June 2003
IMF Country Report No. 03/154

Azerbaijan Republic: 2003 Article IV Consultation, Second Review Under the Poverty Reduction and Growth Facility, and Requests for Waivers of Performance Criteria, Extension of Arrangement and Rephasing of Purchases—Staff Report; Staff Supplement; Public Information Notice and Press Release on the Executive Board Discussion; and Statement by the Executive Director for the Azerbaijan Republic

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of a combined discussion of the 2003 Article IV consultation with the Azerbaijan Republic, Second Review Under the Poverty Reduction and Growth Facility, and Requests for Waivers of Performance Criteria, Extension of Arrangement and Rephasing of Purchases, the following documents have been released and are included in this package:

- the staff report for the combined 2003 Article IV consultation, second review under the Poverty Reduction and Growth Facility, and requests for waivers of performance criteria, extension of arrangement and rephasing of purchases, prepared by a staff team of the IMF, following discussions that ended on **March 6, 2003**, with the officials of the Azerbaijan Republic on economic developments and policies. **Based on information available at the time of these discussions, the staff report was completed on April 29, 2003**. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- a staff supplement of **May 9, 2003** updating information on recent economic developments.
- a Public Information Notice (PIN) and Press Release **summarizing the views of the Executive Board as expressed during its May 14, 2003, discussion** of the staff report on issues related to the Article IV consultation and the IMF arrangement, respectively.
- a statement by the authorities of the Azerbaijan Republic.

The document(s) listed below have been or will be separately released.

Joint Staff Assessment of the Poverty Reduction Strategy Paper
Letter of Intent sent to the IMF by the authorities of the Azerbaijan Republic*
Poverty Reduction Strategy Paper
Report on Observance of Standards and Codes
Selected Issues Paper and Statistical Appendix
*May also be included in Staff Report

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

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

Copies of this report are available to the public from

International Monetary Fund • Publication Services
700 19th Street, N.W. • Washington, D.C. 20431
Telephone: (202) 623-7430 • Telefax: (202) 623-7201
E-mail: publications@imf.org • Internet: http://www.imf.org

Price: $15.00 a copy

International Monetary Fund
Washington, D.C.

INTERNATIONAL MONETARY FUND

AZERBAIJAN REPUBLIC

Staff Report for the 2003 Article IV Consultation, Second Review Under the Poverty Reduction and Growth Facility, and Requests for Waivers of Performance Criteria, Extension of Arrangement and Rephasing of Purchases

Prepared by European II and Policy Development and Review Departments

Approved by Julian Berengaut and Martin Fetherston

April 29, 2003

- The staff discussions for the 2003 Article IV consultation and the second review under the Poverty Reduction and Growth Facility (PRGF) were held in Baku during February 23–March 6, 2003. The mission met with the Prime Minister, Deputy Prime Minister, Ministers of Finance, Economic Development, and Education, the Governor of the National Bank, and representatives of the banking and diplomatic communities, NGOs, and parliament, as well as other senior officials. The mission comprised Messrs. Wakeman-Linn (head), Hobdari and Gvenetadze (all EU2), Ms. Aturupane (PDR), Messrs. Desai and Danninger (both FAD), Mr. Surin (BLS) and Ms. Moss (staff assistant, EU2) and was assisted by Mr. Mered, the Resident Representative. Mr. Zurbrügg, Executive Director for Azerbaijan, participated in several meetings.
- In concluding the 2001 Article IV consultation in February 2002, Directors commended the authorities for continued strong economic performance, and stressed that economic diversification was crucial for sustained reduction in poverty. Directors welcomed the comprehensive plan to strengthen energy sector financial discipline. Finally, Directors were encouraged by the regulations designed to ensure the planning, execution and monitoring of the oil fund and state budgets in the context of a consolidated budget, stressing that, if used wisely, the oil fund could make a crucial contribution to combating poverty in Azerbaijan.
- Azerbaijan's statistical base is adequate to conduct effective surveillance and the publication policy is open. Implementation of the recommendations outlined in the country's ROSC data module, completed in March 2003, would further strengthen economic statistics. The authorities have agreed to publish the data ROSC.
- Azerbaijan continues to avail itself of the transitional arrangements of Article XIV, but no longer maintains restrictions under such transitional arrangements.

Tables

Text Boxes

Appendices

Attachments

Azerbaijan: Basic Data

Social and demographic indicators (2000)	
Area (in sq. km)	86,600
Population (in thousands)	8,203
Percent urban	51
Percent rural	49
Population growth rate (in percent)	0.8
Life expectancy at birth (in years)	72
Infant mortality rate (per 1,000 population)	12.8
Physicians (per 1,000 population)	3.6
GDP per capita (in U.S. dollars, at average 2002 exchange rate)	747

	1998	1999	2000	2001	2002 1/
	(In percent of GDP)				
Structure of GDP					
Industry and construction	35.0	39.1	42.5	43.5	45.6
of which: Oil and gas sector	11.5	20.1	30.5	32.0	29.5
Agriculture	18.0	18.2	15.9	14.8	14.2
Other	47.0	42.7	41.5	41.7	40.2
	(Percentage change, unless otherwise indicated)				
Output and employment					
GDP (in billions of manats)	17,203	18,875	23,591	26,578	29,602
Real GDP	10.0	7.4	11.1	9.9	10.6
Employment	0.2	0.1	-0.1	0.3	0.3
Prices and wages					
Consumer price inflation					
Average	-0.8	-8.5	1.8	1.5	2.8
End of Period	-7.6	-0.5	2.2	1.3	3.3
Average nominal manat wage	18.9	9.5	20.2	17.3	21.2
Real manat wage	19.9	19.7	18.1	15.6	17.9
Average nominal dollar wage	22.5	2.8	10.7	12.7	16.8
Real dollar wage	23.5	12.6	8.7	11.1	13.6
	(In millions of US dollars)				
External sector					
Exports of goods	678	1,025	1,799	2,046	2,305
Imports of goods	1,724	1,433	1,539	1,465	1,823
Current account balance	-1,364	-600	-187	-50	-769
(in percent of GDP)	-30.7	-13.1	-3.6	-0.9	-12.6
	(In percent of GDP)				
Consolidated Government					
Total revenue	19.6	18.5	21.2	21.5	28.0
Total expenditure (including net lending)	23.8	23.6	20.8	20.3	28.3
Fiscal balance (- deficit)	-3.9	-4.7	-0.6	0.9	-0.5
	(Percentage change, unless otherwise indicated)				
Financial markets					
Manat reserve money, end of period	-22.3	20.9	22.1	9.0	11.0
Manat broad money, end of period	-10.6	5.3	11.1	7.8	15.5
Manat velocity relative to non-oil GDP (ratio) 3/	10.4	10.8	11.7	11.9	11.9
Exchange rate (manat/US$)					
End of period	3,890	4,378	4,565	4,775	4,893
Period average	3,869	4,120	4,474	4,657	4,834

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

1/ Preliminary data.
2/ Revenue and expenditure in 2002 include the estimated value of SOCAR's unpaid energy deliveries to the utility companies (5.4 percent of GDP).
3/ Defined as non-oil GDP divided by average manat broad money.

Executive Summary

A three-year arrangement under the PRGF, in an amount equivalent to SDR 80.45 million (50 percent of quota) was approved on July 6, 2001. The first semi-annual loan was disbursed in July 2001, and the second was disbursed in March 2002. The **2001 Article IV consultation** with Azerbaijan was concluded on February 20, 2002.

Macroeconomic developments remained favorable in 2002, with strong and broad-based real GDP growth and low inflation. The central bank continued to intervene in the market largely to smooth out short-term fluctuations in the nominal exchange rate, and the real effective exchange rate has been depreciating steadily since mid-1999. Fiscal policy was modestly expansionary in 2002, in line with program objectives.

Performance relative to the quantitative targets under the program was strong, as all quantitative performance criteria and most indicative targets were met. While most indicative targets for end-December 2002 were missed, this was due to actions taken by the government, and supported by staff, to finance SOCAR's share of the new oil export pipeline, Baku-Tbilisi-Ceyhan.

Implementation of the structural reforms under the program was slower than planned, delaying completion of the second review. The authorities are requesting several waivers related to delays in structural reforms. However, there was a significant acceleration of reforms beginning in late 2002, and the authorities have now introduced measures that meet or exceed program objectives, including on the missed performance criteria. One half of energy sector quasi-fiscal subsidies have been eliminated in two years.

The key challenge facing Azerbaijan over the medium term will be to ensure that the projected boom in oil exports is managed effectively, and in a manner consistent with sustainable non-oil growth and poverty alleviation. This will require development of a sound strategy for the use of oil revenues. The development of such a strategy is the most pressing issue facing the authorities.

For 2003, **real GDP growth** is projected at 9.2 percent, while the CPI is targeted to increase 2.5 percent. The **external current account** deficit is expected to deteriorate sharply, but will be offset by higher net oil-sector FDI. The **non-oil fiscal deficit** will increase modestly during the year, but will remain below the sustainable level.

The government has adopted a comprehensive structural reform program, including amendments to the Budget Systems Law that will further strengthen the links between the state and oil fund budgets, measures to further enhance payments discipline in the energy sector, acceleration of SOCAR restructuring, and measures to further strengthen the banking sector.

I. Introduction

1. The staff discussions for the 2003 Article IV consultation and the second review under the Poverty Reduction and Growth Facility (PRGF) were held in Baku during February 23–March 6, 2003.[1]

2. The Executive Board completed Azerbaijan's 2001 Article IV consultation, and approved completion of the first review and disbursal of the second tranche (SDR 8.05 million) under Azerbaijan's PRGF arrangement, on February 20, 2002. Directors commended the authorities for continued strong economic performance, felt prospects for broad-based economic growth were encouraging, and stressed that economic diversification was crucial for sustained reduction in poverty. Directors welcomed the comprehensive plan to strengthen energy sector financial discipline, noting that failure to reduce quasi-fiscal subsidies would threaten economic stability and prospects for diversification. Finally, Directors were encouraged by the regulations designed to ensure the planning, execution and monitoring of the oil fund and state budgets in the context of a consolidated budget, stressing that, if used wisely, the oil fund could make a crucial contribution to combating poverty in Azerbaijan.

3. In the attached letter of intent (LOI) to the Managing Director, dated April 23, 2003 (Attachment I), the authorities set out their economic performance under the PRGF arrangement to date and their planned economic policies for 2003, and propose performance criteria for end-June and end-December 2003, indicative targets and benchmarks for end-June, end-September and end-December 2003. The authorities also request several waivers, a rephasing of the third review and an extension of the PRGF arrangement through March 31, 2005, as noted below.

4. Azerbaijan continues to avail itself of the transitional arrangements under Article XIV, but no longer maintains restrictions under such transitional arrangements. Staff has identified measures in connection with the granting of tax clearance certificates that give rise to exchange restrictions under Article VIII, Section 2(a), which Azerbaijan should eliminate before accepting the obligations of Article VIII, Sections 2, 3 and 4.[2] Discussions

[1] The mission consisted of Messrs. Wakeman-Linn (head), Hobdari and Gvenetadze (all EU2), Ms. Aturupane (PDR), Messrs. Desai and Danninger (both FAD), Mr. Surin (BLS) and Ms. Moss (staff assistant, EU2) and was assisted by Mr. Mered, the Resident Representative. Mr. Zurbrügg, Executive Director for Azerbaijan, participated in several meetings. The mission met with the Prime Minister, Deputy Prime Minister, Ministers of Finance, Economic Development, and Education, the National Bank Governor, and representatives of the banking and diplomatic communities, NGOs, and parliament, as well as other officials.

[2] At the request of the authorities, the staff is assessing whether there are any jurisdictional implications of additional measures, including on the making of interest payments and the repayment of credits contracted from foreign banks.

with the authorities on the elimination of these restrictions are ongoing. Azerbaijan has not sought, and staff does not recommend, approval of these exchange restrictions.

II. Recent Developments

A. Macroeconomic Developments

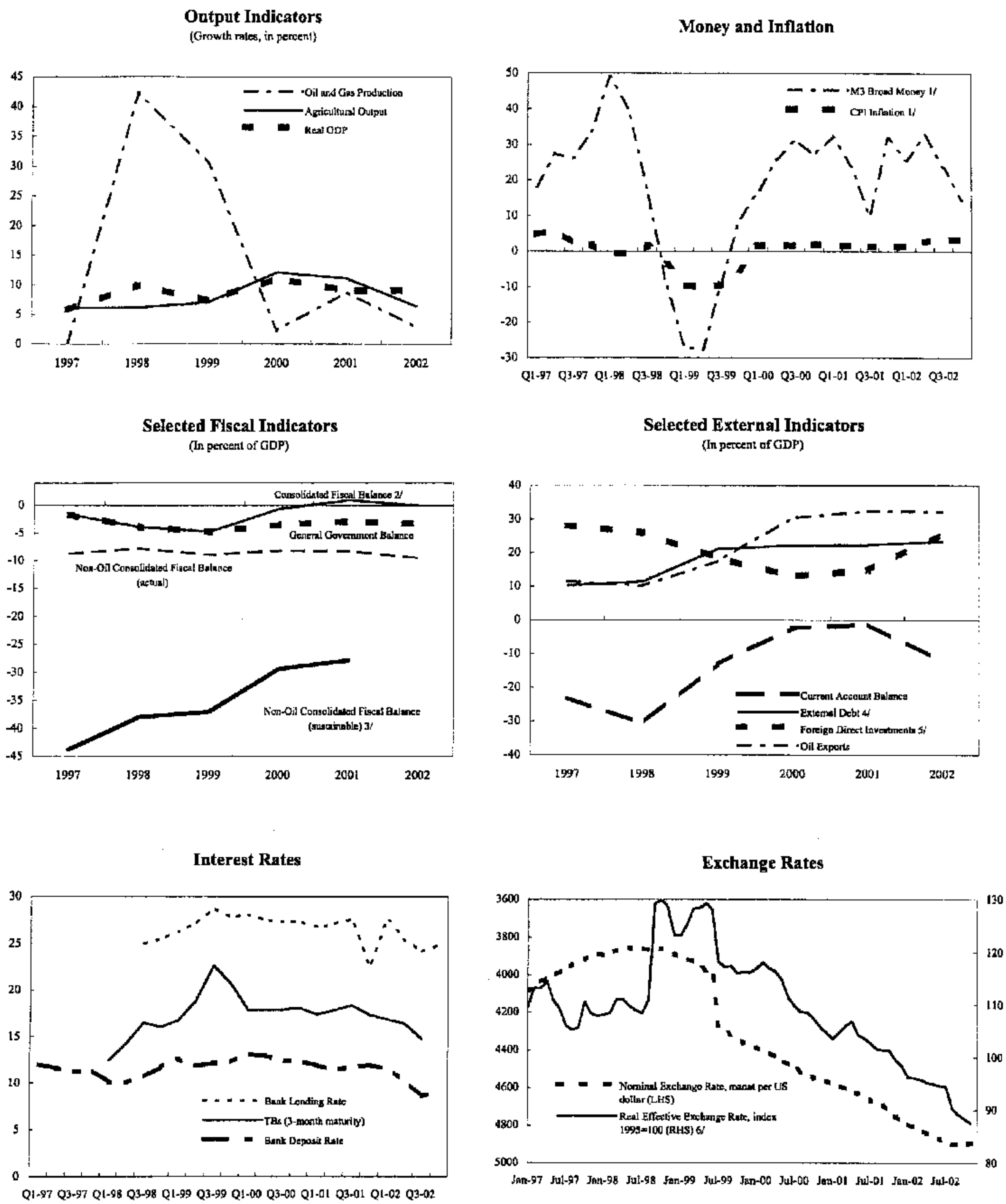
5. **Economic developments in Azerbaijan in recent years have been characterized by strong economic growth—averaging over 10 percent per year for the last few years—combined with low single-digit inflation.** While exports have been dominated by oil and oil products, and investments in the energy sector have been an important engine of growth for the economy, other sectors—including transportation, communications and services—have also grown rapidly. Particularly noteworthy is the agricultural sector where, following comprehensive land reform in the mid-1990s, value added has increased by more than 5 percent per year for six consecutive years, with growth in some years exceeding 10 percent. Nonetheless, the economy remains heavily dependent on oil and oil product exports—which account for around 90 percent of total exports—and thus vulnerable to international oil market developments.

6. **Economic developments continued to be favorable in 2002, and were slightly better than expected**. High oil prices and significant growth in investment (largely FDI) in the oil and gas sectors, combined with strong performance in other sectors, contributed to 10.6 percent real GDP growth (Table 1, Figure 1), notwithstanding a generally weak international economic environment. Prices remain fairly stable, with end-period consumer price inflation of 3.3 percent.

7. The most significant development in the real sector in 2002 was the sanctioning[3] by investors of the **Baku-Tbilisi-Ceyhan (BTC) oil export pipeline**, as well as the associated full field development of the **Azeri-Chirag-Guneshli (ACG) oil field.** Combined with the **Shah Deniz gas field** and associated gas export pipeline (which was sanctioned in early 2003), these and other energy sector projects will result in over US$8 billion in investments over the period 2002-2004, and will contribute to a rapid growth in energy sector output and exports (Box 1).

[3] Sanctioning is a formal stage in the investment process, where the partners all commit to providing their share of the investment funds.

Figure 1. Azerbaijan: Recent Economic Developments, 1997--2002



Source: Azerbaijan authorities and Fund staff estimates.

1/ 12-month growth rates.

2/ Includes the balances of the General Government and of the Oil Fund.

3/ Sustainable non-oil fiscal balance is defined below.

4/ Includes only public and publicly guaranteed external debt.

5/ Excludes capital repatriation from foreign investors.

6/ Decrease means depreciation.

Box 1: Azerbaijan Oil Production and Oil Exports: A Regional Comparison

Azerbaijan has a rich natural resource endowment with substantial oil reserves in the Caspian region. Overall, oil reserves in the country are estimated to be the third largest in the Caspian region, following Kazakhstan and Turkmenistan.

On the basis of current oil reserves estimates, the oil production profile for Azerbaijan indicates a short but steep increase in oil production relative to other countries in the region. Total oil production for Azerbaijan is expected to rise sharply from 2004 through the turn of the decade and subsequently fall almost as rapidly, in the absence of a significant new oil discovery (Figure 1). On the other hand, oil production in Kazakhstan is expected to have a lengthy sustained peak. Revenues from oil wealth accruing to Azerbaijan will be substantial, but short-lived.

Azerbaijan is much more dependent on oil exports than other countries in the region. Oil exports (crude oil and oil products exports) comprised almost 90 percent of Azerbaijan exports in 2002 and are expected to retain a similar share through the end of the decade (Figure 2). In contrast, oil exports in Kazakhstan and Russia comprised 50 and 37 percent of total exports respectively in 2002.

Figure 1: Oil Production, 1994-2024[2]

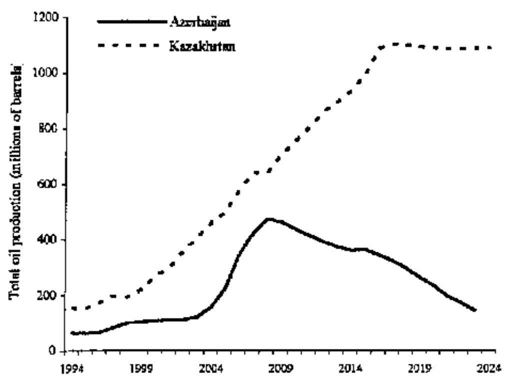
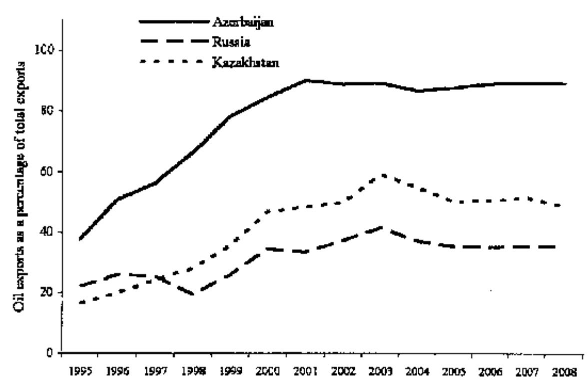


Figure 2: Oil Exports,[1] 1995-2008[2]



[1]Oil exports comprise crude oil and oil products exports for Azerbaijan and Russia and only crude oil exports for Kazakhstan. Oil products exports for Kazakhstan are negligible.

[2]Source: IMF staff estimates.

8. **Balance of payments developments were somewhat better than projected in 2002.** In addition to higher than expected oil prices, non-oil exports grew faster than anticipated, led by agricultural and chemical product exports. There was an expected current account deficit in 2002, largely due to oil-sector related imports, which was more than financed by FDI. Azerbaijan's **exchange rate policy** continues to rely on the exchange rate as a nominal anchor, with interventions focused on stabilizing fluctuations around a trend judged to be consistent with the authorities' inflation target. As noted earlier, Azerbaijan's inflation has remained in low single digits since 1996. The modest depreciation of the real effective exchange rate, which has been ongoing since mid-1999, continued in 2002.

9. **The most crucial reforms in Azerbaijan in recent years have focused on enhancing energy sector financial discipline.** As discussed in detail below, nonpayments and other implicit and explicit subsidies in the energy sector have been the major economic problem facing the country. With the reforms of the last two years, the government has made significant strides toward the eradication of this problem.

10. Despite the strong economic performance in recent years, **poverty remains a serious problem in Azerbaijan**, with the State Statistics Committee estimating that 49 percent of the population living in poverty, and 17 percent in extreme poverty. Thus, combating poverty remains the key economic challenge facing the country.

11. **Overall, economic developments and prospects reaffirm the importance of the primary objective of Azerbaijan's PRGF-supported economic program**: the development of the non-oil sectors of the economy (and thereby the creation of income opportunities) through continued implementation of monetary and fiscal policies consistent with macroeconomic stability, improving the environment for private sector development including through improved governance, accelerating structural reforms, and strengthening energy sector financial discipline.

12. **Experience also reaffirms the appropriateness of the program design.** Macroeconomic stability continues to be an important feature of the Azerbaijan economy, and exchange rate policy is contributing to growth in non-oil exports. Combined with improved governance and progress in structural reforms, macroeconomic stability has helped the country begin to experience new private investments outside the oil and gas sector (including, for example, in the aluminum and electricity industries). Finally, improvements in financial performance in the energy sector will increasingly free up resources for important infrastructure reforms and poverty alleviation efforts.

13. **The one area in which economic performance has been somewhat at odds with program assumptions has been the pace of structural reforms.** Going forward, it will be important for the government to ensure that timetables for structural reforms are realistic, and to seek to enhance their ability to more quickly implement needed reforms.

B. Program Performance

14. **Financial policies were broadly in line with program projections,** as all quantitative performance criteria and most indicative targets for end-March, June and September 2002 were met (Tables 2-8).[4] While most indicative targets for end-December were missed, except those related to external debt and net international reserves, this was due to actions taken, in consultation with the Fund and Bank staffs, to finance SOCAR's share of the BTC.[5] Given the importance of BTC to Azerbaijan's economic prospects, the staff supports the decisions made regarding this financing, and would have proposed a modification of the end-December targets to make room for this financing if there had been a Board discussion of Azerbaijan's PRGF arrangement in late 2002.

15. **Monetary policy was consistent with program targets, and more generally with the authorities' goal of maintaining domestic price stability, while accommodating the rapid real GDP growth.** Excluding the effects of BTC financing (which had no domestic monetary impact), net international reserves grew more rapidly than programmed, largely due to the higher than programmed oil prices, while net domestic assets (NDA) of the Azerbaijan National Bank (ANB) grew more slowly than projected. While broad money growth was almost entirely due to higher than forecast foreign currency deposits, the ANB allowed reserve money to exceed program targets since, with non-oil GDP growing faster than expected and manat velocity in line with projections, this higher reserve money growth was consistent with the inflation target. **The recovery in money demand in Azerbaijan has been more modest than in other CIS countries**, for reasons explored briefly in Box 2 and in more depth in the accompanying Selected Issues Paper (SIP) (SM/03/158, 4/29/03).

16. Fiscal policy was modestly expansionary in 2002, in line with program objectives, and consistent with the authorities' intentions to very gradually increase their use of oil revenue. Excluding BTC financing, the non-oil deficit grew by 1.1 percent of GDP, below the program ceiling. The non-oil fiscal deficit remained well below the sustainable level.[6] This is consistent with the authorities' desire to save a large share of oil wealth, and the practical need to be cautious in spending oil revenues while the institutions for managing and spending that wealth are in a developmental state.

---

[4] The indicative target for expenditure arrears was missed by a small amount at end-March and end-June, but met at end-September. These figures actually capture unpaid bills; Azerbaijan does not track overdue bills separately, as these have not been a problem recently.

[5] Similarly, the decline in net international reserves of the ANB in early 2003 was due to a transfer of pre-2000 oil bonus money from the ANB to the oil fund to finance BTC.

[6] The non-oil deficit is the fiscal deficit excluding oil-related revenues. "Sustainable non-oil deficit," as used here, means the level of real expenditures that can be permanently financed from the use of oil revenues. The definition and measurement of the sustainable non-oil deficit is presented in more detail in (SIP SM/03/158).

Box 2: Monetization and Dollarization Trends in the BRO Countries

There has been continued increase in monetization across the BRO (Baltics, Russia and Others) in recent years, following a brief reversal in the aftermath of the Russian crisis of mid-1998. The growth in real money balances has been particularly high in Kazakhstan and Ukraine, with the M3/GDP ratio increasing, respectively, by nearly 90 percent and over 60 percent since end-1999. Strong, although more moderate, growth in real money balances continues in the Baltics, with the M3/GDP ratio increasing by about 30 percent during the same period in all three countries, as well as in Georgia (50 percent), Moldova (40 percent) and Russia (30 percent). In Azerbaijan, the increase in M3/GDP ratio since end-1999 amounted to about 70 percent, but to a large extent this reflected a recovery of real money balances that had declined sharply in the aftermath of the Russian crisis. Since the start of the stabilization program of early-1996, the M3/GDP ratio in Azerbaijan grew by a moderate 35 percent, lower than in most BRO countries (for more details see the chapter on Monetization Trends in Azerbaijan in the SIP). The remonetization observed in most BRO countries, from an abnormally low level, reflects generally increased confidence in the authorities' macroeconomic policies and management, as well as gradual banking sector restructuring. These monetization trends are also, in part, a reflection of positive BOP developments across the region, in particular high oil prices (for Azerbaijan, Russia and Kazakhstan) and a surge in transfers from abroad (e.g. Ukraine).

Despite the recent progress in financial deepening observed in most BRO countries, the level of monetization in the region, except for the Baltics, remains far below the levels prevailing in the transition economies of Eastern Europe. This is an indicator of generally slow progress in structural reforms, including in enterprise, financial sector, and judicial system reforms.

