt are reported on a quarterly basis with a lag of one to two months. A debt service schedule for public and publicly guaranteed external debt separately identifying the principal and interest components, is also provided with monthly periodicity and with a one quarter lag. However, systematic information on nonguaranteed external debt, including a sectoral breakdown of such debt, is lacking. The 2004 mission emphasized that the responsibility for compiling external debt statistics be clearly assigned to a specific government agency. The authorities are committed to strengthening the debt management system, including maintaining a database on debt comprising not only public and publicly guaranteed external and domestic debt, but also external and domestic debt of state-owned enterprises. The IMF plans to provide technical assistance, including on the monitoring of private non-guaranteed external debt, as part of the Regional TA Project for Public Debt Management initiated in September 2002.

Statistical Appendix: Core Statistical Indicators
(As of November 15, 2004)

	Exchange Rates	International Reserves 1/	Central Bank Balance Sheet	Reserve/ Base Money	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Overall Government Balance 2/	GDP	External Debt 3/	Debt Service 3/
Date of latest observation	10/31/04	10/31/04	10/31/04	10/31/04	10/31/04	10/31/04	10/31/04	Q2 2004	Q2 2004	09/30/04	09/31/04	Q2 2004	Q2 2004
Date received	11/02/04	11/10/04	11/10/04	11/10/04	11/15/04	11/15/04	11/10/04	10/14/04	10/14/04	10/25/04	10/17/04	08/09/04	08/09/04
Frequency of Data	D	D	D	D	M	M	M	Q	Q	M	M	Q	Q
Frequency of reporting	D	D	D	D	M	M	M	Q	Q	M	M	Q	Q
Source of data	A	A	A	A	A	A	A	A	A	A	A	A	A
Mode of reporting	C	C	C	C	C	C	C	C	C	C	C	C	C
Confidentiality	U	U	U	U	U	U	U	U	U	U	U	B	B
Frequency of publication	D	M	M	M	M	M	M	Q	Q	M	M	Q	Q

1/ Monthly data on total official reserve assets and daily ANB net interventions in the foreign exchange market are provided within 15 days from the end of each month. Data on official reserves during the month are provided on request from Fund staff. Azerbaijan does not disseminate the reserves template, but the ANB and the government of Azerbaijan do not engage in any forward or futures transactions that could give rise to contingent short-term net drains on foreign currency assets.

2/ The general government balance is calculated from financing items.

3/ External debt is reported for public and publicly guaranteed external debt with quarterly periodicity and timeliness. A debt service schedule for public and publicly guaranteed external debt, separately identifying the principal and interest components, is reported with monthly periodicity and with a one quarter lag.

Statement by the IMF Staff Representative
December 22, 2004

1. The following information has become available since the issuance of the staff report. It does not change the thrust of the staff appraisal.

2. Macroeconomic developments remain consistent with program projections and objectives. **Real GDP** grew 10 percent during January-November 2004 relative to the same period in 2003. The CPI index increased 2.3 percent in November following the significant administrative increase in domestic energy prices (staff report, ¶ 49). Net of the direct effect of these energy price increases, inflation in November would have been 0.7 percent. The nominal manat/US dollar **exchange rate** has remained stable. The growth in **monetary aggregates** has slowed modestly, with annual manat reserve money growth declining to about 33 percent at end-November, compared to 38 percent at end-September.

3. There were four **prior actions** for the completion of the fourth review under the PRGF, as summarized in Table 8 of the staff report. All have now been implemented, as follows (i) the National Bank Law (NBL) has been adopted, as Parliament passed an NBL consistent with staff advice on December 10, 2004, and the President signed the law on December 21; (ii) the authorities informed the staff on December 15 that the policy of giving all banks the right to serve as collection points for gas and water bills has been in effect for some time, and the respective utilities also cooperate with all participating banks; (iii) a medium-term path of non-oil deficits consistent with staff advice has been approved through a Cabinet of Ministers' instruction of December 6, 2004, specifying a 2.4 percent increase in the non-oil fiscal deficit relative to non-oil GDP in 2005, and a one percent increase in subsequent years through 2008; (iv) the authorities announced on December 7, 2004 that pensioners are free to choose the payment outlet (including private commercial banks) they wish to receive their pensions, and the ATM cards issued to pension recipients can now be used at any ATM in the country.

