INTERNATIONAL MONETARY FUND

IMF Country Report No. 24/45

REPUBLIC OF AZERBAIJAN

2023 ARTICLE IV CONSULTATION—PRESS RELEASE; AND STAFF REPORT;

February 2024

In the context of the Staff Report for the 2023 Article IV Consultation, the following documents have been released and are included in this package:

- A **Press Release.**
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on a lapse of time basis, following discussions that ended on November 16, 2023 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 December 19, 2023.
- An **Informational Annex** prepared by the IMF staff.

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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PRESS RELEASE

PR24/41

IMF Executive Board Concludes 2023 Article IV Consultation with the Republic of Azerbaijan

FOR IMMEDIATE RELEASE

Washington, DC – February 6, 2024: On January 11, 2024, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with the Republic of Azerbaijan and endorsed the staff appraisal without a meeting on a lapse of time basis[2].

Following the strong rebound from the pandemic, growth moderated in 2023, and inflation eased. Real GDP increased by 4.6 percent in 2022, driven by a 9 percent increase in non-hydrocarbon GDP, with recovery in the construction and transportation sectors. Hydrocarbon GDP shrank by 2.7 percent, with oil production facing technical challenges only partially offset by rising gas production. Growth has been moderating in 2023, reflecting a deceleration of non-hydrocarbon growth to about 3 percent and declining hydrocarbon production. After increasing sharply to 14.3 percent (yoy) in December 2022, inflation declined to 3.9 percent in October 2023, driven by a broad-based decline in food, nonfood, and services prices.

High oil and gas prices sustained a strong external and fiscal position. The current account balance improved to a surplus of 29.8 percent of GDP in 2022 (from 15.1 percent in 2021) and remained strong in the first half of 2023 (10.1 percent of GDP). Combined Central Bank of Azerbaijan (CBA) and Sovereign Oil Fund of Azerbaijan (SOFAZ) reserves reached about $55.5 billion by October 2023. The overall budget surplus increased to over 6 percent of GDP in 2022, from 4 percent in 2021, while the nonoil primary balance also improved by about 1 ½ percent of nonoil GDP. During January-October 2023, overall budget surplus remained broadly similar as in the same period of 2022.

Growth and inflation are projected to moderate in the medium term. With the post-pandemic surge waning and continued structural decline in oil production, growth is projected to decelerate to around 2.4 percent in 2023 and to 2.3 percent in the medium term, and the output gap is expected to close in 2024. Inflation is projected at 4.4 percent by end-2023, and to remain within the CBA target band in the medium term. Supported by elevated oil prices,

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. Staff hold separate annual discussions with the regional institutions responsible for common policies for the countries in four currency unions – the Euro-Area, the Eastern Caribbean Currency Union, the Central African Economic and Monetary Union, and the West African Economic and Monetary Union. For each of the currency unions, staff teams visit the regional institutions responsible for common policies in the currency union, collect economic and financial information, and discuss with officials the currency union's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis of discussion by the IMF Executive Board. Both staff's discussions with the regional institutions and the Board discussion of the annual staff report subsequently are considered an integral part of the Article IV consultation with each member.

[2] The Executive Board takes decisions under its lapse-of-time procedure when the Board agrees that a proposal can be considered without convening formal discussions.

the external position is projected to remain strong with trade surpluses and continued foreign reserves accumulation.

Risks to the outlook remain broadly balanced, but external uncertainty is high. An intensification of the war in Ukraine and the conflict in Israel and Gaza could result in high hydrocarbon prices and demand, boosting exports and fiscal revenues. However, it could also lead to higher food prices, presenting downside risks for food security and inflation. A global slowdown could negatively impact Azerbaijan's terms of trade and, along with weakness of trading partner economies and deeper geoeconomic fragmentation, weigh on the outlook. Domestic risks to the baseline projection arise from pro-cyclical fiscal policy, fiscal risks from state-owned enterprises (SOEs), and extreme climate events that would affect agricultural production, food security, and inflation. On the upside, a peace agreement with Armenia could potentially increase trade in the region.

Executive Board Assessment

In concluding the AIV consultation with Azerbaijan, Executive Directors endorsed the staff's appraisal as follows:

Growth is moderating, following the post-pandemic surge in 2022, and inflation has eased. In the first 10 months of 2023, oil production declined, while non-hydrocarbon growth moderated. Hydrocarbon output is projected to continue contracting gradually as the expected structural decline in oil production will be only partially offset by rising gas production. The external position in 2022 is assessed as stronger than implied by fundamentals and desirable policies. After peaking in late 2022, inflation has recently returned to the target band of 4 ± 2 percent. However, inflation risks remain, both from potential external shocks and from continued strong domestic demand. Risks to the outlook remain broadly balanced but high, reflecting highly uncertain external developments.

Fiscal policy should remain prudent in the near term. Although the authorities are expected to continue meeting the non-oil primary balance target of -25 percent of non-oil GDP this year, owing to the overperformance in 2022, the projected increase in the deficit is unwarranted based on cyclical considerations, as the output gap is still positive. Inflation has also just returned to the target band and inflationary pressures remain. Saving any revenue overperformance or expenditure shortfall would help to reduce the risk to inflation and sustain gains from the last two years of consolidation.

The authorities' continued commitment to medium-term fiscal consolidation is welcome. Continued fiscal adjustment of at least 1.5 percent of non-oil GDP in the medium term is needed to reduce the gap with the permanent-income-hypothesis benchmark of 12.5 percent of non-oil GDP. This adjustment will require both continued spending prudence, as well as measures to boost non-hydrocarbon revenues. The authorities are also encouraged to clarify the conditions for revising the fiscal targets and correction mechanisms to further strengthen the credibility of the fiscal rule.

The monetary policy stance is appropriate, and caution is advised before further easing monetary policy. With inflation returning to the target band, the central bank cut policy rates in November 2023, after tightening by 275 points from mid-2021 to May 2023 and increasing reserve requirements. However, inflation risks from external and domestic factors remain. Therefore, tightening fiscal stance, decelerating income and wage growth, and the absence of adverse food price shocks are needed before considering further easing.

The CBA should continue to strengthen the monetary transmission mechanism. The launch of the new operational framework and following efforts to mop up liquidity are welcome and have led to improvements in the transmission from the policy rate to the interbank rate. Further effort to strengthen transmission to bank lending rates are needed, which, along with improved forecasting and communication, would help pave the way in the medium- to long-run to greater exchange rate flexibility and a hybrid inflation targeting regime.

The banking sector is resilient and should play a bigger role in the economy. Financial soundness indicators continue to show a strong banking sector, though they do not fully capture risks. Staff recommends that continued comprehensive assessments of credit quality are needed, given restructured loans remain elevated, as well as moving to risk-based supervision and consolidated supervision of large banks. The authorities' ongoing assessment of the financial sector role in the economy is welcome and should be followed by enhanced efforts to deepen financial markets.

Diversification will entail reforms to strengthen governance, limit the role of the SOEs, and de-carbonize the economy. Progress on increasing fiscal transparency and judicial independence, as well as ongoing efforts to increase private sector participation in SOEs and improve their financial position, will help improve the business environment, increase private investment, and enhance productivity. Implementation of MONEYVAL's recommendations is crucial. The authorities' efforts to achieve their climate commitments are welcome and would benefit from taking stock of the associated fiscal burden, as well as reducing it through complementary policies, such as phasing out fossil fuel subsidies.

Azerbaijan: Selected Economic and Financial Indicators, 2020–28

	2020	2021	2022	2023	2024	Projections 2025	2026	2027	2028
	(Annual percentage change, unless otherwise specified)								
National income									
GDP at constant prices	-4.2	5.6	4.6	2.4	2.3	2.3	2.3	2.3	2.3
Of which: Oil sector 1/	-6.3	2.0	-2.7	-1.5	-0.5	-0.5	-0.5	-0.5	-0.5
Non-oil sector	-2.9	7.1	9.1	4.2	3.6	3.5	3.5	3.5	3.5
Consumer price index (period average)	2.8	6.7	13.9	9.4	4.7	5.0	4.5	4.0	4.0
Consumer price index (end of period)	2.6	12.0	14.4	4.4	5.0	5.0	4.0	4.0	4.0
Money and credit									
Domestic credit, net	-2.4	20.0	25.3	17.2	9.6	8.8	7.5	7.2	6.5
Of which: Credit to private sector	-0.7	16.7	17.4	17.4	12.0	10.0	8.0	8.0	8.0
Manat base money	11.6	32.2	-2.8	9.0	9.0	9.0	9.0	9.0	9.0
Manat broad money	11.3	17.6	23.8	8.3	10.0	9.0	7.8	8.5	8.5
Total broad money	1.1	18.7	23.6	6.8	8.5	7.5	6.3	7.0	7.0
External sector									
Exports f.o.b.	-36.6	72.3	94.6	-39.3	6.9	-7.8	-5.6	-1.7	-5.4
Of which: Oil sector	-40.0	77.0	105.1	-42.3	7.0	-9.5	-7.1	-2.6	-7.1
Imports f.o.b.	-11.1	3.4	29.7	7.2	2.5	1.0	0.3	0.3	0.3
Of which: Oil sector	-0.3	-13.4	56.3	18.9	-3.9	2.8	2.2	2.0	2.7
Real effective exchange rate	4.4	1.6	11.0	…	…	…	…	…	…
	(In percent of GDP, unless otherwise specified)								
Gross investment	23.7	17.1	12.7	21.8	21.6	21.9	21.8	22.0	23.3
Consolidated government	11.5	9.3	8.0	10.2	9.1	8.5	7.8	7.3	7.2
Private sector	12.1	7.8	4.7	11.5	12.5	13.4	14.0	14.7	16.1
Of which: Oil sector	0.1	-3.9	-6.3	-4.4	-2.9	-2.5	-2.2	-1.9	-1.7
Gross national savings	24.5	32.8	42.1	34.1	34.9	32.4	30.3	29.7	29.2
Consolidated general government finances 2/									
Total revenue and grants	33.7	36.4	32.2	33.5	31.8	29.7	29.1	28.5	27.5
Total expenditure 3/	40.1	32.3	25.9	31.5	31.4	31.1	30.6	30.0	29.8
Current expenditure 3/	28.6	23.0	18.2	21.3	22.3	22.6	22.7	22.7	22.6
Net acquisition of non-financial assets	11.5	9.3	7.7	10.2	9.1	8.5	7.8	7.3	7.2
Overall fiscal balance 3/	-6.4	4.1	6.3	2.0	0.4	-1.4	-1.5	-1.5	-2.2
Non-oil primary balance, in percent of non-oil GDP	-30.6	-23.9	-22.4	-24.4	-22.5	-20.6	-18.0	-16.4	-15.3
General government debt 4/	21.3	26.3	17.3	18.3	18.0	18.6	18.9	19.3	20.8
General government and government-guaranteed debt	54.0	41.6	26.9	25.9	24.3	24.7	24.9	25.1	26.4
External sector									
Current account (- deficit)	-0.5	15.1	29.8	12.4	13.4	10.5	8.5	7.7	5.9
Foreign direct investment (net)	-1.8	-4.1	-6.5	-4.2	-2.8	-2.5	-2.2	-2.0	-1.7
Memorandum items:									
Gross official international reserves (in millions of U.S. dollars)	6,369	7,075	8,996	11,281	11,481	11,681	11,881	12,081	12,281
in months of next year's non-oil imports f.o.b.	5.8	4.7	7.0	8.5	8.6	8.8	8.9	9.0	8.9
Nominal GDP (in millions of manat)	72,578	93,203	133,826	130,617	135,534	140,720	146,474	152,568	159,409
Nominal non-oil GDP (in millions of manat)	51,132	57,432	69,826	79,583	86,323	93,838	101,493	109,247	117,548
Nominal GDP (in millions of U.S. dollars)	42,693	54,825	78,721	76,833	79,726	82,776	86,161	89,746	93,770
Oil Fund Assets (in millions of U.S. dollars)	43,564	45,025	49,034	51,120	52,819	53,205	53,425	53,744	54,424
Assumed oil price, WEO plus $2-$3 premium (in U.S. dollars per barrel)	44.8	71.2	98.4	82.5	81.9	78.0	74.7	71.9	69.5
Assumed natural gas price, WEO plus a premium (in U.S. dollars per thousands of cubic meters)	173.5	368.1	740.0	384.8	393.1	291.7	362.6	322.6	319.0
Exchange rate (manat/dollar, end of period)	1.7	1.7	1.7	…	…	…	…	…	…

Sources: National 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 the impact of an extraordinary SOFAZ transfer ($1.4 bn to the CBA in 2017) and expenditures for the NPL program in 2019 (AzN 650 mil).

4/ Starting in 2021, includes guarantees issued to Aqrakredit for its acquisition of distressed assets from the IBA.

INTERNATIONAL MONETARY FUND

REPUBLIC OF AZERBAIJAN

STAFF REPORT FOR THE 2023 ARTICLE IV CONSULTATION

December 19, 2023

KEY ISSUES

Context. Growth is moderating following a strong post-pandemic rebound, and inflation is easing. The near-term challenge is to resume fiscal consolidation following a temporary easing, and to ensure that inflation—which has recently returned to the target band—does not reignite amid external risks and domestic pressures. In the medium to long term, Azerbaijan's biggest challenge is to reduce dependence on the hydrocarbon sector and advance private sector-led economic diversification.

Policy Recommendations

- Pursue fiscal adjustment. Following the fiscal easing in 2023, fiscal consolidation should resume. Fiscal adjustment would be appropriate from a cyclical perspective, supporting the CBA's efforts to keep inflation within the target band; to ensure long-term fiscal sustainability and intragenerational equity, in view of the projected decline in hydrocarbon revenues; and to maintain fiscal space to use in case fiscal risks—including those related to climate change—materialize.

- Ensure that the recent disinflation is sustained before further monetary easing. Inflation has been declining rapidly and the CBA has recently reduced interest rates. However, caution is needed before further monetary easing. External factors that have been the main driving force of falling inflation could be quickly reversed, and domestic demand pressures remain strong on the back of expansionary fiscal policy and robust wage and income growth. Strengthening the monetary transmission mechanism to advance the transition to hybrid inflation targeting should continue.

- Strengthen financial supervision. Financial soundness indicators point to a sound banking sector, but vigilance is needed. The CBA should move to a risk-based supervision, supervise larger banks on a consolidated basis, and continue to conduct stress tests and thematic inspections to assess banks' asset quality. Additionally, the banking sector needs to play a more pivotal role in financing the economy.

- Diversify the economy. Hydrocarbon production will decline in the medium term. The private sector will have to play a more important role, which will require, among other reforms, addressing the still-large SOE sector and improving governance. Developing the renewable energy sector also contributes to diversification, while meeting Azerbaijan's climate commitments.

Approved By
Zeine Zeidane (MCD) and Fabian Valencia (SPR)

Discussions with the authorities were held in Baku during November 1–16, 2023. The staff team comprised of Anna Bordon (head), Jiri Jonas, and Gustavo Ramirez (all MCD), Safari Kasiyanto (MCM), with support from Carlos Segura (MCD). Marcel Peter and Rashad Hasanov (OED) participated in the discussions. Branden Laumann provided excellent production assistance. The mission met with Finance Minister Sharifov, Central Bank of Azerbaijan Chairman Kazimov, Minister of Labor and Social Protection S. Babayev, Minister of Ecology M. Babayev, Minister of Economy Jabbarov, other senior officials, and representatives of the private sector, civil society, academia, and the diplomatic community. Branden Laumann and Maria Gaetskaya provided excellent production assistance.

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ANNEXES

CONTEXT: NEW CHALLENGES

1. **Following the strong rebound from the pandemic, growth moderated in 2023, and inflation eased**. Growth remained robust in 2022 driven by the rapid expansion of the nonhydrocarbon sector on the back of high oil prices and the post-pandemic rebound, but moderated in 2023, owing to declining hydrocarbon production. Inflation that peaked in September 2022 started falling in March 2023 and entered the target band in September 2023.

2. **Regional conflicts and uneven global growth continue to loom large on the economy**. While Azerbaijan benefited from high oil and gas prices, the ongoing war in Ukraine and conflict in Israel and Gaza continue to pose risks on the economy, including from another surge in food prices. A slowdown in some major economies could also lead to fluctuations in oil and gas prices and affect exports and budget revenues, as well as economic activity. Meanwhile, the outcome of ongoing peace talks with Armenia remain uncertain. In the long term, the main challenges remain fiscal consolidation and diversification of the economy.

Azerbaijan: Implementation of IMF Recommendations

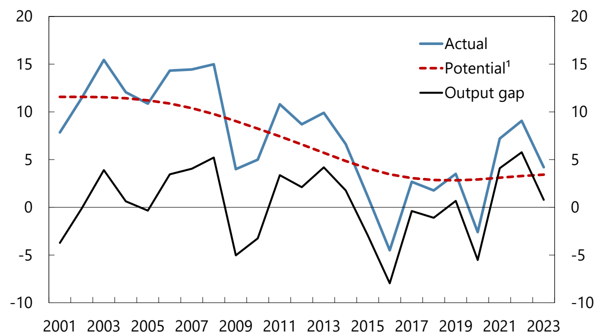
2022 Article IV Recommendations	Policy Actions Taken
Fiscal Policy	
Some of the 2022 fiscal space resulting from high oil and gas prices could be used to mitigate the impact of high food prices on the most vulnerable.	The large windfall from high oil prices was managed prudently. The authorities extended subsidies to some inputs in the agriculture sector and provided cash transfers to vulnerable households.
Fiscal consolidation in the order of at 1.5 percent of non-oil GDP per year would ensure medium- and long-term fiscal sustainability.	Fiscal policy implementation in 2022 was broadly in line with the target, with non-oil primary deficit declining by 1.4 percent of non-oil GDP.
Medium-term fiscal adjustment should remain in line with the revised fiscal rule.	The authorities envisage a back-loaded medium-term adjustment. The 2023 budget envisages fiscal expansion because of increased capital expenditure on the reconstruction of the Karabakh region.
Monetary and Exchange Rate Policy	
Further monetary tightening would be needed to reduce the risk that inflation and inflation expectations become more entrenched and difficult to reverse.	CBA continued gradually increasing its policy rates. Additionally, reserve requirements have been increased to help mop up excess liquidity in the banking sector.
Work should continue to develop domestic markets to improve monetary policy transmission.	The authorities have introduced changes to its monetary operation framework to improve liquidity management and monetary transmission.
Financial Sector Policy	
Uncollateralized business loans and restructured loans, as well as rapid consumer lending growth, pose a risks and should be monitored.	The authorities have implemented regulatory measures, including increased risk weight to consumer loans, to mitigate the risks from rapid consumer lending.
CBA should move to a risk-based supervisory framework and supervise large banks on a consolidated basis. Stress tests and thematic inspections must continue to assess banks' asset quality.	Authorities want to address banks' limited modelling capacity and data constraints before moving to IFRS9 reporting system, to enhance banking supervision and regulation.
Structural Policy	
Address impediments to private sector growth and job creation, developing a greener and more competitive economy.	Azerbaijan 2030: National Priorities for Socio-Economic Development approved in February 2021 identified development on non-oil sector and more sustainable business environment as one of the priorities.
A successful SOE reform is needed to promote a private-sector led growth and reduce fiscal risks.	The authorities have requested TA on SOE reform and continue to coordinate and monitor SOE activity through the Azerbaijan Investment Holding.

3. Policy implementation was broadly in line with past Fund advice. In 2022, the authorities saved the large oil revenue windfall, launched a revised fiscal rule, and phased out the exceptional support to the financial sector. The 2023 budget envisages an expansionary fiscal policy, largely to finance the reconstruction of the Karabakh region. Fiscal consolidation is expected to resume next year. Monetary policy was tightened as recommended, and steps towards monetary policy framework modernization were introduced. Efforts to improve SOE performance continue.

RECENT DEVELOPMENTS

4. Following the strong rebound from the pandemic, growth moderated in the first 10 months of 2023. Real GDP increased by 4.6 percent in 2022, driven by a 9.1 percent increase in non-hydrocarbon GDP, with recovery in the construction and transportation sectors. Hydrocarbon GDP shrank by 2.7 percent, with oil production facing technical challenges only partially offset by rising gas production. Non-hydrocarbon growth appears to be decelerating back to trend in the first 10 months of the year (3.1 percent, YTD). The estimated output gap remains positive.

Nonoil GDP and Output Gap
(In percent)



[1] HP Filter.
Sources: Azerbaijan authorities and IMF staff estimates.

5. Inflation has eased significantly. After increasing sharply to 14.4 percent (yoy) in December 2022, inflation declined to 3.9 percent in October, driven by a broad-based decline in food, nonfood, and services prices. Core inflation declined from 14 percent in December 2022 to 3.8 percent (yoy) in October. Inflation has now moved to within the CBA target range of 4±2 percent.

6. High oil and gas prices sustained a strong external position. The current account balance improved to a surplus of 29.8 percent of GDP in 2022 (from 15.1 percent in 2021) and remains strong in the first half of 2023 (14.5 percent of GDP). Sustained FX earnings continued to support the de facto peg, with limited demand for FX in official auctions since 2020. Combined CBA and SOFAZ reserves reached 45 months of next year's imports at end-2022, and about $55.5 billion by October 2023. The external position in 2022 is assessed as stronger than implied by fundamentals and desirable policies (Annex I).

7. Fiscal consolidation continued in 2022. On the back of higher hydrocarbon revenues, the overall budget surplus increased to over 6 percent of GDP, from 4 percent in 2021. The nonoil primary balance also recorded an improvement of about 1 ½ percent of nonoil GDP, supported by a 20 percent increase in nonoil revenues (reflecting strong VAT and personal income tax revenue growth) and somewhat lower (16 percent) spending increase. SOFAZ oil revenues rose by a moderate 5.5 percent, as the impact of higher average oil price was partly offset by lower oil production. With strong nominal GDP growth, public and publicly guaranteed debt declined sharply to 27 percent of GDP by end-2022, from 42 percent in 2021. During January-October 2023, overall budget surplus remained broadly similar as in the same period of 2022, with higher SOFAZ revenues offsetting higher expenditure.

Azerbaijan: Fiscal Developments in 2023

	January-October (mil manat)		% change
	2022	2023	
General government revenue	**36,487**	**40,613**	**11.3**
General government revenue ex. SOFAZ	22,754	23,435	3.0
State budget revenue	27,029	26,413	-2.3
SOFAZ revenue	13,733	15,496	12.8
General government expenditure	**25,610**	**29,704**	**16.0**
Overall balance	**10,877**	**10,909**	**0.3**
Overall balance excluding SOFAZ revenue	(2,856)	(4,587)	60.6

Source: Ministry of Finance

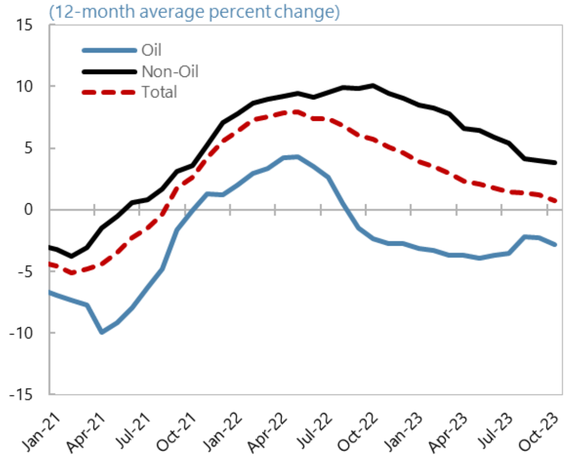
8. **Following the gradual tightening of the monetary stance, the Central Bank of Azerbaijan (CBA) recently cut interest rates**. Between mid-2021 and May 2023, the CBA increased the interest rate by 275 points to 9 percent. With inflation declining and the policy rate positive in real terms, the CBA paused at its July and September meetings, and reduced the rate by 50 points in November to 8.5 percent. The CBA has also significantly increased reserve requirements to mop up excess liquidity from the banking sector. Between August 2022 and August 2023, it raised and differentiated in several steps required reserves in national currency from 0.5 percent to 5 percent (10 percent for banks with deposits of legal entities exceeding AZN 1 billion), and in foreign currency from 1 percent to 6 percent (12 percent for banks with deposits of legal entities exceeding AZN 750 million). The CBA introduced in September 2022 a new monetary policy operational framework to improve monetary policy transmission.

9. **The banking sector remains resilient, but pockets of vulnerabilities remain**. Capital buffers are adequate, with capital adequacy ratios at 18.5 percent in September 2023. Credit continues to expand, particularly to households, albeit at a slower pace due to tighter regulatory measures. Nonperforming loans are at a historic low of 3.5 percent. Profitability has also risen, reaching a 2.4 percent return on assets and a 20.8 percent return on equities. De-dollarization trends continue in deposits and loans, accompanied by declining net open FX positions. However, the proportion of restructured loans remains elevated, albeit declining, and non-performing loan classification still lacks adequate qualitative criteria.

Figure 1. Azerbaijan: Recent Developments

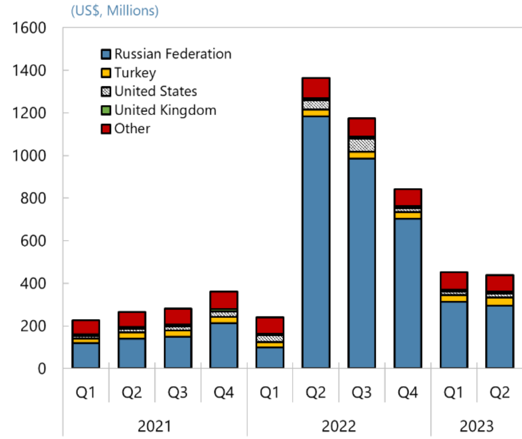
Non-oil sector growth is moderating, while oil production declined…

Real GDP Growth
(12-month average percent change)



…and remittance inflows are also starting to normalize.

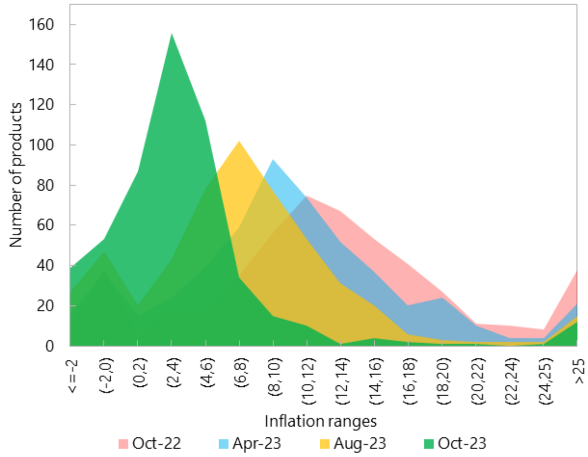
Gross Remittances from the Rest of the World
(US$, Millions)



Sources: Azerbaijan Central Bank.

