INTERNATIONAL MONETARY FUND

IMF Country Report No. 19/301

REPUBLIC OF AZERBAIJAN

September 2019

2019 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR THE REPUBLIC OF AZERBAIJAN

In the context of the Staff Report for the 2019 Article IV Consultation, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its September 6, 2019 consideration of the staff report on issues related to the Article IV Consultation with the Republic of Azerbaijan.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on September 6, 2019, following discussions that ended on June 27, 2019, with the officials of the Republic of Azerbaijan on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on August 20, 2019.
- An **Informational Annex** prepared by the IMF staff.
- A **Statement by the Executive Director** for the Republic of Azerbaijan.

The IMF's transparency policy allows for the deletion of market-sensitive information and premature disclosure of the authorities' policy intentions in published staff reports and other documents.

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September 18, 2019

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IMF Executive Board Concludes 2019 Article IV Consultation with the Republic of Azerbaijan

On September 6, 2019, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with the Republic of Azerbaijan.

The economy is continuing to recover from a banking crisis and recession. Real GDP growth reached 1.4 percent in 2018 and 2.4 percent in the first half of 2019, supported by increases in natural gas production and activity in the services sector. Higher oil prices have helped improve internal and external balances. Lower food prices and a stable exchange rate have kept inflation subdued, below the midpoint of the target band (4±2 percent). With inflation expectations well anchored and the fiscal position strengthening, the Central Bank of Azerbaijan has started to ease monetary policy. The business environment has been improving as bank lending and manat deposits have picked up.

Looking ahead, economic growth is expected to reach 2.7 percent in 2019 on strong hydrocarbon production and robust domestic demand, benefitting from new spending measures. In the medium term, economic growth is projected to settle at 2½ percent, as hydrocarbon expansion stabilizes at about 1¼ percent, and nonoil growth gradually rises above 3 percent. Inflation should remain under control, given low projected food price inflation and continued fiscal consolidation envisaged under a new fiscal rule. With oil prices expected to hover around $60 per barrel, the current account surplus is forecasted to remain sizeable. Public debt is set to decline relative to the size of the economy. Challenges remain, however, including fragilities in bank balance sheets, structural rigidities, governance weaknesses, and lack of transparency. Risks to the outlook are tilted to the downside, but Azerbaijan has room to respond to adverse shocks, given its strong net foreign asset position.

[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.

Executive Board Assessment[2]

Executive Directors agreed with the thrust of the staff appraisal. With the economy recovering from a banking crisis and a prolonged downturn, they commended the authorities for their policy response to the recent economic challenges. Going forward, Directors encouraged the authorities to continue their efforts to diversify the economy, raise its potential, and improve its resilience to shocks. They also emphasized the importance of economic inclusiveness and sharing the exhaustible hydrocarbon wealth with future generations.

Directors saw continued fiscal adjustment as necessary for ensuring long term debt sustainability and intergenerational equity. To mitigate the impact on economic growth, they recommended that fiscal consolidation proceed at a gradual pace and rely primarily on mobilizing nonoil revenues, improving the efficiency of public spending, reforming SOEs, and better targeting transfers and subsidies.

While welcoming the introduction of a fiscal rule, Directors recognized that recent spending packages make compliance with the fiscal rule challenging. In this context, they underscored the importance of complementing the fiscal rule with stronger public financial management, greater fiscal transparency, and better management of fiscal risks.

Given still tight financial conditions and economic slack, Directors broadly encouraged the authorities to continue normalizing monetary policy with a carefully calibrated and data driven approach based on incoming evidence about the impact of recent fiscal measures. They agreed that greater exchange rate flexibility would improve competitiveness, foster diversification, facilitate adjustment to shocks, and enhance risk management. Directors also encouraged the authorities to step up preparations for modernizing monetary and exchange rate policy operations and transitioning to an inflation targeting regime.

Directors agreed that strengthening financial supervision and fostering competition in the banking sector is crucial for ensuring its health and enabling it to play an effective role in intermediating resources for economic growth. While recognizing that the recent program for nonperforming loan resolution is set to improve bank balance sheets, they expressed concern that the program risks worsening moral hazard and repayment culture. Directors encouraged the authorities to conduct an independent asset quality review, phase out regulatory forbearance, and improve transparency.

Directors emphasized the importance of pressing ahead with structural reforms to foster diversified, private sector led and inclusive economic growth. In this context, they welcomed the

[2] 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. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

progress in improving the business environment and encouraged the authorities to make further efforts to reduce the economic footprint of the state and open the economy to greater international trade and investment. Directors also emphasized the importance of addressing governance weaknesses, including by strengthening the AML/CFT and anti-corruption frameworks. In addition, Directors stressed that better data and transparency would improve decision making, promote private sector participation, and reduce vulnerabilities to corruption.

Azerbaijan: Selected Economic Indicators

Population (2018 est.): 9.9 million	Literacy/Poverty rates: 100.0 (2017)/5.4 (2017)
Quota (in SDR million): 391.7	Per capita GDP (in US$, 2018): 4,742
Main products and exports: Oil, gas, and fruits.	Key export markets: Italy, Indonesia, Germany

				Projections	
	2016	2017	2018	2019	2020
Output					
Real GDP growth (in percent)	-3.1	-0.3	1.4	2.7	2.1
Real non-oil GDP growth (in percent)	-4.9	2.4	1.8	2.8	2.7
Real oil GDP growth (in percent)	-0.1	-4.4	0.6	2.5	1.2
Employment					
Unemployment rate (in percent)	5.0	5.1	5.0	5.0	5.0
Prices					
Consumer price index (period average)	12.4	12.8	2.3	3.2	3.3
General government finances					
Revenue (including grants, in percent of GDP)	34.3	34.2	38.8	39.1	37.8
Expenditure (in percent of GDP)	35.4	35.6	33.1	34.7	34.4
Current expenditure	24.6	25.3	19.1	22.9	25.8
Capital spending and net lending	10.8	10.3	14.1	11.9	8.6
Fiscal balance (in percent of GDP)	-1.1	-1.4	5.6	4.4	3.4
Non-oil primary fiscal balance (in percent of non-oil GDP)	-26.7	-30.9	-32.1	-31.1	-30.0
General government gross debt (direct borrowing)	20.6	22.5	18.8	19.7	18.6
General government gross debt including guarantees	50.7	53.2	48.4	51.5	47.8
Money and credit					
Broad money (including foreign currency deposits, percentage change)	-1.9	9.0	11.3	7.2	6.0
Bank credit to the private sector (percentage change)	-24.1	-28.1	14.9	11.1	8.2
Balance of payments					
Current account balance (in percent of GDP)	-3.6	4.1	12.9	9.7	10.0
Foreign direct investment (in percent of GDP)	5.1	0.7	-1.7	5.0	4.7
Gross international reserves (in months of non-oil imports)	4.2	5.1	4.7	5.9	6.3
Exchange rate					
REER (average, percentage change)	-27.0	3.3	5.6	…	…

Sources: Azerbaijani authorities; and IMF staff estimates and projections.

INTERNATIONAL MONETARY FUND

REPUBLIC OF AZERBAIJAN

STAFF REPORT FOR THE 2019 ARTICLE IV CONSULTATION

August 20, 2019

KEY ISSUES

Context: Azerbaijan is recovering from a banking crisis and recession caused by a prolonged decline in oil prices since mid-2014. Monetary conditions remain tight under a de facto peg. Despite rising government spending, the fiscal position is projected to strengthen in 2019 mainly due to firmer oil prices and improvements in revenue administration. Weaknesses in bank balance sheets, structural and policy rigidities, and institutional and governance deficiencies hinder medium-term growth prospects and weaken resilience to shocks.

Main Policy Recommendations:

- **Gradual and growth-friendly fiscal consolidation** is needed to strengthen intergenerational and precautionary buffers while mitigating the adverse impact on the economy. Consolidation could rely on prioritizing and improving the efficiency of spending, rationalizing tax policy, and improving revenue administration. The recently introduced fiscal rule needs to ensure spending discipline and reduce procyclicality. Monetary easing would complement fiscal consolidation. Greater exchange rate (ER) flexibility would facilitate adjustment to shocks and support diversification.

- **Promote inclusive, diversified, and private sector-led growth.** Reducing administrative burden for businesses, encouraging competition, and strengthening governance and transparency would reduce the cost of doing business, foster entrepreneurship, and attract foreign capital. Prioritizing investment for healthcare and education, improving its efficiency, and better targeting of social protection would help nurture human capital and improve productivity.

- **Strengthen policy frameworks and institutions.** Priorities include reforms in public financial and investment management, oversight of state-owned enterprises (SOEs) and governance, as well as fiscal accounting and transparency. Stronger financial regulation and supervision and modernization of monetary and foreign exchange (FX) operations are also needed. Addressing governance weaknesses is essential to reduce vulnerabilities to corruption. More integrated policies, along with better data availability, would support decision making and credibility, and attract investment.

Approved By
Juha Kähkönen (MCD) and Maria Gonzalez (SPR)

Discussions were held in Baku during June 12–27, 2019. The staff team comprised Natalia Tamirisa (head), Marwa Alnasaa, Anastasia Guscina, Kevin Ross (all MCD), Ashni Singh (FAD), and Galen Sher (MCM). Paul Inderbinen and Naghdaliyev Namig (both OED) joined some of the meetings. The team was assisted by Aghgun Gadirli from the IMF's local office, and by Rayah Al Farah and Branden Laumann (MCD) at headquarters. The mission met with Finance Minister Sharifov, CBA Chairman Rustamov, other senior officials, and representatives of the private sector, civil society, academia, media, and the diplomatic community.

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CONTEXT

1. **Having weathered the economic downturn, Azerbaijan has an opportunity to move to a new growth model and improve its resilience to shocks.** With a strong policy response and a rebound in oil prices, growth prospects have brightened, and the banking sector, while still fragile, has stabilized. Nevertheless, the economy remains heavily dependent on hydrocarbon exports[1] and public spending. Financial intermediation remains weak, and the de facto pegged ER continues to encourage dollarization as insurance against devaluation and high inflation.

2. **A longer-term economic development vision is crucial for achieving sustainable, private sector-led and diversified growth.** Given the exhaustibility of hydrocarbon[2] resources and the need to create jobs for a young population, Azerbaijan's economic future depends on its ability to reduce the economic footprint of the state, promote competition, and improve governance and transparency. An integrated macroeconomic, financial, and structural policy framework is needed to avoid procyclicality, ensure adequate savings for future generations, and more effectively respond to unanticipated shocks.

3. **The implementation of Fund advice has been mixed.** While policy announcements in the fiscal, monetary, and financial sector areas have broadly followed Fund staff's recommendations, the implementation of policy measures has often been delayed.

Azerbaijan: Implementation of IMF Recommendations

2017 Article IV Recommendations		Policy Actions Taken
	Fiscal Policy	
Target a nonoil primary balance (NOPB) consolidation of at least a ½ pp of nonoil GDP per year.		After deteriorating in 2018, NOPB is expected to improve in 2019; after that, the authorities intend to consolidate by 1 pp of nonoil GDP per year.
Mobilize nonoil revenues by strengthening tax administration, expanding the tax base, and removing distortionary tax exemptions.		Customs and tax administration have strengthened, but tax exemptions for fostering SME growth have expanded.
Simplify the fiscal rule. Submit a Fiscal Risk Statement as part of the annual budget to monitor risks associated with SOEs, extra-budgetary funds, and credit support programs.		A new rule-based fiscal framework (without a Fiscal Risk Statement) is being implemented in 2019. An SOE Monitoring Committee has been created in the MOF.
	Monetary and ER Policy	
Recalibrate monetary policy in line with macroeconomic conditions and ER policy.		Since early 2018, the CBA has cut the main refinancing rate by 7¾ pp to 8¼ percent as y/y inflation has fallen to 2½ percent.
Allow greater ER flexibility to absorb shocks, improve price discovery and preserve buffers.		The CBA moved to (de jure) floating ER regime in December 2015 but have kept the ER stable at 1.70 manat per dollar since March 2017.
Continue modernizing the CBA's monetary and ER policy frameworks.		The CBA has committed to moving toward an inflation targeting regime over the medium term.
	Financial Sector Policy	
Further downsize the largest state bank (IBA), resolve its NPLs, and privatize it.		The IBA's balance sheet shrunk further in 2018, after declining by some 40 percent in 2017. The authorities are discussing privatization plans with an IFI advisor. NPLs have declined.

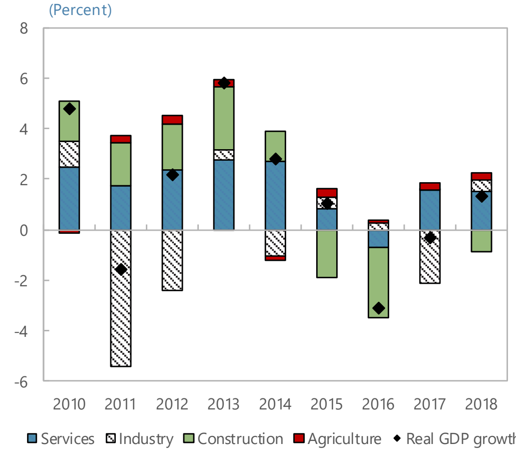
[1] The hydrocarbon sector accounts for some 41 percent of GDP, 92 percent of exports, and 65 percent of fiscal revenues.

[2] "Hydrocarbon" and "oil" are used interchangeably in this Staff Report to denote oil, oil products, and natural gas.

Azerbaijan: Implementation of IMF Recommendations (continued)		
Address NPL problem and restart credit intermediation.		A new NPL recovery program for private individuals, bank owned private credit bureau, and new secured transactions and collateral laws are being implemented.
Strengthen bank supervision by restoring FIMSA's independence, ceasing regulatory forbearance, implementing the Bank Resolution Law, closing banks with negative capital, and publishing FSIs.		Regulations for on-site inspections have been approved. FIMSA received TA on FSIs.
Structural Policy		
Complete the WTO membership process and apply the OECD's Investment Guidelines and diversify the economy away from oil.		Continued to implement the government's 2020 Structural Reform agenda. Nonhydrocarbon exports rose but export concentration in hydrocarbons remains high. No progress on WTO accession.
Implement reforms to reduce the costs of doing business and remove barriers to competition.		Azerbaijan's rank in the World Bank's 2019 Doing Business Indicators improved by 32 places to 25th place, while its rank in the World Economic Forum's Global Competitiveness Indicators fell by 4 spots to 69th place.

RECENT DEVELOPMENTS

Contribution to Real GDP Growth, 2010-2018
(Percent)



4. **The recovery is gaining pace.** Economic activity in 2018 remained sluggish, owing to a continued downturn in construction and a decline in hydrocarbon output. The economy expanded by 2.4 percent through the first six months of 2019, driven by an uptick in the service sector activity and increased gas production.[3] With declining imported food prices under a de facto ER peg, and remaining excess capacity, inflation fell to 2.3 percent in 2018 from 13 percent (y/y) in 2017 and stood at 2.6 percent this June.

5. **External balances continue to improve.** The current account surplus increased by 8.8 percentage points (pp) of GDP to 12.9 percent of GDP in 2018 on firmer oil prices. Despite higher financial outflows, international official reserves of the Central Bank of Azerbaijan (CBA) and the Oil Fund (SOFAZ) rose by 2 pp of GDP to $44 billion (98 percent of GDP). However, competitiveness deteriorated, with a 7 percent appreciation in the real effective ER and a worsening of the nonoil current account deficit.

6. **A new fiscal rule was introduced in 2019.** The rule requires (i) the year-ahead projected nonoil primary balance (NOPB) as a percent of nonoil GDP to be no worse than the current-year NOPB, and (ii) nominal spending growth not to exceed 3 percent over the previous year's approved expenditures. "Spendable" oil revenues are also constrained under the rule (Annex III). The rule was announced as part of a broader package of public financial management (PFM) reforms, including

[3] Three Southern Gas Corridor projects became operational in 2018, with the last one is scheduled to start next year. In 2017, the authorities signed a new production sharing agreement with the consortium of foreign oil companies, which together with the state oil company (SOCAR) extract oil and gas.

a medium-term expenditure framework (MTEF), public debt management strategy, and a budget classification law.

7. The fiscal stance is set to reverse from stimulus to tightening. In 2018, the NOPB deteriorated by 1.2 pp to -32.1 percent of nonoil GDP on increased social and infrastructure spending and SOE capital injections, amid slower nonoil revenue growth. The 2019 budget implied consolidation of 1 pp of nonoil GDP under the new fiscal rule. The budget reflected gains from improved revenue administration and new tax policy measures aimed at reducing informality and broadening the tax base. These gains were partially offset by losses from expanding tax deductions, exemptions, and investment tax credits, as well as a reduction of the personal income tax rate. New spending initiatives in 2019 were compensated by cuts in capital spending, expenditure reallocations, and the use of CBA profits under a revised budget passed in June. After these revisions, the 2019 NOPB is still expected to improve by 1 pp of nonoil GDP.

Summary of Main New Tax Policy Measures

Tax Policy Administration
- Use of electronic cash registers and receipts that submit real time data
- Reports on the use of cash
- Increased financial sanctions for evasion and noncompliance

Personal Income Taxes (PIT)
- No PIT on monthly nonoil, nonpublic sector incomes under AzN 8,000
- Required PIT withholding on payments to informal suppliers

Corporate Income Taxes (CIT)
- CIT exemptions for dividends and capital gains
- Increased depreciation allowances
- Expanded definition of capital gains

Value Added Taxes (VAT)
- Acceleration VAT refund process
- Expanded compulsory VAT registration

Excise Taxes (ET)
- List of excisable goods expanded and ET rates increased

Simplified Tax (ST)
- ST rate has been reduced from 4 to 2 percent
- Tightening of thresholds to qualify as a ST taxpayers

New (PIT, CIT, VAT, ST, Asset tax) Exemptions/Deductions
- On agricultural manufacturers, catering/retail, SME cluster companies
- Exemptions/deductions in place for 3 to 7 years

Box 1. New Spending Packages

Two spending packages were introduced through Presidential Decrees in the first half of 2019. The government's publicly expressed intention was to compensate the public for the adverse impact of the past devaluations, banking crisis and economic downturn. Parliamentary elections are scheduled for November 2020.

The spending packages contain the following main components:

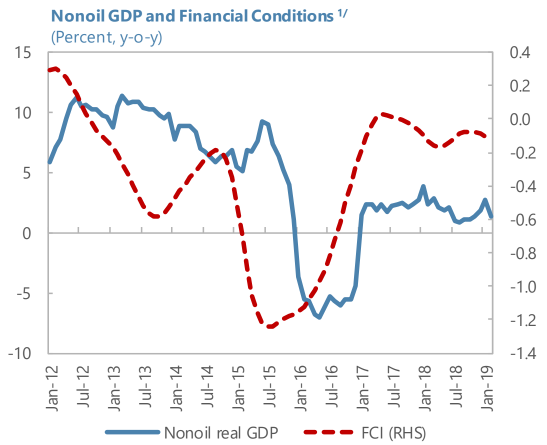
- *Increases in minimum wages and pensions (0.6 percent of GDP)*, with the minimum monthly wage (pension) raised from AzN 130 (73) to AzN 180 (130) in April, and to AzN 250 (200) in October 2019.

- *Increases in public sector wages* of about 40 percent (1.0 percent of GDP) from September 2019.

- *An NPL resolution / consumer loan bailout,* whereby banks and consumers receive some AzN 650 million manat (0.8 percent of GDP) as compensation for past devaluations (see Box 2 for more details).

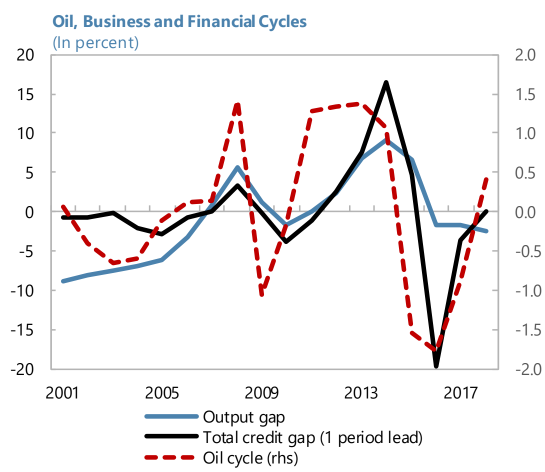
The packages are expected to affect up to 30 percent of the population and have broad macroeconomic, fiscal, and financial sector implications, as discussed elsewhere in this Staff Report.

8. Monetary and financial conditions remain tight. Since January 2018, the CBA has reduced its refinancing rate from 15 to 8¼ percent and narrowed the interest rate corridor to +/-2 pps around the refinancing rate. Manat base and broad money have expanded, and excess liquidity has remained ample. However, since inflation has fallen faster than nominal interest rates, real interest rates have risen. With the ER fixed at AzN/US$ 1.70 since April 2017 and trading partner currencies depreciating, the nominal and real effective ERs appreciated (by 5–7 percent in 2018), further tightening financial conditions.



Source: National authorities, Haver, and IMF staff calculations and estimates.
1/ FCI components are weighted by their relative standard deviations.

9. Bank lending has picked up with the recovery in demand. Private sector credit was growing at 11 percent (y/y) as of June, with sizable increases in transportation, trade, and household lending. The uptick in lending, however, has taken place against a backdrop of continued weaknesses in bank balance sheets and supervision (¶10, 27). Credit guarantee funds, as well as the creation of the private credit bureau and collateral registry, have contributed to the expansion of credit. Manat household deposits have risen and are de-dollarizing, in part because the government's blanket guarantee on deposits was extended in March 2019 for one more year.



Source: National authorities, Haver, and IMF staff calculations.

10. Despite recent improvements, weaknesses in bank balance sheets persist. The banking system's reported profitability and capital adequacy have improved, reflecting loan reclassification and restructuring, the reversal of loss provisions, bail-in of creditors, and fresh capital. Financial Market Supervisory Authority (FIMSA) has increased the number of on-site inspections and has updated several regulations. Nevertheless, regulatory forbearance appears to be continuing. Some banks remain undercapitalized with high NPLs and may not be complying with limits on large exposures and related party lending. Moreover, the ultimate beneficial ownership of some banks is opaque. The favorable system-wide capital adequacy ratio (20 percent with a Tier I ratio at 19 percent) is driven by the largest bank, International Bank of Azerbaijan (IBA), whose balance sheet was restructured. Ongoing de-dollarization and near-term ER stability are expected to keep risks from currency mismatches manageable.

11. The authorities are taking steps to address impediments to growth.[4] Azerbaijan's Doing Business score rose by 8.45 points to 78.6, with improvements in obtaining credit,

[4] The country's strategic and development priorities are described in its "2020 Reform Agenda."

construction permits and electricity connections; registering property, paying taxes, and labor regulations. The authorities are also putting in place institutional infrastructure to provide services to small and medium enterprises (SMEs), implement e-government, and create specialized business courts. They are developing a new utility tariff schedule to reduce subsidies and improve SOE health. Digitalization of customs services and launching of the Green Corridor regime in February 2019 have simplified customs clearance procedures, reducing opportunities for corruption. While applauding progress in e-government, a recent EU business climate report stressed the importance of following through on announced reforms and continuing improvements in transparency, education, and market development.[5]

Azerbaijan: Structural Policy Measures Announced in 2018

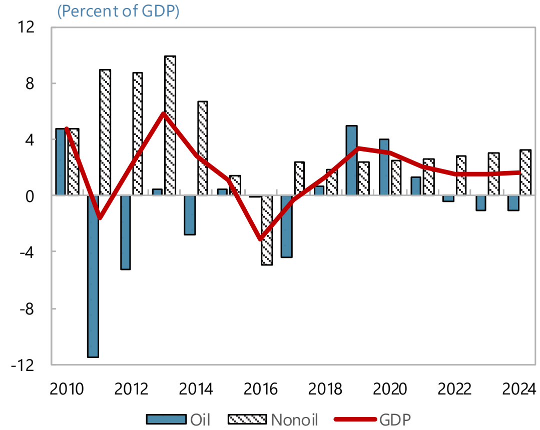
Business Promotion	Government Process	Labor Markets	Legal Reform
Opened a single window at the Baku City Executive Office for dealing with construction permits.	Made paying taxes easier by introducing e-invoicing and unified tax return for social security contributions and enhancing the online platform for filing corporate income tax.	Reduced notice period for redundancy and dismissals and severance payments.	New specialized business courts will be created, improved judicial training in commercial law and strengthen enforcement.
Established a new credit bureau and a new unified collateral registry to improve access to credit.	Broaden the services of the state agency for public services (ASAN) to begin issuing energy-related permits and implementing e-government.	Launched new unemployment insurance program and expanded active labor market programs (ALMs) focusing on entrepreneurial and vocational training.	
Created electronic registration for companies and individual entrepreneurs for starting business.	Established a new energy regulator (AERA), which is proposing a new utility tariff schedule aimed at reducing subsidies and improving the financial health of SOE utilities.	Implemented pension reforms with increased retirement ages and greater reliance on insurance-based principles.	
Established one-stop shop to streamline the process of connecting to the electrical grid.		Increased the number of registered labor contracts.	

OUTLOOK AND RISKS

12. **Growth is expected to strengthen in 2019, before settling around 2½ percent in the medium term.** Real GDP is projected to expand by 2.7 percent in 2019 as the impact of the new spending packages kicks in and the gas pipeline network comes on stream. Subsequently, hydrocarbon growth will stabilize as expanding production from the Shah Deniz II gas project and Azeri Central East oil project compensates for declining oil production in other fields. Nonhydrocarbon growth will rise gradually to around 3.2 percent over the medium term. Moderating capital investment, structural rigidities, and bank weaknesses will weigh on economic

[5] https://eeas.europa.eu/delegations/azerbaijan/64138/eu-business-climate-report-2019_en. The authorities are continuing discussions with the EU on a partnership agreement.

prospects. Inflation will remain below 3.5 percent, given the stable ER and low food price inflation. With oil prices projected at around $60 per barrel and the fiscal position improving, the current account surplus will remain sizeable.



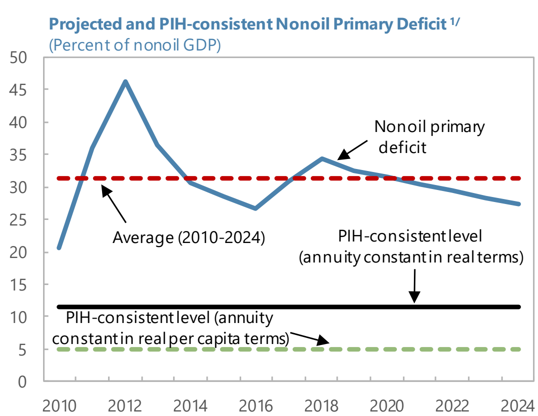
Source: National authorities and IMF staff calculations.

13. Risks are tilted to the downside (Annex II). A decline in oil prices, for example, due to slowing global demand, would worsen fiscal and external positions and put pressure on the ER. Materialization of large contingent liabilities would weaken debt sustainability. Another source of risk stems from the fragmentation and other weaknesses in the policy frameworks and governance, which may result in slower-than-expected progress in implementing structural reforms, cleaning up the banking sector, and improving resilience. Recent increases in public sector wages may propagate to the private sector, creating second-round inflation effects and further undermining competitiveness. Heightened geopolitical tensions are an additional source of risk. On a more positive note, exposure to global financial markets, mainly through SOFAZ, is mitigated by portfolio diversification. Low economic diversification limits exposure to international trade shocks. Upside risks stem from higher oil prices and faster reforms.