INTERNATIONAL MONETARY FUND
EXTERNAL RELATIONS DEPARTMENT

Press Release No. 04/276
FOR IMMEDIATE RELEASE
December 23, 2004

International Monetary Fund
Washington, D.C. 20431 USA

IMF Executive Board Completes Fourth Review Under Azerbaijan Republic's PRGF Arrangement and Approves US$19.7 Million Disbursement

The Executive Board of the International Monetary Fund (IMF) has completed the fourth review of the Azerbaijan Republic's performance under the three-year Poverty Reduction and Growth Facility (PRGF) arrangement. In doing so, the Board approved a request for a waiver for the non-observance of the structural performance criteria with respect to the adoption of a procedure for future automatic adjustment of domestic energy prices, enactment of the Banking System Law, and submission to the parliament of a new central bank law. The Board approved the authorities' request to rephase the remaining disbursements, cancel the previously planned sixth review and correspondingly reduce access under arrangement to SDR 67.58 million (about US$103.6 million).

The Board also approved an extension of the arrangement from March 31, 2005 to July 4, 2005.

The IMF's Executive Board approved the three-year arrangement on July 6, 2001 (see News Brief No. 01/53) for an amount equivalent to SDR 80.45 million (about US$123.4 million). Completion of the latest review will bring total disbursements under the arrangement to SDR 54.71 million (about US$83.9 million).

Following the Executive Board's discussion on Azerbaijan, Mr. Águstin Carstens, Deputy Managing Director and Acting Chair, said:

"Azerbaijan's macroeconomic performance under the Fund-supported program has been commendable, with high broad-based GDP growth, relatively low inflation, and a strong external position. The government has made further progress in structural reforms albeit with some delays.

"The recently approved long-term oil revenue management strategy is consistent with a sustainable use of oil wealth and the major macroeconomic objectives of the government, including low inflation and sustainable growth of the non-oil sector.

"The continuation of policies aiming to maintain macroeconomic stability, together with further advancement of structural reforms, is key to achieving the objectives under Azerbaijan's State Program for Poverty Reduction and Economic Development targeting an improvement in competitiveness of the economy and a significant reduction in poverty.

"The 2005 budget targets a 2.4 percent of GDP increase in the non-oil deficit compared with the expected 2004 outcome. This increase is broadly consistent with the authorities' medium-term strategy of a gradual increase in spending out of oil wealth, as well as with program macroeconomic objectives for 2005.

"While the policy mix for 2005 is consistent with the authorities' inflation objective of about 5 percent, inflation developments should be closely monitored and additional steps should be taken, if necessary, in order to achieve the inflation objective.

"Progress is being made in financial sector reform. The new Banking System Law and the recently adopted Azerbaijan National Bank Law reflect the recommendations of the recent Financial Sector Assessment Program, and lay out sound legal foundations for operations of commercial banks and for strengthening central bank independence. The adoption of a package of measures to foster competition in the banking system is welcome. However, continued delays in privatizing the two largest banks have slowed down the development of a competitive banking system in Azerbaijan.

"The authorities' decision to increase domestic prices of most energy products in November 2004 is an important step toward reducing the gap between domestic and world market energy prices. Adhering to the commitment to review energy prices at least once a year in the context of the annual budget preparation process will be essential to reduce energy-related quasi-fiscal subsidies.

"Resolute efforts are needed to carry forward the authorities' structural reform agenda, which in 2005 will be geared toward further strengthening the financial discipline of state-owned enterprises, elaborating a civil service reform strategy, improving the annual budget preparation process, and tackling monopolistic tendencies in the banking sector. Continued efforts will also be needed to strengthen governance, including through fully implementing the recent Law on Fighting Corruption and Anti-Corruption Decree, especially in view of the importance of ensuring sound management and use of oil wealth," Mr. Carstens said.

The PRGF is the IMF's concessional facility for low-income countries. PRGF-supported programs are based on country-owned poverty reduction strategies adopted in a participatory process involving civil society and development partners, and articulated in a Poverty Reduction Strategy Paper, or PRSP. This is intended to ensure that each PRGF-supported program is consistent with a comprehensive framework for macroeconomic, structural, and social policies, to foster growth and reduce poverty. PRGF loans carry an annual interest rate of 0.5 percent, and are repayable over 10 years with a 5 ½-year grace period on principal payments.