One important characteristic of the monetization process in many BRO countries is that it has taken place mainly through an increase in foreign currency deposits (FCD) with the banking system, with the growth in domestic currency deposits lagging behind the growth of nominal GDP. Dollarization has increased sharply since 1998 in Kazakhstan and Azerbaijan, with the share of FCD to M3 at end-2002 more than double its 1998 level in both countries. Growth in dollarization during this period has also been high in Georgia, Moldova and Tajikistan, while it has remained basically unchanged in the Baltics, the Kyrgyz Republic, Russia, and Ukraine. As of end-2002, the share of FCD to M3 amounted to nearly 50 percent in Azerbaijan, Georgia, and Kazakhstan, and about 30 percent in the rest of BRO.

Persistence in dollarization, against a background of sustained disinflation across the region, has been observed elsewhere earlier. In the BRO, it may be related to the relatively low level of development of domestic financial markets prevailing in these countries. Since there are few attractive assets available in local currency in most countries, investors have little choice but to invest in assets denominated in foreign currency. By opening the way to holding foreign currency-denominated assets, dollarization allows investors to diversify their portfolios and to reduce risks. In addition, it is possible that part of the measured increase in dollarization reflects a switch of cash dollar holdings for dollar deposits, as confidence in banks increases.

17. While the deficit was in line with program projections, **there was a change in the composition of expenditures and financing.** Current expenditures were well below programmed levels, largely reflecting a cautious decision to postpone a wage increase in light of revenue uncertainties. Capital expenditures (excluding BTC) exceeded program levels by a similar magnitude, primarily due to higher than anticipated disbursements under foreign-financed projects. As a result, external financing covered a larger than anticipated share of

the deficit, with shortfalls relative to budget targets in privatization and treasury bill proceeds. The shortfall in treasury bill proceeds reflected a conscious choice, as the authorities sought to reduce treasury bill interest rates. Consequently, these rates have declined from around 16 percent in mid-2002 to below 8 percent in early 2003.

18. With regard to **revenues**, 2002 saw modest tax reforms—primarily the adoption of the destination principle for VAT on all trade, and a reduction in the payroll tax rate from 33 to 30.5 percent. In the 2003 budget, a further reduction—to 28.5 percent—was approved, as well as a reduction (from 27 to 25 percent) in the enterprise profit tax, offset by a tightening of depreciation allowances, in line with the authorities' intention to gradually broaden the tax base while reducing tax rates. In an effort to stimulate regional development and contrary to Fund and Bank staff advice, the government introduced regional and sectoral variations in the enterprise profit tax (EPT), with the rate as low as 10 percent in some regions. A number of additional reforms are under consideration, including reductions in the number of income tax brackets as well as the top rate, and the possible introduction of special economic zones. These changes are consistent with the general trend of tax reforms in the region.

19. Finally, the development of the oil fund (SOFAZ) has continued, including through efforts to strengthen the **rules for management of oil revenues and related expenditures through SOFAZ.** Despite these efforts, 2002 brought a series of incidents involving ad hoc decisions on expenditures from SOFAZ, as discussed below. SOFAZ continues to serve primarily as a savings fund, consistent with the authorities' intentions. This is somewhat different from how other Caspian oil producers are handling their oil wealth (Box 3).

C. Structural Reforms and the PRSP

20. Structural reforms have continued throughout 2002 and 2003, albeit at a somewhat erratic pace. Most importantly, significant strides were made in enhancing financial discipline in the energy sector, and thereby reducing the waste of resources in that sector. The authorities also continued their focus on developing the financial sector, strengthening the management of public funds, and improving the business environment. The authorities also adopted in early 2003 a Poverty Reduction Strategy. While much was accomplished in structural reforms in 2002, delays in certain reforms—caused by administrative problems and difficulties in reaching decisions on key reforms—resulted in several structural performance criteria under the PRGF arrangement not being met, as discussed below (Box 4).

Box 3: Oil Revenue Management: Azerbaijan and Kazakhstan

Azerbaijan and Kazakhstan created natural resources funds to manage surging petroleum revenues. Generally oil funds are established with two primary objectives: stabilization and savings for future generations. These objectives have been given different emphasis in the oil funds of Azerbaijan and Kazakhstan.

The State Oil Fund of the Republic of Azerbaijan (SOFAZ) was established in 1999. Its main objective is professional management of oil and gas related revenues for the benefit of the country and its future generations—i.e., savings. The inflow and outflow rules of Azerbaijan's oil fund have clearly been designed to reflect this feature and save a large part of government revenues. SOFAZ receives all government revenues associated with post-Soviet oil and gas production fields. Tax revenues from older fields continue to flow to the state budget. Oil fund inflows are not related to an oil price level or a budgetary position, thus limiting the fund's potential for stabilization. On the outflow side, Azerbaijan's oil fund rules currently forbid spending above the amount of inflows in any given year. Observance of this rule would guarantee the steady growth of savings in the fund.

The Kazakh Oil Fund—the National Fund for the Republic of Kazakhstan (NFRK) — was established in 2001. The main objectives of the fund are accumulation of financial assets for the future generations (savings function) and reduction of the vulnerability of the country's budget to fluctuations in the world prices for raw materials (stabilization function). Accumulation in the NFRK is contingent on achieving the baseline budgetary revenue target, which uses pre-approved reference prices. The inflow rule specifies that all oil and gas revenues in surplus of the annual baseline target are transferred to the NFRK. The NFRK has also received privatization receipts and bonus payments from the petroleum sector. NFRK makes an important contribution to stabilizing budget revenues. If budget revenue collection is below the baseline projections, the gap can be filled by a transfer from the NFRK. Ten percent of projected baseline budgetary oil revenue as well as revenue from investment activities of the fund remain in the fund.

In both Azerbaijan and Kazakhstan, the creation of an oil funds had a positive impact on fiscal discipline and contributed to better transparency and accountability of oil revenue management.

Energy Sector Financial Discipline

21. **In 2000, quasi-fiscal subsidies in the energy sector exceeded 20 percent of Azerbaijan's GDP.**[7] Resources that could have been used to rehabilitate the economic infrastructure and combat poverty were instead being wasted in indiscriminate subsidization of inefficient energy consumption, while interenterprise and tax arrears were growing. As a result, attempts to enhance energy sector financial discipline have been at the heart of the government's economic reform efforts in recent years.

[7] For a discussion of the many sources of quasi-fiscal subsidies in the energy sector, and an explanation of the measurement of quasi-fiscal subsidies, see Azerbaijan: The Size of Quasi-Fiscal Subsidies Implicit in Current Domestic Energy Policies. Azerbaijan Republic: Selected Issues and Statistical Appendix, IMF Country Report No. 02/41.

Box 4. Structural Performance Criteria and Benchmarks End-March 2002		
Reform measure	**Status**	**Comments**
A. Structural Performance Criteria		
Adoption of a timetable for the unification of domestic and export prices for natural gas, oil and oil products	Not observed	The deadline was not met. However, on Feb. 10, 2003 the Cabinet of Ministers issued a decree that brought natural gas, crude oil and most oil products prices in line with long-run world market prices.
Adoption, in consultation with the Fund staff, of a timetable for the gradual reduction of the number of specific tariffs and the weighted average tariff, consistent with the commitment in the MEFP	Observed	
Adoption of a timetable for the full privatization of the International Bank (IBA), and a timetable for the preparation of the United Universal Joint Stock Bank (BUS Bank) for privatization	Not observed	Timetables were adopted by presidential decree on April 17, 2003.
Allocation of quarterly tax credits to SOCAR, and subsidies to Azerenergy and Azerigas, for fuel delivered to but not paid for by the utilities	Not observed	Subsidies and tax credits for 2002 have been allocated, but well outside the programmed time frame. Streamlined procedures for the timely allocation of such tax credits and subsidies have been adopted in consultation with Fund staff.
B. Structural Benchmarks		
Submission to Parliament of the new Banking System Law	Not observed	The end-March 2002 deadline for submitting the law to Parliament was not met. The draft law is expected to be submitted to Parliament shortly, and its adoption is planned for June 2003.
Submission to Parliament of a new Budget Systems Law that is consistent with best international practices	Observed	
Adoption of a timetable, in 2002, for all short term elements of the Customs Committee reform program	Observed	

22. **Efforts in the energy sector have focused on four objectives**: i) making explicit the previously quasi-fiscal subsidies, so as to enhance transparency and facilitate decision making; ii) increasing payments for utility services; iii) improving the efficiency of the state oil company, SOCAR; and iv) improving the efficiency of the electricity and gas sectors. These reforms have been quite successful; **from 22 percent of GDP in 2000, the (fiscal and quasi-fiscal) subsidies in the energy sector were reduced to an estimated 11 percent in 2002, and are expected to decline further in 2003**.

23. Starting in 2002, **SOCAR has been granted tax credits for all fuel delivered to the electricity and gas companies**, but only at domestic prices. The true cost of these subsidies was much higher—for example, the domestic price of natural gas was US$15 per 1000 cubic meters, compared to an import cost of US$52. The 2003 budget includes tax credits and subsidies at international prices, as domestic energy prices have now been unified with import or export parity, as appropriate. In addition, the 2003 budget includes an explicit cash subsidy for Azerchemia—a state-owned chemical company that SOCAR was previously required to provide fuel to regardless of whether it received payment. SOCAR is now expected to provide fuel only at international prices and only if it receives full payment.

24. **The timely quarterly allocation of tax credits to SOCAR, as well as the publication of these tax credits, was a quarterly performance criterion under the PRGF arrangement.** While these credits were allocated and full information published, bureaucratic delays meant the subsidies were not allocated on time (LOI, paragraph 10). The authorities have now adopted, in consultation with Fund staff, a timetable with streamlined procedures for the future allocation of these credits, and are requesting waivers for the nonobservance of these performance criteria.

25. Similarly, **the adoption of a timetable for the unification of domestic and world market prices of natural gas, crude oil and oil products was an end-March 2002 structural performance criterion.** While it took longer than anticipated for the government to make decisions on this issue, they have now actually unified domestic and estimated long-run world market prices[8] of natural gas, crude oil and most oil products (LOI, paragraph 9). In addition, they have committed to unifying domestic and world market prices of the two products whose prices remain below world market levels in early 2004. Based on these actions, the authorities request a waiver for nonobservance of this performance criterion.

Financial Sector Reforms

26. **Financial sector reforms continue in Azerbaijan, despite delays in some important areas** (LOI, paragraph 15). New large and small value payments systems have been introduced, enabling banks to offer a wider range of services to their clients. Non-viable banks—particularly those not able to meet the new US$2.5 million capital requirement—have been closed, with the number of banks in the country having declined from over 70 in 1999 to 47 today. In addition, the ANB has prepared—in consultation with MAE—a new Banking System Law which, when passed by parliament, will provide a solid legal foundation for a modern banking system. Progress on the restructuring of BUS Bank—the last wholly state-owned bank—has also continued, supervised closely by the ANB as well as the Ministry of Finance.

---

[8] In consultation with Fund and World Bank staff, prices were unified not with actual world market prices, but with what world market prices would be if world crude oil prices were at US$20 per barrel, which is the Bank staff estimate of long run equilibrium prices.

27. Other reforms, however, have been delayed. **There has been little progress toward the privatization of the International Bank of Azerbaijan (IBA)**—the dominant bank in the system, which remains 51 percent state owned. Despite a continuing intention to sell 20 percent of the bank to EBRD, as a step toward full privatization, the desire to first recapitalize the bank and differences over how to undertake the sale led to little progress in 2002. The end-March 2002 structural performance criterion, calling for the adoption of timetables for the privatization of IBA and the preparation for privatization of BUS Bank, was not observed. As these timetables have now been adopted, as noted below, the government requests a waiver for the nonobservance of this performance criterion.

Fiscal Sector Reforms

28. A wide array of fiscal reforms were implemented in 2002 and early 2003 (LOI, paragraph 13), largely focused on improving governance in the handling of public funds Most importantly, **a new Budget Systems Law,** designed in close cooperation with the Fund and World Bank, has been adopted. This law requires parliamentary approval of the budget at a much more detailed level, the preparation of and reporting to parliament of a Medium Term Expenditure Framework (MTEF), and greater reporting to parliament and the public on budget execution.

29. **Tax administration** reforms have continued (LOI, paragraph 14). Most strikingly, the number of tax officials has been reduced by 40 percent, with the salaries of remaining staff increased 100 to 200 percent. Similarly, all short-term elements of the reform program for the **State Customs Committee** have been implemented, with work continuing on the medium and long-term reform efforts (LOI, paragraph 26).

Governance

30. A number of the reforms noted above are aimed at improving governance. In addition, the government sought the views of the international and domestic business community—including in two meetings with the president—on their governance concerns. Based on the results of these meetings, there has been a dramatic reduction (by around 85 percent) in the number of types of businesses requiring licenses, and the process of receiving licenses for the remaining businesses has been streamlined. As a result of these and other efforts, several governance/investment climate surveys (EBRD's Business Environment and Enterprise Performance Survey, IFC's Foreign Investment Advisory Service, PRS Group's International Country Risk Guide, and Heritage Foundation's Economic Freedom Survey) have reported **significant improvements in Azerbaijan's investment climate in the last three years.**

Poverty Reduction Strategy

31. Azerbaijan's PRSP, or State Program for Poverty Reduction and Economic Developments (SPPRED), was launched in a national conference in October 2002 and formally adopted in February 2003, following a consultative process discussed in the accompanying Joint Staff Assessment (JSA) (EBD/03/39, 4/24/03). As the JSA notes, this

well designed strategy reflects genuine ownership, and if effectively implemented should contribute greatly to poverty reduction in Azerbaijan.

32. As noted in the LOI (paragraph 6), the macroeconomic framework for the PRSP differs somewhat from the PRGF framework. These differences are due to the fact that the PRSP framework was finalized in the third quarter of 2002, and in the intervening 7-8 months, developments related to oil prices, FDI and non-oil sector growth have been somewhat different than projected. Thus, as the LOI notes, the PRGF macroeconomic framework is considered by the government as an updated version of the PRSP framework.

III. Report on the Discussions

A. Key Challenges for 2003 and the Medium Term

33. The staff and authorities agreed that **the general thrust of the reform strategy** for the past two years—maintaining macroeconomic stability while seeking to enhance prospects for growth in non-oil sectors, including by effective management of oil sector revenues, strengthened energy sector financial discipline, the development of a more competitive financial sector, and improvements in governance—**was and remains an appropriate response to the economic challenges the country faces.**

34. Maintenance of macroeconomic stability has been one of the key successes of the Azerbaijan government in recent years, and the staff and authorities agreed that it is necessary to ensure this stability is maintained. The introduction of the oil fund has led to dramatic improvements in the transparency of the management and expenditure of oil revenues. Reductions in quasi-fiscal subsidies have contributed to improved energy efficiency in the economy. Combined with progress in governance, this has helped bring out substantial continuing growth across a wide range of sectors. It is, however, too early to see clear evidence of the impact of most of these reforms on poverty. The challenges remain, particularly the need to further reduce energy sector subsidies and improve governance, but the staff and authorities agreed that the reform agenda remains the correct response to Azerbaijan's economic challenges, as the challenges in 2003 are not expected to be qualitatively different than those in 2002.

35. Going forward, it was agreed that the key challenge for the authorities will be to develop a comprehensive strategy—involving fiscal, monetary and exchange rate policy—for the management of the rapid growth in oil and gas revenues that is expected to begin in 2005. Azerbaijan will increasingly need to manage massive oil sector revenues in a way that does not discourage the development of the non-oil sector.

Management of Oil Revenues

36. There were differences of opinion between the staff and authorities with regard to developments in the management of oil revenues. While SOFAZ has greatly enhanced the transparency of such management, and the rules to ensure the development, implementation and monitoring of a truly comprehensive fiscal policy are generally appropriate, the staff

expressed concern that these rules were not always respected. In particular, while the decisions to increase expenditures in 2002 on Internally Displaced Persons (IDPs) and refugees were laudable, these decisions were made in an ad hoc manner, and without the preparation and approval of a revised consolidated budget as called for in the oil fund rules. **The staff felt these actions represented a serious threat to the integrity and coherence of fiscal policy. The authorities felt they were at most minor deviations from the oil fund rules**, reflecting the need to develop effective procedures for implementing these rules.

37. The staff and authorities reached understandings that there was a need to enhance the legislative foundation of the oil fund—through 2002, SOFAZ and its operating and budget rules existed solely on the basis of presidential decrees. There was a difference of opinion as to the best way to achieve this objective, however. **The staff argued that an oil fund law was necessary,** to codify existing oil fund rules and thereby provide greater assurance that these rules will be adhered to.

38. The authorities disagreed, arguing that the existing rules were sound and that presidential decrees provided a sufficient legal foundation. In the end, the staff and the authorities reached understandings that, at least as an interim measure, **key rules related to the preparation and execution of the oil fund budget would be embodied in revisions to the budget systems law**. The staff continues to believe that an oil fund law will be necessary at some point.

Financial Sector Reforms

39. Discussions on reforms in the financial sector focused largely on two issues: the privatization of IBA and proposed deposit insurance. On IBA, privatization was delayed by the authorities' desire to recapitalize it first. This recapitalization is now complete. An additional complicating factor was that, while the government preferred to sell 20 percent of IBA to the EBRD out of government-held shares, EBRD expressed a preference for buying newly issued shares, so that the purchase price could further add to the bank's capital. Staff indicated support for either approach, as further recapitalization—if necessary—could be accomplished in other ways, and urged the government to accelerate the process of privatizing IBA.

40. With regard to **deposit insurance**, the authorities intended to include provisions for deposit insurance in the Banking System Law. Staff argued that this was premature, as banking supervision needed to be strengthened first. The staff also expressed reservations about features of the draft deposit insurance system, arguing that the design of the system needed reconsidering. The authorities acknowledged these points, but felt it was politically necessary to pass deposit insurance legislation. Therefore, while they intend to keep the deposit insurance chapter in the Banking System Law, they agreed to include provisions that would delay its effectiveness until these issues are resolved. The authorities also agreed that, in the interim, they would work with the Fund staff to reconsider key design features, which could be amended before deposit insurance takes effect.

B. Program Discussions and Macroeconomic Policies for 2003

41. Completion of discussions on the second review were delayed, largely due to difficulties in reaching agreement on energy price adjustments, delays in bank privatization, and differences over the best way to ensure the integration of the oil fund and state budgets. The resolution of these issues in January 2002—including not simply the adoption of a timetable for energy price unification but actual unification—made it possible for the staff to seek to conclude discussions on an updated LOI. With the adoption of a Poverty Reduction Strategy, program discussions focused primarily on which measures in that strategy should be reflected in the government's PRGF arrangement, and the precise nature of the policy commitments to include in the PRGF. The LOI clearly identifies the links between the policy commitments in that document and in the PRSP.

Fiscal Policy

42. In the face of a growing oil fund and anticipated rapid growth in oil related revenues in the coming years, and in line with Fund staff recommendations for oil producing countries, the staff urged the authorities to increasingly focus their attention on the **non-oil deficit as the proper measure of fiscal stimulus provided to the economy.** The authorities accepted this recommendation, including by acknowledging that the fiscal deficit performance criterion under the program should be modified to focus on the non-oil deficit.

43. The authorities intend to modestly increase their use of oil-related revenues in 2003 (LOI, paragraph 17). The staff supports this increased non-oil deficit, as it remains below the sustainable level and the increased expenditures are well planned. In particular, the increased expenditure on infrastructure projects should be beneficial for the long term competitiveness of the economy; such expenditures were deliberately constrained in previous years, as the government sought to develop procedures for oil fund financed expenditures, improve procurement procedures and develop a supreme audit institution.

44. The key structural reform in the fiscal area for 2003 is the recently submitted package of **amendments to the Budget Systems Law (BSL)**. These amendments (LOI, paragraph 18) will enshrine the key oil fund rules in law, give parliament the authority to approve the consolidated budget expenditure and deficit ceilings—the first time parliament will have any control over the oil fund—and strengthen the BSL in other ways. Plans to use the BSL to prevent municipalities from borrowing were derailed by a Ministry of Justice ruling that this would be unconstitutional.

45. With the 2003 budget, the authorities have completed the process of **subjecting all taxpayers to the tax laws** (LOI, paragraph 21). With SOCAR no longer paying a negotiated tax target, the government is confronted with a new challenge—volatility in this crucial source of revenue. The staff and authorities agreed the government should **save SOCAR tax payments early in 2003 that are in excess of budgeted levels,** due to higher than budgeted oil prices, and to use these savings as a cushion if oil prices decline at some point in the future (LOI, paragraph 22).

46. **Other tax reform plans include a commitment to reunify the EPT in the context of the 2004 budget** (LOI, paragraph 23). The authorities had introduced variations in the EPT in an effort to encourage regional development. The staff argued that such policies do not work, and run counter to the government's efforts to improve tax administration. In the end, the authorities agreed to reunify the EPT rate starting January 1, 2004—possibly at a significantly lower rate than the current standard of 25 percent—and to request assistance from the Fund and World Bank to develop a more effective regional development program during 2003. The proposal for the introduction of special economic zones was not discussed, as the staff was at the time not aware of this proposal.

47. **The composition of expenditures has changed little during recent years, but the recently adopted PRSP has set new spending priorities.** In the absence of sectoral reforms (e.g., education, health sector, civil service), past budgets showed few expenditure innovations. Reforms primarily concentrated on eliminating expenditure arrears, funding energy consumption by budget users, reducing quasi-fiscal subsidies in the energy sector, and incorporating extrabudgetary activities of budget organizations. While the 2003 budget continues with these measures, it also reflects priorities reflected in the PRSP, including increased capital expenditures, raising minimum public wages and pensions, and building a social safety net to support reforms in the energy sector.

48. **All previously extra-budgetary operations of budget organizations have been included in the budget starting in 2003,** but earmarking of revenues has been eliminated in only a few instances. The staff urged the authorities to eliminate all remaining earmarking in the 2004 budget, but the authorities plan to move only gradually, fearing that incentives to collect these revenues could be undermined. Staff accepted this as a reasonable though not first-best alternative. Similarly, building on the progress in recent years, the staff proposed that the authorities identify all remaining quasi-fiscal subsidies during 2003, and either eliminate them or incorporate them explicitly into the 2004 budget (LOI paragraph 28). The authorities noted that this suggestion was consistent with their general reform intentions.

49. The government intends to finance key infrastructure projects in 2003 from the Oil Fund (e.g., rehabilitation of parts of the irrigation system). Given the importance of these projects, the staff supported this decision, but recommended that further investment plans be based on a comprehensive public investment program. Public sector wage increases aim to reduce the gap with private sector compensation. Staff urged the authorities to move cautiously on public sector wages in the absence of a general civil service reform plan.

50. The authorities reaffirmed that, in the event they have to **pay additional funds for the construction of BTC**, they would consult with Fund and World Bank staff to ensure that this was done in a manner which did not undermine the reform efforts. Finally, the authorities will take a number of steps to strengthen the **management and control of domestic and external debts**, as well as to resolve disputed debt obligations with Kazakhstan, Turkmenistan and Uzbekistan (LOI, paragraphs 30-32).

Monetary and Exchange Rate Policies

51. The primary objective of **ANB's monetary policy** remains the maintenance of domestic price stability. In view of the difficulties in predicting money demand in Azerbaijan, the ANB continues to use the **exchange rate** as a nominal anchor for monetary policy. This policy has in effect led to informal exchange rate targeting, allowing for a modest nominal depreciation vis-à-vis the US dollar within a narrow band. The staff and the authorities agreed that this exchange rate policy has served Azerbaijan well—contributing to low single digit annual inflation since early 1996 and growth in international reserves—and that it remains appropriate. In addition, in light of the strong growth in 2002 of non-oil exports, there is no evidence of competitiveness problems, and the staff and authorities believe the level of the exchange rate is appropriate.

52. The monetary program targets consumer price inflation of 2.5 percent for 2003. In line with developments over the last few years, the program assumes a small decline in broad money velocity, which the staff believes would be consistent with continued modest nominal depreciation of the exchange rate. The key challenge facing the ANB in 2003 will be to sterilize the impact of the planned SOFAZ spending as well as oil-related FDI, while maintaining domestic price stability. Although the ANB has introduced a variety of monetary instruments over the past few years, the treasury bill market is small, and thus the scope for open market operations is limited. The ANB's influence on money supply therefore comes largely from interventions in the foreign exchange market. To assist the ANB in maintaining price stability and avoiding excessive swings in the nominal exchange rate, the Ministry of Finance, SOFAZ and SOCAR have agreed to provide the ANB with monthly updates of their expected pattern and volume of foreign exchange transactions in 2003. In addition, the ANB has announced that, effective May 1, 2003, banks will no longer be able to satisfy up to 50 percent of their required reserves with treasury bill holdings. It is also prepared, if necessary, to use ANB bills or remunerated commercial bank deposits with the ANB to mop up excess liquidity. The staff supports these moves, which should have minimal impact on ANB profits in 2003.

53. To **strengthen the banking system**, the authorities have decided to take a number of steps. Key among these reforms, they intend to accelerate efforts to privatize IBA and BUS Bank, and have adopted appropriate timetables (LOI, paragraph 37). In addition, to date all **government demand for financial services**—a significant share of the domestic market—has been met by either IBA or BUS Bank. The staff urged the authorities to tender for these services, to enable other banks to compete for this business. The authorities were reluctant to move rapidly in this area, as they feel many private banks are not capable of providing reliable services. They recognized the importance of eventually allowing competition in this market, however, and decided to focus on this issue during 2003, and to set a date after which tenders will be issued for all such services.

54. The Azeri authorities have recently sent staff a voluntarily completed questionnaire on Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT) Policies

and Institutions. Azerbaijan has ratified the UN Convention on the Suppression of the Financing of Terrorism. Staff is currently reviewing the authorities' response.

Governance

55. **The authorities recognize the need to continue efforts to improve governance in Azerbaijan.** While the tax and customs administration reform programs will be central to that effort, it was agreed more needed to be done. The government recognized the need to complete the process of separating commercial and regulatory functions during 2003 (LOI, paragraph 45). The authorities also proposed to review the structure of government during 2003, a decision the staff supports, as it could contribute to enhancing the government's ability to implement policy reforms in more timely fashion. Finally, the government will seek parliamentary approval of anti-corruption legislation in 2003.

Energy Sector Financial Discipline

56. There was consensus on the importance of energy sector financial discipline for Azerbaijan's economy, as well as agreement on the general thrust of these reforms. There were however, during the course of 2002, difficult discussions over domestic energy prices. While acknowledging the importance of **unifying domestic and world market energy prices**, the authorities were reluctant to make major price reforms for political reasons. The staff, working closely with the World Bank, advised the authorities to unify the price of imported natural gas with the cost of that gas. With respect to oil and oil products, it was agreed that it would be appropriate for Azerbaijan to use its position as an oil exporter to insulate the domestic economy from international swings in oil prices, by unifying domestic prices not with actual international prices but with those that would prevail if oil prices were around US$20 per barrel (roughly consistent with the budget forecast, as well as with World Bank staff estimates of the long run world price level). For the two most socially sensitive products—diesel fuel and kerosene—it was agreed that price unification should be deferred to 2004, and that the 2004 budget should include a targeted subsidy mechanism to cushion the most vulnerable from the effects of these increases.