14. The authorities broadly shared staff's views on the outlook and risks. They noted considerable uncertainty about the impact of recent spending measures on domestic demand and inflation in the near term. Over the medium term, the authorities saw larger upside risks to private sector growth from recent structural reform measures. They also considered that the risk of contingent liabilities materializing was negligible, given low interest rates, long durations, and the quality of the underlying projects.

POLICY DISCUSSIONS

There was a consensus that the authorities' strong policy actions have helped Azerbaijan's economy weather recent shocks. Many interlocutors believed, however, that deeper policy reforms are needed for more inclusive, sustainable, diversified, and private sector-led growth, with opportunities available to all. Policy discussions focused on policies and frameworks to ensure macro-financial stability, create a new growth model, and foster economic inclusiveness.



Source: National authorities and IMF staff calculations.
1/ The gap between actual non-oil primary balance and non-oil primary balance recommend by the Permanent Income Hypothesis. The higher the value the greater the effort needed to restore intergenerational equity.

A. Rule-Based Fiscal Policy

15. The authorities and staff agreed that strengthening long-term fiscal sustainability is an important policy priority. Azerbaijan has some fiscal space, given low gross public debt on a downward trajectory, low gross financing needs and largely negative net debt to GDP, and with SOFAZ assets amounting to 82 percent of GDP as of end-2018.[6] However, a large gap (23 pps of nonoil GDP) from the long-term Permanent Income Hypothesis (PIH)-based NOPB benchmark of -11 percent of nonoil GDP implies a need for significant adjustment to share exhaustible oil wealth with future generations, notwithstanding the sensitivity of these calculations to the underlying assumptions.

Azerbaijan: Spending Packages, Offsets, and Net Expenditures 1/

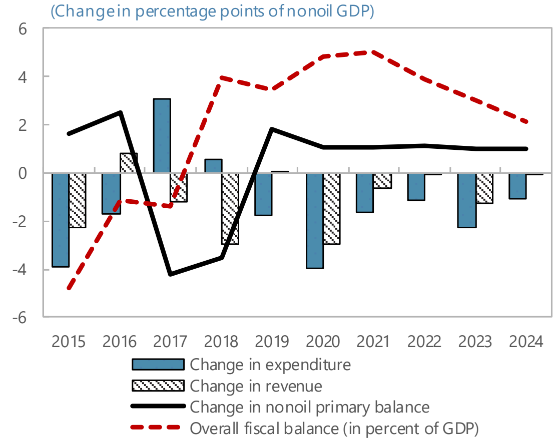
New spending packages (2019)	In % of 2018 budgeted spending	In % of 2019 GDP
Consumer loan bailout / NPL resolution 2/	2.4	0.8
Minimum wage and pension increase	1.9	0.6
40% increase public sector wages	2.9	1.0
Total spending	**7.3**	**2.4**
Fiscal offsets		
Existing room relative to ceiling	0.8	0.3
Under execution of capex budget	2.1	0.7
Reallocation from reserve fund	1.9	0.6
Total offsets	**4.8**	**1.6**
New expenditures not offset (int'l accting)	**2.5**	**0.8**

1/ Estimates provided by the authorities.
2/ One-time expenditure.

16. With the recovery underway, the authorities have appropriately shifted to fiscal tightening in 2019. Under the revised 2019 budget, they intend to offset the new expenditures (2.4 percent of GDP, Box 1) by spending reallocations (1.6 percent of GDP), while booking the remaining portion of expenditure (linked to the consumer loan bailout) off-budget, along with the offsetting CBA profit transfer. Although staff records all budget spending and CBA profit transfers above the line, both the authorities' and staff's projections imply a 1 pp of nonoil GDP improvement in the NOPB, consistent with the original 2019 budget. Staff supported this stance, both on cyclical and long-term sustainability grounds.

17. Looking ahead, the authorities reaffirmed their commitment to gradual fiscal consolidation. They intend to consolidate the fiscal position by about 1 pp of nonoil GDP yearly in 2020 and beyond. The authorities and staff agreed that this pace of consolidation strikes a good balance between the goals of strengthening buffers and supporting economic growth, but that it would not close the intergenerational equity and external gaps (Annex I). More ambitious fiscal consolidation (3 pp of non-oil GDP cumulatively over the next five

Nonoil Primary Balance Components
(Change in percentage points of nonoil GDP)



Source: National authorities and IMF staff calculations.

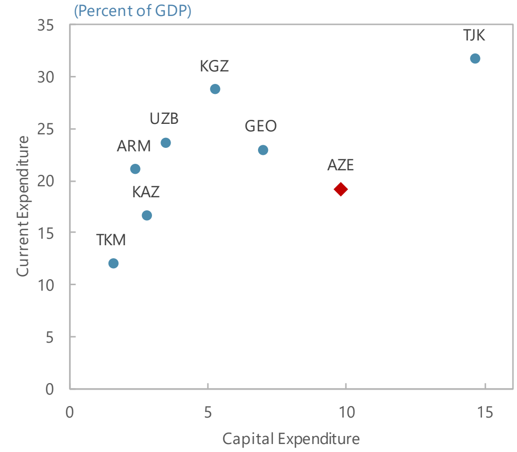
[6] SOFAZ's investment portfolio is highly liquid with 80 percent of assets in short-term money market instruments. While primarily a wealth fund, SOFAZ's charter allows its resources to be used for "solving important nation-wide problems." In 2017, SOFAZ made an extraordinary transfer of AzN 3.5 billion to the CBA as part of the government's stabilization plan. SOFAZ also invests a portion of its assets in the domestic oil sector.

years) could be achieved by identifying additional spending efficiency gains and introducing comprehensive revenue and tax reforms. The authorities, however, considered that a faster pace of consolidation was not feasible, given the recent jump in structural expenditures,[7] plans to introduce medical insurance, and still sluggish growth.

18. In staff's view, improvements in the efficiency of public spending, tax policy, and revenue collection would allow the fiscal position to be consolidated in a growth-friendly way.

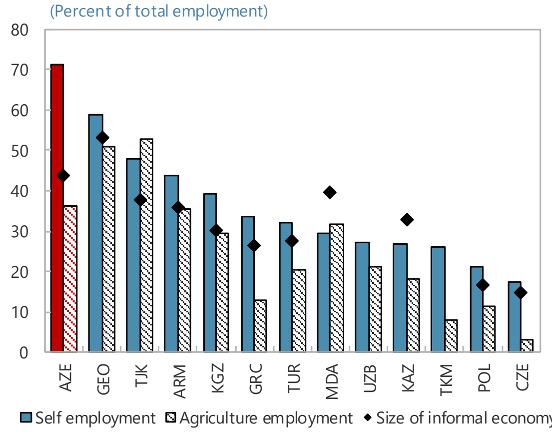
- ***Spending.*** The authorities rightly aim to achieve fiscal consolidation mainly through better prioritization and moderation of capital spending. In this context, staff urged the authorities to finalize and implement draft regulations requiring public investment projects to be appraised and selected in accordance with transparent criteria, as well as to broaden public procurement reforms. Advancing planned spending reviews in targeted sectors such as education would also be beneficial. Making public sector wage adjustments rule based and better aligned with performance would help reduce spending rigidities.[8] Civil service reform would be useful in this regard. Social spending should be well-targeted and condition-based (Annex V).

Current and Capital Expenditure, 2018
(Percent of GDP)



- ***Revenues.*** Streamlining tax exemptions would foster revenue mobilization and equity. In this context, staff welcomed the authorities' work on estimating the cost and efficiency of tax exemptions and urged them to complete it swiftly. Over the medium term, staff also recommended undertaking comprehensive reforms of revenue administration and tax policy to identify additional nonoil revenue gains; staff stands ready to support the authorities in undertaking the respective diagnostic analyses. While recognizing potential benefits of comprehensive reforms,

Employment Status Relative to Informality, 2018
(Percent of total employment)



Source: World Bank Development Indicators, and IMF calculations.

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[7] According to staff's preliminary estimates, the full-year effects of the recent wage measures would raise structural budget spending by 7 percent. The public sector wage bill would increase from 5½ percent of GDP to about 7¾ percent in the medium term.

[8] See IMF (2018), "Public Wage Bills in the Middle East and Central Asia", https://www.imf.org/en/Publications/Departmental-Papers-Policy-Papers/Issues/2018/01/09/Public-Wage-Bills-in-the-Middle-East-and-Central-Asia-45535

the authorities gave priority to implementing recent tax and revenue administration measures aimed at reducing informality.

19. The authorities and staff recognized that recent spending packages make compliance with the fiscal rule more difficult. Under staff's projections, nominal expenditure growth will exceed the 3 percent ex ante cap set by the fiscal rule already in 2019. (This is not the case under the authorities' revised budget as some spending items and CBA profits are recorded off-budget.) Going forward, all agreed that increases in public sector wages, combined with indexation, would make compliance with the rule challenging.

20. The authorities favor refining the rule based on first-year experiences. In this context, staff emphasized the importance of compliance with the rule to build policy credibility and that any refinement should ensure the rule's ability to foster fiscal discipline in line with long-term fiscal sustainability objectives while avoiding procyclicality (Annex III). The existing rule should continue to be followed until amended by law, and the use of off-budget or other operations inconsistent with best international practices to satisfy the rule should be avoided. Any modifications should be carefully designed, planned and communicated to ensure that the effectiveness of the rule-based framework and confidence in it are not eroded. The authorities have requested technical assistance (TA) to review the application of the rule and consider any needed refinements.

21. Staff stressed that the fiscal rule should be supported by strong PFM practices and processes. The fiscal rule should be linked to the budget through a clear fiscal strategy to guide budget priorities, with a medium-term budget framework in place. The authorities noted that the current rule was implemented at a time when several PFM prerequisites were still at an early stage of development. Plans to implement an MTEF have been announced, work is at conceptual stages, and the aim is to present pilots for three sectors with the 2021 budget. Mandatory in-year and end-of-year reviews of performance under the rule would help to improve accountability and ensure compliance. Systematic identification and monitoring of risks to the fiscal outlook would also help to secure compliance.

22. Better fiscal transparency would also improve macro-fiscal performance and reduce vulnerabilities to corruption (Annex IV). Publishing more timely and comprehensive fiscal data, including detailed information on budgets and outturns, SOE support and investment spending, and fiscal risks would improve macro-fiscal analysis and forecasting as well as accountability and transparency across government, underpinning credibility of the fiscal rule. Greater transparency and better public

Public Financial Management Framework Recommendations

Fiscal Rule
- Publish the Chamber of Accounts (COA) report on budget execution, assessing ex-post compliance under the fiscal rule
- Publish updates on the economy, fiscal performance, and projections

MT Framework
- Strengthen strategic (policy making) phase of budget preparation
- Publish pre-budget fiscal strategy statement
- Implement the medium-term expenditure framework

Expenditures
- Improve selection, execution, and evaluation of public investment projects
- Establish mechanism for periodic targeted spending reviews

Fiscal Risks
- Publish statement of fiscal risks
- Strengthen fiscal risk management and SOE oversight

procurement would improve efficiency and reduce corruption risks. Azerbaijan has joined the IMF's e-GDDS and is revising reporting in line with the latest Government Financial Statistics Manual. A Fiscal Transparency Evaluation (FTE) would help construct a more comprehensive picture of the public finances and of fiscal risks, take stock of transparency practices, and develop a reform action plan. The authorities emphasized their commitment to fiscal transparency and will consider requesting an FTE.

23. Staff and the authorities agreed that SOE restructuring is important to reduce demands on the public purse and improve economic efficiency. The largest of over 5,000 active SOEs operate as monopolies in strategic sectors and are too big to fail. Past devaluations, sluggish growth, quasi-fiscal activity, and poor governance have weakened the financial position of most SOEs, which required increased budget support. In response, the authorities have strengthened financial accounting practices, created an SOE monitoring commission, and issued new SOE governance guidelines. They agreed with the importance of adjusting tariff schedules to achieve viability and prioritizing investments to replace aging capital in the electricity, gas, water, railroad and shipping sector SOEs. Staff recommended that commercial and noncommercial activities be separated, and a commercial performance framework enacted. This would help to accelerate privatization.

B. Supporting Monetary Policy

24. The CBA has appropriately started the process of normalizing interest rates. With inflation projected to remain below the midpoint of the CBA's publicly announced 2 to 6 percent inflation band, inflation expectations well anchored, and the U.S. interest rate futures lower, staff saw room to continue monetary easing. While acknowledging potential room for more cuts, the CBA viewed the monetary stance as less tight than staff and emphasized increased uncertainty about the inflation forecast, given recent fiscal measures. The CBA also noted that the monetary base has expanded rapidly after the crisis, at the same time as the government's cashless economy program has reduced money in circulation and improved base money stability. The authorities and staff agreed that decisions about future changes in interest rates should be made particularly carefully at this juncture, based on incoming evidence regarding the impact of recent fiscal measures.

Key Monetary and ER Policy Framework Recommendations

Transition to Inflation Targeting (IT)

- Create detailed strategy to transition to IT and publish a summary
- Amend Central Bank Law as needed to further enhance independence
- Allow ER flexibility, while maintaining the ER as nominal anchor
- Use more actively interest rate policy and FX operations
- Build analytical capacity; publish forecasts of inflation and key variables
- Activate and utilize liquidity forecasting and monitoring units

Monetary Operations

- Utilize de facto floor system and standing liquidity absorption facility
- Issue LT notes at market determined rates to sterilize excess liquidity
- Introduce overnight OMO fine tuning instruments
- Expand issuance and use of MoF paper as collateral
- Adjust reserve requirement ratio upward to become effective

FX Market

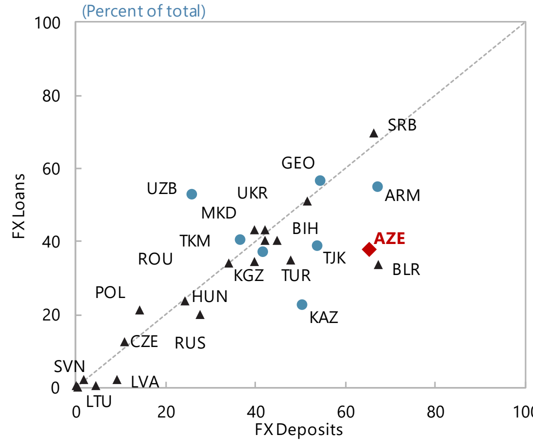
- The CBA should be the sole provider of FX to the market
- Introduce ER arrangement with horizontal bands, with variation limits
- CBA develop communication strategy
- Increase ER transparency of FX auctions by publishing detailed results

25. The authorities and staff saw greater ER flexibility as important for improving competitiveness, facilitating diversification and adjustment to shocks, and promoting better

risk management. Staff noted that the de facto peg limited the development of the interbank market and interest rate channel of monetary policy and risked fueling the same macro-financial vulnerabilities that led to the recent crisis. Given firmer oil prices, adequate reserves, and the introduction of the fiscal rule, the timing for introducing ER flexibility was opportune. Moreover, greater ER flexibility along with fiscal and financial sector policy measures, would help to improve Azerbaijan's external position, which in staff's assessment, is moderately weaker than implied by fundamentals (Annex I). However, the authorities favored maintaining ER stability at least in the near term. They felt that it helped to maintain confidence and macroeconomic stability and considered that slow progress in diversification and weak competitiveness were mostly due to structural impediments. The CBA plans to move to a hybrid inflation targeting (IT) regime within 3–5 years, relying both on a nominal interest rate operating target and a stabilized market-determined ER as the nominal anchors, after the necessary conditions were in place. This could set the stage for a fully-fledged IT over the long term.

26. In the meantime, the CBA intends to focus on modernizing its policy framework and addressing structural impediments to IT. Shallow markets, difficulties in liquidity management, banking vulnerabilities, dollarization, and weak transmission suggest the CBA will have difficulty influencing interest rates and inflation. Staff recommended improving the policy framework, including by strengthening CBA independence, operationalizing the de facto floor system, and formalizing the action and communication plan for transitioning to IT. Moreover, the CBA's analytical and forecasting capacity should be bolstered and its policy toolkit expanded, along with steps to strengthen and deepen the financial system. The authorities plan to continue their ongoing monetary and ER policy TA program with the Fund.

Bank Deposit and Loan Dollarization
(Percent of total)



Source: National authorities and IMF staff calculations.

C. Financial Stability and Development

27. There was agreement that while improved, the situation in the banking system remains fragile. Dollarization, unhedged FX positions, and NPLs are still high, with some banks being undercapitalized or insolvent. Notwithstanding progress in removing bad assets from its balance sheet and restructuring its FX liabilities, IBA still does not have a viable business model. Staff stressed that existing undercapitalized banks be given a strict deadline to recapitalize or close, and large banks with narrow capital buffers be required to strengthen them. Supervisory forbearance should be terminated, regulatory norms enforced, and banks' corporate governance strengthened. Privatization of IBA should be initiated as soon as possible.

28. Strengthening FIMSA's independence and resources is essential for it to be effective. FIMSA indicated that its current charter provides for full operational independence on budget and staffing issues but that it lacks independence over decisions to grant new licenses. The closure of financial institutions may require political consent. In the authorities' view, the implementation of several new regulations (including on FX lending) and a new methodology for systemically important banks have bolstered oversight.[9] Staff recommended the use of gap analysis against Basel Core Principles to identify specific areas for improvement in supervision and moving quickly to resolve uncertainty over possible extensions of the blanket deposit insurance guarantee. The authorities have requested TA on financial sector regulation and supervision and have expressed interest in an FSAP Update.

Box 2. New NPL Resolution Program

The program is designed to reduce NPLs and compensate individuals whose debt servicing burden increased due to the 2015 devaluations:

- Some AzN 650 million has been sent from the state budget to banks. About half of this amount has been retained by banks to pay down overdue retail loans, where applicable. As a result, capital in the banking system is expected to increase by AzN 300 million (7.4 percent of end-2018 system-wide capital). The remaining portion (0.4 percent of GDP) has been sent by banks to individuals (in debit card form) to compensate them for having serviced their outstanding loans at the new (depreciated) ER.

- Banks are also required to restructure FX retail loans. These loans are redenominated to manat, their terms are extended, interest rates are reduced, and accrued interest and fees are written off. The redenomination to manat exacerbates banks' open currency positions. To mitigate banks' FX risk, the CBA will make loans of some AzN 680 million available to banks at low interest rates and under government guarantees. The CBA will also make $215 million worth of dollar-denominated bonds available to banks for purchase. By taking a loan from the CBA in manat and using the proceeds to buy a dollar-denominated bond, a bank can close its open currency position.

29. While the new NPL program will improve household balance sheets, it will have limited impact on the health of the banking sector. The program will boost banks' liquidity, and the restructuring will reduce loan dollarization. The authorities expect that bank solvency will improve in a small number of banks, as positive effects from government transfers outweigh negative effects of accrued interest write-offs. However, staff and authorities agreed that the program creates moral hazard by undermining incentives for proper risk management of new FX loans and worsens repayment culture. NPLs are likely to remain high after the program (12.9 percent), and uncertainty surrounding NPL estimates will persist.

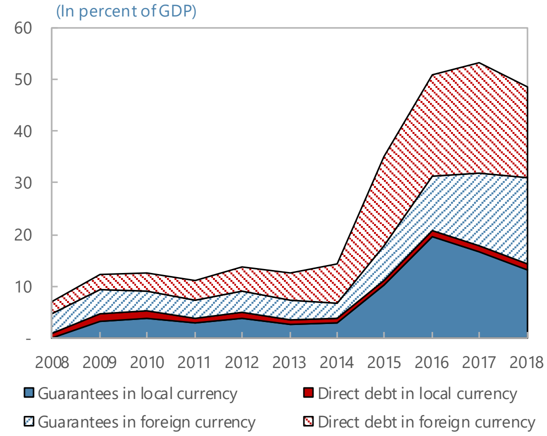
30. Staff welcomes that the authorities are starting to take a more comprehensive approach to solving the NPL problem. With the banks, FIMSA has been developing an out-of-court settlement system to facilitate NPL resolution. FIMSA is also drafting legal amendments that would enable the creation of asset management companies. They are also assessing possible reforms to the responsible lending law, with an aim toward directing resources to tradable goods sectors. Building on FIMSA's efforts, staff stressed that an independent and transparent asset quality review (AQR) remains essential to ascertain likely loan recovery rates. On-site inspections of provisioning practices are not a substitute for AQRs. Imposing timetables to resolve NPLs through write-offs or sales and making the process cheaper and quicker are essential. Improving bank

[9] FIMSA has identified four systemically important banks that have a CAR requirement of 11 percent, compared to ten percent for the rest of the system.

governance and rolling back regulatory forbearance would help prevent a weakening in bank balance sheets. Transparent accounting of bad asset management and resolution is also needed.

31. Staff highlighted the importance of a coordinated approach to debt market development. Creating a capital market development strategy in consultation with all relevant stakeholders would soften the FX risk of the sovereign debt profile that exacerbates the fear of floating. Such a strategy would set out a roadmap for developing deeper local currency bond market, with longer tenors, more diversified investor base, market-determined pricing, and enhanced secondary market liquidity. Better coordination among the Ministry of Finance, CBA, and SOFAZ would help ground government's borrowing and investment decisions in an integrated asset-liability management framework that assesses the risk-return trade-offs as well as broader macro-financial implications. The authorities concurred but felt that a manat bond market could become concentrated among a few domestic investors and crowd out lending to private sector.

Currency Composition of Public Debt and Guarantees
(In percent of GDP)



Source: National authorities and IMF staff calculations.

32. Financial data and analysis should be strengthened. While financial institutions are in principle required to publish accurate data, capital and NPL figures in several banks are widely viewed as questionable. This uncertainty discourages banks from participating in interbank transactions. Building on recent TA, FIMSA should verify and start publishing financial soundness indicators, more detailed banking system data, and a financial stability report.

D. Fostering Sustainable, Diversified, and Inclusive Growth

33. Despite recent reforms, structural impediments to private sector growth and job creation persist, including: (i) weak governance and institutions; (ii) limited SME access to credit; (iii) inefficient labor markets; (iv) export concentration; (v) limited product and trade market competition; and (vi) sizeable skill gaps. Azerbaijan scores below emerging market peers on World Bank governance indicators, and the EBRD reports high exclusion gaps in SME finance and labor markets. The size of the state remains large, with state support to struggling SOEs crowding out more growth-enhancing investment. The result is high informality, limited FDI, weak entrepreneurship and SME development, and low productivity.

34. **There was a shared view that promoting inclusive growth is critical for Azerbaijan's economic advancement and resilience** (Annex V). The authorities are continuing discussions with the UN on achieving Sustainable Development Goals. They expected that recent spending packages, tax exemptions, and the consumer loan restructuring program will increase the purchasing power of the population. Staff cautioned that broad-based increases in wages that are disconnected from productivity growth are also likely to raise the cost of doing business, disincentivize private sector employment, and weaken competitiveness. In this context, staff emphasized the increased importance of lowering entry barriers, including by applying the Anti-Monopoly Law, to improve market efficiency. The authorities are continuing discussions with the WTO on accession, and staff encouraged completing the WTO membership process, to inject a needed dose of competition into domestic markets and foster diversification. Applying the OECD's Investment Guidelines would also attract nonoil FDI and know-how. Regarding financial inclusion, staff emphasized the need for expanding financial literacy and promoting competition in the banking sector, to stimulate SMEs and reduce the reliance on tax incentives. Staff noted that continued skill mismatches highlight the importance of prioritizing and improving the efficiency of public spending on education.

Azerbaijan: Inclusive Growth Indicators

	Benchmark	Year	Indicator	EMDE Average
Growth				
GDP per capita growth (percent; 2015-17 average)	B		-2.0	1.4
Gross Fixed Capital Formation (percent of GDP; 2015-17 average)	G		24.7	24.1
Poverty and Inequality				
Poverty headcount ratio at $3.20/day (percent of population; 2005)	G	2005	0.0	32.9
Multidimensional poverty (percent of population)	G		2.4	31.2
Prevalence of stunting (% of children under 5, 2013)	G	2013	18.0	22.7
GINI Index (2005)	G	2005	16.6	39.6
Child mortality (per 1,000, 2016)	G	2016	30.9	36.6
Growth in mean consumption (growth, %, bottom 40th percentile)			n.a.	2.4
Human Development and Access to Services				
Human Development Index (2017)	G	2017	0.8	0.6
Life expectancy at birth (years, 2016)	G	2016	72.0	69.5
Access to electricity (% of population, 2016)	G	2016	100.0	78.4
Net school enrollment, secondary, total (% population,)			n.a.	63.1
Individuals using internet (% population, 2016)	G	2016	78.2	40.8
Literacy rate (% population, 2016)	G	2016	99.8	79.1
Government				
Commitment to reducing inequality index (2017)	B	2017	0.34	0.35
Government spending on social safety net programs (percent of GDP, 2018)	B	2018	0.8	1.6
Coverage of social safety net programs in poorest quintile (% population, 2008)		2008	n.a.	42.3
Government expenditure on education, total (% GDP, 2015)	B	2015	3.0	4.6
Health expenditure, domestic general government (% of GDP, 2015)	B	2015	1.4	2.9
Access to Finance				
Account at a financial institution (% age 15+, 2017)	B	2017	28.6	43.0
Domestic credit to private sector (% GDP, 2017)	B	2017	16.3	39.8
Loans to SMEs (% of GDP,)			n.a.	7.8

	Indicator	EMDE Average
Labor Markets (ILO estimates)		
Unemployment rate (% of total labor force, 2017)	5.0	7.5
Female unemployment rate (% of female labor force, 2017)	5.4	9.6
Youth unemployment rate (% of total labor force ages 15-24, 2017)	13.8	16.5
Labor force participation (% of total population ages 15+, 2017)	66.1	63.0
Female labor force participation (% of female population ages 15+, 2017)	62.9	51.0
Youth labor force participation (% of population ages 15-24, 2017)	39.0	43.5
Business Environment[1]		
Ease of Doing Business (DTF, 2018)	70.2	56.2
Registering property (DTF, 2018)	82.1	57.4
Enforcing Contracts (DTF, 2018)	67.5	52.4
Paying Taxes (DTF, 2018)	84.2	63.8
Getting electricity (DTF, 2018)	68.0	60.0
Trading across borders (DTF, 2018)	84.2	62.8
Global Competitiveness Index (2018)	4.7	3.9
Governance[1]		
Global Competitiveness Index - Institutions Index (2017)	4.6	3.6
Government Effectiveness (WGI, 2016)	-0.2	-0.5
Regulatory Quality (WGI, 2016)	-0.3	-0.4
Rule of Law (WGI, 2016)	-0.5	-0.4
Control of Corruption (WGI, 2016)	-0.8	-0.3
Corruption Perceptions Index (2017)	31.0	36.2
Gender Equity and Inclusion		
Account at a financial institution (female vs male, %, 2014)	79.4	79.6
Female employment to population ratio (%, 2017)	59.5	46.8
Literacy rate (female vs male, %, 2016)	99.9	86.1
Net school enrollment, secondary (female vs male, %,)	n.a.	97.3
Gender Gap Index (2017)	0.7	0.7
Female seats in Parliament (share of total seats, 2018)	19.0	19.5

Better than EMDE Average **Worse than EMDE Average**

Sources: IMF World Economic Outlook, World Bank, World Economic Forum, International Labour Organization, Transparency International, UNDP, Oxfam International.
1 / Indicators use official sources and surveys to summarize perceptions of the quality of governance and business environments.