Statement by Fritz Zurbrügg Executive Director for Azerbaijan Republic and Faig Mammadov Advisor to Executive Director
December 22, 2004

Our Azerbaijan authorities continue to value the strong cooperation with the Fund and appreciate the staff's support and policy advice. The comprehensive set of papers covering the Article IV Consultations, the fourth PRGF review, as well as the assessment of the financial system provide an in-depth analysis of the current macroeconomic and financial situation. Our authorities are very satisfied with the continued positive developments of the main macroeconomic indicators. Strong growth in both the oil and non-oil sectors, moderate inflation, growing international reserves, as well as a disciplined fiscal policy stance underscore Azerbaijan's success in sustaining sound macroeconomic performance. All quantitative performance criteria for end-2003, and end-March, end-June, and end-September 2004 were met.

The authorities are fully aware of the important challenges that remain in the area of structural reforms to ensure that this performance can be maintained over the medium and long term and that it translates into a significant reduction of the existing poverty levels. Our authorities recognize that the implementation of structural measures has been slower than envisaged under the program. However, it was important to garner sufficiently broad support for these difficult measures. Our authorities are confident that the adoption of the long-term oil revenue management strategy, the adoption of the National Bank Law, and the implementation of the State Program for the Regional Development, which has already resulted in the creation of more than 80,000 new jobs during the last year, are crucial steps in moving forward the structural reform agenda.

Fiscal Policy

Fiscal policy was tight and broadly in line with the program's objectives. The main objectives of the authorities were to reduce the overall tax burden, broaden the tax base, and stimulate investment activity in the economy. Notwithstanding reductions of social security contribution rates and other measures aimed at further optimizing the tax levels, revenues of the state budget increased significantly. In line with the recently adopted strategy for the management of oil revenues, and despite high oil prices and large capital inflows, Azerbaijan has demonstrated a solid track record of sound fiscal policy by maintaining a sustainable level of the overall and non-oil deficits. Furthermore, in line with prudent budgetary management rules, excess inflows of revenues resulting from higher than budgeted oil prices are accumulated in the special stabilization account at the treasury. While the authorities had intended to establish the rules for the operation of this account in the Presidential Decree of the 2005 Budget, it was deemed to be more appropriate to include them in a Cabinet of Ministers regulation.

The important and politically difficult recent increase in energy prices will help further reduce subsidies in this area and improve effectiveness in the management of the public utilities. The authorities remain committed to gradually move energy prices to cost recovery levels.

The implementation of the State Program for Poverty Reduction and Economic Growth (SPPRED) and other policy decisions aimed at strengthening economic growth while maintaining macroeconomic stability, are reflected in the spending priorities. With minimum wage increases and other measures in 2004, the budget has become more oriented toward the poverty reduction objectives. Capital expenditure from the budget also continues to rise significantly in 2005.

Fiscal transparency in hydrocarbon activity is a long-term commitment of the Azerbaijani authorities. The State Oil Fund of Azerbaijan continues to accumulate and manage the oil and gas related revenues in a prudent manner. As summarized in Box 1, Azerbaijan is a strong supporter of the Extractive Industries Transparency Initiative (EITI). Working in close cooperation with the industry and civil society representatives, it is one of the first countries to agree to the EITI reporting mechanisms. Furthermore, by adopting the Accounting Law, reporting standards of the state owned enterprises (SOEs) will also be improved substantially and brought in conformity with international standards.

Monetary Policy

Several factors have increased inflationary pressures, such as strong foreign currency inflows and general economic growth, increased minimum wages and targeted support, higher oil and import prices. The authorities see their primary task in ensuring that these factors do not lead to a breach of single digit inflation levels, which have been successfully maintained for the last years. This is reflected in the 5 percent inflation rate targeted in the monetary program for 2005.

Our authorities are glad to note that Azerbaijan has accepted the obligations under Article VIII Sections 2, 3, and 4. They are also intensively working with the Fund and other partners in developing, institutionalizing and operationalizing the AML/CFT framework. Recommendations of the FSAP are being taken on board in the conduct of the monetary and financial sector policies.

Financial Sector Policy

The development of the whole spectrum of the financial services has continued together with the improvement of key performance indicators in the sector. The annual growth rate of banking credit to the economy has increased from 32 percent in 2003 to about 50 percent this year and underscores the strengthening of financial intermediation. The growth of the banking sector assets by 45 percent (US$1.5bn in 2004) and a decline of NPLs points to further improvement in the quality of lending. Although interest rates on deposits continued to decline, the rising level of banking deposits by 50 percent in the last 11 months demonstrates on the one hand an increasing confidence of the population in the banking sector, and on the other hand indicates the rising income levels. Structural changes in the banking sector will continue through further consolidation and greater foreign participation.