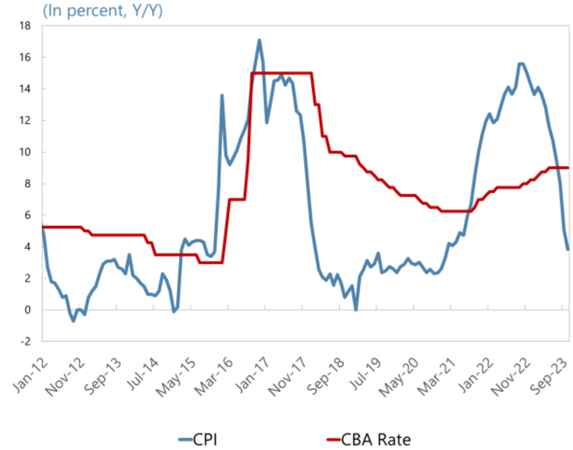
Inflation has retracted from the 2022 peak…

Distribution of Inflation at the 8 digit product level
(In percent, Y/Y)



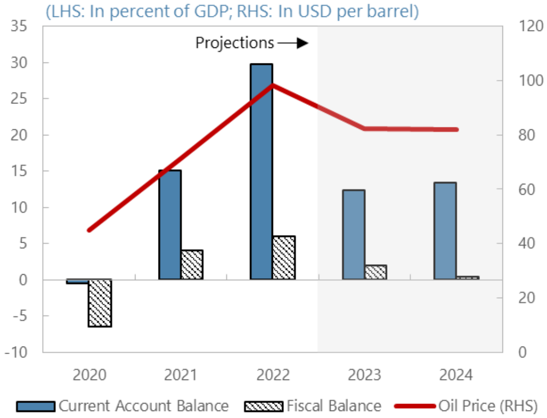
…with the CBA keeping a tight monetary policy.

CBA Rate and CPI Inflation, 2012-2023
(In percent, Y/Y)



Favorable oil prices have strengthened current account and fiscal balances.

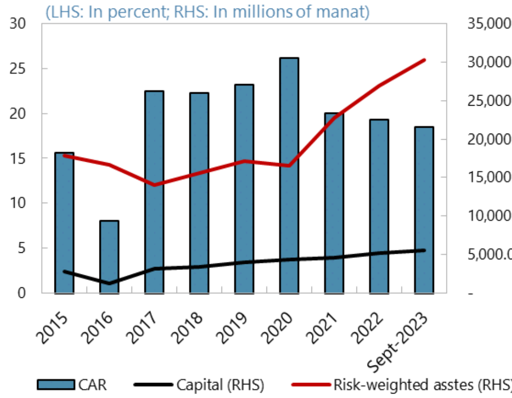
Oil Price, Fiscal and Current Account Balances
(LHS: In percent of GDP; RHS: In USD per barrel)



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

The capital adequacy ratio remains high.

Capital Adequacy Ratio[1/]
(LHS: In percent; RHS: In millions of manat)



Sources: National authorities, and IMF staff calculations and estimates.
1/ The Capital Adequacy Ratio represents the median among all 26 Azerbaijani banks.

OUTLOOK AND RISKS

10. Growth and inflation are projected to moderate in 2023. Growth is projected to decelerate to around 2.4 percent in 2023 and 2.3 percent in the medium term, with the waning of the post-pandemic surge and structural decline in oil production, and the output gap is expected to close in 2024. Supported by elevated oil prices, the external position is expected to remain strong with trade surpluses and continued reserves accumulation. Inflation is projected at 4.4 percent by end-2023 (9.4 percent average for the year) and to remain within the CBA target band in the medium term.

11. Risks to the outlook remain broadly balanced, but external uncertainty is high. An intensification of the war in Ukraine and the conflict in Israel and Gaza, through high hydrocarbon prices and demand, presents upside risks, boosting exports and fiscal revenues, as well as, through high food prices, downside risks for food security and inflation. Commodity price volatility also presents similar upside and downside risks. A global slowdown will negatively impact Azerbaijan's terms of trade and, along with weakness of trading partner economies, weigh on the outlook. Deeper geoeconomic fragmentation could increase input prices and disrupt payment systems, while also potentially diverting trade flows to Azerbaijan. Domestic risks arise from pro-cyclical fiscal policies, fiscal risks from SOEs, and extreme climate events that would affect agricultural production, food security, and inflation. On the upside, a peace agreement with Armenia could potentially increase trade in the region, while absence of it can pose downside risks to growth and investment.

12. The authorities broadly agreed with staff's view on the outlook and the balance of risks. They noted that the war in Ukraine and sanctions on Russia could have both negative and positive long-term impact on the economy. The authorities pointed to increasing interest from foreign investors and rising activity in the trade route between Asia and Europe as trade flows are diverted from Russia. They believe the impact of a global slowdown on the domestic economy will be weak and delayed, as Azerbaijan is not well integrated. On the downside, they noted the potential adverse impact on economic activity from climate change.

POLICY DISCUSSIONS

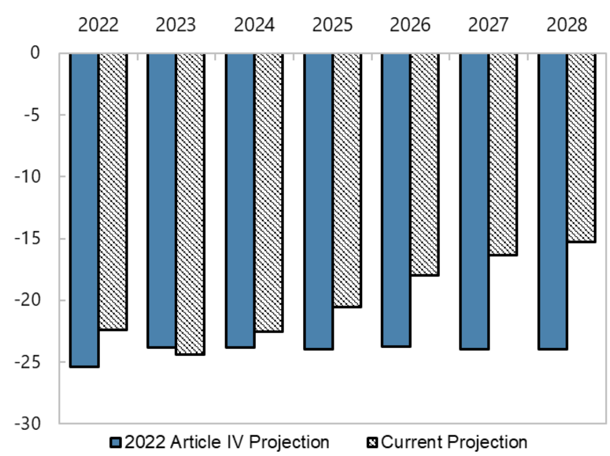
Policy discussions focused on: (i) fiscal policy in the near and medium term, including the fiscal rule and measures to maintain fiscal sustainability and intragenerational equity given the projected oil revenue decline; (ii) the monetary policy response to declining inflation and modernization of the monetary policy framework; (iii) the soundness of the banking sector and its role in financing the economy; and (iv) measures to promote diversification, particularly reforms to SOEs, governance and anti-corruption, and climate change mitigation.

A. Fiscal Policy: Staying the Course on Fiscal Consolidation

13. Following two years of fiscal consolidation, the non-oil primary deficit is projected to increase in 2023. The authorities have made significant strides to reduce the non-oil fiscal deficit in recent years, including a large overperformance relative to target in 2022, which contributed to reining in inflation. This overperformance also gave the authorities fiscal space—which is assessed to be substantial —to accommodate high-priority capital spending in 2023. As a result, the nonoil primary deficit is projected to increase from 22.4 percent of nonoil GDP in 2022 to around 24.4 percent of nonoil GDP in 2023 (somewhat below the authorities' 25 percent of nonoil GDP target), and the overall budget surplus is projected to shrink from 6.3 percent of GDP in 2022 to 2 percent of GDP in 2023 (partly reflecting the lower-than-previously projected oil price). The projected increase in the nonoil primary deficit will create a fiscal impulse, which along with elevated—though declining—wage and income growth, would help sustain strong domestic demand and pose a risk to inflation, which has just returned to the target band. To reduce this risk, staff recommended maintaining prudent budget execution and saving any expenditure shortfall or revenue overperformance.

14. Staff welcomes the authorities' continued commitment to medium-term fiscal consolidation. For 2024, staff projects a reduction of the nonoil primary deficit by about 2 percent of nonoil GDP, reflecting mainly moderate expenditure growth in line with the 2024 budget.[1] The baseline medium-term projection shows a further deficit decline, assuming: (i) continued moderate growth in current spending and a gradual decline in capital spending in line with the authorities' medium-term expenditure plan; (ii) expiration of the private nonoil sector PIT exemption by 2026; and (iii) no further erosion of the tax base as a result of new tax holidays and exemptions. Based on these assumptions, the nonoil primary deficit is projected to decline significantly to around 15 percent of nonoil GDP by 2028, while the public debt-to-GDP ratio increases moderately by about 3 percent of GDP to around 21 percent. Compared to the 2022 Article IV projection, the faster reduction of non-oil primary deficit reflects mainly slower projected expenditure growth. The overall risk of sovereign debt stress is assessed to be low (Annex III). Fiscal space is assessed to be substantial, reflecting relatively low government debt and gross financing needs, as well as high and mostly liquid sovereign fund assets.

Non-Oil Primary Balance
(percent of Non-Oil GDP)



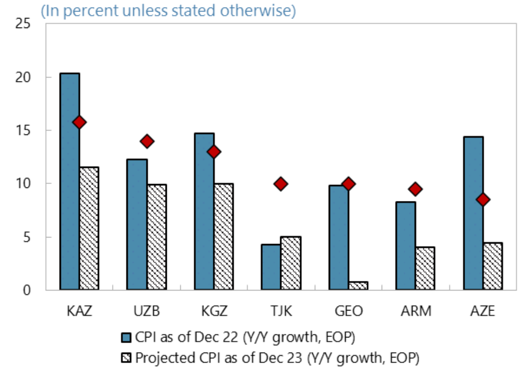
[1] The 2024 budget submitted to Parliament envisages unchanged nonoil primary balance but is based on conservative nonoil revenue projections.

15. The planned fiscal consolidation is necessary to prepare for the projected decline in hydrocarbon production and revenues. Continued annual reduction of the non-oil primary deficit by at least 1.5 percent of non-oil GDP over the medium term remains appropriate to reduce the gap with the permanent income hypothesis (PIH) benchmark estimate of 12.5 percent of GDP, necessary to ensure intragenerational equity and maintain fiscal space to respond to future fiscal risks, including those related to climate change. The authorities' plans are consistent with this objective. However, while continued spending discipline is necessary, boosting nonoil revenues would need to play an increasing role. Staff encourages them to maintain spending prudence, including continued moderation in the growth of the wage bill, rationalization of subsidies, and gradual increase in domestic energy prices. However, in the longer term, spending discipline alone will not be sufficient to offset the loss of hydrocarbon revenues, as continued reliance on spending compression, could begin to adversely impact the quality of public services. Therefore, measures to boost non-hydrocarbon revenues, which together with reduction in less productive expenditures should both support fiscal sustainability and provide fiscal space to finance priority spending needs. Staff encourages the authorities to continue their effort to improve tax administration, broaden the tax base, and explore new sources of budgetary revenues. Staff also encourages the authorities to consider further improvements in the design of the fiscal rule, including by reassessing the triggers to changes to the fiscal targets, as well as by further clarifying the operation of correction mechanisms, and to continue efforts to modernize the budget framework.

16. The authorities agreed that medium-term fiscal consolidation is needed but did not consider the 2023 fiscal policy a source of potential inflationary pressures. They noted that the widening of the nonoil primary deficit in 2023 reflected mainly the overperformance in 2022, when the nonoil primary balance strengthened more than targeted. They argued that fiscal policy does not contribute to higher inflation which reflects mainly external factors. The authorities recognized that hydrocarbon production and budget revenues will be declining and that alternative sources of revenues, in combination with spending constraint, will be needed to ensure fiscal sustainability. They noted that the nonoil revenue base is not wide enough and will need to be broadened. Regarding the fiscal rule, the authorities argued that the amended Budget System Law already incorporates conditions for adjusting the fiscal targets, and the correction mechanism is in place. The authorities explained that the medium-term budgetary framework specifies fiscal risks, including from climate change, and measures to mitigate them.

B. Monetary Policy: Reining in Inflation and Enhancing Monetary Policy Framework

Caucasus and Central Asia: Monetary Policy Rates and CPI
(In percent unless stated otherwise)



Sources: Haver analytics, and IMF staff estimates and projections.
Note: CPI projections for 2023 are as of December 1st, 2023.

17. With actual and projected inflation declining rapidly, the CBA cut the policy rate by 50 basis points in November. This partly reverses the 275 points tightening during mid-2021 and May 2023. The CBA saw the recent decline in inflation as reflecting mainly falling imported inflation: decline in food prices and international transportation costs and the appreciation of the nominal effective exchange rate.

18. With inflation falling rapidly, the monetary stance is appropriate and staff counsels caution before reducing rates further. With both current and projected inflation declining rapidly, the CBA's refinancing rate remains positive in real terms even following the recent cut.[2] In addition, growth is moderating, and the estimated positive output gap is closing. However, staff recommends caution before continuing to reduce interest rates. External factors that have been the main driving force of falling inflation could be quickly reversed, fiscal policy is budgeted to be expansionary in 2023, and strong (though decelerating) wage and income growth continues to support domestic demand. If disinflation continues, the 2023 fiscal stance turns out to be tighter than budgeted, wage growth continues to decelerate, and adverse food price shocks do not materialize, then further reducing the CBA rates could be considered.

19. The authorities have made progress in modernizing the monetary policy framework, but further work is needed to strengthen the monetary transmission. The authorities continue to *de facto* peg the currency to the US dollar and view the transition to a more flexible arrangement and hybrid inflation targeting a medium-term undertaking.[3] In 2022, in line with TA recommendations, the CBA introduced a new monetary policy operational framework (Annex IV). It launched new standing facilities for liquidity provision and sterilization, expanded the range of open market operations, and took steps to develop the infrastructure for the interbank market. The new framework has already helped to improve the transmission of the policy rate to the interbank rate. The interbank market has become more active, and in September 2023, interbank one-week repo interest rate has moved for the first time inside the interest rate corridor. However, the transmission to bank lending rates has yet to improve. The authorities should continue efforts to modernize monetary policy, including by strengthening the CBA's analytical and forecasting capacity and enhancing communication.

20. The authorities agreed that caution is required before proceeding with further monetary policy easing. They agreed that while inflation has declined faster than projected, both external and domestic uncertainties related to the inflation outlook remain. Geopolitical tensions, emergence of new conflicts, as well as climate change could push food and energy prices up. Domestic demand pressures pose the main domestic inflation risk. The authorities explained that they will consider further gradual monetary easing only if the above-mentioned external and domestic inflation risks do not materialize and if inflation projections show inflation staying close to the middle of the target range. They noted that the changes in the monetary policy operational framework introduced in 2022 work well and intend to continue improving monetary transmission and working toward a phased transition to a hybrid inflation targeting regime.

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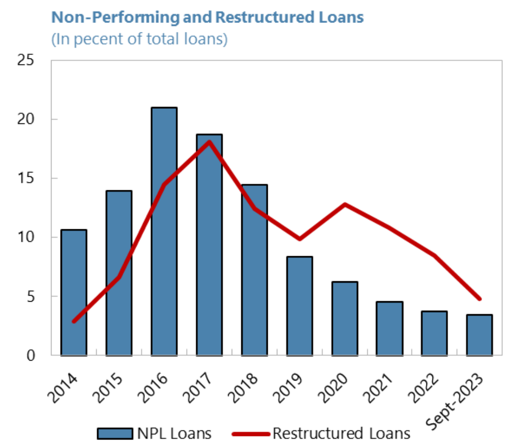
[2] In addition, Chapter 2 of the MCD Regional Economic Outlook estimated a long-run neutral real rate of 2 ¼ percent, which is below the real policy rate of about 3.5 percent using end-2024 projected inflation. Uncertainty around these estimates is large.

[3] Despite the *de facto* peg to the US dollar, the low level of financial integration, due to less developed domestic financial markets, has allowed Azerbaijan to pursue relatively independent monetary policy.

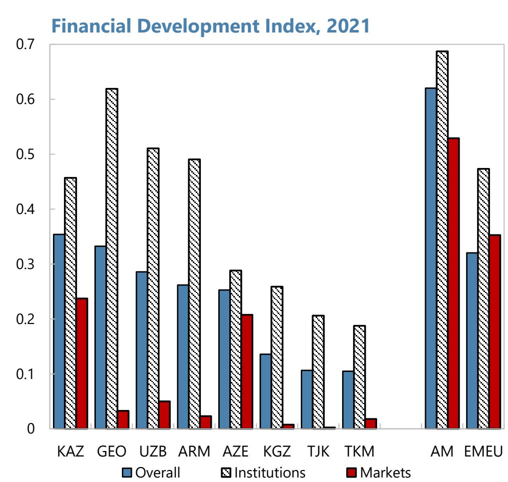
C. Financial Sector Policy: Monitoring Risks and a Bigger Role for the Sector

21. Banking sector financial soundness indicators are strong, but do not fully capture risks. NPL figures are low, but do not fully reflect the level of restructured loans. Despite an 18 percent decrease by September 2023, restructured loans remain elevated at 1.1 billion manat or 4.7 percent of the loan portfolio. There is also a difference in loan-loss provisions between the official (prudential-based) figures and that under IFRS 9, with some banks showing lower provisions under official regulations. Staff recommends continuing to conduct comprehensive assessments of credit quality, including by conducting stress tests and thematic inspections, and faster progress in NPL resolution.



22. Staff welcomes the CBA's measures to reign in rapid consumer lending growth, and recommends continued efforts to enhance supervision. The CBA tightened debt-to-income (DTI) ratios and provisioning requirements for riskier consumer loans in 2022, which has increased loan-loss provisions for such loans and slowed consumer lending growth. Staff welcomes plans to transition to risk-based and consolidated supervision, and recommends accelerating this transition.

23. The financial sector should assume a more pivotal role in supporting economic growth and diversification. Despite recent progress in the banking sector, the financial sector plays a limited role in supporting the economy compared to peer economies. It remains dominated by a few conglomerates, and financial inclusion is low. In recent years, interest rate spreads have risen, owing to increasing operating costs and profit margins (Annex V). However, deepening the financial markets will be a gradual process of developing and strengthening institutions, market infrastructure, and regulatory frameworks. In this context, staff looks forward to the comprehensive assessment of the financial sector role in the economy that is being conducted by the authorities, including identifying and targeting areas of cost inefficiencies in the banking sector, such as the high level of operating cost, and supports the development of digital financial services such as open banking and fintech to foster competition and expand financial inclusion, especially for SMEs.



24. The authorities asserted the fundamental health of the banking sector and saw that it does not pose any risks to financial stability. The CBA deemed the level of restructured loans as manageable, noting that the level has declined without increasing NPLs. Furthermore, the CBA agreed with the need for comprehensive credit quality assessments, noting the discrepancies in loan-loss provisions under prudential and IFRS 9 standards. The CBA also closely tracks consumer credit and other credit segments and commits to enhanced supervision, preparing a transition plan to risk-based and consolidated supervisions. Acknowledging the need for deeper financial sector development, the authorities are preparing a comprehensive assessment of the financial sector's role, with the results expected by December 2023.

D. Structural Reforms: Diversify and De-Carbonize

25. Azerbaijan's long-term challenge remains to diversify the economy. The development plan, Azerbaijan 2030, establishes a roadmap to reduce dependency on hydrocarbons and to promote a more sustainable and diversified economy. The plan recognizes that for the private sector to be an engine of growth and employment, it is necessary to improve the business environment, including by increasing transparency and combating corruption; enhance the efficiency of state-owned enterprises and increase competition; and introduce renewable energy sources. As part of the effort to promote FDI, boost high value export, and diversify the economy, the authorities have set up the Alat Free Economic Zone (Box 1). While the AFEZ could help promote these objectives, the incentives to investors need to be properly structured so as not to undermine the objective of boosting nonoil tax revenues. Therefore, it is important that tax and other incentives are targeted and time bound.

26. Countering corruption and promoting good governance are crucial to attracting private investment. To this end, the authorities have simplified licensing procedures, improved fiscal transparency, enhanced public service delivery through one-stop shop centers, and approved a National Anti-Corruption Action Plan that envisaged conflict of interest legislation and electronic submission of asset disclosure declarations by 2024. Further progress was achieved, with legal amendments increasing the independence of the Judicial Legal Council, the forthcoming implementation of the recently approved public procurement law, and issuance of AML/CFT laws that strengthen the detection and prevention of legalization of property from criminal and terrorist activities.[4] However, more effort to follow up on the recommendations on governance and anti-corruption at the time of the 2022 AIV consultation is needed, such as in: (i) upgrading and effectively enforcing the anti-corruption legal and institutional framework; (ii) improving the asset disclosure system; (iii) further increasing beneficial ownership transparency, particularly in the extractive industry; and (iv) strengthening the property rights framework.

[4] Azerbaijan is undergoing an AML/CFT assessment by MONEYVAL, with the report expected to be adopted in December 2023 and published in 2024.

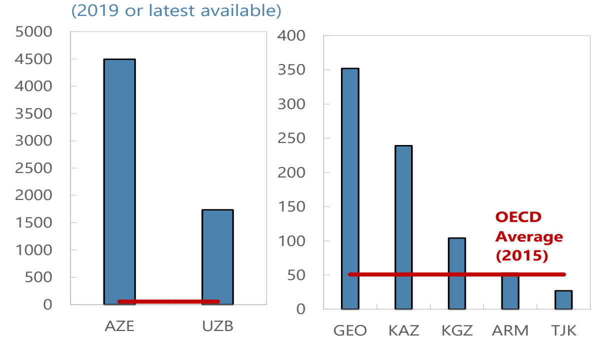
Box 1. Azerbaijan: Alat Free Economic Zone (AFEZ)

The AFEZ is aimed at promoting diversification in the economy. The 850-hectare zone, launched in June 2022, provides an investor-centric environment for high-value-added and export-oriented manufacturing and internationally traded services. The business-friendly environment is anchored around a legal framework that takes precedence over national laws (except for criminal and AML.CFT laws) to enhance the ease of doing business; strategic location next to the Baku International Port, railways, highways, and planned air cargo facilities; and on-site one-stop-shop business center for appraisal, licensing, permitting. From the existing infrastructure covering about 60 hectares of land, there are plans to expand the zone to offer air cargo, warehousing, as well as residential and financial services. Eligible businesses should export at least 75 percent of its production.

AFEZ offers several incentives. Industries established in the AFEZ are exempt from VAT, withholding or any other corporate taxes, and customs duties. Employees are also exempt from income tax (up to a monthly salary of about $4,700). There are no restrictions on foreign ownership. The AFEZ also offers full protection of intellectual property rights and has an independent regulatory body and dispute resolution procedures. There is also no requirement for a local partner, although the zone authority aims at establishing ties between investors and local companies and creating industrial training facilities to further boost the zone's employment impact.

27. The large footprint of SOEs in the economy should also be addressed. The authorities have taken steps toward monitoring large SOEs, with the development of a centralized data system and the establishment of key performance indicators. This year, the government also announced plans to attract private sector participation in eight SOEs. Still, SOE presence remains large, and more progress is needed to increase efficiency and reduce state participation. Staff continues to recommend separating commercial from noncommercial activities in SOEs, with the latter to be financed from the budget; increasing transparency of SOE performance; and facilitating further private sector involvement. Staff looks forward to the results of the OECD-WB assessment of SOE corporate governance.

Number of Non-Financial SOEs
(2019 or latest available)



Sources: Ramirez Rigo and others 2021; Richmond and others 2019; and IMF staff calculations.
Note: Uzbekistan reporting non-financial companies with at least 90 percent direct or indirect state ownership (central government).

28. The diversification strategy dovetails with commitments to tackling climate change. With a commitment to reduce greenhouse gas (GHG) emissions by 35 percent from 1990 levels by 2030, the authorities have been improving the legislative and institutional environment to promote the renewable sector and initiating renewable energy projects with multilateral and bilateral groups, and the private sector. Still, the cost of implementing all the projects in time to meet these commitments will be significant. Policies to reduce greenhouse gas emissions as well as the potential fiscal burden, such as gradually withdrawing fossil fuel direct and indirect subsidies and enhancing energy efficiency regulations, should be considered. This will not only help Azerbaijan reach its climate commitments, but also promote the renewable energy sector as a future driver of economic growth and employment, while remaining fiscally prudent.

29. The authorities concurred with staff on the need to pursue structural reforms to enhance productivity and promote sustainable growth. The authorities agreed with staff on improving the business climate, including through governance and anti-corruption reforms, and highlighted efforts to enhance labor market productivity and increase economic complexity, including through the recently opened Alat Free Economic Zone. They noted that the financial performance of large SOEs have already improved significantly. On climate issues, the authorities highlighted their mitigation plan that targets the largest sources of GHG emissions, including gas emissions, flaring, and leakages in the transportation of gas. They noted that there are few explicit fossil fuel subsidies but acknowledged that there is a need to re-evaluate the pricing of some utilities that remain below market. The authorities acknowledged that the transition will be costly and mentioned efforts to attract private sector resources to invest in green projects, as well as to mobilize fiscal revenues through fossil fuel excise taxes.

STAFF APPRAISAL

30. Growth is moderating, following the post-pandemic surge in 2022, and inflation has eased. In the first 10 months of 2023, oil production declined, while non-hydrocarbon growth moderated. Hydrocarbon output is projected to continue contracting gradually as the expected structural decline in oil production will be only partially offset by rising gas production. The external position in 2022 is assessed as stronger than implied by fundamentals and desirable policies. After peaking in late 2022, inflation has recently returned to the target band of 4 ± 2 percent. However, inflation risks remain, both from potential external shocks and from continued strong domestic demand. Risks to the outlook remain broadly balanced but high, reflecting highly uncertain external developments.

31. Fiscal policy should remain prudent in the near term. Although the authorities are expected to continue meeting the non-oil primary balance target of -25 percent of non-oil GDP this year, owing to the overperformance in 2022, the projected increase in the deficit is unwarranted based on cyclical considerations, as the output gap is still positive. Inflation has also just returned to the target band and inflationary pressures remain. Saving any revenue overperformance or expenditure shortfall would help to reduce the risk to inflation and sustain gains from the last two years of consolidation.

32. The authorities' continued commitment to medium-term fiscal consolidation is welcome. Continued fiscal adjustment of at least 1.5 percent of non-oil GDP in the medium term is needed to reduce the gap with the permanent-income-hypothesis benchmark of 12.5 percent of non-oil GDP. This adjustment will require both continued spending prudence, as well as measures to boost non-hydrocarbon revenues. The authorities are also encouraged to clarify the conditions for revising the fiscal targets and correction mechanisms to further strengthen the credibility of the fiscal rule.

33. The monetary policy stance is appropriate, and caution is advised before further easing monetary policy. With inflation returning to the target band, the central bank cut policy rates in November 2023, after tightening by 275 points from mid-2021 to May 2023 and increasing reserve requirements. However, inflation risks from external and domestic factors remain. Therefore, tightening fiscal stance, decelerating income and wage growth, and the absence of adverse food price shocks are needed before considering further easing.

34. The CBA should continue to strengthen the monetary transmission mechanism. The launch of the new operational framework and following efforts to mop up liquidity are welcome and have led to improvements in the transmission from the policy rate to the interbank rate. Further effort to strengthen transmission to bank lending rates are needed, which, along with improved forecasting and communication, would help pave the way in the medium- to long-run to greater exchange rate flexibility and a hybrid inflation targeting regime.

35. The banking sector is resilient and should play a bigger role in the economy. Financial soundness indicators continue to show a strong banking sector, though they do not fully capture risks. Staff recommends that continued comprehensive assessments of credit quality are needed, given restructured loans remain elevated, as well as moving to risk-based supervision and consolidated supervision of large banks. The authorities' ongoing assessment of the financial sector role in the economy is welcome and should be followed by enhanced efforts to deepen financial markets.

36. Diversification will entail reforms to strengthen governance, limit the role of the SOEs, and de-carbonize the economy. Progress on increasing fiscal transparency and judicial independence, as well as ongoing efforts to increase private sector participation in SOEs and improve their financial position, will help improve the business environment, increase private investment, and enhance productivity. Implementation of MONEYVAL's recommendations is crucial. The authorities' efforts to achieve their climate commitments are welcome and would benefit from taking stock of the associated fiscal burden, as well as reducing it through complementary policies, such as phasing out fossil fuel subsidies.