35. **Addressing governance, anti-corruption and AML/CFT vulnerabilities would also support the creation of a private sector-led, inclusive growth model.** In addition to fiscal transparency and procurement, ensuring accountability on oil and non-oil revenue outcomes and banking sector supervision (discussed above and in Annex IV) requires bolstering the anti-

corruption framework.[10] The July 2018 IACP monitoring report recognized progress in raising awareness about corruption, and in the functioning of the government's *Commission on Combating Corruption*. However, limited transparency and engagement hinder assessment and formulation of recommendations. Staff urged stepped-up reforms in line with the UNCAC and the recommendations that the country received to strengthen its anti-corruption strategy and policies, the rule of law, and the enforcement of the asset declarations regime for public officials. Further strengthening the AML/CFT framework, particularly preventive measures, beneficial ownership, risk-based supervision, and enhancing prosecution and conviction, would assist anti-corruption efforts. Continued engagement between the authorities and key stakeholders would facilitate strengthening the anti-corruption and AML/CFT frameworks in the coming years.[11]

STAFF APPRAISAL

36. The policy priority for Azerbaijan at the current juncture is fostering private sector-led and diversified growth while improving resilience to future shocks. The authorities' policy response to the recent banking crisis and economic downturn has helped stabilize the economy. The economy has started to recover but remains undiversified and vulnerable to external shocks. The exhaustibility of hydrocarbon resources and the need to create jobs for a young population require creating new sources of growth. Key steps needed in this direction include reducing the economic footprint of the state, promoting competition, and improving governance and transparency. Close integration of policies and coordination among policymakers are essential to maintain macro-financial stability while improving the economy's ability to adjust to shocks.

37. Continuing fiscal consolidation is important to save an adequate portion of the exhaustible oil wealth for future generations. Most importantly, consolidation should be growth-friendly, achieved by mobilizing higher non-oil revenues, improving the efficiency of public spending, prioritizing investments in human capital, restructuring of SOEs and better targeting transfers and subsidies. While reducing the non-oil primary deficit by 1 percentage point of non-oil GDP would help build precautionary buffers and maintain debt sustainability, further adjustment would be needed to improve intergenerational equity. The external position, which is moderately weaker than implied by fundamentals and desirable policies, would also strengthen as a result.

38. The introduction of a fiscal rule in 2019 was a major step forward. Yet the 2019 spending packages will challenge the authorities' ability to comply with the fiscal rule. As the authorities consider refining the fiscal rule based on the first-year experience, they must ensure that it fosters fiscal discipline and is robust, sustainable, and credible. Demonstrating a commitment to the fiscal rule by establishing a solid track record will improve credibility. It is also

[10] Azerbaijan participates in the *OECD Istanbul Anti-Corruption Action Plan (IACP)*, *GRECO (Group of States against Corruption)* and *OGP (Open Government Partnership*). Implementing recommendations of these bodies can contribute to compliance with the *UN's Convention Against Corruption (UNCAC)*. Azerbaijan is in "inactive" status in the OGP given concerns over engagement with stakeholders (NGOs, CSOs).

[11] In the context of implementing the Fund's Enhanced Framework on Governance, staff did not get the opportunity to discuss issues pertaining to the anti-corruption framework during this consultation. Well after the mission, staff received the authorities' answers to staff's questionnaire on governance and will follow up in the course of future surveillance activities.

important to complement the fiscal rule with stronger public financial management practices and procedures, as well as greater fiscal transparency and better management of fiscal risks.

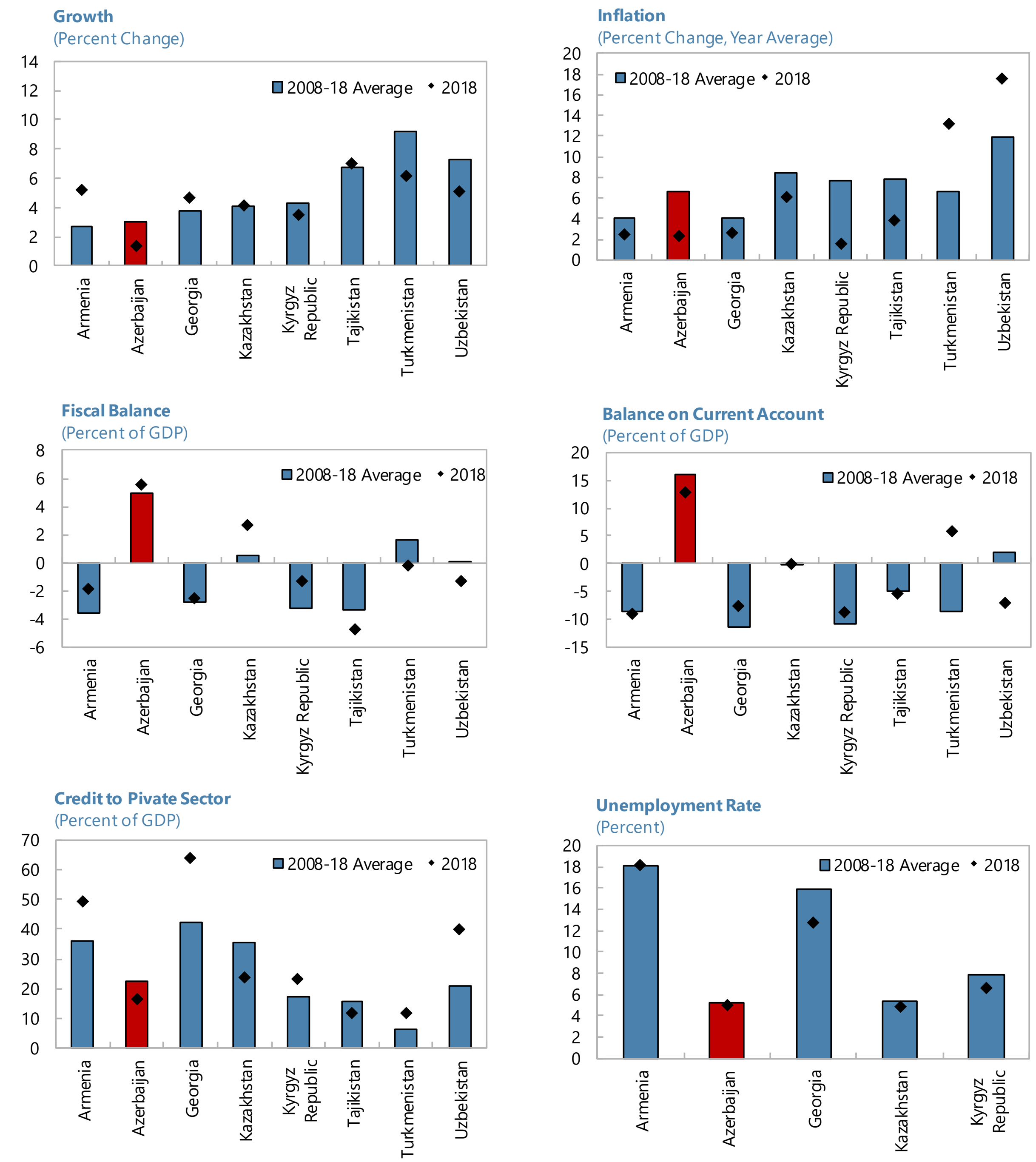
39. A further monetary easing appears appropriate, given still tight financial conditions and remaining spare capacity. Transitioning to inflation targeting and greater ER flexibility would help to absorb shocks and promote better risk management. Together with steps to modernize monetary operations and increase issuance of local currency securities, it would foster financial market development, facilitate liquidity management, and provide a benchmark for corporate bonds and a risk-free investment for the private sector. Financial repression, including through interest rate caps, should be resisted.

40. Strengthening financial supervision and increasing competition would enable the financial sector to support economic growth. While the NPL resolution program is likely to improve bank balance sheets, the sector remains fragile and uncompetitive. The NPL resolution program risks worsening the moral hazard and repayment culture, without improving banking sector supervision, governance, or transparency standards. Banks are still not required to disclose their ultimate beneficiaries and enjoy regulatory forbearance, which increases vulnerabilities to corruption. An independent asset quality review would be a critical starting point for assessing the true health of the system. Together with further upgrading and strengthening of financial sector supervision, this would improve confidence and prevent a build-up of future vulnerabilities.

41. Transitioning to a new diversified, private sector-led growth model requires removal of structural impediments. Opening to international trade and investment, reducing the size of the public sector, and improving financial inclusion and governance are essential for a competitive and efficient private sector to develop. Recently announced institutional and regulatory reforms are positive steps that should be followed by effective implementation, monitoring, and assessment to ensure that the underlying policy goals are realized. Better data and transparency would improve decision-making and promote private sector growth and reduce vulnerabilities to corruption.

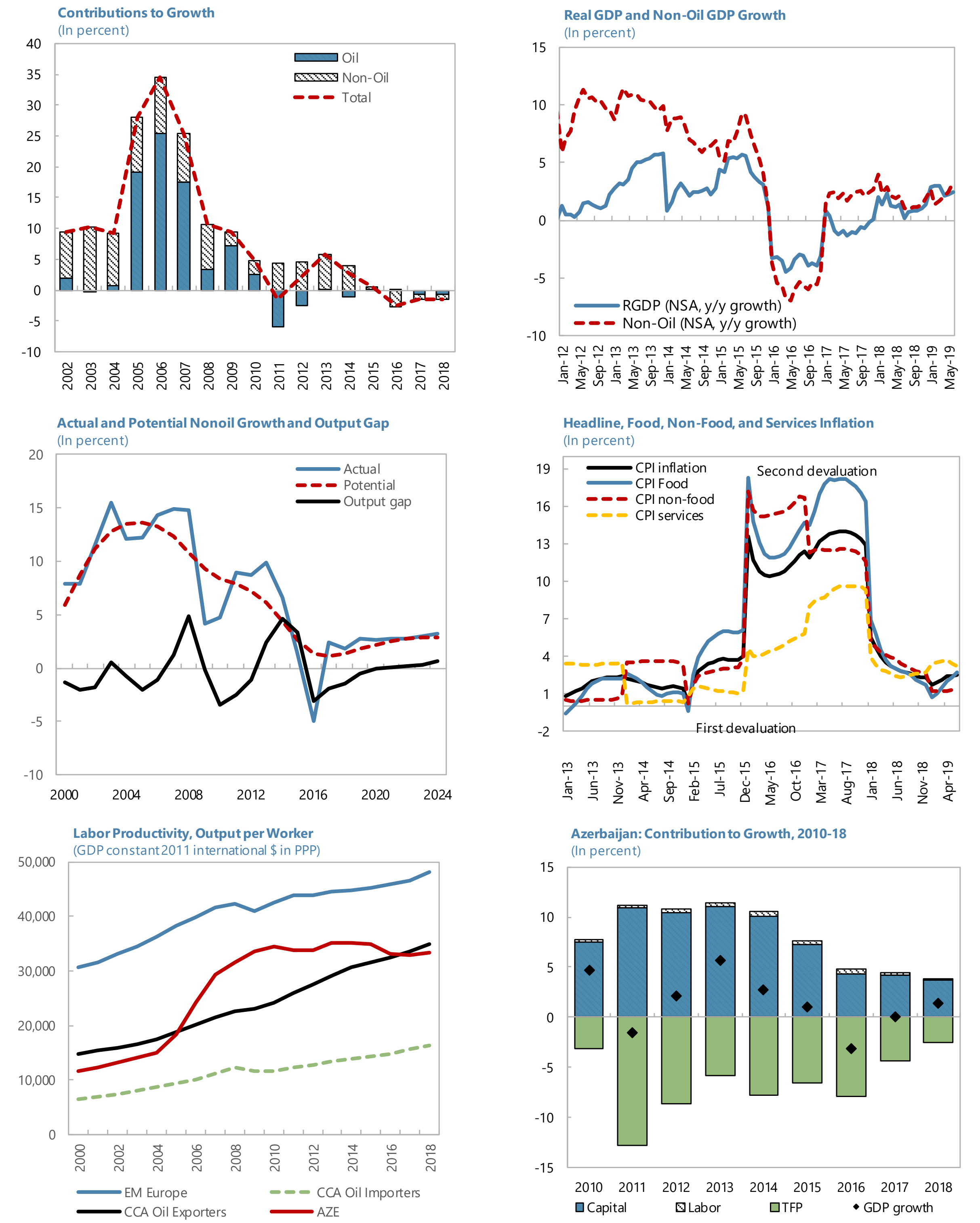
42. It is recommended that the next Article IV consultation takes place on the standard 12-month cycle.

Figure 1. Azerbaijan: Caucasus and Central Asia Macroeconomic Outcomes



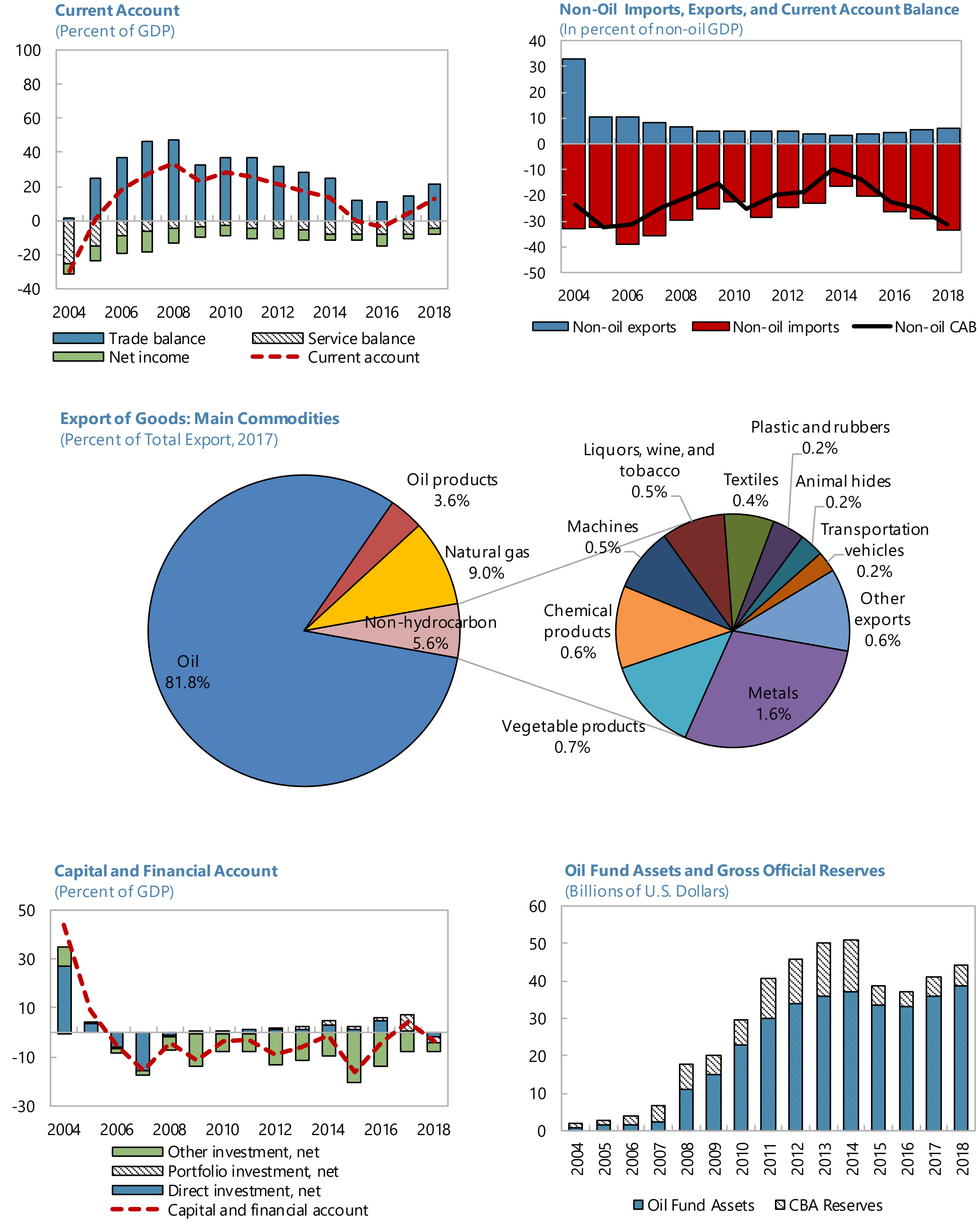
Sources: World Economic Outlook, and IMF staff calculations.

Figure 2. Azerbaijan: Real Sector Indicators



Sources: National authorities, Haver, and IMF staff calculations.

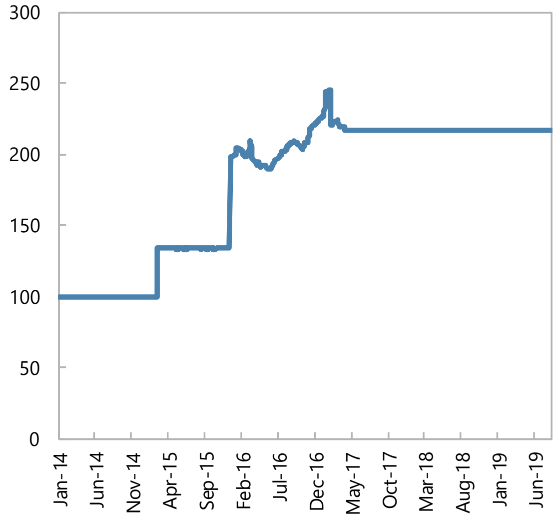
Figure 3. Azerbaijan: External Sector



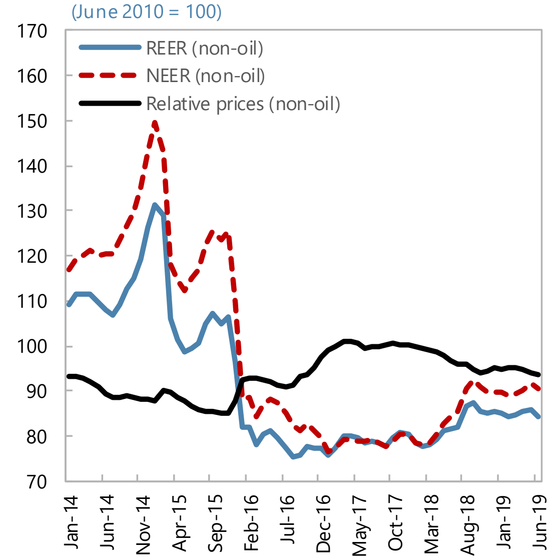
Sources: WITS, Haver, and IMF staff calculations.

Figure 4. Azerbaijan: Exchange Rate

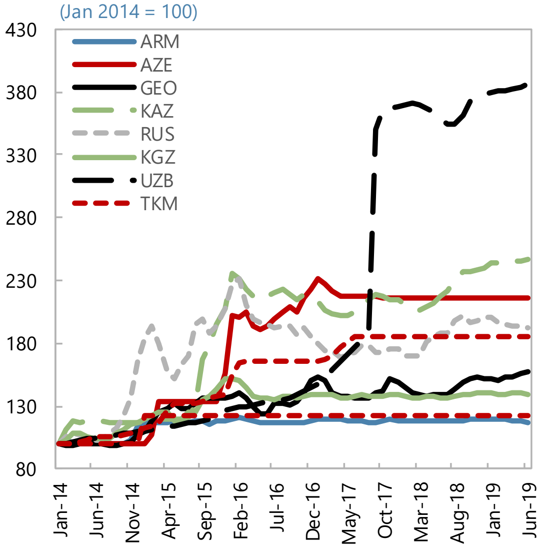
Azerbaijan: Exchange Rate
(AzN per USD)



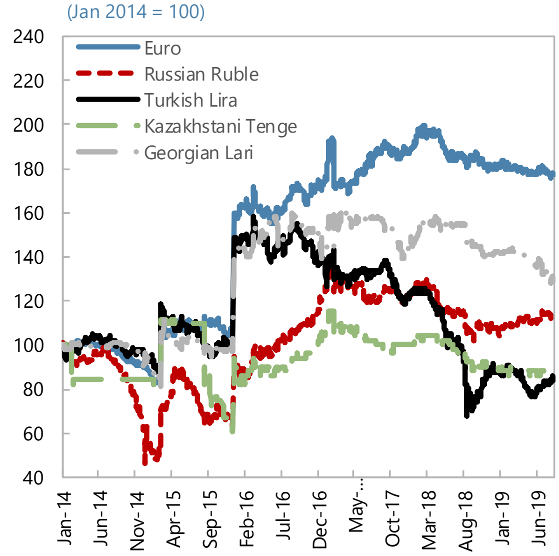
Azerbaijan: Non-oil sector's REER, NEER, Relative Prices
(June 2010 = 100)



CCA Domestic Currency per USD
(Jan 2014 = 100)

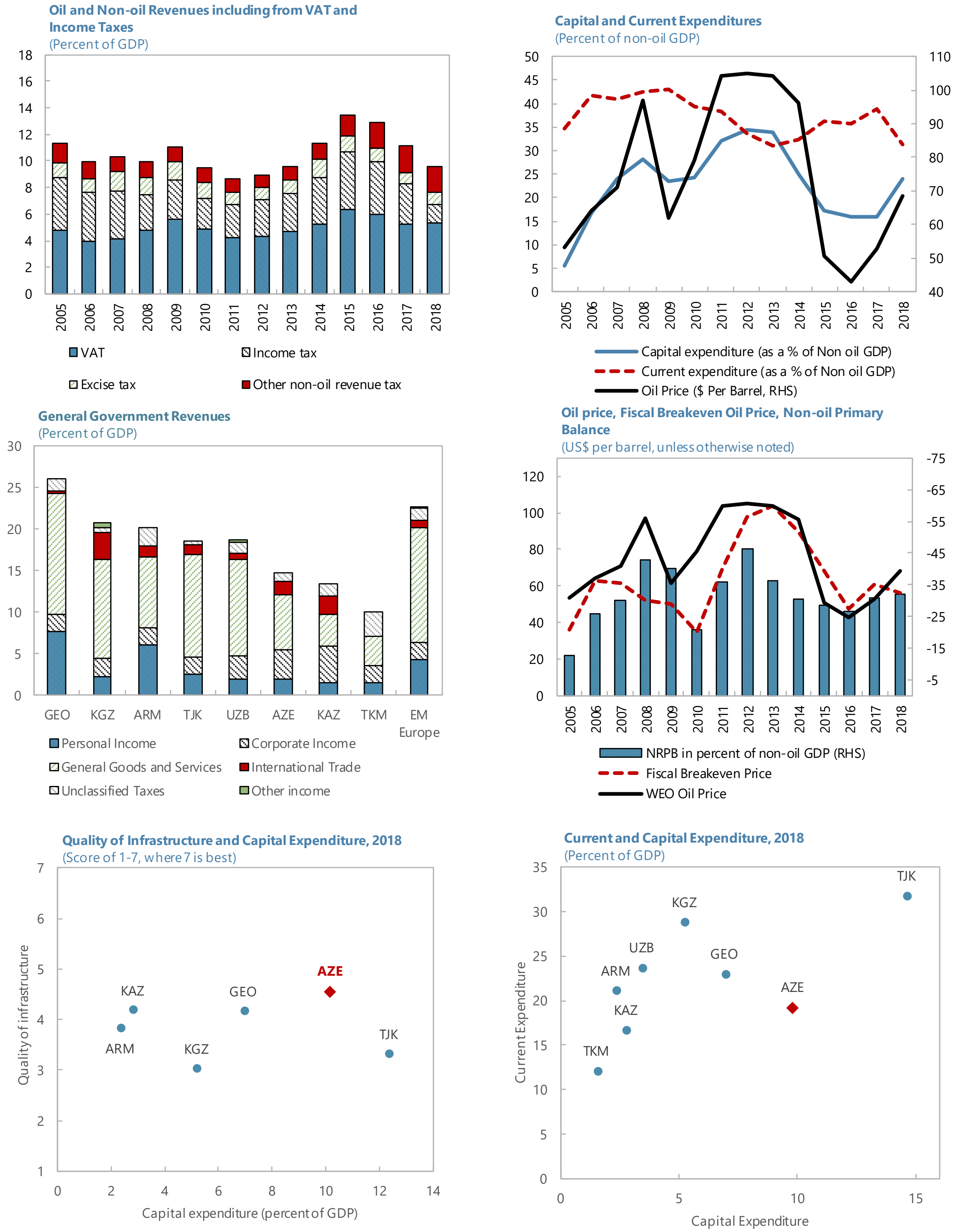


Azerbaijan: Manat cross exchange rates
(Jan 2014 = 100)



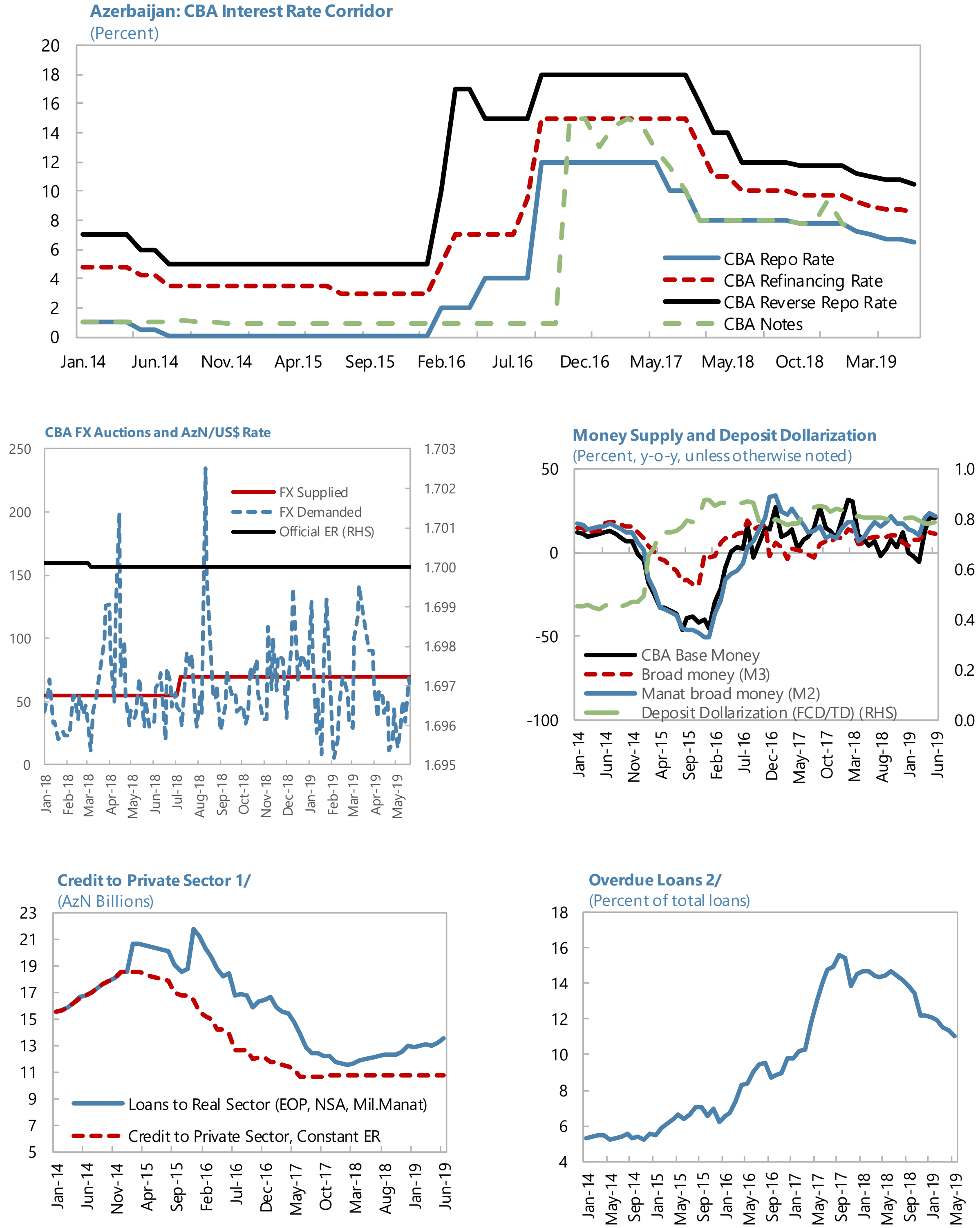
Sources: National authorities, Haver, and IMF staff calculations.

