

Republic of Azerbaijan: 2008 Article IV Consultation—Staff Report; Staff Statement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Republic of Azerbaijan

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2008 Article IV consultation with the Republic of Azerbaijan, the following documents have been released and are included in this package:

- The staff report for the 2008 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on March 12, 2008, with the officials of the Republic of Azerbaijan on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on May 8, 2008. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- A staff statement of May 23, 2008 updating information on recent developments.
- A Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its May 23, 2008 discussion of the staff report that concluded the Article IV consultation.
- A statement by the Executive Director for Republic of Azerbaijan.

The document listed below will be separately released.

Statistical Appendix

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

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: \$18.00 a copy

**International Monetary Fund
Washington, D.C.**

INTERNATIONAL MONETARY FUND

REPUBLIC OF AZERBAIJAN

Staff Report for the 2008 Article IV Consultation

Prepared by Staff Representatives for the 2008 Consultation with Azerbaijan

Approved by Lorenzo Pérez and Mark Plant

May 8, 2008

- **Mission:** February 27–March 12, 2008, Baku.
- **Team:** Ms. Fichera (head), Mmes. Zermeño, Koeda, John (assistant), Mr. Ding (all MCD), and Mr. Pratt (MCM external expert). Mr. Pérez (MCD) and Mr. Lanz (OED) attended policy discussions. Mr. Gvenetadze, resident representative, and the local office staff, assisted the mission.
- **Exchange system:** Azerbaijan accepted the obligations of Article VIII, Sections 2, 3, and 4, effective November 30, 2004. A new de facto exchange rate arrangement that pegs the manat to a dollar/euro currency basket became operational in March 2008, replacing a crawling peg exchange system that had been in place since 2006.
- **Data:** Azerbaijan has participated in the General Data Dissemination System since 2001. Provisions of data to the Fund is adequate for surveillance.
- **Previous consultation:** concluded on May 9, 2007. The staff report and PIN are available at <http://www.imf.org/external/pubs/cat/longres.cfm?sk=21031.0>.

Contents

Page

| | |
|---|----|
| Executive Summary | 3 |
| I. Introduction..... | 4 |
| II. Recent Developments | 5 |
| III. Outlook | 12 |
| A. Short-Term..... | 12 |
| B. Medium- and Long-Term..... | 14 |
| IV. The Authorities' Views..... | 17 |
| A. Macroeconomic Policy Mix to Reduce Inflation..... | 17 |
| B. Improving the Quality and Efficiency of Public Expenditures..... | 18 |
| C. Strengthening the Financial System..... | 18 |
| V. Staff Appraisal | 19 |

Tables

| | |
|--|----|
| 1. Selected Economic and Financial Indicators, 2004–08 | 22 |
| 2. Balance of Payments, 2004–08..... | 23 |
| 3. Consolidated Central Government Operations, 2004–08 (In millions of manats) | 24 |
| 4. Consolidated Central Government Operations, 2004–08 (In percent of non-oil GDP) | 25 |
| 5. Summary Accounts of the National Bank, 2004–08 | 26 |
| 6. Monetary Survey, 2004–08..... | 27 |
| 7. Banking System Soundness Indicators, 2004–07 | 28 |
| 8. Selected Economic and Financial Indicators, 2006–13 | 29 |
| 9. Public Sector Debt Sustainability Framework, 2003–13..... | 30 |
| 10. External Debt Sustainability Framework, 2003–13..... | 31 |
| 11. Economic and Financial Indicators, 2006–13..... | 32 |

Boxes

| | |
|--|----|
| 1. Non-Oil Revenues: Recent Developments and Policy Issues | 7 |
| 2. Banking Sector Developments..... | 10 |
| 3. Exchange Rate Assessment for Azerbaijan | 13 |

EXECUTIVE SUMMARY

The 2008 Article IV consultation discussions focused on policies to contain inflation, the need to improve the quality and efficiency of public expenditure, and measures to strengthen the resilience of the banking system to shocks and to promote the development of the financial sector.

Economic developments and outlook

Economic growth was strong in 2007, led by a major increase in oil production. Non-oil GDP continued to expand rapidly pushed by large increases in public expenditure, including wages and pensions. The overall fiscal balance was in surplus, but the non-oil primary deficit deteriorated. A large current account surplus resulted in a major accumulation of foreign reserves and oil fund assets. But inflation rose to almost 20 percent, also reflecting the lack of monetary and exchange rate policy actions to reduce the impact of the fiscal expansion, and an uncompetitive business environment. The growth and external outlook remains favorable on account of strong oil production and prices, but, if macroeconomic policies remain loose, inflation will remain high.

The authorities' views

The authorities intend to continue with their expansionary fiscal plans in 2008, in line with their strategy to pursue fast improvements in living standards and infrastructures to set the basis for long-term non-oil growth. They reported intentions to moderate the fiscal expansion in 2009. In the meantime, they have adopted a new exchange rate arrangement that pegs the manat to a dollar/euro currency basket, aimed at keeping the nominal effective exchange rate stable. They expect the new arrangement to help contain imported inflation and view it as a step towards preparing the foreign exchange market for more exchange rate flexibility. The ANB has strengthened prudential regulations and supervision to contain potential risks from a very rapid credit expansion. The authorities are also considering measures to develop the financial market.

Staff recommendations

- Moderate the 2008 fiscal expansion and tighten the fiscal stance in 2009 to avoid the entrenchment of a nascent wage-price spiral.
- Facilitate the unavoidable real exchange rate adjustment through more nominal appreciation rather than through higher inflation, by allowing the manat to appreciate against the basket.
- Significantly strengthen the medium-term expenditure framework to improve the quality and efficiency of public spending and the monitoring of financial operations of public enterprises.
- Reinforce the enforcement of current and planned prudential regulation to address probable risks from a very rapid credit expansion.
- Take steps to help the development of the financial market and measures to enhance competition and strengthen the supply response of the economy.

I. INTRODUCTION

1. **Major expansions in oil and gas production and large increases in public expenditure resulted in spectacular growth in Azerbaijan during 2005–07.** Annual real growth has been above 20 percent since 2005, resulting in higher living standards, lower unemployment, and rapidly declining poverty. While the oil boom has created unprecedented opportunities for economic and social development, its temporary nature and the expansionary policies being pursued pose significant macroeconomic challenges going forward.

2. **The short and medium-term challenges have not changed much from those identified in the 2007 Article IV consultation, but they have intensified.** Booming oil revenues will continue to provide abundant financing for large increases in government spending in the pursuit of a fast-track development strategy. Real appreciation pressures from the recent terms-of-trade gains, amplified by the large fiscal expansion, will continue to occur mostly through high inflation, particularly if monetary and exchange rate policy remains subdued. Growing government spending is likely to deepen problems with expenditure quality and efficiency, in the absence of more effective public expenditure management. Unless structural reforms are deepened, governance problems and an uncompetitive business environment are likely to hinder a stronger supply response. Finally, rapid credit expansion and limited risk assessment capacity by banks pose new challenges for regulation and supervision, while an underdeveloped financial system limits long-term funding and saving options.

3. **The discussions focused on:**

- The appropriate macroeconomic policy mix to reduce inflation through a more restrained fiscal policy and a more determined use of exchange rate policy;
- The need to improve the quality and efficiency of public expenditures, particularly for public investment; and,
- Measures to strengthen the resilience of the banking system to shocks and to promote the development of the financial sector.

II. RECENT DEVELOPMENTS

Azerbaijan: Selected Economic Indicators, 2003–07
(Annual percentage change, unless otherwise specified)

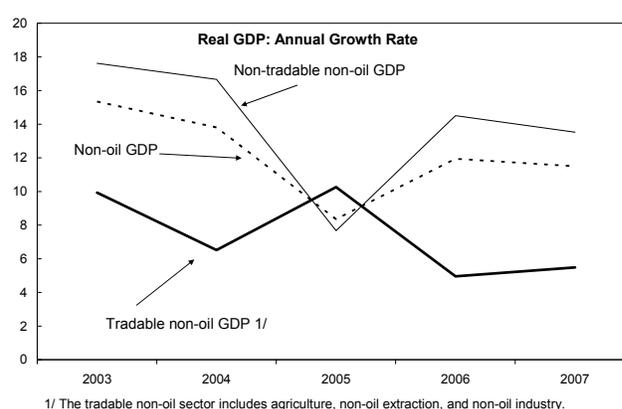
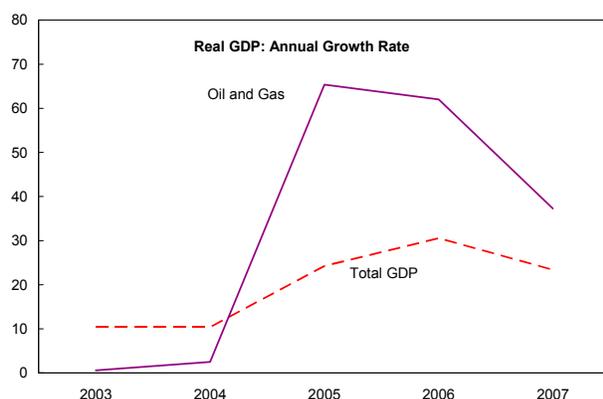
| | 2003 | 2004 | 2005 | 2006 | 2007 Prel. |
|--|-------|-------|-------|-------|---------------|
| Real GDP | 10.5 | 10.4 | 24.3 | 30.5 | 23.4 |
| Oil sector | 0.6 | 2.5 | 65.4 | 62.0 | 37.3 |
| Non-oil sector 1/ | 15.3 | 13.8 | 8.4 | 11.9 | 11.5 |
| CPI (end-of-period) | 3.6 | 10.4 | 5.5 | 11.4 | 19.5 |
| Nominal GDP per capita (in U.S. dollars) | 880 | 1,040 | 1,574 | 2,469 | 3,663 |
| Poverty (in percent of population) 2/ | 39.7 | 28.5 | 24.0 | 20.8 | 16.0 |
| Overall fiscal balance (in percent of GDP) | -0.8 | 1.0 | 2.6 | -0.2 | 2.4 |
| Non-oil primary fiscal balance (in percent of non-oil GDP) | -17.0 | -12.9 | -12.6 | -31.1 | -32.1 |
| Oil revenue (in percent of non-oil GDP) | 16.2 | 14.7 | 17.4 | 30.8 | 38.2 |
| Non-oil revenue (in percent of non-oil GDP) | 22.1 | 24.3 | 27.5 | 29.9 | 33.3 |
| Expenditure (in percent of non-oil GDP) | 40.8 | 37.7 | 40.5 | 59.3 | 66.1 |
| Manat base money | 23.7 | 38.2 | 7.5 | 132.6 | 101.4 |
| Credit to the economy | 38.3 | 60.2 | 53.0 | 63.6 | 96.5 |

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

1/ Includes oil and gas transportation.

2/ World Bank estimates for 2003-05, State Statistical Committee for 2006-07

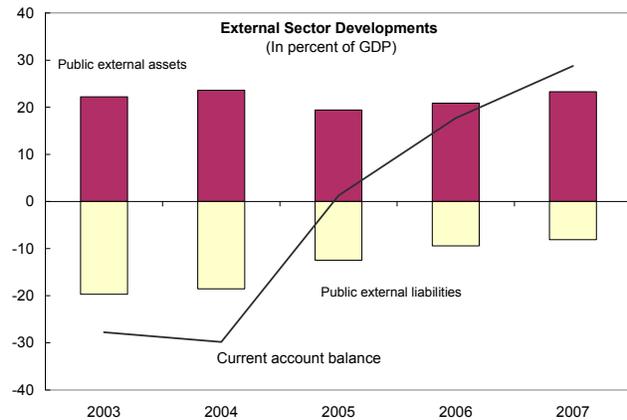
4. **The dominance of oil has increased, driving Azerbaijan’s strong economic growth performance** (Table 1).¹ In 2007, oil GDP grew by 37 percent and accounted for 59 percent of total GDP. Non-oil growth remained strong at about 12 percent, driven mostly by strong non-tradable sectors activity, particularly construction, commerce, and communications. The spectacular growth coupled with very high oil prices pushed per capita GDP to an estimated \$3,663, and the official rates of poverty and unemployment declined significantly.



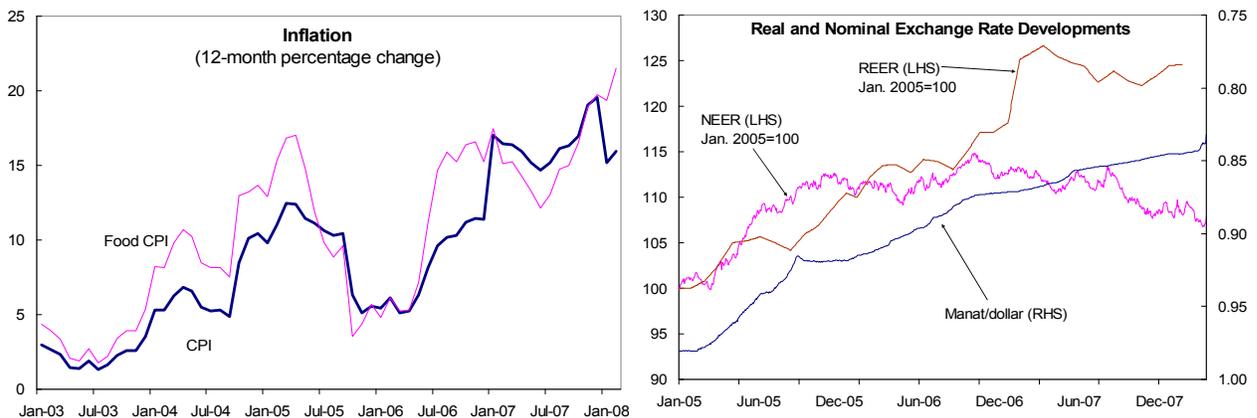
¹ Across the document, oil refers to both oil and gas.

5. **Booming oil exports strengthened the balance of payments further (Table 2).**

The current account surplus rose to 29 percent of GDP in 2007. However, non-oil exports—mostly agro-industry and metal products—remained relatively small at about 10 percent of non-oil GDP, as exporters faced rising labor costs and an appreciating real exchange rate. Despite very large investment repatriation from foreign oil companies, the government’s oil fund assets together with the international reserves at the Azerbaijan National Bank (ANB) reached about \$7.3 billion—triple the amount of external public sector debt in 2007.



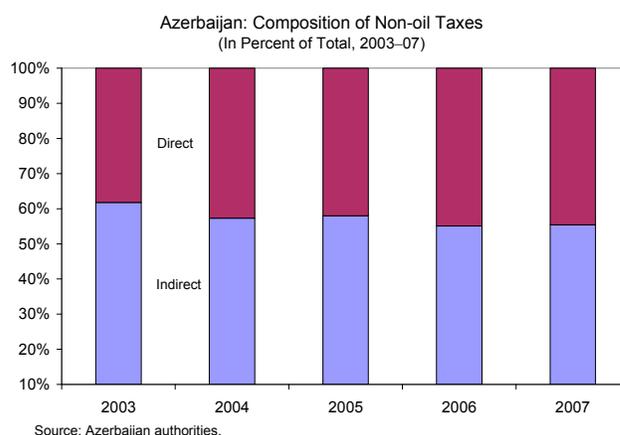
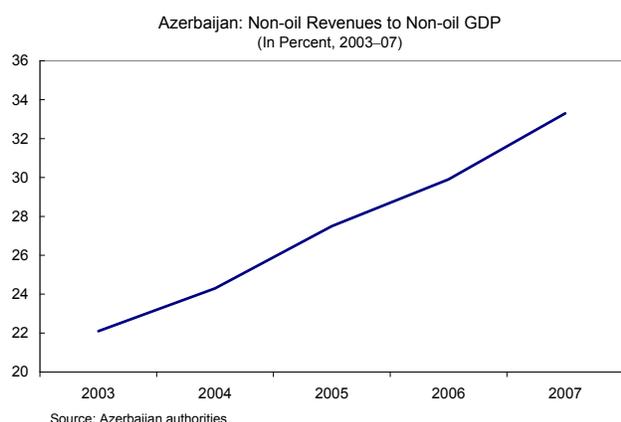
6. **Inflation accelerated, reflecting fiscal-induced demand pressures, rising international food and commodity prices, increases in administered energy prices, and an accommodative monetary policy.** Twelve-month inflation reached 19.5 percent in December, and remained high at 18.2 percent in March 2008, despite the fact that the January 2007 large energy price increase had already been absorbed in the base. The real effective exchange rate appreciation continued, because of widening inflation differentials with Azerbaijan’s trading partners.



7. **The consolidated fiscal balance returned to surplus in 2007, but the non-oil primary deficit to non-oil GDP ratio increased (Tables 3 and 4).** Oil revenue grew by about 60 percent, and rising incomes and consumption—together with improved tax administration—boosted non-oil revenue (Box 1). Budgetary expenditure rose to 66 percent of non-oil GDP. Wages and transfers together increased by 46 percent. Following a two-fold jump in 2006, investment spending rose by 63 percent, and progress to strengthen expenditure planning, execution, and monitoring, particularly of large projects, was limited.

Box 1. Non-Oil Revenues: Recent Developments and Policy Issues

The rapid increase in non-oil revenues from 22 percent of non-oil GDP in 2003 to 33¼ percent in 2007 reflects booming consumption and growing incomes and corporate profits, which constitute the base of the VAT and income taxes, respectively. In addition, significant improvements in tax administration, particularly during 2006–07, have also generated very positive results.



The following measures are at the core of the recent improvements:

- A major cleanup of the VAT registration system cut almost by a half the number of registered taxpayers over 2005–07, and reduced fraud by eliminating unjustified refunds;
- Improved taxpayers' services strengthened voluntary compliance; and
- The introduction of an automated system covering all non-oil taxes eased significantly tax processing.

Nevertheless, non-oil tax revenues remain below potential. This is explained by a costly system of exemptions regarding the VAT; customs administration problems that continue to undermine the revenues from non-oil customs duties; and a large, but difficult-to-quantify informal economy that mostly escapes the tax system.