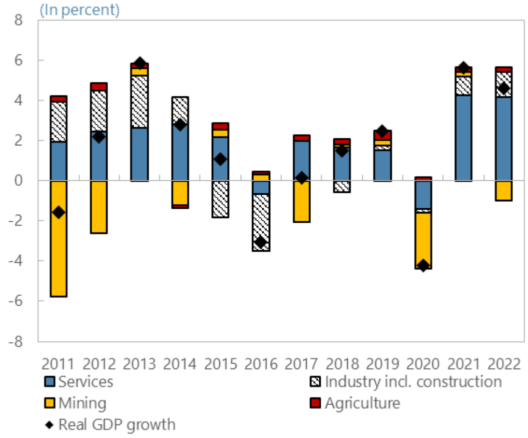
37. It is recommended that the next Article IV consultation takes place on the standard 12-month cycle.

Figure 2. Azerbaijan: Real Sector Indicators

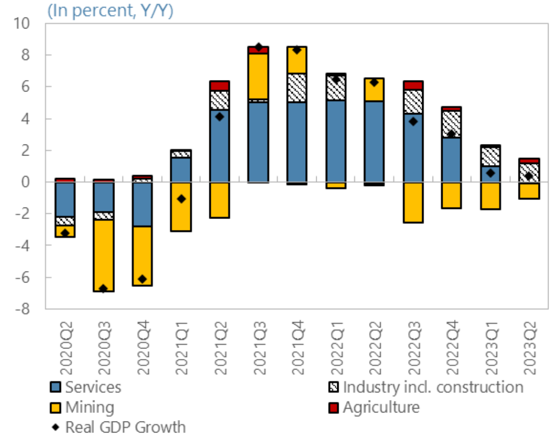
The growth momentum extended to 2022, led by contact-intensive activities and construction,...

... but some sectors started to decelerate or contract in recent months.

Contribution to Real GDP Growth, 2011-2022
(In percent)



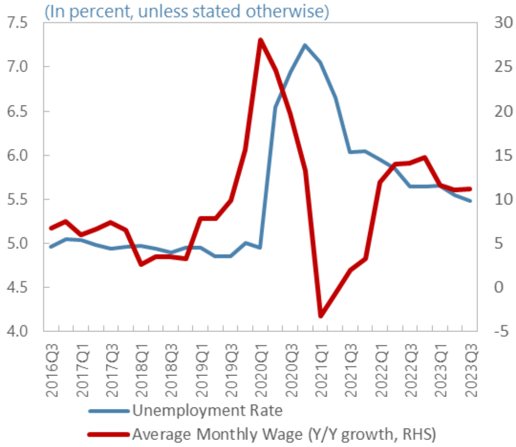
Quarterly Sectoral Contributions to Growth
(In percent, Y/Y)



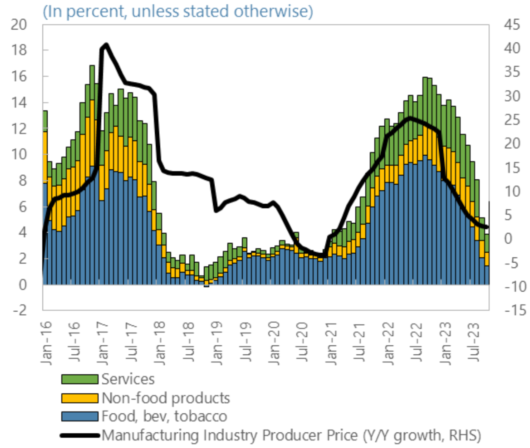
The labor market is normalizing after the pandemic.

Inflationary pressures are receding, led by the decline of food prices ...

Unemployment Rate and Wages
(In percent, unless stated otherwise)



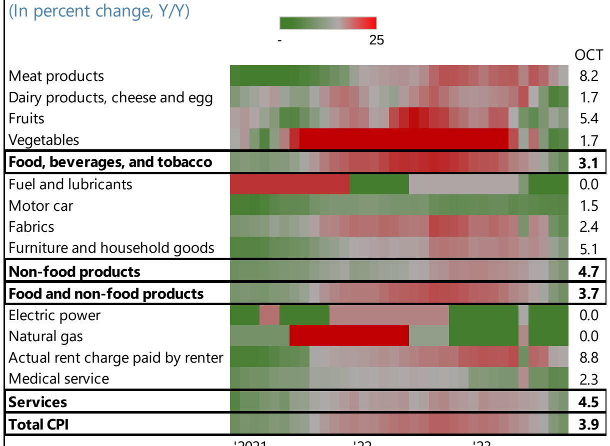
Contributions to Headline Inflation, Y/Y EOP
(In percent, unless stated otherwise)



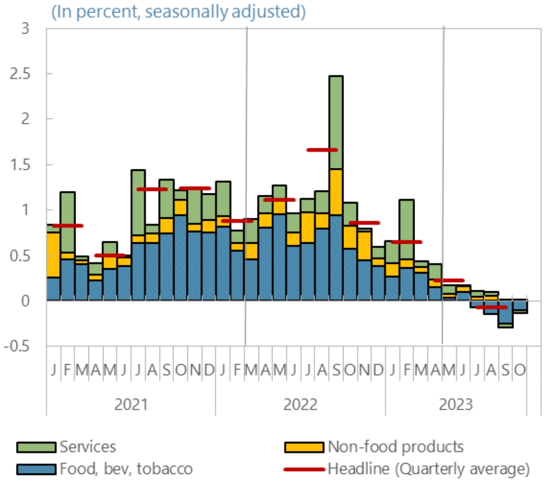
... followed by other items in the consumer basket,...

... and disinflation since the last quarter of 2022.

Consumer Price Index, EOP
(In percent change, Y/Y)



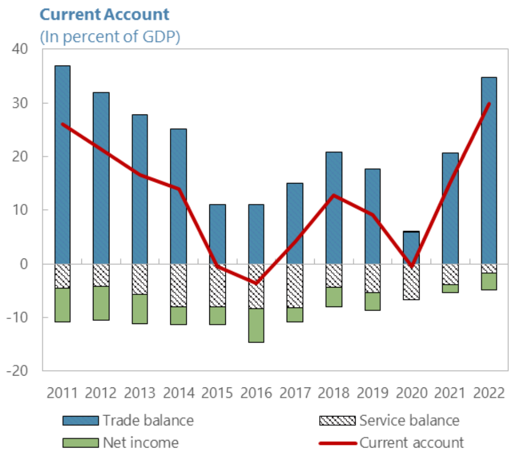
Contributions to Headline Inflation, M/M
(In percent, seasonally adjusted)



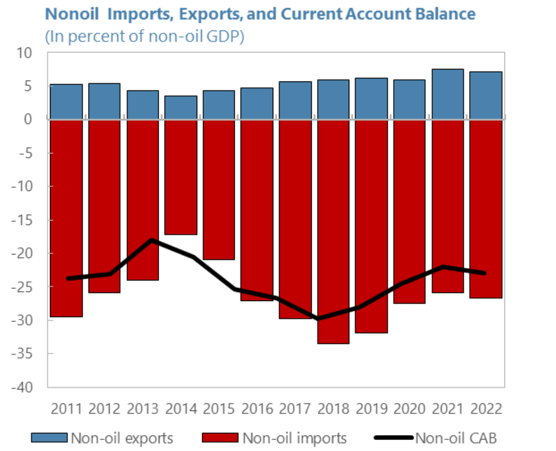
Sources: National authorities, Haver, and IMF staff calculations.

Figure 3. Azerbaijan: External Sector

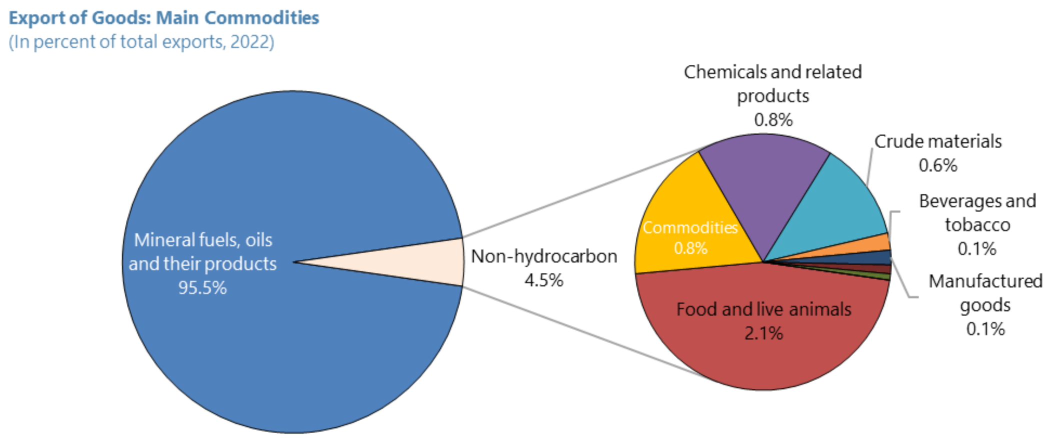
The external position improved further, as oil and gas prices rose…



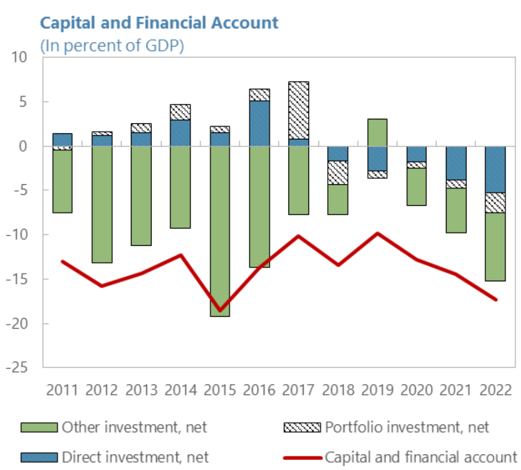
… while the nonoil components were broadly unchanged.



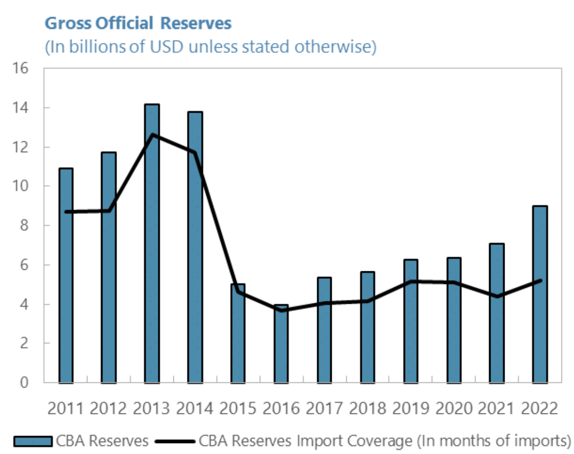
Exports are highly concentrated in hydrocarbon products.



Despite net outflows of FDI and other investment…

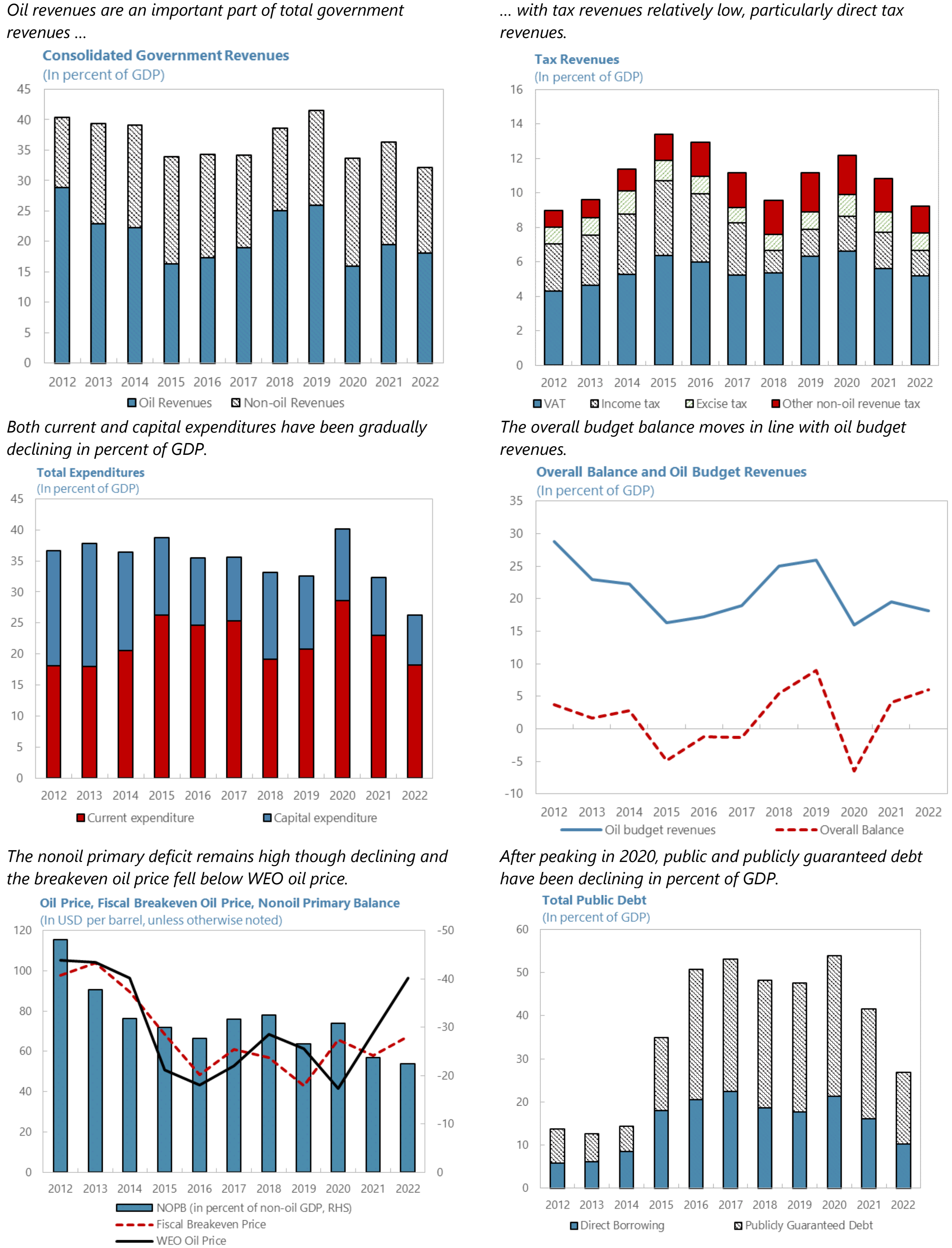


…substantial reserves were accumulated.



Sources: WITS, Haver, and IMF staff calculations.

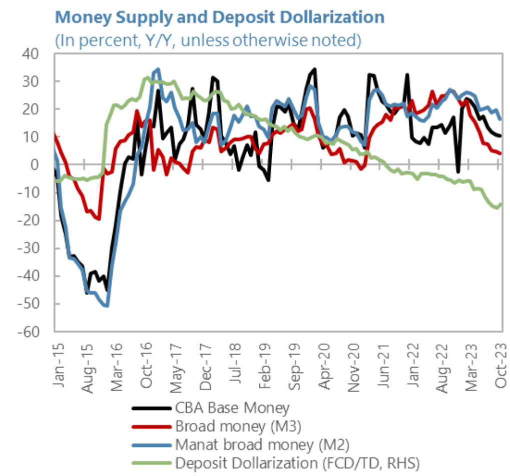
Figure 4. Azerbaijan: Fiscal Sector



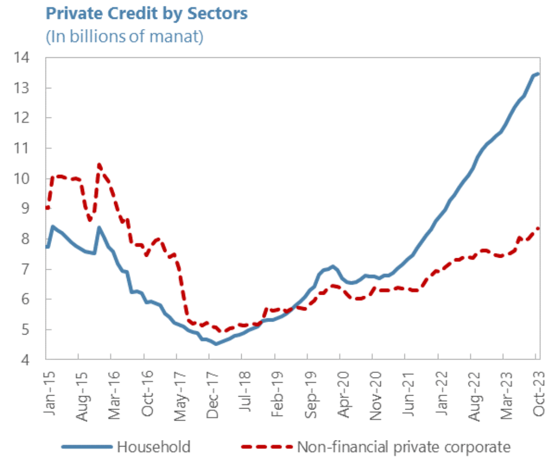
Sources: National authorities, Haver, IMF World Economic Outlook, and IMF staff calculations.

Figure 5. Azerbaijan: Monetary and Exchange Rate Developments

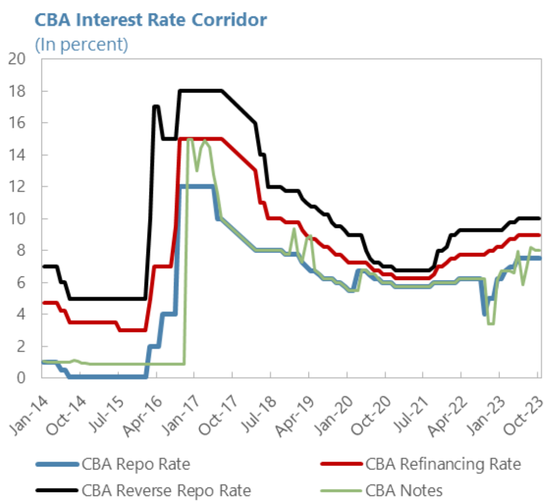
After picking up in 2022, money growth decelerated in 2023…



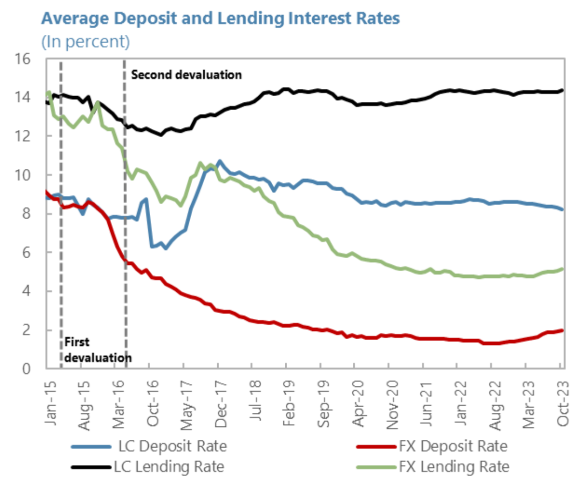
… while credit to households continues to grow rapidly.



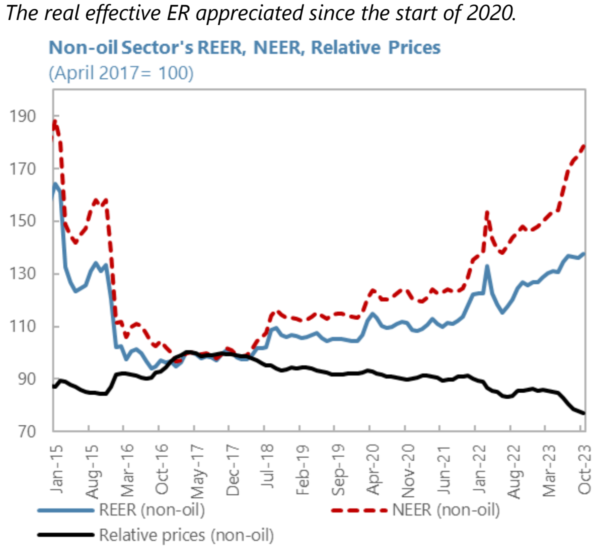
CBA continued tightening gradually in 2022 and 2023H1…



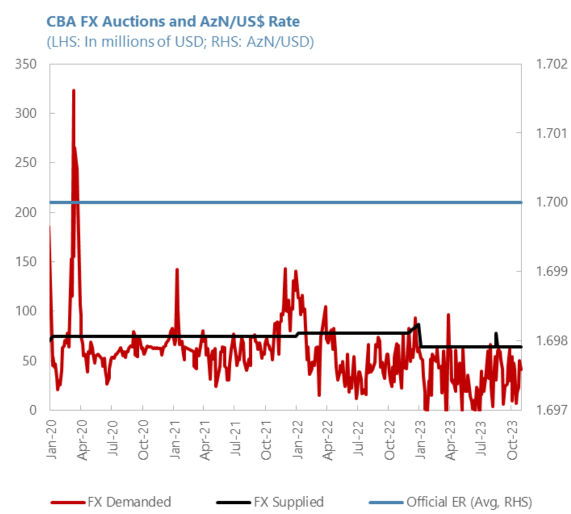
…but bank LC lending and deposit rates remain broadly stable.



The real effective ER appreciated since the start of 2020.



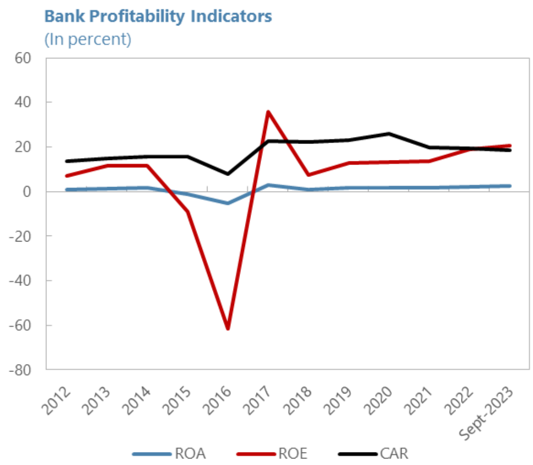
Since Q2 2021, FX demand was mostly below FX supply.



Sources: Haver, and IMF staff calculations.

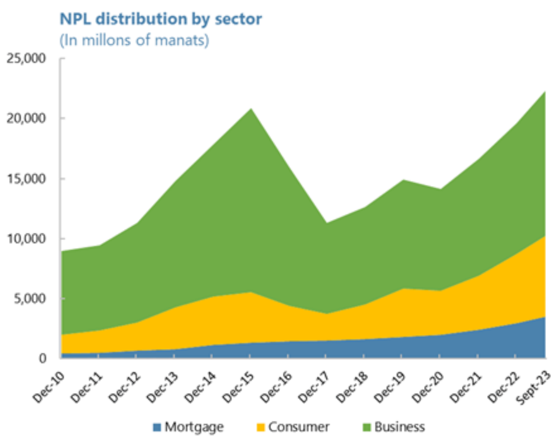
Figure 6. Azerbaijan: Banking Sector

Capital remains adequate, and profitability has risen.

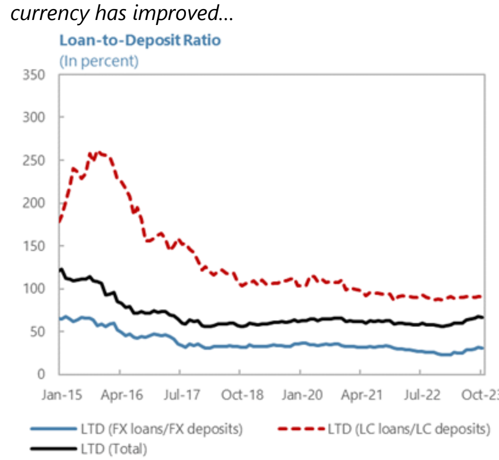


The nonperforming loans ratio has been declining…

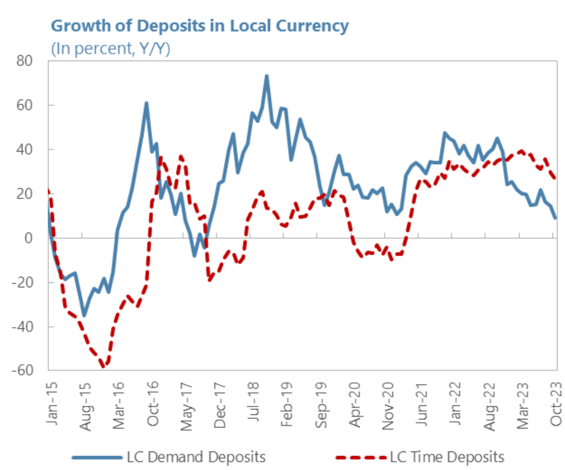
… with business loans accounting for the biggest portion.



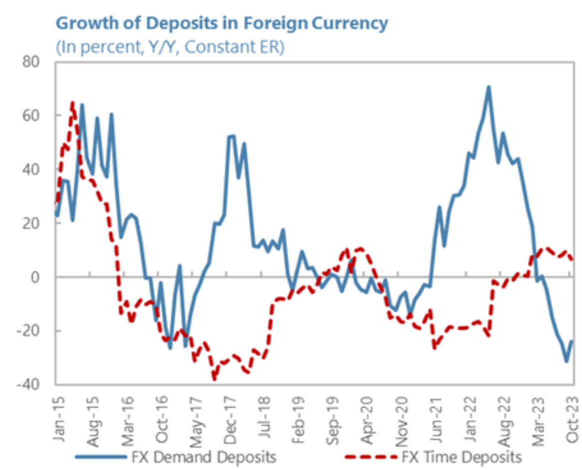
Banking sector liquidity in both local currency and foreign currency has improved…



…although the growth in local currency deposits has slowed…



…as is the case with foreign currency demand deposits.



Sources: National authorities, Haver, and IMF staff estimates.
1/ 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.