Figure 5. Azerbaijan: Fiscal Sector



Sources: National authorities, Haver, IMF World Economic Outlook, IMF Public Investment Management Assessment, World Economic Forum, Global Competitiveness Index, and IMF staff calculations.

Figure 6. Azerbaijan: Monetary Sector

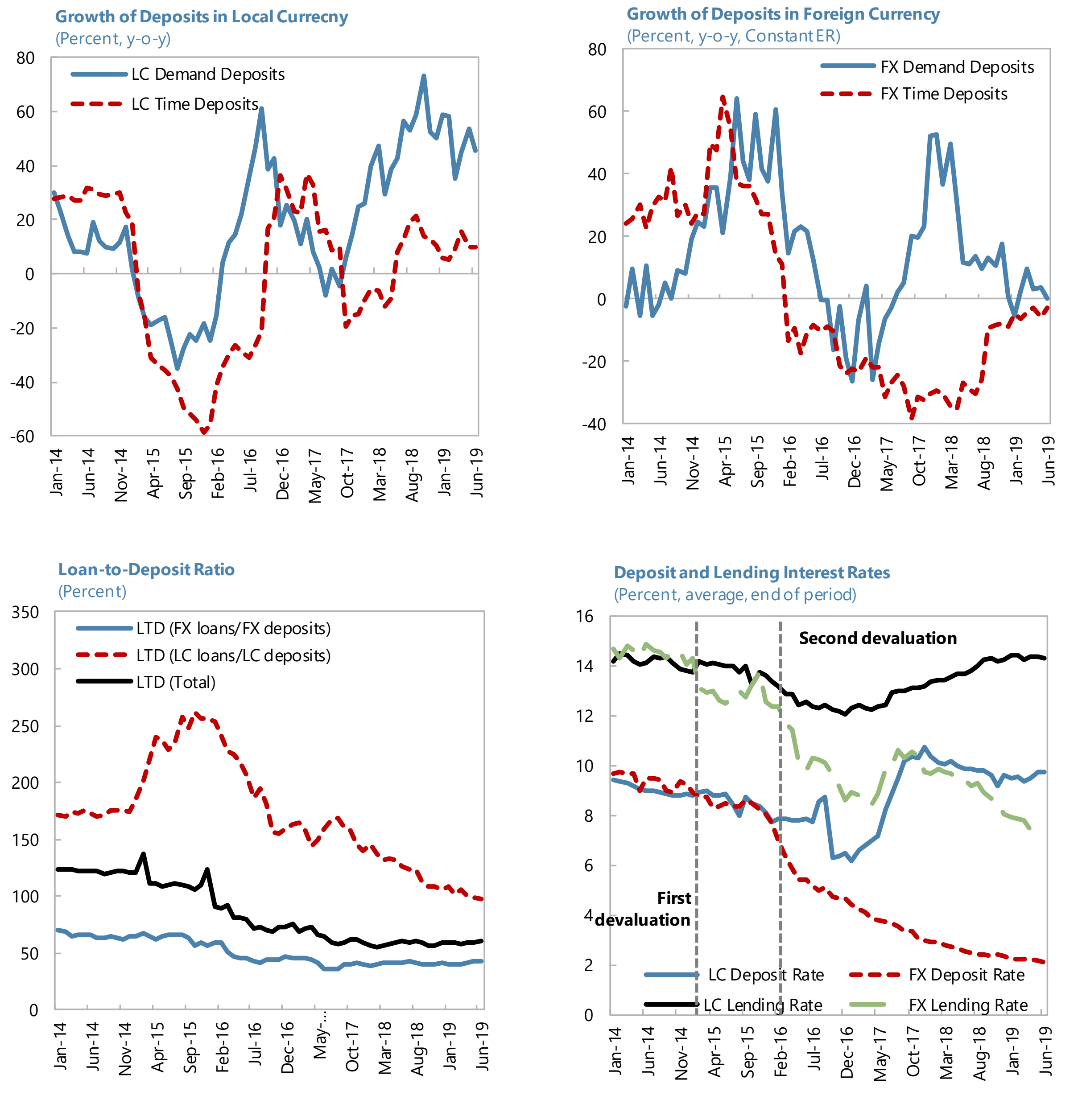


Sources: National authorities, Haver, and IMF staff estimates.

1/ Reduction of credits in September and October 2015 due to one bank restructuring.

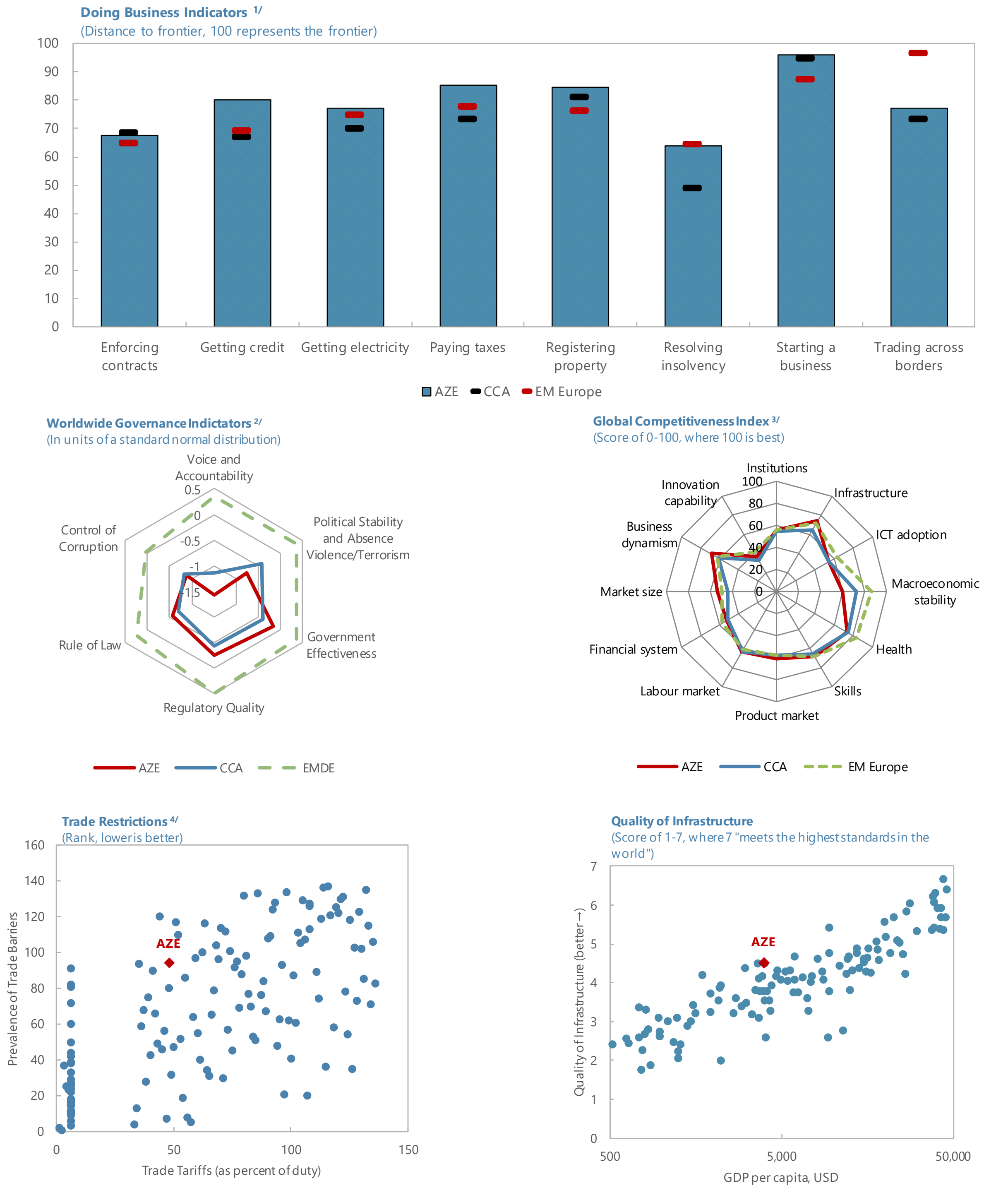
2/ According to the 2015 FSAP report, for statistical purposes only overdue payments are classified as non-performing loans (NPLs). The reported time series of NPLs does not fully reflect actual NPLs.

Figure 7. Azerbaijan: Deposits and Interest Rates



Sources: Haver, and IMF staff calculations.

Figure 8. Azerbaijan: Business Environment and Governance



Sources: World Bank Ease of Doing Business, Worldwide Governance Indicators, WEF Global Competitiveness Indicators, World Bank Enterprise Surveys, and IMF staff calculations.

1/ Survey-based indicators reflect investors' perceptions on the business environment.

2/ Survey-based indicators summarizes perceptions of quality of governance, higher score indicates better governance. Estimates of governance range from approximately -2.5 (weak) to 2.5 (strong).

3/ Uses both official data and survey responses from executives on areas of competitiveness, higher is better.

4/ Indices on the prevalence of trade barriers ranking and subcomponents are based on WEF's quantitative and qualitative assessment of the trade environment. These indicators should be interpreted with caution due to a limited number of respondents, a limited geographical coverage, and standardized assumptions on business constraints, and information availability.

Figure 9. Azerbaijan: Public Sector Debt Sustainability Analysis (DSA) – Baseline Scenario

(In percent of GDP unless otherwise indicated)

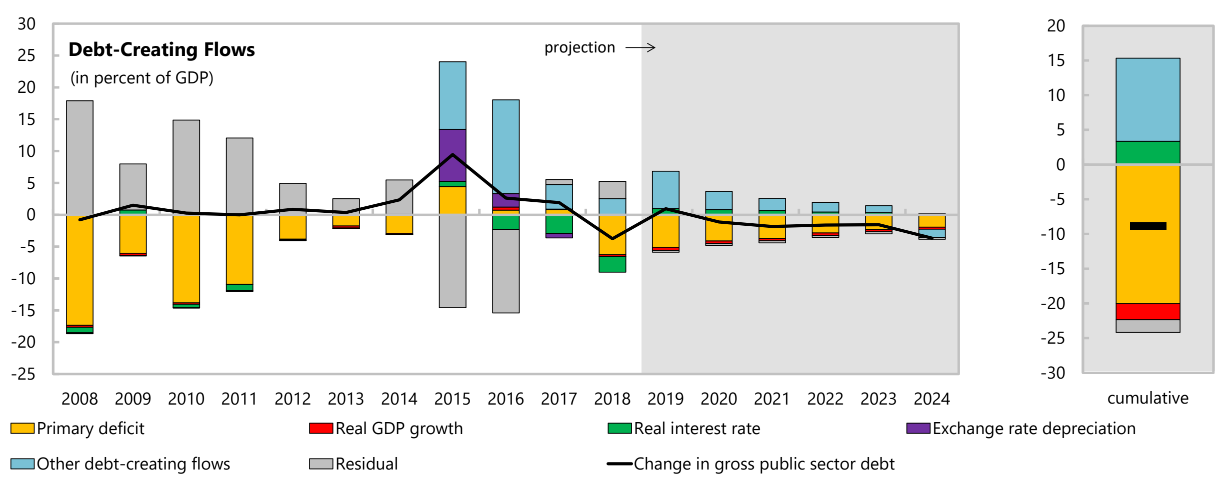
Debt, Economic and Market Indicators [1]

	Actual			Projections					
	2008-2016 [2]	2017	2018	2019	2020	2021	2022	2023	2024
Nominal gross public debt	8.6	22.5	18.8	19.7	18.6	16.7	15.1	13.6	9.9
Public gross financing needs	-4.5	3.7	-1.7	-2.3	-0.1	3.1	4.5	5.6	8.4
Net public debt	-45.2	-64.0	-63.3	-67.2	-69.4	-70.2	-68.9	-66.7	-66.3
Real GDP growth (in percent)	3.6	-0.3	1.4	2.7	2.1	2.1	2.2	2.3	2.5
Inflation (GDP deflator, in percent)	6.1	16.7	12.2	-1.5	0.2	1.2	1.9	2.5	2.7
Nominal GDP growth (in percent)	9.8	16.4	13.4	0.5	2.2	3.4	4.3	5.1	5.4
Effective interest rate (in percent) [4]	2.8	3.0	3.4	3.8	4.3	4.9	4.7	4.7	4.1

As of April 05, 2019		
Sovereign Spreads		
EMBIG (bp) 3/		362
5Y CDS (bp)		229
Ratings	Foreign	Local
Moody's	Ba2	Ba2
S&Ps	BB+	BB+
Fitch	BB+	BB+

Contribution to Changes in Public Debt

	Actual			Projections							
	2008-2016	2017	2018	2019	2020	2021	2022	2023	2024	cumulative	debt-stabilizing primary balance [9]
Change in gross public sector debt	1.8	1.9	-3.8	1.0	-1.1	-1.8	-1.6	-1.6	-3.7	-8.9	
Identified debt-creating flows	-2.3	1.1	-6.5	1.2	-0.8	-1.5	-1.3	-1.3	-3.4	-7.0	
Primary deficit	-5.7	0.8	-6.3	-5.1	-4.1	-3.7	-2.9	-2.3	-1.9	-20.1	-1.4
Primary (noninterest) revenue and grants	40.7	34.2	38.8	39.1	37.8	37.2	36.0	34.9	33.9	218.8	
Primary (noninterest) expenditure	35.0	35.1	32.5	34.0	33.7	33.5	33.1	32.5	31.9	198.8	
Automatic debt dynamics [5]	0.7	-3.6	-2.7	0.5	0.4	0.3	0.1	0.0	-0.1	1.1	
Interest rate/growth differential [6]	-0.5	-2.9	-2.7	0.5	0.4	0.3	0.1	0.0	-0.1	1.1	
Of which: real interest rate	-0.4	-3.0	-2.4	1.0	0.8	0.7	0.4	0.3	0.2	3.4	
Of which: real GDP growth	-0.1	0.0	-0.3	-0.5	-0.4	-0.4	-0.4	-0.3	-0.3	-2.3	
Exchange rate depreciation [7]	1.1	-0.7	0.0	…	…	…	…	…	…	…	
Other identified debt-creating flows	2.8	3.9	2.5	5.8	2.9	1.9	1.5	1.1	-1.3	12.0	
Privatization (negative)	-0.1	-0.2	-0.1	-0.1	-0.2	-0.2	-0.2	-0.2	-0.2	-0.9	
Contingent liabilities	2.8	4.0	2.7	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Accumulation/Drawdown of Deposits	0.0	0.0	0.0	6.0	3.0	2.1	1.6	1.3	-1.1	12.9	
Residual, including asset changes [8]	4.1	0.8	2.7	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-1.8	



Source: IMF staff.

1/ Public sector is defined as general government.

2/ Based on available data.

3/ EMBIG.

4/ Defined as interest payments divided by debt stock (excluding guarantees) at the end of previous year.

5/ Derived as [(r - π(1+g) - g + ae(1+r)]/(1+g+π+gπ)) times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

6/ The real interest rate contribution is derived from the numerator in footnote 5 as r - π (1+g) and the real growth contribution as -g.

7/ The exchange rate contribution is derived from the numerator in footnote 5 as ae(1+r).

8/ Includes asset changes and interest revenues (if any). For projections, includes exchange rate changes during the projection period.

9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

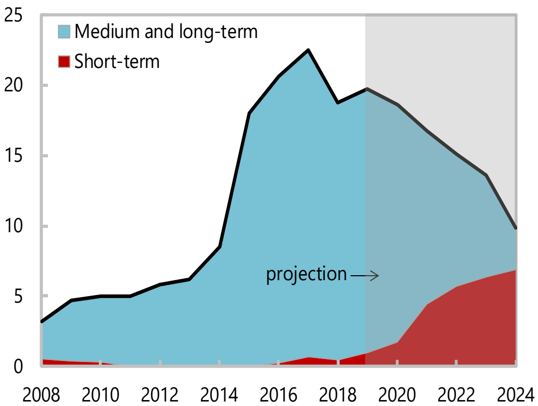
Figure 10. Azerbaijan: Public DSA - Composition of Public Debt and Alternative Scenarios

(In percent of GDP unless otherwise indicated)

Composition of Public Debt

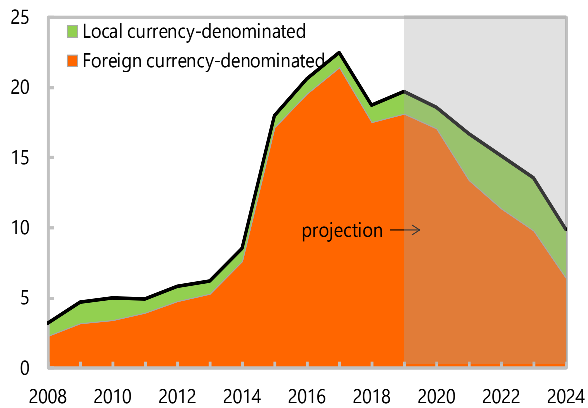
By Maturity

(in percent of GDP)



By Currency

(in percent of GDP)

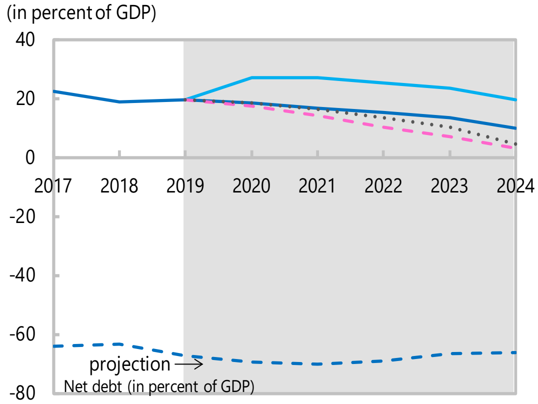


Alternative Scenarios

Baseline
Contingent Liability Shock
Historical
Constant Primary Balance

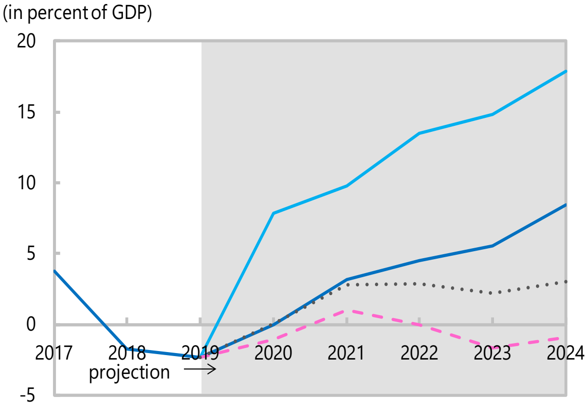
Gross Nominal Public Debt

(in percent of GDP)



Public Gross Financing Needs

(in percent of GDP)



Underlying Assumptions

(in percent)

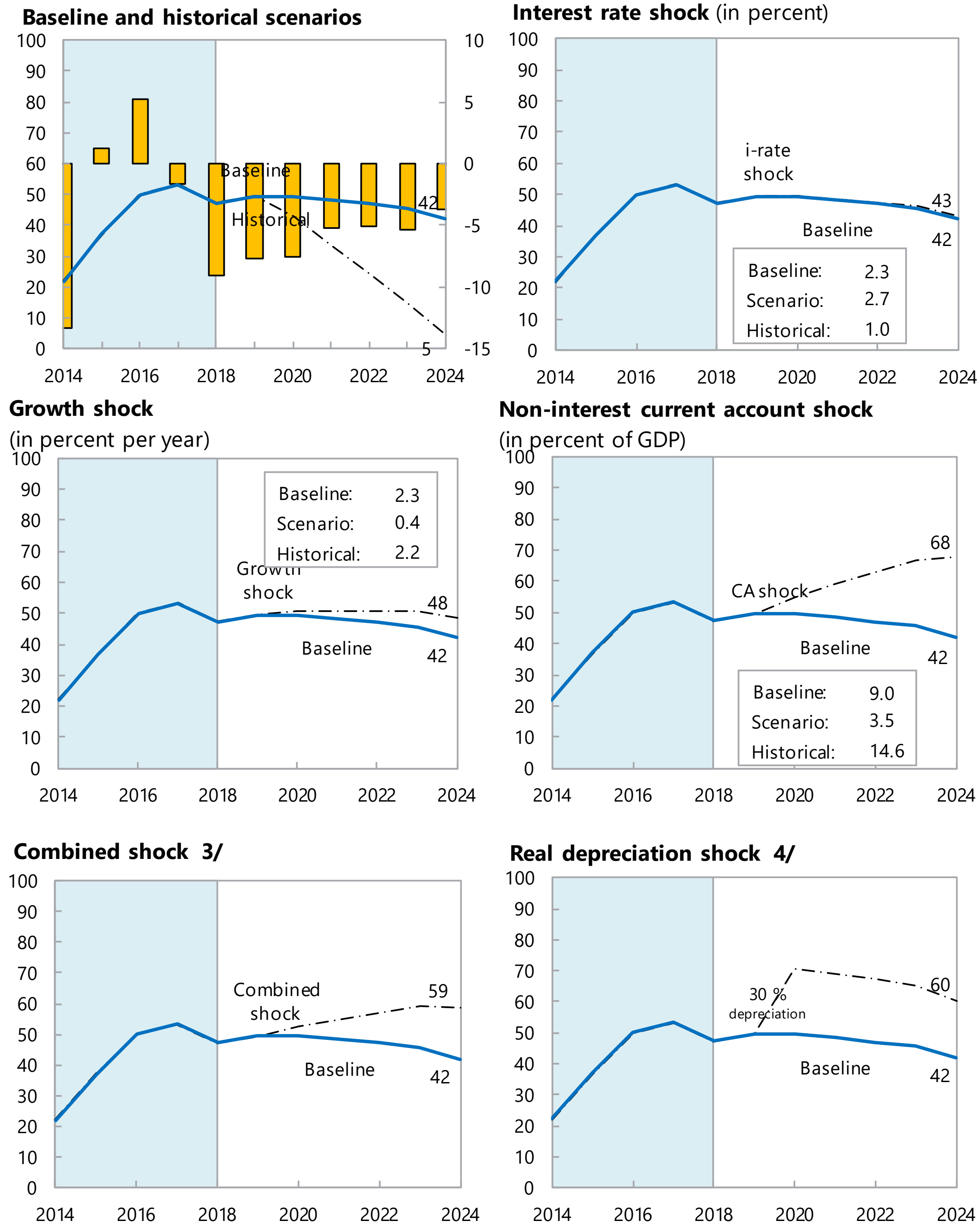
Baseline Scenario	2019	2020	2021	2022	2023	2024
Real GDP growth	2.7	2.1	2.1	2.2	2.3	2.5
Inflation	-1.5	0.2	1.2	1.9	2.5	2.7
Primary Balance	5.1	4.1	3.7	2.9	2.3	1.9
Effective interest rate	3.8	4.3	4.9	4.7	4.7	4.1
Constant Primary Balance Scenario						
Real GDP growth	2.7	2.1	2.1	2.2	2.3	2.5
Inflation	-1.5	0.2	1.2	1.9	2.5	2.7
Primary Balance	5.1	5.1	5.1	5.1	5.1	5.1
Effective interest rate	3.8	4.3	5.0	5.3	6.2	6.8

Historical Scenario	2019	2020	2021	2022	2023	2024
Real GDP growth	2.7	2.2	2.2	2.2	2.2	2.2
Inflation	-1.5	0.2	1.2	1.9	2.5	2.7
Primary Balance	5.1	4.0	4.0	4.0	4.0	4.0
Effective interest rate	3.8	4.3	4.2	3.4	3.7	3.7
Contingent Liability Shock						
Real GDP growth	2.7	-1.6	-1.5	2.2	2.3	2.5
Inflation	-1.5	-0.7	0.2	1.9	2.5	2.7
Primary Balance	5.1	-3.0	3.7	2.9	2.3	1.9
Effective interest rate	3.8	7.6	4.8	4.1	3.5	3.0

Source: IMF staff.

Figure 11. Azerbaijan: External Debt Sustainability: Bound Tests 1/ 2/

(External debt in percent of GDP)



Sources: International Monetary Fund, Country desk data, and staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ For historical scenarios, the historical averages are calculated over the ten-year period, and the information is used to project debt dynamics five years ahead.
3/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.
4/ One-time real depreciation of 30 percent occurs in 2010.

Table 1. Azerbaijan: Selected Economic and Financial Indicators, 2017–24

			Projections					
	2017	2018	2019	2020	2021	2022	2023	2024
	(Annual percentage change, unless otherwise specified)							
National income								
GDP at constant prices	-0.3	1.4	2.7	2.1	2.1	2.2	2.3	2.5
Of which: Oil sector 1/	-4.4	0.6	2.5	1.2	1.2	1.2	1.2	1.2
Non-oil sector	2.4	1.8	2.8	2.7	2.7	2.8	3.0	3.2
Consumer price index (period average)	12.8	2.3	3.2	3.3	3.4	3.5	3.5	3.5
Money and credit								
Domestic credit, net	-13.9	2.5	6.3	3.6	3.9	4.3	5.2	5.4
Of which : Credit to private sector	-28.1	14.9	11.1	8.2	7.9	8.0	8.4	8.7
Manat base money	8.7	11.7	7.0	7.1	7.2	7.3	7.4	7.5
Manat broad money	8.0	13.3	9.1	7.9	8.0	8.2	8.4	8.6
Total broad money	9.0	11.3	7.2	6.0	6.2	6.4	6.6	6.8
External sector								
Exports f.o.b.	14.7	37.2	-17.1	-0.2	-1.3	-0.1	1.1	1.8
Of which: Oil sector	13.5	40.2	-18.7	-0.7	-2.1	-0.8	0.6	1.3
Imports f.o.b.	0.4	21.2	-18.2	-3.4	-4.2	-3.1	-2.0	-1.4
Of which: Oil sector	-42.3	30.0	1.6	1.8	2.6	2.5	2.6	2.5
Real effective exchange rate	3.3	5.6	--	--	--	--	--	--
	(In percent of GDP, unless otherwise specified)							
Gross investment	24.4	20.1	21.3	20.0	20.4	20.5	20.8	21.2
Consolidated government	10.3	14.1	11.9	8.6	8.8	8.4	8.3	8.3
Private sector	14.1	6.0	9.5	11.4	11.6	12.1	12.4	12.9
Of which: Oil sector	-6.2	-1.8	7.0	6.6	6.7	6.5	6.2	6.0
Gross national savings	28.5	33.0	31.1	30.1	28.2	27.4	28.0	28.8
Consolidated general government finances 2/								
Total revenue and grants 3/	34.2	38.8	39.1	37.8	37.2	36.0	34.9	33.9
Total expenditure 4/	35.6	33.1	34.7	34.4	34.2	33.8	33.1	32.4
Current expenditure 4/	25.3	19.1	22.9	25.8	25.5	25.4	24.8	24.1
Net acquisition of non-financial assets	10.3	14.1	11.9	8.6	8.8	8.4	8.3	8.3
Overall fiscal balance 4/	-1.4	5.6	4.4	3.4	3.0	2.2	1.7	1.5
Non-oil primary balance, in percent of non-oil GDP	-30.9	-32.1	-31.1	-30.0	-29.1	-28.1	-27.1	-26.1
General government gross debt (direct borrowing)	22.5	18.8	19.7	18.6	16.7	15.1	13.6	9.9
General government gross debt including guarantees	53.2	48.4	51.5	47.8	43.9	39.5	35.1	28.9
External sector								
Current account (- deficit)	4.1	12.9	9.7	10.0	7.7	6.9	7.2	7.7
Foreign direct investment (net)	0.7	-1.7	5.0	4.7	4.8	4.6	4.5	4.3
Memorandum items:								
Gross official international reserves (in millions of U.S. dollars)	5,335	5,626	5,926	6,226	6,526	6,826	7,126	7,426
in months of next year's non-oil imports f.o.b.	5.1	4.7	5.9	6.3	6.8	7.4	7.8	8.3
Nominal GDP (in millions of manat)	70,338	79,797	80,215	81,981	84,786	88,474	92,949	97,988
Nominal non-oil GDP (in millions of manat)	45,017	46,881	49,712	52,713	55,977	59,559	63,493	67,818
Nominal GDP (in millions of U.S. dollars)	41,375	46,940	47,185	48,224	49,874	52,043	54,676	57,640
Oil Fund Assets (in millions of U.S. dollars)	35,807	38,515	40,986	42,421	43,361	43,746	43,883	43,942
Assumed oil price, WEO plus $2 premium (in U.S. dollars per barrel)	54.8	70.3	63.5	59.9	58.0	57.2	57.2	57.6
Exchange rate (manat/dollar, end of period)	1.7	1.7	1.7	1.7	1.7	1.7	1.7	1.7

Sources: Azerbaijani authorities; and IMF staff estimates and projections.