57. **This left only the domestic price of crude oil.** In general, crude is not sold domestically in Azerbaijan. There had been two exceptions. SOCAR's extraction division sold crude to refineries at the domestic price. The authorities acknowledged that this made it difficult to discern the true level of efficiency of the refineries, which were able to buy crude at less than US$8 per barrel and sell the refined products at close to international prices. However, they were reluctant to increase the domestic price, as certain PSAs require the operator to sell specified quantities of crude to the government at the domestic price. An increase in the domestic price to world market levels would cost the government about US$25 million per year. This issue was resolved through a restructuring of SOCAR that involves SOCAR extraction paying a service fee to the refineries, and SOCAR being prohibited from selling crude oil at below export parity. Domestic prices now only apply to transactions clearly specified in PSAs.

58. Having unified most domestic and world market prices, some in the government felt no more was necessary. The staff argued, however, that now that prices had been adjusted to be in line with an estimated long run world oil price, **it was important to take steps to ensure they remain generally in line with world market prices,** while not necessarily matching the volatility of world market prices. The authorities concurred, and committed to adopting, by end-2003, an automatic mechanism for the future adjustment of domestic oil and gas prices.

Trade and Investment Policy

59. The authorities reiterated their commitment to a liberal trade regime. They indicated their continuing intention to replace specific with ad valorem customs duties, and to further reduce the weighted average tariff rate (LOI, paragraph 8). They are seeking to accelerate their negotiations for WTO membership, with technical assistance from the United States. The authorities, however, maintain their ban on scrap metal exports (scrap metals constituted less than 1 percent of non-oil exports prior to the ban). The staff urged the replacement of this ban with an export licensing system, but the authorities were unwilling to do so, because of the link between domestic scrap metal operations and criminal activity.

C. Medium-Term Prospects and Capacity to Repay the Fund

60. **Azerbaijan's medium term economic prospects are promising.** In the short run FDI, which over 2002-2004 will be well in excess of 100 percent of 2003 GDP, will provide a strong growth impetus, an impetus that will be replaced by rapid growth in oil and gas production and exports when these projects are completed. Add to this the recent performance in growth in other sectors, and there is good reason to be optimistic about the country's growth prospects.

61. The staff and authorities agreed that non-oil sectors in Azerbaijan are likely to grow by around 9 percent per year, on average, over the period 2003-2005. While part of this growth will be due to spillover effects from oil sector investments, unrelated sectors (agriculture, aluminum) can be expected to continue to perform well, particularly in light of the growing availability of microfinance and small scale credits, as well as recent non-oil FDI. In addition, the continued efforts to improve the business environment, combined with ongoing efforts to rehabilitate crucial economic infrastructure, should provide additional impetus to non-oil growth.

62. **However, the medium term outlook is subject to an unusually high degree of risk stemming from the economy's heavy reliance on oil and gas exports.** In important ways, the risk has declined since Azerbaijan's last Article IV consultation, as the key energy sector investment projects have been sanctioned and appear to be on track for completion in late 2004 or 2005, as previously hoped (the Shah Deniz project will apparently be completed about one year later than previously planned). But with roughly 90 percent of exports coming from oil and gas, the recent volatility in oil prices emphasizes the uncertainties facing

Azerbaijan. In addition, continuing growth in the non-oil sectors will depend on the effective management of this oil wealth.

63. The **medium-term balance of payments** projections are based on end-March 2003 WEO oil price projections. The current account deficit is forecast to increase from 12.6 percent of GDP in 2002 to 29.7 percent in 2003, and to average 28 percent during 2004–2005, with these deficits largely financed by FDI. In 2006, with the full operation of the ACG, BTC and Shah Deniz projects and the related surge in exports and decline in oil sector imports, the current account deficit is projected to fall sharply to 7.7 percent of GDP before moving into surplus beginning in 2007. The financing gaps for 2003 and 2004 will be covered by the proposed disbursements from the Fund (US$36 million in 2003 and US$35 million in 2004), the World Bank Structural Adjustment Credit (US$33 million in 2003) and bilateral support. The authorities agreed with the mission's assessment both of the balance of payments prospects, as well as the uncertainty surrounding those prospects.

64. The staff reiterated its belief that the authorities should attach high priority to the **development of a medium- to long-term strategy for the use of oil revenues**. The staff has made this point in the past, but found little interest on the part of the authorities. Thus, the staff was encouraged when the authorities agreed with this opinion, and requested the Fund and World Bank staffs to help the government develop such a strategy during 2003. The chapter on the economic challenges of rising oil revenues in the SIP, as well as a recent World Bank Public Expenditure Review on a similar topic, will hopefully serve as useful starting points for the government's considerations.

65. **Azerbaijan has established a good record of servicing its debt to the Fund, and the staff expects the continued timely meeting of the country's external obligations.** Azerbaijan's government and government guaranteed external debt was 23 percent of GDP in 2002 and is expected to average around 20 percent of GDP over the medium-term. Azerbaijan has a good record of honoring its external obligations, and its external debt service payments—at an average of 3.2 percent of exports of goods and services in the medium-term—suggest that the risk is limited. Obligations to the Fund are projected to peak in 2003 at less than 3 percent of exports of goods and services, or at 11 percent of gross reserves.

66. **Azerbaijan has debt disputes with Kazakhstan, Turkmenistan and Uzbekistan.** In the case of Kazakhstan, the Azeris do not acknowledge responsibility for the debt of a state-owned enterprise. The Azeri authorities believe their debts to Uzbekistan have been settled, and they have not been able to reach agreement with the Turkmen authorities regarding the level of their obligations to that government.

D. Technical Assistance and Statistical Issues

67. Azerbaijan provides **core data** to the Fund, and the information is adequate for surveillance purposes. While the authorities have made significant progress in improving the quality and timeliness of macroeconomic statistics, a number of weaknesses need to be

addressed in national accounts and producer prices. In these areas, technical assistance continues to be provided by the Fund (Appendix I). Azerbaijan has a strong record of implementing recommendations from Fund technical assistance, and continued assistance is justified.

68. A data ROSC mission in May 2002 carried out a review of Azerbaijan's data dissemination practices compared to the GDDS, as well as an in-depth assessment of the quality of macroeconomic statistics. The report of that mission has been agreed with the authorities, and has now been published on the IMF web site. The report notes that **Azerbaijan meets and in many cases substantially exceeds GDDS recommendations—in many areas even SDDS requirements—on periodicity and timeliness for its macroeconomic statistics.** To meet SDDS requirements fully, several improvements, noted in the ROSC report, are needed.

69. The authorities have largely completed the implementation of the recommendations of the **safeguards assessment** (LOI, paragraph 44). The remaining recommendations from the safeguards assessment—to revise the legal framework and to address the modalities for profit distribution so that "profit transfers" to the budget truly reflect profits, and not a figure set in the budget—have not yet been resolved. The staff urged the authorities to address these issues in the forthcoming revisions to the Central Bank Law.

E. Program Monitoring

70. Measures to be implemented as prior actions for the completion of the second review, as well as structural performance criteria and benchmarks for end-June and end-December 2003, are listed in Box 5 and described in the LOI. Quantitative performance criteria for end-June and end-December 2003, and indicative targets for end-June, end-September and end-December 2003 are specified in the LOI, Table 2. These targets are based on the WEO projections for oil prices prevailing at the time the program was discussed with the authorities (US$31 and US$25 per barrel, respectively, in 2003 and 2004). The subsequent downward revisions in WEO oil price projections do not impact program conditionality, as all relevant quantitative performance criteria are fully adjusted for changes in oil prices relative to programmed oil prices. Only if oil prices fell below the budget assumption of US$19.50 on average for 2002 would there be a need to reconsider the program targets. The updated disbursement schedule is presented in Table 9.

71. The program contains a number of structural conditions, which the staff and authorities believe are critical to the program's success, as explained in Box 6. In many cases, multiple conditions refer to various stages of the same reform (e.g., submission of the Budget Systems Law amendments to parliament as a prior action, and implementation of those amendments as a performance criterion).

Box 5. Prior Actions, Structural Performance Criteria and Structural Benchmarks		
	Area	**Action**
Prior Actions (All prior actions to be implemented no later than April 30, 2003)	Budget Systems Law (BSL)	Submission to Parliament of amendments to BSL (as specified in paragraph 55 of LOI)
	Bank privatization	Adoption of privatization timetables for International Bank (IBA) and United Universal Joint Stock Bank (paragraph 37 of LOI)
	Budget system	Adoption of procedures for allocation of tax credits and subsidies for unpaid fuel consumed by utilities, in consultation with Fund staff (paragraph 10 of LOI)
	Pension contributions	Issuance of Cabinet of Ministers decree instructing timely payment of pension contributions by state-owned enterprises (paragraph 34 of LOI)
End-June 2003		
Structural Performance Criteria	Budget Systems Law	Adoption by Parliament of amendments submitted as prior actions (as specified in paragraph 55 and 56 of LOI)
	VAT refunds	Adoption by the Cabinet of Ministers of improved regulations on VAT refunds (as specified in paragraph 56 of LOI)
Structural Benchmarks	Revenue forecasting	Establishment of a revenue forecasting commission (as described in paragraph 25 of LOI)
	Banking System	Adoption by Parliament of a new Banking Systems Law (as described in paragraph 42 of LOI)
End-December 2003		
Structural Performance Criteria	Enterprise profit tax	Determine a single uniform enterprise profit tax rates for all non-oil companies (as described in paragraphs 23 and 57 of LOI)
	Energy prices	Adoption of a procedure for future automatic adjustments of domestic energy prices (as described in paragraphs 52 and 57 of LOI)
	Specific customs duties	Replacement of specific with ad-valorem customs duties in continued adherence to timetables adopted in compliance with end-March 2002 structural performance criteria (as described in paragraphs 26 and 57, see also EBS/02/21)
	VAT exemptions	Adoption of a Cabinet of Ministers decision reducing list of VAT exemptions and requiring that all future changes be done in the context of annual budget preparation process (as described in paragraphs 24 and 57 of LOI)
	Bank privatization	Issuance of a tender for all remaining government shares in IBA (as described in paragraphs 37 and 57 of LOI)
Structural Benchmark	State Customs Committee (SCC)	Continued adherence to the SCC reform program (as described in paragraph 26 of LOI)

Box 6. Structural Conditionality Streamlining Assessment

1. Coverage of Structural Conditionality in the Program

Structural Conditionality under the proposed program includes prior actions for the second review of PRGF, and performance criteria and benchmarks for end-June and end-December 2003, as follows:

- ***fiscal policy****, through a prior action and a structural performance criterion on the Budget Systems Law; a prior action on pension contributions; a performance criterion on VAT refunds and another one on VAT exemptions. This conditionality is relevant for the fiscal objectives of the program;*

- ***banking sector****, through a prior action and a performance criterion. The conditionality is critical to safeguard the integrity of the banking system and to establish a level playing field in the banking sector;*

- ***trade policy****, through a structural performance criterion. Further liberalization of the trade regime is essential for the balanced development of Azerbaijan's economy;*

- ***energy sector****, through a prior action and a structural performance criterion. Arrears, nonpayments, and waste of resources in the domestic energy sector pose a serious potential threat to medium-term macroeconomic stability;*

- ***governance issues****, through a structural benchmark on the Customs Committee. Reforming the Customs Committee is a central element of the effort to improve governance in Azerbaijan.*

2. Status of Structural Conditionality from Earlier Programs

See Box 5 on structural conditionality for end-March 2002 that were not met.

3. Structural Areas Covered by Bank Lending and Conditionality

A Structural Adjustment Credit (SAC II) was approved in March 2002. SAC II includes conditionality on (i) public, social, and financial sectors; (ii) reduction of implicit subsidies, privatization, and regulatory reform in the utilities sectors; and (iii) private sector development. The EBRD plays an important role in banking sector reform.

4. Other Relevant Structural Conditions not Included in the Current Program

Contrary to the previous program, the current program does not include conditionality on enterprise privatization. The World Bank takes the lead on this issue.

IV. STAFF APPRAISAL

72. **Azerbaijan's economic prospects are promising, but subject to an unusually high degree of risk stemming from the country's substantial and growing dependence on oil exports.** The staff is encouraged by the progress made to date on developing infrastructure for the effective management of oil wealth, and by the recent decision to save revenue from unusually high oil prices as a cushion against future low oil prices. The staff urges the authorities to adhere to this plan, and to develop a contingency plan, to be followed in the event of a prolonged and substantial reduction in oil prices.

73. The staff also urges the authorities to move expeditiously to **develop a medium- to long-term strategy for the use of oil revenue, which is economically sound, politically reasonable, and which will effectively contribute to combating the problem of poverty in the country.** Without such a strategy, there will be a real risk of substantial ad hoc expenditures in response to political pressures. Pending the development of this strategy, and in light of the economic challenges likely to face the country in 2003, the staff believes that a continuation of the financial policies that were implemented in 2002 remains appropriate.

74. **Program implementation continues to be strong, notwithstanding delays in structural reforms.** Financial policies remain consistent with macroeconomic stability, and the authorities have again demonstrated their ability to adapt to changing international circumstances. The progress on energy sector financial discipline—with an actual reduction in quasi-fiscal subsidies of 11 percent of GDP in two years—has been impressive. While the pace of structural reforms slowed somewhat in mid-2002, it has accelerated again in recent months and—with the exception of progress on bank privatization—the overall progress on structural reforms is impressive. The recently adopted PRSP calls for policies consistent with continued macroeconomic stability, as well as further structural reforms and measures to enhance governance that should stimulate growth and job creation in the non-oil sectors, and thereby contribute to the government's poverty reduction goals.

75. The staff believes **the fiscal stance remains appropriate in light of the country's macroeconomic prospects.** Over time, there will be economic justification and political pressure to increase the non-oil deficit (i.e., to increase spending from the oil fund). Thus the amendments to the Budget Systems Law, which more closely integrate the oil fund and state budgets into a comprehensive budget, are very welcome. Staff urges the authorities to find a constitutional way of prohibiting municipal borrowing.

76. **The staff welcomes the commitment to reunify the Enterprise Profit Tax as an important tax policy improvement**. At the same time, the staff is concerned about proposals for special economic zones that would extend a wide array of direct and indirect tax breaks to participants. If the authorities are determined to introduce special economic zones, the staff urges them to limit tax incentives to covering standard remissions of indirect taxes and customs duties in relation to exports.

77. **Enhancing energy sector financial discipline was, and remains, at the heart of the authorities' economic reform program**. The most difficult reforms remain: further increasing payments by energy consumers, restructuring overstaffed and inefficient state-owned enterprises, and eliminating the remaining subsidies. The staff congratulates the authorities for their progress to date on this issue, and urges them to continue these efforts.

78. **While welcoming the ongoing reforms in the banking sector, the staff is disappointed by the lack of progress in privatization of IBA**. This must be a priority; as long as the government owns the dominant bank, there will not be a competitive financial system in Azerbaijan. Similarly, efforts to privatize BUS Bank should be accelerated. The staff welcomes the recent presidential decrees adopting timetables for the privatization of these banks, and urges the authorities to adhere to these timetables. Similarly, the staff regrets the slow progress in adopting the Banking System Law, and urges the authorities to enact this law quickly.

79. The staff believes **the exchange rate of the manat is appropriate, as is the exchange rate policy being followed by the ANB**. In addition, the commitment to domestic price stability as the main guide to monetary policy remains appropriate. The staff urges the authorities to accelerate WTO accession negotiations, and to continue implementing a liberal trade policy. The staff is generally satisfied with the steps taken by the ANB to implement the recommendations of the Safeguards Assessment, but emphasizes the importance of improving the rules for distribution of ANB profits. The staff encourages the authorities to enhance their efforts to resolve outstanding debt disputes.

80. The staff is satisfied that **existing economic statistics provide an adequate basis for analyzing economic developments** in Azerbaijan. Nonetheless, the staff urges the authorities to continue their efforts to strengthen the statistical system, in line with the recommendations in the recently completed ROSC data module.

81. The staff is encouraged by the **ongoing process of improving governance**, particularly in the handling of public money in the state budget and the oil fund, as well as in tax and customs administration, and welcomes the substantial reduction in licensing requirements. However, while acknowledging the improvement in Azerbaijan's investment climate, the staff notes that this is improvement from a low level, and emphasizes the need for continuing efforts to enhance governance.

82. The main **risk to the program stems from volatile oil prices**. While the decision to save SOCAR taxes attributable to higher than budgeted oil prices is welcome, the risk remains. Second, political risk to the program may be greater than usual this year, as the authorities prepare for presidential elections in October. Third, there remains some modest risk of delays in key energy sector investment projects. Finally, the authorities continue to have difficulty implementing reforms in a timely fashion, even when there is little disagreement about the reforms.

83. **Notwithstanding these risks, the staff continues to believe the program has good prospects for success**. The authorities are requesting waivers for the performance criteria related to SOCAR tax credits and two end-March structural performance criteria; the staff supports these requests, since all policies subject to performance criteria have been implemented, in some cases the reforms have gone well beyond what was specified in the performance criteria—e.g., unifying domestic and world market energy prices, rather than merely adopting a timetable for their unification—and the delays did not jeopardize achievement of the program's objectives. The authorities are also requesting a rephasing of the third review and fourth disbursement, and a lengthening of the arrangement; the staff supports these requests as well. Given the authorities' strong track record in implementing sound financial policies, and the generally impressive record of structural reforms in the last three years, the staff recommends completion of the second review under the PRGF arrangement.

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

Table 1. Azerbaijan: Selected Economic and Financial Indicators, 2000-2005

	2000	2001		2002		2003	2004	2005
	Act.	Prog.	Act.	Prog.	Prel. Est.		Proj.	
	(Annual percentage change, unless otherwise specified)							
GDP at current prices	25.0	12.4	12.7	5.3	11.4	13.8	6.7	10.6
GDP at constant prices	11.1	9.0	9.9	8.5	10.6	9.2	8.8	10.5
Of which: oil sector	2.4	8.5	7.9	6.6	3.9	0.3	7.9	27.4
other sectors	13.7	9.1	10.4	9.0	12.3	11.4	9.0	7.0
Implicit GDP deflator	12.5	3.2	2.5	-3.0	0.7	4.1	-1.9	0.0
Consumer price index (end-period)	2.2	1.3	1.3	3.0	3.3	2.5	2.5	2.5
Consolidated government finance 1/								
Total revenue	42.9	15.4	16.2	14.9	16.4	17.7	5.0	12.5
Total expenditure	10.5	7.8	9.9	25.0	25.5	25.2	-1.2	9.1
Of which: current expenditure	11.9	7.4	6.1	22.0	14.1	24.3	3.8	10.1
investment expenditure	3.0	10.2	32.3	42.3	79.6	27.8	-16.0	5.4
investment expenditure (net of BTC loan)	3.0	10.2	32.3	42.3	52.2	9.4	15.8	5.4
Money and credit 2/								
Net foreign assets	11.5	20.5	78.9	5.6	4.7	6.2	...	...
Net domestic assets	15.6	-2.0	-48.4	4.7	8.1	9.8	...	...
Domestic credit	16.3	18.1	20.1	5.6	11.5	8.0	...	...
Of which: credit to the economy	-1.9	5.8	7.8	6.1	8.9	8.5	...	...
Manat broad money (average, annual changes)	1.9	9.7	7.7	11.2	14.8	15.1	...	...
Foreign currency deposits (level, as a ratio to broad money)	37.5	42.4	48.0	40.7	46.9	46.9	...	...
Income velocity of average manat broad money (M2) 3/	11.7	11.9	11.9	11.9	11.9	11.9	...	...
External sector (in US dollars)								
Exports f.o.b.	73.5	7.9	13.7	-21.4	12.7	16.5	-10.7	17.3
Of which: oil sector	89.7	14.2	21.1	-24.8	11.1	17.0	-13.3	18.7
Imports f.o.b.	7.4	-5.4	-4.8	41.1	24.5	70.0	10.2	-10.6
Of which: oil sector	-24.8	12.9	-5.5	293.3	142.7	328.1	10.1	-31.6
Export volumes	18.5	34.0	31.8	3.9	15.2	-1.2	9.9	34.8
Import volumes	13.2	3.1	-2.4	38.4	20.7	64.3	10.2	-10.5
Terms of trade	71.2	-12.8	-12.1	-25.8	-5.1	14.0	-18.8	-12.8
Real effective exchange rate (- deprec.)	-9.8	...	-6.1	...	-8.3	...	...	...
	(In percent of GDP)							
Gross fixed investment	23.1	31.1	22.9	47.3	34.8	55.3	54.9	45.8
Consolidated government 4/	3.0	4.1	3.5	4.0	5.7	6.4	5.1	4.8
Private sector	20.1	27.0	19.3	43.3	29.0	48.9	49.8	41.0
Of which: oil sector	11.2	15.6	14.6	29.9	27.4	41.1	41.0	31.3
Gross domestic savings	21.3	33.4	24.3	26.8	25.4	31.7	24.7	29.7
Gross national savings	17.1	28.8	19.8	23.8	20.2	25.6	20.2	24.6
Consolidated government	2.4	4.5	4.5	3.9	5.2	4.5	4.6	5.1
Private sector	14.7	24.3	15.3	19.9	15.0	21.1	15.6	19.5
Consolidated government finance 1/								
Revenue	21.2	22.2	21.5	23.6	22.5	23.3	22.9	23.3
Total expenditure	20.8	22.7	20.3	23.7	22.9	25.2	23.3	23.0
Overall fiscal balance	-0.6	-0.5	0.9	-0.1	-0.5	-1.9	-0.4	0.3
Statistical discrepancy	1.0	0.0	0.2	...	0.1	...	...	...
Nonoil deficit PC 5/	-7.8	...	-7.9	...	-10.0	-12.0	-10.6	-9.1
External sector								
Current account (- deficit)	-3.6	-2.3	-0.9	-23.4	-12.6	-29.7	-34.6	-21.3
Foreign direct investment (net)	0.9	6.1	5.1	22.4	17.1	30.1	31.4	19.6
External debt outstanding 6/	22.2	21.9	22.2	24.4	22.6	21.1	21.0	20.2
External debt service ratio (including IMF) 7/	4.6	5.3	4.9	7.1	4.4	5.6	5.0	3.7
Memorandum items:								
Gross official external reserves (US$ millions)	680	725	725	749	721	735	788	832
Nominal GDP (in manat billion)	23,591	26,494	26,578	27,887	29,602	33,675	35,937	39,735
Nominal GDP (US$ millions)	5,273	5,692	5,708	5,840	6,124	6,882	7,345	8,121
Nominal GDP per capita (in US dollars)	653	699	701	711	746	832	880	966

Sources: Azeri authorities and staff estimates and projections.

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

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

3/ In terms of nonoil GDP.

4/ For 2002 and 2003 includes investments of US$50 mln. and US$121.5 mln., respectively, for the government's share in BTC, equivalent to 0.8 percent and 1.8 percent of GDP, respectively.

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

6/ Government and government guaranteed external debt.

7/ In percent of exports of goods and services.

Table 2. Azerbaijan: Monetary Survey, 2000-2003 1/2/

	2000	2001				2002								2003				
	Dec.	March	June	Sept.	Dec.	March		June		Sept.		Dec.		Mar.	Jun.	Sept.	Dec	
	Act.	Act.	Act.	Act.	Act.	Prog.	Act.	Prog.	Act.	Prog.	Act.	Prog.	Act.	Proj.	Proj.	Proj.	Prog	Proj.
	(in billions of manats)																	
Net foreign assets	394	1,635	1,697	2,144	2,433	2,147	2,487	2,241	2,540	2,284	2,782	2,336	2,596	2,053	2,216	2,578	2,705	2,838
Net international reserves of the ANB (convertible)	1,569	1,496	1,604	2,010	1,970	1,957	2,043	2,045	2,154	2,079	2,198	2,111	2,130	1,758	1,875	2,162	2,471	2,369
Net foreign assets of commercial banks (convertible)	-1,177	135	92	135	454	192	438	197	383	206	540	226	464	294	339	415	235	467
Other	2	4	2	-1	9	-1	5	-1	3	-1	44	-1	2	2	2	2	-1	2
Net domestic assets	2,192	855	775	634	942	850	599	968	669	1,009	578	1,049	1,219	1,434	1,517	1,452	1,362	1,603
Domestic credit	1,711	1,712	1,649	1,941	2,231	2,158	2,040	2,275	2,022	2,315	2,140	2,354	2,625	2,835	2,908	2,833	2,633	2,939
Net claims on general government	87	63	-24	185	405	322	187	388	127	371	181	390	493	674	664	505	416	473
Net claims on central government	671	610	522	787	951	868	832	934	777	917	728	936	798	674	664	505	962	473
Pre-2000 oil bonus deposits	-541	-546	-546	-546	-546	-546	-546	-546	-546	-546	-546	-546	-304	0	0	0	-546	0
Other claims (net)	-42	0	0	-56	0	0	-98	0	-104	0	0	0	0	0	0	0	0	0
Credit to the economy	1,624	1,649	1,673	1,756	1,826	1,836	1,852	1,887	1,896	1,944	1,959	1,964	2,132	2,160	2,244	2,328	2,217	2,466
Other items (net)	481	-857	-874	-1,307	-1,289	-1,308	-1,441	-1,307	-1,353	-1,306	-1,562	-1,304	-1,406	-1,401	-1,391	-1,382	-1,271	-1,337
Broad money	2,586	2,490	2,472	2,778	3,375	2,998	3,085	3,209	3,209	3,293	3,360	3,385	3,815	3,487	3,733	4,030	4,068	4,440
Manat broad money	1,608	1,484	1,474	1,604	1,755	1,695	1,670	1,847	1,786	1,921	1,767	2,006	2,026	1,853	1,984	2,141	2,411	2,360
Currency outside banks	1,350	1,233	1,250	1,318	1,469	1,373	1,378	1,496	1,496	1,537	1,450	1,605	1,669	1,507	1,614	1,742	1,832	1,919
Manat deposits	258	251	224	286	286	322	291	351	290	384	317	401	358	346	370	399	579	440
Foreign currency deposits	978	1,006	999	1,175	1,620	1,303	1,416	1,362	1,423	1,372	1,593	1,379	1,789	1,634	1,749	1,889	1,657	2,081
	(changes in percent of beginning of year total broad money stock, unless otherwise specified; quarterly changes cumulative)																	
Net foreign assets	...	48.0	50.4	67.7	78.9	-0.4	1.6	2.7	3.2	3.8	10.3	5.6	4.7	-14.2	-10.0	-0.5	10.8	6.2
Net domestic assets	...	-51.7	-54.8	-60.2	-48.4	-1.7	-10.2	2.2	-8.1	3.4	-10.8	4.7	8.1	5.6	7.8	6.1	9.1	9.8
Domestic credit	...	0.1	-2.4	8.9	20.1	-0.7	-5.7	3.2	-6.2	4.3	-2.7	5.6	11.5	5.5	7.4	5.5	8.1	8.0
Credit to the economy	...	1.0	1.9	5.1	7.8	2.0	0.8	3.7	2.1	5.3	3.9	6.1	8.9	0.8	3.0	5.1	7.4	8.5
Broad money (M3) (percentage change)	...	-3.7	-4.4	7.5	30.5	-2.1	-8.6	4.8	-4.9	7.5	-0.4	10.5	13.0	-8.6	-2.1	5.6	20.2	16.4
Average broad money (M3) (percentage change)	...	...	...	...	28.6	6.9	17.5	9.5	14.5	14.7	19.5	13.7	22.6	8.4	7.2	15.2	15.6	22.5
Average manat broad money (M2) (percentage change)	...	...	...	...	7.7	...	7.5	...	11.2	...	10.6	11.2	18.7	7.7	6.5	14.5	17.1	25.0
Currency as a ratio to broad money	...	49.5	50.6	47.4	43.5	45.8	44.7	46.6	46.6	46.7	43.2	47.4	43.7	43.2	43.2	43.2	45.0	43.2
Foreign currency deposits as a ratio to broad money	...	40.4	40.4	42.3	48.0	43.5	45.9	42.4	44.4	41.7	47.4	40.7	46.9	46.9	46.9	46.9	40.7	46.9
Memorandum Items:																		
Gross international official reserves (US$ millions)	680	645	651	744	725	731	751	733	756	743	754	749	721	624	647	709	789	735
Net international official reserves (US$ millions)	344	325	348	436	428	425	444	444	468	451	477	458	462	380	406	468	536	513
Velocity of total broad money (M3) 3/	7.7	...	...	...	6.8	...	...	...	...	...	...	...	6.2	...	...	...	...	6.1
Reserve money (quarterly changes cumulative)	29.0	-15.2	-14.5	-9.0	1.6	-4.5	-7.4	5.2	-1.2	7.5	0.6	10.2	13.6	-8.9	-2.9	4.4	18.2	14.5

Sources: Azerbaijan National Bank; and Fund staff estimates.