Table 1. Azerbaijan: Selected Economic and Financial Indicators, 2020-28

				Projections					
	2020	2021	2022	2023	2024	2025	2026	2027	2028
				(Annual percentage change, unless otherwise specified)					
National Income									
GDP at constant prices	-4.2	5.6	4.6	2.4	2.3	2.3	2.3	2.3	2.3
Of which: Oil sector 1/	-6.3	2.0	-2.7	-1.5	-0.5	-0.5	-0.5	-0.5	-0.5
Non-oil sector	-2.9	7.1	9.1	4.2	3.6	3.5	3.5	3.5	3.5
Consumer price index (period average)	2.8	6.7	13.9	9.4	4.7	5.0	4.5	4.0	4.0
Consumer price index (end of period)	2.6	12.0	14.4	4.4	5.0	5.0	4.0	4.0	4.0
Money and Credit									
Domestic credit, net	-2.4	20.0	25.3	17.2	9.6	8.8	7.5	7.2	6.5
Of which : Credit to private sector	-0.7	16.7	17.4	17.4	12.0	10.0	8.0	8.0	8.0
Manat base money	11.6	32.2	-2.8	9.0	9.0	9.0	9.0	9.0	9.0
Manat broad money	11.3	17.6	23.8	8.3	10.0	9.0	7.8	8.5	8.5
Total broad money	1.1	18.7	23.6	6.8	8.5	7.5	6.3	7.0	7.0
External Sector									
Exports f.o.b.	-36.6	72.3	94.6	-39.3	6.9	-7.8	-5.6	-1.7	-5.4
Of which: Oil sector	-40.0	77.0	105.1	-42.3	7.0	-9.5	-7.1	-2.6	-7.1
Imports f.o.b.	-11.1	3.4	29.7	7.2	2.5	1.0	0.3	0.3	0.3
Of which: Oil sector	-0.3	-13.4	56.3	18.9	-3.9	2.8	2.2	2.0	2.7
Real effective exchange rate	4.4	1.6	11.0	...	...	...	...	...	...
				(In percent of GDP, unless otherwise specified)					
Gross Investment	23.7	17.1	12.7	21.8	21.6	21.9	21.8	22.0	23.3
Consolidated government	11.5	9.3	8.0	10.2	9.1	8.5	7.8	7.3	7.2
Private sector	12.1	7.8	4.7	11.5	12.5	13.4	14.0	14.7	16.1
Of which: Oil sector	0.1	-3.9	-6.3	-4.4	-2.9	-2.5	-2.2	-1.9	-1.7
Gross National Savings	24.5	32.8	42.1	34.1	34.9	32.4	30.3	29.7	29.2
Consolidated General Government Finances 2/									
Total revenue and grants	33.7	36.4	32.2	33.5	31.8	29.7	29.1	28.5	27.5
Total expenditure 3/	40.1	32.3	25.9	31.5	31.4	31.1	30.6	30.0	29.8
Current expenditure 3/	28.6	23.0	18.2	21.3	22.3	22.6	22.7	22.7	22.6
Net acquisition of non-financial assets	11.5	9.3	7.7	10.2	9.1	8.5	7.8	7.3	7.2
Overall fiscal balance 3/	-6.4	4.1	6.3	2.0	0.4	-1.4	-1.5	-1.5	-2.2
Non-oil primary balance, in percent of non-oil GDP	-30.6	-23.9	-22.4	-24.4	-22.5	-20.6	-18.0	-16.4	-15.3
General government debt 4/	21.3	26.3	17.3	18.3	18.0	18.6	18.9	19.3	20.8
General government and government-guaranteed debt	54.0	41.6	26.9	25.9	24.3	24.7	24.9	25.1	26.4
External Sector									
Current account (- deficit)	-0.5	15.1	29.8	12.4	13.4	10.5	8.5	7.7	5.9
Foreign direct investment (net)	-1.8	-4.1	-6.5	-4.2	-2.8	-2.5	-2.2	-2.0	-1.7
Memorandum Items:									
Gross official international reserves (in millions of U.S. dollars)	6,369	7,075	8,996	11,281	11,481	11,681	11,881	12,081	12,281
in months of next year's non-oil imports f.o.b.	5.8	4.7	7.0	8.5	8.6	8.8	8.9	9.0	8.9
Nominal GDP (in millions of manat)	72,578	93,203	133,826	130,617	135,534	140,720	146,474	152,568	159,409
Nominal non-oil GDP (in millions of manat)	51,132	57,432	69,826	79,583	86,323	93,838	101,493	109,247	117,548
Nominal GDP (in millions of U.S. dollars)	42,693	54,825	78,721	76,833	79,726	82,776	86,161	89,746	93,770
Oil Fund Assets (in millions of U.S. dollars)	43,564	45,025	49,034	51,120	52,819	53,205	53,425	53,744	54,424
Assumed oil price, WEO plus $2-$3 premium (in U.S. dollars per barrel)	44.8	71.2	98.4	82.5	81.9	78.0	74.7	71.9	69.5
Assumed natural gas price, WEO plus a premium (in U.S. dollars per thousands of cubic meters)	173.5	368.1	740.0	384.8	393.1	291.7	362.6	322.6	319.0
Exchange rate (manat/dollar, end of period)	1.7	1.7	1.7	...	...	...	...	...	...

Sources: National 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 the impact of an extraordinary SOFAZ transfer ($1.4 bn to the CBA in 2017) and expenditures for the NPL program in 2019 (AzN 650 mil).

4/ Starting in 2021, includes guarantees issued to Aqrakredit for its acquisition of distressed assets from the IBA.

Table 2a. Azerbaijan: Balance of Payments, 2020–28

(In millions of U.S. dollars, unless otherwise specified)

						Projections			
	2020	2021	2022	2023	2024	2025	2026	2027	2028
Exports, f.o.b.	12,588	21,692	42,207	25,632	27,389	25,254	23,838	23,440	22,184
Oil and gas sector	10,817	19,145	39,267	22,640	24,235	21,942	20,384	19,852	18,437
Other	1,771	2,547	2,940	2,992	3,155	3,313	3,454	3,588	3,747
Imports, f.o.b.	-10,077	-10,419	-13,509	-14,479	-14,841	-14,989	-15,034	-15,079	-15,124
Oil and gas sector	-1,876	-1,625	-2,539	-3,019	-2,900	-2,981	-3,047	-3,106	-3,192
Others	-8,200	-8,794	-10,970	-11,459	-11,941	-12,008	-11,987	-11,973	-11,932
Trade Balance	2,512	11,274	28,697	11,153	12,548	10,265	8,804	8,361	7,060
Services, net	-2,841	-2,123	-2,698	-1,304	-1,296	-1,316	-1,315	-1,342	-1,375
Oil and gas sector	-2,417	-1,645	-1,983	-584	-542	-528	-490	-486	-482
Others	-424	-478	-715	-721	-754	-788	-824	-856	-893
Factor income, net	-456	-1,319	-5,487	-3,351	-3,645	-3,302	-3,277	-3,259	-3,268
Oil and gas	-1,438	-1,857	-6,078	-4,064	-4,351	-3,939	-3,939	-3,939	-3,939
Others	982	539	591	714	706	637	662	680	671
Transfers, net	558	459	2,965	3,011	3,050	3,076	3,099	3,121	3,144
Current Account Balance	-228	8,292	23,478	9,510	10,658	8,724	7,312	6,881	5,561
Non-oil Current Account Balance	-5,314	-5,726	-5,189	-5,463	-5,784	-5,770	-5,596	-5,440	-5,263
Capital account, net	-7	-4	--	--	--	--	--	--	--
Direct investment, net	-770	-2,242	-5,099	-3,261	-2,227	-2,084	-1,938	-1,788	-1,629
Oil and gas	-486	-2,940	-6,127	-4,639	-3,651	-3,562	-3,474	-3,385	-3,296
Others	-284	698	1,028	1,378	1,424	1,478	1,536	1,597	1,667
Portfolio investment, net	-282	-519	-1,793	-84	-144	-223	-223	-223	-223
Other investment, net	-1,801	-2,749	-6,045	-2,578	-6,838	-6,282	-5,183	-4,804	-3,284
Oil and gas	-270	-111	-5,052	-617	-642	-935	-1,106	-1,248	-1,387
Others	-1,531	-2,638	-994	-1,961	-6,197	-5,347	-4,077	-3,556	-1,897
Oil bonus	452	457	452	450	450	451	452	453	454
Financial derviatives	0	0	0	0	0	0	0	0	0
Financial Account, Net	-2,401	-5,052	-12,485	-5,473	-8,759	-8,139	-6,892	-6,361	-4,682
Capital and Financial Account Balance	-2,408	-5,057	-12,485	-5,473	-8,759	-8,139	-6,892	-6,361	-4,682
Errors & Omissions	648.0	-153.6	-1617.8	0.0	0.0	0.0	0.0	0.0	0.0
Overall Balance	-1,988	3,081	9,375	4,036	1,899	585	420	520	880
Financing	1,848	-3,235	-10,358	-4,036	-1,899	-585	-420	-520	-880
Change in net foreign assets of CBA (increase -)	-111	-706	-1,921	-2,285	-200	-200	-200	-200	-200
Change in Oil Fund assets (increase -)	-241	-1,461	-4,009	-1,751	-1,699	-385	-220	-320	-680
Change in other government FX assets (increase -)	2200	-1068	-4429	0	0	0	0	0	0
Memorandum Items:									
Current account balance (in percent of GDP)	-0.5	15.1	29.8	12.4	13.4	10.5	8.5	7.7	5.9
Gross official international reserves	6,369	7,075	8,996	11,281	11,481	11,681	11,881	12,081	12,281
in months of next year's non-oil imports f.o.b.	5.8	4.7	7.0	8.5	8.6	8.8	8.9	9.0	8.9
Oil Fund assets	43,564	45,025	49,034	51,120	52,819	53,205	53,425	53,744	54,424
Total external debt (in percent of GDP)	21.6	15.1	9.7	9.8	8.8	8.8	8.9	9.0	9.1
Oil price (US$ per barrel)	44.8	71.2	98.4	82.5	81.9	78.0	74.7	71.9	69.5
Exchange rate (average, AZN/$)	1.7	1.7	1.7	...	...	...	...	...	...
Nominal GDP (in millions of U.S. dollars)	42,693	54,825	78,721	76,833	79,726	82,776	86,161	89,746	93,770

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

Table 2b. Azerbaijan: Balance of Payments, 2020–28

(In percent of GDP, unless otherwise specified)

	2020	2021	2022	2023	2024	2025	2026	2027	2028
				Projections					
Exports, f.o.b.	29.5	39.6	53.6	33.4	34.4	30.5	27.7	26.1	23.7
Oil and gas sector	25.3	34.9	49.9	29.5	30.4	26.5	23.7	22.1	19.7
Other	4.1	4.6	3.7	3.9	4.0	4.0	4.0	4.0	4.0
Imports, f.o.b.	-23.6	-19.0	-17.2	-18.8	-18.6	-18.1	-17.4	-16.8	-16.1
Oil and gas sector	-4.4	-3.0	-3.2	-3.9	-3.6	-3.6	-3.5	-3.5	-3.4
Others	-19.2	-16.0	-13.9	-14.9	-15.0	-14.5	-13.9	-13.3	-12.7
Trade Balance	5.9	20.6	36.5	14.5	15.7	12.4	10.2	9.3	7.5
Services, net	-6.7	-3.9	-3.4	-1.7	-1.6	-1.6	-1.5	-1.5	-1.5
Oil and gas sector	-5.7	-3.0	-2.5	-0.8	-0.7	-0.6	-0.6	-0.5	-0.5
Others	-1.0	-0.9	-0.9	-0.9	-0.9	-1.0	-1.0	-1.0	-1.0
Factor income, net	-1.1	-2.4	-7.0	-4.4	-4.6	-4.0	-3.8	-3.6	-3.5
Oil and gas	-3.4	-3.4	-7.7	-5.3	-5.5	-4.8	-4.6	-4.4	-4.2
Others	2.3	1.0	0.8	0.9	0.9	0.8	0.8	0.8	0.7
Transfers, net	1.3	0.8	3.8	3.9	3.8	3.7	3.6	3.5	3.4
Current Account Balance	-0.5	15.1	29.8	12.4	13.4	10.5	8.5	7.7	5.9
Non-oil Current Account Balance	-12.4	-10.4	-6.6	-7.1	-7.3	-7.0	-6.5	-6.1	-5.6
Capital Account, Net	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Direct investment, net	-1.8	-4.1	-6.5	-4.2	-2.8	-2.5	-2.2	-2.0	-1.7
Oil and gas	-1.1	-5.4	-7.8	-6.0	-4.6	-4.3	-4.0	-3.8	-3.5
Others	-0.7	1.3	1.3	1.8	1.8	1.8	1.8	1.8	1.8
Portfolio investment, net	-0.7	-0.9	-2.3	-0.1	-0.2	-0.3	-0.3	-0.2	-0.2
Other investment	-4.2	-5.0	-7.7	-3.4	-8.6	-7.6	-6.0	-5.4	-3.5
Oil and gas	-0.6	-0.2	-6.4	-0.8	-0.8	-1.1	-1.3	-1.4	-1.5
Others	-3.6	-4.8	-1.3	-2.6	-7.8	-6.5	-4.7	-4.0	-2.0
Oil bonus	1.1	0.8	0.6	0.6	0.6	0.5	0.5	0.5	0.5
Financial derviatives	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financial Account, Net	-5.6	-9.2	-15.9	-7.1	-11.0	-9.8	-8.0	-7.1	-5.0
Capital and Financial Account Balance	-5.6	-9.2	-15.9	-7.1	-11.0	-9.8	-8.0	-7.1	-5.0
Errors & Omissions	1.5	-0.3	-2.1	0.0	0.0	0.0	0.0	0.0	0.0
Overall Balance	-4.7	5.6	11.9	5.3	2.4	0.7	0.5	0.6	0.9
Financing	4.3	-5.9	-13.2	-5.3	-2.4	-0.7	-0.5	-0.6	-0.9
Change in net foreign assets of CBA (increase -)	-0.3	-1.3	-2.4	-3.0	-0.3	-0.2	-0.2	-0.2	-0.2
Change in Oil Fund assets (increase -)	-0.6	-2.7	-5.1	-2.3	-2.1	-0.5	-0.3	-0.4	-0.7
Change in other government FX assets (increase -)	5.2	-1.9	-5.6	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum Items:									
Current account balance	-0.5	15.1	29.8	12.4	13.4	10.5	8.5	7.7	5.9
Gross official international reserves	14.9	12.9	11.4	14.7	14.4	14.1	13.8	13.5	13.1
in months of next year's non-oil imports f.o.b.	5.8	4.7	7.0	8.5	8.6	8.8	8.9	9.0	8.9
Oil Fund assets	102.0	82.1	62.3	66.5	66.3	64.3	62.0	59.9	58.0
Oil price (US$ per barrel)	44.8	71.2	98.4	82.5	81.9	78.0	74.7	71.9	69.5
Exchange rate (average, AZN/$)	1.7	1.7	1.7	…	…	…	…	…	…
Nominal GDP (in Millions of US$)	42,693	54,825	78,721	76,833	79,726	82,776	86,161	89,746	93,770

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

Table 3a. Azerbaijan: Statement of Consolidated Government Operations, 2020–28

(In millions of manat)

				Projections					
	2020	2021	2022	2023	2024	2025	2026	2027	2028
Revenue									
Total revenue	24,467	33,906	43,062	43,751	43,112	41,759	42,649	43,513	43,891
Tax revenue	13,786	16,735	24,741	27,535	25,832	25,667	27,338	28,384	29,455
Income taxes	3,503	4,152	9,362	10,097	7,390	6,327	7,140	7,305	7,434
Individual income tax	1,151	1,195	1,462	1,666	1,807	1,965	2,925	3,148	3,388
Enterprise profits tax	2,352	2,957	7,900	8,431	5,583	4,362	4,215	4,157	4,047
Value added tax (VAT)	4,818	5,214	6,963	7,555	8,016	8,360	8,676	9,000	9,337
Excise taxes	898	1,106	1,359	1,533	1,655	1,784	1,914	2,046	2,187
Taxes on international trade	1,561	2,626	2,020	2,763	2,934	3,094	3,214	3,337	3,465
Other taxes	641	600	677	831	902	980	1,060	1,141	1,228
Social security contributions	2,365	3,037	4,360	4,755	4,935	5,123	5,333	5,555	5,804
Nontax revenue	10,661	17,151	18,302	16,196	17,260	16,072	15,292	15,108	14,414
Of which : Oil Fund revenues	9,361	15,986	16,867	14,792	15,750	14,445	13,545	13,240	12,416
Grants	20	20	20	20	20	20	20	20	20
Expenditure									
Total Expenditure	29,139	30,088	34,661	41,123	42,516	43,727	44,775	45,774	47,432
Current Expense	20,771	21,453	24,406	27,759	30,235	31,820	33,289	34,564	35,957
Compensation of employees	6,197	6,050	7,465	8,500	8,920	9,296	9,655	9,992	10,352
Use of goods and services	6,027	7,257	6,730	7,877	8,744	9,205	9,656	10,094	10,561
Social benefits	5,644	6,001	8,113	8,954	9,893	10,404	10,953	11,326	11,650
Of which : Social protection fund	1,180	1,762	1,930	1,999	2,168	2,357	2,550	2,744	2,953
Subsidies	2,272	1,485	1,401	1,756	1,907	2,015	2,031	2,054	2,088
Grants	20	20	20	20	20	20	20	20	20
Interest	605	628	632	594	691	816	910	1,010	1,221
Other expense 1/	5	13	45	58	60	62	64	66	66
Net Acquisition of Nonfinancial Assets	8,368	8,635	10,255	13,364	12,281	11,907	11,486	11,210	11,475
Overall Balance 1/	-4,673	3,818	8,401	2,628	596	-1,968	-2,126	-2,261	-3,541
Overall balance excluding one off items 2/	-4,673	3,818	8,401	2,628	596	-1,968	-2,126	-2,261	-3,541
Non-oil primary balance 3/	-15,622	-13,727	-15,646	-19,431	-19,428	-19,286	-18,250	-17,866	-17,944
Net Financial Transactions	-4,673	3,818	7,989	2,628	596	-1,968	-2,126	-2,262	-3,543
Net Acquisition of Financial Assets	-3,961	4,603	8,513	3,904	2,623	356	36	157	712
Oil Fund	-3,065	4,603	8,878	2,977	2,889	655	374	543	1,155
Privatization and other sale of assets	-61	0	-115	-138	-166	-199	-238	-286	-343
Banking System 4/	-843	0	-250	-300	-100	-100	-100	-100	-100
Others	8	0	0	1,366	0	0	0	0	0
Net Incurrence of Liabilities	712	1,059	489	1,276	2,027	2,324	2,162	2,419	4,255
Domestic debt issuance	750	600	200	200	400	500	650	435	448
Of which: Domestic banking sector	1,135	373	1,870	200	200	400	500	300	0
External Loans	952	347	253	300	500	878	1,000	1,200	1,200
Other	-990	112	36	776	1,127	947	512	784	2,607
Memorandum Items:									
Oil revenue	11,554	18,172	24,267	22,653	20,715	18,135	17,033	16,614	15,621
Non-oil revenue	12,912	15,734	18,796	21,098	22,397	23,625	25,616	26,897	28,267
Non-oil tax revenue 5/	9,227	11,512	12,981	14,918	15,932	16,854	18,516	19,454	20,446
Non-oil GDP (in million of manats)	51,132	57,432	69,826	79,583	86,323	93,838	101,493	109,247	117,548

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

1/ Includes the extraordinary SOFAZ transfer ($1.4 billion) to the CBA in 2017

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/ Tax revenue excluding AIOC and SOCAR profit tax.

Table 3b. Azerbaijan: Statement of Consolidated Government Operations, 2020–28

(In percent of non-oil GDP)

				Projections					
	2020	2021	2022	2023	2024	2025	2026	2027	2028
Revenue									
Total revenue	47.9	59.0	61.7	55.0	49.9	44.5	42.0	39.8	37.3
Tax revenue	27.0	29.1	35.4	34.6	29.9	27.4	26.9	26.0	25.1
Income taxes	6.9	7.2	13.4	12.7	8.6	6.7	7.0	6.7	6.3
Individual income tax	2.3	2.1	2.1	2.1	2.1	2.1	2.9	2.9	2.9
Enterprise profits tax	4.6	5.1	11.3	10.6	6.5	4.6	4.2	3.8	3.4
Value added tax (VAT)	9.4	9.1	10.0	9.5	9.3	8.9	8.5	8.2	7.9
Excise taxes	1.8	1.9	1.9	1.9	1.9	1.9	1.9	1.9	1.9
Taxes on international trade	3.1	4.6	2.9	3.5	3.4	3.3	3.2	3.1	2.9
Other taxes	1.3	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Social security contributions	4.6	5.3	6.2	6.0	5.7	5.5	5.3	5.1	4.9
Nontax revenue	20.9	29.9	26.2	20.4	20.0	17.1	15.1	13.8	12.3
Of which : Oil Fund revenues	18.3	27.8	24.2	18.6	18.2	15.4	13.3	12.1	10.6
Grants	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Expenditure									
Total Expenditure	57.0	52.4	49.6	51.7	49.3	46.6	44.1	41.9	40.4
Current Expense	40.6	37.4	35.0	34.9	35.0	33.9	32.8	31.6	30.6
Compensation of employees	12.1	10.5	10.7	10.7	10.3	9.9	9.5	9.1	8.8
Use of goods and services	11.8	12.6	9.6	9.9	10.1	9.8	9.5	9.2	9.0
Social benefits	11.0	10.4	11.6	11.3	11.5	11.1	10.8	10.4	9.9
Of which : Social protection fund	2.3	3.1	2.8	2.5	2.5	2.5	2.5	2.5	2.5
Subsidies	4.4	2.6	2.0	2.2	2.2	2.1	2.0	1.9	1.8
Grants	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Interest	1.2	1.1	0.9	0.7	0.8	0.9	0.9	0.9	1.0
Other expense 1/	0.0	0.0	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Net Acquisition of Nonfinancial Assets	16.4	15.0	14.7	16.8	14.2	12.7	11.3	10.3	9.8
Overall Balance 1/	-9.1	6.6	12.0	3.3	0.7	-2.1	-2.1	-2.1	-3.0
Overall balance excluding one off items 2/	-9.1	6.6	12.0	3.3	0.7	-2.1	-2.1	-2.1	-3.0
Non-oil primary balance 3/	-30.6	-23.9	-22.4	-24.4	-22.5	-20.6	-18.0	-16.4	-15.3
Net Financial Transactions	-9.1	6.6	11.4	3.3	0.7	-2.1	-2.1	-2.1	-3.0
Net Acquisition of Financial Assets	-7.7	8.0	12.2	4.9	3.0	0.4	0.0	0.1	0.6
Oil Fund	-6.0	8.0	12.7	3.7	3.3	0.7	0.4	0.5	1.0
Privatizations and other sale of assets	-0.1	0.0	-0.2	-0.2	-0.2	-0.2	-0.2	-0.3	-0.3
Banking System 4/	-1.6	0.0	-0.4	-0.4	-0.1	-0.1	-0.1	-0.1	-0.1
Others	0.0	0.0	0.0	1.7	0.0	0.0	0.0	0.0	0.0
Net Incurrence of Liabilities	1.4	1.8	0.7	1.6	2.3	2.5	2.1	2.2	3.6
Debt securities	1.5	1.0	0.3	0.3	0.5	0.5	0.6	0.4	0.4
Of which: Domestic banking sector	2.2	0.6	2.7	0.3	0.2	0.4	0.5	0.3	0.0
External Loans	1.9	0.6	0.4	0.4	0.6	0.9	1.0	1.1	1.0
Other	-1.9	0.2	0.1	1.0	1.3	1.0	0.5	0.7	2.2
Memorandum Items:									
Oil revenue	22.6	31.6	34.8	28.5	24.0	19.3	16.8	15.2	13.3
Non-oil revenue	25.3	27.4	26.9	26.5	25.9	25.2	25.2	24.6	24.0
Non-oil tax revenue 5/	18.0	20.0	18.6	18.7	18.5	18.0	18.2	17.8	17.4
Non-oil GDP (in billion of manats)	51.1	57.4	69.8	79.6	86.3	93.8	101.5	109.2	117.5

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

1/ Includes the extraordinary SOFAZ transfer ($1.4 billion) to the CBA in 2017)
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/ Tax revenue excluding AIOC and SOCAR profit tax.

Table 4. Azerbaijan: Summary Accounts of the Central Bank, 2020–28

(In millions of manat, unless otherwise specified)

				Projections					
	2020	2021	2022	2023	2024	2025	2026	2027	2028
Net Foreign Assets	14,371	15,570	18,835	19,175	19,515	19,855	20,195	20,535	20,875
Net international reserves of the CBA	14,372	14,366	18,604	19,177	19,517	19,857	20,197	20,537	20,877
Gross international reserves	14,750	15,627	19,804	20,376	20,716	21,056	21,396	21,736	22,076
Foreign liabilities	-379	-1,261	-1,199	-1,199	-1,199	-1,199	-1,199	-1,199	-1,199
Other items, net	-1	-1	-1	-1	-1	-1	-1	-1	-1
Net Domestic Assets	681	1,813	2,049	4,892	6,591	8,201	9,641	11,403	13,300
Domestic credit	2,622	3,115	3,215	6,077	7,793	9,421	10,880	12,659	14,575
Net claims on consolidated central government	-4,626	-4,851	-3,114	-3,015	-3,015	-3,015	-3,015	-2,915	-2,815
Of which : claims on central government	297	304	317	317	317	317	317	317	317
manat deposits of central government	-2,662	-3,454	-3,626	-3,526	-3,526	-3,526	-3,526	-3,426	-3,326
Net claims on banks 1/	7,247	7,966	7,440	9,092	10,808	12,436	13,894	15,574	17,390
Credit to the economy	0	0	0	0	0	0	0	0	0
Net claims on other financial corporations 1/									
Other items, net	-1,940	-1,302	-1,167	-1,184	-1,202	-1,220	-1,238	-1,257	-1,276
Reserve Money	15,053	19,761	20,884	24,068	26,106	28,057	29,837	31,938	34,175
Manat reserve money	13,564	17,938	17,444	19,014	20,725	22,591	24,624	26,840	29,255
Currency outside CBA	11,840	12,310	14,714	13,814	15,265	16,639	18,136	19,769	21,548
Bank reserves and other deposits	1,725	5,628	2,730	5,200	5,460	5,952	6,487	7,071	7,708
Reserves in foreign currency	1,489	1,824	3,440	5,054	5,381	5,466	5,213	5,098	4,919

Sources: National authorities; 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, 2020–28

(In millions of manat, unless otherwise specified)

				Projections					
	2020	2021	2022	2023	2024	2025	2026	2027	2028
Net Foreign Assets	18,436	20,171	25,031	25,684	26,106	26,529	26,953	27,378	27,804
Net international reserves of the CBA	14,372	14,366	18,604	19,177	19,517	19,857	20,197	20,537	20,877
Net foreign assets of commercial banks	4,290	6,293	7,041	7,141	7,241	7,341	7,441	7,541	7,641
Other	-226	-488	-614	-633	-651	-668	-684	-699	-713
Net Domestic Assets	3,667	7,067	10,685	13,236	16,986	20,569	23,827	27,694	31,818
Domestic credit, net	9,959	13,043	18,509	23,205	26,390	29,583	32,552	35,611	38,576
Net claims on consolidated central government	-4,982	-4,397	-1,971	-844	-544	-44	556	1,056	1,257
Credit to the economy	14,934	17,433	20,473	24,043	26,928	29,621	31,990	34,550	37,314
Of which: private sector	14,934	17,433	20,473	24,043	26,928	29,621	31,990	34,550	37,314
Credit to other financial public sector	7	7	7	7	7	6	6	6	5
Other items, net	-6,293	-5,976	-7,823	-9,970	-9,404	-9,014	-8,725	-7,917	-6,758
Broad Money	29,186	34,647	42,825	45,729	49,602	53,308	56,690	60,682	64,932
Manat broad money	20,303	23,870	29,550	32,010	35,217	38,381	41,384	44,905	48,699
Cash outside banks	10,773	10,941	13,297	11,327	12,058	12,645	13,238	13,837	14,436
Manat deposits	9,530	12,930	16,252	20,683	23,159	25,737	28,145	31,068	34,264
Foreign currency deposits	8,883	10,776	13,275	13,719	14,384	14,926	15,306	15,777	16,233
ıual percentage cha									
Net foreign assets	8.9	9.4	24.1	2.6	1.6	1.6	1.6	1.6	1.6
Net domestic assets	-25.7	92.7	51.2	23.9	28.3	21.1	15.8	16.2	14.9
Credit to the economy	-0.7	16.7	17.4	17.4	12.0	10.0	8.0	8.0	8.0
Of which: private sector	-0.7	16.7	17.4	17.4	12.0	10.0	8.0	8.0	8.0
Broad money (M3)	1.1	18.7	23.6	6.8	8.5	7.5	6.3	7.0	7.0
Manat broad money (M2)	11.3	17.6	23.8	8.3	10.0	9.0	7.8	8.5	8.5
Reserve money	14.7	31.3	5.7	15.2	8.5	7.5	6.3	7.0	7.0
Manat reserve money	11.6	32.2	-2.8	9.0	9.0	9.0	9.0	9.0	9.0
Memorandum Items:									
Gross official international reserves (US$ millions)	6,369	7,075	8,996	11,281	11,481	11,681	11,881	12,081	12,281
Velocity of total broad money (M3)	1.7	1.7	1.7	1.7	1.7	1.8	1.8	1.8	1.8
Credit to private sector in percent of non-oil GDP	29.2	30.4	29.3	30.2	31.2	31.6	31.5	31.6	31.7
Share of foreign currency credits in total credit portfolio	30.8	27.7	24.9	22.4	20.2	18.2	16.4	14.7	13.3
Current to broad money ratio	36.9	31.6	31.1	24.8	24.3	23.7	23.4	22.8	22.2
Share of foreign currency deposits in total deposits	48.2	45.5	45.0	39.9	38.3	36.7	35.2	33.7	32.1
Foreign currency deposits to broad money ratio	30.4	31.1	31.0	30.0	29.0	28.0	27.0	26.0	25.0

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

Table 6. Azerbaijan: Banking Sector Financial Soundness Indicators, 2019–Sept 2023

(In percent)

	2019	2020	2021	2022	Sept 2023
Regulatory Capital to Risk-Weighted Assets (Median)	23.2	26.1	20.0	19.3	18.5
Capital to Assets	14.0	14.7	12.9	11.0	12.2
Liquid Assets to Total Assets 1/	39.5	38.2	40.3	25.9	28.7
Nonperforming Loans (NPLs) to Total Loans	8.3	6.2	4.5	3.8	3.5
Loan-loss provisioning to nonperforming loans ratio	117.1	55.0	57.5	58.1	63.5
Bank Return on Assets	1.6	1.8	1.8	2.7	3.0
Bank Return on Equity	24.9	12.7	13.6	18.5	20.3

Sources: National authorities; and IMF staff estimates.