In the short term, the authorities expect to broaden the non-oil tax base by: (i) implementing a modern system of risk-management for audits; (ii) strengthening voluntary compliance and establishing basic conditions for effective self-assessment; and (iii) reducing non-oil VAT exemptions. Progress on customs administration is expected once new regulations consistent with WTO rules are approved and implemented.

The authorities are also considering a comprehensive review of non-oil tax policy to support the development of medium-sized companies and the diversification of the economy. In particular, they are interested in a simpler tax system with flat and lower personal and corporate income taxes, and a lower VAT rate, once the non-oil tax base has been further expanded.

Azerbaijan: Estimates of VAT Revenue Losses, 2006–07 1/

| | 2006 | 2007 |
|--|------|-------|
| Actual VAT and simplified tax revenues | | |
| In millions of manat | 766 | 1,226 |
| In percent of non-oil GDP | 8.9 | 11.0 |
| Revenue loss due to exemptions 2/ | | |
| In millions of manat | 381 | 504 |
| In percent of non-oil GDP | 4.4 | 4.5 |
| Revenue losses excluding exemptions | | |
| In millions of manat | 209 | 63 |
| In percent of non-oil GDP | 2.4 | 0.6 |

Source: Azerbaijan authorities data; and Fund staff estimates.

1/ Fund staff estimates based on the authorities' data.

2/ The estimated exemption rate of 29.4 percent was provided by the Ministry of Taxes.

Azerbaijan: Estimates of Customs Duties Losses, 2006–07 1/

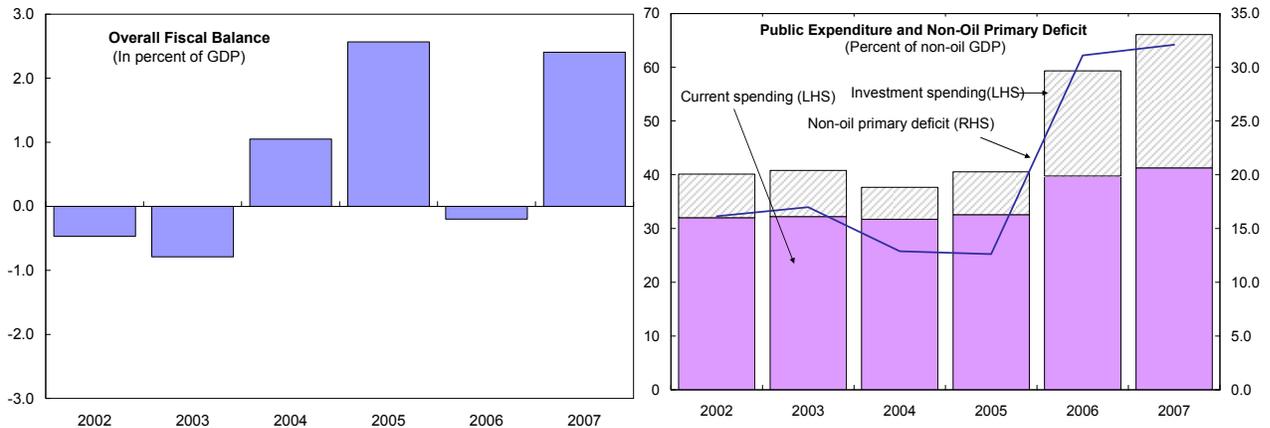
| | 2006 | 2007 |
|---|------|------|
| Actual import duty revenue | | |
| In millions of manat | 139 | 159 |
| In percent of non-oil GDP | 1.6 | 1.4 |
| Estimated revenue losses due to exemptions 2/ | | |
| In millions of manat | 36 | 49 |
| In percent of non-oil GDP | 0.4 | 0.4 |
| Estimated revenue losses excluding exemptions | | |
| In millions of manat | 62 | 109 |
| In percent of non-oil GDP | 0.7 | 1.0 |

Source: Azerbaijan authorities; data and Fund staff estimates.

1/ Fund staff estimates based on the authorities' data.

2/ The exemption rate (18.2 percent) and the average statutory rate (5.7 percent) were provided by the customs officials.

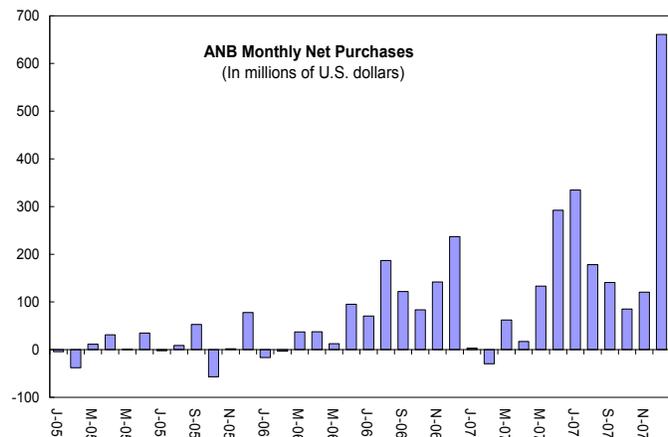
Tax credits to the state oil and energy companies were reduced, reflecting increased energy prices and better collection rates. Yet, the government was unable to make a comprehensive assessment of the quasi-fiscal activities of the large state-owned enterprises (SOEs), since their economic and financial operations in 2007 were not adequately monitored. Staff estimates the implicit energy subsidies at about 15 percent of non-oil GDP, because of an increasing gap between domestic energy prices and world prices since the January 2007 adjustment.



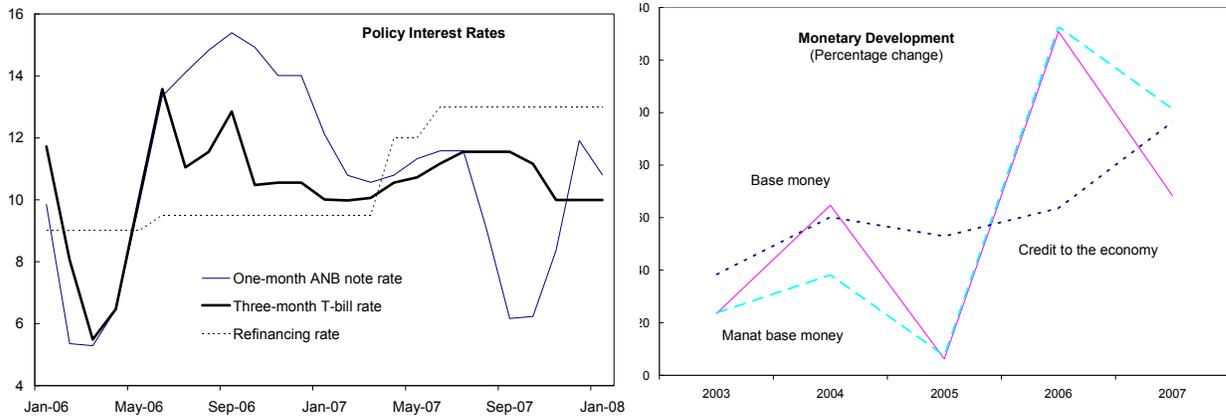
8. Policy coordination problems and limited operational independence at the ANB constrained the monetary policy response to the fiscal-induced overheating.

In the context of a de facto slowly appreciating crawling peg to the dollar, the pace of manat

appreciation was lower than originally envisaged by the authorities. The ANB established a new interest rate corridor to provide a better signaling mechanism, but policy interest rates remained negative in real terms. The ANB bought from the government about US\$2 billion in 2007—of which one third in December—and sterilized only a fraction of the currency issued in exchange, leading to about 100 percent increase in manat base money. There is



little evidence that the July 2007 removal of restrictions on capital outflows to OECD countries had the intended effect of mitigating the monetary expansion. Abundant liquidity and increasing foreign borrowing by banks, boosted an accelerating credit expansion (Tables 5 and 6).



9. **In March 2008, the ANB announced the introduction of a new exchange rate arrangement aimed at stabilizing the manat nominal effective exchange rate.** The manat is now pegged to a dollar/euro currency basket, in which the weight of the euro will gradually increase. The basket peg and the envisaged weight adjustments are aimed at mitigating imported inflation.

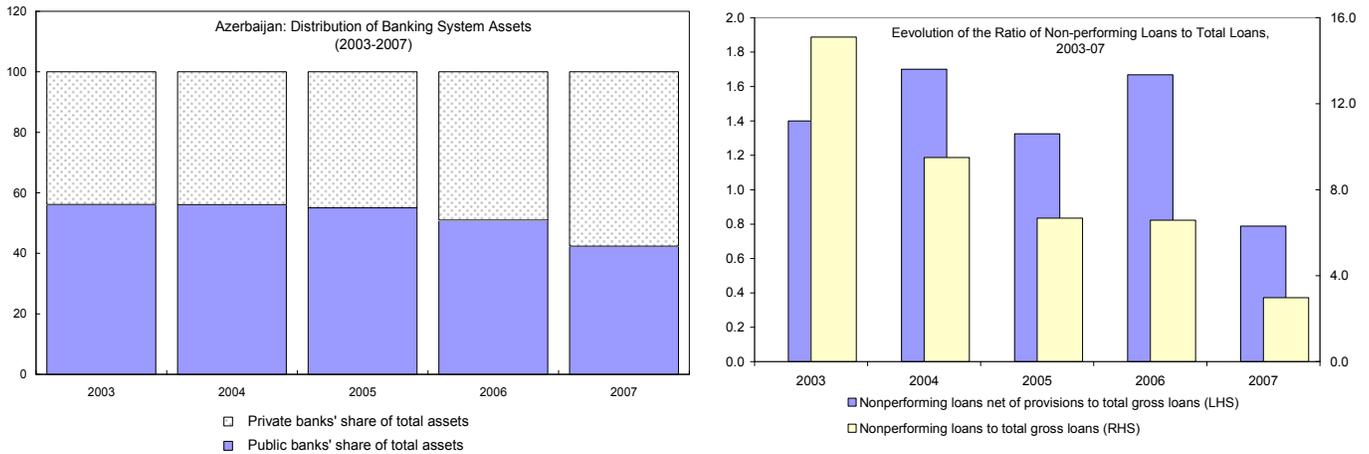
10. **Banks' prudential indicators improved and supervision strengthened in 2007, but credit risks intensified and some structural weaknesses of the banking system persisted** (Table 7 and Box 2). Deposits and assets concentration at the largest bank -state-owned International Bank of Azerbaijan (IBA)—declined, but is still high. The new deposit insurance scheme covers 37 out of 46 banks and is strengthening depositors' confidence. At end-2007, all banks met the 12 percent regulatory risk-weighted capital adequacy requirement. However, credit to the economy almost doubled in 2007, creating new risks.

11. **The financial system is underdeveloped, providing few long-term instruments for savers and investors.** The limited stock exchange activity is concentrated in treasury bills and ANB notes. Government bonds are issued with a maximum one-year maturity. In the absence of a yield curve, the corporate bond market is very thin, limiting funding choices for companies. With no domestic mutual or private pension funds and minimal life insurance, the government and corporate bonds market is illiquid. For individuals, there are virtually no domestic savings products beyond bank accounts—currently providing negative real returns—and real estate.

12. **Structural reforms to promote a competitive non-oil sector remain slow, but WTO accession plans are driving new efforts.** The one-stop facility for business registration is now operational, facilitating the establishment of new companies. Licensing requirements, though, remain heavy and unregulated, and governance issues—particularly in customs—are quoted by business as major impediments. Parliamentary approval of important bills to strengthen governance and the business environment (e.g. anti-monopoly, investment, and AML/CFT laws) has been pending for more than a year. Nonetheless, ongoing work to upgrade legislation in line with WTO rules in areas such as customs and technical standards and specifications is expected to improve the business environment.

Box 2. Banking Sector Developments

Azerbaijan's banking sector has registered stunning growth in recent years. The degree of monetization, measured as the ratio of broad money to non-oil GDP, has doubled in the past two years. Banking sector credit to the economy has expanded by more than 50 percent per year since 2004; it grew by 96 percent in 2007. Private banks have grown faster than state-owned banks, and accounted for 58 percent of total assets at end-2007, from 45 percent two years ago.



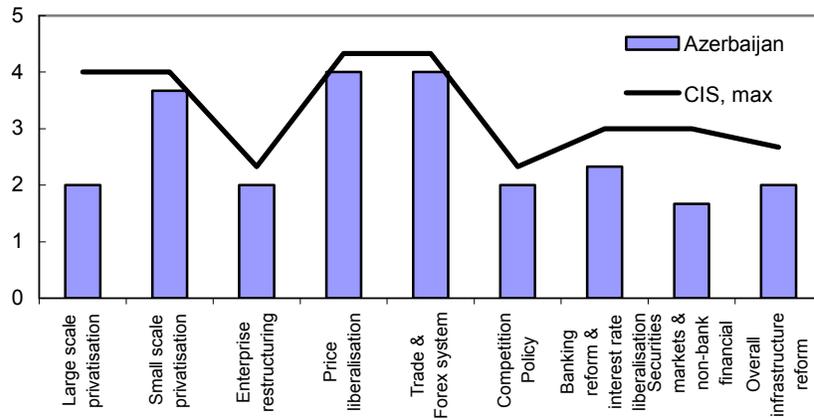
The officially reported soundness indicators and compliance with prudential regulations generally improved in 2007. All banks met the capital adequacy requirement at end-2007, including the two state-owned banks.¹ Nonperforming loan (NPL) ratios declined significantly, largely reflecting a doubling of credit outstanding during the year. There was no bank violating the limit on net open foreign exchange position at end-2007. In addition, the authorities' stress test shows that the banking system is resilient to interest rate and exchange rate shocks of moderate magnitude.

However, the current credit boom poses risks to the banking sector. Rapid credit expansion coupled with limited risk management capacity may lead to a lagged deterioration in the quality of banks' portfolios. The risks could intensify in a couple of years when the economic activity is projected to slow down. Discussions with the ANB and commercial banks also revealed that the banking sector is highly exposed to the property sector through lending to the construction sector and using property as collateral for other loans. Furthermore, a few banks may face liquidity risks as they funded new credit in 2007 partially through external borrowing that needs to be refinanced in 2008, although the scale of foreign borrowing was constrained by the tightening global liquidity conditions in the latter part of the year.

The ANB has moved to take prudential and other measures to address increasing risks. Measures in the pipeline include: (i) introducing reserve requirements on foreign borrowing; (ii) tightening asset classification standards and raising provisioning requirements for NPLs; (iii) restricting the use of subordinate debt in meeting the capital adequacy requirements; iv) increasing the risk weight for mortgage loans and toughening the criteria for collateralized loans. Moreover, the ANB reviewed banks' risk management systems, carried out more targeted inspections, and pushed banks to reduce credit growth targets.

¹ IBA increased its capital base partly by issuing subordinated debt in international capital market. Kapital Bank doubled its capital by selling 50 percent of its share to three private companies; it plans to sell the remaining state shares by mid-2008.

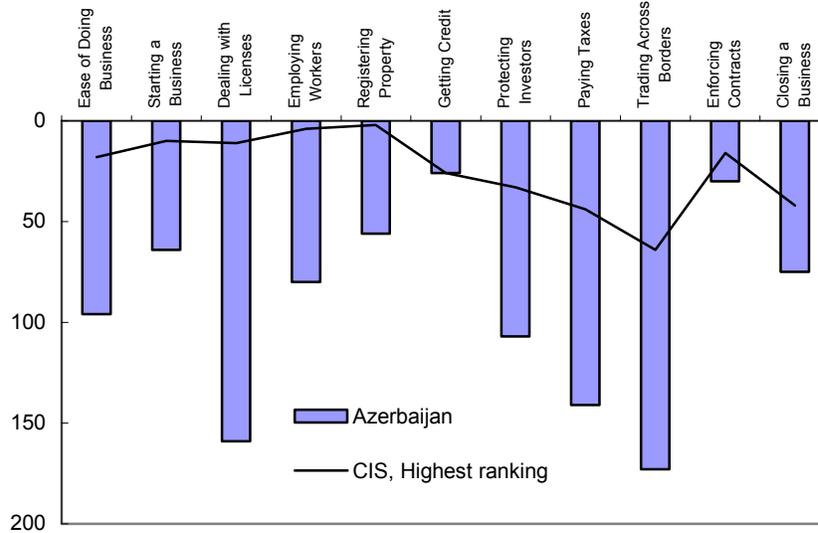
Transition Indicators, 2007 1/



Source: EBRD Transition Indicators database.

1/ The transition indicators range from 1 to 4+, with 1 representing little or no change from a rigid, centrally planned economy, and 4+ representing the standards of an industrialized market economy.

Doing Business Report Rankings 1/

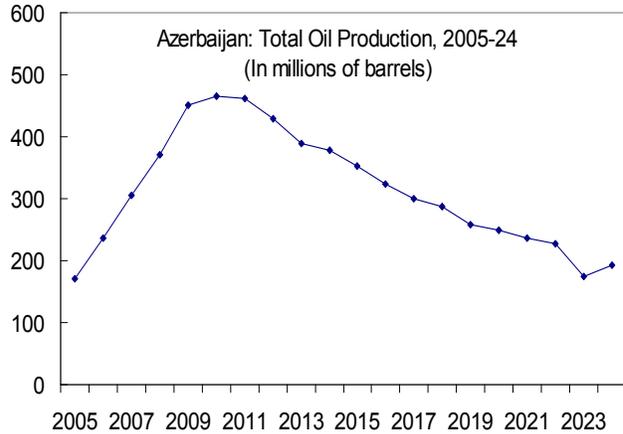


Source: World Bank Doing Business 2008 report, covering the period April 2006 to June 2007.

1/ Economies are ranked on their ease of doing business, from 1 – 178, with first place being the best. A high ranking on the ease of doing business index means the regulatory environment is conducive to the operation of business.