1/ Includes the production and processing of oil and gas.

2/ Consolidates State Budget, State Oil Fund of Azerbaijan (SOFAZ), Nakhchevan Autonomous Region (NAK) and State Social Protection Fund.

3/ Includes a transfer of CBA profits (AzN 650 million) in 2019.

4/ Includes the impact of an extraordinary SOFAZ transfer ($1.4 billion) to the CBA in 2017. Includes expenditures for the NPL program in 2019 (AzN 650 million).

Table 2a. Azerbaijan: Balance of Payments, 2017–24
(In millions of U.S. dollars, unless otherwise specified)

			Projections					
	2017	2018	2019	2020	2021	2022	2023	2024
Exports, f.o.b.	15,152	20,794	17,243	17,217	16,995	16,974	17,168	17,476
Oil and gas sector	13,679	19,176	15,589	15,481	15,163	15,043	15,134	15,335
Other	1,473	1,618	1,654	1,736	1,832	1,931	2,034	2,141
Imports, f.o.b.	-9,037	-10,952	-8,958	-8,655	-8,293	-8,033	-7,872	-7,760
Oil and gas sector	-1,343	-1,745	-1,772	-1,804	-1,852	-1,898	-1,947	-1,996
Others	-7,695	-9,207	-7,185	-6,850	-6,441	-6,134	-5,925	-5,763
Trade balance	6,115	9,841	8,285	8,562	8,702	8,941	9,296	9,717
Services, net	-3,379	-2,062	-2,032	-2,528	-3,652	-4,208	-4,179	-4,151
Oil and gas sector	-3,103	-1,712	-1,677	-2,164	-3,277	-3,820	-3,776	-3,731
Others	-277	-350	-355	-365	-375	-388	-403	-420
Factor income, net	-1,760	-2,460	-2,397	-1,948	-1,964	-1,917	-1,968	-1,959
Oil and gas	-1,847	-2,850	-2,556	-2,136	-2,169	-2,152	-2,165	-2,165
Others	87	390	159	187	206	236	197	206
Transfers, net	709	731	740	754	769	785	801	815
Current account balance	1,685	6,051	4,596	4,839	3,856	3,602	3,949	4,422
Non-oil current account balance	-5,703	-6,818	-4,988	-4,537	-4,009	-3,570	-3,296	-3,021
Capital account, net	100	1	1	1	1	1	1	1
Direct investment, net	302	-808	2,341	2,246	2,398	2,418	2,438	2,459
Oil and gas	210	-345	1,970	1,867	2,010	2,021	2,033	2,045
Others	92	-463	372	380	388	396	405	414
Portfolio investment, net	2,669	-1,241	537	644	691	688	609	636
Other investment, net	-3,177	-1,591	-5,205	-6,496	-6,207	-6,523	-7,060	-7,659
Oil and gas	1,414	261	316	423	533	555	437	563
Others	-4,591	-1,852	-5,521	-6,920	-6,739	-7,078	-7,497	-8,221
Oil bonus	1	450	500	500	500	500	500	500
Financial derviatives	4	-1	0	0	0	0	0	0
Financial account, net	-201	-3,191	-1,827	-3,106	-2,618	-2,918	-3,514	-4,065
Capital and financial account balance	-101	-3,189	-1,825	-3,104	-2,616	-2,916	-3,512	-4,063
Errors and omissions	388	646	0.0	0.0	0.0	0.0	0.0	0.0
Overall balance	1,971	3,508	2,771	1,735	1,240	685	437	359
Financing	-1,971	-3,508	-2,771	-1,735	-1,240	-685	-437	-359
Change in net foreign assets of CBA (increase -)	-1,360	-291	-300	-300	-300	-300	-300	-300
Change in Oil Fund assets (increase -)	-2,660	-2,709	-2,471	-1,435	-940	-385	-137	-59
Change in other government FX assets (increase -)	2,048	-508	0	0	0	0	0	0
Memorandum items:								
Current account balance (in percent of GDP)	4.1	12.9	9.7	10.0	7.7	6.9	7.2	7.7
Gross official international reserves	5,335	5,626	5,926	6,226	6,526	6,826	7,126	7,426
in months of next year's non-oil imports f.o.b.	5.1	4.7	5.9	6.3	6.8	7.4	7.8	8.3
Oil Fund assets	35,807	38,515	40,986	42,421	43,361	43,746	43,883	43,942
Public and publicly guaranteed external debt (in percent of GDP)	53.3	47.3	49.7	49.7	48.6	47.3	45.7	42.0
Oil price (US$ per barrel)	54.8	70.3	63.5	59.9	58.0	57.2	57.2	57.6
Nominal GDP (in millions of U.S. dollars)	41,375	46,940	47,185	48,224	49,874	52,043	54,676	57,640

Sources: Azerbaijani authorities; and IMF staff estimates and projections.

Table 2b. Azerbaijan: Balance of Payments, 2017–24

(In percent of GDP, unless otherwise specified)

		Projections						
	2017	2018	2019	2020	2021	2022	2023	2024
Exports, f.o.b.	36.6	44.3	36.5	35.7	34.1	32.6	31.4	30.3
Oil and gas sector	33.1	40.9	33.0	32.1	30.4	28.9	27.7	26.6
Other	3.6	3.4	3.5	3.6	3.7	3.7	3.7	3.7
Imports, f.o.b.	-21.8	-23.3	-19.0	-17.9	-16.6	-15.4	-14.4	-13.5
Oil and gas sector	-3.2	-3.7	-3.8	-3.7	-3.7	-3.6	-3.6	-3.5
Others	-18.6	-19.6	-15.2	-14.2	-12.9	-11.8	-10.8	-10.0
Trade balance	14.8	21.0	17.6	17.8	17.4	17.2	17.0	16.9
Services, net	-8.2	-4.4	-4.3	-5.2	-7.3	-8.1	-7.6	-7.2
Oil and gas sector	-7.5	-3.6	-3.6	-4.5	-6.6	-7.3	-6.9	-6.5
Others	-0.7	-0.7	-0.8	-0.8	-0.8	-0.7	-0.7	-0.7
Factor income, net	-4.3	-5.2	-5.1	-4.0	-3.9	-3.7	-3.6	-3.4
Oil and gas	-4.5	-6.1	-5.4	-4.4	-4.3	-4.1	-4.0	-3.8
Others	0.2	0.8	0.3	0.4	0.4	0.5	0.4	0.4
Transfers, net	1.7	1.6	1.6	1.6	1.5	1.5	1.5	1.4
Current account balance	4.1	12.9	9.7	10.0	7.7	6.9	7.2	7.7
Non-oil current account balance	-13.8	-14.5	-10.6	-9.4	-8.0	-6.9	-6.0	-5.2
Capital account, net	0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Direct investment, net	0.7	-1.7	5.0	4.7	4.8	4.6	4.5	4.3
Oil and gas	0.5	-0.7	4.2	3.9	4.0	3.9	3.7	3.5
Others	0.2	-1.0	0.8	0.8	0.8	0.8	0.7	0.7
Portfolio investment, net	6.5	-2.6	1.1	1.3	1.4	1.3	1.1	1.1
Other investment	-7.7	-3.4	-11.0	-13.5	-12.4	-12.5	-12.9	-13.3
Oil and gas	3.4	0.6	0.7	0.9	1.1	1.1	0.8	1.0
Others	-11.1	-3.9	-11.7	-14.3	-13.5	-13.6	-13.7	-14.3
Oil bonus	0.0	1.0	1.1	1.0	1.0	1.0	0.9	0.9
Financial derviatives	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financial account, net	-0.5	-6.8	-3.9	-6.4	-5.2	-5.6	-6.4	-7.1
Capital and financial account balance	-0.2	-6.8	-3.9	-6.4	-5.2	-5.6	-6.4	-7.0
Errors and omissions	0.9	1.4	0.0	0.0	0.0	0.0	0.0	0.0
Overall balance	4.8	7.5	5.9	3.6	2.5	1.3	0.8	0.6
Financing	-4.8	-7.5	-5.9	-3.6	-2.5	-1.3	-0.8	-0.6
Change in net foreign assets of CBA (increase -)	-3.3	-0.6	-0.6	-0.6	-0.6	-0.6	-0.5	-0.5
Change in Oil Fund assets (increase -)	-6.4	-5.8	-5.2	-3.0	-1.9	-0.7	-0.3	-0.1
Change in other government FX assets (increase -)	5.0	-1.1	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:								
Current account balance	4.1	12.9	9.7	10.0	7.7	6.9	7.2	7.7
Gross official international reserves	12.9	12.0	12.6	12.9	13.1	13.1	13.0	12.9
in months of next year's non-oil imports f.o.b.	5.1	4.7	5.9	6.3	6.8	7.4	7.8	8.3
Oil Fund assets	86.5	82.1	86.9	88.0	86.9	84.1	80.3	76.2
Public and publicly guaranteed external debt	53.3	47.3	49.7	49.7	48.6	47.3	45.7	42.0
Oil price (US$ per barrel)	54.8	70.3	63.5	59.9	58.0	57.2	57.2	57.6
Nominal GDP (in Millions of US$)	41,375	46,940	47,185	48,224	49,874	52,043	54,676	57,640

Sources: Azerbaijani authorities; and IMF staff estimates and projections.

Table 3a. Azerbaijan: Statement of Consolidated Government Operations, 2017–24

(In millions of manat)

			Projections					
	2017	2018	2019	2020	2021	2022	2023	2024
Revenue								
Total revenue	24,075	30,925	31,363	30,965	31,552	31,849	32,415	33,185
Tax revenue	9,994	11,255	12,680	12,721	12,761	12,944	13,265	13,675
Income taxes	3,326	3,496	4,571	4,541	4,518	4,554	4,645	4,765
Individual income tax	1,040	996	904	959	1,018	1,083	1,155	1,233
Enterprise profits tax	2,286	2,500	3,667	3,583	3,500	3,471	3,490	3,532
Value added tax (VAT)	3,669	4,288	4,255	4,260	4,251	4,288	4,369	4,482
Excise taxes	613	729	1,041	1,060	1,077	1,105	1,142	1,188
Taxes on international trade	1,022	1,283	1,270	1,256	1,236	1,231	1,239	1,257
Other taxes	700	721	692	733	779	829	883	944
Social security contributions	665	739	851	870	899	939	986	1,040
Nontax revenue	14,061	19,650	18,663	18,224	18,771	18,905	19,150	19,510
Of which : Oil Fund revenues	12,138	17,614	15,940	15,695	15,971	15,890	15,991	16,188
Tax credits for SOCAR energy subsidies	0	0	0	0	0	0	0	0
Grants	20	20	20	20	20	0	0	0
Expenditure								
Total Expenditure	25,035	26,450	27,844	28,193	29,039	29,910	30,799	31,726
Current Expense	17,823	15,236	18,330	21,138	21,592	22,464	23,045	23,590
Compensation of employees	3,959	4,414	6,347	6,730	7,147	7,605	8,107	8,659
Use of goods and services	2,970	3,093	3,860	3,893	4,556	4,894	5,311	6,707
Social benefits	4,394	4,579	5,080	7,480	6,829	6,906	6,535	5,166
Of which : Social protection fund	1,303	1,337	1,418	1,504	1,597	1,699	1,811	1,935
Subsidies	2,141	2,576	2,442	2,396	2,397	2,432	2,495	2,571
Grants	20	20	20	20	20	0	0	0
Interest	375	542	568	605	628	591	560	447
Other expense 1/	3,965	10	13	14	16	37	38	39
Net Acquisition of Nonfinancial Assets	7,212	11,214	9,515	7,054	7,447	7,446	7,754	8,136
Overall balance 1/	-961	4,475	3,519	2,772	2,513	1,939	1,616	1,459
Overall balance excluding one off items 2/	1,539	4,475	3,519	2,772	2,513	1,939	1,616	1,459
Statistical discrepancy	0	0	0	0	0	0	0	0
Non-oil primary balance 3/	-13,897	-15,038	-15,460	-15,836	-16,262	-16,758	-17,226	-17,730
Net financial transactions	-961	4,475	3,519	2,772	2,513	1,939	1,616	1,459
Net acquisition of financial assets	4,961	4,994	6,005	4,181	3,544	2,780	2,513	2,450
Oil Fund	1,998	4,605	4,200	2,439	1,598	655	233	100
Privatization and other sale of assets	-107	-112	-118	-124	-130	-137	-143	-151
Banking system 4/	-653	-473	-326	-261	-261	-261	-261	-261
Other	3,722	974	2,249	2,127	2,338	2,523	2,685	2,762
Net incurrence of liabilities	5,922	519	2,486	1,409	1,031	841	897	991
Debt securities	976	-1,086	791	799	798	798	897	991
Of which: Domestic banking sector	964	-1,088	325	200	200	200	0	0
Loans (all external)	4,945	1,605	1,696	610	233	44	0	0
Memorandum items:								
Oil revenue	13,311	20,056	19,546	19,213	19,402	19,287	19,402	19,636
Non-oil revenue 5/	10,763	10,869	11,817	11,752	12,150	12,562	13,013	13,549
Non-oil tax revenue 6/	8,155	8,074	8,224	8,334	8,431	8,608	8,868	9,188
Non-oil GDP (in million of manats)	45,017	46,881	49,712	52,713	55,977	59,559	63,493	67,818

Sources: Azerbaijani authorities; and IMF staff estimates and projections.

1/ Includes the extraordinary SOFAZ transfer ($1.4 billion) to the CBA in 2017, and in 2019 a transfer of CBA profits (AzN 650 million) and expenditures for the NPL program (AzN 650 million).
2/ Excludes the impact of the 2017 extraordinary SOFAZ transfer ($1.4 billion) to the CBA.
3/ Defined as non-oil revenue minus total expenditure (excl. interest payments) and statistical discrepancies.
4/ Comprises government deposits in CBA and commercial banks.
5/ Excludes AIOC profit tax, profit oil, and SOCAR profit tax, but includes VAT and excise taxes on oil and gas, tax withholding on the AIOC's subcontractors, energy subsidies.
6/ Tax revenue excluding AIOC and SOCAR profit tax, and social contributions.

Table 3b. Azerbaijan: Statement of Consolidated Government Operations, 2017–24

(In percent of non-oil GDP)

			Projections					
	2017	2018	2019	2020	2021	2022	2023	2024
Revenue								
Total revenue	53.5	66.0	63.1	58.7	56.4	53.5	51.1	48.9
Tax revenue	22.2	24.0	25.5	24.1	22.8	21.7	20.9	20.2
Income taxes	7.4	7.5	9.2	8.6	8.1	7.6	7.3	7.0
Individual income tax	2.3	2.1	1.8	1.8	1.8	1.8	1.8	1.8
Enterprise profits tax	5.1	5.3	7.4	6.8	6.3	5.8	5.5	5.2
Value added tax (VAT)	8.1	9.1	8.6	8.1	7.6	7.2	6.9	6.6
Excise taxes	1.4	1.6	2.1	2.0	1.9	1.9	1.8	1.8
Taxes on international trade	2.3	2.7	2.6	2.4	2.2	2.1	2.0	1.9
Other taxes	1.6	1.5	1.4	1.4	1.4	1.4	1.4	1.4
Social security contributions	1.5	1.6	1.7	1.6	1.6	1.6	1.6	1.5
Nontax revenue	31.2	41.9	37.5	34.6	33.5	31.7	30.2	28.8
Of which : Oil Fund revenues	27.0	37.6	32.1	29.8	28.5	26.7	25.2	23.9
Tax credits for SOCAR energy subsidies	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Grants	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Expenditure								
Total Expenditure	55.6	56.4	56.0	53.5	51.9	50.2	48.5	46.8
Current Expense	39.6	32.5	36.9	40.1	38.6	37.7	36.3	34.8
Compensation of employees	8.8	9.4	12.8	12.8	12.8	12.8	12.8	12.8
Use of goods and services	6.6	6.6	7.8	7.4	8.1	8.2	8.4	9.9
Social benefits	9.8	9.8	10.2	14.2	12.2	11.6	10.3	7.6
Of which : Social protection fund	2.9	2.9	2.9	2.9	2.9	2.9	2.9	2.9
Subsidies	4.8	5.5	4.9	4.5	4.3	4.1	3.9	3.8
Grants	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Interest	0.8	1.2	1.1	1.1	1.1	1.0	0.9	0.7
Other expense 1/	8.8	0.0	0.0	0.0	0.0	0.1	0.1	0.1
Net Acquisition of Nonfinancial Assets	16.0	23.9	19.1	13.4	13.3	12.5	12.2	12.0
Overall balance 1/	-2.1	9.5	7.1	5.3	4.5	3.3	2.5	2.2
Overall balance excluding one off items 2/	3.4	9.5	7.1	5.3	4.5	3.3	2.5	2.2
Statistical discrepancy	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Non-oil primary balance 3/	-30.9	-32.1	-31.1	-30.0	-29.1	-28.1	-27.1	-26.1
Net financial transactions	-2.1	9.5	7.1	5.3	4.5	3.3	2.5	2.2
Net acquisition of financial assets	11.0	10.7	12.1	7.9	6.3	4.7	4.0	3.6
Oil Fund	4.4	9.8	8.4	4.6	2.9	1.1	0.4	0.1
Privatizations and other sale of assets	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2
Banking system 4/	-1.4	-1.0	-0.7	-0.5	-0.5	-0.4	-0.4	-0.4
Other	8.3	2.1	4.5	4.0	4.2	4.2	4.2	4.1
Net incurrence of liabilities	13.2	1.1	5.0	2.7	1.8	1.4	1.4	1.5
Debt securities	2.2	-2.3	1.6	1.5	1.4	1.3	1.4	1.5
Of which: Domestic banking sector	2.1	-2.3	0.7	0.4	0.4	0.3	0.0	0.0
Loans (all external)	11.0	3.4	3.4	1.2	0.4	0.1	0.0	0.0
Memorandum items:								
Oil revenue	29.6	42.8	39.3	36.4	34.7	32.4	30.6	29.0
Non-oil revenue 5/	23.9	23.2	23.8	22.3	21.7	21.1	20.5	20.0
Non-oil tax revenue 6/	18.1	17.2	16.5	15.8	15.1	14.5	14.0	13.5
Non-oil GDP (in billion of manats)	45.0	46.9	49.7	52.7	56.0	59.6	63.5	67.8

Sources: Azerbaijani authorities; and IMF staff estimates and projections.

1/ Includes the extraordinary SOFAZ transfer ($1.4 billion) to the CBA in 2017, and in 2019 a transfer of CBA profits (AzN 650 million) and expenditures for the NPL program (AzN 650 million).
2/ Excludes the impact of the 2017 extraordinary SOFAZ transfer ($1.4 billion) to the CBA.
3/ Defined as non-oil revenue minus total expenditure (excl. interest payments) and statistical discrepancies.
4/ Comprises government deposits in CBA and commercial banks.
5/ Excludes AIOC profit tax, profit oil, and SOCAR profit tax, but includes VAT and excise taxes on oil and gas, tax withholding on the AIOC's subcontractors, energy subsidies.
6/ Tax revenue excluding AIOC and SOCAR profit tax, and social contributions.

Table 4. Azerbaijan: Summary Accounts of the Central Bank, 2017–24
(In millions of manat, unless otherwise specified)

	2017	2018	2019	2020	2021	2022	2023	2024
			Projections					
Net foreign assets	12,012	11,400	11,910	12,420	12,930	13,440	13,950	14,460
Net international reserves of the CBA	12,019	11,400	11,910	12,420	12,930	13,440	13,950	14,460
Gross international reserves	12,022	11,403	11,913	12,423	12,933	13,443	13,953	14,463
Foreign liabilities	-2	-2	-2	-2	-2	-2	-2	-2
Other items, net	-7	0	0	0	0	0	0	0
Net domestic assets	-2,141	-756	-595	-422	-346	-321	-241	-101
Domestic credit	4,237	4,666	4,908	5,164	5,323	5,434	5,600	5,828
Net claims on consolidated central government	-1,481	-1,580	-2,125	-2,560	-2,995	-3,430	-3,866	-4,301
Of which : claims on central government	53	40	40	40	40	40	40	40
manat deposits of central government	-939	-1,142	-1,687	-2,122	-2,557	-2,993	-3,428	-3,863
Net claims on banks 1/	5,718	6,246	7,033	7,724	8,319	8,864	9,466	10,129
Other items, net	-6,378	-5,422	-5,503	-5,586	-5,670	-5,755	-5,841	-5,929
Reserve money	9,873	10,644	11,315	11,998	12,584	13,119	13,709	14,359
Manat reserve money	8,543	9,546	10,214	10,939	11,727	12,583	13,514	14,527
Currency outside CBA	8,140	8,364	8,645	9,342	10,138	10,809	11,553	12,333
Bank reserves and other deposits	403	1,182	1,569	1,597	1,589	1,774	1,961	2,195
Reserves in foreign currency	1,329	1,098	1,101	1,059	857	536	195	-168

Sources: Central Bank of Azerbaijan; and IMF staff estimates and projections.

1/ Includes CBA holdings of Aqrarcredit's bonds as a part of the SPV, and IBA deposits.

Table 5. Azerbaijan: Monetary Survey, 2017–24

(In millions of manat, unless otherwise specified)

	2017	2018	2019	2020	2021	2022	2023	2024
			Projections					
Net foreign assets	15,422	15,314	15,904	16,494	17,084	17,674	18,265	18,857
Net international reserves of the CBA	12,019	11,400	11,910	12,420	12,930	13,440	13,950	14,460
Net foreign assets of commercial banks	3,566	4,078	4,178	4,278	4,378	4,478	4,578	4,678
Other	-162	-165	-185	-205	-225	-245	-264	-282
Net domestic assets	7,350	10,028	11,261	12,312	13,505	14,872	16,431	18,202
Domestic credit, net	19,025	19,509	20,739	21,490	22,326	23,291	24,512	25,847
Net claims on consolidated central government	-2,338	-3,549	-3,768	-4,203	-4,603	-4,999	-5,314	-5,709
Credit to the economy	11,363	13,058	14,507	15,693	16,929	18,290	19,826	21,556
Of which: private sector	11,363	13,058	14,507	15,693	16,929	18,290	19,826	21,556
Credit to other financial public sector	10,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000
Other items, net	-11,675	-9,481	-9,478	-9,178	-8,821	-8,419	-8,081	-7,644
Broad money	22,772	25,341	27,165	28,805	30,589	32,546	34,695	37,059
Manat broad money	12,466	14,126	15,415	16,633	17,969	19,444	21,076	22,882
Cash outside banks	7,490	7,601	7,684	8,023	8,402	8,634	8,882	9,112
Manat deposits	4,976	6,525	7,731	8,611	9,567	10,810	12,193	13,770
Foreign currency deposits	10,306	11,215	11,750	12,172	12,620	13,101	13,620	14,177
	(Annual percentage change)							
Net foreign assets	93.8	-0.7	3.9	3.7	3.6	3.5	3.3	3.2
Net domestic assets	-43.2	36.4	12.3	9.3	9.7	10.1	10.5	10.8
Credit to the economy	-35.7	14.9	11.1	8.2	7.9	8.0	8.4	8.7
Of which: private sector	-28.1	14.9	11.1	8.2	7.9	8.0	8.4	8.7
Broad money (M3)	9.0	11.3	7.2	6.0	6.2	6.4	6.6	6.8
Manat broad money (M2)	8.0	13.3	9.1	7.9	8.0	8.2	8.4	8.6
Reserve money	6.9	7.8	6.3	6.0	4.9	4.3	4.5	4.7
Manat reserve money	8.7	11.7	7.0	7.1	7.2	7.3	7.4	7.5
Memorandum items:								
Gross official international reserves (US$ millions)	5,335	5,626	5,926	6,226	6,526	6,826	7,126	7,426
Velocity of total broad money (M3)	2.0	1.9	1.8	1.8	1.8	1.8	1.8	1.8
Broad money in percent of non-oil GDP	50.6	54.1	54.6	54.6	54.6	54.6	54.6	54.6
Credit to private sector in percent of non-oil GDP	25.2	27.9	29.2	29.8	30.2	30.7	31.2	31.8
Share of foreign currency credits in total credit portfolio	42.2	38.0	34.2	30.8	27.7	24.9	22.4	20.2
Currency to broad money ratio	32.9	30.0	28.3	27.9	27.5	26.5	25.6	24.6
Share of foreign currency deposits in total deposits	67.4	63.2	60.3	58.6	56.9	54.8	52.8	50.7
Foreign currency deposits to broad money ratio	45.3	44.3	43.3	42.3	41.3	40.3	39.3	38.3

Sources: Central Bank of Azerbaijan; and IMF staff estimates and projections.