Note: This data is based on prudential reporting methodology.

1/ Liquid assets include cash and cash equivalents, claims on the CBA, Nostro accounts, and deposits with financial institutions.

Annex I. External Sector Assessment

Overall Assessment*: Staff assesses the external position in 2022 to be stronger than implied by fundamentals and desirable policies. High oil and gas prices boosted oil export revenues, resulting in a significant improvement of the external position in 2022. With the protracted nature of the war in Ukraine, global energy prices are expected to remain high in the medium term, providing significant external buffers. If external conditions persist, the current account (CA) balance will likely be stronger than the level needed to ensure sufficient savings for future generations. This overall assessment is subject to a high degree of uncertainty related to the future path of oil and gas prices.*

Potential Policy Responses*: Given the projected decline of hydrocarbon revenues, fiscal consolidation is needed to preserve fiscal sustainability and achieve greater intergenerational equity. As this would increase the saving-investment balance, this policy should go in tandem with reforms that facilitate financial deepening, for bank credit to the private sector to rise closer to the EM average, and structural reforms to promote private investment and diversification.*

Current Account

Background. The CA surplus nearly doubled in 2022, further increasing external buffers. Following a CA surplus of 15.1 percent of GDP in 2021, the CA balance improved further to a surplus of 29.8 percent of GDP in 2022, owing to rising global oil and gas prices that more than offset the contraction in crude oil production. The nonoil CA deficit declined in 2022, but remains high at 6.6 percent of GDP, driven by large nonoil imports. Nonoil exports are low at 3.7 percent of GDP. The CA surplus is projected to moderate to 12.4 percent of GDP in 2023 due to the normalization of oil and gas prices and then to gradually decline in tandem with the projected reduction of oil prices and expected decline in oil export volumes. The trade surplus remains strong (21.1 percent of GDP) in the first half of 2023. Rising demand for gas in Europe could generate additional business opportunities, but this will require significant capital investments.

Assessment. Overall, staff assesses the external position to be stronger than the level consistent with medium-term fundamentals and desirable policies. This assessment is based on the EBA-lite commodity module's consumption model, based on the PIH, given its relevance. Specifically, staff assesses the CA gap to be positive and around 3 percent of GDP, based on the constant real annuity estimated by the EBA-Lite commodity approach. The results are highly sensitive to the assumed oil price.

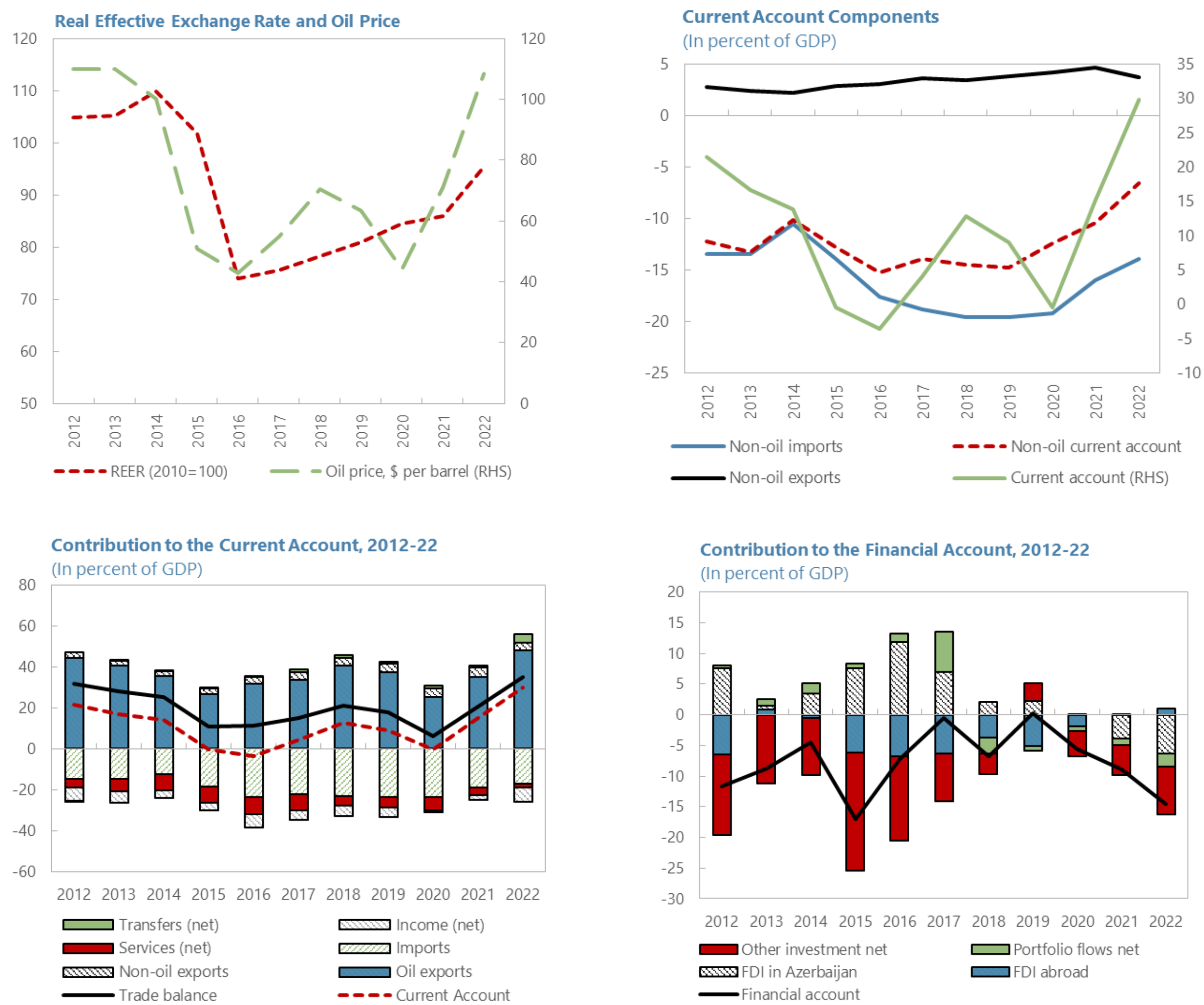
Table AI.1. Azerbaijan: Model Estimates for 2022
(In percent of GDP)

	CA model 1/	**REER model** 1/	**Consumption model**
		(in percent of GDP)	
CA-Actual	**29.8**		**29.8**
Cyclical contributions (from model) (-)	0.3		0.3
Additional temporary/statistical factors (-)	0.0		0.0
Natural disasters and conflicts (-)	0.5		0.5
Adjusted CA	**29.0**		**29.0**
CA Norm (from model) 2/	**3.3**		**26.0**
Adjustments to the norm (-)	0.0		0.0
Adjusted CA Norm	**3.3**		**26.0**
CA Gap	**25.7**	**-1.3**	**3.0**
o/w Relative policy gap	6.6		
Elasticity	-0.3		-0.3
REER Gap (in percent)	**-89.5**	**4.6**	**-10.2**

1/ Based on the EBA-lite 3.0 methodology
2/ Cyclically adjusted, including multilateral consistency adjustments.

Real Exchange Rate
Background. The manat continued to appreciate in 2022. It has been de facto pegged to the dollar at a rate of 1.7 since April 2017. The real effective exchange rate (REER) was 26 percent stronger than 2017 at the end of 2022 and appreciated further by 8.8 percent by October 2023. The recent appreciation has been driven mostly by the U.S. dollar nominal appreciation vis à-vis trading partners' exchange rates (particularly Russia and Turkey). **Assessment**. The current account and REER models suggest a REER gap in a wide range of -89.5 to 4.6 percent. The permanent income model—the preferred approach—points to a negative REER gap, in line with the positive CA gap implied by a constant real annuity.
Capital and Financial Accounts: Flows and Policy Measures
Background. Azerbaijan has been a net supplier of capital. The capital and financial accounts recorded net cumulative outflows in 2022 and in the first half of 2023, reflecting the large CA surplus. **Assessment**. Azerbaijan's capital and financial accounts are generally open but domestic financial markets are underdeveloped compared to those in regional and global peers. Capital inflows are dominated by FDI, mostly related to the oil sector, and portfolio inflows, while outflows include trade credits, bank outflows, and outward FDI, mainly by the national oil company.
FX Intervention and Reserves Level
Background. With the large CA surplus, the CBA's gross international reserves increased significantly, reaching $9 billion (11.4 percent of GDP, 8.5 months of next year's imports of goods) by end-2022 and $10.5 billion by end-October 2023. The CBA's reserves are complemented by the liquid part of foreign assets held by the Oil Fund (SOFAZ). This liquid part, mostly fixed income instruments, equities, and gold, represents about 75 percent of the $49 billion in assets (63 percent of GDP) at end 2022. Together, CBA and SOFAZ liquid assets are equivalent to 44 months of next year's imports. **Assessment**. The external reserve coverage remains more than adequate. Azerbaijan scores much better than most EMs on all criteria of the IMF's Assessing Reserve Adequacy (ARA) metric, which combines information on exports, broad money, short-term debt, and other investment liabilities (yellow diamonds lower left chart). This is the case even after adjusting the ARA metric for the country's heavy reliance on oil exports (green diamond in same chart). Reserve coverage scores are projected to remain strong into 2028, given expected CA surpluses, rising reserves, and limited increases in external debt (red diamonds).

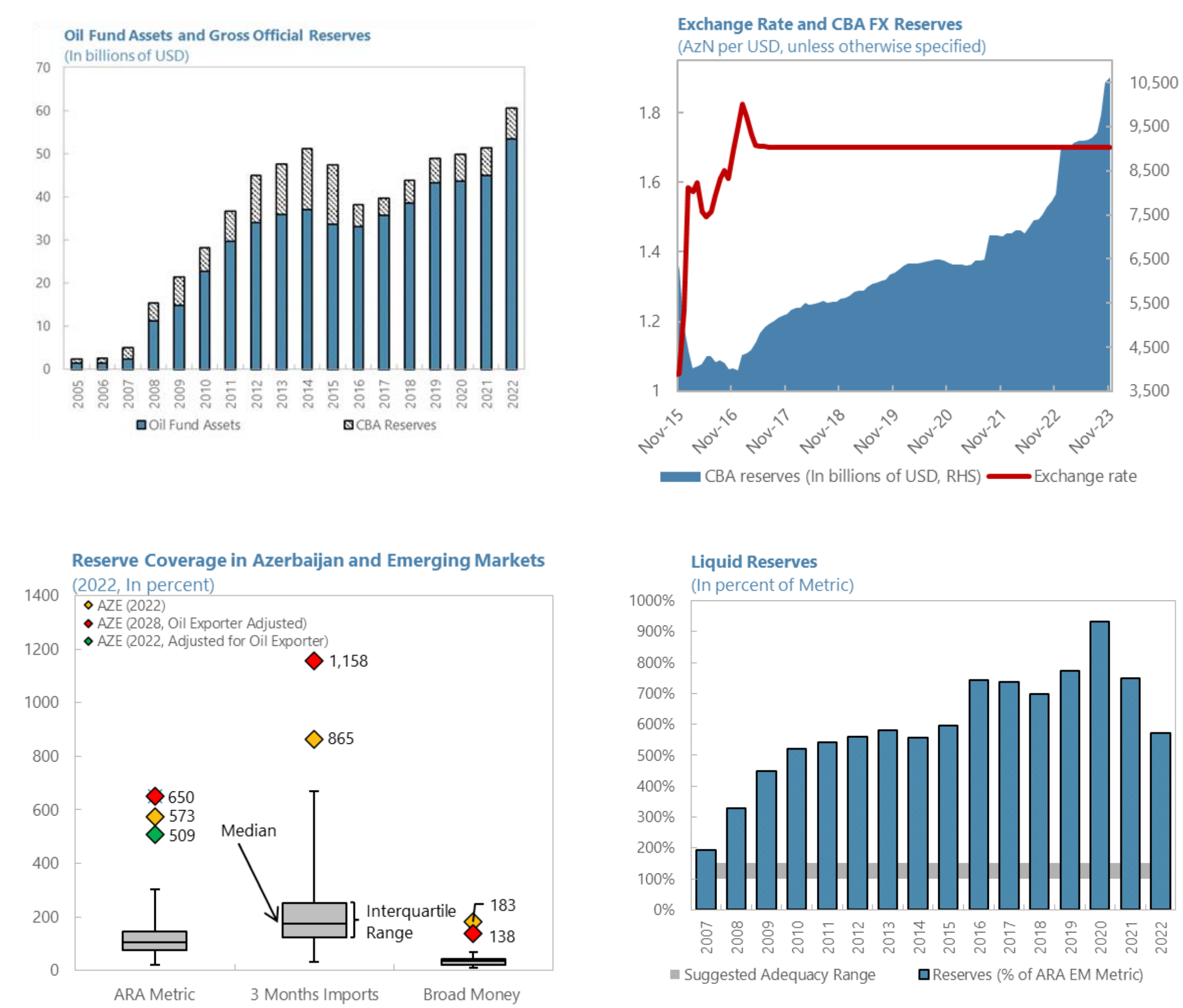
Figure AI.1. Azerbaijan: Real Effective Exchange Rates and Contributions to Current Account



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

- The EBA-Lite commodity approach1 is preferable for assessing the CA position in Azerbaijan because it is based on the permanent income hypothesis (PIH) and reflects the fundamental goal of achieving intergenerational equity in this country with nonrenewable resources. Assuming the annuity is constant in real terms, the CA norm is estimated at 26 percent of GDP in 2022, implying a favorable CA gap of 3 percent of GDP.2 The gap is expected to remain positive over the medium term at 4.4 percent of GDP and will provide substantial buffers if associated windfalls are well capitalized over time.
- The current account model, which estimates an equilibrium level of the CA consistent with the gamut of structural and policy factors in the IMF's multilaterally consistent External Balance Assessment-Lite framework, suggests that the CA was substantially stronger than implied by fundamentals and desirable policies in 2022. The CA norm is estimated at 3.3 percent of GDP, implying a favorable gap of 25.7 percent of GDP, after adjusting for the remaining cyclical effects and other exogenous factors.

Figure AI.2. Azerbaijan: Exchange Rates and Reserve Adequacy



Sources: National authorities, Haver, IMF FAD Reserve Adequacy Tool, and IMF staff calculations.

Note: The data for EM refer to a sample of 47 emerging markets.

[1] Bems, R., and I. de Carvalho Filho, 2009, "Exchange Rate Assessments: Methodologies for Oil-Exporting Countries," IMF Working Paper 09/281.

[2] The estimated norm is sensitive to the choice of model parameters, such as the GDP growth rate, interest rate, and population growth rate, as well as the underlying oil prices.

Annex II. Risk Assessment Matrix[1]

Risk Assessment Matrix			
Risk	**Likelihood**	**Possible Impact**	**Policy Advice**
External Risks and Spillovers			
Intensification of regional conflicts. Escalation of Russia's war in Ukraine or other regional conflicts and resulting economic sanctions disrupt trade (e.g. energy, food, tourism, and/or critical supply chain components), remittances, FDI and financial flows, and payment systems, and lead to refugee flows.	**High**	**High.** As a large oil and gas exporter, Azerbaijan would benefit from higher oil and gas prices, increased government revenue and stronger balance of payments. However, the food imports bill would rise. Tightening financial conditions and rising risk premia would have a limited impact given the low dependence on external financing and limited presence of nonresident investors.	Maintain a prudent fiscal policy and avoid a procyclical boost to budget spending. Save most of the oil revenue windfall. Use part of the additional revenues to provide temporary support to the most vulnerable. Continue the prudent borrowing policy to avoid increasing dependence on external financing.
Commodity price volatility. A succession of supply disruptions (e.g. due to conflicts, uncertainty and export restrictions) and demand fluctuations causes recurring commodity price volatility, external and fiscal pressures in EMDEs, contagion effects, and social and economic instability.	**High**	**High**. Rising food prices could lead to higher inflation. Budgetary spending will also increase to protect the vulnerable. However, given the large dependence on hydrocarbon production and exports, volatility of oil and gas prices could have a more significant impact on the balance of payments, budget, and economic activity.	Follow a prudent fiscal policy to avoid adding to inflationary pressures. Use fiscal space for emergency spending. In the longer term, pursue structural reforms to reduce the economy's dependence on hydrocarbon.

[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.

Risk Assessment Matrix			
Risk	**Likelihood**	**Possible Impact**	**Policy Advice**
Deepening geoeconomic fragmentation. Broader and deeper conflict(s) and weakened international cooperation result in a more rapid reconfiguration of trade and FDI, supply disruptions, protectionism, technological and payment systems fragmentation, rising input costs, financial instability, a fracturing of international monetary and financial systems, and lower potential growth.	**High**	**Medium.** Prospects for economic diversification could be affected. Reconfiguration could however be beneficial, as exports and trade routes are diverted towards Azerbaijan.	Accelerate structural reforms and promote private sector development. Enhance integration with the world economy.
Abrupt global slowdown or recession. Global and idiosyncratic risk factors combined to cause a synchronized sharp growth downturn, with recessions in some countries, adverse spillovers through trade and financial channels, and market fragmentation causing sudden stops in EMDEs.	**Medium**	**Medium.** Global slowdown could have a negative impact on Azerbaijan's hydrocarbon exports, tourism, and remittances, affecting the fiscal and external position and growth.	Prudently use fiscal and external buffers to mitigate the adverse impact of external shocks, without risking fiscal sustainability.
Extreme climate events. Extreme climate events driven by rising temperatures cause loss of human lives, severe damage to infrastructure, supply disruptions, lower growth, and financial instability.	**Medium**	**Medium.** Severe drought could affect agricultural output and increase food prices.	Use fiscal space to temporarily support the most vulnerable. Build resilient infrastructure and accelerate efforts to promote a more sustainable and green economy.
Domestic Risks			
Loss of spending discipline, leading to a procyclical fiscal policy. Higher oil and gas prices boost budget revenues, leading to increased spending pressures.	**Medium**	**Medium.** Pressure to increase spending, instead of saving the oil windfall revenues, could lead to a procyclical fiscal policy, increase inflation, and delay fiscal consolidation, weakening the long-term fiscal position and fiscal rule credibility.	Gradually but steadily reduce the nonoil primary deficit by maintaining spending discipline, saving most of the oil windfall revenues, and increasing nonoil budget revenues.
Weak SOE performance. Failure to improve the financial performance of weak SOEs will result in continued losses, with negative impact on economic growth and on the effort to diversify the economy. It could also renew	**Medium**	**Low.** While government guarantees are limited and have not been increasing in recent years, failure to strengthen SOEs could increase the risk of new guarantees issued and	Implement comprehensive reforms to improve corporate governance and efficiency of SOEs. Divest SOEs that

Risk Assessment Matrix			
Risk	**Likelihood**	**Possible Impact**	**Policy Advice**
the accumulation of contingent liabilities to the budget.		existing guarantees called, increasing government debt. Inefficient SOEs would hamper efforts to promote the private sector, diversify the economy, and increase potential growth.	are not strategically important and could operate on a commercial basis.

Annex III. Summary of Sovereign Risk and Debt Sustainability Assessment

Table AIII.1. Azerbaijan: Risk of Sovereign Stress

Horizon	Mechanical signal	Final assessment	Comments
Overall	...	Low	The overall risk of sovereign stress is low, reflecting a low level of vulnerability in the near and medium term, and moderate level of vulnerability in the long term.
Near term 1/	Low	...	
Medium term	Low	Low	Medium-term risks are assessed as low as overall deficit and borrowing needs are projected to remain moderate, with projected high oil price and increasing production of natural gas mitigating the impact of declining oil production and oil revenues.
Fanchart	Moderate	Moderate	
GFN	Low		
Stress test	...	...	
Long term	...	Moderate	Long-term risks are moderate as the decline in hydrocarbon revenues is projected to increase the deficit and public debt gradually and moderately, while public sector assets are projected to increase further.
Sustainability assessment 2/			Not required for surveillance-only countries.
Debt stabilization in the baseline			No

DSA Summary Assessment

Commentary: Azerbaijan is at a low overall risk of sovereign stress. While Azerbaijan's public debt is projected to increase gradually in the baseline, it remains relatively low as a percent of GDP and relative to sovereign fund assets. However, with hydrocarbon production and government hydrocarbon revenues projected to gradually decline in the medium- and long term, in the absence of fiscal adjustment, fiscal balance is projected to gradually weaken, and borrowing requirements and public debt to gradually increase. Still, medium-term liquidity risks as analyzed by the GFN Financeability Module are low. Mechanical signal shows moderate fanchart risk, reflecting past elevated volatility of debt drivers. With an improved macro framework, less procyclical fiscal policy and large asset buffers, staff also assesses this risk as moderate. Over the longer run, Azerbaijan should implement reforms to diversify its economy, reduce reliance on the hydrocarbon revenues and boost nonoil revenues. The authorities acknowledge the need to undertake this adjustment and are planning measures to diversify the economy, reducing the probability that this risk would materialize. Thus, staff assesses the long-term risks as

Source: Fund staff.

Note: The risk of sovereign stress is a broader concept than debt sustainability. Unsustainable debt can only be resolved through exceptional measures (such as debt restructuring). In contrast, a sovereign can face stress without its debt necessarily being unsustainable, and there can be various measures—that do not involve a debt restructuring—to remedy such a situation, such as fiscal adjustment and new financing.

1/ The near-term assessment is not applicable in cases where there is a disbursing IMF arrangement. In surveillance-only cases or in cases with precautionary IMF arrangements, the near-term assessment is performed but not published.

2/ A debt sustainability assessment is optional for surveillance-only cases and mandatory in cases where there is a Fund arrangement. The mechanical signal of the debt sustainability assessment is deleted before publication. In surveillance-only cases or cases with IMF arrangements with normal access, the qualifier indicating probability of sustainable debt ("with high probability" or "but not with high probability") is deleted before publication.

Table AIII.2. Azerbaijan: Debt Coverage and Disclosures

						Comments
1. Debt coverage in the DSA: 1/	CG	GG	NFPS	CPS	Other	
1a. If central government, are non-central government entities insignificant?					n.a.	
2. Subsectors included in the chosen coverage in (1) above:						

		Subsectors captured in the baseline	Inclusion	Comments
CPS / NFPS / GG: expected / CG	1	Budgetary central government	Yes	
	2	Extra budgetary funds (EBFs)	No	Not applicable
	3	Social security funds (SSFs)	Yes	
	4	State governments	No	Not applicable
	5	Local governments	No	Not significant
	6	Public nonfinancial corporations	No	
	7	Central bank	No	
	8	Other public financial corporations	Yes	

3. Instrument coverage:	Currency & deposits	Loans	Debt securities	Oth acct. payable 2/	IPSGSs 3/

4. Accounting principles:	Basis of recording		Valuation of debt stock		
	Non-cash basis 4/	Cash basis	Nominal value 5/	Face value 6/	Market value 7/

5. Debt consolidation across sectors:	Consolidated	Non-consolidated

Color code: chosen coverage; Missing from recommended coverage; Not applicable

(Chosen coverage: CG; Budgetary central government; Social security funds (SSFs); Other public financial corporations; Currency & deposits; Loans; Debt securities; Cash basis; Nominal value 5/; Non-consolidated. Missing from recommended coverage: Oth acct. payable 2/; IPSGSs 3/. Not applicable: Extra budgetary funds (EBFs); State governments; Local governments; Public nonfinancial corporations; Central bank.)

Reporting on Intra-Government Debt Holdings

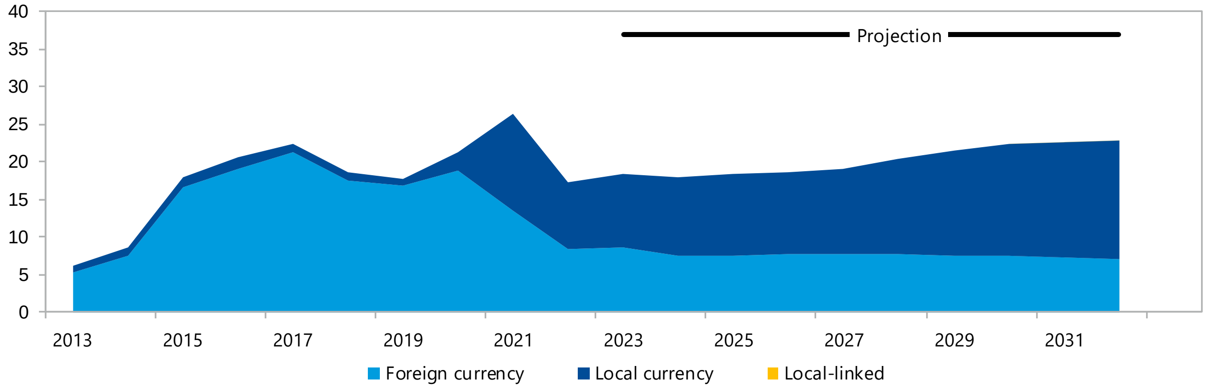
Issuer \ Holder		Budget. central govt	Extra-budget. funds	Social security funds	State govt.	Local govt.	Nonfin. pub. corp.	Central bank	Oth. pub. fin corp	Total
1	Budget. central govt									0
2	Extra-budget. funds									0
3	Social security funds									0
4	State govt.									0
5	Local govt.									0
6	Nonfin pub. corp.									0
7	Central bank									0
8	Oth. pub. fin. corp									0
	Total	0	0	0	0	0	0	0	0	0

1/ CG=Central government; GG=General government; NFPS=Nonfinancial public sector; PS=Public sector.
2/ Stock of arrears could be used as a proxy in the absence of accrual data on other accounts payable.
3/ Insurance, Pension, and Standardized Guarantee Schemes, typically including government employee pension liabilities.
4/ Includes accrual recording, commitment basis, due for payment, etc.
5/ Nominal value at any moment in time is the amount the debtor owes to the creditor. It reflects the value of the instrument at creation and subsequent economic flows (such as transactions, exchange rate, and other valuation changes other than market price changes, and other volume changes).
6/ The face value of a debt instrument is the undiscounted amount of principal to be paid at (or before) maturity.
7/ Market value of debt instruments is the value as if they were acquired in market transactions on the balance sheet reporting date (reference date). Only traded debt securities have observed market values.