1/ The accounts are based on the new classification of monetary accounts recommended by STA and adopted by the authorities, and do not include the Oil Fund.

2/ As of June 2001, accounts are valued at program exchange rates of 4,606 manat per US dollar and 1.26 US dollar per SDR.

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

Table 3. Azerbaijan: Summary Accounts of the Azerbaijan National Bank , 2000-2003 1/ 2/

(In billions of manats)

	2000	2001				2002								2003				
	Dec.	March	June	Sept.	Dec.	March		June		Sept		Dec.		Mar.	June	Sept.	Dec.	
	Act.	Act.	Act.	Act.	Act.	Program	Act	Program	Act	Program	Act	Program	Act.	Proj.	Proj.	Proj.	Prog	Proj.
Net foreign assets	1,569	1,497	1,604	2,011	1,970	1,957	2,042	2,045	2,153	2,079	2,198	2,111	2,124	1,752	1,870	2,156	2,471	2,363
Net international reserves (convertible)	1,569	1,496	1,604	2,010	1,970	1,957	2,043	2,045	2,154	2,079	2,198	2,111	2,130	1,758	1,875	2,162	2,471	2,369
Gross international reserves (convertible)	3,102	2,970	2,999	3,426	3,339	3,365	3,458	3,374	3,482	3,424	3,471	3,452	3,320	2,874	2,978	3,265	3,636	3,383
Foreign liabilities (convertible)	-1,534	-1,474	-1,395	-1,415	-1,369	-1,408	-1,415	-1,329	-1,328	-1,346	-1,273	-1,340	-1,190	-1,116	-1,103	-1,103	-1,165	-1,014
Other	0	0	0	0	0	0	-1	0	-1	0	0	0	-6	-6	-6	-6	0	-6
Net domestic assets	199	3	-92	-402	-175	-242	-379	-157	-380	-149	-393	-133	-85	105	111	-27	-133	-28
Domestic credit	612	458	370	64	232	180	20	263	-2	269	-8	285	240	426	421	274	273	229
Net claims on general government	-90	-159	172	-22	132	67	-70	139	-86	122	-90	106	154	326	311	148	81	93
Net claims on central government	452	387	719	524	678	613	573	685	558	669	456	652	457	326	311	148	628	93
Pre -2000 oil bonus deposits	-541	-546	-546	-546	-546	-546	-546	-546	-546	-546	-546	-546	-304	0	0	0	-546	0
World Bank counterpart funds	0	0	0	0	0	0	-97	0	-97	0	0	0	0	0	0	0	0	0
Claims on banks	701	617	197	86	101	113	90	123	84	147	82	179	86	100	110	125	191	135
Other items (net)	-413	-456	-462	-466	-407	-422	-398	-420	-378	-419	-385	-418	-325	-321	-310	-301	-406	-256
Reserve money	1,767	1,499	1,512	1,609	1,795	1,714	1,663	1,888	1,773	1,930	1,805	1,978	2,039	1,857	1,981	2,129	2,338	2,336
Manat reserve money	1,542	1,431	1,422	1,505	1,681	1,625	1,516	1,774	1,652	1,821	1,656	1,855	1,866	1,704	1,817	1,955	2,211	2,139
Currency in circulation	1,420	1,314	1,318	1,396	1,534	1,442	1,453	1,572	1,595	1,615	1,568	1,697	1,756	1,535	1,637	1,760	1,897	1,931
Bank reserves	122	117	105	109	147	183	63	202	57	207	88	158	110	168	180	195	314	208
Reserves in foreign currencies	223	65	87	99	107	82	141	107	112	101	142	116	167	144	153	165	120	187
Other deposits	2	4	3	5	7	7	6	7	9	7	7	7	6	10	10	10	7	10

Sources: Azeri authorities and staff estimates and projections.

1/ These accounts are based on the new classification of monetary accounts recommended by STA and adopted by the authorities, and do not include the Oil Fund.

2/ As of June 2001, accounts are valued at program exchange rates of 4,606 manat per US dollar and 1.26 US dollar per SDR.

Table 4. Azerbaijan : Consolidated Government Operations, 2001-2003

(In billions of manats)

	2001	2002 2/							2003 2/				2003 2/	
	Year	Q1	Q2	Q3	Q4	Year			Q1	Q2	Q3	Q4	Year	
	Act.		Est.		Prel. Est.	Prog.	Prog. 2/	Prel. Est.		Proj.			Budget	Proj.
Total revenue and grants	5,714	1,905	2,015	2,055	2,301	6,580	8,150	8,276	1,996	2,316	2,389	2,736	9,089	9,437
Total revenue	5,686	1,905	2,015	2,055	2,244	6,491	8,094	8,219	1,996	2,316	2,389	2,686	9,039	9,387
Tax revenue	3,891	980	1,079	1,208	1,309	4,648	4,648	4,575	1,174	1,327	1,345	1,540	5,039	5,386
Income tax	1,062	278	266	337	406	1,230	1,230	1,287	284	331	351	385	1,350	1,350
Individual income tax	474	114	130	149	158	530	530	550	122	142	151	165	580	580
Enterprise profits tax	588	164	136	188	248	700	700	737	162	189	200	219	770	770
Social security contributions	565	158	182	108	193	643	643	641	148	163	167	240	718	718
Value added tax (VAT)	1,266	355	400	470	450	1,635	1,635	1,574	419	487	476	533	1,919	1,919
Excise taxes	555	67	107	151	109	495	495	433	63	74	77	86	300	300
Taxes on international trade	300	82	84	102	108	492	492	376	216	220	191	203	482	830
SOCAR additional revenue	...	...	...	...	...	...	...	...	113	101	70	65	...	348
Other taxes	143	42	40	39	42	153	153	164	45	52	83	89	270	270
Nontax revenue	1,795	359	525	490	667	1,843	1,843	2,041	423	589	645	746	2,402	2,402
of which: Oil Fund revenues 1/	1,001	226	267	290	371	880	880	1,153	215	310	316	305	1,147	1,147
Tax credits for SOCAR energy subsidies	...	566	411	357	268	...	1,603	1,603	400	400	400	400	1,599	1,599
Total grants (current)	28	0	0	0	57	89	57	57	0	0	0	50	50	50
Total expenditure	5,403	1,672	1,996	1,854	2,862	6,619	8,222	8,384	2,308	2,581	2,474	2,723	10,087	10,087
Current expenditure	4,459	1,494	1,676	1,579	1,940	5,501	7,104	6,690	1,665	1,935	2,046	2,276	7,922	7,922
Primary current expenditure	4,343	912	1,250	1,206	1,634	5,386	6,989	5,002	1,224	1,498	1,595	1,784	6,101	6,101
Wages and salaries	1,187	254	336	290	398	1,502	1,502	1,278	316	407	399	481	1,604	1,604
Goods and services	1,196	186	321	362	483	1,435	1,435	1,353	386	512	592	619	2,110	2,110
Transfers to households	1,665	423	501	414	603	1,973	1,973	1,941	460	490	550	641	2,140	2,140
of which : social protection	1,334	338	410	319	509	1,457	1,457	1,575	377	407	467	558	1,808	1,808
Subsidies	76	10	20	19	24	156	156	73	49	49	39	26	163	163
Oil Fund (operating expenditures)	0	0	0	0	2	3	3	3	1	1	1	1	5	5
Other	220	39	70	120	124	317	317	354	12	39	14	16	80	80
Contingent expenditure	...	0	0	0	0	...		0	10	10	20	55	95	95
SOCAR energy related subsidies	...	566	411	357	268	...	1,603	1,603	400	400	400	400	1,599	1,599
Interest	116	16	15	16	38	115	115	85	32	27	31	37	127	127
Current balance (-, deficit)	1,254	411	339	475	361	1,080	1,080	1,586	331	381	343	460	1,167	1,515
Investment expenditure and net lending	943	178	320	275	922	1,119	1,119	1,694	643	646	428	448	2,165	2,165
Domestically-financed	283	58	150	200	477	590	590	885	550	561	194	206	1,510	1,510
without BTC loan	283	58	150	200	235	590	590	643	227	290	194	206	916	916
Foreign-financed	660	119	169	75	445	529	529	809	93	85	235	242	655	655
Statistical discrepancy	64	43	-20	130	-121	0	0	33	0	0	0	0	0	0
Consolidated government balance, cash basis (-, deficit)	247	190	40	70	-440	-39	-39	-141	-312	-265	-85	12	-998	-650
Excluding Oil Fund Revenue	-754	-36	-227	-219	-811	-922	-922	-1,293	-527	-575	-401	-293	-2,145	-1,797
Excluding foreign project loans	907	309	209	145	5	490	490	668	-219	-180	150	254	-343	5
Non-oil deficit	...	-929	-1,044	-1,114	-1,380	...	...	-2951	-1,038	-1,141	-964	-899	...	-4042
Financing	-247	-190	-40	-70	440	39	39	138	312	265	85	-12	998	650
Domestic (net)	-921	-443	-208	-135	-4	-599	-599	-793	230	173	-289	-243	233	-129
Banking system	62	-223	-66	51	328	-13	-13	90	200	-11	-158	-32	347	-1
Of which:Treasury bills	54	-33	5	27	-49	34	34	-50	10	5	5	20	40	40
Oil Fund	-1,105	-246	-250	-229	-313	-725	-725	-1,038	9	146	-168	-255	-253	-268
Nonbank sector	-67	0	1	0	1	20	20	3	1	3	3	5	10	10
Privatizations and other sale of assets	86	25	18	40	24	150	150	106	20	35	35	40	130	130
Other	102	1	90	2	-43	-31	-31	47	0	0	0	0	0	0
External (net)	675	254	168	65	444	639	639	931	82	93	374	231	764	780
Loans	709	276	174	88	450	720	720	988	111	110	404	252	862	878
Project loans	679	131	174	88	450	576	576	844	111	95	253	252	712	712
Oil bonuses	30	0	0	0	0	0	0	0	0	15	0	0	0	15
World Bank SAC	0	144	0	0	0	143	143	144	0	0	151	0	150	151
Amortization due	-34	-22	-6	-23	-6	-80	-80	-57	-29	-18	-31	-21	-98	-98
Financing gap	0	0	0	0	0	0	0	0	0	0	0	0	0	0

Sources: Azeri authorities and staff estimates and projections.

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

2/ Includes SOCAR's quasi-fiscal energy sector revenues and expenditures.

Table 5. Azerbaijan: Selected Fiscal Indicators, 2000-2003

(In percent of GDP, unless otherwise specified)

	2000	2001		2002			2003
	Act.	Program	Act.	Program 1/	Budget	Prel. Est. 1/	Proj 1/
Total revenue and grants	21.2	22.2	21.5	29.0	23.4	28.0	28.0
Total revenue	20.7	22.1	21.4	28.7	23.3	27.8	27.9
of which : tax revenue	14.5	14.8	14.6	16.7	16.7	15.5	16.0
nontax revenue	6.3	7.3	6.8	6.6	6.6	6.9	7.1
Tax credits for SOCAR energy subsidies	...	...	...	5.4	...	5.4	4.7
of which : oil revenue 1/	7.5	8.7	9.4	14.8	...	15.5	15.4
nonoil revenue	13.2	13.4	12.0	13.9	13.9	12.3	12.5
nonoil revenue (percent of nonoil GDP)	18.3	17.8	17.0	17.2	17.2	16.9	17.1
Total grants (current)	0.5	0.2	0.1	0.3	0.2	0.2	0.1
Total expenditure	20.8	22.7	20.3	29.2	23.6	28.3	30.0
Primary expenditure	20.4	22.3	19.9	28.7	23.2	22.6	24.5
Primary current expenditure	17.4	18.2	16.3	19.3	19.2	16.9	18.1
Of which : wage bill	4.6	5.0	4.5	5.4	5.4	4.3	4.8
goods and services	4.8	5.2	4.5	5.1	5.1	4.6	6.3
transfers	6.7	6.4	6.3	7.1	7.1	6.6	6.4
Domestically financed investment and net lending 2/	1.3	1.3	1.1	2.1	2.1	3.0	4.5
Foreign-financed investment	1.7	2.8	2.5	1.9	1.9	2.7	1.9
SOCAR energy related subsidies	...	...	...	5.4	...	5.4	4.7
Interest on public debt	0.4	0.5	0.4	0.4	0.4	0.3	0.4
Wages/ primary expenditure (in percentage)	26.5	27.3	27.3	27.9	28.1	25.5	26.3
Transfers / primary expenditure (in percentage)	38.3	35.4	38.3	36.6	36.9	38.8	35.1
Wages/ non-oil revenue (in percentage)	34.9	37.1	37.3	38.8	38.8	35.2	38.0
Transfers / nonoil revenue (in percentage)	50.4	48.0	52.4	50.9	50.9	53.4	50.8
Expenditure in education and health	4.7	4.8	4.3	4.8	4.8	4.6	4.6
Education	3.8	3.8	3.5	3.9	3.9	3.7	3.6
Health	0.9	1.0	0.8	1.0	1.0	0.9	1.0
Military expenditure	2.1	2.0	1.8	2.2	2.2	2.1	2.1
Current expenditure	17.8	18.6	16.8	19.7	19.6	22.6	23.5
Investment expenditure	3.0	4.1	3.5	4.0	4.0	5.7	6.4
Current balance (+ , surplus)	3.4	3.6	4.7	3.9	3.9	5.4	4.5
Primary balance (+, surplus)	-0.2	0.0	1.4	0.3	0.3	-0.2	-1.6
Primary balance, excluding oil (+, surplus)	-7.7	-8.7	-8.1	-9.1	-9.1	-15.7	-16.9
Primary balance (excl. externally financed investment)	1.5	2.8	3.8	2.2	2.2	2.5	0.4
Consolidated government balance, cash basis (+, surplus)	-0.6	-0.5	0.9	-0.1	-0.1	-0.5	-1.9
Excluding Oil Fund revenue	-17.6	-3.9	-2.5	-3.3	...	-4.4	-5.3
Non-oil Balance PC (net of BTC)	-7.8	...	-7.9	...	...	-9.1	-10.2
Memorandum items:							
Total external assistance, excluding IMF	3.6	3.4	2.7	2.6	2.6	3.3	2.6
Project financing	1.7	2.8	2.6	2.1	2.1	2.9	2.1
Program financing	1.9	0.6	0.1	0.5	0.5	0.5	0.5
Financing gap	0.0	0.0	0.0	0.0	0.0	0.0	0.0

Sources: Azeri authorities and staff estimates and projections.

1/For 2002 and 2003 includes quasi-fiscal energy sector revenues and expenditures. Program estimate for oil revenue in 2002 has been adjusted accordingly.

2/ Investment expenditure increases by 0.8 percent of GDP in 2002 and by 1.8 percent of GDP in 2003 due to an equity investment by the government in BTC Azerbaijan.

Table 6. Azerbaijan: Balance of Payments, 2001-2005

(In millions of U.S dollars)

	2001	2002	2003						2004	2005
			Q1	Q2	Q3	Q4	Year			
	Est.	Prel. Est.	Proj.	Proj.	Proj.	Proj.	Prog.	Proj	Proj.	Proj.
Exports, f.o.b.	2,046	2,305	723	656	645	661	1,753	2,685	2,398	2,813
Of which: oil and oil products	1,841	2,046	650	586	575	583	1,512	2,394	2,076	2,464
other	205	259	73	70	70	78	241	291	322	349
Imports, f.o.b.	-1,465	-1,823	-517	-887	-872	-824	-2,613	-3,100	-3,416	-3,053
Of which: oil and gas sectors	-138	-336	-101	-475	-460	-403	-1,097	-1,438	-1,583	-1,083
other	-1,327	-1,487	-416	-412	-412	-422	-1,515	-1,662	-1,833	-1,970
Trade balance	581	482	206	-230	-227	-163	-860	-415	-1,018	-240
Services (net)	-375	-936	-425	-266	-266	-259	-1,137	-1,215	-1,202	-1,069
Credit	290	362	95	97	97	99	309	386	422	458
Debit	-665	-1,298	-519	-362	-362	-357	-1,446	-1,601	-1,624	-1,527
Of which: oil and gas sectors	-329	-868	-394	-237	-237	-253	-973	-1,122	-1,096	-970
Income	-332	-386	-114	-126	-121	-133	-264	-493	-409	-509
Investment income (net)	-256	-326	-97	-105	-103	-111	-172	-416	-333	-432
o/w profit of oil consortium	-291	-344	-111	-103	-107	-100	-240	-420	-378	-517
Compensation of employees	-47	-39	-10	-11	-11	-12	-55	-45	-47	-49
Interest on public debt (including Fund)	-29	-20	-6	-10	-6	-10	-36	-32	-29	-28
Transfers (net)	77	70	16	20	20	20	52	77	84	90
Private	13	15	4	4	4	5	16	17	18	20
Public	64	55	13	16	16	15	37	60	66	70
Current account balance	-50	-769	-316	-602	-594	-535	-2,209	-2,046	-2,544	-1,727
Net direct investment	299	1,048	297	538	585	654	2291	2,074	2,306	1,591
Oil companies	197	984	275	513	560	626	2172	1,974	2,201	1,470
contracted (net)	732	1,613	474	695	754	804	2613	2,727	2,906	2,420
capital repatriation	-542	-629	-198.8	-185.0	-193.8	-177.8	-491	-755	-705	-950
bonus	7	0	0.0	3.0	0.0	0.0	50	3	0	0
Other	101	64	22	25	25	28	119	100	105	120
Public sector capital	140	167	13	-1	79	35	104	126	123	131
Medium Long-term borrowing	185	216	23	21	90	57	166	190	180	180
Budget support	0	30	0	0	33	0	30	33	0	0
Other long-term loans	185	185	23	21	57	57	136	157	180	180
Scheduled amortization	-45	-48	-10	-21	-11	-22	-63	-64	-57	-49
Other (including short term capital) 1/	-19	-135	-76	61	26	-55	100	-44	315	253
Capital account balance	420	1,080	234	598	690	634	2,494	2,156	2,744	1,975
Errors and omissions	-48	-75	0	0	0	0	0	0	0	0
Overall balance	322	236	-82	-3	97	99	286	110	200	248
Financing	-322	-236	81	4	-97	-99	-290	-110	-200	-283
Change in net foreign assets of NBA (-, increase)	-74	-35	79	-26	-62	-47	-78	-55	-74	-71
Net credit from the Fund	-29	-39	-17	-3	0	-21	-38	-42	-20	-27
Disbursements/purchases	10	10	0	18	18	0	32	36	35	18
Repayments/repurchases	-39	-49	-17	-21	-18	-21	-70	-77	-55	-45
Change in gross official reserves (-, increase)	-45	4	97	-23	-62	-26	-40	-14	-54	-44
Change in other foreign liabilities (+, increase)	0	0	0	0	0	0	0	0	0	0
Change in arrears (-, decrease)	0.2	-0.2	0	0	0	0	0	0	0	0
Change in oil fund assets (-, increase) 2/	-221	-201	2	30	-34	-52	-212	-55	-126	-212
Adjustment (Oil Fund required reserves) 3/	-27	0	0	0	0	0	0	0	0	0
Financing gap	0	0	1	-1	0	0	5	0	0	35
Memorandum items:										
Current account balance (in percent of GDP)	-0.9	-12.6	...	...	...	...	-33.3	-29.7	-34.6	-21.3
Excluding oil sector imports	7.3	7.1	...	...	...	...	-2.1	7.5	1.8	4.0
Gross official reserves (US$ millions)	725	721	624	647	709	735	789	735	788	832
Gross official reserves (in months of non-oil imports c.i.f.)	4.5	4.0	...	...	...	...	4.5	3.7	3.7	3.8
Oil fund assets	493	693	...	...	...	...	851	748	875	1,087
WEO oil price (US$ per barrel)	24.3	25.0	...	...	...	...	20	31.0	25.0	22.0

Sources: Azeri authorities and staff estimates and projections.

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

2/ Assumes change in Oil Fund accumulation rules from 2003 onwards, whereby SOCAR retains its share of profit oil from the Azeri-Chirag-Guneshli Production Sharing Agreement.

3/ This corrects for the required reserves held at the ANB against the deposits of the Oil Fund, prior to 2001when the Fund's resources were transferred to the ANB from a commercial bank.

Table 7: Azerbaijan : Capacity to Repay the Fund, 2000-2005
(In millions of SDR's)

	2000	2001	2002	2003	2004	2005
			Projections			
Outstanding use of Fund credit	257.7	234.8	204.9	174.6	160.1	140.4
IMF obligations	49.6	39.0	42.1	58.8	42.0	33.7
Purchases and Disbursements	0.0	8.1	8.1	25.7	25.7	12.9
Repurchases and Repayments	39.0	30.9	38.0	56.0	40.3	32.6
Charges	10.6	8.1	4.1	2.8	1.7	1.1
Outstanding use of Fund credit as a ratio of						
Exports of goods and services	16.6	12.8	9.9	7.8	7.8	5.9
External public debt	29.2	23.6	19.2	16.6	14.3	11.8
Gross official reserves	50.3	41.2	36.8	32.8	28.0	23.2
GDP	6.5	5.2	4.3	3.5	3.0	2.4
Quota	160.1	145.9	127.3	108.5	99.5	87.2
Debt service obligations to IMF as a ratio of						
Exports of goods and services	3.2	2.1	2.0	2.6	2.1	1.4
External public debt	5.6	3.9	3.9	5.6	3.8	2.8
Gross official reserves	9.7	6.9	7.6	11.0	7.3	5.6
GDP	1.3	1.0	1.0	1.2	0.8	0.6
Quota	30.8	24.3	26.2	36.6	26.1	20.9
Memorandum item:						
quota (million SDR)	160.9	160.9	160.9	160.9	160.9	160.9

Source: Staff estimates and projections.

Table 8. Azerbaijan: Macroeconomic Framework, 2000-2008

	2000	2001	2002	2003	2004	2005	2006	2007	2008
	Act	Act	Act			Projections			
GDP and prices (annual percentage changes)									
Real GDP	11.1	9.9	10.6	9.2	8.8	10.5	13.9	16.2	10.7
Oil sector	2.4	7.9	3.9	0.3	7.9	27.4	47.6	48.1	22.2
Other sectors	13.7	10.4	12.3	11.4	9.0	7.0	5.5	5.0	5.0
GDP deflator	12.5	2.5	0.7	4.1	-1.9	0.0	2.1	2.8	2.0
Consumer price index (end-period)	2.2	1.3	3.3	2.5	2.5	2.5	2.5	2.5	2.5
Monetary aggregates (annual percentage changes)									
Broad Money (M3)	27.1	30.5	13.0	16.4	13.7	11.7	10.1	9.6	9.6
Credit to non-government 2/	-1.7	-17.5	16.7	15.7	13.7	11.7	10.1	9.6	9.6
Savings and investments (in percent of GDP)									
Gross fixed investment	23.1	22.9	34.8	55.3	54.9	45.8	39.3	31.0	26.7
Consolidated government	3.0	3.5	5.7	6.4	5.1	4.8	4.7	4.5	4.6
Private sector	20.1	19.3	29.0	48.9	49.8	41.0	34.6	26.4	22.1
Of which: oil sector	11.2	14.6	27.4	41.1	41.0	31.3	24.4	16.5	12.4
Gross domestic savings	21.3	24.3	25.4	31.7	24.7	29.7	38.8	55.4	62.3
Gross national savings	17.1	19.8	20.2	25.6	20.2	24.6	31.6	43.4	54.0
Consolidated government	2.4	4.5	5.2	4.5	4.6	5.1	5.3	6.7	13.3
Private sector	14.7	15.3	15.0	21.1	15.6	19.5	26.3	36.7	40.6
Consolidated government (in percent of GDP)									
Revenue 1/	21.2	21.5	28.0	28.0	27.3	27.3	25.2	24.4	30.2
Expenditures 1/	20.8	20.3	28.3	30.0	27.8	27.0	24.5	22.2	21.4
Current	18.6	16.8	17.2	18.5	18.3	18.1	17.2	16.6	16.8
of which: interest payments	0.4	0.4	0.3	0.4	0.4	0.4	0.3	0.3	0.3
Investments	3.5	3.5	5.7	6.4	5.1	4.8	4.7	4.5	4.6
Overall balance	-0.6	0.9	-0.5	-1.9	-0.4	0.3	0.7	2.1	8.7
Non-oil balance PC (net of BTC expenditure)	-8.1	-7.9	-9.1	-10.2	-10.6	-9.1	-8.8	-9.3	-9.7
Balance of payments (in millions of US dollars)									
Trade balance	260	581	482	-415	-1,018	-240	856	3,432	5,047
Exports	1,799	2,046	2,305	2,685	2,398	2,813	3,837	6,246	7,828
Of which: Oil and gas sector	1,519	1,841	2,046	2,394	2,076	2,464	3,456	5,834	7,380
Imports	1,539	1,465	1,823	3,100	3,416	3,053	2,980	2,814	2,781
Of which: Oil and gas sector	147	138	336	1,438	1,583	1,083	914	674	538
Services, net	-225	-375	-936	-1,215	-1,202	-1,069	-905	-677	-511
Receipts	260	290	362	386	422	458	499	542	588
Payments	485	665	1,298	1,601	1,624	1,527	1,405	1,219	1,099
Of which: Oil and gas sector	154	329	868	1,122	1,096	970	836	643	513
Income, net	-295	-332	-386	-493	-409	-509	-780	-1,469	-1,191
Current account balance	-187	-50	-769	-2,046	-2,544	-1,727	-724	1,402	3,472
Capital and financial account balance	490	420	1,080	2,156	2,744	1,975	1,260	-642	-1,707
Of which: net FDI	149	299	1,048	2,074	2,306	1,591	965	-853	-1,931
Memorandum items:									
Gross official reserves									
- in millions of US dollars	680	725	721	735	788	832	849	908	960
- in months of prospective nonoil sector imports of GNFS	4.9	4.5	4.0	3.7	3.7	3.8	3.8	3.9	4.0
External debt/GDP (in percent)	22.2	22.2	22.6	21.1	21.0	20.2	18.4	16.2	15.2
External debt service/exports of GNFS (in percent)	4.6	4.9	4.4	5.6	5.0	3.7	2.4	1.6	1.1
Nominal GDP									
- in billions of Manats	23,591	26,578	29,602	33,675	35,937	39,735	46,212	55,215	62,348
- in millions of US dollars	5,273	5,708	6,124	6,882	7,345	8,121	9,445	11,285	12,742

Sources: Azeri authorities; and Fund staff projections.