Table 6. Azerbaijan: External Debt Sustainability Framework, 2014–24

(In percent of GDP, unless otherwise indicated)

	Actual							Projections						
	2014	2015	2016	2017	2018			2019	2020	2021	2022	2023	2024	Debt-stabilizing non-interest current account 6/
Baseline: External debt	22.0	37.0	50.0	53.3	47.3			**48.4**	**47.7**	**46.9**	**46.1**	**45.0**	**41.6**	**1.9**
Change in external debt	7.0	15.0	13.0	3.3	-6.0			1.1	-0.6	-0.8	-0.8	-1.2	-3.4	
Identified external debt-creating flows (4+8+9)	-12.9	11.8	20.1	-14.1	-18.4			-7.9	-8.6	-6.2	-5.3	-5.4	-6.0	
Current account deficit, excluding interest payments	-14.0	0.0	3.0	-5.0	-14.0			-11.6	-12.0	-9.7	-8.7	-8.7	-8.8	
Deficit in balance of goods and services	-69.5	-75.7	-90.2	-89.3	-92.0			-80.2	-78.7	-77.0	-74.0	-70.3	-67.1	
Exports	43.3	39.4	46.5	48.0	54.3			47.2	46.2	44.1	42.0	40.2	38.7	
Imports	-26.2	-36.3	-43.7	-41.3	-37.7			-33.0	-32.5	-32.9	-32.0	-30.1	-28.4	
Net non-debt creating capital inflows (negative)	1.2	0.8	3.8	-5.7	0.9			3.7	3.2	3.3	3.2	3.3	3.1	
Automatic debt dynamics 1/	-0.1	10.9	13.4	-3.4	-5.3			0.0	0.2	0.2	0.1	0.0	-0.3	
Contribution from nominal interest rate	0.1	0.4	0.6	0.9	1.2			1.2	1.2	1.2	1.1	1.0	0.8	
Contribution from real GDP growth	-0.4	-0.3	1.5	0.1	-0.6			-1.2	-1.0	-1.0	-1.0	-1.0	-1.1	
Contribution from price and exchange rate changes 2/	0.2	10.9	11.2	-4.4	-5.8			...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	19.9	3.3	-7.1	17.4	12.4			9.0	8.0	5.4	4.5	4.3	2.6	
External debt-to-exports ratio (in percent)	50.8	93.8	107.6	111.2	87.1			102.6	103.4	106.5	109.8	112.0	107.6	
Gross external financing need (in billions of US dollars) 4/	-10.0	0.7	2.0	-0.7	-4.3			-4.1	-4.3	-3.2	-3.1	-3.3	-2.4	
in percent of GDP	-13.3	1.3	5.2	-1.7	-9.1	10-Year	10-Year	-8.4	-8.5	-6.2	-5.8	-5.9	-4.1	
Scenario with key variables at their historical averages 5/								**48.4**	**43.0**	**34.8**	**26.0**	**17.4**	**7.4**	**0.5**
Key Macroeconomic Assumptions Underlying Baseline						Historical Average	Standard Deviation							
Real GDP growth (in percent)	2.8	1.1	-3.1	-0.3	1.4	2.2	3.7	2.7	2.1	2.1	2.2	2.3	2.5	
GDP deflator in US dollars (change in percent)	-1.3	-33.1	-23.2	9.7	12.2	-0.9	18.5	0.7	1.4	0.6	1.1	1.8	2.3	
Nominal external interest rate (in percent)	0.8	1.2	1.3	2.0	2.5	1.0	0.7	2.6	2.6	2.6	2.4	2.3	1.8	
Growth of exports (US dollar terms, in percent)	-9.3	-38.5	-12.2	12.9	28.4	0.4	23.7	-10.2	1.3	-1.9	-1.5	-0.4	0.9	
Growth of imports (US dollar terms, in percent)	1.2	-6.5	-10.4	3.5	3.5	5.6	17.9	-9.6	2.0	3.9	0.7	-1.9	-1.1	
Current account balance, excluding interest payments	14.0	0.0	-3.0	5.0	14.0	14.6	10.9	11.6	12.0	9.7	8.7	8.7	8.8	
Net non-debt creating capital inflows	-1.2	-0.8	-3.8	5.7	-0.9	-0.6	2.4	-3.7	-3.2	-3.3	-3.2	-3.3	-3.1	

1/ Derived as [r - g - r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock, with r = nominal effective interest rate on external debt; r = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as [-r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock. r increases with an appreciating domestic currency (e > 0) and rising inflation (based on GDP deflator).

3/ For projection, line includes the impact of price and exchange rate changes.

4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

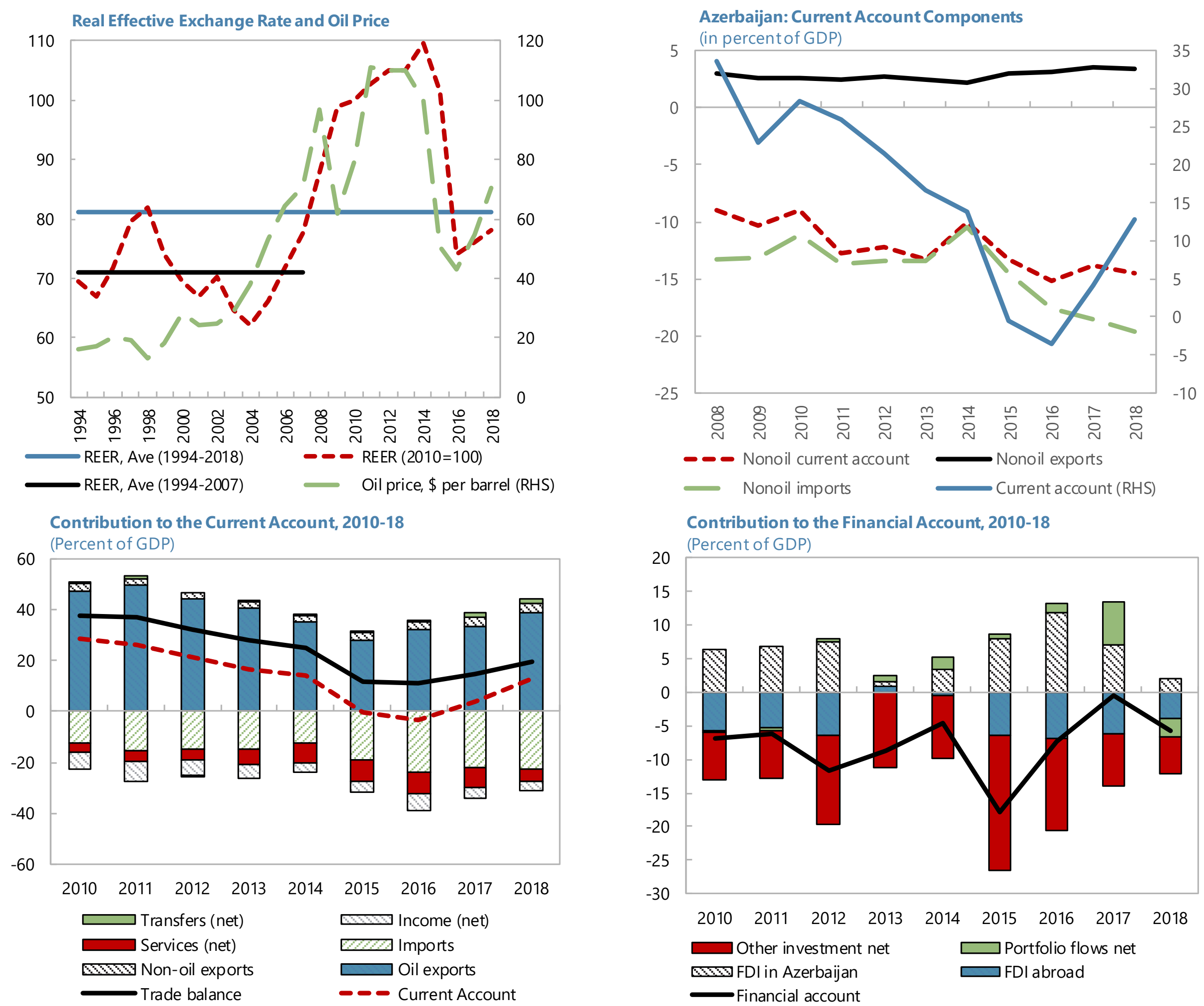
6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

Annex I. External Sector Assessment

The external position improved in 2018 on higher oil prices and lower oil-related services imports. Despite a large CA surplus in 2018, the external position is moderately weaker than implied by fundamentals and desirable policies. External stability risks are mitigated by sizable FX reserves.

1. The CA continued to strengthen in 2018. The CA and REER tend to move with oil prices. After a decade of double-digit CA surpluses, the oil price shock of 2014–15 led to a sharp deterioration in the CA. A recovery in oil prices in 2017–18, coupled with a reduction in oil-related construction and business services (as many projects were completed), led to a rebound of the CA to a surplus of 4.1 and 12.9 percent of GDP in 2017 and 2018 respectively. The nonoil CA balance, however, continued to worsen given a marked increase in nonoil imports and meager growth in nonoil exports. In the near term, the overall CA surplus is expected to decline to about 10 percent of GDP as oil prices moderate and the impact of the recent appreciation of the REER kicks in.

Azerbaijan: Real Effective Exchange Rates and Contributions to Current Account

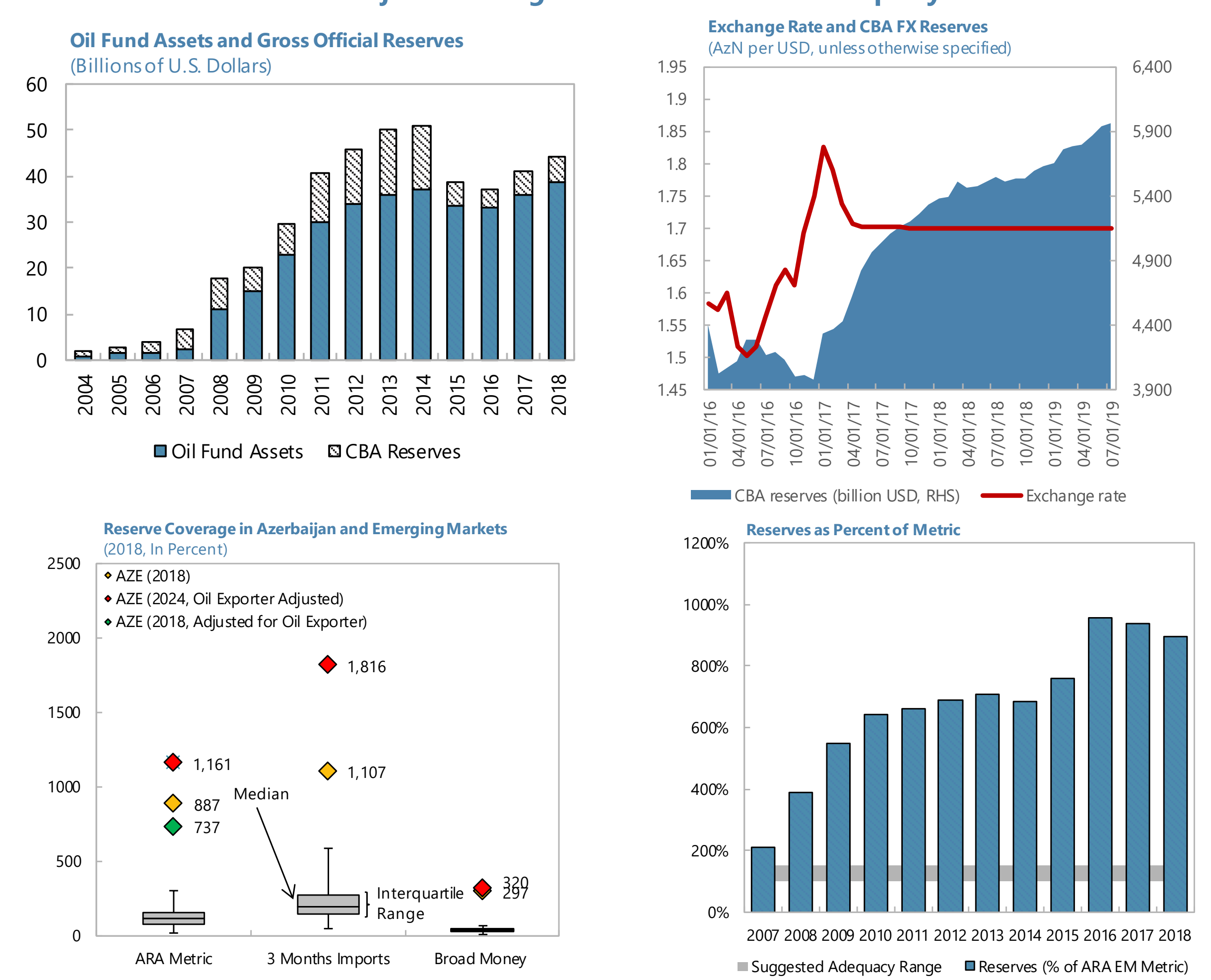


Sources: National authorities, IMF World Economic Outlook, and IMF staff calculations.

2. **The financial account registered net outflows in 2018**. While the acquisition of foreign assets remained relatively stable, foreign liabilities, particularly FDI and portfolio inflows, declined. FDI averaged over 7 percent of GDP in the 2010–17 period but fell to only 2 percent of GDP in 2018.

3. **Azerbaijan's overall reserve coverage is more than adequate according to the IMF's Assessing Reserve Adequacy (ARA) metric**. CBA's gross official international reserves increased by 7.5 percent, to $5.8 billion (12.2 percent of GDP, 5.1 months of next year's imports) by end-2018. CBA's reserves are complemented by foreign assets held by the Oil Fund (SOFAZ) of $38.6 billion (82 percent of GDP) at end-2018. Together CBA reserves and SOFAZ assets are equivalent to 39 months of next year's imports. The ARA metric, which combines information on imports, broad money and short-term debt, shows that Azerbaijan scores much better than most EMs on all criteria (yellow diamonds). This is the case even after adjusting the ARA metric for the country's heavy reliance on hydrocarbon exports (green diamond). Reserve coverage scores remain strong into 2024, given strong CA surpluses, rising reserves, and limited increases in external debt (red diamonds).

Azerbaijan: Exchange Rates and Reserve Adequacy



Source: National authorities, Haver, IMF FAD Reserve Adequacy Tool, and IMF staff calculations.
Note: The data for EM refer to a sample of 48 emerging markets.

4. **Despite sizeable CA surplus, the external position appears to be moderately weaker than implied by fundamentals and desirable policy settings**. The assessment is based on the EBA-Lite methodology, which uses regression estimates of CA and REER norms and gaps. Norms are the estimated levels of the CA based on underlying fundamentals, while gaps are the deviations of observed values from the norms. To predict the equilibrium of the CA consistent with structural and policy factors, EBA-Lite uses regression analysis for a large sample of countries. Policy changes that would reduce the external gap over the forecast period include: (i) deeper fiscal consolidation to strengthen long-term fiscal sustainability benchmarks (additional 3.3 pp of nonoil GDP increase in NOPB to -23 percent of nonoil GDP by 2024, mainly through improvements in the efficiency of spending)); (ii) higher public health expenditure (an increase of about 1 pp of GDP to 2.3 percent of GDP by 2024 to get closer to the EM average of 3.5 percent of GDP, accompanied by improvements in the efficiency of healthcare spending); and (iii) financial deepening (for bank credit to the private sector to reach the level of 18 percent of GDP, accompanied by improvements in bank supervision and regulation).

5. **The results of the EBA-lite regression-based model point to slight overvaluation of the manat**. The EBA-lite methodology estimates a multilaterally-consistent cyclically adjusted CA norm of 13.3 percent of GDP compared to an actual cyclically-adjusted CA surplus of 11.6 percent of GDP in 2018. This results in an estimated CA gap of -1.7 percent of GDP, and a REER gap of 4.9 percent. This indicates that for the CA to be at the norm, the REER should depreciate by 4.9 percent. The results imply a CA gap, driven mainly by the fiscal policy gap. Moreover, the manat has been held constant at about AzN/$ 1.70 since April 2017, while regional trading partners experienced depreciations.

ESR Classification of the Overall Assessments

CA GAP	REER GAP 1/	Description in overall assessment
-1.7 percent of GDP	4.9	The external position is moderately weaker than implied by fundamentals and desirable policy settings. 2/

Sources: Staff estimates.
1/ Based on an elasticity of -0.35.
2/ Reflects a CA gap range of [-2%, -1%].

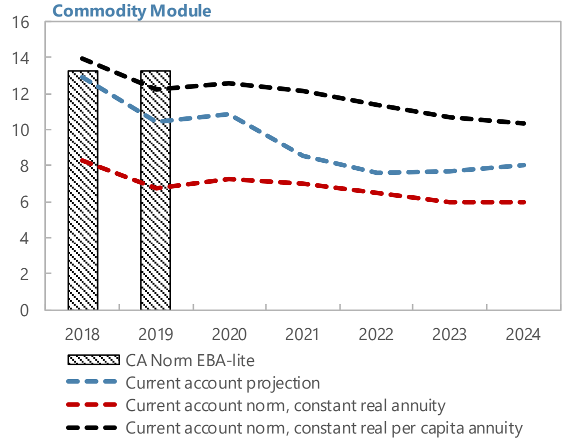
6. **The bottom-line assessment of the external position is sensitive to assumptions**. Assuming no policy gaps, the CA and REER gaps would be -2.4 percent of GDP and 6.8 percent respectively, suggesting weaker external position than implied by fundamentals. Financial deepening and higher healthcare spending lower the CA norm. The intuition is that public health expenditure is akin to a social protection policy that discourages precautionary saving. If the need for additional fiscal consolidation were the only assumed policy gap, the estimated CA and REER gaps of -2.6 percent of GDP and 7.3 percent respectively, would point to a weaker external position. Assuming Azerbaijan needs to bring its level of healthcare spending closer to EM average over the medium term, and promote financial deepening (Annex V), the estimated CA and REER gaps would point to a moderately weaker external position.

CA and REER Gaps Under Different Policy Gap Assumptions

	CA GAP	REER GAP
No policy change	-2.4%	6.8%
Fiscal consolidation	-2.6%	7.3%
Fiscal consolidation and financial deepening	-2.4%	7.0%
Fiscal consolidation, financial deepening, and increase in healthcare spending	-1.7%	4.9%

7. The results of the consumption-allocation commodity module are broadly in line with EBA-Lite regression-based model. The commodity module considers the exhaustible nature of exhaustible commodity income and incorporates the need to smooth consumption over time and between generations. Using the approach developed by Bems and Carvalho (2010), the consumption-allocation commodity module examines annuity payments that are kept either at a constant real annuity or a constant real per capita annuity. The latter is the preferred measure, as it ensures that each person in each generation is allocated the same real resources out of the country's wealth. The consumption-based allocation model suggests the CA norm of 14.2 percent of GDP for Azerbaijan measured at constant real per capita annuity, whereas the EBA-lite CA methodology suggests 13.3 percent of GDP. A higher CA norm in the commodity module can be explained by the fact that volatile revenue flows motivate more precautionary savings to smooth consumption. The results for per capita annuity imply a CA gap of 1.3 percent of GDP in 2018 that widens to 2.5 percent over the medium term.

CA and CA Norms Under Consumption-Allocation Commodity Module



Source: National authorities, and IMF calculations.

Annex II. Risk Assessment Matrix[1]

Nature/Source of Main Threats	Overall Level of Concern	
	Relative Likelihood (high, med, low)	**Expected Impact if Threat Materializes** (high, medium, or low)
GLOBAL RISKS		
Rising protectionism and retreat from multilateralism. Trade actions threaten the global trading system and regional integration, reducing growth and confidence. In the medium term, geopolitical competition and tensions lead to fragmentation, which undermine the global rules-based order, with further negative effects on growth and stability.	**High**	**Medium** Disruptions in the global trading system and in regional integration would adversely affect Azerbaijan's plans to expand nonhydrocarbon exports and hydrocarbon processing industry, as well as attempts to enter global value chains.
Sharp tightening of global financial conditions, resulting in higher debt service; stress on leveraged firms and households; capital account pressures; and a possible downturn. The tightening could reflect restrictive U.S. monetary policy or a rise in risk premiums given concerns about debt levels, a disorderly Brexit; policy missteps.	**Medium to Low**	**Low** A sharp tightening of global financial conditions would have a limited first-round impact given low exposures, capital controls, and no plans to engage in extensive new external borrowing.
Weaker-than-expected global growth. The global growth slowdown could be synchronized as weakening outlooks in the U.S., Europe and China feed off each other and impact on earnings, asset prices and credit performance.	**Medium to High**	**High** Slower global growth would reduce oil and natural export volumes and gas prices. The combination of both would worsen internal and external balances, increase Azerbaijan's external vulnerabilities, and result in lower overall economic growth.
Intensification of the security risks in parts of the Middle East, Africa, Asia, and Europe, leading to socio-economic and political disruptions.	**High**	**Medium** Greater security risks may raise hydrocarbon prices helping to increase growth. However, it could also disrupt the operation of the transport of oil and natural gas to Europe, preventing the country from benefitting of higher hydrocarbon prices. Moreover, FDI in the region could be negatively affected.
Large swings in energy prices. Risks are broadly balanced, reflecting offsetting—but large—supply and demand shocks. Uncertainty surrounding the shocks translates to elevated price volatility, complicating economic management and adversely affecting energy sector investment.	**Medium**	**High** Given Azerbaijan's high oil dependence, the economy could go into recession. The oil fund savings could help cushion the shock. A prolonged price decline would necessitate a large fiscal adjustment.
Cyberattacks on financial system and broader private and public institutions, disrupting socio-economic activities.	**Medium**	**Low** Internet related financial activity is relatively low. Past internet connectivity outages had limited impact on activity. The authorities have a national cybersecurity strategy, but the CBA lacks one for its critical information infrastructures.

[1] The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 and 30 percent, and "high" a probability between 30 and 50 percent). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities. Non-mutually exclusive risks may interact and materialize jointly.

Nature/Source of Main Threats	Overall Level of Concern	
	Relative Likelihood	**Expected Impact if Threat Materializes** (high, medium, or low)
COUNTRY-SPECIFIC RISKS		
Disruptions in oil production if recent efforts to stabilize oil output are insufficient or unsustainable.	**Medium**	**High** Disruptions in oil production would undermine growth prospects and result in deteriorations of the overall fiscal and external positions.
Financial sector risks could increase if further deterioration in banking sector profitability, capitalization, and lack of viable business plans (particularly in IBA) further compromise the stability and soundness of a fragile system under weak supervisory oversight.	**Medium**	**Medium/High** A further deterioration in systemic banks would result in additional fiscal costs, destabilizing deposit runs, and bank closures. The government may provide financial support.
Fiscal revenues may be less than expected given the large uncertainty regarding the efficacy of new tax policy reforms. SOEs would become more a drain on the public purse.	**Medium**	**Low** Shortfalls in fiscal revenue may require the state budget authorities to rely on the issuance of additional treasury bonds, putting pressure on yields.
Political instability and civil tensions could increase given some four years of weak growth and lack of reforms.	**Low**	**Medium** Political instability and civil unrest would lead to a domestic and international confidence crisis; and civil and (possibly) human rights distress, damaging economic, diplomatic and political ties.
Escalation of the regional conflicts would raise tensions with neighboring countries and could limit trade and financial flows.	**Medium**	**High** Military conflict would entail severe economic and social impacts and damage FDI prospects, particularly in the non-oil sector.
Policy responses: Staff recommended: (i) growth friendly fiscal consolidation to the authorities to build policy buffers along with monetary easing; (ii) policies to promote inclusive, diversified, private-sector led growth; and (iii) actions to strengthen policy frameworks, institutions and governance. Inter alia, this would entail: urgently addressing the banking sector vulnerabilities, including adopting concrete actions to privatize IBA; strengthening the fiscal position as envisaged in the 2019 approved budget; and allowing ER flexibility and the ER market to be determined by competitive market forces.		

Annex III. New Fiscal Rule

1. The fiscal rule, adopted in 2018, aims to support macroeconomic stability and intergenerational equity and limit procyclicality of fiscal policy. The rule specifies the NOPB path and the methodology for calculating the annual ceiling of consolidated budget expenditures, including a ceiling on spending out of oil revenues. Given the need for a sizable fiscal adjustment to achieve the PIH benchmarks, the rule is asymmetric, limiting scope for stabilization policy during downturns

2. The main provisions of the rule are as follows:

i. *A consolidated budget (CB) balance rule*: requires the year-ahead projected nonoil primary balance (NOPB) as a percent of nonoil GDP to improve over the current-year NOPB. The NOPB targets are set by the MOF and approved by the President.

ii. *A CB expenditure rule*: restricts nominal spending growth to 3 percent over the previous year's approved expenditures.

iii. *Countercyclical rule*: CB spending is limited to projected nonoil revenues and "spendable" oil revenues. If projected oil revenues exceed a fixed threshold (30 percent of NFA),[1] a portion (20 percent) of the excess is combined with the threshold to calculate "spendable" oil revenues. Conversely, when projected oil revenues are below the threshold, "spendable" oil revenues equal projected oil revenues plus a portion (20 percent) of the shortfall.

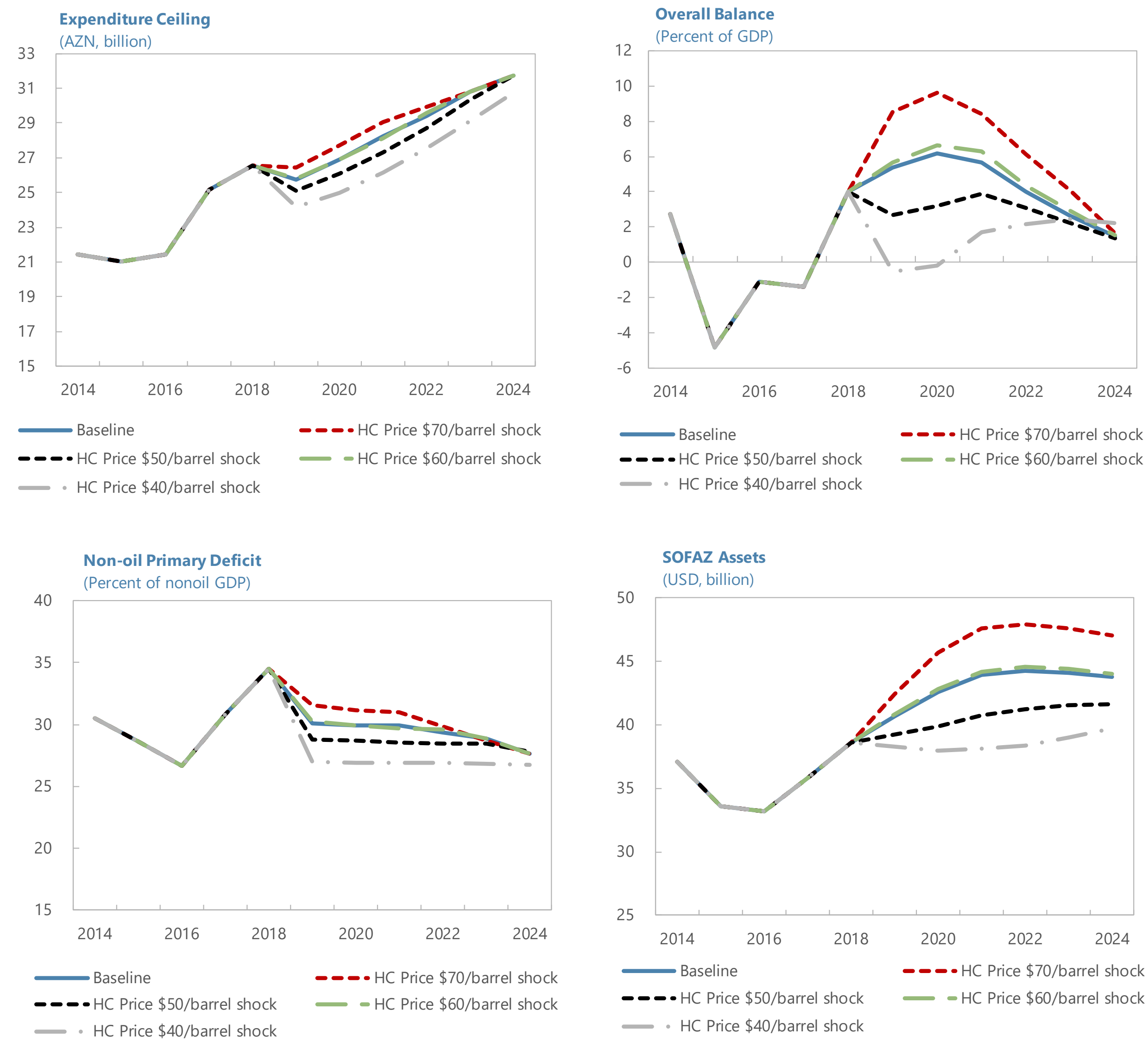
iv. *CB* expenditures are set as the lower of provisions (ii) and (iii) above, whilst respecting (i).

v. *An escape clause:* can be enacted whenever actual revenues or financing are 10 percent below the corresponding quarterly forecast or 5 percent below corresponding non-oil revenue forecast, or by a Presidential Decree. If enacted, the Cabinet must present proposals for bringing expenditures back in line with the rule. Initial projections for future years are submitted to the Cabinet by April 15 and revised projections by September 15.