III. OUTLOOK

13. **Azerbaijan’s short- and medium-term economic prospects remain strongly dependent on oil sector developments, and on how the authorities manage the related opportunities and challenges.** The main risk to the outlook is a major downward correction in oil prices, although unlikely in the short term. However, if loose macroeconomic policies continue, high-inflation expectations would become entrenched, damaging the prospects for robust long-term non-oil growth, and eroding achievements in poverty reduction. The government’s projects to address infrastructure needs, particularly in energy and transportation, if efficiently executed, would help strengthen the basis for the development of a competitive non-oil sector.



A. Short-Term

14. **The growth and external outlook for 2008 remains strong,** with overall growth projected at 18½ percent. Non-oil growth—driven by large public expenditure—would moderate to a still high 9 percent. The current account surplus would rise to 40 percent of GDP, reflecting higher oil export volumes and prices. Oil fund assets and international reserves are projected to more than triple from end-2007, to reach \$25 billion at end 2008—about 50 percent of projected GDP.

15. **Large public spending plans are expected to keep aggregate demand and inflation high in 2008.**² Massive increases in oil revenue underpin a projected overall fiscal surplus of 29 percent of GDP, matched by a major accumulation of oil fund assets. Despite buoyant non-oil revenue, the non-oil primary deficit would worsen by 7 percentage points of non-oil GDP to reach 39 percent, reflecting pension and wage increases of about 40 percent and a 55 percent rise in investment. Heightened aggregate demand would keep inflation close to 20 percent.

16. **The implementation of the currency basket arrangement should help limit the impact of imported inflation,** by containing the inflationary effect of import price increases triggered by the depreciation of the dollar against other major currencies. Preparing the ground for more flexibility in the future, the new arrangement will also help address the current undervaluation of the manat (Box 3).

² The 2008 projections are based on the budget and staff’s assessment of preliminary plans for a mid-year supplementary budget.

Box 3. Exchange Rate Assessment for Azerbaijan

The macroeconomic balance (MB) approach indicates that Azerbaijan’s real exchange rate is moderately undervalued.

The MB approach estimates how much the real effective exchange rate (REER) would have to adjust from the prevailing level to move the current account into positions consistent with medium-term equilibrium—the current account norm. Based on the CGER panel regression coefficients, Azerbaijan’s underlying current account surplus is above the norm by about 7 percent of GDP in 2013.¹ This suggests a current REER undervaluation of about 16 percent.

Azerbaijan: Macroeconomic Balance Approach to Exchange Rate Assessment
(In percent of GDP, unless indicated otherwise)

| | 2013 |
|--|-------|
| Fundamental variables for Azerbaijan | |
| Fiscal balance | -10.7 |
| Old age dependency 1/ | 13.0 |
| Population growth (percentage change) | 0.8 |
| Initial NFA | -7.6 |
| Oil balance | 27.7 |
| Output growth (percentage change) | -3.4 |
| Relative Income 2/ | 19.8 |
| Current account norm | 7.2 |
| Projected current account balance 3/ | 0.9 |
| Underlying current account balance 4/ | 14.6 |
| Misalignment (percent, - indicates undervaluation) | -16.1 |

Sources: Fund staff estimates and projections.

1/ Ratio of population above 65 to prime-age population between 24 and 64.

2/ Ratio of per-capita PPP income to the U.S. level.

3/ According to the baseline projections, which assume real appreciation in the medium term.

4/ The baseline projection is adjusted upward by excluding the assumed real appreciation.

For a country like Azerbaijan, which is undergoing a temporary oil production boom, the standard MB approach does not provide a very robust valuation of the currency. Given Azerbaijan’s oil production profile, the country is bound to register sizable underlying current account surpluses during the peak production years. However, looking beyond the peak production years, Azerbaijan’s underlying current account balance will decline sharply, as exemplified by a fall in the current account surplus from 12 percent of GDP in 2012 to below 1 percent in 2013. A one-year extension in the timeframe of the analysis to 2014 would entail a further decline of the underlying current account, taking it closer to the norm and substantially reducing the measured degree of exchange rate undervaluation. Moreover, a significant portion of the current account surplus is to be accumulated in the state oil fund, reflecting the need to save the oil wealth to achieve intergenerational equity. Thus any normative analysis must allow for this temporary buildup in reserves. Allowing for Azerbaijan’s particular situation, the assessed magnitude of exchange rate undervaluation does not represent an exchange rate misalignment.

Alternative approaches to exchange rate assessment. Data deficiency precludes the application of the equilibrium real exchange rate approach, and the external sustainability approach suffers the same bias as the MB approach. The purchasing power parity approach, which relies solely on the relationship between relative prices and incomes per capita, indicates that Azerbaijan’s REER was undervalued by about 15 percent in 2007.

¹ Based on the baseline medium-term projections. Following the CGER exercise, the 2013 values of the fundamental variables for Azerbaijan and its trading partners are used to compute the norm. See Methodology for CGER Exchange Rate Assessments, IMF, November 2006.

B. Medium- and Long-Term

17. The staff discussed with the authorities a “baseline” scenario that assumes continued large expenditure increase (Table 8).³ The annual rate of expansion of public spending is projected to slow down over the medium term compared with recent years but will remain at about 30 percent, to support rapid increases in living standards and improved infrastructure. Pressures for continued real wage and pension increases would entrench a wage-price spiral and keep inflation high. High spending would initially support non-oil growth. But persistent inflation and rising labor costs would discourage private sector investment, causing non-oil growth to decelerate to below 5 percent by 2013. Although high oil price projections push forward the fiscal sustainability constraint, and both public and external debt-to-GDP ratios are projected to decline over the medium term (Tables 9 and 10), the rising non-oil deficit would start denting oil fund assets in 2012–2013.

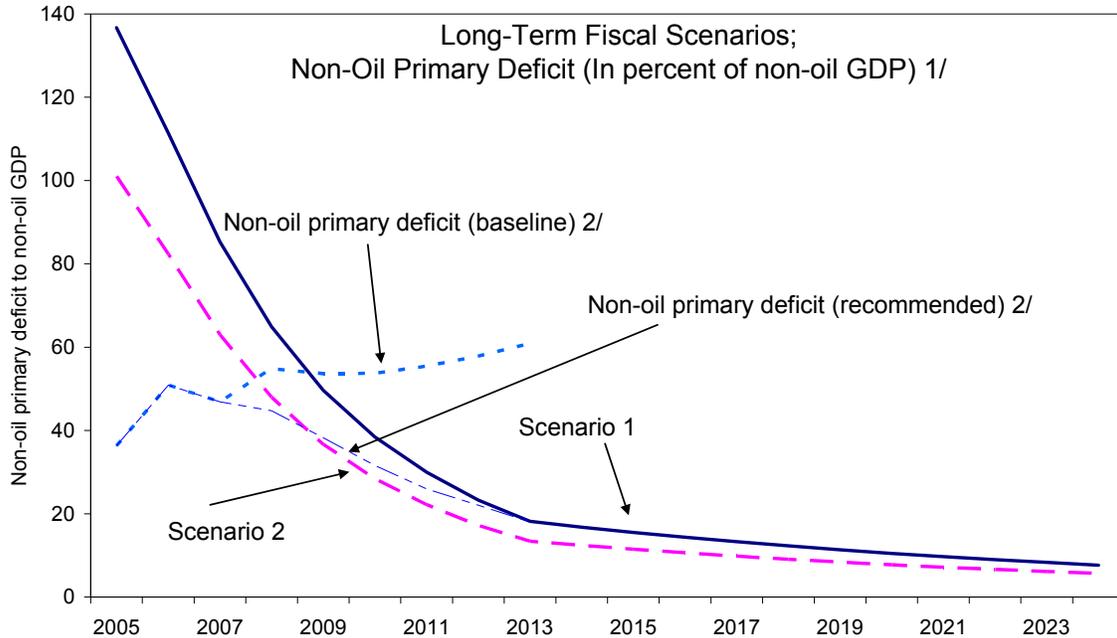
Eventually, in the absence of significant fiscal correction before the mid of the decade, an unsustainable debt dynamics would kick in.

| Azerbaijan: Fiscal Developments under the Baseline Scenario 1/ | | | | |
|--|-----------------------------|-------|-------|-------|
| | 2007 | 2008 | 2010 | 2012 |
| | Prel. | | Proj. | |
| | (In percent of GDP) | | | |
| Overall fiscal balance | 2.4 | 29.1 | 24.0 | 2.6 |
| Non-oil primary balance | -13.3 | -14.0 | -18.8 | -28.9 |
| Current expenditure | 17.1 | 15.4 | 20.2 | 30.3 |
| Capital expenditure | 10.3 | 10.6 | 12.7 | 16.7 |
| Est. implicit fuel subsidies | 6.1 | 5.7 | 4.2 | 3.5 |
| Oil Fund Assets | 9.6 | 37.2 | 76.3 | 72.4 |
| | (In percent of non-oil GDP) | | | |
| Non-oil primary balance | -32.1 | -39.0 | -43.9 | -51.7 |
| Current expenditure | 41.3 | 42.8 | 47.2 | 54.2 |
| Capital expenditure | 24.8 | 29.6 | 29.7 | 30.0 |
| <i>Memorandum items</i> | (percentage change) | | | |
| Real GDP | 23.4 | 18.6 | 4.8 | -1.7 |
| Real Non-oil GDP | 11.5 | 9.0 | 6.0 | 5.0 |
| CPI (end of period) | 19.5 | 22.0 | 19.0 | 19.0 |

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

1/ Under the baseline scenario, the pace of spending increase is projected to slow down to 30 percent a year starting in 2009. Current spending is assumed to grow faster than investment because of the higher impact of inflation on wages and transfers.

³ The scenario is based on the assumption of unchanged policies. Although the authorities have mentioned their intention to slow down expenditure increases starting in 2009, they have not yet prepared a medium-term fiscal framework consistent with this intention.



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

1/ Scenario 1: Sustainable primary non-oil deficit to non-oil GDP (WEO, February 27, 2008 oil prices up to 2013; constant at the 2013 WEO projected level for 2014-2024).

Scenario 2: Sustainable primary non-oil deficit to non-oil GDP (oil price at US\$70 per barrel from 2008).

2/ According to a broader definition of the primary non-oil deficit (including estimates of implicit subsidies).

18. More moderate public expenditure increases would be consistent with lower inflation and long-term fiscal sustainability (Table 11).

Staff presented an alternative scenario, where the government would implement in 2008 a more moderate fiscal expansion than envisaged and then gradually tighten the fiscal stance over the medium term. Budget execution in 2008 would focus on the completion of existing projects, while the government would work to strengthen public expenditure management. Wage and pension outlays would be kept at the original budget level, and spending for goods and services would be reduced. The ANB would allow a faster exchange rate appreciation and convert a smaller amount of oil revenue dollars, lowering base money and credit growth. Aggregate demand would moderate and inflation would start declining. Gradual but continued reduction in the non-oil primary deficit to non-oil GDP ratio in the outer years would set up a virtuous cycle of disinflation and reduced real appreciation, with beneficial effect on private non-oil investment and competitiveness. The government would accumulate much higher financial assets in the oil fund and meet the

Azerbaijan: Fiscal Developments under the Alternative Scenario 1/

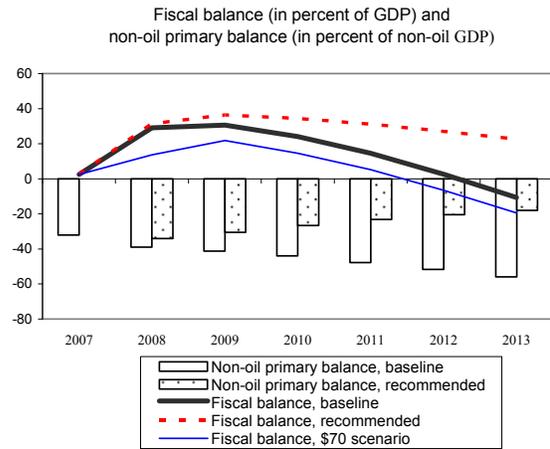
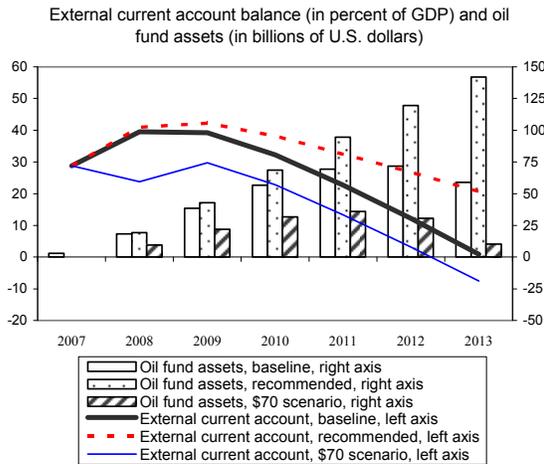
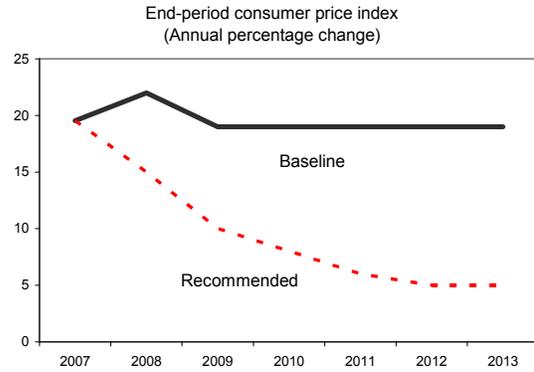
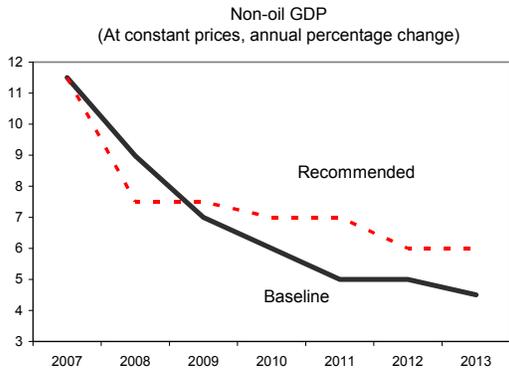
| | 2007 | 2008 | 2010 | 2012 |
|---|-------|-------|-------|-------|
| | Prel. | | Proj. | |
| (In percent of GDP) | | | | |
| Overall fiscal balance | 2.4 | 31.4 | 34.4 | 27.1 |
| Non-oil primary balance | -13.3 | -12.0 | -10.3 | -9.5 |
| Current expenditure | 17.1 | 14.8 | 14.4 | 15.4 |
| Capital expenditure | 10.3 | 9.4 | 9.1 | 9.7 |
| Est. implicit fuel subsidies | 6.1 | 3.8 | 1.9 | 0.8 |
| Oil Fund Assets | 9.6 | 39.6 | 93.5 | 128.2 |
| (In percent of non-oil GDP) | | | | |
| Non-oil primary balance | -32.1 | -34.0 | -26.6 | -20.4 |
| Current expenditure | 41.3 | 42.2 | 37.1 | 33.1 |
| Capital expenditure | 24.8 | 26.7 | 23.6 | 20.9 |
| <i>Memorandum items</i> (Percentage change) | | | | |
| Real GDP | 23.4 | 17.8 | 5.2 | -1.2 |
| Real Non-oil GDP | 11.5 | 7.5 | 7.0 | 6.0 |
| CPI (end of period) | 19.5 | 15.0 | 8.0 | 5.0 |

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

1/ Under the alternative scenario, upfront fiscal moderation and gradual consolidation over the medium-term support declining inflation and allow for faster accumulation of oil fund assets, in line with the authorities' long term oil revenue management strategy.

fiscal sustainability constraint reflected in its long-term oil revenue management strategy in each of the projection years.

Azerbaijan: Medium-Term Macroeconomic Scenarios, 2007-13



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

IV. THE AUTHORITIES' VIEWS

A. Macroeconomic Policy Mix to Reduce Inflation

19. **Although they consider inflation uncomfortably high, the authorities do not plan to reduce the pace of public spending in 2008.** They see the 2007 inflation outcome as exceptional, reflecting the early 2007 energy price increases and the rise in international commodity prices, as well as the fiscal expansion. Their short-term concerns with high inflation still give way to the importance they attach to using the oil wealth early on to improve living standards and critical infrastructure. The mid-year supplementary budget will thus include allocations for pension increases and accommodate the rising costs of imported inputs for investment projects. The authorities noted that the recent introduction of the new VAT bank accounts is likely to raise VAT collection above projections, with a cooling effect on aggregate demand.⁴

20. **The government agreed that, going forward, fiscal moderation and better policy coordination are necessary to reduce inflation and achieve long-term growth and fiscal sustainability.** Progress toward establishing a medium-term macroeconomic framework has been made with the establishment of a macroeconomic coordination committee comprising the main economic policy makers. The authorities intend to prepare the 2009 budget in the context of a coherent medium-term framework.

21. **The currency basket arrangement will be used to limit imported inflation.** The authorities conceded that last year a slow pace of appreciation against the dollar added to the inflation dynamics. They see the new basket peg as an effective tool in containing imported inflation, with the manat appreciating faster versus the U.S. dollar under current conditions. They also stressed that by creating the possibility of two-way movements in the manat/dollar exchange rate, the new arrangement will help develop the foreign exchange market, and encourage the introduction of hedging instruments. The ANB sees a more developed and deeper foreign exchange market as a precondition toward greater exchange rate flexibility to be pursued over time.

22. **Though real appreciation pressures continue, the authorities consider the undervaluation of the manat to be moderate and a temporary phenomenon.** They noted that a relatively short oil-production horizon in Azerbaijan justifies their intention to limit nominal appreciation at this juncture of booming oil exports so as to avoid the need for abrupt depreciation when oil production declines sharply.

⁴ The new system, aimed at reducing fraud, requires registered VAT taxpayers to maintain a sub-account with the ANB through which all VAT transactions (output and input taxes) must pass. Monthly net VAT liabilities must be paid from this account.