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

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

Table 9: Azerbaijan: Review and Phasing of Disbursements
Under the Proposed PRGF Arrangement

(In millions of SDRs)

Date of Disbursement	Conditions	Disbursement
July 13, 2001	Disbursed upon Board approval of the PRGF arrangement	8.05
February 28, 2002	Disbursed upon completion of the first review under the PRGF arrangement	8.05
After Board date (May 14, 2003)	Completion of the second review; end-March 2002 performance criteria	12.87
On or after August 15, 2003	Completion of the third review; end-June 2003 performance criteria	12.87
On or after February 15, 2004	Completion of the fourth review; end-December 2003 performance criteria	12.87
On or after August 15, 2004	Completion of the fifth review; end-June 2004 performance criteria	12.87
On or after February 15, 2005	Completion of the final review; end-December 2004 performance criteria	12.87

Azerbaijan: Fund Relations
As of March 31, 2003

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

2. **General Resources Account:**	**SDR Million**	**Percent of Quota**
Quota	160.90	100.00
Fund Holdings of Currency	261.46	162.50
Reserve position in Fund	0.01	0.01

3. **SDR Department:**	**SDR Million**	**Percent of Allocation**
Holdings	10.92	N/A

4. **Outstanding Purchases and Loans:**	**SDR Million**	**Percent of Quota**
Extended arrangements	45.59	28.33
Contingency and Compensatory	28.16	17.50
Systemic Transformation	26.81	16.66
PRGF arrangements	91.86	57.09

5. **Financial Arrangements:**

Type	**Approval Date**	**Expiration Date**	**Amount Approved (SDR Million)**	**Amount Drawn (SDR Million)**
PRGF	07/06/2001	07/05/2004	80.45	16.10
EFF	12/20/1996	03/19/2000	58.50	53.24
ESAF/PRGF	12/20/1996	03/19/2000	93.60	81.90

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

	Forthcoming				
	2003	2004	2005	2006	2007
Principal	43.30	40.29	32.57	25.25	24.45
Charges/Interest	1.99	1.62	1.06	0.66	0.37
Total	45.28	41.90	33.63	25.92	24.82

7. **Safeguards Assessment**

Under the Fund's safeguards assessment policy, National Bank of Azerbaijan (NBA) is subject to an assessment with respect to the PRGF arrangement, which was approved on July 6, 2001 and is scheduled to expire on July 5, 2004 (in view of the delay in completing the second review under the program, the authorities are requesting that the PRGF arrangement be extended to March 31, 2005). A safeguards assessment of the NBA was completed on March 8, 2002. The assessment concluded that risks may exist in the legal structure and independence of the Central Bank, and in its internal audit and control systems.

The authorities have largely completed the implementation of the recommendations of the safeguards assessment, with the following two exceptions. First, the recommended revision of the legal framework and modalities for ANB's profit distribution has not been implemented, and the ANB's "profit transfers" to the budget do not represent actual ANB profits but the target set in the annual budget law. The staff has urged the authorities to address this issue in the forthcoming revisions to the Central Bank Law. Second, the recommendation to establish an audit committee under the ANB's Board of Directors has not been implemented, as the existing law on the Central Bank does not allow such a structure.

8. **Exchange Rate Arrangements**

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

Azerbaijan has been classified by the staff with the group of countries whose exchange rate regimes are managed floats.

9. **Article IV Consultation**

The 2001 Article IV consultation with Azerbaijan was concluded on February 20, 2002.

10. **ROSCs**

A fiscal transparency ROSC module was prepared by FAD (SM/00/278, 12/12/01).
A data dissemination ROSC module was completed by STA in March, 2003 (IMF Country Report No. 03/86). The authorities have agreed to publish the ROSC and it has now been put on the IMF web site.

11. **Resident Representative**

Mr. Michael Mered, the Fund's fourth Resident Representative took up his duties in Baku in July 2000.

12. **Resident Advisers**

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

August 2000, and then through May 2001. Mr. B.K. Chaturvedi has been replaced by Mr. A. Khan whose assignment started May 2001 and ended in August 2002. A technical long-term adviser for tax administration, Mr. Mark Zariski, was stationed in Baku from April 1995 until April 1996. He was succeeded by Mr. Peter Barrand, who was stationed in Baku from January 2001 until December 2002. Mr. Isaac Svartsman was resident advisor in the ANB for bank supervision and restructuring from September 1998 to April 2001.

Azerbaijan: Technical Assistance 1998-2003

Fund Dept.	Area of Assistance	Mission Dates
FAD	Treasury project inspection	April/May 1998
MAE	Bank restructuring	May 1998
BCS	Book entry system	October 1998
LEG	Tax code legislation	November 1998
FAD	Tax administration	December 1998
LEG	Tax code	Jan./Feb. 1999
STA	Balance of payments statistics	Mar./April 1999
LEG	Tax code	Mar./April 1999
MAE	Bank restructuring	April/May 1999
FAD	Tax administration	Sept./Oct. 1999
MAE	Bank restructuring	Oct./Nov. 1999
STA	Price statistics	November 1999
STA	National accounts statistics	November 1999
FAD	Tax administration	Jan./Feb. 2000
FAD	Customs administration	March/April 2000
FAD	Expenditure policy	April/May 2000
LEG	Tax code	September 2000
MAE	Bank restructuring	October 2000
FAD	Treasury computerization	Oct./Nov. 2000
STA	Price statistics	November 2000
STA	National accounts and GDDS	November 2000
STA	Money and banking statistics	Nov/ Dec. 2000
STA	National accounts and GDDS	February 2001
STA	Price statistics	February 2001
STA	Balance of Payments Statistics	April 2001
MAE	Banking supervision	May 2001
MAE	Payments system	May 2001
MAE	Central Bank Internal Audit	June 2001
FAD	Customs Administration	June 2001
FAD	Budget systems law	August 2001
MAE	Bank restructuring and monetary operations	June 2001
TRE	Safeguards assessments	January 2002
LEG/MAE	Banking legislation	January 2002
MAE	Central Bank accounting	January 2002
MAE	Payments system	February 2002
STA	National Accounts	Oct./Nov. 2002
MAE	Bank restructuring and monetary operations	December 2002
STA	National Accounts	Jan./Feb. 2003

Source: International Monetary Fund

Azerbaijan: IMF-World Bank Relations

Partnership in Azerbaijan's Development Strategy

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

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

- The IMF has taken the lead in assisting Azerbaijan in enhancing macroeconomic stability and related structural reform measures. In this regard, the Fund has encouraged the authorities to continue with fiscal consolidation and to maintain a prudent monetary policy stance. The Government has also been encouraged to enhance governance and strengthen financial discipline in the energy sector, and to improve the legal and regulatory environment for private sector development. The Fund has supported Azerbaijan's economic reform program since 1995. The authorities were successful in achieving macroeconomic stabilization under the economic reform program supported by the early IDA and IMF structural adjustment arrangements, which formed the foundation for an ongoing Fund-supported program under the Poverty Reduction and Growth Facility (PRGF), approved by the Executive Board in July 2001, with the first review endorsed by the Board on February 20th, 2002 and the second review scheduled for May 14 2003.

- The World Bank has taken the lead in the policy dialogue on structural reforms, including poverty reduction measures, public expenditures, agricultural policies, private sector development, institution building and governance. A range of instruments is used to conduct the dialogue. SAC II is supporting a wide-ranging structural reform agenda and its accompanying institution building and technical assistance credit (IBTA II) is assisting institutional capacity building, especially of government budget preparation and execution, privatization and utility reforms. This broad-based policy reform approach is combined with sector investments in agriculture, roads, water, refugees/IDPs, environment, education, health and domestic gas. Recent analytical and advisory assistance has included a poverty assessment, a PER, a CPAR (procurement assessment), a CFAA (financial accountability), pension reforms paper and ongoing exercises on trade facilitation and mitigation of the social costs of utility price increases.

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

Table 1. Bank-Fund Collaboration on Azerbaijan

Area	Specialized Advice from Fund	Specialized Advice from Bank	Key Instruments
Macroeconomic Framework/ Management	Monetary policy, exchange rate, fiscal and trade policies, economic statistics	Medium- to long-term public expenditure management of oil windfall, trade reform.	*IMF:* PRGF performance criteria and benchmarks on monetary and fiscal targets. *Bank:* SAC II and IBTA II support of reforms in budget preparation and execution, PER, integrated trade development framework.

Budget	Consolidated medium-term budget framework, including the Oil Fund's operations, budget systems law, treasury modernization, tax policy and administration, customs, debt management, extra budgetary funds	Budget systems law, consolidated medium-term budget framework, integration of the Oil Fund's governance framework, PIP capacity building.	*IMF:* PRGF performance criteria on overall consolidated fiscal deficit, excluding Oil Fund revenues and overall consolidated non-oil deficit including quasi-fiscal activities; performance criteria related to rules and legislation related to ensuring coherent fiscal policy. *Bank*: SAC II conditionality on governance of the Oil Fund, budget systems law, MTEF and PIP, and IBTA-II supported activities for capacity building.
Public Sector Reform	Support to State Customs Committee, Ministry of Taxes, Ministry of Finance	Support to Ministry of Environment, Ministry of Economic Development and consolidation of Agencies and Departments, State Procurement Agency, Chamber of Accounts	*IMF*: PRGF performance criteria and benchmarks related to ongoing administrative reforms in customs, taxes and finance. *Bank*: technical assistance supported by IBTA-II.
Energy Sector Reform	Strengthening financial discipline in energy sector by unification of domestic and international prices for natural gas and oil products, allocation of subsidies to Azerenergy and Azerigas, and offsetting tax credits to SOCAR, full payment by budgetary organizations for their utility consumption.	Strengthening financial discipline in energy sector by elimination of implicit subsidies and improved collections and tariff policies, privatization of distribution companies, introduction of regulatory framework and agency, and specialized advice on oil and gas sector development.	*IMF:* PRGF performance criteria and benchmarks related to domestic energy prices, as well as the incorporation of previously quasi-fiscal subsidies into the state budget *Bank*: SAC II conditionality on utility reforms, especially aimed at improving financial viability. PPIAF/ESMAP TA on sector restructuring and regulations. IBTA-I and –II supported assistance for privatization and in analyzing the environmental and social impact of such reforms and designing measures to protect the poor.
Financial Sector Reform	Strengthening the competitiveness and health of the banking system, privatization of state-owned banks, revision and introduction of a new legal framework for the	Restructuring and privatization of large State banks, strengthening of ANB's supervisory capacity, introduction of electronic payment systems, credit rating agencies and registries, SME credit.	*IMF:* PRGF performance criteria and benchmarks on bank privatization, banking system law and central bank law. *Bank*: SAC 2 conditions on the financial sector and the financial sector TA credit.

	banking sector (banking law, bankruptcy law, central bank law), development of manat financial markets, including the market for T-bills, safeguards assessment of a financial sector, FSAP		
Social/Poverty		Public expenditure reforms, strengthening of monitoring and evaluation systems, reform strategies for education, health, social assistance and protection as well as pension reform and direct assistance to IDPs.	*Bank*: Conditionality in SAC 2. Poverty Assessment and TA for Household and other surveys, assistance with design of pension reforms and better targeting of social expenditures. Project to assist IDPs and refugees. Education and Health LILs aimed at improving service delivery to the poor.
Private Sector Development	Trade and investment policy	Integrated framework for trade and business development, improving and monitoring of the business and investment environment, streamlining procedures for entry and exit, enhancing high-level public/private sector dialogue, trade and transport facilitation, SME support, and privatization of SOEs.	*IMF:* PRGF *Bank*: enhanced public-private partnership supported via SAC II and IBTA II; analytical assistance on the nexus of business environment and governance in cooperation with FIAS; integrated trade and business development framework report. trade and transport facilitation report; SAC II and IBTA II supported TA on privatization and labor redeployment.
Other sectors		Strengthening rural and agricultural infrastructure, transport policy and infrastructure, environmental clean-up and preservation.	*Bank*: investment projects in environment, agriculture and highways.

IMF-World Bank Collaboration in Specific Areas

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

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

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

- The Bank leads the dialogue on structural reforms through the **SAC II**, approved by the Bank's Board in FY02. Bank leads in the areas of:

- **Privatization and Private Sector Development.** The Bank is taking the lead in the formulation of an integrated strategy and action plan for trade and private sector development.[1] An important element of the strategy is in providing a framework to better integrate the efforts of key stakeholders—i.e., the Government, multilateral and bilateral donors, the private sector, and others—in promoting non-oil trade and investment. The four broad policy components include: (i) Improving the Trade Policy Regime and Market Access—creating a more export-friendly tariff structure, accelerating Azerbaijan's accession to the WTO, increasing access to regional markets and the European Union; improving access to finance; streamlining administrative procedures; (ii) Enhancing Trade Facilitation—streamlining and strengthening customs procedures and improving the quality and capacity of Azerbaijan's transportation infrastructure; (iii) Improving the Macro Business Environment - the macro business environment cover a wide range of issues impacting on private sector development, including improving business registration and licensing; land acquisition and site development; labor market policies; taxation; access to credit; support for SMEs; contract enforcement and dispute settlement; and public sector governance; and (iv) Developing Competitive Industry Clusters—

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

industry-specific strategies for improving inter-firm cooperation, promoting innovation and quality, encouraging specialization and strengthening supply chains.

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

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

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

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

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

Areas of shared responsibility

- The Bank and the Fund are working jointly in the following three main areas, supported by the Bank's SAC 2, several investment and technical assistance operations and the Fund's PRGF.

- **Public Expenditure Management.** This area includes public expenditure management reforms aimed at introduction of a medium-term expenditure framework and public investment program, consolidation of all extrabudgetary resources including the Oil Fund with the state budget, modernization of the Treasury, strengthening the Chamber of Accounts and supporting tax and customs administration. Both institutions are involved in supporting treasury modernization, while the Fund is providing technical assistance in support of tax and customs operations. The Fund and the Bank work very closely together on the formulation and implementation of the Budget Systems Law and recent amendments to the Law were submitted to Parliament as a prior action for the PRGF and second tranche release of SAC II. The governance framework for the Oil Fund is another area, in which there is very close cooperation, as well as the elimination of all quasi-fiscal subsidies.

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

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

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

- The Fund leads the dialogue on fiscal matters, setting the overall ceiling on the consolidated budget. In addition to the achievement of overall fiscal targets the Fund-supported PRGF includes performance criteria and structural benchmarks requiring: (i) adoption of improved regulations, in consultation with Fund staff, on the issuance of VAT refunds; (ii) establishment of a revenue forecasting commission, and (iii) adoption of the new Banking System Law.

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

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

World Bank's contacts:

Judith M. Deane (JDeane@worldbank.org), Country officer. Phone (202) 473 5045

Christian Petersen (CPetersen@worldbank.org), Lead economist. Phone (202) 473 3965

Azerbaijan: Statistical Issues

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

A data ROSC mission, which took place in May 2002, carried out a review of Azerbaijan's data dissemination practices against the GDDS, as well as an in-depth assessment of the quality of national accounts, CPI, PPI, government finance, monetary, and balance of payments statistics. The Data ROSC module is published on the IMF external website.

I. Real Sector

National Accounts Statistics

STA has appointed a peripatetic advisor to provide technical assistance on national accounts statistics to the State Statistics Committee of Azerbaijan (SSC) for a two-year period. The first two missions under the project, which were conducted in October-November 2002 and January-February 2003, identified various weaknesses in the compilation of national accounts. The main recommendations were that: (i) the Gross National Income (GNI) estimates should be revised in order to better reflect the income paid from Azerbaijan to the rest of the world and the income of Azerbaijan residents received from abroad; (ii) the SSC needs to develop new tools to assess the scope of informal sector activities in the economy; (iii) the calculation of sectoral deflators needs further improvement; and (iv) the SSC should be provided with a more detailed quarterly report on state budget execution from the Ministry of Finance to calculate accurately the intermediate consumption for non-market services. The advisor is going to assist the authorities in implementing the recommendations and also in establishing a data compilation system for quarterly national accounts on a discrete basis. The project is expected to be completed in May 2004.

Price Statistics

The Price Department of SSC intends to update the consumer basket of goods and services and respective weights used for the compilation of the Consumer Price Index (CPI). No changes have been introduced to this basket during the last five years, and some items need to be removed and others added to it, to reflect changes in the consumption of households over the period. The compilation of the CPI based on new weights started in January 2003 on a pilot basis. The SSC will review the quality of the new CPI in June 2003, before deciding to discontinue the compilation of the old CPI. A STA technical assistance mission aimed at improving the CPI is planned for June 2003. The price department regularly publishes the Producer Price Index (PPI) series which starts from October 2001.

II. Fiscal Sector

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

III. Monetary Sector

A STA technical assistance mission visited Baku in May 2002 and found the monetary statistics to be in full compliance with the GDDS and SDDS standards in terms of quality, coverage and timeliness, with the following two exceptions. First, the mission recommended that the chart of accounts for commercial banks be revised so as to allow a distinction of commercial banks' holdings of securities issued by residents and nonresidents. Second, some changes were needed to record properly the accounts of the IMF and other international financial organizations in the balance sheet of the Azerbaijan National Bank (ANB). The mission also developed new report forms, to reflect the adoption of new charts of accounts for the ANB and the commercial banks that became effective in January 2003 and September 2002, respectively. These forms are now used to generate automatically the analytical tables required for monitoring the PRGF-supported program.

IV. External Sector

Balance of Payments (BOP): The overall structure of the balance of payments statistics is in broad conformity with the guidelines presented in the *Balance of Payments Manual, fifth edition*. Remaining weaknesses in the balance of payments compilation include (i) poor information on foreign direct investments (FDI) in the non-oil sector (ii) undercoverage of nonguaranteed external debt; (iii) poor data on migrants' transfers; and (iv) misclassification of current transfers and other liabilities transactions. An STA mission provided assistance on balance of payments and external debt statistics in March-April 2001, while the May 2002 data ROSC mission identified measures for further improving the balance of payments statistics.

The ANB has made steady progress towards implementing the recommended short-term measures in the Data ROSC module for strengthening the balance of payments statistics. Almost all short-term measures have been completed; the methodology for compiling reserve assets has been revised to exclude the Oil Fund assets and reclassify them into other investment assets of the government; a new survey form for oil sector enterprises has been designed and distributed to international oil consortia for their input; and the scope and classification of BOP statistics have been improved by separately identifying errors and omissions, goods for processing, transportation services by modes of transport, insurance services, and subcomponents of reserve assets. The separate identification of reinvested earnings still needs to be implemented, while the assignation of responsibilities for compilation of nonguaranteed external debt of the private and banking sectors will need legislation in order to move forward.

Substantial progress has also being made in implementing the Data ROSC module's medium-term recommendations on balance of payments statistics; the development of documentation on BOP sources and methods has been completed, but publication of this documentation is scheduled for 2004 due to budgetary constraints this year; a project to introduce advanced computing technology for data compilation and processing has been implemented; the ANB is working on strengthening the methodology on travel with respect to the estimation of shuttle trade and per capita expenditures of travelers; and the SSC plans to evaluate the statistical techniques used for the surveys on services and FDI transactions that it conducts, with a view to improving them.

International Investment Position (IIP): The ANB has initiated compilation of the IIP statistics, but the IIP statement is still at a preliminary stage. Starting from 1999, the IIP data are published in the IMF's *International Financial Statistics*.

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

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

Statistical Appendix: Core Statistical Indicators
(As of April 1, 2003)

	Exchange Rates	International Reserves 1/	Central Bank Balance Sheet	Reserve/ Base Money	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Overall Government Balance 2/	GDP	External Debt 3/	Debt Service 3/
Date of latest observation	Mar. 28	End-Feb.	End-Feb.	End-Feb.	End-Feb.	End-Feb.	End-Feb.	Q4 2002	Q4 2002	End- Nov.	End-Dec.	Q42002	Q4 2002
Date received	Apr 1	Mar. 15	Mar. 15	Mar. 15	Mar. 15	Mar. 15	Mar. 8	Mar.17	Mar.17	Jan. 7	Jan. 8	Feb. 21	Feb. 21
Frequency of Data	D	D	D	D	M	M	M	Q	Q	Q	M	M	M
Frequency of reporting	D	D	D	D	M	M	M	Q	Q	Q	M	Q	Q
Source of data	A	A	A	A	A	A	A	A	A	A	A	A	A
Mode of reporting	C	C	C	C	C	C	C	C	C	C	C	C	C
Confidentiality	U	U	U	U	U	U	U	U	U	U	U	B	B
Frequency of publication	D	M	M	M	M	M	M	Q	Q	Q	M	Q	Q

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

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

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

April 23, 2003

Mr. Horst Köhler
Managing Director
International Monetary Fund
700 19th Street
Washington, DC 20431

Dear Mr. Köhler:

1. On February 20, 2002, the IMF Executive Board completed the first review under Azerbaijan's Poverty Reduction and Growth Facility (PRGF) arrangement, which is in support of our three-year economic program. We would like to take this opportunity to inform you about our continuing implementation of this program, as well as our policy intentions for 2003, to propose performance criteria, indicative targets and structural benchmarks for end-June, end-September and end-December 2003, to request waivers for non-observance of several structural performance criteria, and to request the completion of the second review under our PRGF arrangement. This letter should be read as additional to our original letter of intent and Memorandum of Economic and Financial Policies, dated June 15, 2001, as well as our second letter of intent, dated February 6, 2002.

2. In view of the delay in completing this second review, we hereby request that the third review be rephased, and that it be based on our economic performance as of end-June 2003, with subsequent reviews every six months. This would result in the final test date under the program being end-December 2004, and thus we request that the arrangement be extended to March 31, 2005. Our performance relative to the quantitative performance criteria and indicative targets for 2002 is presented in Table 1, and the proposed **quantitative performance criteria (for end-June and end-December 2003) and indicative targets** for end-June, end-September and end-December 2003 are detailed in Table 2. The third and fourth reviews are scheduled for completion by August 15, 2003 and Feburary 15, 2004, respectively, Performance relative to these targets and criteria will be measured as detailed in Annex I. These performance criteria are consistent with those previously identified under the program, with one important exception. Consistent with best practices for oil exporting countries, we are increasingly focusing our attention on the non-oil fiscal deficit—the consolidated deficit minus cash revenues from the oil sector—and we propose that the fiscal performance criterion under the program be determined based on this concept, which will help us to avoid excessive dependence on oil revenue.

3. The quantitative performance criteria and indicative targets, as well as our program policies and objectives, as described below, are fully consistent with our **State Program for Poverty Reduction and Economic Development (PRSP)**, which has recently been

finalized, and approved by the President of the Azerbaijan Republic, Mr. Heydar Aliyev. This program was prepared in close consultation with civil society and parliament, and will now form the basis for all our economic reform efforts.

Macroeconomic Developments

4. All **quantitative performance criteria** under the program for end-March 2002 and end-September 2002 were met. Macroeconomic indicators continue to be consistent with program targets; real **GDP growth** in 2002 was 10.6 percent, compared to the program target of 8.5 percent. Period average consumer price inflation for 2002 was 2.8 percent, compared to our target of 2.4 percent. All indicative targets for end-March, end-June and end-September 2002 were met as well, except for the targets on budgetary expenditure arrears for end-March and end-June 2002, which were missed by small amounts; by end-September 2002, the level of budgetary expenditure arrears was below the program's indicative target.

5. **Indicative targets for end-December 2002** related to net credit to the government, net domestic assets of the National Bank (ANB) and the consolidated government deficit were missed by small amounts. This was due to actions taken to finance Azerbaijan's share of the Baku-Tbilisi-Ceyhan (BTC) oil export pipeline. While our PRSP program recognizes, and strongly emphasizes, the critical importance of timely construction of the BTC pipeline, the need for such expenditures by the government, as well as their timing and magnitude, were not known at the time of the last review by the IMF Executive Board of our program performance. The financing of these expenditures was undertaken in close consultation with the Fund staff, to ensure consistency with our program objectives.

6. We continue to believe that the real growth and inflation targets for 2003, as spelled out in the first review of our program, remain broadly appropriate. We currently project real GDP growth in 2003 of 9.2 percent, and will target end-period CPI inflation of 2.5 percent. Our monetary and fiscal policies for 2003 have been designed to be consistent with these targets. However, in the current environment of high uncertainty and instability in oil prices, we recognize that there is a greater than usual risk in achieving our goals. The macroeconomic framework underlying this letter differs slightly from that in our PRSP, as it was finalized more recently and thus reflects the latest information on factors such as oil prices, However, it is fully consistent with the objectives and policies in our PRSP.

7. As a result, we are preparing contingency plans to be implemented in the event that oil prices turn out to be either much higher or much lower than currently projected, and will discuss these plans carefully with Fund staff. In the event of much higher prices, the budget will save additional tax revenues, as discussed below. In addition, we will consider requiring SOCAR to use any additional after-tax revenue it receives from these higher oil prices to pay its tax arrears from previous years, and encourage SOCAR to review, jointly with the ANB, the possibility of saving any remaining excess earnings abroad in order to avoid adverse macroeconomic impacts of the foreign exchange inflows. In the event of modest declines in oil prices, these could be accommodated by drawing down on the higher revenues saved early

in 2003 from high oil prices. If prices decline sharply, so that average 2003 oil export prices are significantly below the budgeted level, we will consult with Fund staff in working out our response. We have also begun, in consultation with Fund and World Bank staff, to prepare medium to long term plans for the use of the growing oil and gas revenue. In particular, we will consider during 2003 the future role and use of funds saved from the above-budget SOCAR tax payments.