Commentary: Debt coverage includes only the central governemnt. Debt guaranteed by the government is not included in public debt, except for, starting in 2021, the guarantees issued to Aqrakredit for its acquisition of distressed assets from the IBA. Azerbaijan is a unitary state. Other than the Nakhichevan Autonomous Republic (included in the GG), there are no independent states and no debt issued by local governments.

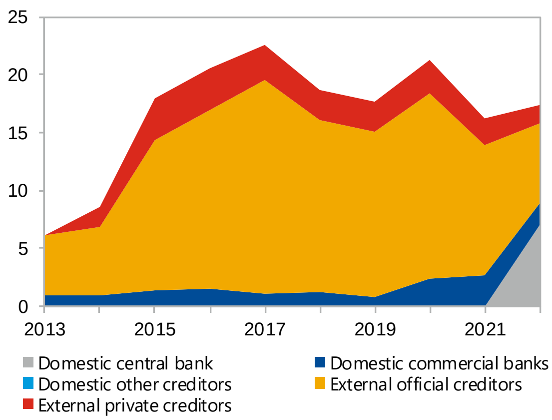
Figure AIII.1. Azerbaijan: Public Debt Structure Indicators

Debt by Currency (Percent of GDP)



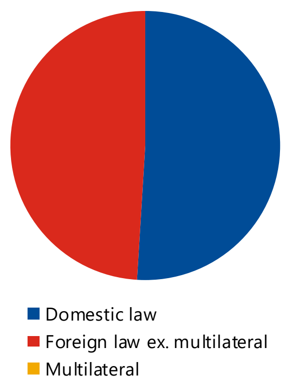
Note: The perimeter shown is general government.

Public debt by holder (percent of GDP)



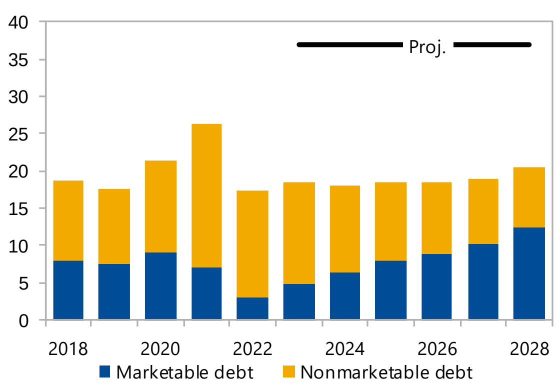
Note: The perimeter shown is general government.

Public debt by governing law, 2022 (percent)



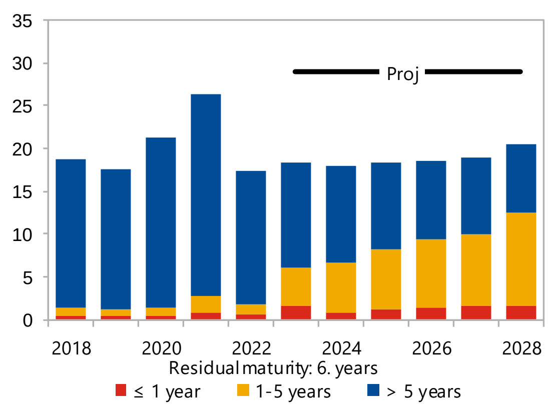
Note: The perimeter shown is general government.

Debt by instruments (percent of GDP)



Note: The perimeter shown is general government.

Public debt by maturity (percent of GDP)



Note: The perimeter shown is general government.

Commentary: The projected declining share of external debt reflects the authorities' plan to reduce the dependence on external borrowing. Increased central bank share in 2021 reflects the recognition of guarantee to Aqrarkredit, a government-controlled credit agency, on the bond it issued to acquire bad assets from the IBA during the 2015-16 crisis.

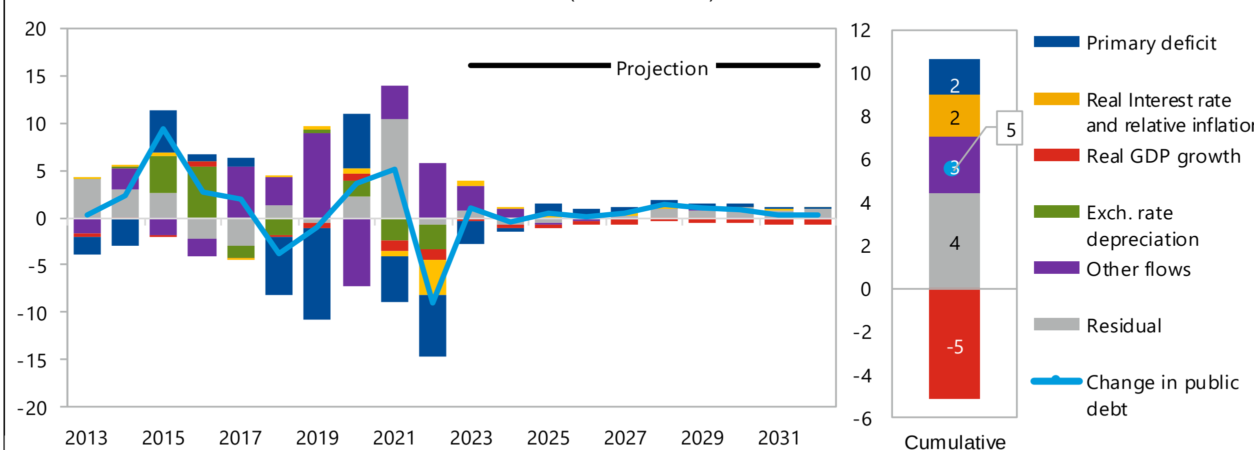
Table AIII.3. Azerbaijan: Baseline Scenario

(Percent of GDP unless indicated otherwise)

	Actual	Medium-term projection						Extended projection			
	2022	2023	2024	2025	2026	2027	2028	2029	2030	2031	2032
Public debt	17.3	18.4	18.0	18.4	18.6	19.0	20.4	21.5	22.3	22.7	23.0
Change in public debt	-9.0	1.1	-0.4	0.4	0.2	0.4	1.4	1.0	0.8	0.4	0.3
Contribution of identified flows	-8.3	0.4	0.4	1.0	0.1	0.2	0.6	0.2	-0.2	-0.5	-0.6
Primary deficit	-6.4	-2.4	-0.2	1.4	0.6	0.6	0.7	0.6	0.3	0.1	0.0
Noninterest revenues	32.2	33.5	31.8	29.7	29.1	28.5	27.5	27.1	26.7	26.4	25.7
Noninterest expenditures	25.7	31.1	31.6	31.0	29.7	29.2	28.2	27.7	27.0	26.4	25.7
Automatic debt dynamics	-7.5	0.2	-0.3	-0.2	-0.2	-0.2	-0.2	-0.4	-0.4	-0.4	-0.5
Real interest rate and relative inflation	-3.7	0.6	0.1	0.2	0.2	0.2	0.2	0.1	0.1	0.1	0.1
Real interest rate	-6.4	0.6	0.1	0.2	0.2	0.2	0.2	0.1	0.1	0.1	0.1
Relative inflation	2.7	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Real growth rate	-1.2	-0.4	-0.4	-0.4	-0.4	-0.4	-0.4	-0.5	-0.5	-0.5	-0.6
Real exchange rate	-2.7	...	...	...	...	...	...	...	...	...	...
Other identified flows	5.7	2.7	0.9	-0.1	-0.3	-0.3	0.1	0.1	-0.1	-0.1	-0.2
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other transactions 1/	5.7	2.7	0.9	-0.1	-0.3	-0.3	0.1	0.1	-0.1	-0.1	-0.2
Contribution of residual	-0.7	0.7	-0.8	-0.6	0.1	0.3	0.8	0.8	1.0	0.8	0.9
Gross financing needs	-5.3	-0.9	1.7	2.6	2.3	2.7	3.0	3.2	3.2	3.8	4.1
of which: debt service	1.1	1.5	1.9	1.2	1.7	2.1	2.3	2.6	2.9	3.7	4.0
Local currency	0.3	1.0	0.6	0.7	1.1	1.5	1.6	1.8	1.8	2.6	2.9
Foreign currency	0.9	0.6	1.2	0.5	0.5	0.6	0.8	0.9	1.1	1.1	1.1
Memo:											
Real GDP growth (percent)	4.6	2.4	2.3	2.3	2.3	2.3	2.3	2.4	2.4	2.5	2.5
Inflation (GDP deflator; percent)	37.3	-1.3	1.8	1.5	1.5	1.3	1.4	2.5	2.5	2.5	2.5
Nominal GDP growth (percent)	43.6	-2.4	3.8	3.8	4.1	4.2	4.5	5.5	5.6	5.7	5.9
Effective interest rate (percent)	2.6	1.9	2.3	2.4	2.6	2.7	2.6	2.9	3.0	3.1	3.0

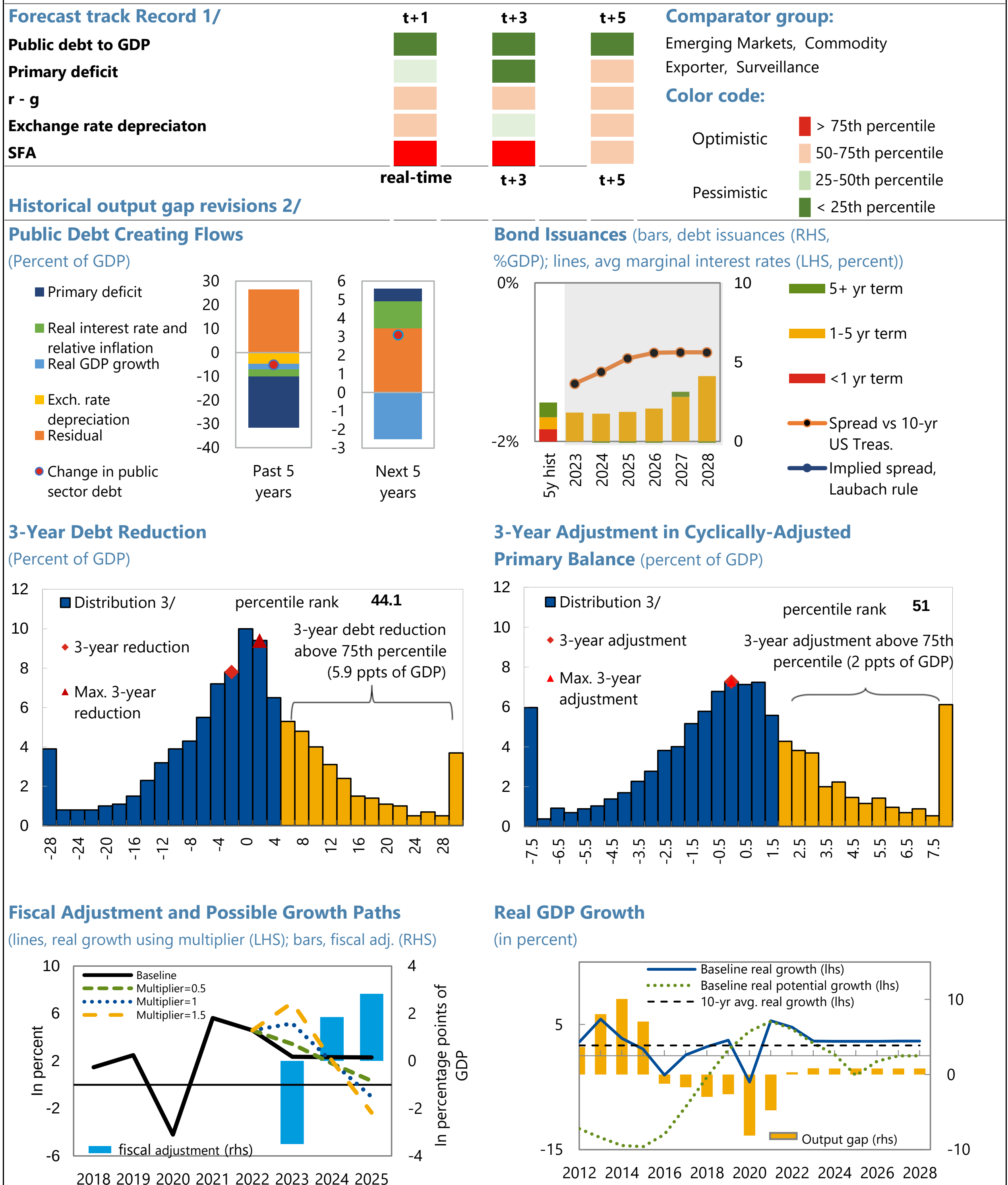
Contribution to Change in Public Debt

(Percent of GDP)



Staff commentary: Public debt is projected to increase gradually, reflecting mainly the moderate though declining primary deficit, and assumption that part of the oil revenues will be saved, boosting SOFAZ assets. 1/ Includes accumulation of SOFAZ assets

Figure AIII.2. Azerbaijan: Realism of Baseline Assumptions



Commentary: Following the recovery from COVID-19, and reflecting the declining oil production, growth is projected to moderate. Realism analysis does not point to major concerns: past forecast errors do not reveal any systematic biases and the projected fiscal adjustment and debt reduction are well within the norms.

Source : IMF Staff.
1/ Projections made in the October and April WEO vintage.
2/ Data cover annual obervations from 1990 to 2019 for MAC advanced and emerging economies. Percent of sample on vertical axis.
3/ Starting point reflects the team's assessment of the initial overvaluation from EBA (or EBA-Lite).

Figure AIII.3. Azerbaijan: Medium-term Risk Analysis

Debt fanchart and GFN financeability indexes

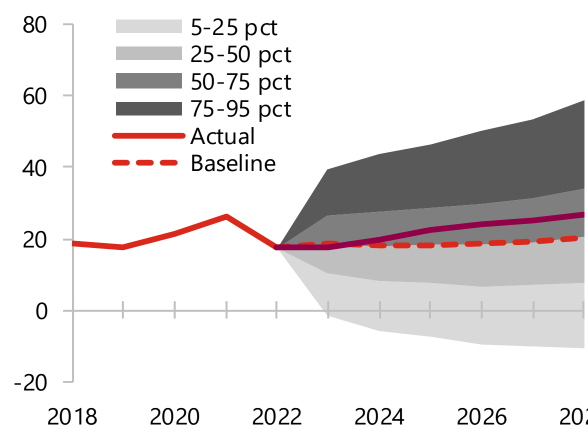
(percent of GDP unless otherwise indicated)

Module	Indicator	Value	Risk index	Risk signal
Debt fanchart module	Fanchart width	69.6	1.0	...
	Probability of debt not stabilizing (pct)	84.0	0.7	...
	Terminal debt level x institutions index	11.7	0.3	...
	Debt fanchart index	**...**	**2.0**	**Moderate**
GFN finance-ability module	Average GFN in baseline	1.9	0.7	...
	Bank claims on government (pct bank assets)	7.3	2.4	...
	Chg. in claims on govt. in stress (pct bank asset	1.4	0.5	...
	GFN financeability index	**...**	**3.5**	**Low**

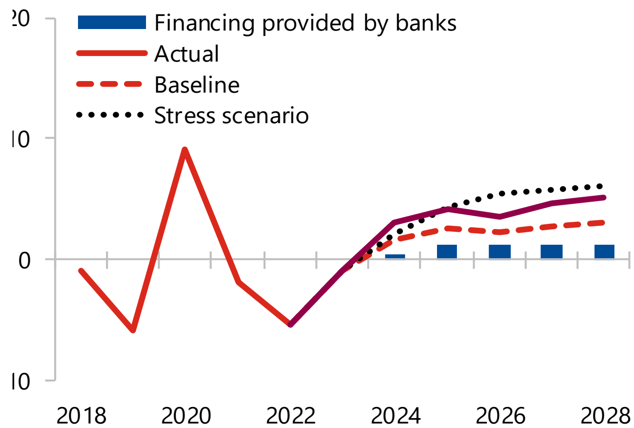
Adv. Econ., Non-Com. Exp, Program: 0, 25, 50, 75, 100

Legend: Interquartile range; Azerbaijan

Final fanchart (pct of GDP)



Gross Financing Needs (pct of GDP)

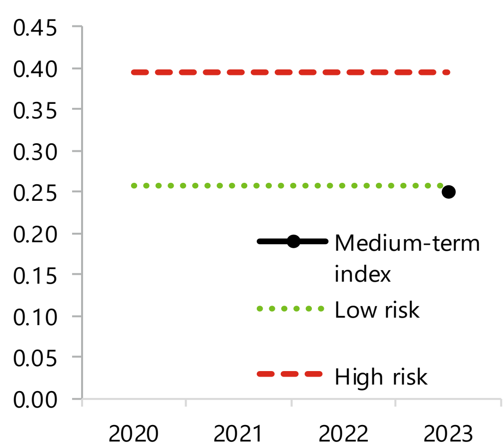


Triggered stress tests (stress tests not activated in gray)

Banking crisis | Commodity prices | Exchange rate | Contingent liab. | Natural disaster

Medium-term index

(index number)



Medium-term risk analysis

	Low risk threshold	High risk threshold	Weight in MTI	Normalized level
Debt fanchart index	1.1	2.1	0.5	0.4
GFN finaceability index	7.6	17.9	0.5	0.1
Medium-term index (MTI)	0.3	0.4	...	0.3, Low

Prob. of missed crisis, 2023-2028 (if stress not predicted): 9.1 pct.

Prob. of false alarm, 2023-2028 (if stress predicted): 42.0 pct.

Commentary: Of the two medium-term tools, the Debt Fanchart Module is pointing to a moderate level of risk, reflecting mainly past elevated macroeconomic volatility, while the GFN Financeability Module suggests a low level of risk. The commodity price stress test does not result in a significant worsening of debt and GFN path relative to the baseline, as the baseline already includes the projected oil production decline. Exceptionally high real GDP growth during 2005-09 associated with the oil boom was discarded when constructing the fan chart.

Figure AIII.4. Azerbaijan: Long-term Risk Analysis

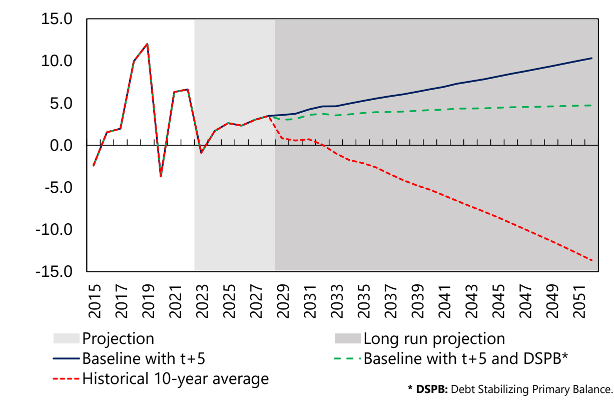
Large Amortization Trigger

Projection	Variable	Risk Indication
Medium-term extrapolation	GFN-to-GDP ratio Amortization-to-GDP ratio Amortization	
Medium-term extrapolation with debt stabilizing primary balance	GFN-to-GDP ratio Amortization-to-GDP ratio Amortization	
Historical average assumptions	GFN-to-GDP ratio Amortization-to-GDP ratio Amortization	

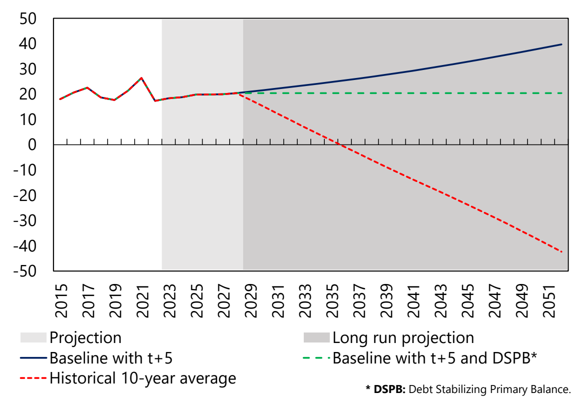
Overall Risk Indication	

Alternative Baseline Long-term Projections

GFN-to-GDP ratio



Total public debt-to-GDP ratio



Commentary: Amortization payments are projected to increase as a result of the gradual increase in borrowing, the Eurobond maturity of $950 million in 2024, and a large share of medium-term debt in both domestic and external borrowings. The historical 10-year average scenario underscores how Azerbaijan has benefited in the past from high oil revenues. Over the long-run, debt amortization will be steadily increasing as hydrocarbon production and related revenues decline, necessitating more borrowing in the absence of adjustment. However, the authorities understand the fiscal implications of declining oil revenues and are committed to implement spending and revenue measures to ensure fiscal sustainability. Therefore, the long-term fiscal risks stemming from the decline in hydrocarbon production risks are expected to remain manageable.

Annex IV. Modernization of the Monetary Policy Framework and Monetary Transmission[1]

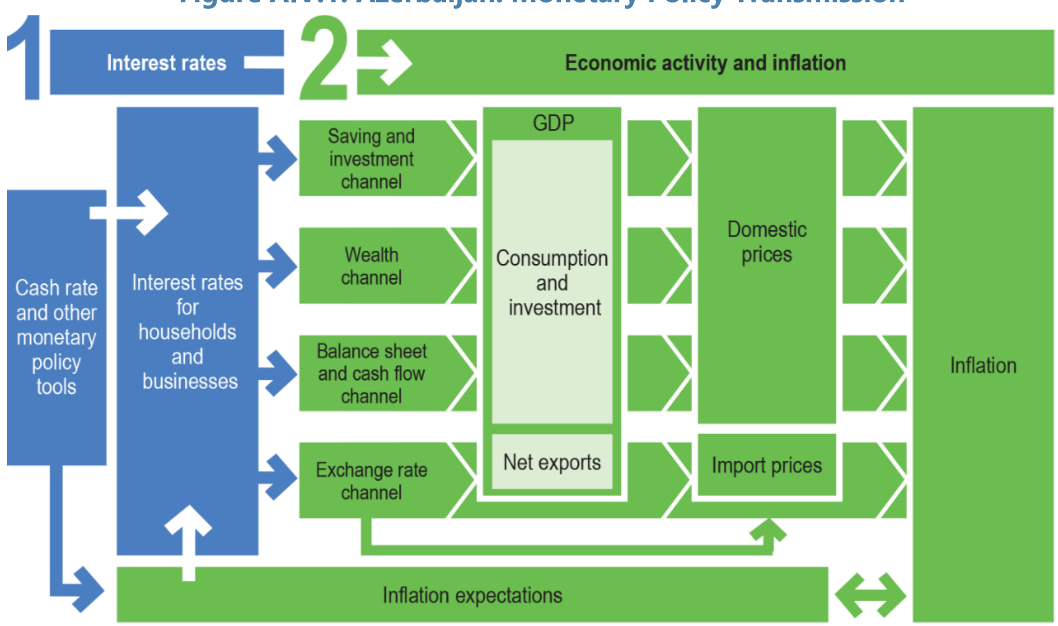
A. Introduction

1. The authorities have begun to modernize the monetary policy framework. Presently, Azerbaijan is running a *de facto* fixed exchange rate regime, but the authorities are planning to transit to an inflation targeting regime in the medium term. In 2022, the CBA implemented several measures aimed at improving the monetary policy operational framework and transmission.[2] This note reviews these measures and provides a preliminary assessment on how they contributed to strengthening the monetary policy transmission.

B. Monetary Policy Transmission

2. Monetary policy transmission describes how monetary policy changes made by central banks affect inflation and economic activity. Two main stages of monetary transmission can be identified. The first stage of monetary transmission (blue boxes in figure A.IV.1.) describes how changes in the central bank policy rate affect interest rates in the economy, including interbank interest rates, rates on government securities, and bank deposit and lending rates. **The second stage of monetary transmission** (green boxes in Figure A.IV.1.) describes how changes in economy's interest rates affect economic activity and inflation.

Figure AIV.1. Azerbaijan: Monetary Policy Transmission



Source: Reserve Bank of Australia [The Transmission of Monetary Policy | Explainer | Education | RBA.]

[1] Prepared by Jiri Jonas (MCD).

[2] See Central Bank of Azerbaijan. 2022. Monetary Policy Framework – Explanatory Document. Central Bank of Azerbaijan, Baku.

3. There are several transmission channels between the interest rates and output/inflation:

- *Savings and investment channel.* This channel operates by affecting households and business' decisions on consumptions and investment.
- *Wealth channel.* Changes in asset prices result in changes in peoples' wealth, which can impact their savings and investment.
- *Balance sheet and cash flow channel.* This channel operates by affecting the liquidity position of households and businesses, and thus their capacity and willingness to spend or invest.
- *Exchange rate channel.* Changes in exchange rate can affect economic activity in export-oriented sectors or in sectors exposed to import competition.
- *Inflation expectations channel.* Inflation expectations could affect current behavior of household and businesses, for example, wage negotiations or spending/savings decision, and thereby also demand, output and inflation.

4. The effectiveness of monetary transmission depends on the weakest link in the whole transmission sequence. For example, if the changes in the CBA policy rate do not translate into changes in interbank rates, this undermines the transmission effectiveness as the initial policy impulse does not propagate through the transmission chain. Appropriately, the CBA's effort to improve monetary transmission began with the operation of the interbank market (blue block). Improving the transmission between the blue and green blocks, and within green blocks, takes more time as it requires more fundamental and structural changes of the behavior, constraints, and incentives of households and businesses.

5. Monetary transmission tends to be less effective in low income and emerging market countries (LICs/EMCs).[3] This is due to several LICs/EMCs characteristics:

- *Relatively small size of the formal financial sector*. Smaller size of the financial sector means smaller interaction with the nonfinancial economy and thus smaller impact of financial variables (e.g., interest rates) on demand, output, and inflation.
- *Weak bank competition.* Because of the presence of several dominant banks and/or state-owned banks, together with underdeveloped nonfinancial sector, LICs/EMCs banks don't face strong competition, which leads to high interest margins (see Annex V). In such environment, banks face less pressure to pass changes in the policy rates to their lending and deposit rates.

[3] See Brandao-Marques, L, G. Gelos, T. Harjes, R. Sahay and Y. Xue. 2020. "Monetary Policy Transmission in Emerging Markets and Developing Economies". IMF Working Paper 20/35. Washington, D.C. Mishra, P., P. Montiel and A. Spilimbergo. 2010. "Monetary Transmission in Low Income Countries." IMF Working Paper 10/223. Washington, D.C.2015; International Monetary Fund. 2015. Evolving Monetary Policy Frameworks in Low-Income and Other developing Economies. Washington, D.C. International Monetary Fund. 2023. "Implications of CBDCs for Monetary Policy Transmission". Fintech Note 2023/010. Washington, D.C.

- *Central bank independence*. In LICs/EMCs, central banks tend to be less independent, which limits both the scope for independent policy decisions and its effects.

- *Underdeveloped money and interbank market.* These markets are often not well developed in LICs/EMCs, banks distrust each other, and there is little or no transaction among banks to redistribute that liquidity.

- *Underdeveloped secondary market for government securities.* Low development hampers central banks' capacity to use these markets to conduct monetary policy transactions, weakening the transmission from short-term interbank rates to long-term rates.

- *Small and illiquid stock market, inefficient real estate market.* This makes firms' capital and real estate difficult to price and trade, weakening the transmission from interest rates to asset and real estate prices and to investment/output.

- *Low capital mobility* implies that changes in policy rates and domestic market interest rates tend to have a lesser impact on the exchange rate.