23. **The ANB does not plan to use interest rates actively to respond to inflation because of a weak transmission mechanism and fears of speculative capital flows.** There is no intention to raise policy rates significantly in the short term, despite negative real interest rates. The authorities emphasized that liquidity conditions in the system are cyclical and largely linked to tax payments and government spending and do not respond effectively to interest rate changes. Moreover, appreciation pressures on the manat and large interest rate differentials with partner countries are already attracting short-term speculative flows, which the ANB intends to contain.

B. Improving the Quality and Efficiency of Public Expenditures

24. **The government recognized that the high pace of spending is undermining the quality and efficiency of public projects.** Line ministers have therefore been instructed to complete existing projects, before they can initiate new ones. With assistance from development partners, the government is also building up domestic capacity to conduct cost-benefit analysis for project proposals. Moreover, some large projects co-financed by the World Bank and other IFIs are subject to higher standards both at the preparation and execution stage; this will help strengthen project management capacity in the administration.

25. **The adoption of IFRS accounting starting in 2008 will enhance the transparency of SOEs' operations and their financial discipline.** The authorities reported that all large SOEs have submitted their 2008 budget plans for vetting to the ministry of finance. A few SOEs need to provide clarifications on their spending plans, but the majority of the SOEs' budgets have already been vetted. The government has also adopted a schedule for intra-year monitoring of individual enterprises' budget execution. These measures are expected to increase SOEs' financial discipline and accountability.

C. Strengthening the Financial System

26. **The authorities are well aware of the structural weaknesses of the banking system and will continue to address them.** The privatization of Kapital Bank will be completed in 2008 and, on the basis of that experience, the authorities will prepare plans for privatizing IBA. They also expect the minimum capital requirement introduced in 2007 to help consolidate the banking system and increase efficiency. A few large international banks have already set up representative offices in Azerbaijan and may decide to establish branches or subsidiaries. The authorities welcome enhanced foreign participation in the banking system to promote competition and the adoption of international best practices.

27. **The ANB is taking sound supervisory measures to contain the risks from the sharp increase in bank lending.** The authorities shared staff's concerns that the rapid credit expansion makes deterioration in credit quality probable, especially during economic downturns. They consider the measures already taken and those in the pipeline as adequate to contain systemic risks. The ANB noted that its capacity to operate risk-based supervision is

strengthening and that recent increase in ANB salaries will improve staff retention, namely skilled supervisors.

28. **The authorities agreed on the importance of developing other sectors of the financial system, including the bond, insurance, and private pension markets.** The government is keen to encourage the development of a deeper financial system and is considering the issuance of longer term bonds to help establish a yield curve and support the development of the corporate bond market. However, the authorities are concerned that the interest rate levels needed to make longer-term bonds attractive domestically would draw additional foreign speculative flows and complicate further macroeconomic management.

V. STAFF APPRAISAL

29. **Azerbaijan's economic prospects are favorable, but sustainable improvements in economic conditions require cautious management.** The impressive progress in living standards of the last few years is a major achievement, but it is at risk if the upward inflation trend persists. While inflationary pressures have emerged globally, the inflation dynamics in Azerbaijan has been particularly rapid. Macroeconomic policy should be adjusted promptly to prevent high inflation expectations from becoming entrenched, driving the nascent wage-price spiral, and inflicting serious damage on long-term growth prospects.

30. **Given strong fiscal dominance, successful disinflation requires fiscal adjustment.** An adjustment process that allows for continuous but moderate increases in real public spending would still allow for higher living standards and a gradual upgrade of productive infrastructure. Given the current high inflation environment, the government needs to move determinedly to establish its anti-inflation credentials. Efforts at moderating the 2008 fiscal expansion and fiscal tightening in 2009 would send a credible signal.

31. **The adjustment should focus on reducing the pace of expenditure increases.** Although strong tax administration will help keep non-oil taxes buoyant, an adjustment in the pace of expenditure is critical to cool down aggregate demand in an economy where the supply response is limited. A successful moderation in expenditure and further achievements with broadening the tax base would eventually provide space for reducing tax rates and support the authorities' objective of promoting the development of a competitive non-oil private sector.

32. **Expenditure moderation would also help address increasing problems with the quality and efficiency of public spending, particularly investment.** The extraordinary increase in investment spending since 2005 calls for the urgent establishment of effective institutional mechanisms to ensure proper planning execution and monitoring of public projects. The adoption of a comprehensive medium-term expenditure framework (MTEF) in the context of the 2009 budget—consistent with medium-term macroeconomic stability—would be a major step. An adequate MTEF should reflect transparently the government's

priority, the cost-benefits of projects, and their recurrent maintenance costs. Institutional improvements in the areas of internal auditing and public procurement and the adoption of international public sector accounting standards would enhance accountability and value for money.

33. **In a similar vein, a better monitoring of SOEs' operations is needed.** The largest SOEs can have significant impact on aggregate demand. To ensure that their operations are consistent with the government's macroeconomic objectives, the corporate governance of the largest enterprises should be strengthened. Following on the 2005 OECD guidelines for best practices in managing commercially oriented SOEs, it is critical to separate the commercial and regulatory functions of SOEs—particularly utilities. In addition, SOEs' decision-making process should become more transparent and the chain of accountability of managers should be clarified.

34. **Monetary and exchange rate policy needs to be used actively to fight inflation.** Staff welcomes the adoption of the new currency basket arrangement and encourages the authorities to use it more actively to fight inflation, particularly given that interest rate changes have limited effect on aggregate demand. The authorities should consider allowing the manat appreciate against the basket in case of continued inflationary pressures.

35. **The real exchange rate appears to be moderately undervalued.** However, allowing for the temporary nature of the current oil production boom, the undervaluation should be less than what the standard approaches indicate. As long as real appreciation pressures persist in the medium term, the authorities should consider introducing more flexibility in the new basket peg to prevent the real appreciation from materializing mostly through high inflation.

36. **Completing the state's disengagement from bank ownership is necessary to create a level playing field and strengthen competition in the banking system.** Once the privatization of Kapital Banka is finalized, the government should proceed to prepare the privatization of IBA. A transparent sale process for this systemically important bank is of utmost importance for the sound development of the banking system.

37. **The ANB's supervisory measures are welcome, but substantial risks remain.** Stronger enforcement of the current and planned prudential measures would help contain risks. To anticipate the likely increase in the proportion of nonperforming loans, the ANB should consider raising the general provision for collateralised loans—currently at 2 percent—in recognition of difficulties in claiming collateral. A higher risk-weight for foreign currency loans to customers whose income is in manat would also be a sound prudential measure.

38. **Government support for capital market development is needed,** mainly through the issuance of government bonds of varying maturities to establish a yield curve as the basis

for pricing corporate debt. The participation of institutional investors could be further encouraged by changes to the law to allow the development of mutual funds. Full implementation of the requirement on larger companies to follow IFRS accounting would bring transparency in corporate financial statements and support the development of the equity and bond markets.

39. **The implementation of a coherent structural reform agenda is critical to promote strong non-oil growth over the medium term.** Strong market concentration in several sectors of the economy indicates that there are informal obstacles to competition, which need to be addressed. The WTO accession process is providing a useful framework for reforms. A priority should be the envisaged reform of customs legislation and administrative practices, including regulations for customs valuation, a simplified tariff schedule, and the introduction of a single document for custom clearance. Progress in these areas would help reduce nontariff barriers to imports and increase the supply response of sectors currently shielded from competition.

40. It is proposed that Azerbaijan remains on a 12-month consultation cycle.

Table 1. Azerbaijan: Selected Economic and Financial Indicators, 2004–08

| | 2004 | 2005 | 2006 | Prel. 2007 | Proj. 2008 |
|---|--|--------|--------|---------------|---------------|
| | (Annual percentage change, unless otherwise specified) | | | | |
| National income | | | | | |
| GDP at current prices | 19.4 | 46.8 | 49.7 | 43.4 | 49.5 |
| GDP at constant prices | 10.4 | 24.3 | 30.5 | 23.4 | 18.6 |
| Oil GDP | 2.5 | 65.4 | 62.0 | 37.3 | 27.7 |
| Non-oil GDP 1/ | 13.8 | 8.4 | 11.9 | 11.5 | 9.0 |
| Implicit GDP deflator | 8.1 | 18.1 | 14.7 | 16.2 | 26.1 |
| Consumer price index (end-period) | 10.4 | 5.5 | 11.4 | 19.5 | 22.0 |
| Consumer price index (period average) | 6.7 | 9.7 | 8.4 | 16.6 | 19.6 |
| Consolidated central government finance | | | | | |
| Total revenue | 20.0 | 36.9 | 67.5 | 51.5 | 178.8 |
| Of which: non-oil revenue | 29.1 | 34.9 | 34.5 | 43.2 | 27.6 |
| Total expenditure | 8.3 | 28.7 | 80.9 | 43.3 | 42.4 |
| Of which: current expenditure | 15.4 | 22.8 | 50.9 | 33.5 | 34.8 |
| investment expenditure | -18.6 | 59.9 | 203.6 | 63.1 | 55.0 |
| Money and credit | | | | | |
| Net foreign assets | 47.9 | 7.5 | 89.3 | 46.9 | 75.0 |
| Net domestic assets | 46.9 | 47.9 | 82.7 | 106.4 | 65.2 |
| Credit to the economy | 60.2 | 53.0 | 63.6 | 96.5 | 55.0 |
| Manat base money | 38.2 | 7.5 | 132.6 | 101.4 | 68.3 |
| Broad money | 47.5 | 22.1 | 86.4 | 72.4 | 70.0 |
| Foreign currency deposits ratio to broad money | 54.5 | 56.9 | 37.9 | 25.4 | 17.9 |
| Velocity of broad money (M3) 2/ | 6.3 | 5.2 | 4.8 | 3.5 | 2.8 |
| External sector (in U.S. dollars) | | | | | |
| Exports f.o.b. | 42.6 | 104.4 | 70.1 | 63.1 | 57.3 |
| Of which: oil sector | 43.6 | 113.0 | 75.4 | 66.5 | 59.7 |
| Imports f.o.b. | 31.5 | 21.4 | 21.1 | 14.1 | 30.4 |
| Of which: oil sector | 46.5 | 18.7 | -9.1 | -25.8 | -25.5 |
| Export volumes | 10.3 | 47.8 | 41.0 | 47.1 | 19.5 |
| Import volumes | 17.8 | 15.6 | 9.8 | 2.5 | 22.1 |
| Terms of trade | 13.9 | 17.0 | 11.6 | 4.3 | 23.3 |
| Real effective exchange rate (- deprec.) | -3.8 | 6.3 | 8.7 | 8.8 | ... |
| | (In percent of GDP, unless otherwise specified) | | | | |
| Gross investment | 58.0 | 41.5 | 29.9 | 20.4 | 16.3 |
| Consolidated government | 3.9 | 4.1 | 8.6 | 10.3 | 10.6 |
| Private sector | 54.1 | 37.4 | 21.2 | 10.2 | 5.6 |
| Of which: oil sector | 38.5 | 17.6 | 7.8 | 3.7 | 1.5 |
| Gross national savings | 28.2 | 42.8 | 47.6 | 49.2 | 55.8 |
| Consolidated government | 5.1 | 7.0 | 8.8 | 12.7 | 39.7 |
| Private sector 3/ | 23.0 | 35.8 | 38.7 | 36.5 | 16.1 |
| Consolidated central government finance | | | | | |
| Overall fiscal balance | 1.0 | 2.6 | -0.2 | 2.4 | 29.1 |
| Non-oil primary balance, in percent of non-oil GDP | -12.9 | -12.6 | -31.1 | -32.1 | -39.0 |
| Implicit energy subsidies, in percent of non-oil GDP | 20.1 | 23.5 | 19.8 | 14.8 | 15.9 |
| External sector | | | | | |
| Current account (- deficit) | -29.8 | 1.3 | 17.7 | 28.8 | 39.5 |
| Foreign direct investment (net) | 26.8 | 3.5 | -6.2 | -16.6 | -4.1 |
| Public and publicly guaranteed external debt | 18.5 | 12.5 | 9.4 | 8.1 | 7.5 |
| Memorandum items: | | | | | |
| Nominal GDP (in millions of manats) | 8,530 | 12,523 | 18,746 | 26,884 | 40,204 |
| Nominal non-oil GDP (in millions of manats) 1/ | 5,858 | 7,002 | 8,655 | 11,131 | 14,462 |
| Population (mid-year, in millions) | 8.3 | 8.4 | 8.5 | 8.6 | 8.6 |
| Nominal GDP per capita (in U.S. dollars) | 1,040 | 1,574 | 2,469 | 3,663 | 5,689 |
| Gross official international reserves (in millions of U.S. dollars) | 1,075 | 1,178 | 2,500 | 4,273 | 7,410 |
| Oil Fund assets (in millions of U.S. dollars) 4/ | 972 | 1,394 | 1,869 | 3,019 | 18,241 |
| Exchange rate (manat/dollar, end-of-period) | 0.981 | 0.919 | 0.871 | 0.845 | ... |

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

1/ Includes oil and gas transportation.

2/ Defined as gross domestic demand (excluding oil sector-related imports) divided by average broad money.

3/ The historical data include the statistical discrepancy.

4/ Includes the central government's foreign exchange deposits managed by the Oil Fund.

Table 2. Azerbaijan: Balance of Payments, 2004–08
(In millions of U.S. dollars, unless otherwise specified)

| | 2004 | 2005 | 2006 | Prel. 2007 | Proj. 2008 |
|---|--------|--------|--------|---------------|---------------|
| Exports, f.o.b. | 3,743 | 7,649 | 13,015 | 21,230 | 33,398 |
| Oil sector | 3,232 | 6,883 | 12,075 | 20,100 | 32,094 |
| Other | 511 | 766 | 939 | 1,130 | 1,305 |
| Imports, f.o.b. | -3,582 | -4,350 | -5,269 | -6,010 | -7,840 |
| Oil sector | -1,624 | -1,927 | -1,752 | -1,300 | -968 |
| Other | -1,958 | -2,423 | -3,517 | -4,710 | -6,871 |
| Trade balance | 161 | 3,299 | 7,745 | 15,220 | 25,558 |
| Services, net | -2,238 | -1,970 | -1,923 | -2,130 | -1,506 |
| Credit | 492 | 683 | 940 | 1,250 | 1,979 |
| Debit | -2,730 | -2,653 | -2,863 | -3,380 | -3,485 |
| <i>Of which</i> : oil sector | -1,909 | -1,658 | -1,602 | -1,839 | -1,167 |
| Income | -701 | -1,646 | -2,681 | -5,080 | -5,937 |
| Investment income, net | -605 | -1,666 | -2,684 | -5,025 | -5,941 |
| <i>Of which</i> : profit of oil consortium | -521 | -1,422 | -2,375 | -4,860 | -6,074 |
| Compensation of employees, net | -95 | 21 | 3 | -55 | 4 |
| Transfers, net | 188 | 484 | 566 | 1,000 | 1,276 |
| Private | 131 | 369 | 504 | 910 | 1,204 |
| Public | 57 | 115 | 62 | 90 | 72 |
| Current account balance | -2,589 | 167 | 3,708 | 9,010 | 19,391 |
| Capital account, net | -4 | 41 | -4 | -3 | 11 |
| Direct investment, net | 2,351 | 459 | -1,289 | -5,130 | -2,019 |
| Abroad, net | -1,205 | -1,221 | -705 | -280 | -1,186 |
| <i>Of which</i> : oil sector, net | -1,202 | -1,217 | -689 | -260 | -1,166 |
| In reporting economy, net | 3,556 | 1,680 | -584 | -4,850 | -833 |
| Oil sector, net | 3,461 | 1,459 | -963 | -5,200 | -1,201 |
| Credit | 4,615 | 4,246 | 4,101 | 3,900 | 1,879 |
| Debit | -1,154 | -2,787 | -5,064 | -9,100 | -3,080 |
| Others, net | 96 | 221 | 379 | 350 | 368 |
| Portfolio investment, net | -18 | 31 | -12 | -30 | 831 |
| Other investment | 754 | 64 | -393 | -660 | 161 |
| Assets, net | -233 | -890 | -1,006 | -1,530 | -1,502 |
| Liabilities, net | 987 | 954 | 613 | 870 | 1,664 |
| General government | 35 | 38 | 80 | 140 | 554 |
| Government guaranteed | -41 | 74 | 1 | 230 | 310 |
| Others, net | 993 | 842 | 531 | 500 | 800 |
| Oil sector | 1,095 | 768 | 275 | -450 | 500 |
| Others | -101 | 74 | 256 | 950 | 300 |
| Financial account, net | 3,087 | 554 | -1,695 | -5,820 | -1,027 |
| Capital and financial account balance | 3,083 | 595 | -1,698 | -5,823 | -1,016 |
| Errors and omissions | -50 | -126 | -256 | -255 | 0 |
| Overall balance | 444 | 636 | 1,753 | 2,932 | 18,375 |
| Financing | -444 | -636 | -1,753 | -2,932 | -18,375 |
| Change in net foreign assets of ANB (increase -) | -317 | -161 | -1,342 | -1,782 | -3,153 |
| Net credit from the Fund | -60 | -29 | -37 | -37 | -15 |
| Disbursements/purchases | 0 | 20 | 0 | 0 | 0 |
| Repayments/repurchases | -60 | -48 | -37 | -37 | -15 |
| Change in gross official international reserves (increase -) | -257 | -132 | -1,305 | -1,745 | -3,137 |
| Change in Oil Fund assets (increase -) 1/ | -127 | -476 | -411 | -1,150 | -15,222 |
| Memorandum items: | | | | | |
| Current account balance (in percent of GDP) | -29.8 | 1.3 | 17.7 | 28.8 | 39.5 |
| Gross official international reserves | 1,075 | 1,178 | 2,500 | 4,273 | 7,410 |
| Gross official international reserves (in months of next year's non-oil imports c.i.f.) | 3.8 | 3.0 | 4.8 | 5.6 | 7.2 |
| Oil Fund assets 1/ | 972 | 1,394 | 1,869 | 3,019 | 18,241 |
| Public and publicly guaranteed external debt stock (in percent of GDP) | 18.5 | 12.5 | 9.4 | 8.1 | 7.5 |
| Private sector debt (in percent of GDP) | 22.3 | 22.2 | 18.8 | 14.1 | 11.7 |
| WEO oil price (US\$ per barrel) | 37.8 | 53.3 | 64.3 | 71.1 | 95.5 |

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

1/ Includes the central government's foreign exchange deposits managed by the Oil Fund.