3. Simulations confirm the asymmetric countercyclical properties of the rule. It is countercyclical on upside oil price shocks, allowing for NFA accumulation. The rule's cap on nominal increase in consolidated expenditures restricts expenditures from exceeding baseline levels even at higher oil prices, maintaining a downward non-oil primary deficit trend. It also enables the build-up of SOFAZ assets. During oil price downturns, the rule requires only partial adjustment of expenditures to cover shortfalls in oil revenues. While allowing some use of SOFAZ assets for stabilization purposes, it safeguards them for future generations.

[1] NFA is defined as the sum of oil fund assets, government deposits, and SOE liabilities to treasury minus public debt (excluding guarantees).

Azerbaijan: Application of New Fiscal Rule



Source: National authorities, and IMF staff calculations.
Note: Several oil price shock scenarios were simulated to assess the outcomes of the rule on the expenditure ceiling, overall balance and NOPB, and SOFAZ assets. The baseline scenario assumes February 2019 WEO oil price forecasts. The remaining scenarios assume a two-year shock in oil prices with a subsequent gradual return to the baseline over the projection period: $60/barrel (the price adopted in the 2019 budget), an upside shock price of $70/barrel and two downside shock prices of $50/barrel and $40/barrel.

4. Possible improvements in the rule include:

i. *Spending stability and budget predictability*: setting the target for the non-oil deficit or the expenditure ceiling over the medium term would result in a more stable path for expenditure growth, making it less dependent on current year oil prices. The spending ceiling and NOPB path would be revised only every three-four years.

ii. *Flexibility and asymmetric countercyclicality*: The rule is less countercyclical in downturns than upturns. With a large fall in oil prices, the rule would imply a larger upfront adjustment. This could be mitigated by placing a floor on the ratio of NFA to annual oil revenues, in combination with limits on nonoil real primary expenditures and the NOPB of SOEs, all within a four-year budget plan. If oil revenues rose above the baseline path assumed in the budget, spending can be increased only by maintaining the same ratio of NFA to oil revenue. By contrast, any shortfall would be covered in the year of the fall but would need to restore the NFA ratio within five years. This would allow increasing spending somewhat with higher oil prices, while avoiding immediate fiscal contraction during oil price declines.

iii. *Institutional coverage and quasi-fiscal activity*: the current institutional perimeter of the rule is the CB. Outside the CB, several other entities in the public sector such as SOEs can conduct fiscal operations on government's behalf, including delivering subsidies by selling at prices below cost recovery, creating employment, and delivering social programs. Limiting coverage to the CB runs the risk of not capturing such activities. Extending the perimeter to include SOEs will involve a trade-off with the practicality of monitoring the financial operations of SOEs, given limited availability of information on that sector at present.

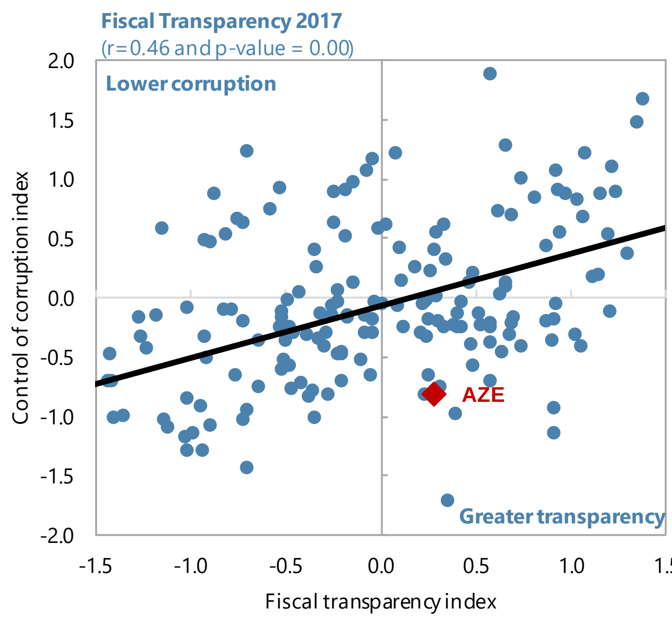
iv. *Definitions*: NFA should only incorporate liquid assets and easily recoverable financial liabilities (owed by SOEs to the government) to ensure a realistic calculation of available assets. Currently, non-oil expenditure (revenue) is defined to include debt repayments (debt disbursements). The inclusion of these financing flows in the above-the-line aggregates could distort the application of the rule.

v. *Defining adequate enforcement and reporting requirements*: It would be useful to require periodic MOF reporting on fiscal performance compared to the rule and suggestions for remedial measures in case the rule is not followed.

Annex IV. Fiscal Governance

Fiscal Transparency

1. **The government has made progress in improving data dissemination**. In line with recommendations of the IMF's Enhanced General Data Dissemination System (e-GDDS), the authorities have started to publish some data through the National Summary Data Page (NSDP), with links to statistics published by the Ministry of Finance, State Statistical Committee, and the Central Bank of Azerbaijan. Regular and timely publication of essential fiscal and macroeconomic data will provide policymakers and stakeholders with easy access to information critical for monitoring economic conditions and policies.



Sources: International Budget Partnership, Open Budget Index; World Bank; Worldwide Governance Indicators; IMF, World Economic Outlook Database; and IMF staff estimates.

2. **The authorities are working on enhancing the quality of government financial statistics (GFS), public-sector debt statistics (PSDS), and fiscal reporting**. The Fund has been providing technical assistance to Azerbaijan as part of the three-year Central Asia and South Caucasus Fiscal Transparency Project to assist the authorities in compiling GFS and PSDS in line with the GFS Manual (GFSM) 2014 and PSDS Guide (PSDSG). A detailed narrative is published on the annual budget, providing a description of the main activities and projections for the budget year. Quarterly and annual budget execution reports are also published. The authorities have also established a SOE monitoring commission which is compiling data on the 14 largest SOEs.

3. **While these steps are welcome, more could be done**. The IMF's Fiscal Transparency Code (FTC) sets out recommended transparency practices across four main pillars. Some actions that Azerbaijan can take to achieve closer alignment with the standards set in the Code include:

- **Reporting:** advancing ongoing efforts to publishing fiscal data in line with GFSM 2014 and PSDSG; expanding the budget execution reports with disaggregated data by administrative, functional, or economic classification, and reflecting outturns compared with projections and previous year outturns; and publishing consolidated IPSAS-compliant financial statements.

- **Forecasting and Budgeting:** including in the budget documentation details of the macroeconomic and fiscal projections for the medium-term and their underlying assumptions;

providing more data on budgetary expenditure by functional and economic classification; and publishing details of major investment projects and the associated multi-year costs.

- **Risk Analysis and Management:** publishing a report on the finances of the SOE sector; continuing to monitor the financial sector for emergent risks; and expanding the information published on fiscal risks with sensitivity analyses based on macroeconomic assumptions, in a comprehensive fiscal risk statement.

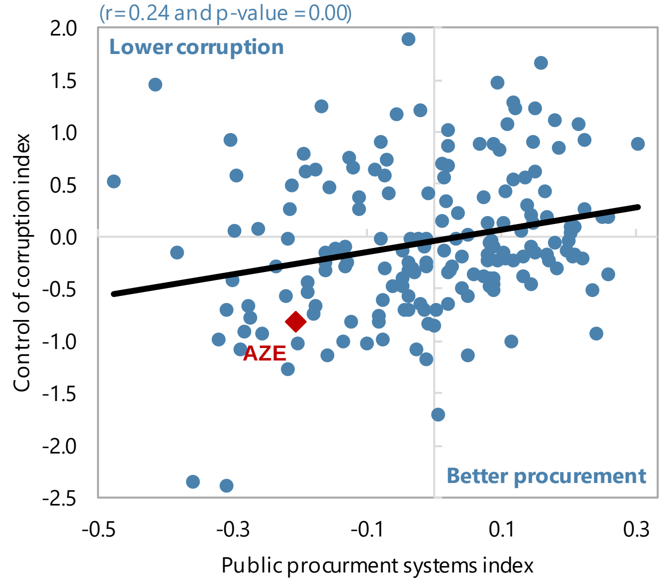
- **Resource Revenue Management:** continuing to publish self-assessments on application by SOFAZ of Santiago principles, pertaining to legal and governance structures, organizational design, and operational practices; and maintaining adherence to EITI standards.[1]

4. The last Open Budget Index (OBI) identified possible areas for improvement. The OBI assesses whether the government makes key budget documents available to the public online in a timely and comprehensive manner. The 2017 assessment identified the following areas in which Azerbaijan could improve its score in terms of public availability of documents: pre-budget statement, citizens budget, and mid-year review. Closer alignment with the practices recommended by the FTC could also help improve Azerbaijan's OBI score. The IMF's Fiscal Transparency Evaluation assesses performance against the Code and develops an action plan to address any identified weaknesses.

Public Procurement

5. Azerbaijan abolished the State Procurement Agency in 2017 and created the State Service for Antimonopoly Policy and Consumer Rights' Protection in the Ministry of Economy. The new agency oversees the general legal procurement framework, monitoring and auditing of tenders, and resolving complaints and conflicts. The procurement system remains highly decentralized with more than 800 procuring entities.[2] Each entity oversees their own tender process, evaluations of bids and final

Public Procurement Systems 2017
(r=0.24 and p-value =0.00)



Sources: International Budget Partnership, Open Budget Index; World Bank; Worldwide Governance Indicators; IMF, World Economic Outlook Database; and IMF staff estimates.

[1] Azerbaijan withdrew from the EITI in 2017 but affirmed its commitment to transparency in the sector. The Extractive Industries Transparency Commission was created in 2017. It published two reports, in 2016 and 2017. SOFAZ is a member of the International Forum of Sovereign Wealth Funds (IFSWF) and in 2016 published a self-assessment on application of Santiago principles, pertaining to legal and governance structures, organizational design, and operational practices. The next assessment is due in 2019.

[2] A procuring entity is any organization with 30 percent state ownership, which purchases goods and services.

selections. Moreover, Azerbaijan's procurement fares poorly when benchmarked against other countries.

6. A proposed new State Procurement Law could help modernize the procurement process. It includes provisions for: (i) e-procurement; (ii) an electronic unified register of procurement contracts; (iii) mechanisms to limit participation of nonreliable bidders; (iv) the development of procurement plans; (v) stronger civil servant ethical guidelines; (vi) competitive negotiation rules;[3] and (vii) complaint procedures. Implementing the new procurement law would help deliver value for money and suppress opportunities for corruption. Given the large size of public procurement in Azerbaijan, losses due to inefficiencies and abuses can be costly.[4] A comprehensive diagnostic assessment of the procurement system would help inform an action plan to strengthen the system beyond implementation of e-procurement.

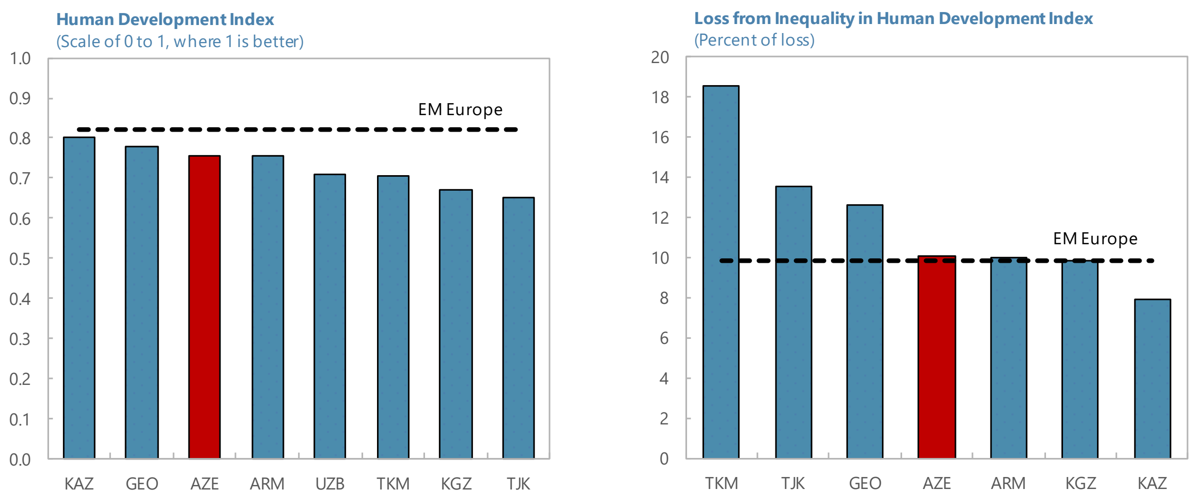
[3] Domestic producers will be given preference over foreign producers. For example, winning domestic producer bids can exceed the lowest cost foreign bid by at least 20 percent.

[4] Government spending on goods and services and capital projects is about 18 percent of GDP.

Annex V. Inclusive Growth

1. **Inclusive growth (IG) is a multifaceted concept that captures both the sustainability of the growth model and the extent to which it creates opportunities for all citizens**. With nonoil growth relatively slow since 2015 and oil production faltering, promoting equitable, broad-based, and sustainable growth is macro-critical. Azerbaijan performs well compared to its CCA peers in income inequality, life expectancy, and access to schooling. However, it lags in other IG indicators, such as in health and education outcomes, efficiency of social spending, governance and control of corruption, and access to credit by SMEs.[1]

Azerbaijan: Human Development and Inequality



Source: United Nations Development Programme *Human Development Index,* and IMF staff calculations.
Note: The Human Development Index (HDI) is the geometric mean of life expectancy, expected and mean years of schooling, and gross national income per capita (2011 PPP $). The inequality-adjusted HDI measures the loss in HDI value when inequality is accounted for, and it is based on the Atkinson family of inequality measures. Refer to the technical note for more information: http://hdr.undp.org/sites/default/files/hdr2018_technical_notes.pdf.

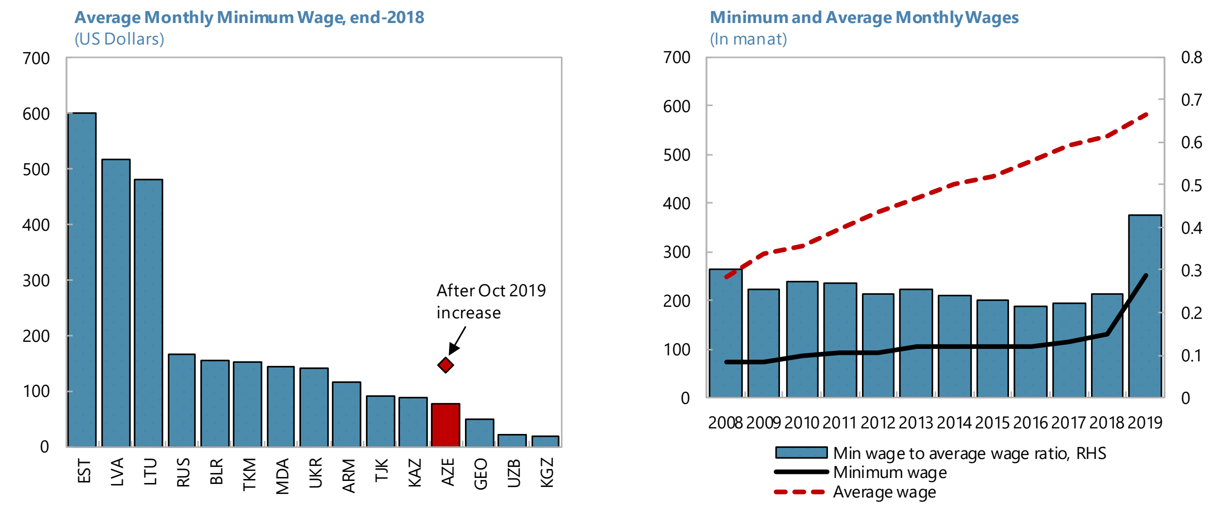
2. **Social spending indicators signal room for improvement**. Spending on education, healthcare, and targeted social protection has been shown to promote growth and reduce income inequality (Dollar and Kray, 2002; IMF 2018). Azerbaijan stands out as spending the least in percent of GDP on health and education in the CCA, although in per capita terms it is in line with peers.[2] Efficiency of public expenditure is also a concern, as outcomes, particularly in education and healthcare, fall short of those predicted by public outlays.

[1] Azerbaijan presented a voluntary national review of their Sustainable Development Goals in July 2019 (https://sustainabledevelopment.un.org/memberstates/azerbaijan).

[2] After a 19 percent jump in 2019, spending on education and health is set to increase by additional 45 percent in 2020.

3. Recent economic spending packages have a social protection element. The statutory minimum wage in Azerbaijan is relatively low compared to regional peers. It has not kept up with increasing cost of living, and the gap between average and minimum wage has been rising. Even with the latest increase in minimum wages, Azerbaijan would still fall below the 0.6 ratio of minimum to average wage recommended by the European Social Charter. Recent steps to raise minimum pensions and minimum wages should help alleviate poverty and reduce inequality.

Azerbaijan: Minimum and Average Wages



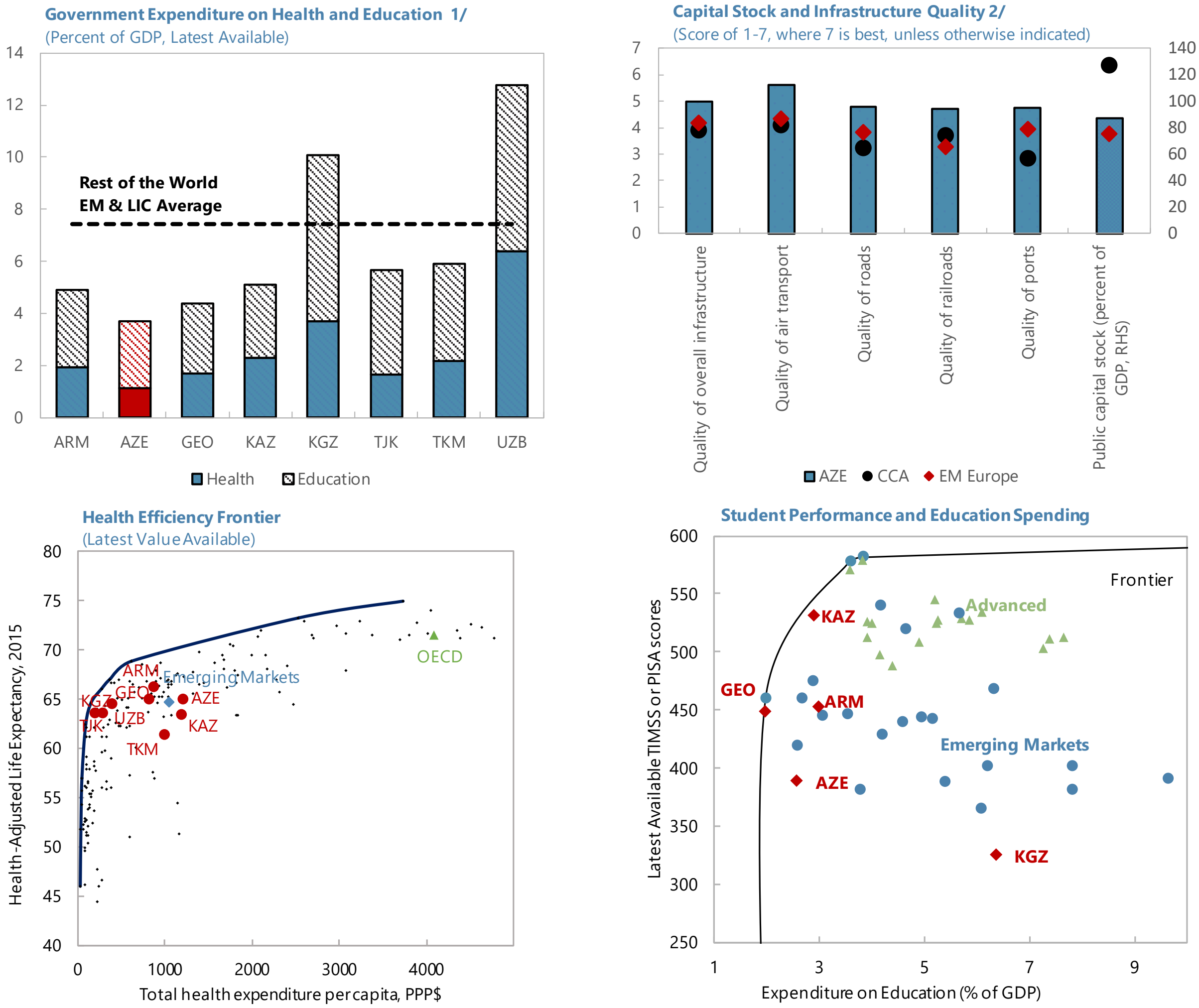
Source: Haver Analytics, CBA, ILO, and IMF staff calculations.

4. Low financial inclusion has long been identified as key impediment to inclusive growth. Better access to finance, particularly for SMEs, can provide impetus to private sector growth, employment generation, and diversification. Azerbaijan ranks poorly in access to credit compared to peers. Financial inclusion is particularly problematic for youth compared to other CCA countries, with only 12 percent having a bank account. Lack of trust in banks and high cost of borrowing stand out as top barriers to financial access. High collateral requirements and insufficient credit bureau coverage have been identified as constraints to SME access to financing.[3]

5. Improving the business climate and governance can lift productivity growth and enable the private sector to play a larger economic role. Private investment has declined precipitously since the Global Financial Crisis. While Azerbaijan has passed laws and regulations to promote competition, implementation is still weak. Azerbaijan ranks poorly compared to regional and EM averages in controlling corruption. Institutional quality and regulatory burden have been identified as the main obstacles to doing business and causes of high economic informality in Azerbaijan (Abdih and Medina, 2013).

[3] "Financial Inclusion of Small and Medium-Sized Enterprises in the Middle East and Central Asia," IMF 19/02.

Figure 1. Azerbaijan: Social Spending and Infrastructure Quality

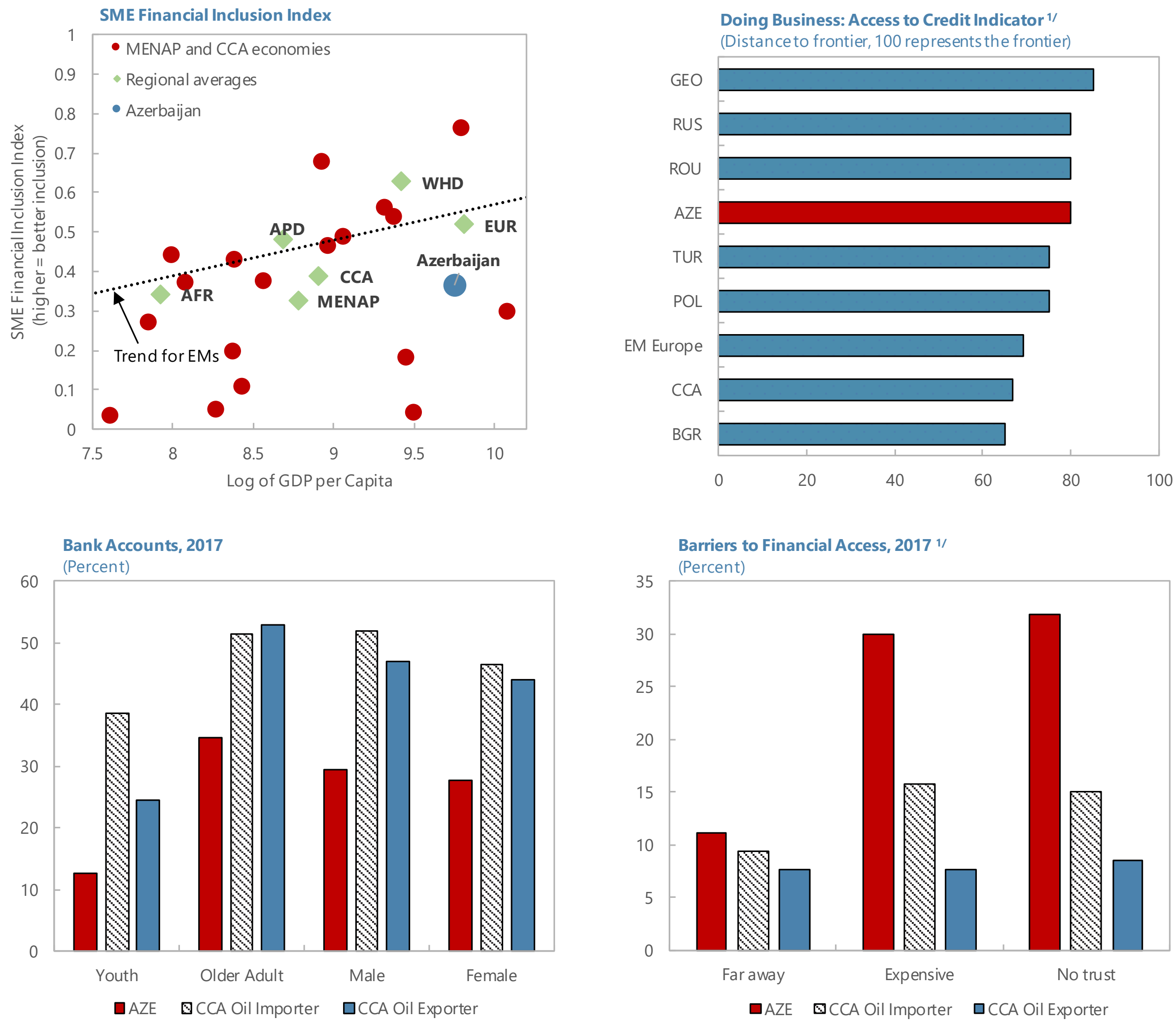


Source: TIMSS and PISA evaluations, WEF Global Competitiveness Indicators, IMF Fiscal Monitor October 2017, IMF FAD Expenditure Assessment Tool, and IMF staff calculations. Note: TIMSS and PISA scales are different, but both are centered around 500 with a standard deviation of 100. PISA – Program for International Student Assessment, TIMSS – Trends in International Mathematics and Science Study.

1/ For Azerbaijan, health and education expenditure excludes capital expenditure, such as construction of schools and hospitals.

2/ Indices on the quality of infrastructure are based on WEF's quantitative and qualitative assessment of the country environment. These indicators should be interpreted with caution due to a limited number of respondents, a limited geographical coverage, and standardized assumptions on business constraints, and information availability.