The new Banking System and Central Bank Laws prepared in coordination with the Fund has significantly strengthened the banking sector legislation. The authorities are confident that this will provide the basis to improve the quality of the financial sector in Azerbaijan, in particular given the strengthening of the supervisory framework.

Structural Policy

Strengthening the operational effectiveness and financial management at the large SOEs has continued. As noted in the LOI, quarterly reporting on the annually approved budgets of these organizations will further be ensured with the aim to eventually moving all public utilities towards the full cost recovery.

Creation of favorable conditions and supporting development of the non-oil sector represents one of the highest priorities of the authorities. The implementation of a comprehensive regional development program, focusing on the development of both business and physical infrastructure in the regions and rural area, as well as easing the tax burden and improving the business climate resulted in the opening of hundreds of new enterprises throughout the country.

The adoption of the Law on Civil Services, the implementation of Anti-Corruption legislation, the preparation of the Competition Law, and the continuing privatization are part of the efforts to improve governance and the rule of law. The adoption of the Accounting Law and introduction of the international reporting standards starting January 2005, as well as the rise in the salaries of the civil workers and strengthening of internal controls will also contribute to the improved governance.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL
RELATIONS
DEPARTMENT

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International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Concludes 2004 Article IV Consultation with the Azerbaijan Republic

On December 22, 2004, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Azerbaijan Republic.[1]

Background

A three-year arrangement under the PRGF, in an amount equivalent to SDR 80.45 million (50 percent of quota) was approved on July 2, 2001. Four disbursements under this arrangement have been made through December 2003.

Economic developments in Azerbaijan in recent years have been characterized by strong growth and low inflation. Real GDP grew by an annual average of over 10 percent during 2000-03, driven by oil-sector FDI and related spillover effects in the construction and transportation sectors, substantial gains in agriculture following land reform in the mid-1990s, and robust growth in non-oil exports (primarily agriculture and chemical products). Inflation remained low, despite the recent pick up. The real effective exchange rate, which depreciated by 11 percent in 2003, has remained broadly stable in 2004. As of end September 2003, the gross international reserves of the National bank of Azerbaijan (ANB) amounted to US$952 million, providing for over 4.1 months of prospective non-oil import coverage, and the deposits of the State Oil Fund of Azerbaijan (SOFAZ) reached around US$900 million.

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

Fiscal policy was moderately expansionary in 2003, but tightened in 2004 due to lower-than-budgeted expenditure and strong performance in tax revenue, reflecting the positive impact of tax administration reforms as well as tax policy changes. As a result, the 2004 non-oil deficit as a share of non-oil GDP is now expected to be lower than previously projected. The 2005 budget targets a non-oil deficit of 16.8 percent of non-oil GDP, which is 2.4 percentage points higher than the expected 2004 outcome, but still well below the estimated long-run sustainable level. While the share of wages in total spending is relatively high and rising, reflecting excessive government employment, the level of public sector wages is still low.

Monetary and credit aggregates expanded rapidly in 2003 and the first nine months of 2004, following the ANB's unsterilized purchases of foreign exchange inflows to resist nominal appreciation. Together with the impact of strong government wage increases in the second half of 2003, this contributed to an acceleration in inflation to 6.8 percent at end-April 2004. To slow the growth in monetary aggregates, starting in March, the ANB allowed the nominal exchange rate to appreciate modestly, and began selling ANB bills. These steps helped slow reserve money growth and inflation declined to 4.9 percent at end-September. Utilization of ANB bills as an instrument for sterilization should help the ANB to control inflation, which picked up in October largely due to one time factors.

Deposit growth was nearly 70 percent in the 12 months through end-September 2004, leading to a significant increase in bank lending, albeit from a low base. Nonperforming loans increased slightly at end-2003 relative to end-2002, before declining in the first half of 2004. Nominal Interest rates have continued to decline.

Balance of payment developments remained positive in 2003 and the first half of 2004. The current account deficit increased to nearly 30 percent of GDP in 2003, from just over 12 percent in 2002, and is expected to decline only modestly in 2004, due to oil-related imports financed by FDI. Non-oil exports grew by nearly 45 percent. Public and publicly guaranteed external debt in percent of GDP is projected to decline to 18 percent by end-2004 and 2005, compared to 20 percent at end-2003.