Table 3. Azerbaijan: Consolidated Central Government Operations, 2004–08
(In millions of manats)

| | 2004 | 2005 | 2006 | Prel. 2007 | Proj. 2008 |
|---|-------|-------|--------|---------------|---------------|
| Total revenue and grants | 2,288 | 3,143 | 5,253 | 7,949 | 22,162 |
| Total revenue | 2,288 | 3,132 | 5,248 | 7,949 | 22,162 |
| Tax revenue | 1,317 | 1,902 | 3,341 | 5,634 | 6,548 |
| Income taxes | 445 | 673 | 1,768 | 3,046 | 3,111 |
| Individual income tax | 222 | 317 | 407 | 589 | 750 |
| Enterprise profits tax | 223 | 355 | 1,361 | 2,458 | 2,361 |
| Social security contributions | 182 | 198 | 294 | 551 | 572 |
| Value added tax (VAT) | 453 | 600 | 738 | 1,179 | 1,725 |
| Domestic | 281 | 346 | 386 | 644 | 980 |
| Imports | 171 | 254 | 351 | 535 | 745 |
| Excise taxes | 72 | 141 | 187 | 403 | 450 |
| Taxes on international trade | 101 | 205 | 239 | 287 | 457 |
| Other taxes | 64 | 85 | 115 | 167 | 233 |
| Nontax revenue 1/ | 592 | 938 | 1,499 | 2,152 | 15,614 |
| Of which: Oil Fund revenues 2/ | 303 | 596 | 984 | 1,813 | 15,233 |
| Tax credits for SOCAR energy subsidies | 379 | 292 | 408 | 163 | 0 |
| Total grants (current) | 0 | 11 | 5 | 0 | 0 |
| Total expenditure | 2,207 | 2,839 | 5,135 | 7,356 | 10,472 |
| Current expenditure | 1,858 | 2,281 | 3,442 | 4,595 | 6,192 |
| Primary current expenditure | 1,459 | 1,973 | 3,021 | 4,402 | 6,081 |
| Wages and salaries | 423 | 580 | 745 | 1,086 | 1,521 |
| Goods and services | 496 | 716 | 1,285 | 1,854 | 2,511 |
| Transfers | 503 | 640 | 884 | 1,297 | 1,851 |
| Of which: social protection fund | 404 | 495 | 566 | 1,038 | 1,409 |
| Subsidies | 27 | 28 | 41 | 161 | 188 |
| Oil Fund (operating expenditures) | 1 | 2 | 1 | 4 | 10 |
| Other | 9 | 7 | 66 | 0 | 0 |
| SOCAR energy-related subsidies | 379 | 292 | 408 | 163 | 0 |
| Interest | 19 | 16 | 13 | 30 | 111 |
| Current balance (-, deficit) | 431 | 862 | 1,811 | 3,354 | 15,970 |
| Investment expenditure and net lending | 349 | 558 | 1,693 | 2,761 | 4,280 |
| Domestically-financed | 244 | 438 | 1,427 | 2,613 | 3,754 |
| Foreign-financed | 105 | 120 | 266 | 148 | 526 |
| Statistical discrepancy | -8 | -17 | 155 | -54 | 0 |
| Non-oil primary balance | -755 | -884 | -2,691 | -3,571 | -5,637 |
| Consolidated government balance, cash basis | 90 | 321 | -37 | 646 | 11,690 |
| Excluding foreign project loans | 195 | 441 | 229 | 795 | 12,216 |
| Financing | -90 | -321 | 37 | -646 | -11,690 |
| Domestic (net) 3/ | -212 | -436 | -223 | -830 | -12,390 |
| External (net) | 122 | 115 | 260 | 183 | 700 |
| Memorandum items: | | | | | |
| Oil revenue 4/ | 864 | 1,221 | 2,667 | 4,247 | 17,438 |
| Non-oil revenue 5/ | 1,425 | 1,922 | 2,585 | 3,701 | 4,724 |
| Implicit subsidies 6/ | 1,179 | 1,647 | 1,710 | 1,647 | 2,295 |

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

1/ Includes contingent revenues accrued on the "deposit account" of budgetary organizations.

2/ 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.

3/ Includes changes in Oil Fund assets.

4/ Includes SOCAR tax credits for energy subsidies.

5/ Includes grants, VAT and excise taxes on oil and gas, and tax withholding on the Azerbaijan International Operating Company's subcontractors.

6/ Fund staff estimates.

Table 4. Azerbaijan: Consolidated Central Government Operations, 2004–08
(In percent of non-oil GDP)

| | 2004 | 2005 | 2006 | Prel. 2007 | Proj. 2008 |
|---|-------|-------|-------|---------------|---------------|
| Total revenue and grants | 39.1 | 44.9 | 60.7 | 71.4 | 153.2 |
| Total revenue | 39.1 | 44.7 | 60.6 | 71.4 | 153.2 |
| Tax revenue | 22.5 | 27.2 | 38.6 | 50.6 | 45.3 |
| Income taxes | 7.6 | 9.6 | 20.4 | 27.4 | 21.5 |
| Individual income tax | 3.8 | 4.5 | 4.7 | 5.3 | 5.2 |
| Enterprise profits tax | 3.8 | 5.1 | 15.7 | 22.1 | 16.3 |
| Social security contributions | 3.1 | 2.8 | 3.4 | 4.9 | 4.0 |
| Value added tax (VAT) | 7.7 | 8.6 | 8.5 | 10.6 | 11.9 |
| Domestic | 4.8 | 4.9 | 4.5 | 5.8 | 6.8 |
| Imports | 2.9 | 3.6 | 4.1 | 4.8 | 5.2 |
| Excise taxes | 1.2 | 2.0 | 2.2 | 3.6 | 3.1 |
| Taxes on international trade | 1.7 | 2.9 | 2.8 | 2.6 | 3.2 |
| Other taxes | 1.1 | 1.2 | 1.3 | 1.5 | 1.6 |
| Nontax revenue 1/ | 10.1 | 13.4 | 17.3 | 19.3 | 108.0 |
| Of which : Oil Fund revenues 2/ | 5.2 | 8.5 | 11.4 | 16.3 | 105.3 |
| Tax credits for SOCAR energy subsidies | 6.5 | 4.2 | 4.7 | 1.5 | 0.0 |
| Total grants (current) | 0.0 | 0.2 | 0.1 | 0.0 | 0.0 |
| Total expenditure | 37.7 | 40.5 | 59.3 | 66.1 | 72.4 |
| Current expenditure | 31.7 | 32.6 | 39.8 | 41.3 | 42.8 |
| Primary current expenditure | 24.9 | 28.2 | 34.9 | 39.5 | 42.0 |
| Wages and salaries | 7.2 | 8.3 | 8.6 | 9.8 | 10.5 |
| Goods and services | 8.5 | 10.2 | 14.8 | 16.7 | 17.4 |
| Transfers | 8.6 | 9.1 | 10.2 | 11.7 | 12.8 |
| Of which: social protection fund | 6.9 | 7.1 | 6.5 | 9.3 | 9.7 |
| Subsidies | 0.5 | 0.4 | 0.5 | 1.4 | 1.3 |
| Oil Fund (operating expenditures) | 0.0 | 0.0 | 0.0 | 0.0 | 0.1 |
| Other | 0.2 | 0.1 | 0.8 | 0.0 | 0.0 |
| SOCAR energy-related subsidies | 6.5 | 4.2 | 4.7 | 1.5 | 0.0 |
| Interest | 0.3 | 0.2 | 0.2 | 0.3 | 0.8 |
| Current balance (-, deficit) | 7.4 | 12.3 | 20.9 | 30.1 | 110.4 |
| Investment expenditure and net lending | 6.0 | 8.0 | 19.6 | 24.8 | 29.6 |
| Domestically-financed | 4.2 | 6.3 | 16.5 | 23.5 | 26.0 |
| Foreign-financed | 1.8 | 1.7 | 3.1 | 1.3 | 3.6 |
| Statistical discrepancy | -0.1 | -0.2 | 1.8 | -0.5 | 0.0 |
| Non-oil primary balance | -12.9 | -12.6 | -31.1 | -32.1 | -39.0 |
| Consolidated government balance, cash basis | 1.5 | 4.6 | -0.4 | 5.8 | 80.8 |
| Excluding foreign project loans | 3.3 | 6.3 | 2.6 | 7.1 | 84.5 |
| Financing | -1.5 | -4.6 | 0.4 | -5.8 | -80.8 |
| Domestic (net) 3/ | -3.6 | -6.2 | -2.6 | -7.5 | -85.7 |
| External (net) | 2.1 | 1.6 | 3.0 | 1.6 | 4.8 |
| Memorandum items: | | | | | |
| Oil revenue 4/ | 14.7 | 17.4 | 30.8 | 38.2 | 120.6 |
| Non-oil revenue 5/ | 24.3 | 27.5 | 29.9 | 33.3 | 32.7 |
| Implicit subsidies 6/ | 20.1 | 23.5 | 19.8 | 14.8 | 15.9 |

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

1/ Includes contingent revenues accrued on the "deposit account" of budgetary organizations.

2/ 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.

3/ Includes changes in Oil Fund assets.

4/ Includes SOCAR tax credits for energy subsidies.

5/ Includes grants, VAT and excise taxes on oil and gas, and tax withholding on the Azerbaijan International Operating Company's subcontractors.

6/ Fund staff estimates.

Table 5. Azerbaijan: Summary Accounts of the National Bank, 2004–08
(In millions of manats)

| | 2004 | 2005 | 2006 | 2007 | Proj. 2008 |
|--|-------|-------|-------|-------|---------------|
| Net foreign assets | 850 | 930 | 2,071 | 3,527 | 5,816 |
| Net international reserves | 850 | 931 | 2,061 | 3,524 | 5,813 |
| Gross international reserves | 1,054 | 1,082 | 2,179 | 3,612 | 5,888 |
| Foreign liabilities | -205 | -151 | -118 | -88 | -75 |
| Other items, net | 0 | -1 | 9 | 3 | 3 |
| Net domestic assets | -16 | -44 | -26 | -87 | -200 |
| Domestic credit | 64 | -9 | 8 | -60 | -167 |
| Net claims on central government | 20 | -52 | 25 | 93 | 81 |
| <i>Of which</i> : claims on central government | 142 | 140 | 138 | 137 | 125 |
| manat deposits of central government | -94 | -158 | -74 | -33 | -33 |
| Claims on banks | 63 | 73 | 94 | 97 | 102 |
| Credits to the economy | 1 | 1 | 1 | 1 | 1 |
| ANB notes | -20 | -31 | -113 | -251 | -351 |
| Other items, net | -80 | -35 | -34 | -27 | -33 |
| Reserve money | 834 | 886 | 2,045 | 3,441 | 5,617 |
| Manat reserve money | 640 | 688 | 1,600 | 3,221 | 5,419 |
| Currency outside ANB | 526 | 594 | 1,449 | 2,911 | 4,949 |
| Bank reserves and other deposits | 114 | 94 | 150 | 310 | 470 |
| Reserves in foreign currency | 194 | 198 | 445 | 220 | 197 |

Sources: Azerbaijan National Bank; and Fund staff estimates and projections.

Table 6. Azerbaijan: Monetary Survey, 2004–08
(In millions of manats, unless otherwise specified)

| | 2004 | 2005 | 2006 | 2007 | Proj. 2008 |
|---|----------------------------|-------|-------|--------|---------------|
| Net foreign assets | 961 | 1,033 | 1,954 | 2,872 | 5,026 |
| Net international reserves of the ANB | 850 | 931 | 2,061 | 3,524 | 5,813 |
| Net foreign assets of commercial banks | 114 | 109 | -103 | -468 | -640 |
| Other | -3 | -7 | -3 | -185 | -147 |
| Net domestic assets | 542 | 802 | 1,466 | 3,026 | 4,999 |
| Net claims on central government | -29 | -69 | 36 | 48 | 67 |
| Credit to the economy | 945 | 1,445 | 2,364 | 4,644 | 7,200 |
| Other items, net | -373 | -574 | -935 | -1,667 | -2,268 |
| Broad money | 1,503 | 1,835 | 3,420 | 5,897 | 10,025 |
| Manat broad money | 684 | 791 | 2,123 | 4,402 | 8,231 |
| Cash outside banks | 478 | 547 | 1,311 | 2,714 | 4,613 |
| Manat deposits | 206 | 244 | 812 | 1,688 | 3,618 |
| Foreign currency deposits | 819 | 1,043 | 1,297 | 1,496 | 1,795 |
| | (Annual percentage change) | | | | |
| Net foreign assets | 47.9 | 7.5 | 89.3 | 46.9 | 75.0 |
| Net domestic assets | 46.9 | 47.9 | 82.7 | 106.4 | 65.2 |
| Credit to the economy | 60.2 | 53.0 | 63.6 | 96.5 | 55.0 |
| Broad money (M3) | 47.5 | 22.1 | 86.4 | 72.4 | 70.0 |
| Manat broad money (M2) | 31.9 | 15.8 | 168.3 | 107.3 | 87.0 |
| Reserve money | 64.7 | 6.3 | 130.8 | 68.3 | 63.2 |
| Manat reserve money | 38.2 | 7.5 | 132.6 | 101.4 | 68.3 |
| Memorandum items: | | | | | |
| Gross official international reserves (US\$ millions) | 1,075 | 1,178 | 2,500 | 4,273 | 7,410 |
| Velocity of total broad money (M3) 1/ | 6.3 | 5.2 | 4.8 | 3.5 | 2.8 |
| Broad money as a ratio to non-oil GDP | 25.7 | 26.2 | 39.5 | 53.0 | 69.3 |
| Currency as a ratio to broad money | 31.8 | 29.8 | 38.3 | 46.0 | 46.0 |
| Foreign currency deposits as a ratio to broad money | 54.5 | 56.9 | 37.9 | 25.4 | 17.9 |

Sources: Azerbaijan National Bank; and Fund staff estimates and projections.

1/ Velocity is defined as gross domestic demand (excluding oil sector-related imports) divided by average broad money.

Table 7. Azerbaijan: Banking System Soundness Indicators, 2004–07

| | | 2004 | 2005 | 2006 | 2007 |
|-----------------------------------|--|--|-------|-------|-------|
| | | (In percent, unless otherwise specified) | | | |
| Core Set | | | | | |
| <i>Capital adequacy</i> | Regulatory capital to risk-weighted assets | 19.9 | 20.7 | 18.7 | 19.9 |
| | Private banks | 30.0 | 29.3 | 24.0 | 22.0 |
| | Public banks | 8.8 | 10.8 | 11.7 | 16.0 |
| | Regulatory tier I capital to risk-weighted assets | 17.0 | 16.5 | 15.1 | 14.9 |
| | Private banks | 26.7 | 24.0 | 20.0 | 17.8 |
| | Public banks | 6.4 | 7.9 | 8.5 | 9.3 |
| <i>Asset quality</i> | Nonperforming loans net of provisions to total gross loans | 1.7 | 1.3 | 1.7 | 0.8 |
| | Private banks | 1.8 | 1.2 | 0.9 | 0.5 |
| | Public banks | 1.6 | 1.4 | 2.6 | 1.2 |
| | Nonperforming loans to total gross loans | 9.5 | 6.7 | 6.6 | 3.0 |
| | Private banks | 6.4 | 4.2 | 4.0 | 1.9 |
| | Public banks | 12.4 | 8.8 | 9.5 | 4.4 |
| <i>Earnings and profitability</i> | Return on assets | 1.9 | 1.9 | 1.3 | 1.9 |
| | Private banks | 1.0 | 2.5 | 1.5 | 2.8 |
| | Public banks | 2.6 | 1.3 | 1.9 | 2.6 |
| | Return on equity | 12.9 | 13.2 | 9.9 | 14.3 |
| | Private banks | 3.9 | 10.6 | 5.8 | 11.0 |
| | Public banks | 39.1 | 20.7 | 21.0 | 24.2 |
| <i>Liquidity</i> | Liquid assets to total assets | 31.8 | 25.3 | 24.9 | 14.6 |
| | Private banks | 27.1 | 21.0 | 17.3 | 14.3 |
| | Public banks | 35.6 | 28.9 | 32.3 | 14.9 |
| | Liquid assets to short-term liabilities | 100.2 | 83.6 | 72.6 | 58.2 |
| | Private banks | 123.8 | 99.4 | 78.2 | 82.1 |
| | Public banks | 90.0 | 76.4 | 70.0 | 42.2 |
| Encouraged Set | | | | | |
| Deposit takers | | | | | |
| | Capital to assets | 11.9 | 11.9 | 11.1 | 11.2 |
| | Foreign currency-denominated loans to total loans | 70.5 | 64.9 | 51.6 | 46.8 |
| | Private banks | 56.6 | 51.8 | 38.4 | 32.9 |
| | Public banks | 83.5 | 75.8 | 66.5 | 64.8 |
| | Foreign currency-deposits to total deposits | 80.1 | 81.4 | 63.3 | 51.4 |
| | Private banks | 80.6 | 78.3 | 53.0 | 38.5 |
| | Public banks | 79.9 | 82.9 | 70.0 | 63.6 |
| Other Indicators | | | | | |
| | Private banks' share of total assets | 43.9 | 44.9 | 49.0 | 57.6 |
| | Public banks' share of total assets | 56.1 | 55.1 | 51.0 | 42.4 |
| | Interest income to non-interest income | 125.5 | 188.0 | 209.3 | 261.7 |
| | Private banks | 168.6 | 251.9 | 266.9 | 321.2 |
| | Public banks | 93.2 | 142.3 | 160.4 | 193.5 |

Source: Azerbaijan National Bank.