Progress on Structural Reforms

8. **Structural reforms have been broadly in line with our program commitments.** However, some important structural measures took longer to implement than envisioned in the program, and thus we must request several waivers related to **structural performance criteria** under the program. The timetable for the reduction in the number of specific import tariffs was adopted by end-March 2002, as called for under the program, and we have begun implementing that timetable. The first two steps were taken on October 1, 2002 and April 1, 2003, converting specific tariffs for 19 product categories to ad valorem tariffs. These changes have also reduced the weighted average tariff in Azerbaijan significantly, from 7.9 percent in 2001 to much closer to our target of 6.5 percent. The final two steps will be taken on October 1, 2003 and April 1, 2004, after which specific tariffs will only apply to excisable goods.

9. Despite significant progress in other structural reforms, timetables for the unification of domestic and world market energy prices, as well as for the privatization of the International Bank of Azerbaijan (IBA) and United Universal Bank (BUS Bank), took longer than anticipated to design and approve. These timetables have now been adopted, in consultation with the Fund staff, and are being implemented. We have recently increased the **domestic prices** of natural gas, gasoline, fuel oil and most oil products (except kerosene and diesel fuel) to estimated long run import or export parity, as appropriate. The price of diesel fuel has recently been increased, but not to world market levels. In addition, as a result of reforms of SOCAR, crude oil is no longer sold in the domestic market. We have also adopted, via presidential decrees, timetables for the privatization of IBA and BUS Bank, as discussed below. We thus request waivers for these two end-March 2002 structural performance criteria.

10. In addition, we have allocated **subsidies to Azerenergy and Azerigas, and offsetting tax credits to SOCAR** (the State Oil Company of the Azerbaijan Republic), for the amount of fuel delivered to these utility companies but not paid for by them, for all of 2002, we have published information on these subsidies and tax credits, and we have included these subsidies and tax credits in published reports on the execution of the consolidated budget. However, administrative difficulties prevented us from taking these actions on the timely basis envisioned in the program. We have now designed a new procedure for the timely allocation of these tax credits and subsidies, in consultation with Fund staff, and therefore request waivers for the relevant performance criteria. These subsidies have for the first time been included in the 2003 state budget approved by

parliament, converting what had previously been quasi-fiscal subsidies into budgetary subsidies.

11. These steps are key elements of our comprehensive program to strengthen **financial discipline in the energy sector.** Other elements of that program that we have implemented in the last year include the full payment by budgetary organizations, for the first time in recent years, for their utility consumption in 2002. In addition, following the successful introduction of private management for our largest electricity distribution network in 2002, which contributed to a substantial increase in collection rates (although these rates nonetheless remain far too low), by end-2002 we had signed management contracts for the three remaining electricity distribution networks.

12. We have also recently announced, and are in the process of implementing, a **restructuring of SOCAR**, designed to improve financial transparency and more clearly identify which parts of SOCAR are operating efficiently and which need further reforms. The process of privatizing parts of SOCAR's operations, particularly those not directly related to its core operations, have begun, with companies employing in total 10,000 people separated from SOCAR and privatized in 2002.

13. Structural reforms have also been broadly in line with **structural benchmarks** under the program. Most importantly, a new Budget Systems Law was designed in close cooperation with the staffs of the Fund and World Bank. This law has now been adopted, and we are working to implement it, in consultation with Fund staff. We have also continued to work—with the assistance of the IMF, the World Bank and the United States government—on computerization of our treasury system.

14. In addition, we have continued our efforts to strengthen the customs and tax administration systems. A **reform program for the State Customs Committee** (SCC) was adopted in early 2002, and has been aggressively implemented since then. Key elements of this program have included the introduction of customs brokers and bonded warehouses. In the **Ministry of Taxes**, we have an ongoing program to improve administration; the most significant step we have taken recently was the reduction in Ministry staff by 40 percent, combined with an increase in all salaries by either 100 or 200 percent. This is designed to reduce the incentive for corruption and provide enhanced incentives for strong performance. In addition, the number of local offices has been substantially reduced, and we have strengthened the operations of local offices by improving headquarters' surveillance of their operations, and by preparing, disseminating and training office staff in standard procedures for taxpayer registration, return filing and payment, audit and collection enforcement. We have also strengthened the Large Taxpayer Unit, and initiated the process of full automation of tax offices. While a draft new Banking System Law has been designed, in cooperation with Fund staff, it took longer than anticipated to complete, and thus has only recently been submitted to the parliament.

15. We have made considerable progress in strengthening the regulatory framework of the **banking sector**, including through the issuance of 13 new or revised prudential regulations

conforming to best international practices, including risk-based capital, loan loss provisioning and asset classification regulations. Some of these regulations are being upgraded to bring them fully in line with international best practices, with the help of USAID technical assistance. We have also continued to expand further our range of monetary instruments. During 2002 the ANB introduced repurchase and reverse repurchase of treasury bills, and in early 2003 we created an instrument allowing banks to place interest-bearing deposits with the ANB, to be used to withdraw excess liquidity. A small value payment system was introduced in November 2002, which will significantly increase the range of banking services offered to small businesses and households.

16. Based on an assessment of opinions of domestic and international investors, the government has in 2002 taken significant steps to **improve the business environment**, beyond the tax and customs administration reforms discussed above. Most importantly, the number of business activities requiring licenses has been dramatically reduced, and the process of receiving licenses for the few remaining industries requiring them has been streamlined. To further improve transparency, we have also adopted a new Constitutional Law, requiring the government to report to parliament early each year about the government's activities in the previous year.

Economic Policies for 2003

Fiscal Reforms

17. Fiscal policy in 2003 will be driven by our desire to improve our domestic infrastructure and to more adequately compensate civil servants and pensioners, consistent with the objectives expressed in our PRSP (Appendix 2). While some of the additional expenditures will be financed by higher non-oil revenues, the planned increases will also require slightly greater usage of oil revenues. As a result, our non-oil deficit (the overall fiscal balance, excluding oil-related revenue) will increase by 1.1 percent of GDP, to 10.8 percent of GDP. This non-oil deficit remains well below the long-term sustainable level.

18. We have a comprehensive agenda of fiscal reforms that we intend to implement in 2003. The most important is the continuing development of the State Oil Fund of Azerbaijan (SOFAZ). In this context, we intend to take steps to **enhance the legislative foundation of SOFAZ and further integrate the oil fund and state budgets.** In particular, and as a prior action for the proposed completion of the IMF Executive Board's second review of our PRGF arrangement, we have submitted to parliament amendments to the Budget Systems Law, prepared in consultation with Fund and World Bank staff, that will (i) call for parliamentary approval of the deficit and expenditure ceilings of the consolidated budget (with the consolidated budget defined to include the state budget, budget of the Social Protection Fund and budget of the Oil Fund, excluding Oil Fund revenues; (ii) require that all expenditures in the consolidated budget (except for expenditures on the management of the oil fund and its assets) be executed by the treasury, and that all capital expenditures be part of the State Investment Program; (iii) assign responsibility for the preparation of the consolidated budget to the Ministry of Finance; (iv) ensure that extra-budgetary funds do not

make portfolio investments in domestic commercial activities or issue loans or loan guarantees; and (v) require that SOFAZ hold equity positions only through highly rated professional portfolio managers in international markets. We propose that the adoption of these critical amendments by end-June 2003 be a structural performance criterion for completion of the third review under our PRGF arrangement.

19. In conjunction with these amendments, we have proposed additional amendments designed to improve the Budget Systems Law. These amendments will clarify the jurisdiction of the Chamber of Accounts over the operations of the consolidated budget, as well as extra-budget funds and budgetary organizations; clarify that the Ministry of Finance, working in close cooperation with the extra-budgetary funds and the Chamber of Accounts, has the authority to prescribe uniform reporting formats for the state extra-budgetary funds and budgetary organizations; clarify that the Ministry of Finance has exclusive control over government banking arrangements; and preclude municipalities from market borrowing. We will also work in 2003 to strengthen our Medium Term Expenditure Framework and State Investment Program (SIP) for 2003-05, which has recently been adopted, ensuring they reflect the priorities and objectives of our PRSP, and that the 2004 budget is consistent with these documents (PRSP, Section 4.1). Finally, working in close consultation with Fund and World Bank staff, we will design procedures for the effective implementation of the new Budget Systems Law, including the development of sound procedures for consolidated budget preparation. In that context, we will consider the establishment of a commission, under the aegis of the Cabinet of Ministers, to determine the priorities of the annual and medium-term budgets.

20. During 2003, we will work to design, in consultation with the World Bank, **mechanisms to compensate the poor** for planned increases in 2004 in kerosene and diesel fuel prices, as well as the eventual elimination of the implicit and explicit utility subsidies (PRSP, section 3.1). We have also taken steps to strengthen Ministry of Finance oversight of the **fiscal affairs of municipalities**, including by assigning responsibility for municipal affairs to an appropriate official in the Ministry.

Revenues

21. With the 2003 state budget, we have **completed the process of subjecting all taxpayers to the tax legislation.** Prior to 2001, large state owned enterprises paid taxes according to a pre-determined tax target, independent of the tax laws. In 2001, all these enterprises were required to begin paying taxes according to the tax legislation. However, it was at that time impossible for SOCAR to adhere to the tax laws while simultaneously providing substantial quasi-fiscal subsidies to the utility companies. Now that the cost of these subsidies is borne by the state budget, and not by SOCAR, the company has been instructed that it, too, must pay taxes according to the laws of the country, and do so in a timely fashion. In addition, during 2002 and with the assistance of the Fund, we will **review the tax laws as they apply to SOCAR,** and possibly amend those laws based on international best practices for taxing state-owned oil companies.

22. SOCAR's tax payments will now depend on changes in oil prices. In the current environment of high oil prices, the Ministry of Finance will **save any tax payments from SOCAR in excess of that anticipated in the approved budget, including any cash payments of pre-2003 tax arrears**. Should oil prices fall in the future, resulting in SOCAR tax payments below budgeted levels, these saved funds will then be used to offset the shortfall in revenues. The performance criteria related to net credit to government and net international reserves of the ANB will be adjusted accordingly based on the actual oil export prices, as specified in Attachment 1. During 2003, in consultation with Fund staff, we will develop a long-term strategy for the use of these saved funds.

23. We are committed to developing the regions of Azerbaijan (PRSP, section 4.3). As a first step, in 2003, we introduced regional and sectoral variations in the enterprise profit tax rate. The tax rate now varies from 25 percent in Baku to 10 percent in mountainous regions. During 2003, we will design a more **effective and comprehensive program for development for regional development,** consistent with our State Program on Poverty Reduction and with technical assistance from the staffs of the Fund and World Bank. In the context of the 2004 state budget we will submit to parliament proposals to reunify the enterprise profit tax rate, at a level determined in the context of the budget preparation and based on our analysis of the 2003 experience.

24. To date, exemptions to the value added tax (VAT) have been granted by the Cabinet of Ministers in a series of independent decisions. While each decision has been well motivated, the combined result has been an excessively long list of exemptions. To provide greater coherence to the process of determining VAT exemptions, and ensure that the impact of these exemptions is fully reflected in budget revenue forecasts, we will (i) request technical assistance from the Fund in reviewing our exemptions policies; (ii) in the context of the 2004 budget, and based on the recommendations of the technical assistance mission, substantially reduce the existing list of VAT exemptions, and (iii) commit that future changes to the list of VAT exemptions will be approved only in the context of annual budget preparation process, and be implemented at the same time as the new budget takes effect.

25. More generally, we plan to **improve our procedures for revenue forecasting**. We will establish a revenue forecasting commission under the aegis of the Cabinet of Ministers, and including representatives of the Ministry of Finance, Ministry of Taxes, State Customs Committee (SCC), Ministry of Economic Development, State Statistics Committee, SPF, SOFAZ, SOCAR, and ANB. This committee will be tasked with producing annual revenue forecasts, including preparing careful assessments of the revenue implications of any tax policy proposals, in line with the requirements of the new Budget Systems Law, prior to their consideration by the Cabinet of Ministers.

26. Finally with regard to revenues, we will continue our efforts to **improve tax and customs administration** (PRSP, section 4.1). Consistent with this effort, we are in the process of producing performance indicators for the Ministry of Taxes (designed in consultation with Fund staff), and will use these indicators in the future to assess the

performance of the ministry. We will shortly adopt improved regulations for VAT refunds, to ensure the timely payment of such refunds. In the SCC, we will continue to implement the reform program which was designed on the basis of the external evaluation of the committee which was done in early 2002. Having largely completed the short and medium-term reform efforts, we will now turn our attention to the longer term reforms identified in this program, and have adopted a timetable, in consultation with Fund staff, for the implementation of these long-term reforms. We will also continue the process of replacing specific with ad valorem customs duties, implementing the third of four steps in our timetable on October 1, 2003.

Expenditures

27. In the 2003 budget, we have eliminated the earmarking of revenues for some **extra-budgetary operations of budget organizations**. For all budget organizations that continue to have authority to spend fees and other revenues they earn, we have integrated these funds into the state budget, and their spending plan was approved as part of the process of approving the state budget. We will continue our efforts to gradually reduce all remaining earmarking and thus more comprehensively integrating these funds into the state budget (PRSP, section 4.1).

28. We are also continuing our efforts to **eliminate all quasi-fiscal subsidies** (PRSP, section 5.1). In 2002 we eliminated all preferential utility and transport tariffs, replacing preferential tariffs for internally displaced persons (IDPs) and refugees with explicit budget subsidies. In the 2003 state budget, we have included the quasi-fiscal subsidies previously provided by SOCAR to Azerenergy and Azerigas, and we have added an explicit subsidy from the budget for Azerchemia and informed SOCAR that they are no longer expected to provide fuel to Azerchemia without payment. During 2003, we will identify all remaining quasi-fiscal subsidies, of whatever kind, including those provided to the Baku metro, and either eliminate them or provide cash financing for them in the state budget in 2004, thereby completing the difficult but important process of eliminating quasi-fiscal subsidies. We will also issue no new instructions requiring SOCAR to finance IDP-related expenditures or other expenditures that should be financed by the budget. Starting January 1, 2004, SOCAR will no longer provide any quasi-fiscal subsidies.

29. Finally, while we currently do not expect the government to have to pay additional funds for the construction of the BTC pipeline, should that prove necessary, we will consult with Fund staff on the procedures for financing these expenditures.

Domestic and External Debts

30. In 2003, we will strengthen our **debt management system** (PRSP, section 4.1). We will assign responsibility for maintaining a database on debts to an appropriate state body, in coordination with the State Department of Statistics. This agency will, during 2003, with the assistance of Fund staff, seek to establish a comprehensive database, including not only government and government-guaranteed external and domestic debts, but also external and domestic debts of state-owned enterprises.

31. Current rules largely limit the scope for ministries, other than the Ministry of Finance, to borrow funds. However, according to existing rules, there are circumstances under which line ministries may borrow from domestic banks, and under which borrowed funds can be spent outside the treasury system. We will, in conjunction with other amendments to the budget systems law discussed above, submit an amendment which clearly **prohibits domestic borrowing by any ministry financed by the budget, other than the Ministry of Finance, and requires any funds borrowed by the Ministry of Finance to go through the treasury and be reflected in the state budget.**

32. Finally, we will continue to be cautious in contracting **external debts**, adhering to the debt ceilings in Table 1, and will not contract or guarantee loans for commercial purposes. We are continuing our efforts to resolve disputed external debt obligations with Kazakhstan, Turkmenistan and Uzbekistan, and plan to discuss these matters during the forthcoming meetings of the Azeri-Kazakh and Azeri-Uzbek commissions in 2003.

Pension Reform and Social Assistance

33. We are determined to strengthen our SPF, which is responsible for pensions and most social support payments. First, we are taking steps to improve revenue collections. We have begun the important task of seeking to ensure that all taxpayers registered with the Ministry of Taxes are also registered with the SPF, thereby broadening the tax base. We have also issued a Cabinet of Ministers decree instructing all state-owned enterprises—including SOCAR, Azerenergy, and Azerigas—to ensure the timely payment of their obligations to the SPF. Specifically, they have been instructed to ensure that each month, when they pay their wages, they simultaneously transfer to the SPF funds sufficient to satisfy that month's SPF obligations.

34. We have also begun work on a substantive reform of our pension system in accordance with our **Pension Reform Concept,** and with the assistance of the World Bank and UNDP (PRSP, section 3.1). There are three components to our current reform efforts. First, we have passed a law calling for the establishment of individual social insurance accounts, and plan to have these established for all workers by end-2004. Second, we will reform the system of administering pensions. Currently, the SPF is responsible for collecting pension and allowance revenues, while the Ministry of Labor and Social Protection is responsible for calculating pensions and allowances and making payments to beneficiaries. This division of responsibilities is inefficient, and with assistance from the World Bank, we

will unify these responsibilities in one agency during 2004. In addition, in order to ensure timely payment of pensions with minimum inconvenience to the recipients, we are in the process of introducing an automated payment system, whereby individuals will be able to access their monthly pension payments through a bank card.

Monetary and Financial Sector Reforms

35. We will continue in 2003 to implement a monetary policy aimed at domestic price stability (PRSP, section 4.1). Exchange rate policy will likewise be unchanged, with the market allowed to determine the path of the exchange rate and the ANB intervening only to smooth out temporary fluctuations. We believe that the monetary instruments already at ANB's disposal are sufficient to sterilize the impact of planned SOFAZ spending as well as oil-related Foreign Direct Investment. The ANB will monitor macroeconomic developments closely, and act to ensure the maintenance of Azerbaijan's macroeconomic stability. The government will support the ANB in this effort, including by coordinating financial transactions and ensuring that the Ministry of Finance and SOFAZ provide the ANB with monthly updates of their expected pattern and volume of foreign exchange transactions in 2003. To assist in this effort, the government has instructed SOCAR to provide each month, to the government and to the ANB, an updated forecast of SOCAR's cash flow for 2003.

36. We are determined to **strengthen the competitiveness and health of our banking system** (PRSP, section 4.2). In 2002, we conducted a review of factors inhibiting competitiveness in the banking sector in Azerbaijan. Two factors stood out: first, the market continues to be dominated by the state-owned banks—IBA and BUS Bank. The second problem is related to difficulties in lending stemming from problems enforcing the bankruptcy law, inadequate regulations relating to the use of collateral, the limited use of International Accounting Standards (IAS) outside the banking systems, and continuing problems with the judiciary system.

37. With regard to the dominance of **IBA and BUS Bank**, we will proceed along three lines to reduce this problem. First, we will move aggressively to privatize these banks (PRSP, section 4.2). New presidential decrees—calling for the sale of 20 percent of IBA to EBRD during thesummer of 2003 (which would reduce the government's share to just over 30 percent), the full privatization of IBA by end-2004, the completion of steps to strengthen BUS Bank in 2003, and the privatization of BUS Bank in 2004—have recently been issued. In the case of IBA, the government has entered into intense discussions with EBRD, with the aim of reaching agreement on the sale of 20 percent of IBA by end-June 2003, and is committed to tendering the remaining shares for sale no later than end-2003.

38. Second, we recognize that even after the privatization of these banks, they will continue to dominate the banking system. One advantage these banks continue to have stems from the government's tendency to use these banks exclusively in **providing services to the government**. To resolve this problem, the government has begun preparing to issue tenders for the provision of banking services to the government and will during 2003 determine, in

consultation with Fund staff, a date by which all banking services to the government will be contracted solely on the basis of competitive tenders.

39. To address the problems in lending, the government will, with the assistance of the World Bank, review the **Bankruptcy Law** with the aim of identifying problems in this law and associated regulations, revising them and submitting amendments, if necessary, to parliament during 2004. We will also work to establish the institution of receivers, improve the training of judges in bankruptcy procedures, and shorten the processing of bankruptcy cases. At the same time, and also with the assistance of the World Bank, we will review and revise as necessary the **rules and regulations related to the registration and use of collateral**. In particular, we will simplify the procedures for registering collateral and improve the tax treatment of sales of collateral, to ensure that only profits earned from the sale of collateral are subject to profit tax. The government has launched a comprehensive program, designed to accelerate the introduction of IAS accounting (PRSP, section 4.2). In this context, we will prepare in 2003, in consultation with the World Bank, a new Law on Accounting, and a program for the introduction of IAS standards in state-owned enterprises, as the first step toward requiring IAS accounts in all state-owned enterprises. We will also continue our efforts to strengthen the judiciary system.

40. Third, to demonstrate our openness to international banks, by end-June 2003 we will eliminate the **ceiling on foreign bank participation** in the Azeri banking system (PRSP, section 4.3).

41. We will also seek to **strengthen the state securities market for treasury bills, and the development of manat financial markets** more generally. A commission consisting of representatives of the Ministry of Finance, ANB and State Committee for Securities has been created and charged with guiding this effort. Among other steps, in consultation with Fund staff, we will review the registration system for treasury bills and ANB bonds, and at a minimum significantly simplify this system. We will also create conditions for equal access to treasury bill markets for all potential participants, consider the introduction of new types of securities denominated in local currency, and ensure enhanced disclosure of information related to the state securities market.

42. We have prepared, with the assistance of the Fund, a new **Banking System Law,** which has now been submitted to parliament. In order to further strengthen confidence in the banking sector, we also intend to introduce a **deposit insurance** system, but not earlier than January 2005. The fulfillment of the preconditions for introducing deposit insurance, including the capacity of bank supervision to meet international standards, will be assessed in close consultation with Fund staff. To that end, during 2003 and 2004 we will continue to strengthen bank supervision and will review the current draft deposit insurance system, with assistance from Fund staff. The draft Banking System Law specifies that the deposit insurance scheme will be activated not earlier than 2005 and only if all participating banks fulfill a set of prudential standards and requirements, as specified by appropriate regulations issued by the ANB.

43. We will also continue our efforts to strengthen the operations of the ANB. Toward that end, we will prepare a revised **Central Bank Law** (PRSP, section 4.3), in consultation with Fund staff. In light of the importance of such a law, we will take time to ensure the preparation of a high quality law, and will submit this law to parliament sometime in 2003. We attach high priority to enhancing training of ANB staff, and to our ongoing efforts to ensure the ANB structure is consistent with international best practices. We also are continuing our efforts, with the assistance of USAID, to strengthen banking supervision.

44. While the January 2002 IMF **safeguards assessment** mission found that the ANB's annual external audit and financial reporting are generally adequate, certain vulnerabilities were identified. To address these issues, the ANB has (i) established a formal process for reconciling the data in the ANB financial statements to the data reported to the IMF under the Poverty Reduction and Growth Facility arrangement, which includes a review of the reconciliation by the ANB's Internal Audit Department, and (ii) formally adopted IAS as its underlying accounting framework in order to base the recording of transactions during the year on IAS requirements. Additional efforts to strengthen ANB auditing and reporting, as recommended by the safeguards mission, are ongoing. The recommendation to establish an audit committee under the ANB's Board of Directors has not been implemented, as the existing law on the Central Bank does not allow such a structure.

Structural Reforms in 2003

Government Operations, Structure and Governance

45. In 2003, we will seek to complete the process of **separating commercial and regulatory functions** (PRSP, section 4.3). We will, during the course of the year, identify all remaining instances of institutions exercising both commercial and regulatory functions, and separate them. In particular, we will transfer all regulatory functions currently exercised by Azal, Azeri Rail and Caspian Shipping Company to the Ministry of Transport, separate the commercial and regulatory functions of the Ministry of Communications, and transfer remaining regulatory functions from SOCAR to the appropriate government institution.

46. In addition, we will build on the progress we have made in **government restructuring** in recent years, with the creation of the Ministries of Economic Development, Energy and Transportation. During 2003, with the assistance of the International Financial Institutions, we will review the existing government structure. A decision on possible restructuring will be made based on the results of this review.

47. We will also continue our efforts to improve **governance and the business environment**. Crucial in this regard will be our ongoing efforts to improve tax and customs administration, as discussed above, as well as to strengthen the Chamber of Accounts, our supreme audit institution. We also expect parliament to pass, during 2003, anti-corruption legislation (PRSP, section 4.3). This legislation is expected to provide a legal definition of corruption, and introduce specific anti-corruption measures.

Energy Sector Financial Discipline

48. **Strengthening energy sector financial discipline** remains at the heart of our economic reform program (PRSP, section 4.3). Most energy sector quasi-fiscal subsidies have been put on budget, and thus government, parliament and the public are more aware of the true costs of these subsidies. Now we face the more serious challenge of actually reducing these subsidies. This will require a number of reforms: improvements in collections for utilities; increases in the efficiency of SOCAR, the utility companies, and key energy-consuming state-owned enterprises; and eventually a revision of electricity and gas tariffs to cover the true costs of providing these services.

49. Key to our efforts to strengthen financial discipline are steps to improve **payments for utility services**. We have made great strides in this area, by ensuring that budgetary organizations pay in full for their actual utility consumption, signing long-term management contracts for our electricity distribution companies, and giving these companies the right to cut off services to non-paying customers. Building on these reforms, in 2003 we will aim to sign long-term management contracts for our gas and water distribution companies, and will enhance our efforts to ensure that state-owned enterprises pay their utility bills. We will also seek to initiate the use of "smart cards" for the payment of utility services, to reduce the opportunities for corruption (PRSP, section 4.3).

50. Ensuring that these companies pay their bills in many cases will require a **restructuring of their organization and operations**. This will be necessary to enhance their efficiency and reduce their energy consumption. In 2003, building on the recent decisions regarding SOCAR restructuring, we will seek the assistance of EBRD in designing a more comprehensive restructuring of that company. We will also seek technical assistance in designing restructuring programs for Azerenergy, Azerigas, Azerbaijan Regional Water Company and Azerchemia.

51. We have requested assistance from the World Bank related to **utility tariffs**. In particular, we will seek their assistance in reviewing the tariff structure and determining a structure that would eventually cover the costs of providing the services, and in designing a system for compensating vulnerable households from the eventual increase in these tariffs.

52. Finally, having unified **domestic prices** of natural gas and most oil products with import or export parity, as appropriate, we will now prepare to unify in early 2004 the domestic and estimated long run world market prices for the two remaining oil products—kerosene and diesel fuel—whose prices remain below world market levels, including by designing, in consultation with the World Bank, a mechanism to compensate the most vulnerable who are impacted by these price changes (PRSP, section 3.1). In addition, to ensure that domestic energy prices stay unified with world market prices, by end-December 2003 we will design an automatic mechanism for the periodic adjustment of domestic prices of oil products and natural gas, to keep them in line with world market prices, with that mechanism being implemented in 2004.