Structural reforms, which slowed in late 2003 and early 2004, accelerated again recently. The authorities adopted a long-term oil revenue management strategy, which is consistent with a sustainable use of oil wealth and growth in non-oil sectors, as well as maintenance of macroeconomic stability. The 2005 budget was based on this strategy. The new Banking System Law is a substantial improvement over the previous one, allowing the authorities to implement many of the Basel Core Principles' recommendations by amending relevant ANB regulations. The newly adopted National Bank Law is consistent with international best practices and calls for higher transparency, improved corporate governance and strengthened ANB independence in banking supervision. The authorities' recent decision to adjust domestic prices of energy products and commit to review and adjust these prices as necessary, at least once a year, is an important step towards reduction of energy-related subsidies and improvement of efficiency in the energy sector.

The first annual report of Azerbaijan's State Program for Poverty Reduction and Economic Development, reflecting extensive consultation with civil society, was completed in May 2004. While some progress has been made in alleviating poverty and reducing the disparities in income distribution, combating poverty remains a key challenge in Azerbaijan.

Azerbaijan accepted the obligations of Article VIII, Sections 2, 3, and 4 effective November 30, 2004, and is committed to maintain an exchange system free of restrictions in making payments and transfers for current international transactions.

Executive Board Assessment

Directors commended the authorities for Azerbaijan's strong macroeconomic performance in recent years reflected in double-digit broad-based GDP growth; rising gross international reserves and savings in the Oil Fund; declining external debt ratios; and relatively low inflation. Directors noted that, while this positive outcome is in part attributable to favorable external factors, including high oil prices and large oil-related FDI, it also reflects prudent financial policies and some progress in structural reforms. Directors expressed concern, however, that—despite the high real GDP growth—the incidence of poverty remains high.

Directors agreed that the main challenge facing the Azerbaijan authorities over the medium- and long-term is to manage effectively a large but temporary surge in oil revenue. In this context, they welcomed the recent adoption of a long-term strategy for the use of oil revenue, which calls for maintaining oil wealth constant in real terms and limiting annual fluctuations in non-oil fiscal deficits. Establishing a sound, transparent fiscal framework was seen as essential for enabling the country's oil wealth to support the sustainable development of the non-oil sector and poverty reduction. In this connection, Directors also underscored the need to strengthen the implementation of the structural agenda, which aims at reducing rigidities, diversifying the economy, and creating an investor-friendly environment. They attached particular importance to enhancing reforms in the financial and energy sectors and improving governance.

Directors supported the government's decision to increase non-oil fiscal deficits gradually over the next three years, consistent with the oil revenue management strategy, as well as with macroeconomic stability and expenditure implementation capacity. They also emphasized that the planned increases in the non-oil fiscal deficits over the medium term should involve a combination of expenditure increases in physical and human capital, as well as tax cuts targeted to non-oil sectors, in order to improve the competitiveness of Azerbaijan's economy. Furthermore, Directors urged the authorities to design and implement targeted social assistance, and increase pro-poor government spending to cushion vulnerable groups against the adverse impact of reforms. In addition, they underscored the need for a comprehensive civil service reform to ensure a steady increase in wages while containing the wage bill.

Directors noted the government's approval of revenue and expenditure plans for major state-owned enterprises in 2004 and the authorities' commitment to add the State Oil Company of the Azerbaijan Republic to the list of monitored enterprises in 2005. They encouraged the authorities to use these plans to strengthen monitoring of these enterprises and take necessary steps to improve their financial performance, in particular in the energy sector. Directors stressed the need to improve financial discipline and transparency in state-owned enterprises, in order to reduce continuing quasi-fiscal subsidies to them.

Directors were encouraged by recent progress in reducing gaps between domestic and world market energy prices. However, they noted that related fiscal and quasi-fiscal subsidies remained high, despite the significant progress made in recent years. In this regard, Directors were encouraged by the authorities' commitment to review domestic energy prices at least once a year in the context of the annual budget process, with an objective of gradually aligning them with world market levels. Some Directors, however, urged the authorities to consider the adoption of an automatic price adjustment mechanism while mitigating any adverse effects on the poor.

Directors were encouraged by the progress made in implementing Azerbaijan's State Program for Poverty Reduction and Economic Development (SPPRED), including the preparation of a Medium-Term Expenditure Framework and Public Investment Program in support of the SPPRED. They noted, however, that links between the SPPRED objectives and the annual budget should be strengthened, and recommended the adoption of a comprehensive strategy to address the current weaknesses in early 2005.