Table 8. Azerbaijan: Selected Economic and Financial Indicators, 2006–13
(Baseline scenario)

| | 2006 | Prel. | | Proj. | | | | |
|---|--------|--------|--------|--------|--------|--------|--------|--------|
| | | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 |
| (Annual percentage change, unless otherwise specified) | | | | | | | | |
| National income | | | | | | | | |
| GDP at current prices | 49.7 | 43.4 | 49.5 | 22.3 | 11.1 | 10.1 | 9.6 | 10.9 |
| GDP at constant prices | 30.5 | 23.4 | 18.6 | 15.6 | 4.8 | 1.6 | -1.7 | -2.6 |
| Oil GDP | 62.0 | 37.3 | 27.7 | 22.6 | 3.9 | -0.9 | -6.9 | -8.8 |
| Non-oil GDP 1/ | 11.9 | 11.5 | 9.0 | 7.0 | 6.0 | 5.0 | 5.0 | 4.5 |
| Implicit GDP deflator | 14.7 | 16.2 | 26.1 | 5.8 | 6.1 | 8.4 | 11.5 | 13.9 |
| Consumer price index (end-period) | 11.4 | 19.5 | 22.0 | 19.0 | 19.0 | 19.0 | 19.0 | 19.0 |
| Consumer price index (period average) | 8.4 | 16.6 | 19.6 | 20.5 | 19.0 | 19.0 | 19.0 | 19.0 |
| Consolidated central government finance | | | | | | | | |
| Total revenue | 67.5 | 51.5 | 178.8 | 30.0 | 8.0 | 3.9 | 1.1 | -0.2 |
| Of which: non-oil revenue | 34.5 | 43.2 | 27.6 | 27.3 | 25.5 | 24.5 | 24.6 | 24.2 |
| Total expenditure | 80.9 | 43.3 | 42.4 | 31.6 | 30.8 | 31.0 | 31.3 | 30.7 |
| Of which: current expenditure | 50.9 | 33.5 | 34.8 | 33.1 | 34.1 | 34.0 | 34.6 | 34.7 |
| investment expenditure | 203.6 | 63.1 | 55.0 | 29.3 | 25.8 | 26.1 | 25.7 | 23.4 |
| External sector (in U.S. dollars) | | | | | | | | |
| Exports f.o.b. | 70.1 | 63.1 | 57.3 | 20.9 | 2.3 | -1.5 | -6.8 | -8.9 |
| Of which: oil sector | 75.4 | 66.5 | 59.7 | 21.1 | 1.8 | -2.1 | -7.7 | -10.1 |
| Imports f.o.b. | 21.1 | 14.1 | 30.4 | 27.9 | 30.2 | 33.5 | 33.6 | 33.4 |
| Of which: oil sector | -9.1 | -25.8 | -25.5 | -21.9 | -27.9 | -6.7 | -6.4 | -9.7 |
| Export volumes | 41.0 | 47.1 | 19.5 | 22.5 | 4.0 | -0.8 | -6.5 | -8.8 |
| Import volumes | 9.8 | 2.5 | 22.1 | 28.4 | 30.9 | 33.0 | 32.4 | 32.2 |
| Terms of trade | 11.6 | 4.3 | 23.3 | -1.0 | -1.2 | -1.1 | -1.3 | -0.9 |
| Real effective exchange rate (- deprec.) | 8.7 | 8.8 | ... | ... | ... | ... | ... | ... |
| (In percent of GDP, unless otherwise specified) | | | | | | | | |
| Gross investment | 29.9 | 20.4 | 16.3 | 16.0 | 18.4 | 20.8 | 23.2 | 25.3 |
| Consolidated government | 8.6 | 10.3 | 10.6 | 11.3 | 12.7 | 14.6 | 16.7 | 18.6 |
| Private sector | 21.2 | 10.2 | 5.6 | 4.8 | 5.7 | 6.2 | 6.4 | 6.6 |
| Of which: oil sector | 7.8 | 3.7 | 1.5 | 0.9 | 0.6 | 0.5 | 0.4 | 0.3 |
| Gross national savings | 47.6 | 49.2 | 55.8 | 55.3 | 50.7 | 43.5 | 35.3 | 26.2 |
| Consolidated government | 8.8 | 12.7 | 39.7 | 41.9 | 36.7 | 29.1 | 19.3 | 7.9 |
| Private sector 2/ | 38.7 | 36.5 | 16.1 | 13.4 | 13.9 | 14.4 | 16.0 | 18.3 |
| Consolidated central government finance | | | | | | | | |
| Total revenue and grants | 28.0 | 29.6 | 55.1 | 58.6 | 57.0 | 53.8 | 49.6 | 44.7 |
| Oil revenue | 14.2 | 15.8 | 43.4 | 46.4 | 43.2 | 38.2 | 31.8 | 24.8 |
| Non-oil revenue | 13.8 | 13.8 | 11.7 | 12.2 | 13.8 | 15.6 | 17.8 | 19.9 |
| Total expenditure | 27.4 | 27.4 | 26.0 | 28.0 | 33.0 | 39.2 | 47.0 | 55.4 |
| Current expenditure | 18.4 | 17.1 | 15.4 | 16.8 | 20.2 | 24.6 | 30.3 | 36.7 |
| Investment expenditure | 9.0 | 10.3 | 10.6 | 11.3 | 12.7 | 14.6 | 16.7 | 18.6 |
| Overall fiscal balance 2/ | -0.2 | 2.4 | 29.1 | 30.6 | 24.0 | 14.5 | 2.6 | -10.7 |
| Non-oil primary balance, in percent of non-oil GDP | -31.1 | -32.1 | -39.0 | -41.2 | -43.9 | -47.7 | -51.7 | -55.9 |
| Implicit energy subsidies, in percent of non-oil GDP | 19.8 | 14.8 | 15.9 | 12.4 | 9.8 | 7.8 | 6.2 | 5.0 |
| External sector | | | | | | | | |
| Current account (- deficit) | 17.7 | 28.8 | 39.5 | 39.2 | 32.3 | 22.7 | 12.1 | 0.9 |
| Foreign direct investment (net) | -6.2 | -16.6 | -4.1 | -1.5 | -0.4 | 0.3 | 0.3 | 0.3 |
| Public and publicly guaranteed external debt | 9.4 | 8.1 | 7.5 | 7.2 | 7.3 | 7.4 | 7.3 | 6.7 |
| Memorandum items: | | | | | | | | |
| Nominal GDP (in millions of manats) | 18,746 | 26,884 | 40,204 | 49,162 | 54,630 | 60,133 | 65,894 | 73,096 |
| Nominal non-oil GDP (in millions of manats) 1/ | 8,655 | 11,131 | 14,462 | 18,566 | 23,438 | 29,345 | 36,804 | 45,939 |
| Population (mid-year, in millions) | 8.5 | 8.6 | 8.6 | 8.7 | 8.8 | 8.8 | 8.9 | 9.0 |
| Nominal GDP per capita (in U.S. dollars) | 2,469 | 3,663 | 5,689 | 7,304 | 8,476 | 9,743 | 11,148 | 12,915 |
| Gross official international reserves (in millions of U.S. dollars) | 2,500 | 4,273 | 7,410 | 10,310 | 14,050 | 19,364 | 26,915 | 37,646 |
| Oil Fund assets (in millions of U.S. dollars) 3/ | 1,869 | 3,019 | 18,241 | 38,366 | 56,645 | 69,276 | 71,809 | 59,004 |

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

1/ Includes oil and gas transportation.

2/ The historical data include the statistical discrepancy.

3/ Includes the central government's foreign exchange deposits managed by the Oil Fund.

Table 9. Azerbaijan: Public Sector Debt Sustainability Framework, 2003–13
(In percent of GDP, unless otherwise indicated)

| | Actual | | | | | Projections | | | | | Debt-stabilizing primary balance 9/ -0.8 | |
|--|--------|------|-------|-------|-------|-------------|------------|------------|------------|------------|---|------------|
| | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | | 2013 |
| 1 Baseline: public sector debt 1/ | 21.8 | 20.2 | 13.3 | 10.2 | 9.1 | 8.2 | 7.9 | 8.1 | 8.2 | 8.3 | 7.9 | 7.9 |
| <i>Of which: foreign-currency denominated</i> | 19.7 | 18.5 | 12.5 | 9.4 | 8.1 | 7.5 | 7.2 | 7.3 | 7.4 | 7.3 | 6.7 | 6.7 |
| 2 Change in public sector debt | -1.2 | -1.7 | -6.8 | -3.1 | -1.2 | -0.9 | -0.3 | 0.2 | 0.1 | 0.0 | -0.4 | -0.4 |
| 3 Identified debt-creating flows (4+7+12) | -1.9 | -4.9 | -9.8 | -5.5 | -5.7 | -32.2 | -32.2 | -24.9 | -15.4 | -3.4 | 9.8 | 9.8 |
| 4 Primary deficit | 1.5 | -1.2 | -2.6 | -0.7 | -2.3 | -29.4 | -30.8 | -24.3 | -14.9 | -3.0 | 10.4 | 10.4 |
| 5 Revenue and grants | 26.8 | 26.8 | 25.1 | 28.0 | 29.6 | 55.1 | 58.6 | 57.0 | 53.8 | 49.6 | 44.7 | 44.7 |
| 6 Primary (noninterest) expenditure | 28.3 | 25.6 | 22.5 | 27.3 | 27.3 | 25.8 | 27.8 | 32.7 | 38.9 | 46.6 | 55.0 | 55.0 |
| 7 Automatic debt dynamics 2/ | -3.2 | -3.4 | -7.1 | -4.8 | -3.2 | -2.7 | -1.3 | -0.5 | -0.4 | -0.4 | -0.4 | -0.4 |
| 8 Contribution from interest rate/growth differential 3/ | -3.3 | -3.3 | -6.3 | -4.4 | -3.0 | -2.7 | -1.3 | -0.5 | -0.4 | -0.4 | -0.4 | -0.4 |
| 9 <i>Of which</i> contribution from real interest rate | -1.2 | -1.4 | -3.0 | -1.6 | -1.3 | -1.6 | -0.2 | -0.1 | -0.3 | -0.5 | -0.6 | -0.6 |
| 10 <i>Of which</i> contribution from real GDP growth | -2.0 | -1.9 | -3.3 | -2.7 | -1.7 | -1.1 | -1.0 | -0.3 | -0.1 | 0.1 | 0.2 | 0.2 |
| 11 Contribution from exchange rate depreciation 4/ | 0.1 | -0.1 | -0.8 | -0.4 | -0.2 | ... | ... | ... | ... | ... | ... | ... |
| 12 Other identified debt-creating flows | -0.3 | -0.4 | -0.2 | 0.0 | -0.2 | -0.1 | -0.1 | -0.1 | -0.1 | -0.1 | -0.1 | -0.1 |
| 13 Privatization receipts (negative) | -0.3 | -0.4 | -0.2 | 0.0 | -0.2 | -0.1 | -0.1 | -0.1 | -0.1 | -0.1 | -0.1 | -0.1 |
| 14 Recognition of implicit or contingent liabilities | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| 15 Other (specify, e.g. bank recapitalization) | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| 16 Residual, including asset changes (2-3)/5/ | 0.7 | 3.3 | 3.0 | 2.4 | 4.5 | 31.3 | 31.9 | 25.1 | 15.5 | 3.4 | -10.2 | -11.1 |
| <i>Of which: increase in official foreign assets (including oil fund assets)</i> | 1.8 | 1.7 | 3.2 | 2.3 | 3.7 | 31.0 | 31.7 | 24.6 | 14.7 | 2.6 | -11.1 | -11.1 |
| Public sector debt-to-revenue ratio 1/ | 81.6 | 75.2 | 53.1 | 36.6 | 30.7 | 14.9 | 13.4 | 14.2 | 15.3 | 16.7 | 17.6 | 17.6 |
| Gross financing need 6/ | 2.7 | 0.3 | -1.7 | 0.7 | -2.1 | -28.7 | -30.3 | -23.8 | -14.4 | -2.5 | 10.8 | 10.8 |
| In billions of U.S. dollars | 0.2 | 0.0 | -0.2 | 0.1 | -0.7 | -14.1 | -19.3 | -17.7 | -12.4 | -2.4 | 12.6 | 12.6 |
| Scenario with oil prices at \$70 per barrel: public sector debt 7/ | | | | | | 9.9 | 9.4 | 9.5 | 9.4 | 9.3 | 8.7 | 8.7 |
| Key macroeconomic and fiscal assumptions underlying baseline | | | | | | | | | | | | |
| Real GDP growth (in percent) | 10.5 | 10.4 | 24.3 | 30.5 | 23.4 | 18.6 | 15.6 | 4.8 | 1.6 | -1.7 | -2.6 | -2.6 |
| Average nominal interest rate on public debt (in percent) 8/ | 1.2 | 1.2 | 0.9 | 0.8 | 1.5 | 4.6 | 3.5 | 4.4 | 4.7 | 4.8 | 4.9 | 4.9 |
| Average real interest rate (nominal rate minus change in GDP deflator, in percent) | -5.5 | -6.9 | -17.2 | -13.9 | -14.7 | -21.6 | -2.3 | -1.6 | -3.7 | -6.7 | -9.0 | -9.0 |
| Nominal appreciation (increase in US dollar value of local currency, in percent) | -0.6 | 0.4 | 6.7 | 5.4 | 3.1 | ... | ... | ... | ... | ... | ... | ... |
| Inflation rate (GDP deflator, in percent) | 6.7 | 8.1 | 18.1 | 14.7 | 16.2 | 26.1 | 5.8 | 6.1 | 8.4 | 11.5 | 13.9 | 13.9 |
| Growth of real primary spending (deflated by GDP deflator, in percent) | 14.1 | 0.1 | 9.2 | 58.2 | 23.1 | 12.1 | 24.7 | 23.1 | 20.9 | 17.8 | 14.8 | 14.8 |
| Primary deficit | 1.5 | -1.2 | -2.6 | -0.7 | -2.3 | -29.4 | -30.8 | -24.3 | -14.9 | -3.0 | 10.4 | 10.4 |

1/ Public and publicly guaranteed external and domestic gross debt.

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

3/ The real interest rate contribution is derived from the denominator in footnote 2/ as $r - \pi(1+g)$ and the real growth contribution as $-g$.

4/ The exchange rate contribution is derived from the numerator in footnote 2/ as $ae(1+r)$.

5/ For projections, this line includes exchange rate changes.

6/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.

7/ \$70 per barrel starting from 2008.

8/ Derived as nominal interest expenditure divided by previous period debt stock.

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

Table 10. Azerbaijan: External Debt Sustainability Framework, 2003–13
(In percent of GDP, unless otherwise indicated)

| | Actual | | | | | | | | | | Projections | | | | | Debt-stabilizing non-interest current account 6/ -1.6 |
|---|--------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------------|--|--|--|--|--|
| | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | | | | | |
| 1 Baseline: External debt | 38.4 | 40.8 | 34.7 | 28.2 | 22.3 | 19.2 | 17.5 | 16.9 | 16.2 | 15.4 | 14.1 | | | | | |
| 2 Change in external debt | 1.5 | 2.4 | -6.1 | -6.5 | -5.9 | -3.0 | -1.7 | -0.7 | -0.7 | -0.8 | -1.3 | | | | | |
| 3 Identified external debt-creating flows (4+8+9) | -9.8 | -3.5 | -18.8 | -24.3 | -21.7 | -38.1 | -40.1 | -32.5 | -23.3 | -12.2 | -0.9 | | | | | |
| 4 Current account deficit, excluding interest payments | 27.4 | 28.7 | -2.5 | -18.8 | -29.8 | -40.4 | -40.4 | -33.2 | -23.7 | -13.1 | -1.7 | | | | | |
| 5 Deficit in balance of goods and services | 23.5 | 23.9 | -10.0 | -27.8 | -41.8 | -49.1 | -45.4 | -35.8 | -24.5 | -11.9 | 0.2 | | | | | |
| 6 Exports | 42.0 | 48.8 | 62.9 | 66.6 | 71.8 | 72.1 | 67.6 | 60.0 | 52.2 | 43.8 | 36.1 | | | | | |
| 7 Imports | 65.6 | 72.7 | 52.9 | 38.8 | 30.0 | 23.1 | 22.2 | 24.2 | 27.7 | 31.9 | 36.2 | | | | | |
| 8 Net non-debt creating capital inflows (negative) | -32.3 | -27.1 | -3.5 | 6.2 | 16.4 | 4.1 | 1.5 | 0.4 | -0.3 | -0.3 | -0.3 | | | | | |
| 9 Automatic debt dynamics 1/ | -4.8 | -5.1 | -12.8 | -11.7 | -8.3 | -1.8 | -1.6 | 0.3 | 0.7 | 1.2 | 1.2 | | | | | |
| 10 Contribution from nominal interest rate | 0.4 | 1.1 | 1.3 | 1.1 | 1.1 | 0.9 | 0.8 | 1.0 | 1.0 | 0.9 | 0.8 | | | | | |
| 11 Contribution from real GDP growth | -3.3 | -3.4 | -6.5 | -6.7 | -4.4 | -2.6 | -2.3 | -0.7 | -0.2 | 0.2 | 0.3 | | | | | |
| 12 Contribution from price and exchange rate changes 2/ | -2.0 | -2.9 | -7.6 | -6.1 | -4.9 | ... | ... | ... | ... | ... | ... | | | | | |
| 13 Residual, incl. change in gross foreign assets (2-3) 3/ | 11.3 | 5.9 | 12.7 | 17.8 | 15.8 | 35.0 | 38.4 | 31.9 | 22.6 | 11.5 | -0.4 | | | | | |
| Of which: increase in gross official foreign assets (including oil fund assets) | 2.8 | 4.4 | 4.6 | 8.2 | 9.2 | 37.4 | 36.3 | 29.7 | 20.9 | 10.2 | -1.8 | | | | | |
| External debt-to-exports ratio (in percent) | 91.5 | 83.7 | 55.2 | 42.3 | 31.0 | 26.6 | 26.0 | 28.1 | 31.0 | 35.2 | 39.2 | | | | | |
| Gross external financing need (in billions of US dollars) 4/ | 2.3 | 2.9 | 0.2 | -3.2 | -8.5 | -18.6 | -24.1 | -23.1 | -18.6 | -11.1 | 0.0 | | | | | |
| In percent of GDP | 31.6 | 33.4 | 1.8 | -15.4 | -27.0 | -38.0 | -37.9 | -31.1 | -21.7 | -11.2 | 0.0 | | | | | |
| Scenario with oil prices at \$70 per barrel: external debt 5/ | | | | | | 23.8 | 21.5 | 20.1 | 18.9 | 17.6 | 15.8 | | | | | |
| Key Macroeconomic Assumptions Underlying Baseline | | | | | | | | | | | | | | | | |
| Real GDP growth (in percent) | 10.5 | 10.4 | 24.3 | 30.5 | 23.4 | 18.6 | 15.6 | 4.8 | 1.6 | -1.7 | -2.6 | | | | | |
| GDP deflator in US dollars (change in percent) | 5.6 | 8.1 | 22.8 | 21.1 | 21.2 | 32.0 | 11.9 | 11.7 | 14.1 | 17.4 | 19.9 | | | | | |
| Nominal external interest rate (in percent) | 1.3 | 3.4 | 4.8 | 4.8 | 5.6 | 6.1 | 5.1 | 6.5 | 6.6 | 6.5 | 6.4 | | | | | |
| Growth of exports (US dollar terms, in percent) | 14.6 | 38.6 | 96.7 | 67.5 | 61.1 | 57.4 | 21.2 | 3.8 | 0.8 | -3.2 | -3.8 | | | | | |
| Growth of imports (US dollar terms, in percent) | 52.8 | 32.3 | 10.9 | 16.1 | 15.5 | 20.6 | 24.4 | 27.6 | 32.5 | 32.9 | 32.8 | | | | | |
| Current account balance, excluding interest payments | -27.4 | -28.7 | 2.5 | 18.8 | 29.8 | 40.4 | 40.0 | 33.2 | 23.7 | 13.1 | 1.7 | | | | | |
| Net non-debt creating capital inflows | 32.3 | 27.1 | 3.5 | -6.2 | -16.4 | -4.1 | -1.5 | -0.4 | 0.3 | 0.3 | 0.3 | | | | | |

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

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

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

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

5/ \$70 per barrel starting from 2008.