Figure 2. Azerbaijan: Financial Inclusion

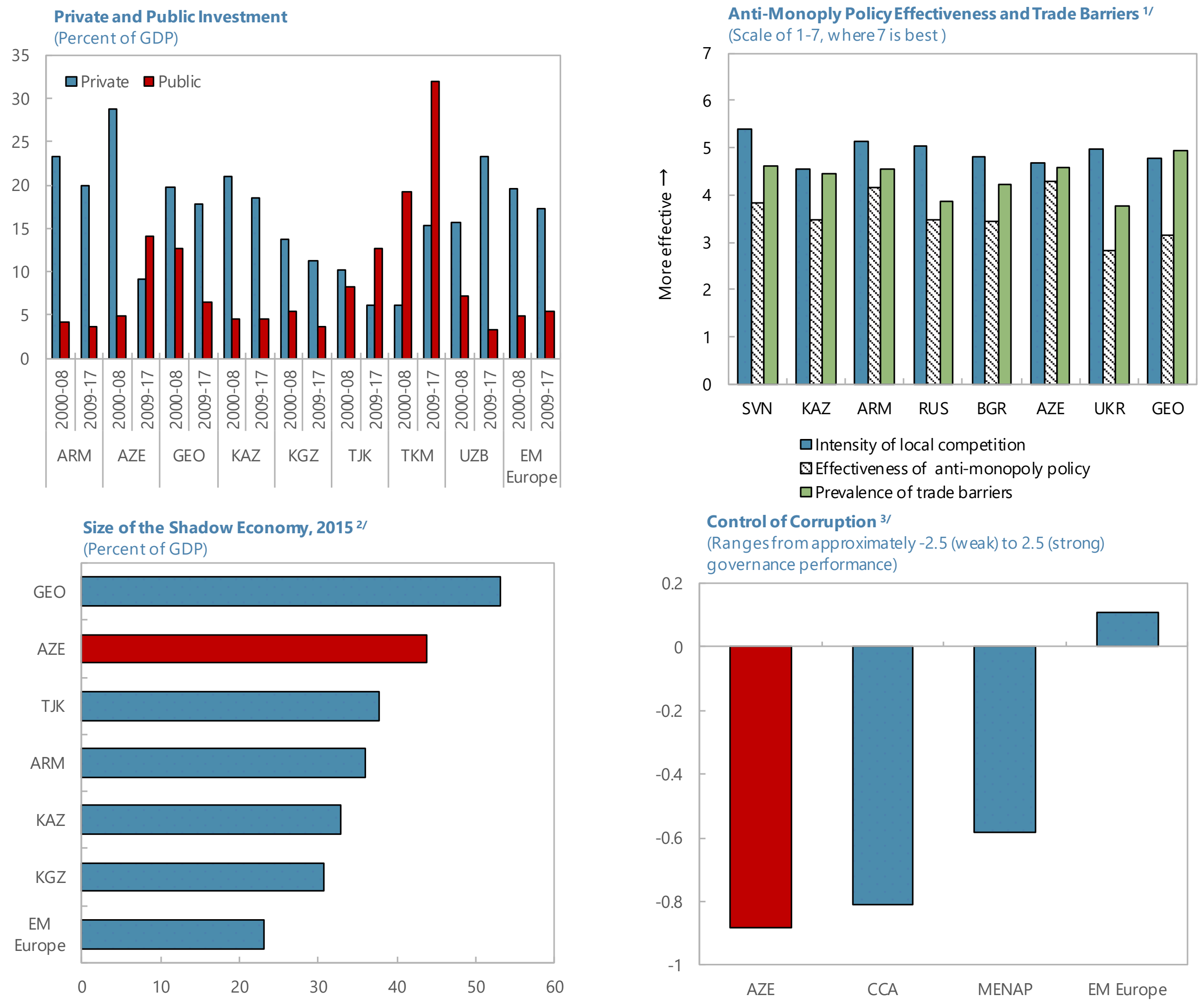


Note: CCA and CCA oil exporter averages exclude Azerbaijan.
Sources: World Bank Ease of Doing Business, Findex Report, IMF World Economic Outlook, and IMF staff calculations.
1/ Survey-based indicators that should be interpreted with caution due to a limited number of respondents, a limited geographical coverage, and standardized assumptions on business constraints and information availability.

6. **Promoting IG requires transforming Azerbaijan into a more diversified private sector-driven economy with opportunities for all to contribute to and benefit from higher growth**. Fiscal reforms should focus on rebalancing spending toward education and healthcare, improving its efficiency, closing infrastructure quality gaps through better governance and procurement, and improved targeting of social protection. Creating fiscal space through revenue mobilization, improved efficiency of spending, and reduced generalized subsidies[4] that disproportionately benefit the rich, would free resources for social spending.

[4] Generalized subsidies (for example, tariffs set below cost recovery on fuel, water, electricity) disproportionately benefit the rich, encourage over-consumption, and result in inefficient allocation of resources.

Figure 3. Azerbaijan: Business Environment



Note: CCA average excludes Azerbaijan.
Source: WEF Global Competitiveness Indicators, World Governance Indicators, IMF World Economic Outlook, IMF WP/18/17, and IMF staff calculations.
1/ Indices of anti-monopoly effectiveness and trade barriers are based on WEF's quantitative and qualitative assessment of the trade environment. These indicators should be interpreted with caution due to a limited number of respondents, a limited geographical coverage, and standardized assumptions on business constraints, and information availability.
2/ Size of the economy estimated using the MIMIC approach, see IMF 2018f WP/18/17.
3/ Survey-based indicators summarize perceptions of control of corruption, higher score indicates better governance. Estimates of range from approximately -2.5 (weak) to 2.5 (strong).

7. **Financial reforms should address the demand and supply impediments to SME inclusion**: (i) cleaning up banks' balance sheets and promoting competition, (ii) increasing credit bureau coverage and lowering collateral requirements; (iii) training entrepreneurs; (iv) developing capital markets. Supporting fair competition, improving governance, strengthening property rights, reducing SOE dominance, and rationalizing business regulations is also important.

INTERNATIONAL MONETARY FUND

REPUBLIC OF AZERBAIJAN

August 20, 2019

STAFF REPORT FOR THE 2019 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

Prepared By

Middle East and Central Asia Department
(In Consultation with Other Departments)

CONTENTS

RELATIONS WITH THE FUND

(As of July 10, 2019)

Membership Status

Date of membership: September 18, 1992

General Resources Account

	SDR Million	Percent Quota
Quota	391.70	100.00
Fund Holdings of Currency	333.90	85.24
Reserve position in Fund	57.83	14.76

SDR Department

	SDR Million	Percent Allocation
Net Cumulative Allocation	153.58	100.00
Holdings	95.73	62.33

Outstanding Purchases and Loans

	SDR Million	Percent of Quota
None	0.00	0.00

Latest Financial Arrangements

Type	Approval Date	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
PRGF	Jul. 06, 2001	Jul. 04, 2005	67.58	54.71
PRGF	Dec. 20, 1996	Mar.19, 2000	93.60	81.90
EFF	Dec. 20, 1996	Mar.19, 2000	58.50	53.24

Projected Payments to the Fund

(SDR million; based on existing use of resources and present holdings of SDRs)

	Forthcoming				
	2019	2020	2021	2022	2023
Principal					
Charges/Interest	0.30	0.58	0.58	0.58	0.58
Total	**0.30**	**0.58**	**0.58**	**0.58**	**0.58**

Safeguards Assessment

Under the Fund's safeguards assessment policy, the Central Bank of Azerbaijan (CBA) was subject to an assessment with respect to the PRGF arrangement that was approved on July 06, 2001, and expired on July 5, 2004. The assessment was completed on March 11, 2002, and it was concluded that the external audit and financial reporting were adequate. The assessment proposed a set of measures to strengthen internal control, data reporting to the Fund, and the legal framework. The majority of the recommendations were implemented, except for the recommendation to establish an Audit Committee. The external audit of 2011 CBA financial statements was completed by April 2012, and the audited financial statements along with the audit opinion has been published on the bank's website as an integral part of 2011 annual report.

Exchange Rate Arrangements

The currency of Azerbaijan is the manat, which became sole legal tender on January 1, 1994. The The *de jure* exchange rate arrangement is classified as free floating, wile the *de facto* regime is a "stabilized arrangement".

Azerbaijan accepted the obligations of Article VIII, Sections 2, 3, and 4 effective November 30, 2004, and maintains an exchange system that is free of restrictions on the making of payments and transfers for current international transactions, except for restrictions maintained for security reasons that have been notified to the Fund.[1]

Article IV Consultation

Azerbaijan is on a 12-month Article IV consultation cycle. The previous Article IV consultation was concluded on a lapse-of-time basis on March 14, 2018.

ROSCs

A fiscal transparency ROSC module was prepared by FAD (SM/00/278, 12/12/01) and updated in April 2003 (SM/03/159, 04/30/03). A fiscal ROSC update mission took place in April 2005. A data dissemination ROSC module was completed by STA in March 2003 (IMF Country Report No. 03/86). The authorities published the fiscal ROSC, and it is available on the IMF web site. Several financial systems ROSC were conducted in the context of the FSAP (2003–04) but were not published. A CPI data ROSC completed in July 2008 (IMF Country Report No. 08/273).

Resident Representative

In October 2009, Mr. Koba Gvenetadze ended his term as IMF Resident Representative in Azerbaijan. Since November 2009, the IMF no longer has a Resident Representative in Azerbaijan, but the IMF

[1] Staff continues to assess the jurisdictional implications of the recently adopted NPL program.

Office in Baku, located in the building of the Ministry of Finance of Azerbaijan, continues to operate, headed by Ms. Aghgun Gadirli (Office Manager).

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 to 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 in 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 to April 1996. He was succeeded by Mr. Peter Barrand, who was stationed in Baku from January 2001 to December 2002. Mr. Isaac Svartsman was resident advisor in the CBA for bank supervision and restructuring from September 1998 to April 2001. Ms. Nataliya Ivanik was stationed in Baku as a STA regional external sector statistics advisor from November 2006 to November 2008.

Azerbaijan: Technical Assistance, 2010–19

Fund Dept.	Delivered Assistance	Mission Dates
LEG	AML/CFT Diagnostic	Feb/Mar 2011
LEG	AML/CFT Structures and tools	Feb/Mar/Oct/Dec 2011
LEG	AML/CFT Legislation	Jul/Dec 2011
STA	Government Finance Statistics	Sep 2011
STA	Balance of Payments Statistics	Mar 2012
MCM	Moving Towards Exchange Rate Flexibility	Mar 2012
LEG	AML/CFT Structures and Tools	Jun/May/Sep/Dec 2012
FAD	Pension Reform	Jul 2012
STA	National Accounts	Feb 2013
LEG	AML/CFT Structures and Tools	Mar 2013
FAD	Debt and Cash Management and Budget Classification	Jun 2013
FAD	Pension Reform Follow Up	Jul/Nov 2013
STA	Quarterly National Accounts Statistics	Sep 2013
MCM	Follow-up Mission-Bank Restructuring (with MCD staff visit)	Mar 2014
STA	Quarterly National Accounts Statistics	May 2014
STA	External Sector Statistics	May 2015
MCM	Bank Restructuring (with MCD staff visit)	Sep 2015
STA	External Sector Statistics	Nov 2015
STA	External Sector Statistics	Apr 2016
MCM	Multi-Topic: Monetary, FX Operations and Bank Supervision	Apr 2016
FAD	TADAT Workshops, Research and Training Consultations	Apr 2016
LEG	Review of the Draft Law on Supervision of Financial Markets	May 2016
LEG	Ongoing review of the Draft Law on Deposit Insurance	Jun 2016
MCM	Bank Supervision	June 2016
MCM	Liquidity Forecasting	Sep 2016
STA	National Accounts	Oct 2016
MCM	Bank Restructuring and Bank Supervision	Oct 2016
MCM	Monetary Policy and Central Bank Operations	Mar 2017
FAD	PFM-Fiscal Rules	Apr 2017
STA	Government Finance Statistics	May 2017
STA	Financial Soundness Indicators	Q1 2018
MCM	Monetary Policy and Central Bank Operations (follow-up)	Q1 2018
MCM	Regulatory and Prudential Framework	Q1 2018
STA	Monetary and Financial Statistics	Q1 2018
STA	Government Finance Statistics (follow-up)	Q1 2018
STA	Balance of Payments Statistics	Q1 2018
STA	Government Finance Statistics (follow-up)	Q2 2018
STA	National Accounts	Q3 2018
MCM	Transition to Inflation Targeting, Monetary and Foreign Exchange Operations	Q3 2018
STA	Government Finance Statistics (follow-up)	Q4 2018

STATISTICAL ISSUES

I. Assessment of Data Adequacy for Surveillance
General: Data provision to the Fund has some shortcomings, but is broadly adequate for surveillance.
National Accounts: The State Statistical Committee (SSC) currently compiles annual and quarterly GDP by production and expenditure at current and constant 2005 prices, however constant price quarterly GDP estimates by expenditure are not yet being published. The 2005 base year is outdated and there is scope to improve the input data and methodology used in producing the GDP estimates (these broadly conform to the System of National Accounts 1993). There is also a need for benchmarking and seasonal adjustment for quarterly GDP and for reexamining the classification of consumption and investment into public and private sectors. The last mission, in Sep-2018, assisted the SSC's National Accounts and Macroeconomic Statistics Department in enhancing the expenditure-side GDP estimates, in addition to consistency between the quarterly and annual GDP estimates, and measurement of taxes and subsidies on products. **Price Statistics:** In 2010, the CPI was revised to update the consumption basket (561 items) and expenditure weights that reflect recent consumption patterns. Prices are collected from 54 geographic areas and disseminated at the national and regional level (nine regional indexes). CPI metadata lack sufficient detail and should be augmented. There is need to expand CPI coverage to include housing and to develop a residential property price index. Producer price indices (PPI) cover all major sectors, but there is not a total output PPI. Finally, export and import price indices (XMPI) are also compiled and released, but related metadata lack detail and should be augmented.
Fiscal Sector: The authorities report annual general government data according to the methodology of the Government Finance Statistics Manual 2001 (GFSM 2001) for inclusion in the GFS Yearbook. However, the stock positions in assets and liabilities have yet to be reported. The compilation of longer time series, including sub-annual series, to support surveillance and fiscal analysis and policy making, is also needed. While further work is required to improve the source data for the compilation of these statistics, the budgetary accounting and reporting system is adequate for a compilation and dissemination of the GFS on a quarterly basis. To address the fiscal reporting issues, Azerbaijan participateds in a three-year STA regional project to build capacity and improve GFS reporting to be used for fiscal policy making and Fund surveillance. STA assisted the authorities to move to the updated GFSM 2014 methodology, strengthen reporting of financial transactions and begin reporting balance sheet positions in assets and liabilities.Further TA in improving fiscal transparency will be provided in the framework of the new Regional Technical Assistance Centre.
Monetary statistics: Following two technical assistance missions in 2017 and 2018, Azerbaijan's monetary and financial statistics improved substantially and are now in full compliance with the methodology of the *Monetary and Financial Statistics Manual and Compilation Guide* (*MFSMCG*). The Central Bank regularly reports to STA monetary data using the standardized report forms (SRFs), with a monthly frequency for the central bank and other depository corporations (ODCs), and a quarterly frequency for other financial corporations.
Financial sector surveillance: The Financial Market Supervisory Authority (FIMSA) received in 2018 technical assistance on financial soundness indicators (FSIs). Available source data would allow the compilation and dissemination of monthly core and encouraged FSIs for deposit takers broadly in compliance with the

methodology of the *FSI Compilation Guide*. However, FIMSA is not reporting to STA the set of core and encouraged FSIs for posting on the IMF's website.

External Sector: Azerbaijan's balance of payments (BOP) statistics are compiled and disseminated by the CBA and are broadly in accordance with the sixth edition of the *Balance of Payments Manual (BPM6)*. The CBA has also re-initiated compilation of International Investment Position (IIP) statistics in 2015, after a hiatus of 6 years. However, important challenges remain, and require high-level officials' support to be addressed, since the adoption of new data sources and estimation techniques may result in revised external sector statistics indicators that portray trends less favorable than the previous data vintage. This includes also the dissemination of IIP and external debt statistics.

Despite the progress achieved with Swiss-funded TA, deficiencies remain in compiling BOP statistics. Significant under-coverage has been identified in balance of payments components such as trade in goods and services, investment income, and some financial account components. A number of methodological inconsistencies have also been identified in estimating assets in trade credit and advances; currency and deposits for other sectors; and reserve assets. These shortcomings affect a number of indicators used for assessing the country's performance such as debt sustainability and reserve assets adequacy.

There is need to take measures for compiling and disseminating the IIP and external debt statistics. Previous TA missions assisted in compiling the draft IIP and external debt statements but the methodological inconsistencies mentioned above in estimating some financial account components led to the accumulation of unrealistic stocks for those components in the IIP. In order to address the inconsistencies between balance of payments and the IIP, revising the estimation techniques and addressing classification issues is required.

Statistics for public and publicly guaranteed external debt are reported quarterly on a due-for-payment 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 a one quarter lag. However, systematic information on nonguaranteed external debt, including a sectoral breakdown, is lacking.

Data on official reserve assets is provided within 15 days of the end of each month. Azerbaijan does not disseminate International Reserves and Foreign Currency Liquidity Template data. TA missions stressed the importance of using the definition of gross official reserve assets that follows the *BPM6*.

II. Data Standards and Quality

In April 2007 a mission assessed progress towards the Special Data Dissemination Standards (SDDS) and provided technical assistance on the outstanding issues required for SDDS subscription.	A data ROSC was published on the IMF's website in 2002.

Azerbaijan: Table of Common Indicators Required for Surveillance

(As of May, 2019)

	Date of latest observation	Date received	Frequency of data[6]	Frequency of reporting[6]	Frequency of publication[6]	Memo Items: Data Quality – *Methodological soundness*[7]	*Data Quality Accuracy and reliability*[8]
Exchange Rates	05/2019	05/31/2019	D	D	M		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	05/2019	05/31/2019	M	M	M		
Reserve/Base Money	05/2019	05/31/2019	M	M	M		
Broad Money	05/2019	05/31/2019	M	M	M	O, O, O, O	O, O, O, O, LO
Central Bank Balance Sheet	05/2019	05/31/2019	M	M	M		
Consolidated Balance Sheet of the Banking System	05/2019	05/31/2019	M	M	M		
Interest Rates[2]	05/2019	05/31/2019	M	M	M		
Consumer Price Index	05/2019	05/31/2019	M	M	M	O, O, O, O	O, LO, O, O, O
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	05/2019	05/31/2019	Q	Q	Q		
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	05/2019	05/31/2019	M	M	M		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	05/2019	05/31/2019	A	A	A		
External Current Account Balance	Q4/2018	05/31/2019	Q	Q	Q		
Exports and Imports of Goods and Services	Q4/2018	05/31/2019	Q	Q	Q		
GDP/GNP	Q4/2018	05/31/2019	Q	Q	M	O, LO, O, LO	LO, LNO, O, O, O
Gross External Debt	Q4/2018	05/31/2019	Q	Q	Q		
International Investment Position	N/A	N/A					

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.

[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.

[3] Foreign, domestic bank, and domestic nonbank financing.

[4] The general government consists of the central government (budgetary funds, extrabudgetary funds, and social security funds) and state and local governments.

[5] Including currency and maturity composition.

[6] Daily (D); Weekly (W); Monthly (M); Quarterly (Q); Annually (A); Irregular (I); Not Available (NA).

[7] Reflects the assessment provided in the data ROSC published on March 20, 2003 and based on the findings of the mission that took place during April 8–23, 2002 for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning (respectively) concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O), largely observed (LO), largely not observed (LNO), or not observed (NO).

[8] Same as footnote 7, except referring to international standards concerning (respectively) source data, statistical techniques, assessment and validation of source data, assessment and validation of intermediate data and statistical outputs, and revision studies.

Statement by Paul Inderbinen, Executive Director for the Republic of Azerbaijan
September 6, 2019

On behalf our Azerbaijani authorities, we would like to thank staff for their candid report and the in-depth and productive discussions during the mission in Baku. The authorities broadly concur with staff's analysis of the macroeconomic and financial stability outlook and their policy recommendations.

Our authorities remain committed to a close partnership with the IMF, as the Azerbaijani economy moves forward to face future challenges. Through knowledge transfer and past financial assistance, the Fund has made invaluable contributions to the significant economic transition achieved in the years since independence, which is much appreciated by the authorities.

Outlook and reform priorities

An oil exporting country, Azerbaijan is in a process of transformation from a public sector-driven economic growth model to a model based on the private sector. Past public-sector led growth has enabled the country to move forward from low-income to upper middle-income status, with a fully modernized economic and social infrastructure. The shocks to oil prices in mid-2014, as well as the steady state reached under the past model, have led the Government to look for new drivers of economic growth. The transformation period has had its own costs, entailing two devaluations of the exchange rate in 2015, downturns in growth, and important vulnerabilities in the financial sector.

Nevertheless, through the implementation of the "Strategic Roadmap for 2020" by the Government since early 2017, Azerbaijan has significantly improved its macroeconomic and financial position. Economic growth has recovered, driven mostly by the non-oil sector. The unemployment rate stands around a record-low level of 5 percent. Inflation was at 2.3 percent on average in 2018, which is 10.5 percentage points below the year before. Despite some remaining fragilities, stability in the banking sector has also been achieved.

The authorities recognize the limitations of public investment as a primary source of growth, and they are well aware of the necessity to promote inclusive, diversified, and private sector-led growth. To this end, a wide range of institutional reforms are being implemented, including easing business procedures, reducing administrative burdens for the private sector, clarifying procedures and increasing transparency in public procurement. The authorities recognize the important role of SMEs as a new engine of sustainable and inclusive growth, and they are focusing on fostering their share in GDP.

The Government is considering a scenario of an additional decline in oil prices and its consequences on fiscal and monetary policy, as well as negative effects on the external sector and additional pressure on the exchange rate. To avoid such consequences, our authorities are focusing on improvement of macroeconomic policy through introducing a rules-based fiscal policy and a new strategy for the management of public debt for the medium and long-run. Work is ongoing to develop a Medium-Term Expenditure Framework, to be implemented in the near future. In its turn, the Central Bank of Azerbaijan has declared to move to an inflation targeting regime over the medium term and has introduced a strategy to this end.

The authorities are aware that the banking sector is facing important challenges and that stability remains fragile. It is well understood that the current credit expansion, especially to households for the financing of consumer goods, could lead to the realization of risks, which in turn could damage financial stability and entail macroeconomic consequences.

Fiscal Policy

The authorities are committed to maintain a prudent fiscal stance. Significant efforts have been made to strengthen sustainability through implementing a new fiscal rule and a public debt strategy; improvements have also been made in the efficiency of public spending, tax policy and administration, and the SOE sector. Our authorities broadly concur with staff on the appropriate pace of growth friendly consolidation over the medium term. In the course of broad ranging Public Financial Management reforms, a new budget classification law has been adopted. Fiscal transparency and accountability have also been improved significantly; data on public finance and budget execution are now broadly disseminated via the new web site of the Ministry of Finance.

An important element of the newly implemented fiscal rule is its aim to decrease oil dependence of budget revenues. Under the rule, the year-ahead projected non-oil primary deficit as a percentage of non-oil GDP has to be below the current year's balance. Correspondingly, the fiscal rule requires the nominal spending growth rate for the year ahead not to exceed 3 percent of the current year's approved expenditures.

Two Presidential decrees on social spending packages were signed in the first half of 2019. The first includes important measures to compensate the public for the adverse impact of past devaluations. In parallel, banks received additional financial support from the Government for NPL resolution. The second decree stipulates a significant increase in public sector wages of about 40 percent, which amounts to 1 percent of GDP, and an increase in minimum wages of 92 percent.

Our authorities are strongly committed to abide by the fiscal rule, despite the important increases in social expenditures. The Ministry of Finance is well-aware that a rules-based fiscal policy will support the sustainability of public finances, and enhance credibility and confidence. The authorities have requested FAD technical assistance to review and refine the fiscal rule framework.

Monetary Policy

Our authorities recognize the importance of sound monetary policy for private led economic growth. It is well understood that bank lending needs to be one of the main sources for financing private sector led growth. The authorities are aware that the new model of growth requires more efficiency in monetary policy transmission to domestic demand. The authorities' agenda for monetary policy is very ambitious and comprehensive. The Central

Bank of Azerbaijan declared its objective to move toward an inflation targeting regime, and has already implemented several preparatory projects. The CBA has asked for technical assistance by MCM.

The primary goal of monetary policy is safeguarding price stability, by maintaining inflation at 4 percent (±2 percent). Since January 2018, CBA has eased monetary policy by reducing the refinancing rate from 15 to 8.25 percent. The authorities' views concur with staff's that any further changes in interest rates should be made cautiously. Monetary policy has gained traction through deposit and note auctions by the CBA, which were activated over the past 5 years. Commercial banks also benefited a lot from those auctions in terms of additional possibilities for asset management in an environment of excess liquidity. CBA deposit and notes auctions have enabled the central bank to focus on base money stability to prevent excess currency from circulation and to avoid additional pressures on the exchange rate.

The authorities are well aware of the importance of a floating exchange rate regime in terms of long run macroeconomic stability and economic competitiveness. CBA declared the move to a floating regime in December 2015. It should, however, be noted that the shifting to a de-facto floating regime will take a certain amount of time. To effect a smooth shift, CBA, in close coordination with the Government, is working on building an efficient infrastructure which will allow it to maintain macroeconomic stability. It is well understood by the authorities that reducing pass-through effect of exchange rate movements to domestic prices is an important task for monetary, and more broadly for macroeconomic, policy. These considerations are a significant element of the strategy for the implementation of the CBA's inflation targeting regime.

Financial Stability

Our authorities share the staff's views on recent developments in the banking sector. Government bailout programs and a wide spectrum of regulations have mitigated the vulnerabilities observed after the oil price shocks. Capital adequacy, the level of NPLs, profitability, and liquidity ratios have improved. Despite these developments, it is well understood that strengthening financial stability remains an urgent task for the bank supervision authority.

The Presidential Decree of March 2019 on the compensation of the public and banks for the past devaluations also provides financing of an NPL resolution program. The latter is considered an important milestone for improving financial stability. As a result of the implementation of the Decree, banking sector activity, including lending and deposit operations, has increased significantly.

The authorities recognize the importance of a sound institutional framework of for the financial system to bolster stability in a sustainable way. The recently established Credit Guarantee Fund, the private Credit Bureau, and the State Registry for collateral have all enhanced the institutional framework of the financial sector.

Despite macroprudential and institutional improvements, it is clear to our authorities that the transition to private sector-led growth requires new approaches in the business models of the banking sector, as well as strengthened bank regulation and supervision. The agreement signed between the Central Bank of Azerbaijan and “Rothschild Global Financial Advisory” on a strategic partnership could be mentioned as one of the steps to this end.

Structural Policies

Institutional reform is a key priority for our authorities. Our government recognize the importance of well-functioning institutions for enabling private sector-led growth. Azerbaijan has implemented a series of important institutional and structural reforms for maintaining a favorable business and investment climate, and an efficient public administration. According to the World Bank’s “Doing Business Report 2019”, Azerbaijan was among the top ten reformist countries globally, ranked in 25th place.

The Government has declared judicial reform as one of the important aspects of institutional reforms in Azerbaijan. Our authorities have made enforcing contracts easier by introducing random and automatic assignment of cases to judges, by implementing an electronic case management system for judges and lawyers, as well as an e-system that allows plaintiffs to file initial complaints electronically, and by adopting a consolidated law on voluntary mediation.

The authorities have strengthened access to credit by allowing non-possessory security interests in one category of movable assets without any restrictions on the use of inventory, including future assets extending automatically to products, proceeds and replacements of the original collateral.

On December 28, 2018, the Parliament of Azerbaijan Republic passed the Law on Amending the Civil Code. The amendments, which became effective on the same day, are highly relevant for protecting minority investors, as they directly address the liability of directors in the case of a prejudicial related-party transaction. Specifically, the amendments allow shareholders to hold interested directors and other board members liable when a related-party transaction is considered unfair and a cause of damage to the company in question.