- *Higher importance of supply-side shocks.* EMC/LIC economies tend to have a higher share of foods and imported goods in the consumption basket, which makes it more difficult for monetary policy to control inflation.

- *Dollarization*. High degree of dollarization of the EMC/LIC economies also undermines the effectiveness of monetary policy. Interest rates on loans and deposits of the banking system in dollars are linked more closely to international rates rather than domestic rates, and the ability of monetary policy to control domestic prices would be limited.[4]

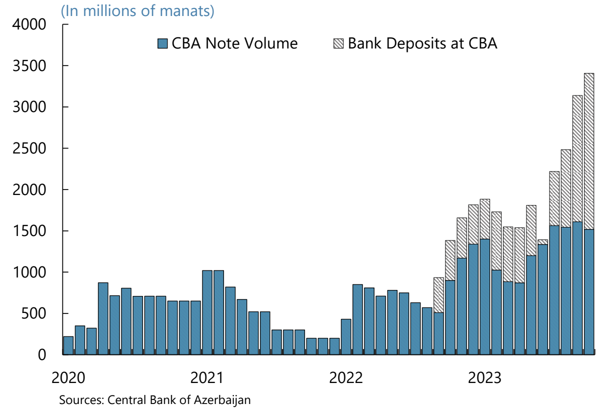
C. Changes to CBA Monetary Policy Operational Framework

6. In September 2022, the CBA began to use monetary policy tools in a new configuration. The tools employed by the Central Bank were augmented by introducing standing facilities (transactions are initiated by banks) and by expanding the range of open market operations (liquidity providing and absorbing operations initiated by the Central Bank, see Table A.IV.1). A new operational platform (Bloomberg trading system) has been introduced to conduct interbank unsecured manat-denominated credit transactions, and methodology was introduced to calculate reference interest rate indices to allow better monitoring of the effectiveness of monetary policy and to be used as a reference rate for pricing of loans, bonds, and derivatives. As for standing facilities, 1-day standing deposit facility will be used for liquidity absorption, while 1-day reverse repo will be used as standing liquidity providing facility. The interest rate on the 1-day deposit facility should be equal to the floor, while the interest rate on the 1-day liquidity provision should be equal to the ceiling of the interest rate corridor.

[4] For comprehensive review of implications of dollarization for monetary policy conduct, see Balino, T. et al., "Monetary Policy in Dollarized Economies." IMF Occasional Paper 171. Washington, D.C.1999.

7. To improve open market operations, 1-,3-,6-, and 9-month note auctions has been held since October 2022 for liquidity absorption.

CBA Notes Outstanding and 1-Day Deposits at CBA

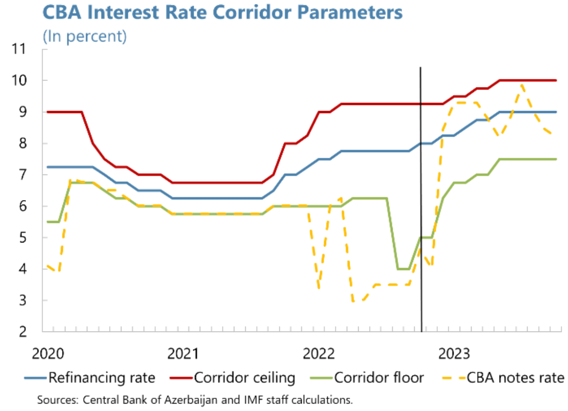


7-day Repo operations have been added into the arsenal of tools for liquidity absorption along with the CBA notes. According to the CBA, interest rates on repo operations will be between the floor of the corridor and the refinancing rate, interest rates on reverse repo operations will range between the refinancing rate and the ceiling of the corridor, and the yields on the 1-, 3-, 6-, and 9-months CBA notes will be market determined. [5] Demand for CBA sterilization notes have been very high recently, with outstanding CBA notes in 2023 often exceeding 1 billion manats, about twice as much as in previous years, while bank use of CBA's 1-day standing deposit facility also picked up. Importantly, interbank activity has been increasing as well in 2023, with the volume of interbank transactions in both secured and unsecured markets increasing (CBA notes and government bonds are used as securitization in the repo market).

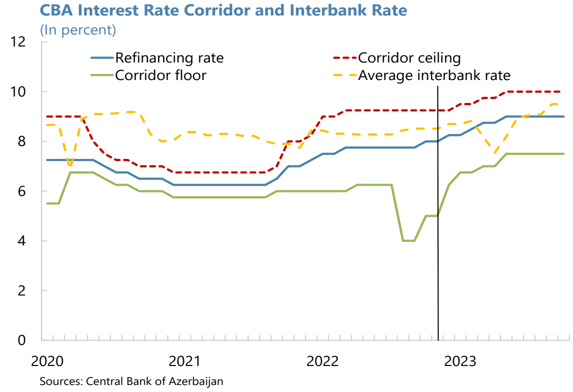
D. Preliminary Assessment of Impact on Monetary Transmission

8. Interbank and CBA notes rates became more sensitive to the CBA policy rate. Prior to the introduction of the September 2022 measures, average interbank lending rate and CBA notes rates have been sometimes moving in the opposite direction to the CBA policy rate (see text figures). The correlation between the CBA refinancing rate and average interbank rate has changed after September 2022: during July 2019 – September 2022, correlation coefficient has been close to zero, but for October 2022-October 2023, the coefficient turned moderately positive at 0.3. Before the September 2022 measures, average interbank rate hovered above the CBA refinancing rate, but since then, the two rates became more closely aligned.

CBA Interest Rate Corridor Parameters



CBA Interest Rate Corridor and Interbank Rate

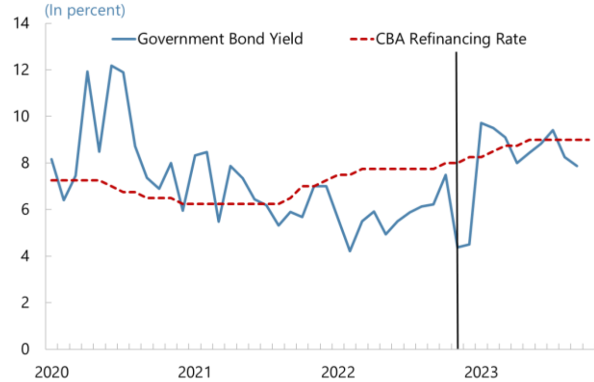


[5] At the time of introduction of new operational framework, because of the large structural liquidity in the banking system, the CBA reduced temporarily the floor of the corridor to 4 percent.

The response of the weighted average yield on CBA notes (maturity 28-252 days) to the CBA refinancing rate has been even more pronounced after September 2022. Before that date, the correlation coefficient was negative, -0.3, but it turned to high positive of almost 0.8 percent thereafter.

9. Government bond yields also became more sensitive to changes in the CBA refinancing rate. The figure shows the evolution of weighted average government bond yield (average of bonds with maturity 1-5 years). Before the September 2022 measures, government bond yields were falling even as inflation was picking up and the CBA began to increase its refinancing rate. However, by the end of 2022, bond yields increased sharply, basically "catching up" with the CBA rates. This is confirmed by the sharp tightening of correlation: the correlation coefficient of CBA refinancing rate and government bond yields was close to zero before September 2022, and about 0.6 thereafter.

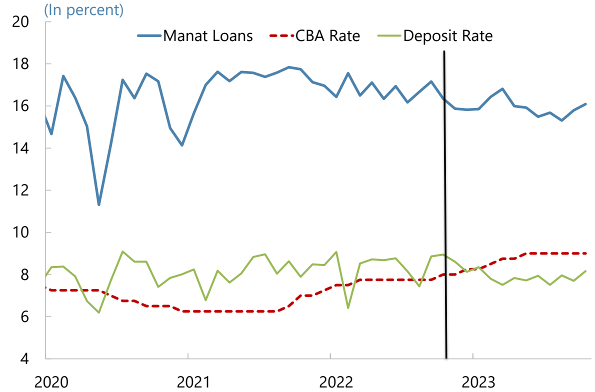
CBA Refinancing Rate and G-Bond Yield
(In percent)



Sources: Central Bank of Azerbaijan, and IMF staff calculations.

10. However, there is yet little evidence of improved transition from the CBA rate to bank lending rates. Historically, bank lending rates in both manat and foreign currency loans have been rather stable, even as inflation has been rather volatile recently, pointing to a large movement in inflation-adjusted (real) interest rates. Correlation coefficient shows no improvement in transmission from CBA rate to manat loan rate: during July 2019 – September 2022, correlation coefficient has been close to zero (0.01) and during October 2022 – October 2023 even turned negative to -0.3. A similar picture shows when we look at the correlation between the CBA refinancing rate and deposit rates: the correlation went from almost nonexistent before September 2022 to strongly negative (-0.78) after.

CBA Rate and New Manat Loans Rate
(In percent)



Sources: Central Bank of Azerbaijan and IMF staff calculations.

Table AIV.1. Azerbaijan: Correlation Coefficient of CBA Refinancing Rate and Economy's Interest Rates		
	Before September 2022	October 2022 – July 2023
CBA Rate-Interbank Rate	0.07	0.3
CBA Rate-Gov't Bond Yield	-0.04	0.58
CBA Rate-CBA Notes Yield	-0.29	0.77
CBA Rate-Bank Lending Rate	0.01	-0.30
CBA Rate-Bank Deposit Rate	0.04	-0.78
Source: CBA Monthly Statistical Bulletin, staff calculations		

E. Conclusions and Policy Recommendations

11. The CBA has taken welcome first steps to strengthen monetary transmission, but further effort is needed. Initial data suggest an improved transmission from the CBA policy rate to interbank rates and CBA notes and government securities' yields. However, improvement in the transmission to bank deposit and lending rate has been slower, and further effort will be needed to address this weak link in the monetary transmission chain.

12. Financial sector is relatively underdeveloped and competition in the banking sector remains weak. Promoting financial development should be an important ingredient of monetary policy modernization and improved transmission.

13. Despite substantial reduction, **dollarization remains relatively high**, and efforts to reduce it should continue, including through macroprudential and regulatory measures (Cakir et al., 2022).

14. Exchange rate flexibility could serve as an important transmission channel for monetary policy, and the modernization of Azerbaijan's monetary policy framework in this direction should improve monetary transmission.

15. Further improvements in liquidity management operations are also needed**,** including further work on developing standards for interbank transactions, use of standard master repo agreements, and continued effort to improve liquidity forecasting techniques.

16. CBDCs, currently explored by the CBA, could also strengthen monetary policy transmission by increasing competition for bank deposits, and promoting financial inclusion and de-dollarization (IMF, 2023b).

17. Finally, **further improvements in the CBA's communication** should also strengthen monetary transmission, by increasing monetary policy predictability and thus strengthening the operation of the inflation expectations channel (IMF, 2023a).

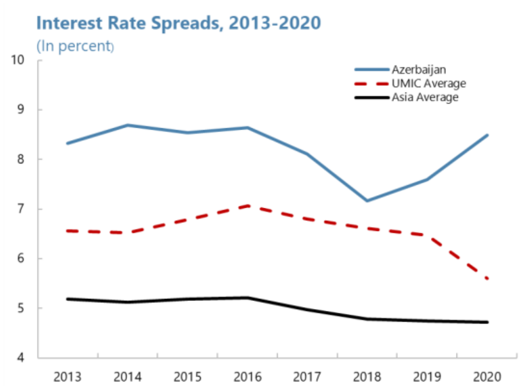
Table AIV.2. Azerbaijan: CBA Standing Facilities and Open Market Operations

Objective	Type of tool	Tools	Frequency	Maturity
Liquidity Providing	Standing Facilities	Reverse Repo	At banks' request	1 day
	Open Market Operations	Reverse Repo Auctions	If necessary	7 days
Liquidity Absorbing		CBA's Note Auction	Under schedule	1,3,6 and 9 months
		Repo Auction	If necessary	7 days
	Standing Facilities	Deposit to CBA	At banks' request	1 day

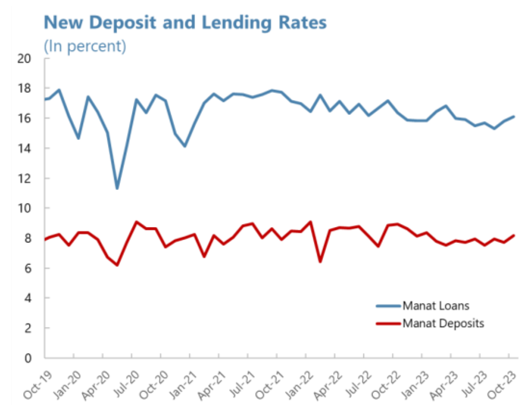
Annex V. Banking Sector Interest Rate Spread Analysis[1]

A. Introduction

1. Over the years, Azerbaijan has been facing a substantial interest rate spread. This pronounced gap between deposit and lending rates exceeds the averages observed in upper-middle income economies. Between 2013 and 2020, the average annual spread in Azerbaijan is 8.2 percentage points, compared to 6.6 percentage points among upper middle-income countries and nearly 5 percentage points among Asian countries.



Sources: Global Economy and IMF staff calculations.



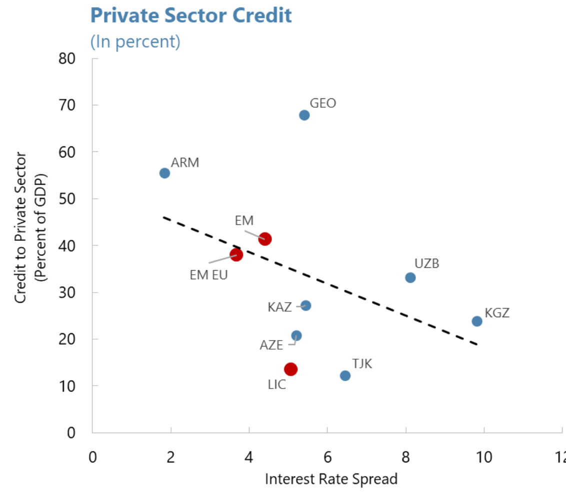
2. The wide interest rate spread poses risks to medium-term growth. The spread signals the flow of funds from savers to borrowers, exerts substantial influence over consumer and business expenditure, and therefore wields critical importance in charting the course and scale of economic growth and price stability. In the context of a competitive and efficient financial system, a wide interest rate spread strongly indicates inefficiency and a lack of competitiveness in the financial sector. Elevated lending rates correspond to an increased risk premium, which curbs borrowing, while lower deposit rates discourage savings. It reflects the high costs of finance in the economy, and, consequently, has the potential to impede the process of financial deepening.[2]

3. Wide interest rate spreads also present a challenge for the transition to inflation targeting. Annex IV investigates the relationship between the CBA policy rate (refinancing rate) and both the interbank and the lending rates. While the correlation between the CBA refinancing rate and the interbank rate has undergone significant changes following the introduction of measures in September 2022, there has been no noticeable improvement in the correlation coefficient between the CBA rate and lending rates for new manat loans. The literature suggests that underlying factors that lead to wide spreads, such as high banking concentration, also reduce the pressure for banks to pass changes in the policy rates to deposit and lending rates.

[1] Prepared by Safari Kasiyanto (MCM).

[2] Gigineishvili, N., et. al., (2023). Paving the Way to More Resilient, Inclusive, and Greener Economies in the Caucasus and Central Asia, IMF Departmental Paper, Middle East, and Centra Asia Department, DP/2023/004.

4. This note reviews the wide interest rate spread in Azerbaijan and provides a preliminary assessment on what drives these conditions and policy recommendations to gradually reduce it.



B. Interest Rate Spread: Theoretical Review

5. The interest rate spread represents the gap between the interest rates at which financial institutions lend money (lending rate) and the rates at which they attract deposits (deposit rate). It represents the profit margin for these institutions by showing the gap between their borrowing costs and the income from lending. According to classical interest rate theory, this rate serves as the reward for deploying capital productively and aligns with the marginal productivity of capital.

6. The interest rate is determined by supply and demand during the intermediation process. Research by Ho and Saunders (1981) centers on the dealership model, portraying commercial banks as "dealers" gathering deposits from the public and extending loans. Banks, incurring costs due to risks posed by the unpredictable behavior of depositors and borrowers, seek positive interest rate spreads to compensate for this uncertainty.[3] Determinants of the interest rate spread include factors such as competition, interest rate risk, risk aversion, market structure, transaction sizes, and interest rate variances.[4] Subsequent research explores credit risk, ownership, taxation, financial leverage, regulatory aspects, accounting standards, and market power in understanding and decomposing interest rate spreads.

7. The various factors determined the interest rate spread can be grouped into three broad categories: macroeconomic conditions, bank-specific factors, and institutional set ups.

8. Macroeconomic Conditions: Inflation expectations can also drive lenders to seek higher interest rates to maintain real returns. Central bank policies, such as changes in policy rates, can influence lending and deposit rates in response to these conditions.

9. Bank-specific factors: Supply and demand dynamics in the financial market are influenced by bank-specific variables like sector efficiency, market structure, operating costs, bank size, credit risk, and diversification.

10. Institutional Setup: Government effectiveness, political stability, and regulatory and supervisory measures may impact the cost structures of financial institutions.

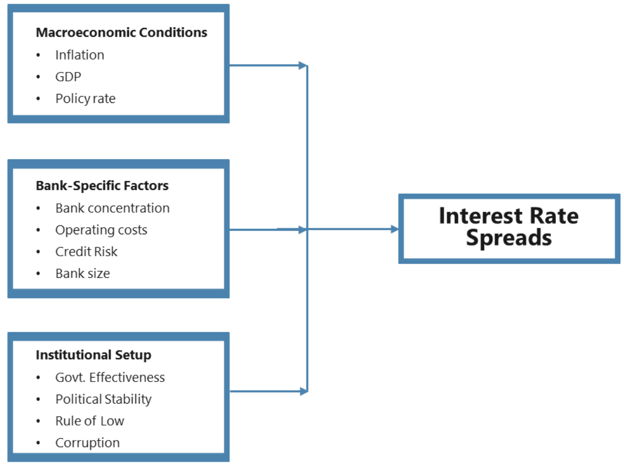
[3] Were, M., & Wambua, J. (2014). What factors drive interest rate spread of commercial banks? Empirical evidence from Kenya. Review of Development Finance. For specific discussion on interest rate spread and bank profitability, see for instance Aboagye, A. Q. Q., & Chithambo, L. (2019). Interest rate spread and bank profitability: Evidence from Sub-Saharan African countries. International Journal of Business and Emerging Markets, 11(3), 279-298.

[4] Thomas S. Y. Ho, & Saunders, A. (1981). The Determinants of Bank Interest Margins: Theory and Empirical Evidence. The Journal of Financial and Quantitative Analysis, 16(4), 581–600. https://doi.org/10.2307/2330377.

C. Preliminary Assessment of Interest Rate Spreads

11. In this section, we provide a preliminary evaluation of the substantial interest rate spreads in Azerbaijan, focusing on bank-specific factors. Our analysis draws on cross-country data from Central Asia, where we assess various dimensions of bank efficiency, encompassing capitalization, NPLs, profitability, and operational costs. To gain insights into the functioning of banks, we conducted comparisons between key metrics, such as customer deposits-to-loan ratios and capital-to-assets ratios, with the aim of identifying the optimal level of intermediation by banks. We compared non-interest expenses in relation to gross income and personnel expenses in relation to non-interest expenses to gauge the efficiency levels of banks. For banks' concentration in Azerbaijan, we scrutinized the trends in the Herfindahl-Hirschman Index (HHI)[5] over recent years to gain a deeper understanding of market concentration dynamics. We also conducted accounting decompositions and examined the breakdown of the Financial Development Index for recent years to support our cross-country analysis.

Conceptual Framework of Spread Determinants



Sources: Various sources and IMF staff calculations.

12. The banking sector in Azerbaijan is resilient, but it also faces notable challenges: a low level of loan to deposit ratio, high operating cost, and increasing concentration levels (Figure AV.1).

- **Capital ratios** are relatively strong, and the deposit-to-loan ratio is close to 170 percent, implying that a substantial portion of deposits remains untapped for lending purposes. This underutilization of deposits indicates that the banking sector has not fully maximized its role as an intermediary between savers and borrowers. Therefore, there is significant room for expanding loan supply to meet demand.

- **NPL levels** are relatively low, despite a notable presence of restructured loans. Continued monitoring of restructured loans to mitigate their potential risks is crucial.

- **Efficiency** metrics indicate that noninterest costs in Azerbaijan are the highest in the region, accounting for 58 percent of financial income, while personnel costs represent over 60 percent of the noninterest expenses. However, profitability ratios in Azerbaijan lag most regional peers except Uzbekistan. These factors suggest that optimizing cost structures and improving operational efficiency are critical for reducing the bank spread and even enhancing overall profitability.

[5] The HHI evaluates international practice markets' competitiveness and concentration level. According to the experience of the US Department of Justice, the value of HHI can vary from 0 to 10000. Based on this index, markets are divided into 3 parts: low-concentrated markets (HHI < 1500), moderately concentrated markets (1500 < HHI < 2500), and highly concentrated markets (HHI > 2500).

13. **Bank concentration** in Azerbaijan has shown low to moderate concentration over the last five years, as measured by the HHI index. However, concentration has been rising, particularly in deposits, assets, and capital. Loans remain relatively less concentrated, given the low credit to GDP in Azerbaijan comparing to the neighboring countries. When we check the coefficient correlation between the interest rate spread and bank concentration in Azerbaijan for the last five years, it resulted at 0.48, indicating a positive correlation with moderate strength. Given the increasing trend in bank concentration, addressing this trend is essential to promote competition and prevent the emergence of monopolistic practices within the banking sector.

Bank Concentration Level
(HHI Index)

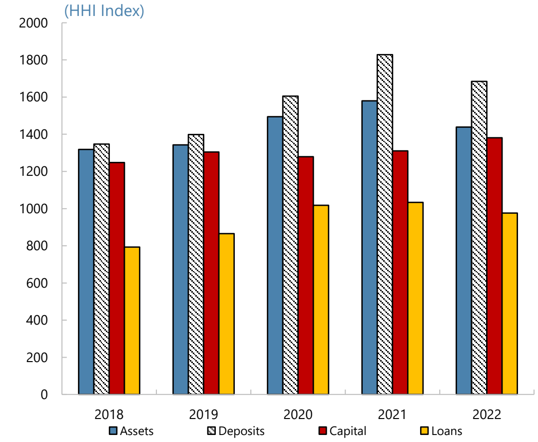
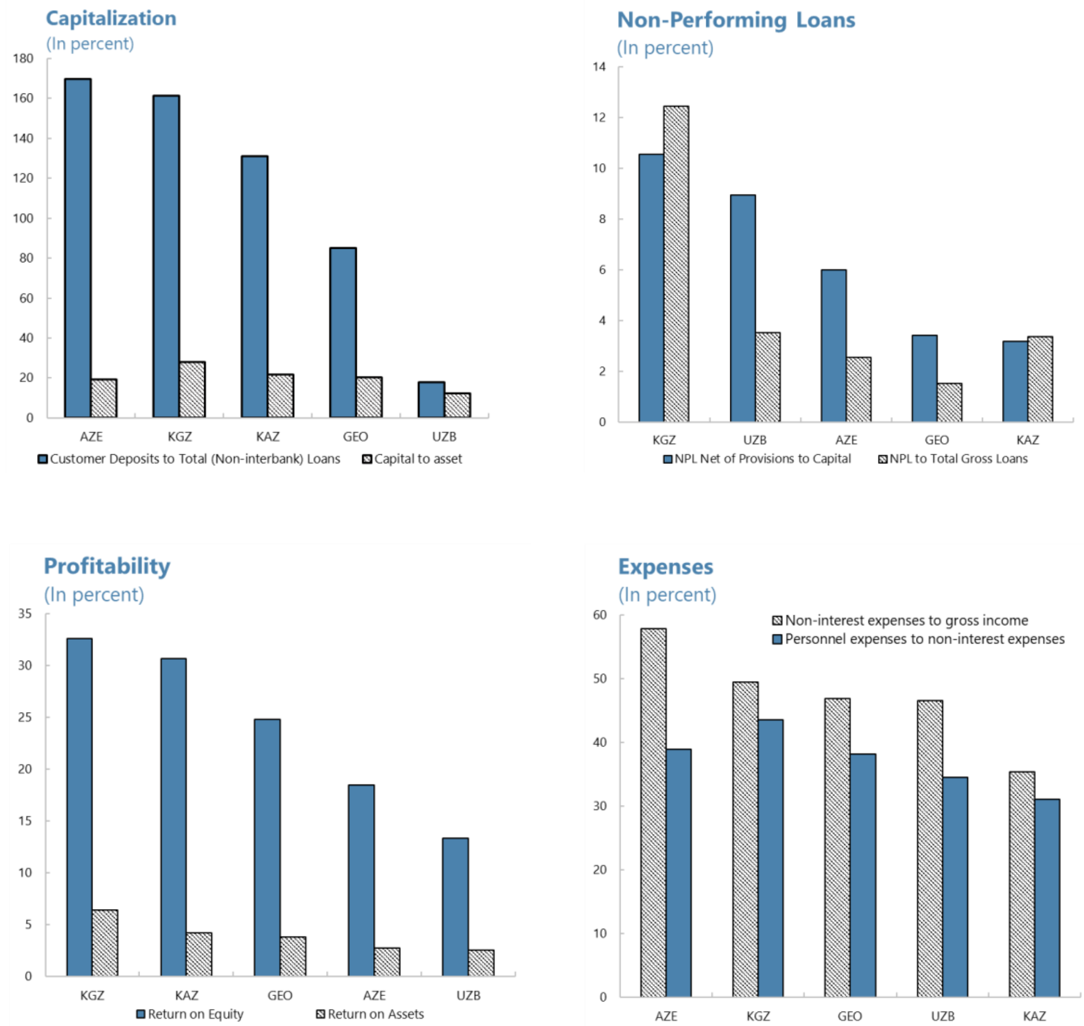


Figure AV.1. Azerbaijan: Various Banks' Developments & Efficiency Indicators in Central Asia, 2022



Sources: IMF FSI, staff calculations.

14. System-wide accounting decompositions of the interest rate spread from 2019 to 2022 show a trend of increasing spreads in recent years, accompanied by expanded profit margins (Table A.V.1). High operating costs, at 5.4 percent on average, can be seen as a primary driver behind the persistently high interest rate spreads. However, the costs associated with loan loss provisions remain low, hovering at around 1 percent of total expenses. Likewise, the expenses incurred for covering required reserves are minimal across the spectrum of banks.

Table AV.1. Azerbaijan: Contributions to Interest Rate Spread
(In percent)

	2019	2020	2021	2022
Interest earned on loans	9.5	10.7	10.3	11.2
Interest paid on interest bearing liabilities	1.9	1.8	1.6	1.6
Spread	**7.6**	**8.9**	**8.6**	**9.6**
Operating cost/loans	5.3	5.6	5.3	5.6
Loan loss provisions/loans	1.2	0.5	1.0	1.0
Interests paid to cover required reserves	0.2	0.2	0.1	0.1
Pre-tax profit margin	1.0	2.6	2.2	3.0

15. The breakdown of components of the Financial Development Index (FDI) from 2018 to 2021 also supports the inefficiency, shallowness, and increasing concentration of banking sector in Azerbaijan (Table A.V.2).

- The overall financial sector development in Azerbaijan experienced a decline from 0.27 in 2018 to 0.25 in 2021. This suggests that the country has faced challenges in developing a robust and thriving financial sector.