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

Table 11. Azerbaijan: Selected Economic and Financial Indicators, 2006–13
(Recommended scenario)

| | 2006 | Prel. 2007 | Proj. | | | | | |
|---|-------|---------------|--------|--------|--------|--------|---------|---------|
| | | | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 |
| (Annual percentage change, unless otherwise specified) | | | | | | | | |
| National income | | | | | | | | |
| GDP at current prices | 49.7 | 43.4 | 47.0 | 19.0 | 7.1 | 5.0 | 2.4 | 1.9 |
| GDP at constant prices | 30.5 | 23.4 | 17.8 | 15.9 | 5.2 | 2.4 | -1.2 | -1.8 |
| Oil GDP | 62.0 | 37.3 | 27.7 | 22.6 | 3.9 | -0.9 | -6.9 | -8.8 |
| Non-oil GDP 1/ | 11.9 | 11.5 | 7.5 | 7.5 | 7.0 | 7.0 | 6.0 | 6.0 |
| Implicit GDP deflator | 14.7 | 16.2 | 24.7 | 2.7 | 1.9 | 2.5 | 3.7 | 3.8 |
| Consumer price index (end-period) | 11.4 | 19.5 | 15.0 | 10.0 | 8.0 | 6.0 | 5.0 | 5.0 |
| Consumer price index (period average) | 8.4 | 16.6 | 16.4 | 12.5 | 9.0 | 7.0 | 5.5 | 5.0 |
| Consolidated central government finance | | | | | | | | |
| Total revenue | 67.5 | 51.5 | 176.6 | 27.1 | 4.3 | 0.2 | -3.3 | -4.6 |
| Of which: non-oil revenue | 34.5 | 43.2 | 27.6 | 18.9 | 15.6 | 13.7 | 11.4 | 11.0 |
| Total expenditure | 80.9 | 43.3 | 29.9 | 13.2 | 9.4 | 7.7 | 6.4 | 6.2 |
| Of which: current expenditure | 50.9 | 33.5 | 27.3 | 13.2 | 9.2 | 7.4 | 7.1 | 7.0 |
| investment expenditure | 203.6 | 63.1 | 34.3 | 13.2 | 9.8 | 8.1 | 5.4 | 5.0 |
| External sector (in U.S. dollars) | | | | | | | | |
| Exports f.o.b. | 70.1 | 63.1 | 57.5 | 21.4 | 3.0 | -0.4 | -4.9 | -6.0 |
| Of which: oil sector | 75.4 | 66.5 | 59.7 | 21.1 | 1.8 | -2.1 | -7.7 | -10.1 |
| Imports f.o.b. | 21.1 | 14.1 | 22.7 | 18.1 | 16.5 | 18.8 | 19.3 | 19.5 |
| Of which: oil sector | -9.1 | -25.8 | -25.5 | -21.9 | -27.9 | -6.7 | -6.4 | -9.7 |
| Export volumes | 41.0 | 47.1 | 19.6 | 23.0 | 4.8 | 0.3 | -4.6 | -5.9 |
| Import volumes | 9.8 | 2.5 | 14.9 | 18.6 | 17.1 | 18.4 | 18.2 | 18.5 |
| Terms of trade | 11.6 | 4.3 | 23.3 | -1.0 | -1.2 | -1.1 | -1.3 | -0.9 |
| Real effective exchange rate (- deprec.) | 8.7 | 8.8 | ... | ... | ... | ... | ... | ... |
| (In percent of GDP, unless otherwise specified) | | | | | | | | |
| Gross investment | 29.9 | 20.4 | 15.7 | 16.2 | 19.8 | 24.1 | 28.8 | 33.8 |
| Consolidated government | 8.6 | 10.3 | 9.4 | 8.9 | 9.1 | 9.4 | 9.7 | 10.0 |
| Private sector | 21.2 | 10.2 | 6.3 | 7.3 | 10.7 | 14.7 | 19.1 | 23.8 |
| Of which: oil sector | 7.8 | 3.7 | 1.5 | 0.9 | 0.6 | 0.5 | 0.5 | 0.4 |
| Gross national savings | 47.6 | 49.2 | 56.7 | 58.5 | 57.9 | 56.6 | 55.5 | 54.5 |
| Consolidated government | 8.8 | 12.7 | 40.8 | 45.4 | 43.5 | 40.5 | 36.8 | 32.7 |
| Private sector 2/ | 38.7 | 36.5 | 15.8 | 13.1 | 14.4 | 16.0 | 18.8 | 21.8 |
| Consolidated central government finance | | | | | | | | |
| Total revenue and grants | 28.0 | 29.6 | 55.6 | 59.4 | 57.9 | 55.2 | 52.1 | 48.8 |
| Oil revenue | 14.2 | 15.8 | 43.7 | 47.5 | 45.0 | 41.3 | 36.9 | 32.3 |
| Non-oil revenue | 13.8 | 13.8 | 12.0 | 11.9 | 12.9 | 14.0 | 15.2 | 16.5 |
| Total expenditure | 27.4 | 27.4 | 24.2 | 23.0 | 23.5 | 24.1 | 25.1 | 26.1 |
| Current expenditure | 18.4 | 17.1 | 14.8 | 14.1 | 14.4 | 14.7 | 15.4 | 16.1 |
| Investment expenditure | 9.0 | 10.3 | 9.4 | 8.9 | 9.1 | 9.4 | 9.7 | 10.0 |
| Overall fiscal balance 2/ | -0.2 | 2.4 | 31.4 | 36.4 | 34.4 | 31.1 | 27.1 | 22.7 |
| Non-oil primary balance, in percent of non-oil GDP | -31.1 | -32.1 | -34.0 | -30.5 | -26.6 | -23.1 | -20.4 | -18.0 |
| Implicit energy subsidies, in percent of non-oil GDP | 19.8 | 14.8 | 10.7 | 7.7 | 5.0 | 2.8 | 1.6 | 0.0 |
| External sector | | | | | | | | |
| Current account (- deficit) | 17.7 | 28.8 | 40.9 | 42.2 | 38.1 | 32.4 | 26.7 | 20.6 |
| Foreign direct investment (net) | -6.2 | -16.6 | -4.0 | -1.2 | 0.0 | 1.0 | 1.4 | 1.8 |
| Public and publicly guaranteed external deb | 9.4 | 8.1 | 7.6 | 7.2 | 7.4 | 7.6 | 7.7 | 7.6 |
| Memorandum items: | | | | | | | | |
| Nominal GDP (in millions of manats) | 18746 | 26,884 | 39,517 | 47,030 | 50,387 | 52,907 | 54,168 | 55,187 |
| Nominal non-oil GDP (in millions of manats) 1/ | 8655 | 11,131 | 13,878 | 16,713 | 19,514 | 22,399 | 25,147 | 28,099 |
| Population (mid-year, in millions) | 8.5 | 8.6 | 8.6 | 8.7 | 8.8 | 8.8 | 8.9 | 9.0 |
| Nominal GDP per capita (in U.S. dollars) | 2469 | 3,663 | 5,650 | 7,251 | 8,377 | 9,485 | 10,471 | 11,504 |
| Gross official international reserves (in millions of U.S. dollars) | 2500 | 4,273 | 6,763 | 8,754 | 11,097 | 14,282 | 17,743 | 22,258 |
| Oil Fund assets (in millions of U.S. dollars) 3/ | 1869 | 3,019 | 19,305 | 42,924 | 68,568 | 94,606 | 119,489 | 141,983 |

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

1/ Includes oil and gas transportation.

2/ The historical data include the statistical discrepancy.

3/ Includes the central government's foreign exchange deposits managed by the Oil Fund.

INTERNATIONAL MONETARY FUND

REPUBLIC OF AZERBAIJAN

Staff Report for the 2008 Article IV Consultation—Informational Annex

Prepared by Middle East and Central Asia Department

May 8, 2008

| | Contents | Page |
|---|----------|------|
| I. Fund Relations | | 2 |
| II. IMF-World Bank Relations | | 5 |
| III. Azerbaijan's relations with the EBRD | | 8 |
| IV. Statistical Issues | | 10 |

ANNEX I: AZERBAIJAN: FUND RELATIONS

(As of March 31, 2008)

I. **Membership Status:** Joined: September 18, 1992; Article VIII

| II. General Resources Account: | SDR Million | Percent of Quota |
|---------------------------------------|--------------------|-------------------------|
| Quota | 160.90 | 100.00 |
| Fund Holdings of Currency | 164.52 | 102.25 |
| Reserve position in Fund | 0.05 | 0.03 |

| III. SDR Department: | SDR Million | Percent of Allocation |
|-----------------------------|--------------------|------------------------------|
| Holdings | 0.66 | N/A |

| IV. Outstanding Purchases and Loans: | SDR Million | Percent of Quota |
|---|--------------------|-------------------------|
| Extended arrangements | 3.66 | 2.27 |
| PRGF arrangements | 55.07 | 34.23 |

V. **Financial Arrangements:**

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

VI. **Projected Obligations to Fund:**

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

| | Forthcoming | | | | |
|------------------|-------------|-------------|-------------|-------------|-------------|
| | <u>2008</u> | <u>2009</u> | <u>2010</u> | <u>2011</u> | <u>2012</u> |
| Principal | 7.28 | 12.03 | 9.66 | 10.94 | 8.53 |
| Charges/Interest | 0.36 | 0.26 | 0.18 | 0.12 | 0.07 |
| Total | 7.65 | 12.29 | 9.83 | 11.06 | 8.60 |

VII. **Safeguards Assessment**

Under the Fund's safeguards assessment policy, Azerbaijan National Bank (ANB) was subject to an assessment with respect to the PRGF arrangement, which was approved on July 6, 2001 and expired on July 4, 2005. A safeguards assessment of the ANB was completed on March 8, 2002. The assessment concluded that risks may exist in the legal structure and independence of the Central Bank, and in its internal audit and control systems.

The authorities have implemented all but one of the 2002 safeguards assessment recommendations. The National Bank Law adopted in 2004 clearly specifies the modalities for the ANB profit distribution, consistent with one of the last two outstanding recommendations, and requires that ANB's internal audit division be responsible only to the

chairman of the ANB Board. The latter falls short of establishing an independent audit committee under the Board, as recommended by the safeguards assessment mission.

VIII. Exchange Rate Arrangements

The currency of Azerbaijan is the manat, which became sole legal tender on January 1, 1994. Currently de jure, the exchange rate is allowed to float against all currencies. Exchange rates for cash transactions are quoted by commercial banks licensed to deal in foreign exchange on the basis of market conditions. A new de facto exchange rate arrangement that pegs the manat to a dollar/euro currency basket became operational in March 2008, replacing a crawling peg exchange rate system that had been in place since 2006.

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

IX. Article IV Consultation

The 2007 Article IV consultation with Azerbaijan was concluded on May 9, 2007.

X. ROSCs

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

XI. Resident Representative

Mr. Koba Gvenetadze, the Fund's sixth Resident Representative, took up his duties in Baku in January 2008.

XII. Resident Advisers

An adviser on the establishment of the Treasury in the Ministry of Finance, Mr. Nurcan Aktürk, was stationed in Baku from December 1994 until September 1996. He was succeeded by Mr. B.K. Chaturvedi, whose assignment was extended twice, first through August 2000, and then through May 2001. Mr. B.K. Chaturvedi was replaced by Mr. A. Khan, whose assignment started in May 2001 and ended in August 2002. A technical long-term adviser for tax administration, Mr. Mark Zariski, was stationed in Baku from April 1995 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. Nataliya Ivanik took up the position of STA regional external sector statistics advisor in November 2006.

Azerbaijan: Technical Assistance, 2003–2007

| Fund Dept. | Area of Assistance | Mission Dates |
|------------|---|----------------|
| FAD | Budget systems law | Feb/March 2003 |
| STA | Consumer Price Statistics | June 2003 |
| STA | National Accounts | Jul/Aug. 2003 |
| MFD | Regional Technical Assistance in Public Debt Management | Jul/Sep. 2003 |
| MFD | Payment and Settlement Systems | September 2003 |
| FAD | Revenue Administration | August 2003 |
| FAD | Tax Policy | August 2003 |
| MFD | Payment and Settlement Systems | January 2004 |
| STA | Balance of Payments Statistics | May 2004 |
| MFD | Payment and Settlement Systems | May 2004 |
| MFD | Regional Public Debt management | April 2004 |
| FAD | Customs Administration | September 2004 |
| STA | National Accounts | Sep/Oct. 2004 |
| FAD | Tax administration | December 2004 |
| MFD | Public Debt Management | December 2004 |
| STA | National Accounts | Mar/Apr. 2005 |
| LEG | AML/CFT Legislation | June 2005 |
| FAD | Taxation of SOCAR Operations | August 2005 |
| STA | Balance of Payments and External Debt Statistics | Nov/Dec. 2005 |
| MFD | Monetary Operations | August 2006 |
| FAD | Public Financial Management | September 2006 |
| STA | Government Finance Statistics | Oct/Nov. 2006 |
| MCM | Banking supervision | April, 2007 |
| FAD | Tax diagnostic | February, 2008 |

ANNEX II: AZERBAIJAN: IMF-WORLD BANK RELATIONS

(As of April 15, 2008)

- The World Bank has been actively involved in structural reforms, poverty reduction measures, public expenditure management, agricultural policies, private sector development, institution building, and governance. A range of instruments is used to conduct the dialogue. SAC-II, which was fully disbursed in June 2003, supported a wide-ranging structural reform agenda and its accompanying second institution building and technical assistance credit (IBTA II) assisted institutional capacity building, especially of the Treasury Information management System (TIMS), public investment program preparation, and utility reforms. The Bank's Board approved a Poverty Reduction Support Credit (PRSC) in May 2005. By supporting the authorities' State Program of Poverty Reduction and Economic Development (SPRED), the PRSC aimed to improve the business environment, the efficiency and effectiveness of allocations in the social sectors, support anti-corruption efforts and increased transparency and accountability of public finances.
- The Bank's new Country Partnership Strategy (CPS) was discussed at the World Bank's Board on December 7, 2006. A CPS Progress Report was prepared in April 2008. The CPS is based on a broad policy reform approach combined with sector investment projects in agriculture, transport, water, refugees/IDPs, environment, education, health, and energy. Analytical and advisory assistance for the next four years includes Programmatic Poverty Assessments, Programmatic Public Expenditure Reviews (PER), an update on the CFAA (financial accountability) and CPAR (procurement), and ongoing work on trade facilitation and mitigation of the social costs of utility price increases. In FY2008, the Bank, in collaboration with other donors, plans to complete three assessments: a Public Expenditure and Financial Accountability (PEFA) assessment, and a Country Procurement Assessment Review. In addition, a Country Economic Memorandum (covering macroeconomic policies, infrastructure, trade and the business environment, financial sector, and employment) is also planned for FY2008. The Bank will continue its advisory services in the energy sector, the health sector, and the water sector.
- After the PRGF arrangement expired in July 2005, close collaboration between the IMF and the World Bank has continued. The World Bank's policy advice will continue to focus on preparation and implementation of the medium term expenditure framework, public expenditure management (PEFA follow up, budget processing, and public accounting) and the business environment (including taxation issues) as well as areas for follow-up on the basis of CEM analysis. The World Bank's recently expanded lending activity will continue to focus on infrastructure, education, private sector development, and other sectoral issues, as well as some financial sector issues. The IMF will continue to focus on macro-critical areas and tax administration, and will collaborate with the Bank on tax policy. The World Bank and the Fund will also share responsibilities on issues of banking and financial sector soundness. The Fund will continue to provide advice on banking sector soundness and supervision and systemic issues and the World Bank will provide assistance on microeconomic issues

that are critical to strengthen the functioning and enhance the depth of the financial sector. The two country teams agreed to coordinate their policy advice in the financial sector area, where overlaps are more likely.