Trade and Investment Policy

53. We will continue to implement a liberal trade policy. As noted above, we will gradually reduce our already moderate weighted average import tariff. We will also not introduce any new import or export restrictions. Accession to the **World Trade Organization** (WTO) is a high priority for our government. We have reached agreement for the United States to provide technical assistance in our WTO accession application and negotiations, and we will make all efforts to expedite this process (PRSP, section 4.3).

54. The government has contracted a diagnostic study of the investment environment by the Foreign Investment Advisory Service (FIAS), a joint IFC-World Bank facility. In consultation with the Fund and World Bank staffs, we intend to **revise the 1992 Law on Protection of Foreign Investments** (PRSP, section 4.3) along the lines recommended in the FIAS report. Also, to assist potential investors, and to help in conveying information to them regarding our efforts to improve governance and the business environment, as well as to give investors a channel to convey their concerns in this regard to the government, we will create an **Investment Council.**

Program Monitoring

55. As **prior actions** for completion of the second review under the PRGF arrangement, we have (i) submitted to parliament amendments to the Budget Systems Law, designed in consultation with the Fund and World Bank staffs, which call for parliamentary approval of the deficit and expenditure ceilings of the consolidated budget, require that all expenditures in the consolidated budget (except for expenditures on the management of the oil fund and its assets) be executed by the treasury and that all capital expenditures be part of the State Investment Program, assign responsibility for the preparation of the consolidated budget to the Ministry of Finance, ensure that extra-budgetary funds do not make portfolio investments in domestic commercial activities or issue loans or loan guarantees, and require that SOFAZ hold equity positions only through highly rated professional portfolio managers in international markets; (ii) adopted, by presidential decree, the timetables for privatization of IBA and BUS Bank; (iii) adopted procedures for the timely allocation of tax credits to SOCAR and subsidies to Azerenergy and Azergas related to unpaid fuel consumed by the utilities; and (iv) issued a Cabinet of Ministers decree instructing all state-owned enterprises to ensure timely payments of their SPF obligations.

56. We propose the following **structural performance criteria for end-June 2003:** (i) enactment of the amendments to the budget systems law that were submitted to parliament as a prior action; and (ii) adoption of improved regulations on the issuance of VAT refunds, which simplify work procedures and documentation requirements and specify appropriate timeframes for the processing of refund applications. As **structural benchmarks** for end-June 2003, we will (i) establish a revenue forecasting commission, as described in paragraph 25 above and in consultation with Fund staff, and (ii) ensure adoption of the new Banking System Law.

57. For end-December 2003, we propose the following **structural performance criteria:** (i) the reunification of the enterprise profit tax rate for all non-oil companies, at a rate determined in part by our analysis of the 2003 experience; (ii) the adoption of a procedure for future automatic adjustments of domestic energy prices, to keep them in line with world market prices, as discussed in paragraph 52 above; (iii) replacement of specific with ad valorem customs duties in continued adherence to the timetable adopted under the end-March 2002 structural performance criterion; (iv) adoption of a Cabinet of Ministers decision reducing the list of VAT exemptions and requiring that all future changes to the list be done only in the context of the annual budget preparation process; and (v) issuance of a tender for all remaining government shares of IBA. We propose that continued adherence to the SCC reform program, as discussed in paragraph 26, be a **structural benchmark** for end-December 2003. Finally, the quarterly allocation of tax credits to SOCAR, and subsidies to Azerenergy and Azerigas, in line with the procedures and timetable adopted as a prior action, will be a **structural benchmark**.

58. The third review of our Poverty Reduction and Growth Facility arrangement will focus on continued progress in energy sector reforms including SOCAR tax payments, banking sector reforms including progress on privatization, and the strengthening of governance in the handling of public resources including in tax and customs administration.

59. The government and the ANB believe that the policies discussed above, combined with the policies described in our previous letters and MEFP, are adequate to achieve the objectives of the program. We will remain in close consultation with the Fund in accordance with Fund policies on such consultation, and will provide the Fund with any information it requests for monitoring program implementation. The government and the ANB stand ready to take any further measures, in consultation with Fund staff, which might be necessary to ensure that the objectives of the program can be achieved.

Sincerely,

//s//
Artur Rasi-zade
Prime Minister
Azerbaijan Republic

//s//
Avaz Alekberov
Minister of Finance
Azerbaijan Republic

//s//
Farhad Aliev
Minister of Economic Development
Azerbaijan Republic

//s//
Elman Rustamov
Chairman, National Bank
Azerbaijan Republic

Attachment

Table 1. Azerbaijan: Quantitative Performance Criteria and Benchmarks for the PRGF, 2002 1/ 2/

	Stock Dec. 2000	Cumulative Changes from January 1, 2001 2002													
		March			June			September			December			
	Prog	Prog	Adj Prog	Act	Prog	Adj Prog	Act	Prog	Adj Prog	Act	Prog	Adj Prog	Act	Act (net of BTC) 3/
	(in billions of manats, unless otherwise specified)													
1. Quantitative performance criteria and benchmarks														
Floor on net international reserves of the ANB (in US$ million)	344	81	82	100	100	102	124	108	109	134	115	117	119	171
Ceiling on net domestic assets of the ANB	199	-441	-443	-577	-356	-362	-578	-348	-355	-591	-332	-343	-284	-526
Ceiling on net credit to the general government from the ANB 4/	-90	-147	-149	-284	-75	-82	-300	-92	-99	-304	-109	-120	-61	-303
Floor on overall consolidated fiscal balance, excluding Oil fund revenues	...	-797	-796	-628	-1,095	-1,096	-855	-1,301	-1,240	-1,074	-1,510	-1,790	-1,885	-1,643
Ceiling on New Nonconcessional External Debt Contracted or Guaranteed by the Consolidated Government or the ANB (excluding the IMF; in US$ million)														
Less than one year's maturity	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Medium- and long-term debt, less than five years	...	0	0	0	0	0	0	0	0	0	0	0	0	0
Other long-term debt (maturity five and more years)	...	20	20	0	40	40	0	60	60	0	80	80	0	0
2. Continuous performance criterion														
Ceiling on Stock of Outstanding Nonreschedulable External Payments Arrears of the Consolidated Government and the ANB	0	0	0	0	0	0	0	0	0	0	0	0	0	0
3. Indicative targets														
Ceiling on stock of ANB's manat reserve money	1,542	83	83	-26	231	231	109	279	279	114	313	313	324	324
Ceiling on net change in stock of unpaid bills accumulated after December 31, 1999	26	50	50	53	50	50	64	50	50	42	50	50	14	14

1/ The program targets are indicative targets for end-June 2002 and end-December 2002, and performance criteria and indicative targets for end-March 2002 ("Prog." column) and end-September 2002 ("Prog." column).

2/ For 2002, foreign exchange components are valued using program exchange rates of 4,606 manat/US$ and 1.26 US$/SDR.

3/ An amount of US$52.5 million was transferred from the pre-2000 oil bonuses at the ANB to the Oil Fund during the fourth quarter of 2002, of which US$49.5 million was used to finance SOCAR's share in the BTC pipeline. Such use of pre-2000 oil bonuses was not anticipated when the end-December 2002 program targets were set in March 2002, but the decision on financing this share was taken in consultation with the staffs of the Fund and the World Bank.

4/ The actual stock of net credit to the government from the ANB in 2002 is adjusted downward by an amount of Manat 304 billion, for claims related to the settlement of the Agroprom debt that took place in June 2001.

Table 2. Azerbaijan: Quantitative Performance Criteria and Benchmarks for the PRGF, 2003 1/ 2/
(In billions of Manats, unless otherwise indicated)

	2002	2003			
	Dec Act	Mar Prog	Jun Prog	Sep Prog	Dec Prog
1. Quantitative performance criteria and benchmarks					
Floor on net international reserves of the ANB (end-of-period stock, in US$ million)	462	380	406	468	513
Ceiling on net domestic assets of the ANB (end-of-period stock)	-85	105	111	-27	-28
Ceiling on net credit to the general government from the ANB (end-of-period stock)	154	326	311	148	93
Ceiling on the overall consolidated non-oil deficit (flows) 3/	...	1,038	2,179	3,143	4,042
Ceiling on New Nonconcessional External Debt Contracted or Guaranteed by the Consolidated Government or the ANB (excluding the IMF) (flows, in US$ million) 3/					
Less than one year's maturity	0	0	0	0	0
Medium- and long-term debt, one to less than five years	...	0	0	0	0
Other long-term debt (maturity five and more years)	...	20	40	60	80
2. Continuous performance criterion					
Ceiling on Stock of Outstanding Nonreschedulable External Payments Arrears of the Consolidated Government and the ANB (end-of-peroid stock, in US$ million)	0	0	0	0	0
3. Indicative targets					
Ceiling on stock of ANB's manat reserve money (end-of-period stock)	1,866	1,704	1,817	1,955	2,139
Ceiling on stock of unpaid bills in excess of Manat 50 billion (end-of-period stock)	-36	0	0	0	0

1/ The program targets are indicative targets for end-March 2003 and end-September 2003, and performance criteria and indicative targets for end-June 2003 and end-December 2003.
2/ Foreign exchange components are valued using program exchange rates of 4,606 manat/US$ and 1.26 US$/SDR.
3/ Cumulative changes from January 1, 2003.

PERFORMANCE CRITERIA AND INDICATIVE TARGETS

I. Targets for Fiscal Aggregates

Note: Use of the words "includes" and "including" should be construed to mean "includes but is not limited to" and "including but not limited to".

1. Ceiling on the Cumulative Change of the Overall Cash Deficit of the Consolidated Government, excluding revenue from the oil sector.

(In billions of manats)

	Cumulative Overall Cash Deficit of the Consolidated Government, excluding oil sector revenues
Cumulative change from December 31, 2002:	
March 31, 2003	1,038
June 30, 2003	2,179
September 30, 2003	3,143
December 31, 2003	4,042

Definition

The **consolidated government** is defined as all levels of government except for municipalities and state-owned enterprises. It includes the state budget agencies, (including the Republican government and local governments but excluding municipal governments), extrabudgetary funds of state budget entities, the Social Protection Fund, the Privatization Fund, and the State Oil Fund (SOFAZ).

The **overall cash deficit of the consolidated government, excluding revenues from the oil sector** is defined as the **overall consolidated deficit**

minus SOCAR's cash tax revenue based on budget assumptions,
minus SOCAR's cash tax revenue differential on account of oil price movements,
minus SOFAZ's revenue.

The **overall cash deficit of the consolidated government** is defined from the financing side as the sum of the following: (i) the change in net credit to the consolidated government from the ANB; (ii) the change in net claims on the consolidated government of the rest of the banking system; (iii) the change in net claims on the consolidated government of domestic nonbank institutions and households; (iv) proceeds from the privatization of state property; (v) the counterparts (-) to increases in net credits or net claims on the consolidated government from the ANB or commercial banks as a result of the bank restructuring program; (vi) net foreign financing of the consolidated government; (vii) the counterparts to changes in the domestic currency valuation of the consolidated government's net credits or net claims as a result exchange rate fluctuations; and (viii) the change in the net position of

SOFAZ. All changes will be calculated as the difference between end-period stocks, valued at end-period exchange rates.

SOCAR's cash tax revenue based on budget assumptions is defined as the government's projected tax payments on basis of budget assumptions.

	SOCAR's cumulative **cash** payments based on budget
Cumulative change from December 31, 2002:	
March 31, 2003	398
June 30, 2003	863
September 30, 2003	1,356
December 31, 2003	1,897

SOCAR cash tax revenue differential on account of oil price movements are additional (reduced) tax revenue payments arising from a higher (lower) actual crude oil price than the budget price. The value of the programmed revenue differential is calculated (i) as the difference between tax obligations arising from the export tax at *programmed* oil prices, volumes, and export costs and export tax obligations based on 2003 budget assumptions for oil prices and export costs, plus (ii) SOCAR tax obligations arising out of the change in the SOFAZ inflow rules (Presidential Decree, February 7, 2003), if they are due in 2003 plus, (iii) any tax payments that the government makes to reduce SOCAR's arrears to the budget.

Programmed levels of SOCAR tax revenue differential:

	SOCAR's cumulative **revenue differential (positive number means additional payments to the budget)**
Cumulative change from December 31, 2002:	
March 31, 2003	113
June 30, 2003	213
September 30, 2003	283
December 31, 2003	348

SOFAZ revenues are defined as the sum of the following: (i) production sharing revenue from the development of oil fields (profit oil) less of SOCAR's share of production sharing revenue; (ii) acreage fees; (iii) investment income on SOFAZ assets; and (iv) any other revenues deposited in SOFAZ, excluding oil signature bonuses. Production sharing revenues, acreage fees, and investment income of SOFAZ will be considered revenues of the SOFAZ regardless of whether they are actually deposited in SOFAZ or another account of the consolidated government.

Net credit from the ANB to the consolidated government is defined as all claims (including securities) of the ANB on the consolidated government less all deposits of the consolidated government with the ANB, including counterpart deposits of loans received from the World Bank and from other official creditors, proceeds from the privatization of state property.

Net claims on the consolidated government of the rest of the domestic banking system are defined to comprise domestic commercial banks'net asset position arising from the operating balances and current accounts of the consolidated government and domestic commercial banks' net asset position arising from other claims (credits, loans, cash advances, holdings of treasury bills or other securities) on and liabilities (deposits, etc.) to the consolidated government.

The change in **net claims on the consolidated government of domestic nonbank institutions and households** is defined to include net sales of treasury bills, bonds, or other government securities to nonbank institutions and households, plus any other increase in liabilities of the consolidated government to domestic nonbank institutions or households.

Proceeds from the privatization of state property are defined as all gross revenues originating from the sale or long-term leasing of state property.

Counterparts to increases in net claims on the consolidated government of the ANB or commercial banks as a result of the **bank restructuring** consist in the full value of the loans taken over or long-term bonds issued by the consolidated government.

Net foreign financing of the consolidated government is defined as the difference between actual disbursements of foreign financing and amortization of consolidated government debt to foreign institutions and households. Foreign financing of the consolidated government is defined as the increase in claims on the consolidated government of foreign institutions and households, excluding the Fund, and including: (i) loans received for balance of payment support (e.g. the World Bank Public Sector Reform Adjustment Credit); (ii) disbursements under foreign loans for financing government capital expenditures or for on-lending to entities outside the general government for investment projects from foreign financial and nonfinancial institutions; (iii) oil signature bonuses; and (iv) net purchases of government securities by foreign (nonresident) institutions and households. Consolidated government guarantees on loans to entities outside the consolidated government are not included as foreign financing, and payments made by the consolidated government to cover defaults on such loans are not included as amortization of consolidated government debt.

The change in **SOFAZ's net position** is the difference between SOFAZ revenues and expenditures.

The **general government** is defined as the consolidated government excluding the SOFAZ.

Adjustors

Ceilings will be adjusted by the full amount of any deviation from the programmed level of the actual financing for the BTC pipeline project plus actual foreign financing of capital projects and foreign loans contracted by the consolidated government for on-lending purposes. A shortfall of financing will result in a downward adjustment of the ceiling. Higher-than-programmed financing will result in an upward adjustment. Cumulative programmed financing is manat 437 billion Q1, manat 801 billion Q2, manat 1,054 billion Q3, manat 1,307 billion Q4.

Ceilings will be adjusted downward by 50 percent of any shortfall in the programmed disbursements of World Bank loans for balance of payments support (e.g. the Public Sector Reform Adjustment Credit). Cumulative programmed disbursements are manat 0 billion Q1 (indicative), manat 0 billion Q2, manat 151 billion Q3, manat 151 billion Q4.

2. Indicative Target: Ceiling on the Stock of Unpaid Bills of the State Budget and the Social Protection Fund accumulated after December 31, 2002

(In billions of manats)

	Stock of Unpaid Bills of the State Budget and the Social Protection Fund
Stock at December 31, 2002	-36
March 31, 2003	0
June 30, 2003	0
September 30, 2003	0
December 31, 2003	0

Definition

The ceiling applies to all **unpaid bills** of the state budget and the Social Protection Fund accumulated after December 31, 2002 (in excess of manat 50 billion). Arrears are defined as expenditures that have been budgeted for, have been verified (the good or the bill has arrived), and have not been paid. Expenditure arrears include all arrears except pension arrears to working pensioners.

3. Ceilings on the Stock of Net Credit from the ANB to the General Government

(In billions of manats)

	Stock of net credit from the ANB
Stock at December 31, 2002	154
March 31, 2003	326
June 30, 2003	311
September 30, 2003	148
December 31, 2003	93

Adjustors

These limits will be adjusted downward (or upward) by 50 percent of the amount by which actual net foreign financing of the general government exceeds (or falls short of) the net amounts programmed from the following sources: (i) the amortization of general government debt to foreign institutions and households, based on the stock of foreign debt outstanding as of December 31, 2002, including loans for budgetary or on-lending purposes, but excluding payments to the Fund and payments on government guaranteed loans to cover defaults by entities outside the general government. Ceilings will be adjusted upwards by 50 percent for any shortfalls of disbursements of World Bank loans for balance of payments support (e.g. the Structural Adjustment Credit), irrespective of their deposit at the ANB or elsewhere and adjusted downwards by 100 percent for disbursements in excess of programmed levels. The ceiling will be adjusted downward (or upward) in the amount by which the programmed SOCAR revenue differential on account of oil price movements fall short (exceed) of the actual SOCAR revenue differential.

Cumulative net foreign financing from these sources is programmed to be manat -29 billion at end-2003 Q1, manat -47 billion at end-Q2, manat 74 billion at end-Q3, manat 53 billion at end-Q4.

Definitions

Net credit from the ANB to the general government is defined as all claims (including securities, but excluding all bonds issued in 2001 by the government in settlement of ANB's claims on Agroprom) of the ANB on the general government less all deposits of the general government with the ANB, including counterpart deposits of loans received from the World Bank and from other official creditors, and proceeds from the privatization of state property. As indicated above, the general government is defined as the consolidated government excluding the SOFAZ. Net Credit to Government will also include any claims of the ANB on the general government related to accounts currently under review by the staff and authorities.

II. Targets for Money Aggregates

1. Ceilings on the Stock of Net Domestic Assets of the ANB

(In billions of manats)

	Ceilings
Stock at December 31, 2002	-85
March 31, 2003	105
June 30, 2003	111
September 30, 2003	-27
December 31, 2003	-28

Adjustors

The ceilings relative to programmed amounts will be adjusted in exactly the same manner as the ceilings for net credit from the ANB to general government.

Definitions

Net domestic assets of the ANB are defined as: (i) *reserve money* (comprising currency in circulation, required reserves, and balances on banks correspondent accounts at the ANB) plus *certificates issued by the ANB* plus *deposits of nongovernment nonbanks* with the ANB minus; (ii) *net international reserves in convertible currencies* of the ANB (as defined in II.2 below) plus *net assets on the ANB's correspondent accounts with central banks in nonconvertible currencies*. Thus defined, the ANB's net domestic assets consist of ANB net credit to the consolidated government (including counterpart deposits)[1], claims on domestic banks, claims on domestic enterprises and households, and other net assets.

2. Floors Under the Stocks of Net International Reserves of the ANB

(In billions of manats)

	Floors
Stock at December 31, 2002	462
March 31, 2003	380
June 30, 2003	406
September 30, 2003	468
December 31, 2003	513

[1] For a definition of consolidated government, see Section I.1.

Adjustors

The ceilings relative to programmed amounts will be adjusted in exactly the same manner as the ceilings for net credit from the ANB to general government.

Definitions

Total **net international reserves of the ANB** are defined as the difference between total gross international reserves assets of the ANB and total official reserve liabilities of the ANB. *Gross international reserve assets* are defined as in the Balance of Payments Manual, 5th edition. Total *Gross international reserve assets* of the ANB include ANB's holdings of monetary gold, holdings of SDRs, any reserve position in the Fund, holdings of foreign exchange in convertible currencies in the form of cash or deposits with nonresident banks that are readily available. Also included are holdings of foreign currency-denominated securities issued by governments or central banks of OECD member states. Excluded are capital subscriptions in international financial institutions, non-liquid assets of the ANB (beyond one year to maturity), as well as pledged or encumbered assets and claims on residents. Official gold holdings shall be valued at US$[250] per troy ounce. Holdings of SDRs and other reserve position in the Fund will be valued at a constant exchange rate of SDR 1: manat 5,804. Other reserve balances will be valued at a constant exchange rate of US$1:manat 4,606. Gross international reserve assets exclude the ANB's net forward position, defined as the difference between the face value of foreign currency denominated ANB off balance sheet claims on nonresidents and foreign currency obligations to both residents and nonresidents. *Official reserve liabilities* of the ANB are defined as outstanding Fund purchases, and liabilities of the ANB to nonresidents with an original maturity of up to and including one year. Reserve liabilities to the Fund will be valued at a constant exchange rate of SDR 1: manat 5,804. Other reserves will be valued at a constant exchange rate of US$1: manat 4,606.

3. Indicative Limits on the Stock of Manat Reserve Money of the ANB

(In billions of manats)

	Limits
Stock at December 31, 2002	1,866
March 31, 2003	1,704
June 30, 2003	1,817
September 30, 2003	1,955
December 31, 2003	2,139

Definition

Manat reserve money of the ANB is defined as the sum of currency issue, required reserves in manats, balances on commercial banks' correspondent accounts with the ANB and other manat liabilities of the ANB to domestic banks.

III. Ceilings on External Debt and External Payments Arrears

New Nonconcessional External Debt Contracted or Guaranteed by the Consolidated Government or the ANB (excluding the Fund)
(In millions of U.S. dollars)

Maturity of one to less than five years:

	Limits
Stock at December 31, 2002	0
March 31, 2003	0
June 30, 2003	0
September 30, 2003	0
December 31, 2003	0

Maturity of five years or more loans:

Stock at December 31, 2002	0
March 31, 2003	20
June 30, 2003	40
September 30, 2003	60
December 31, 2003	80

Definition

Nonconcessional external debt with original maturity of at least one year, contracted or guaranteed by the consolidated government or the ANB, excluding the Fund.

This performance criterion applies not only to debt as defined in point No. 9 of the Guidelines on Performance Criteria with Respect to Foreign Debt (Decision No. 12274-(00/85), August 24, 2000) but also to commitments contracted or guaranteed for which value has not been received. The definition of debt set forth in No. 9 of the guidelines reads as follows: "(a) For the purpose of this guideline, the term "debt" will be understood to mean a current, i.e., not contingent, liability, created under a contractual arrangement through the provision of value in the form of assets (including currency) or services, and which requires the obligor to make one or more payments in the form of assets (including currency) or services, at some future point(s) in time; these payments will discharge the principal and/or interest liabilities incurred under the contract. Debts can take a number of forms, the primary ones being as follows: (i) loans, i.e., advances of money to obligor by the lender made on the basis of an undertaking that the obligor will repay the funds in the future (including deposits, bonds, debentures, commercial loans and buyers' credits) and temporary exchanges of assets that are equivalent to fully collateralized loans under which the obligor is required to repay the funds, and usually pay interest, by repurchasing the collateral from the buyer in the future (such as repurchase agreements and official swap arrangements); (ii) suppliers' credits, i.e., contracts where the supplier permits the obligor to defer payments until some time after the date on which the goods are delivered or services are provided; and (iii) leases, i.e., arrangements under which property is provided which the lessee has the right to use for one or more specified period(s) of time that are usually shorter than the total expected service life of the property, while the lessor retains the title to the property. For the purpose of the guideline, the debt is the present value (at the inception of the lease) of all lease payments expected to be made during the period of the agreement excluding those payments that cover the operation, repair or maintenance of the property. (b) Under the definition of debt set out in point 9(a) above, arrears, penalties, and judicially awarded damages arising from the failure to make payment under a contractual obligation that constitutes debt are debt. Failure to make payment on an obligation that is not considered debt under this definition (e.g., payment on delivery) will not give rise to debt."

Debt rescheduling and restructuring are excluded from the borrowing limits. In determining the level of concessionality of these obligations, the definition of concessional borrowing shall apply. Concessional borrowing is defined as having a grant element of 35 percent or more. For loans with a maturity of at least 15 years, the 10-year average commercial interest reference rates (CIIRRs) published by the OECD should be used as the discount rate for assessing the level of concessionality, while the 6-month average CIRRs should be used for loans with shorter maturities. To both the 10-year and the 6-month averages, the following margins for differing repayment periods should be added: 0.75 percent for repayment periods of less than 15 years; 1 percent for 15-19 years; 1.15 percent for 20-29 years; and 1.25 percent for 30 years or more.

Stock of Short-term External Debt, Contracted or Guaranteed by the Consolidated Government[2] or the ANB
(In millions of U.S. dollars)

	Limits
Stock at December 31, 2002	0
March 31, 2003	0
June 30, 2003	0
September 30, 2003	0
December 31, 2003	0

Definition

Short-term external debt is defined as debt contracted or guaranteed by the consolidated government or the ANB with contractual maturity of less than one year, excluding normal import-related credits.

[2] For a definition of consolidated government, see Section I.1.

Outstanding Nonreschedulable External Payments Arrears
(In millions of U.S. dollars)

	Limits
Stock at December 31, 2002	0
March 31, 2003	0
June 30, 2003	0
September 30, 2003	0
December 31, 2003	0

Definition

The stock of nonreschedulable external payments arrears is defined as the external debt service obligations (principal and interest) of the consolidated government[3] and the ANB, including for government guaranteed loans, to multilateral and bilateral creditors, that have not been paid at the time they are due, excluding arrears on external debt service obligations pending the conclusion of debt rescheduling operations.

[3] For a definition of consolidated government, see Section I.1.

INTERNATIONAL MONETARY FUND

AZERBAIJAN REPUBLIC

Staff Report for the 2003 Article IV Consultation, Second Review Under the Poverty Reduction and Growth Facility, and Requests for Waivers of Performance Criteria, Extension of Arrangement and Rephasing of Purchases

Supplemental Information

Prepared by European II and Policy Development and Review Departments

Approved by Oleh Havrylyshyn and Martin Fetherston

May 9, 2003

I. Recent Economic Developments

1. Economic developments in recent months were broadly consistent with program targets. Real GDP grew an estimated 7.9 percent in the first quarter of 2003 relative to the same period last year. Inflation remains low, with 12-month CPI inflation of 2.3 percent at end-March, down from 3.3 percent at end-2002. As expected, reserve money balances fell at end-March relative to the end-2002 stock, due to seasonal factors, although the decline was less than assumed under the program. Similarly, net international reserves (NIR) of the ANB fell somewhat less than expected.[1]

2. Consistent with two key commitments under the program, SOCAR paid more in taxes in the first quarter than had been assumed in the state budget, with payments reportedly based on actual tax obligations rather than negotiated tax targets, and the Ministry of Finance has saved this higher-than-budgeted tax revenue as a cushion against possible future lower SOCAR tax obligations. Continuing the efforts to improve the business environment, a new presidential decree further streamlines the licensing process for business activities requiring licenses, and a Council of Businessmen has been created and charged with preparing additional proposals for the improvement of the business environment.