- Market development remained stagnant, with a slight decrease from 0.22 in 2018 to 0.21 in 2021. Market depth, which measures the size and liquidity of the financial market, declined notably from 0.15 to 0.11 during this period. Market access, which assesses the ease of entry and participation in the market, has remained subdued.

- Institutional development in the financial sector also shows a slight decline, from 0.31 in 2018 to 0.29 in 2021. This is further divided into three components: institution depth, institution access, and institution efficiency. Institution depth is constantly very low at 0.07 over the years, while institutional access is also stagnant at around 0.24. Institution efficiency witnessed a substantial decline from 0.67 in 2018 to 0.57 in 2021. These indicators highlight the need for strengthening efforts to develop and deepen the financial sector.

Table AV.2. Azerbaijan: Components of Financial Development Index in Azerbaijan

	2018	2019	2020	2021
Overall	**0.27**	**0.27**	**0.26**	**0.25**
Market	**0.22**	**0.22**	**0.22**	**0.21**
Market depth	0.15	0.15	0.15	0.11
Market access	0.52	0.51	0.52	0.52
Institution	**0.31**	**0.3**	**0.28**	**0.29**
Institution depth	0.07	0.07	0.07	0.07
Institution access	0.24	0.23	0.23	0.24
Institution efficiency	0.67	0.64	0.56	0.57

D. Conclusions and Policy Recommendations

16. **The interest rate spread in Azerbaijan is notably wider in comparison to peer economies**. The spread has been persistently high in contrast to upper middle-income countries worldwide and Asian economies. The wider interest rate spread, indicative of inefficiency and a lack of competitiveness in the financial sector, can hinder economic growth, price stability, and financial deepening.

17. **Based on analysis of bank-specific factors, the banking sector has not fully maximized its intermediation role**. Banks' high operating costs yet low profitability and an increasing bank concentration over recent years appear to contribute to the high spread.[6] Deposit-to-loan ratio is very high (nearly 170 percent), while operating costs show the highest among the region and the main explanation for the high interest spread. Bank concentration trend shows an increase over the recent years, particularly on deposits, capitals, and assets. From the FDI breakdown, overall financial sector development in Azerbaijan has also experienced a decline in both market and institution indicators, showing that it has faced challenges in developing a robust and thriving financial sector.

18. **To address these findings, the following steps will be vital in reducing the interest rate spread**:

19. **Review and improve cost structure and efficiency**. Further comprehensive analysis of the cost structure and efficiency is needed to identify areas of inefficiency, including reviewing pricing models for loans, deposits, and other financial products to improve competitiveness. The authorities should also encourage banks to: (i) improve lending in compliance with responsible and sound lending regulations; (ii) implement robust risk management practices to minimize credit and operational losses, including strengthening credit risk assessment, monitoring procedures to reduce NPLs, ensuring effective liquidity and interest rate risk management practices; (iii) diversify funding sources to mitigate the impact of high funding costs; and (iv) leverage data analytics to identify opportunities for optimization and risk mitigation.

[6] For a broader discussion in the region, see Almarzoqi, Raja and Sami Ben Naceur (2015). Determinants of Bank Interest Margins in the Caucasus and Central Asia, IMF Working Paper.

20. Closely monitor bank concentration. The authorities should keep a close eye on the market share of each dominant bank and track any significant increases in their market share. In cases of elevated concentration levels, stress tests should be conducted to evaluate potential crisis or economic downturn repercussions on conglomerates and the broader financial system, as heightened concentration can intensify systemic risks.

21. Assess alternative channels to expand financial inclusion, especially for borrowers, and increase competition. For examples, digital financial services such as open banking and fintech platforms can facilitate access to various financial products and services tailored to the borrowers' needs. These platforms utilize big data analytics to revolutionize lending by processing extensive consumer credit data which can make more informed lending decisions. Digital financial services also increasingly use AI and machine learning to assess creditworthiness of the borrowers in real-time. These technologies can generate accurate and up-to-date credit scores and supporting credit assessment. Online platforms and marketplaces can also foster competition by enabling borrowers to compare various banking products, including loans.

22. Most importantly, move to a more proactive approach to banking sector regulation and accelerate the initiation of risk-based and consolidated supervisions for large banks. A more proactive approach to banking sector regulation and the implementation of risk-based and consolidated supervisions for large banks will help identify vulnerabilities in large banks early, allowing for timely interventions to prevent financial crises, mitigate systemic risks associated with their dominance, lead to more efficient operations and create an environment more conducive to competition (for instance, proactive regulation will enable regulators to encourage cost-reduction measures and promote best practices/international standards).

Annex VI. Confronting Climate Change Challenges[1]

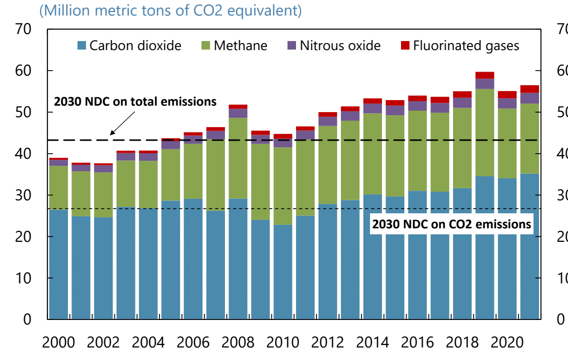
Azerbaijan has committed to reduce its greenhouse gas emissions by 35 percent by 2030 from 1990s levels. In addition, the country needs to transition away from fossil fuels, as hydrocarbon reserves continue to dwindle, posing medium-term challenges to the economy. Energy consumption is heavily dependent on fossil fuels and the use of renewable energy is low. Consumption of energy products benefits from explicit and implicit subsidies and the pricing structure could be adapted more to climate change challenges. In this context, climate actions and policies could play a key role in the transition. This annex is an initial assessment of the costs and benefits associated with various options at hand for Azerbaijan to address climate-related issues and transit to a greener and more sustainable society.

A. Background

1. Azerbaijan has committed to reduce greenhouse gas emissions (GHG). In the context of the 2015 COP21 Paris Agreement, Azerbaijan agreed to reduce its GHG emissions by 35 percent from 1990 levels by 2030. This implies a reduction of about 25 percent from its 2022 levels. In 2021, at COP26 in Glasgow, Azerbaijan committed to further reduce GHG emissions by 40 percent by 2050. A report from the World Bank (2023)[2] concluded that decarbonizing and building resilience in the Azerbaijan economy could cost about 3.2 percent of GDP, cumulative in the next four decades.

2. These commitments align with Azerbaijan's need to diversify away from hydrocarbon industries. Crude oil production and export volumes have been in gradual decline since 2010 and gas production and exports only partially offset the contraction of oil in recent years. Total crude oil production reached 558,000 bpd in 2022, well below the 1 million bpd produced back in 2009. Gas production reached 46.7 bcm in 2022, of which about 35 bcm are commercially produced. With existing reserves, gas production is expected to remain at the 2022 level on average for the next 10 years, before declining. In this context, reducing greenhouse gas emissions by investing in renewable sources of energy, allows Azerbaijan to achieve other objectives:

Azerbaijan. Greenhouse Gas Emissions and National Targets
(Million metric tons of CO2 equivalent)



Sources: IMF Climate Dashboard.

- **Meet rising short- and medium-term export demand for scarcer fossil fuels**. Crude and gas are mostly exported, representing an important source of foreign currency and fiscal revenues. Part of the extracted gas—about 10 billion cubic meters (bcm)—is however used for domestic consumption (households and power generation) at below market prices. With the expansion of renewable energy production capacity, Azerbaijan can increase the exports of gas or extend the life span of existing reserves. This could help generate resources that can finance green investments and provide support to the segments of the population most vulnerable to climate change.

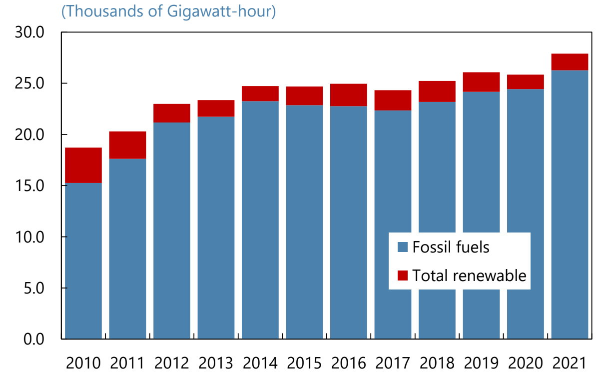
[1] Prepared by Gustavo Ramirez (MCD).

[2] Azerbaijan. Country Climate and Development Report. World Bank. November 2023.

- **Develop the renewable energy sector to boost future economic growth and employment**. Azerbaijan needs to foster nonhydrocarbon industries as an engine of growth. With high potential to develop renewable energy, Azerbaijan has started the process of economic diversification away from hydrocarbon commodities.

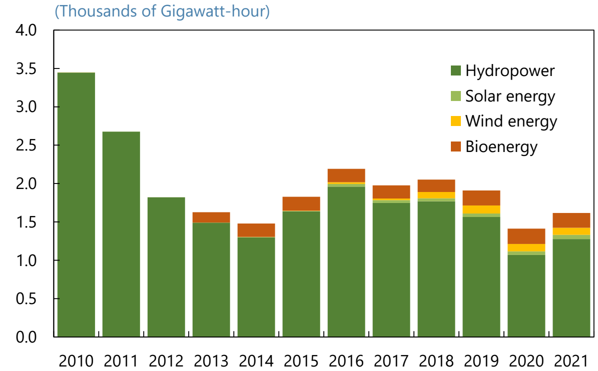
3. **Azerbaijan's energy mix relies heavily on fossil fuels**. More than 95 percent of energy demand consists of natural gas and oil products. In addition, Azerbaijan's total power generation capacity is about 8 GW, of which only 1.3 GW (16.5 percent of total) is from renewable sources, mostly hydropower (1.2 GW). Wind, solar and bioenergy account for the remaining capacity (2.5 percent). In terms of power generation, in 2022, electricity production reached 28.9 billion kWh; of which hydropower plants produced 1.6 billion kWh and other renewable sources add up to 0.4 billion kWh.

Azerbaijan. Power Generation
(Thousands of Gigawatt-hour)



Sources: International Renewable Energy Agency (IRENA); IMF Staff Calculations.

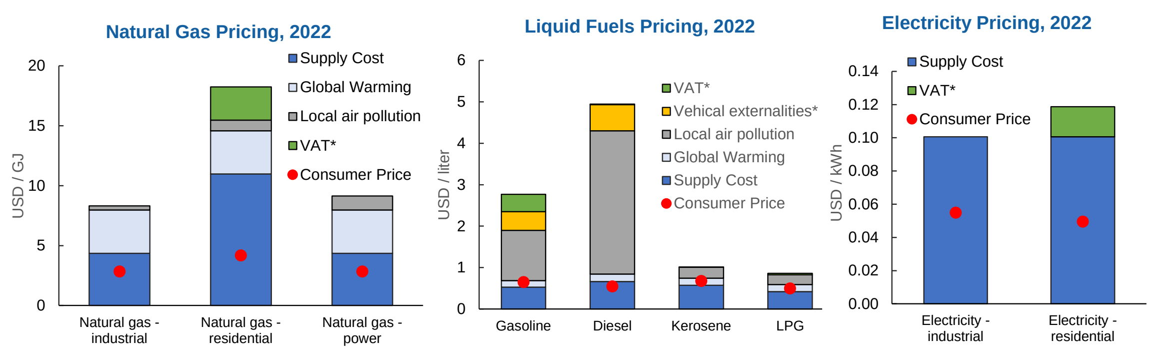
Azerbaijan. Renewable Power Generation
(Thousands of Gigawatt-hour)



Sources: International Renewable Energy Agency (IRENA); IMF Staff Calculations.

4. **The prices of energy products are also mostly regulated and receive significant direct and indirect subsidies**. Azerbaijan regulates domestic energy prices, keeping them well below the economic and environmental costs, with domestic prices in main energy products barely covering the corresponding supply unit cost. Gas for residential and power generation are priced below the supply cost. Explicit and implicit subsidies—the latter includes the unaccounted costs of air pollution and global warming—amount to 2 percent of GDP for residential use, and 2.6 percent of GDP for power generation. Subsidies are also large in gasoline and diesel (6 and 11 percent of GDP, respectively). Electricity is priced equally for industrial and residential use, with subsidies amounting to 1.6 percent of GDP.

Azerbaijan. Energy Pricing and Subsidies



* Weighted by share of consumption relevant for the externality. VAT applies to final consumption.
Source: Fund staff estimates. Fiscal Affair Energy Subsidies Template.

5. **The government has been developing and implementing a strategy toward reducing its dependence on fossil fuels**. The National Development Plan, Azerbaijan 2030, established the roadmap for the green transition. The plan, launched in 2021, set the Clean Environment and Green Growth Strategy, as part of medium- to long-run economic diversification and aimed at enhancing the use of renewable and green energy sources. The authorities plan to increase the installed capacity of renewable energy by 30 percent (equivalent to 1.5 GW). Azerbaijan is collaborating with various stakeholders (international private and development partners) to develop and implement the green strategy, including wind, solar and geothermal potential, covering onshore and offshore projects. Among other more immediate actions, the government is also working to reduce inefficiencies that contribute to GHG emissions in the existing infrastructure.

B. Options Towards a Green Transition

6. **The macroeconomic implications of alternative strategies toward Azerbaijan's green transition can be assessed**. The IMF-WB Climate Policy Assessment Tool (CPAT) analyzes possible strategies for alternative climate and fiscal goals. The CPAT allows the simulation of policy strategies, such as the phasing out of energy subsidies, establishment of a carbon tax, energy efficiency regulations, power "feebates", vehicle fuel economy gains, and various green policies that could be relevant for Azerbaijan. The scenarios below consider a combination of two strategies:

- **Phasing out energy subsidies**: As noted above, energy products in Azerbaijan are regulated and heavily subsidized. The phasing out of energy subsidies will encourage households and firms to reduce fossil fuel energy consumption and switch to renewable energy, making available resources to protect the vulnerable and invest in green technology. In the scenarios below, fossil fuel subsidies and regulated prices are assumed to be gradually phased out in a 5-year period, starting in 2023.

- **Carbon tax**: A carbon tax is a tax on fossil fuels, aimed at pricing the externalities associated to the use of carbon dioxide emitters. Like phasing out subsidies, it increases revenues that can be used for climate change mitigation. The socially efficient tax level could however be very high, if demand is highly inelastic—which is the case when renewable energy options are not available. It can also discourage investment, as firms could shift production to countries without a carbon tax.

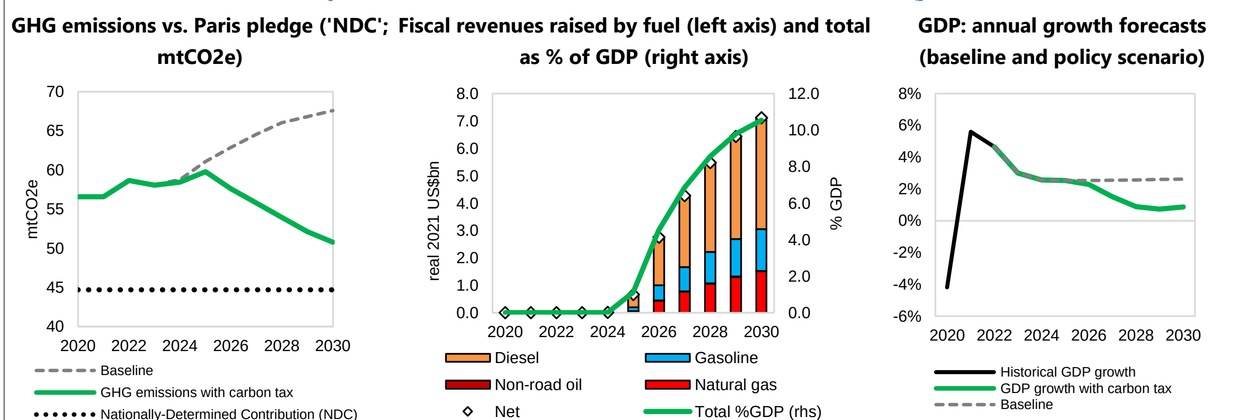
7. **CPAT policy strategies generate resources that can be used to stimulate green-enhancing economic activities.** The simulation of alternative strategies is the engine that promotes behavioral responses in the CPAT to reduce GHG emissions. In addition, they generate fiscal resources that could be used on complementary mitigating policies that reduce GHG emissions further, increase investment in green technology, or support the most vulnerable. These policies include direct household subsidies, direct transfers, public investment, and labor tax incentives.

8. **A combination of policy strategies is needed for Azerbaijan to meet its commitments**. An important step towards achieving Azerbaijan's nationally determined contribution (NDC) is to phase out energy subsidies. It is however not sufficient to curb the rising trend in GHG emissions in coming years to reach the NDC. By 2030, based on the CPAT simulations, in the "Business as Usual" scenario (assuming no actions taken), GHG emissions will be about 50 percent higher than its NDC, additional

fiscal revenues will not be collected, and economic growth would remain at about 2.5 percent per year. Below, the impact of two scenarios are considered.

Scenario 1 envisages the phasing out of direct and indirect energy subsidies and the use of resources raised for labor tax incentives, public investment, and transfers. In this scenario, CPAT simulates the phasing out of existing direct and indirect energy subsidies and assumes that no carbon tax is established to curb GHG emissions and reach Azerbaijan's NDCs. Under this scenario, a significant reduction in GHG emissions is achieved, but Azerbaijan would still be above its NDC. Azerbaijan would achieve a 25 percent reduction of its GHG emissions from the 1990 levels (about 10 percentage points short from its NDC). Fiscal resources generated by the gradual phasing out of subsidies allow the government to mobilize revenues of about 10 percent of GDP by 2030. The additional revenues are assumed to be used for labor tax incentives (40 percent), public investment (30 percent) and the remaining resources (30 percent) are returned as transfers to the economy. This scenario reflects the option that Azerbaijan could split the additional revenues almost evenly to stimulate employment through tax incentives, economic growth through public investment, and support the most vulnerable through direct transfers. The impact of the elimination of subsidies on GDP growth is negative, with the long run GDP growth remaining 1.5 percentage points below the baseline estimates, as most resources obtained from the removal of subsidies are reverted to the economy via tax incentives and transfers, and only 30 percent of the resources are used for public investment. In the CPAT, the multiplier for public investment is 1.5 times higher than for tax incentives and transfers.

Scenario 1: Phasing out fossil fuel subsidies, and spending the revenues equally on labor tax incentives, public infrastructure and transfers to the economy



2015 ND NDC target for Azerbaijan is a 35% reduction in absolute emissions by 2030 vs. 1990. Policy achieves 24.9% vs. BAU in 2030, which is 73.4% of the emissions reductions vs. BAU for NDC.

Shows total additional (vs. baseline) fiscal revenues from the policy net of renewable energy subsidies.

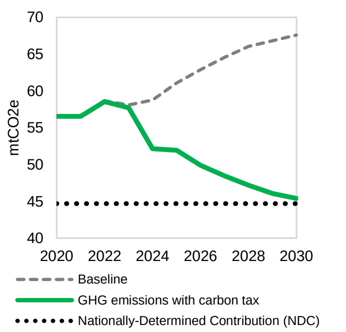
Shows projected GDP growth rates under baseline and policy scenario (including any revenue-recycling). Approach uses fiscal multipliers to estimate impact of each year of the policy on subsequent years.

Scenario 2 envisages the phasing out of all energy subsidies and the imposition of a carbon tax, starting with $30 per ton CO2 in 2024 and increasing it to $45 by 2030, and the use of resources raised for public investment. Under this scenario, Azerbaijan will achieve its GHG emission reduction goals by 2030. In this case, a carbon tax is required at the start of the simulation period ($30 per ton of CO2 by 2024) and will gradually increase to $45 per ton of CO2 by 2030. In this scenario, the fiscal resources obtained from the carbon tax and the phasing out of subsidies are used fully on public investment. By including the proposed carbon tax, fiscal revenues would increase to 12 percent of

GDP—which is higher compared to the first scenario. Under the policy mix presented in this scenario, GDP growth is expected to fall below the baseline for the first few years owing to the negative effect of the carbon tax and the removal of subsidies on the consumption of energy products, and then to grow at the rate of the baseline scenario.

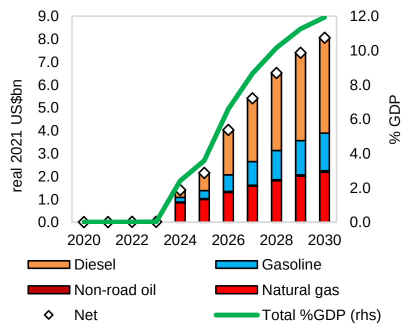
Scenario 2: Phasing out fossil fuel subsidies, imposing a carbon tax and investing additional revenues on public infrastructure

GHG emissions vs. Paris pledge ('NDC'; mtCO2e)



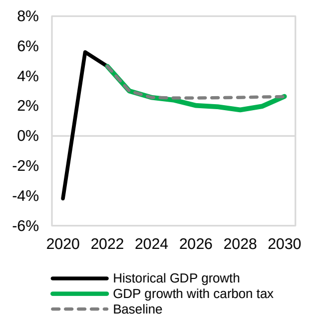
2015 ND NDC target for Azerbaijan is a 35% reduction in absolute emissions by 2030 vs. 1990. Policy achieves 32.8% vs. BAU in 2030, which is 97% of the emissions reductions vs. BAU for NDC.

Fiscal revenues raised by fuel (left axis) and total as % of GDP (right axis)



Shows total additional (vs. baseline) fiscal revenues from the policy net of renewable energy subsidies.

GDP: annual growth forecasts (baseline and policy scenario)



Shows projected GDP growth rates under baseline and policy scenario (including any revenue-recycling). Approach uses fiscal multipliers to estimate impact of each year of the policy on subsequent years.

C. Conclusions

9. Azerbaijan needs to advance the green energy transition. To achieve its NDC, Azerbaijan should consider phasing out existing fossil fuel subsidies to incentivize firms and households to rely less on non-renewables and invest in alternative sources. This will already go a long way to achieving the 2030 target. Other policy actions, such as investment in renewable energy and addressing the economic and environmental cost of existing flaring and leaks in the gas industry, would also help but involve significant cost, potentially on public finances. To help mobilize revenues, other price mechanisms such as a carbon tax could be considered. The revenues raised from such a tax would not only help finance tax incentives and green investment, but also potentially support the vulnerable who will be affected by the energy transition

INTERNATIONAL MONETARY FUND

REPUBLIC OF AZERBAIJAN

STAFF REPORT FOR THE 2023 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

December 19, 2023

Prepared By

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

CONTENTS

RELATIONS WITH THE FUND

(As of October 31, 2023)

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	529.00	100.00
Holdings	471.08	89.05

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)
ECF	Jul. 06, 2001	Jul. 04, 2005	67.58	54.71
ECF	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		
	2023	2024	2025	2026	2027
Principal					
Charges/Interest	0.6	2.45	2.45	2.45	2.45
Total	**0.6**	**2.45**	**2.45**	**2.45**	**2.45**

Exchange Rate Arrangements

The de jure exchange rate arrangement is free-floating, but the de facto regime is classified as a stabilized arrangement. The currency of Azerbaijan is the manat, which became sole legal tender on January 1, 1994. 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 multiple currency practices and 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.

Article IV Consultation

Azerbaijan is on a 12-month Article IV consultation cycle. The previous Article IV consultation was concluded on July 20, 2022.

Resident Representative

Since November 2009, the IMF no longer has a Resident Representative in Azerbaijan, but the IMF Office in Baku headed by an office manager continued to operate, until its closure in June 2023.

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 at current and constant 2005 prices. 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, (September 2018) assisted the SSC's National Accounts and Macroeconomic Statistics Department in enhancing the expenditure-side GDP estimates, consistency between the quarterly and annual GDP estimates, and measurement of taxes and subsidies on products. The authorities requested a CCAMTAC TA mission on national accounts to develop GDP by expenditure components at constant prices. The mission took place in November 2021. **Price Statistics:** In 2010, the CPI was revised to update the consumption basket (520 items). Expenditure weights are updated every year to reflect recent consumption patterns. Prices are collected from 58 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 owner occupied housing and to develop a residential property price index. Producer price indices (PPI) cover all major sectors. 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 2014 (GFSM 2014) for inclusion in the IMF's annual GFS database. 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 participated 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. More recently, STA assistance was provided to compile annual and quarterly GFS data, as well as quarterly public sector debt statistics. Further TA in improving fiscal transparency is being provided under CCAMTAC.
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.

Azerbaijan reports data on some series and indicators of the Financial Access Survey (FAS), including the two indicators (commercial bank branches per 100,000 adults and ATMs per 100,000 adults) adopted by the UN to monitor Target 8.10 of the Sustainable Development Goals (SDGs).

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*. Since 2022, the CBA has started reporting the set of core and encouraged FSIs for posting on the IMF's website, and in June 2022, it published the first issue of the Financial Stability Report.

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 investment income (cash vs accrual), trade credit and advances; currency and deposits for other sectors; and reserve assets (net basis vs gross basis). 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. 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

Azerbaijan participates in the Enhanced General Dissemination System and its National Summary Data Page was launched in February 2019.	A data ROSC was published on the IMF's website in March 2003.

Azerbaijan: Table of Common Indicators Required for Surveillance

(As of December 2023)

	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	12/2023	06/12/2032	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	11/2022	11/24/2023	M	M	M		
Reserve/Base Money	10/2023	11/24/2023	M	M	M		
Broad Money	10/2023	11/24/2023	M	M	M	O, O, O, O	O, O, O, O, LO
Central Bank Balance Sheet	10/2023	11/24/2023	M	M	M		
Consolidated Balance Sheet of the Banking System	10/2023	11/24/2022	M	M	M		
Interest Rates[2]	10/2023	11/24/2023	M	M	M		
Consumer Price Index	10/2023	11/11/2023	M	M	M	O, O, O, O	O, LO, O, O, O
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	Q3/2023	11/30/2023	Q	Q	Q		
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	03/2023	11/30/2023	M	M	M		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	Q2/2023	08/30/2023	Q	Q	Q		
External Current Account Balance	Q2/2023	09/30/2023	Q	Q	Q		
Exports and Imports of Goods and Services	10/2023	11/30/2023	M	M	M		
GDP/GNP	10/2022	11/30/2023	M	M	M	O, LO, O, LO	LO, LNO, O, O, O
Gross External Debt	Q2/2023	10/15/2023	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.

RELATIONS WITH OTHER INTERNATIONAL INSTITUTIONS

(As of November 30, 2023)

Asian Development Bank:

• Country page: https://www.adb.org/countries/azerbaijan/main

• ADB projects and results: https://www.adb.org/countries/azerbaijan/results-adb-supported-operations

European Bank for Reconstruction and Development:

• Country page: https://www.ebrd.com/azerbaijan.html

• EBRD projects: https://www.ebrd.com/work-with-us/project-finance/project-summary-documents.html?1=1&filterCountry=Azerbaijan

World Bank Group:

• Country page: https://www.worldbank.org/en/country/azerbaijan

• Overview of Word Bank Group lending: https://financesapp.worldbank.org/countries/Azerbaijan/

• IBRD-IDA project operations: https://projects.worldbank.org/en/projects-operations/projects-summary?lang=en&countrycode_exact=AZ