Directors welcomed Azerbaijan's participation in the Extractive Industries Transparency Initiative, but noted that limited progress has been made toward improving governance in other areas. They considered that corruption remains a significant problem in Azerbaijan. Directors, therefore, encouraged the authorities to fully implement the recent Law on Fighting Corruption and Anti-Corruption Decree. In this regard, they urged the authorities to complete the separation of commercial and regulatory functions of public enterprises and ministries, improve the functioning of the courts, reduce red tape, and expeditiously tackle monopolistic tendencies in certain markets.

Directors agreed that the use of the exchange rate as a nominal anchor has served Azerbaijan well, and the overall mix of financial policies has been appropriate. Looking forward, they stressed that the planned increases in non-oil deficits in the medium term are likely to intensify real appreciation pressures. Given limited sterilization capacity, Directors recommended accommodating these pressures through nominal exchange rate appreciation, which will be key to achieving the authorities' objective of maintaining a low inflation rate.

Directors welcomed the continued remonetization of the economy, which likely reflects macroeconomic stability and increased confidence in the banking sector. At the same time, they expressed concern that rapid credit growth associated with this process could overwhelm banks' ability to evaluate credit risks. Directors therefore urged the authorities to strengthen banking supervision to ensure that this rapid credit growth does not adversely affect the quality of banks' loan portfolios.

Directors welcomed recent progress in financial sector reforms, including the adoption of the Banking System Law and the National Bank Law, and the implementation of reform steps to foster competition in the banking sector. However, many Directors expressed concern about slow progress in privatizing the remaining two state-owned banks and urged the authorities to press ahead with their privatization plans. Directors also encouraged the authorities to accelerate other financial sector reforms recommended by the Financial Sector Assessment Program, including further liberalization of the market for the provision of all banking services to the government, the strengthening of anti-money laundering legislation, further development of the government securities market, and improvements of corporate governance and accounting and auditing standards.

Directors commended the authorities for their recent acceptance of the obligations of Article VIII, Sections 2, 3, and 4 of the IMF Articles of Agreement and their continued commitment to maintain an exchange system free of restrictions on the making of payments and transfers for current international transactions.

Directors praised the Azeri authorities for the continued improvement in the quality of macroeconomic statistics, and welcomed their commitment to subscribe to the Special Data Dissemination Standard in early 2005.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case. The Staff Report for the 2004 Article IV Consultation with the Azerbaijan Republic will also be available.

Azerbaijan: Selected Economic Indicators

	2001	2002	2003	2004	2005
				Projection	
			(Changes in percent)		
Real economy					
Real GDP	9.6	9.7	10.8	7.8	21.6
CPI (end-of-period)	1.3	3.3	3.6	10.0	5.0
			(In percent of GDP)		
Consolidated government					
Total revenue 1/	18.7	27.3	27.1	27.0	27.2
Total expenditures (including net lending) 1/	18.7	27.7	28.9	26.3	25.0
Fiscal balance 2/	-0.4	-0.5	-1.2	0.9	2.2
Non-oil fiscal balance 3/	-10.4	-14.9	-16.0	-14.4	-16.8
			(Changes in percent)		
Money and credit					
Manat reserve money	9.4	11.1	23.7	36.5	17.3
Manat broad money	7.7	15.5	28.0	30.6	32.9
Banking sector credit to the economy	-17.5	16.7	38.3	51.1	15.3
income velocity of average manat broad money 4/	11.3	11.6	10.9	9.9	9.0
			(In percent of GDP)		
Balance of payment					
Current account balance (-, deficit)	-0.9	-12.3	-28.3	-27.1	-6.6
External public debt 5/	20.2	20.1	20.1	17.5	14.6
Gross international reserves					
In millions of US$, end of period	725	721	803	923	1,181
In months of non-oil sector imports of GNFS	4.5	4.0	3.8	3.9	4.5
Exchange rate					
End-of-period (Manat/US$)	4,775	4,893	4,923	...	...
Real effective exchange rate (-, depreciation)	-6.1	-7.5	-11.3	...	...

Sources: Azeri authorities; and IMF Staff estimates.

1/ Revenue and expenditure starting in 2002 include the estimated value of SOCAR's unpaid energy deliveries to the utilities.

2/ This definition of the general government balance treats revenue from privatization as a financing item, and is measured from below-the-line financing, which includes the statistical discrepancy.

3/ In percent of non-oil GDP.

4/ In terms of non-oil GDP.

5/ Includes government and government guaranteed external debt only.