[1] While actual end-March NIR is higher than the unadjusted indicative target under the proposed program, insufficient information is available at this time on the disbursement of foreign financed capital spending and actual taxes due by SOCAR during the first quarter of 2003 to enable the staff to calculate the adjusted target. Thus staff is not yet in a position to judge performance against the NIR target, as well as most other end-March indicative targets.

3. Unusually heavy rains this spring resulted in serious flooding in three regions of southern Azerbaijan, with some 4,000 households reportedly affected. The government has requested assistance from the World Bank in dealing with the impact of the flood, and may also solicit assistance from other UN organizations. It is too early to determine the impact on agricultural output or GDP more generally, or on the state budget.

II. Implementation of Prior Actions

4. There were four prior actions for the completion of the second review under the PRGF, as specified in paragraph 55 of the LOI and labeled (i) to (iv). All have now been implemented, as described below and summarized in Table 1.

5. Draft amendments to the Budget Systems Law were submitted for Parliament's consideration on April 17, 2003. Consistent with the understandings under the program (prior action (i)), these amendments call for parliamentary approval of the deficit and expenditure ceilings of the consolidated budget, require that all expenditures in the consolidated budget (except for expenditures on the management of the oil fund and its assets) be executed by the treasury and that all capital expenditures be part of the State Investment Program, assign responsibility for the preparation of the consolidated budget to the Ministry of Finance, ensure that extra-budgetary funds do not make portfolio investments in domestic commercial activities or issue loans or loan guarantees, and require that the State Oil Fund (SOFAZ) holds equity position only through highly rated professional portfolio managers in international markets. These amendments have already been approved by the Economic Committee of parliament, and are expected to be considered by the full parliament shortly.

6. A presidential decree and a presidential resolution were issued on April 17, 2003 regarding the privatization, respectively, of International Bank of Azerbaijan (IBA) and BUS Bank. The decree on IBA instructed the Ministry of Economic Development (MOED) to hold negotiations with the EBRD for the sale of 20 percent of the state-owned shares in IBA during the summer of 2003, including signing a Memorandum of Understanding with the EBRD on this issue by May 30, 2003, and to sell by end-2004 the remaining portion of state-owned shares in IBA through cash auctions. In a separate letter, the MOED has committed to announcing the tender for these remaining shares no later than end-2003. The resolution on BUS Bank instructed MOED to submit by July 1, 2003 for presidential approval a plan of action that would ensure all measures for the preparation of BUS Bank for privatization are completed by end-2003, and that the privatization of BUS Bank be completed by end-2004.

7. A streamlined mechanism calling for the provision of quarterly tax credits to SOCAR and subsidies to Azerenergy and Azerigas within 30 days of the end of each quarter was approved on April 15 2003, in a joint decision of the ministers of finance, economic development, and fuel and energy and the president of SOCAR (prior action (iii)).

8. A Cabinet of Minister's decree was issued on April 19, 2003, as called for in prior action (iv), instructing all central, regional, and local government bodies to take urgent

measures to ensure timely payments by all state-owned companies of their State Pension Fund contributions.

9. Nothing in this supplement changes the thrust of the staff appraisal, as detailed in EBS/03/57.

Table 1. Prior Actions for the Completion of the Second Review under the PRGF

Policy Action	Status
(i) Submit to Parliament amendments to Budget System Law (as specified in paragraph 55 of LOI)	Done. Amendments submitted to Parliament on April 17, 2003
(ii) Adopt privatization timetables for International Bank (IBA) and United Universal Joint Stock Bank (paragraph 37 of LOI)	Done. A presidential decree and a presidential resolution were issued on April 17, 2003
(iii) Adopt procedures for allocation of tax credits and subsidies for unpaid fuel consumed by utilities, in consultation with Fund staff (paragraph 10 of LOI)	Done. Streamlined procedures approved on April 15, 2003
(iv) Issue a Cabinet of Ministers decree instructing timely payment of pension contributions by state-owned enterprises (paragraph 34 of LOI)	Done. Cabinet of Ministers decree issued on April 19, 2003

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 03/67
FOR IMMEDIATE RELEASE
June 4, 2003

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

IMF Concludes 2003 Article IV Consultation with the Azerbaijan Republic

On May 14, 2003, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Azerbaijan Republic.[1]

Background

Azerbaijan's economic performance remains strong, owing to both a favorable external environment and prudent macroeconomic policies. Driven by a strong growth in oil-related foreign direct investments and associated spillover effects, real GDP grew 10.6 percent in 2002. Inflation remains low, with the 12-month CPI inflation at 3.3 percent as of end-2002. The gross international reserves of the National Bank of Azerbaijan (ANB) amounted to about US$720 million at end-2002, providing for 4 months of non-oil import coverage, and the deposits of the State Oil Fund of Azerbaijan (SOFAZ) grew to nearly US$700 million by year-end. The sanctioning of the Baku-Tbilisi-Ceyhan (BTC) oil pipeline, and of the associated full field development of the Azeri-Chirag-Guneshi oil field in 2002, will contribute to a sharp boost in foreign direct investments (FDI) through 2005, and in oil and gas exports thereafter.

The stance of fiscal policy remained prudent in 2002. Tax revenue collection increased by about 1 percent of GDP in 2002 relative to 2001, while nontax revenue and grants as a share of GDP remained broadly unchanged. Increases in expenditures during 2002 exceeded the improvement in revenue collection, largely due to investment spending, including on the BTC pipeline. This resulted in a modest increase in the non-oil deficit

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

relative to 2001. The non-oil deficit, however, remained below the sustainable level, consistent with the authorities' intentions to very gradually increase their use of oil revenue.

There was a modest increase in real monetary aggregates during 2002, almost entirely due to foreign currency deposit growth. Reflecting the growth in deposits, bank credit to the economy grew by about 17 percent in 2002 (following 12 percent growth in 2001). Nominal interest rates continued to decline during 2002, but spreads between deposit and lending interest rates remain high at nearly 10 percentage points.

The nominal exchange rate of manat vis-à-vis the US dollar has remained fairly stable, with the ANB intervening in the foreign exchange market largely to smooth temporary fluctuations around a modestly depreciating trend. The real effective exchange rate depreciated by over 8 percent during 2002, following a depreciation of about 6 percent in 2001, continuing a trend that has been ongoing since mid-1999, thus supporting the competitiveness of the Azeri economy.

Azerbaijan's external position improved further during 2002. Oil sector exports grew 11 percent during the year, largely due to higher oil prices relative to 2001, and non-oil exports grew by about 25 percent, led by agricultural and chemical products exports. While the current account deteriorated compared to 2001, this reflected a surge in oil-sector related imports, which were more than financed by higher net FDI. Public and publicly guaranteed external debt remained unchanged during 2002, at about 23 percent of GDP.

Structural reforms continued throughout 2002, and the authorities accelerated implementation of key reforms towards late-2002. Significant progress has been made in enhancing financial discipline in the energy sector, with quasi-fiscal subsidies in the energy sector reduced from over 22 percent in 2000 to about 11 percent in 2002. In addition, the domestic prices of natural gas, crude oil and oil products have been unified with estimated long-term world market prices, except for kerosene and diesel fuel due to social concerns. The authorities are committed to bring the prices for these two products to world market levels in 2004, as they develop a safety net to protect vulnerable elements of the society. The authorities have also made significant progress on a number of governance issues. The reforms in tax and customs administrations continued during 2002—including a 40 percent reduction in the number of tax officials, combined with a significant increase of salary for remaining staff—and the number of businesses requiring licenses was reduced by about 85 percent during the year. During 2002 there were some modest tax reforms, consisting of small reductions in the payroll and profit tax rates, as well as several measures aimed at broadening the tax base. The Poverty Reduction Strategy Paper that was approved in early 2003 is well-designed and based on broad consultative process. Its effective implementation should contribute greatly to reducing poverty in Azerbaijan.

Executive Board Assessment

Executive Directors commended the authorities for Azerbaijan's continued strong macroeconomic performance during 2002, reflected in double-digit and broad-based GDP growth, maintenance of inflation at a single-digit level, stability in the foreign exchange market, and an increase in international reserves. Directors noted that, while a favorable external environment had contributed to this positive outcome, the prudent financial policies adopted by the authorities and—despite some delays—progress in structural reforms had played an important role. In particular, they welcomed the actions taken to develop infrastructure for the effective management of the country's oil wealth and improve the transparency of this process.

Directors noted, however, that despite these impressive macroeconomic achievements, poverty remains pervasive in Azerbaijan and the economy is heavily dependent on the oil sector. They stressed that, to consolidate macroeconomic gains, strengthen the basis for sustained and diversified economic growth, and alleviate poverty, the authorities should develop a medium- and long-term strategy for the use of the expected boom in oil revenues and for putting the energy sector on a sound financial footing, and should continue the aggressive implementation of structural reforms.

Directors agreed that monetary and exchange rate policies remain appropriate, and should continue to aim at maintaining low inflation while preserving the competitiveness of the economy. They observed, however, that the planned increase in oil fund spending for 2003 and over the medium-term, as well as the expected strong increase in oil-related foreign direct investment flows during 2003-2005, will present challenges for the Azerbaijan National Bank (ANB) as it seeks to sterilize the resulting increase in liquidity and maintain the competitiveness of the economy. In that context, Directors supported the ANB's plan to increase the range of monetary policy instruments, including the issuance of ANB bills. Nevertheless, in view of the present limited scope for open market operations, Directors stressed that fiscal policy remains the key tool for macroeconomic management, and encouraged the authorities to strengthen policy coordination between the Ministry of Finance and the ANB as planned.

Directors noted that the prudent fiscal policy adopted by the authorities has been vital to maintaining low inflation and keeping public and publicly-guaranteed debt at moderate levels. They welcomed the focus on the non-oil deficit for assessing the overall fiscal policy stance. Directors agreed that, in view of pressing needs for infrastructure and social spending, the moderate increase in the non-oil deficit in 2003 is appropriate, and also consistent with a long-term strategy of conserving a significant share of oil revenues for future generations. They encouraged the authorities to save any higher-than-budgeted oil revenue in 2003 to provide a cushion against possible future declines in oil prices.

Directors were encouraged by the authorities' plans to strengthen fiscal management and improve the tax system. In this context, they welcomed the recent passage of the draft amendments to the Budget Systems Law, which will ensure closer integration of the state and oil fund budgets into a comprehensive budget and improve accountability. Directors also welcomed the authorities' commitment to reunify enterprise profit tax rates in 2004, and to broaden the tax base including through a significant reduction in VAT exemptions. They expressed concern, however, that the planned introduction of special economic zones (SEZs) could undermine tax and customs administrations reforms and lead to a significant erosion of the tax base. Directors urged the authorities to carefully reconsider the introduction of SEZs, and in any event, to limit tax incentives to standard exemptions of indirect taxes related only to exports.

Directors underscored that financial discipline in the energy sector remains key to macroeconomic stability and economic efficiency in Azerbaijan. They commended the authorities for the energy sector reforms introduced in recent years, including steps to make energy subsidies explicit in the 2000 budget, which have contributed to a significant reduction in explicit and implicit energy subsidies. They were also encouraged by the recent unification of nearly all domestic energy prices with estimated long-run world market prices. Directors, noted, however, that energy-related subsidies remain considerable and urged the authorities to continue energy sector reforms, including by further increasing collections for utility services, and accelerating the restructuring of the State Oil Company of Azerbaijan Republic and the utility companies. They also encouraged the authorities to introduce in 2004 a mechanism for adjusting domestic energy prices regularly to keep them broadly in line with world market prices, while mitigating any adverse impact on the most vulnerable groups.

Directors noted the ongoing reforms in the banking sector, but expressed concern at the slow progress in privatization of the International Bank of Azerbaijan and BUS Bank. Directors welcomed the recent presidential decrees establishing timetables for their privatization and instructing the government to accelerate efforts to privatize these two banks. Directors also urged the authorities to accelerate other financial sector structural reforms to help deepen financial intermediation, including adoption of a new Banking System Law, strengthened enforcement of the bankruptcy law, improved regulations related to the use of collateral, and enhanced competition in the banking sector including through increasing the participation of foreign banks and tendering for government banking services.

Directors encouraged the authorities to continue efforts to improve governance, which they considered crucial to improve the investment climate and prospects for private sector-led growth. In this connection, Directors noted that the creation of the oil fund has contributed to a significant improvement in the transparency of the use of oil revenues. They were also encouraged by continued reform in tax and customs administrations, and the significant reduction in the number of businesses requiring licenses.

Directors commended the authorities for the broad participatory process in preparing Azerbaijan's State Programme on Poverty Reduction and Economic Development, which provides a comprehensive development strategy for poverty alleviation. They stressed that to ensure a successful implementation of this strategy, the sequencing for priority actions needs to be closely linked with annual budgets through the Medium Term Expenditure Framework and Public Investment Program. In this context, Directors encouraged the authorities to continue institutional capacity building within the government for strategy formulation, implementation, monitoring and evaluation, and resource management.

Directors welcomed the quality and timeliness of the data provided by the Azeri authorities, while urging them to address the remaining weaknesses as summarized in the recently published data module of the Report on the Observance of Standards and Codes, with a view to eventual participation in the Special Data Dissemination Standard.

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board.

Azerbaijan: Selected Economic Indicators

	1998	1999	2000	2001	2002 Prel. Est.
	(Changes in percent)				
Real economy					
Real GDP	10.0	7.4	11.1	9.9	10.6
CPI (end-of-period)	-7.6	-0.5	2.2	1.3	3.3
	(In percent of GDP)				
Consolidated Government					
Total revenue 1/	19.6	18.5	21.2	21.5	28.0
Total expenditures (including net lending) 1/	23.8	23.6	20.8	20.3	28.3
Fiscal balance 2/	-3.9	-4.7	-0.6	0.9	-0.5
	(Changes in percent)				
Money and Credit					
Manat reserve money	-22.3	20.9	22.1	9.0	11.0
Manat broad money	-10.6	5.3	11.1	7.8	15.5
Banking sector credit to the economy	6.7	4.2	-1.6	-17.5	16.7
Income velocity of average manat broad money 3/	7.8	7.8	7.7	6.8	6.2
	(In percent of GDP)				
Balance of Payments					
Current account balance (-, deficit)	-30.7	-13.1	-3.6	-0.9	-12.6
External public debt 4/	11.4	21.0	22.2	22.2	22.6
Gross international reserves					
In millions of US$, end of period	449	673	680	725	721
In months of nonoil sector imports of GNFS	3.5	4.7	4.9	4.5	4.0
Exchange Rate					
End-of-period level (Manat/US$)	3,890	4,378	4,565	4,775	4,893
Real effective exchange rate (-, depreciation)	14.9	-5.8	-9.8	-6.1	-8.3

Sources: Azeri authorities; and IMF staff estimates.

1/ Revenue and expenditure in 2002 include the estimated value of SOCAR's unpaid energy deliveries to the utilities (5.4 percent of GDP).

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

3/ In terms of nonoil GDP.

4/ Includes government and government guaranteed external debt only.

INTERNATIONAL MONETARY FUND
EXTERNAL RELATIONS DEPARTMENT

Press Release No. 03/67
FOR IMMEDIATE RELEASE
May 15, 2003

International Monetary Fund
Washington, D.C. 20431 USA

IMF Approves US$18 Million PRGF Disbursement to the Azerbaijan Republic and Requests for Waivers of Performance Criteria and Extension of Arrangement

The Executive Board of the International Monetary Fund (IMF) has completed the second review of the Azerbaijan Republic's performance under a Poverty Reduction and Growth Facility (PRGF) arrangement. Completion of the review will enable the Azerbaijan Republic to draw an amount equivalent to SDR 12.87 million (about US$18 million) from the IMF immediately, which will bring total disbursements thus far under the arrangement to SDR 28.97 million (about US$41 million). Access authorized under the PRGF arrangement (see News Brief No. 01/53) amounts to the equivalent of SDR 80.45 million (about US$113 million).

In completing the review on May 14, 2003, the Executive Board granted waivers in respect of the Azerbaijan Republic's non-observance of three performance criteria pertaining respectively to the adoption of timetables for the unification of domestic and world prices for oil, oil products and natural gas, the full privatization of the International Bank, and the preparation of United Universal Joint Stock Bank for privatization, as well as quarterly granting to the State Oil Company of the Azerbaijan Republic of tax credits. The reforms ultimately undertaken by the authorities in connection with certain performance criteria went beyond what was specified in the performance criteria – e.g., unifying domestic and world market energy prices, rather than merely adopting a timetable for their unification—and the related delays did not jeopardize achievement of the program's objectives.

The commitment period of the three-year PRGF arrangement approved for the Azerbaijan Republic on July 6, 2001 has been extended through March 31, 2005.

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

Following the Executive Board discussion, Eduardo Aninat, Deputy Managing Director and Acting Chair, said:

"Azerbaijan's macroeconomic performance in recent years, with strong, broad-based economic growth and low inflation, has been impressive. However, poverty remains widespread and the economy is heavily dependent on oil-sector revenue. To enhance prospects for sustained growth in the non-oil sectors and to make further progress in alleviating poverty, the authorities will need to develop a strategy for the use of oil wealth. Combined with the aggressive implementation of structural reforms, this will be a critical part of the authorities' overall development strategy as outlined in their recently approved State Programme on Poverty Reduction and Economic Development (PRSP).

"The authorities' preparation of a full PRSP with broad participation from civil society is commendable, and the broad policy priorities outlined in the PRSP are consistent with the multi-dimensional nature of poverty alleviation. It will now be important to ensure that the targeted reforms are implemented on a timely basis, and that the strategy is adjusted in response to changing economic conditions and experience gained during the reform process. To help ensure steady progress toward the PRSP objectives, the authorities are encouraged to enhance their project evaluation capacity, gradually increase capital expenditures, improve the effectiveness of health and education spending, and build a social safety net to support reforms in the energy sector.

"The authorities' commitment to monetary and fiscal policies consistent with macroeconomic stability is laudable, and exchange rate policy remains appropriate for the challenges facing Azerbaijan. In view of pressing needs for infrastructure and social spending, the moderate increase in the non-oil fiscal deficit in 2003 is appropriate, and is consistent with a long-term strategy of conserving a large share of oil revenue for future generations. The authorities are encouraged to save any higher-than-budgeted oil revenues to provide a cushion against possible future declines in oil prices.

"The authorities' decision to focus their attention on the non-oil deficit as the proper measure of fiscal stimulus provided to the economy is appropriate, in view of the volatility of oil prices. In addition, the recent passage of the draft amendments to the Budget Systems Law is welcome, and should help ensure closer integration of the oil fund and state budgets into a comprehensive budget.

"The efforts to enhance energy sector financial discipline have led to a substantial reduction in explicit and implicit subsidies. These subsidies remain considerable, however, and the authorities are encouraged to press ahead with their planned energy sector reforms, including by adopting a mechanism for adjusting energy prices that would ensure domestic energy prices remain broadly in line with world market prices.

"The recent reforms in the banking system, particularly the strengthening of banking supervision and the introduction of large and small-value payments systems, are encouraging. However, slow progress in privatizing remaining state-owned banks has prevented the development of a truly competitive banking sector in Azerbaijan, and the authorities are encouraged to accelerate their privatization.

"With regard to other structural reforms, the commitment to reunify the enterprise profit tax in the context of the 2004 budget is welcome. In addition, progress in governance reforms is encouraging, as the authorities have sought to ensure transparency in the use of oil revenues, significantly reduced the number of businesses requiring licenses, improved tax and customs administrations, and taken measures to eliminate funding sources for international terrorism and to prevent money laundering. The authorities should carefully reexamine their plans to establish special economic zones, as they could undermine governance reforms and lead to significant revenue losses," Mr. Aninat said.

Statement by Fritz Zurbrügg, Executive Director for Azerbaijan Republic
May 14, 2003

My authorities would like to express their appreciation for the work of the staff team and for the consistently high quality of its advice. As the staff report notes, there have been differences of views between the authorities and staff on some issues in the area of structural reforms over the last year. However, the continuous and constructive engagement of both sides has allowed for these outstanding questions to be resolved. The delay in concluding the second review, while certainly regrettable, has provided the government with more time to agree on and build support for the necessary reform measures. I believe that the authorities have used this time well, pushing through several difficult measures and laying the basis for further reforms.

Macroeconomic performance in 2002 has been very good and program implementation continues to be strong. The fact that all quantitative performance criteria were met, notwithstanding the absence of program reviews, underscores the strong ownership that exists in terms of pursuing sound macroeconomic policies. It is also important to note that the macro-framework is closely linked and consistent with the objectives and policies in Azerbaijan's Poverty Reduction Strategy Paper (PRSP).

Fiscal Policy

Fiscal policy has been in line with program objectives. I think the discussion with staff on focusing on the "non-oil deficit" for assessing the fiscal policy stance has been very useful. My authorities have taken on board staff's recommendations. Given the importance of the question on managing oil wealth in Azerbaijan, staff's focus in the Selected Issues Paper is very welcome. The concept of a "sustainable non-oil deficit" provides a helpful benchmark for both the authorities and other parties to better assess how the country is faring in its efforts to save part of the oil wealth for future generations. It is reassuring that even under the most conservative scenario, the calculated sustainable deficit ceiling would be above the currently envisaged deficit for 2003.

Regarding the State Oil Fund of Azerbaijan (SOFAZ), it is fair to say that the way it is managed has received substantial praise from various sides. My authorities believe that, on substance, the oil fund rules have been adhered to and that since its creation, SOFAZ has greatly improved the transparency of managing Azerbaijan's oil resources. While they continue to believe that the existing rules are sound, the authorities have agreed to additionally anchor the most important of these rules in the Budget Systems Law. Respective amendments to the law have been submitted to parliament as a prior action and their actual adoption will be a structural performance criterion for the third review.

A critical achievement in the fiscal area has been to complete the process of subjecting all taxpayers to the tax legislation. In practice, this means that all state-owned enterprises are now paying calculated rather than negotiated taxes. Introducing this principle has been particularly difficult with regard to the state oil company SOCAR, since it used to provide quasi-fiscal subsidies to utility companies which were basically netted out with its tax obligations. Contrary to the past, SOCAR's tax payments will now depend on the oil price and the Ministry of Finance will save any payments in excess of the budgeted amounts. In this respect, the results of the first quarter 2003 reported in the staff supplement are very encouraging.

Further on the revenue side, regional and sectoral variations in the enterprise profit tax rate have been introduced in order to support particular regions and sectors. My authorities acknowledge, however, that tax differentiation is not the ideal instrument to reach this goal due to its potential for distortions. They are thus willing to consider replacing the tax variations by a more effective and comprehensive program for regional development, consistent with the PRSP and with the help of technical assistance from the Fund and the Bank.

Monetary and Financial Sector Reforms

Over the last few years, inflation has remained low despite substantial growth rates. The National Bank (ANB) will continue to implement a monetary policy aimed at domestic price stability while at the same time allowing the market to determine the path of the exchange rate. Concerning the financial sector, a review has been undertaken to identify inhibitors of competitiveness. The review has pointed to the dominance of the state-owned banks as one such inhibitor. The authorities will therefore move aggressively to privatize the two banks in question during 2004. Eliminating the ceiling on foreign bank participation in the banking system will also help to increase competition. The second issue identified in the review related to problems in enforcing the bankruptcy law, inadequate regulations of the use of collateral and the limited use of International Accounting Standards (IAS) outside the banking system. The issues of bankruptcy and use of collateral will be addressed with the assistance of the World Bank. Regarding IAS, the government has launched a comprehensive program for its accelerated introduction.

Structural Reforms

Regarding the record of structural reforms, the staff report qualifies it as "generally impressive". Indeed, the changes and measures undertaken over the last few year have been remarkable not only compared to the regional standard. While the measures might not always have been implemented according to the program timetable, they were eventually implemented. In view of the political sensitivity of many of these measures, this is a major achievement. Making the previously implicit subsidies to Azerenergy and Azerigas visible by publishing the amounts and including them in the consolidated budget has been a step of great importance. For the first time, the Azeri public is made aware of the magnitude of the problem. This will likely increase the pressure to reduce and, eventually, eliminate the subsidies.

Another major structural achievement has been the unification of domestic and world market energy prices. Although my authorities are requesting a waiver for the performance criterion relating to the timetable for price unification, it is important to stress that in early February they effectively unified prices. Therefore, they have done significantly more than required under the program. Together with the elimination of the quasi-fiscal subsidies, this measure will be crucial to strengthen financial discipline in the energy sector. The recently initiated restructuring of SOCAR will be another important element in this regard.

My authorities recognize that making transparent the subsidies in the energy sector is just the first step on the way to actually reducing them. Given the impact such a reduction will have on both individual and corporate consumers by significantly raising prices, the authorities deserve credit for being committed to tackle this difficult issue regardless of the upcoming elections. The authorities have started to take measures in order to make sure that all budgetary organizations as well as state-owned enterprises pay in full for their actual utility consumption. This will constitute a major break with the past, allowing to enhance efficiency and reduce energy consumption. Azerbaijan has sought the assistance of the World Bank in reviewing the utility tariff structure with the aim of coming up with a new system that would eventually cover the costs of providing these services. The authorities are also working with the Bank on the crucial issue of designing a mechanism that will mitigate the impact of price increases on the most vulnerable groups.

The authorities take seriously the need to improve both governance and the business climate. To this end, they have made significant progress in strengthening the customs and tax administration systems. In particular, the reform program for the State Customs Committee has been implemented aggressively while the Ministry of Taxes has been downsized by 40 percent. Regarding the business environment, red tape has been reduced dramatically in terms of licensing requirements. Finally, anti-corruption legislation is expected to be passed by parliament this year, providing a legal definition of corruption and introducing specific anti-corruption measures.

Poverty Reduction Strategy Paper

The State Program for Poverty Reduction and Economic Developments (PRSP) has been formally adopted in February this year. The government's dedicated PRSP website has a wealth of detailed information on the process and its outcomes. I am happy to note staff's assessment that the strategy is well defined, genuinely owned and, if effectively implemented, should contribute greatly to poverty reduction. Indeed, the PRSP is based on a broad participatory process involving all branches of the government, the parliament, civil society, the private sector and donors. This has been a valuable experience which is likely to encourage future broad and open discussions.

Furthermore, international financial institutions have been actively involved throughout the preparation of the strategy, helping to keep the process within the macroeconomic framework. I believe it is important to note that the PRSP is clearly linked with the government's policy commitments under the program and that it is fully consistent with the 2003 budget. The strategy is also sufficiently operational, allowing its use in defining the future path of the current and any subsequent Fund-supported program.

Finally, I can confirm that, like with previous Article IV and Use-of-Fund-Resources staff reports, the authorities are happy to publish today's set of documents.