- The IFC's strategy emphasizes support to the non-oil sector to help economic diversification. To this end, the 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. The IFC's strategy for the non-oil sectors involves (i) promoting competition in the banking sector, establishing 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 small and medium size enterprises (SMEs); (iii) enhancing the business climate and reducing impediments to foreign investments; (iv) supporting agri-business and agro-processing; and (v) creating conditions for private provision of public services.

World Bank contacts:

Christos Kostopoulos (CKostopoulos@worldbank.org), Senior Country Economist for Azerbaijan. Phone (202) 473-8143.

Christian Petersen (CPetersen@worldbank.org), Lead Economist for the South Caucasus. Phone (202) 473-3965.

Azerbaijan: JMAP Implementation

| Title | Products | Provisional Timing of Missions | Expected Delivery Date (tentative) |
|--|--|--|--|
| A. Mutual Information on Relevant Programs | | | |
| World Bank work program in the next 12 months | CPS progress report CEM Poverty assessment Programmatic PER PEFA follow-up Corporate and public sector accountability project CPAR Financial Sector Modernization project Structural reform and econ. policy coordination TA | December 2007–March 2008 October 2007– May 2008 Dececeber 2008 July 2007– June 2008 June 2008– February 2009 FY 2009 FY 2009 April 2008 July 2007– June 2008 | May 2008 (Board) December 2008 (Public) Early 2009 (Public) July 2007– June 2008 FY 2009 March 2008 (Board) FY 2009 May/June 2008 (Board) July 2007– June 2008 |
| IMF work program in the next 12 months | CPI ROSC TA on tax administration 2008 Article IV consultation Staff visit on budget TA on BOP statistics | February 2008 February– March 2008 February– March 2008 September 2008 Resident advisor | April 2008 April 2008 May 2008 September 2008 |
| B. Requests for Work Program Inputs (as needed) | | | |
| | | | |
| C. Agreement on Joint Products and Missions (as needed) | | | |
| Joint product in the next 12 months | FSAP update (tentative) | Late FY 2009 | Fall 2009 |

ANNEX III: AZERBAIJAN'S RELATIONS WITH THE EBRD

(As of March 31, 2008)

As of March 31, 2008, the European Bank for Reconstruction and Development (EBRD) had signed 79 investments in Azerbaijan with cumulative commitments totaling EUR725.7 million. Current Portfolio Stock equals to EUR478.2 million. The EBRD's first operation-the rehabilitation of Yenikend power plant, was signed in December 1994. Since then, the pace and composition of portfolio growth has varied significantly from year to year.

During 2007, the EBRD signed 27 transactions in Azerbaijan for EUR122 million. In 2007, the Bank provided an additional EUR 65.3 million to Azerenerji, the public power utility for the rehabilitation of the country's largest power generation facility, AZDRES. The EBRD has invested additional funds in Milk-Pro, the largest dairy producer in Azerbaijan. Three more Azerbaijani commercial banks became clients of EBRD in 2007 increasing the number of partner banks to nine. The EBRD has signed two syndicated loans under the A/B structure for two local commercial banks. In addition, two leading non-bank microfinance institutions, received funding from EBRD in 2007, with co-financing from the BP-led Regional Development Initiative (RDI). A loan agreement with another non-bank microfinance institution was signed in the second half of 2007. In 2007, the EBRD signed four projects in agribusiness and general industries sectors under the co-financing facility and has provided equity and debt financing to Unileasing (privately owned leasing company).

The ratio of private sector projects in the portfolio now stands at 51 percent. A new, three-year EBRD Country Strategy for Azerbaijan was approved in September 2007. The Strategy sets a number of objectives directed towards the development of enterprise, financial institutions, infrastructure and energy sectors. The EBRD will contribute to the development of the non-oil sector by making direct debt and equity investments and via support to the financial sector. Micro-, small- and medium-sized enterprises will continue to be the primary target for these investments using the instruments available under the ETC Initiative. A special emphasis will be on provision of financial resources to regions outside Baku through the banks' expanding branch networks and providing increased support to the agriculture sector. In the infrastructure and energy sectors, the main focus will be in financing projects and pursuing an active policy dialogue for reforms in the transport, power, municipal infrastructure and environmental clean-up. The EBRD is already taking the lead in policy dialogue with the Government particularly in the power sector and will help drive key sector reforms, legislative and regulatory changes, and attraction of the private sector.

Azerbaijan is part of the "Early Transition Countries" (ETC) initiative. Launched in April 2004, the initiative aims to increase investments in the Bank's eight countries of operation in the early transition stage. The initiative builds on international efforts to address poverty in these countries. Through this initiative, the EBRD focuses its efforts on private sector business development and selected public sector interventions. It aims to stimulate market activity by using a streamlined approach to financing, focusing on smaller projects, mobilizing more investment, and encouraging ongoing economic reform. The Bank will accept higher risk in the projects it finances in the ETCs, while still respecting principles of sound banking.

Azerbaijan: EBRD Portfolio
As of March 31, 2008 (EUR, million)

| Project Name | Date of Agreement | Outstanding Amount |
|--|-------------------|--------------------|
| Yenikend Renewable Energy Project | 21-Dec 1994 | 6.1 |
| Baku Water Rehabilitation Project | 16-Oct 1995 | 3.3 |
| Air Navigation Systems Upgrading | 21-Dec 1996 | 0.9 |
| Mingechaur Power Project | 24-Jun 1997 | 5.1 |
| Microfinance Bank Azerbaijan (MFBA) | 28-Jun 2002 | 4.4 |
| Regional TFP: Azerdemiryolbank | 08-Nov 2002 | 8.7 |
| Regional TFP: UniBank (former MBank) | 02-Dec 2002 | 2.1 |
| Unibank Equity Investment | 05-Sep 2003 | 0.9 |
| Regional TFP: Azerigazbank | 19-Dec 2003 | 6.7 |
| Azerbaijan Multi Bank FW - Bank of Baku | 13-Feb 2004 | 0.3 |
| Azerbaijan: Silk Road | 22-Jul 2004 | 24.8 |
| Azerbaijan Multi Bank FW - Azerdemiryolbank (II) | 27-Sep 2004 | 0.7 |
| Azerbaijan Multi-Bank FW - Bank Respublika | 27-Sep 2004 | 0.4 |
| Regional TFP: Bank Respublika | 27-Sep 2004 | 3.8 |
| Milk-Pro LLC | 19-Nov 2004 | 3.5 |
| MBASK Insurance Company | 28-Jan 2005 | 0.7 |
| Azerbaijan Multi-Bank FW: Bank of Baku (II) | 16-Feb 2005 | 0.1 |
| Unibank A/B Loan | 08-Apr 2005 | 0.3 |
| Lukoil Overseas: Shah Deniz Gas Condensate Field Development | 28-Jul 2005 | 69.5 |
| Baku to Samur | 29-Sep 2005 | 63.2 |
| Azerbaijan Multi Bank FW - Azerigazbank (II) | 14-Oct 2005 | 0.5 |
| Azerbaijan Multi Bank FW - Bank Respublika (II) | 14-Oct 2005 | 0.6 |
| Bank of Baku Equity Investment (Azerbaijan) | 14-Oct 2005 | 3.2 |
| Azerdemiryol Bank Equity Investment | 23-Nov 2005 | 3.1 |
| Azeri Multi Bank Framework - Azerdemiryolbank (MSE) | 23-Nov 2005 | 0.6 |
| Azeri Multi-Bank Framework - Bank Respublika (MSE) | 19-Dec 2005 | 1.0 |
| Azeri Multi-Bank Framework - Unibank (MSE) | 19-Dec 2005 | 1.3 |
| Azerbaijan Multi-Bank FRW - Azerigazbank III | 11-Apr 2006 | 1.3 |
| Azerbaijan Multi Bank FW - Azerdemiryolbank (III) | 20-May 2006 | 3.2 |
| Azerbaijan Multi Bank FW - Bank Respublika (III) | 20-May 2006 | 1.3 |
| Azerbaijan Multi-Bank Fram - Bank of Baku (III) | 20-May 2006 | 2.3 |
| Azerbaijan Multi-Bank Framework - Unibank (II) | 20-May 2006 | 1.3 |
| Unibank A/B loan - II | 07-Sep 2006 | 1.6 |
| ETC Non Bank MFI FW - CredAgro | 26-Sep 2006 | 0.3 |
| DLF - Aqua Vita | 27-Sep 2006 | 2.8 |
| AZDRES Power Plant Rehabilitation | 01-Nov 2006 | 130.8 |
| Azeri Multi-Bank Framework - Rabitabank MSME Loan | 15-Nov 2006 | 1.3 |
| ETC Non-Bank MFI Framework II - FINCA (Azerbaijan) | 15-Nov 2006 | 1.6 |
| Azerbaijan Multi Bank FW - Mugan Bank | 27-Nov 2006 | 1.3 |
| Microfinance Bank Azerbaijan (MFBA) - Equity | 11-Dec 2006 | 0.9 |
| MCFF - Bank Respublika Full Recourse Portion | 13-Dec 2006 | 0.9 |
| Regional TFP: Bank of Baku | 19-Dec 2006 | 2.5 |
| Garadagh Cement | 21-Dec 2006 | 7.5 |
| MCFF - Bank of Baku Full Recourse Portion | 21-Dec 2006 | 2.1 |
| Azerbaijan Multi Bank FW - Nikoil Bank | 14-Feb 2007 | 1.3 |
| MCFF - Unibank - Caspian Supplies | 20-Feb 2007 | 0.4 |
| Unileasing - debt | 14-Mar 2007 | 1.9 |
| Unileasing - Equity | 14-Mar 2007 | 0.5 |
| MCFF - Bank of Baku - Baku Electronics | 12-Apr 2007 | 1.1 |
| MCFF - Bank of Baku Avrova | 26-Apr 2007 | 0.3 |
| Azeri Multi-Bank Framework - Azerigazbank IV | 20-May 2007 | 3.8 |
| MCFF - Azerdemiryolbank Full Recourse Portion | 25-May 2007 | 0.6 |
| Unibank Capital Increase | 27-Jun 2007 | 2.6 |
| Azerbaijan Multi-Bank FRW - Bank Respublika IV | 26-Jul 2007 | 1.9 |
| Bank Respublika A/B loan | 26-Jul 2007 | 3.8 |
| Azeri Multi-Bank Framework - Bank of Baku | 27-Jul 2007 | 1.3 |
| MCFF - Azerdemiryolbank - SABA | 28-Aug 2007 | 0.3 |
| ETC Non-Bank MFI Framework II - Credagro | 30-Oct 2007 | 1.7 |
| ETC Non-Bank MFI FW - Shore Overseas (MSE) | 30-Oct 2007 | 1.3 |
| Unibank A/B Loan III | 31-Oct 2007 | 5.5 |
| Azerbaijan Multi Bank FW - Mugan Bank II | 26-Nov 2007 | 2.5 |
| MCFF - Azerdemiryolbank - Azwirt | 17-Jan 2008 | 2.2 |
| MCFF - Bank Respublika-Veysaloglu | 27-Feb 2008 | 2.7 |
| MCFF-Bank of Baku - Atlant | 19-Mar 2008 | 0.6 |
| Direct Investment / Sub Total | | 414.9 |
| Regional Projects | | |
| Baku-Tbilisi-Ceyhan (BTC) Pipeline | 03-Feb 2004 | 37.6 |
| Baring Vostok Private Equity Fund | 13-Dec 2000 | 0.1 |
| Lukoil Overseas : South Caucasus Gas Pipeline | 28-Jul 2005 | 25.7 |
| Regional Projects / Sub Total | | 63.3 |
| TOTAL | | 478.2 |

ANNEX IV. AZERBAIJAN: STATISTICAL ISSUES

1. Economic and financial statistics provided to the Fund are broadly adequate for surveillance purposes. Although the authorities have made significant progress in improving the quality and timeliness of their macroeconomic statistics, a number of weaknesses should be addressed, particularly in the areas of national accounts, price statistics, and external sector statistics. STA has provided extensive technical assistance and recommendations in these areas.
2. Azerbaijan has participated in the GDDS since mid-2001. In April 2002, a data ROSC mission reviewed Azerbaijan's data dissemination practices against GDDS guidelines and conducted an assessment of the quality of national accounts, consumer price index (CPI), producer price index (PPI), government finance, monetary, and balance of payments statistics. The data module of the ROSC is available on the IMF's external website. Azerbaijan nominated a national SDDS Coordinator in August 2005. An SDDS assessment mission in April 2007 provided technical assistance on the outstanding issues required for SDDS subscription. A data ROSC module to reassess the Consumer Price Index (CPI) took place in February 2008.

A. Real Sector

National accounts and price statistics

3. Under STA's national accounts project, significant technical assistance has been provided to the State Statistics Committee (SSC) and progress has been made in a number of areas. Methods for compiling gross national income have been improved and revised estimates disseminated; quarterly national account estimates at constant prices for 1998–2004 have been compiled; capital investment data have been revised; estimates of undeclared wages have been made; and a new methodology for calculating price indices for the construction and transportation sectors is well underway. The March/April 2005 mission identified the following problems: (i) the Oil Fund's transactions are not adequately reflected in the national accounts due to lack of information from the Oil Fund; (ii) the SSC does not have sufficient information to make reliable estimates of remittances from domestic residents working abroad; and (iii) there are no estimates of informal sector activity.
4. In January 2005, the CPI was revamped: the consumption basket was expanded to cover 585 items and expenditure weights updated to reflect recent consumption patterns. With respect to regional coverage, which is now expanded to 54 regions, the SSC used population-based weights in the aggregation of elementary price indices. However, this treatment raised methodological questions, because (i) international best practices suggest the use of expenditure-based weights in every stage of aggregation in CPI compilation, and (ii) population shares are not reliable proxies for regional expenditure shares. The recent reassessment of the CPI found that expenditure weighting for regional aggregation has now been implemented, but noted that expenditures on owner-occupied housing are inadequately represented by expenditure for maintenance and repairs.

B. Fiscal Sector

5. Recent treasury modernization efforts are expected to improve the compilation of fiscal data. With the assistance of a Fund peripatetic advisor, the Ministry of Finance developed the treasury chart of accounts (COA), an essential input to the new treasury system. The October 2006 STA government finance statistics mission found the latest draft COA broadly consistent with the *Government Finance Statistics Manual, 2001*. The work on the COA is proceeding in parallel with the computerization of Treasury operations.

6. The 2002 data ROSC mission recommended expanding the coverage of government finance statistics by including all operations recorded by the treasury and publishing details on financing and debt outstanding. Starting in 2006, the state budget incorporates transfers to Nakhichevan as a separate expenditure item, but no further details are provided.

C. Monetary Sector

7. The Azerbaijan National Bank (ANB) compiles monetary statistics according to the methodology of the *Monetary and Financial Statistics Manual*. The ANB reports monetary data to STA within three weeks after the end of the reference month, via Standardized Report Forms (SRFs). Monetary and financial data have also been published in the *International Financial Statistics (IFS) Supplement* since December 2006.

D. External Sector

8. Starting in November 2006, a Regional Advisor in External Sector Statistics to Azerbaijan and Georgia has been stationed in Baku to (i) facilitate activities carried out by different government agencies in the development of external sector statistics; (ii) assist with statistical capacity building; (iii) coordinate the technical assistance activities of STA with the MCD's work program; and (4) assist the authorities in coordinating with other international institutions and bilateral agencies involved in technical assistance in statistics in Azerbaijan and Georgia.

9. While the overall structure of the balance of payments (BOP) statistics is broadly consistent with the fifth edition of the *Balance of Payments Manual*, several compilation weaknesses remain. These include (i) insufficient data on FDI stocks and flows that prompt inadequate estimates for FDI income and impede the proper treatment of profit taxes of the oil sector; (ii) undercoverage of nonguaranteed external debt and inconsistencies with the relevant creditor source data; (iii) incorrect treatment of operational leases of mobile equipment; and (iv) an inadequate breakdown between FDI equity and other capital, which is necessary to properly record transactions associated with the Baku-Tbilisi-Ceyhan Pipeline, Shah-Denis gas field, and South Caucasus Pipeline.

10. The ANB has made steady progress toward implementing the short-term measures recommended by the 2002 data ROSC mission. Almost all short-term measures have now been completed: the methodology for compiling reserve assets has been revised to exclude the Oil Fund assets, and they are now classified as other investment assets of the government; a new survey form for oil sector enterprises (IOCs) has been designed and

distributed to international oil consortia; and the scope and classification of BOP statistics have been improved. However, the data provision from IOCs remains insufficient, which hampers the compilation of foreign direct investment estimates due to inconsistencies in timing, coverage, and valuation of the source data.

11. To date, significant progress has also been made in implementing the data ROSC medium-term recommendations. Starting with data for the third quarter of 2005, the classification of services has been expanded, and data on reinvested earnings have been included in the BOP. The compilation system appears to be facing some operational problems due to the lack of collaboration with other data-producing agencies, such as the Oil Fund. Problems also remain with the sources and methods, particularly with regard to short-term liabilities. No data are available on intercompany lending to direct investment enterprises, and trade credit transactions are estimated on the basis of trade statistics and the International Transactions Reporting System (ITRS) data with no clear distinction between asset and liability transactions.

12. The ANB has initiated compilation of the International Investment Position (IIP) statistics, but the IIP statement is still at an evolving stage. The IIP data have been published in the *IFS* since 2002.

13. Statistics for public and publicly guaranteed external debt are reported quarterly on a due-for-payment basis with a lag of one to two months. A debt service schedule for public and publicly guaranteed external debt, separately identifying the principal and interest components, is also provided with a one quarter lag. However, systematic information on nonguaranteed external debt, including a sectoral breakdown, is lacking. The law on external debt, which includes the assignment of responsibility for external debt compilation, has been drafted and provided to the Parliament. On external debt, the 2005 BOP mission noted that it would be desirable to use balance sheet data from commercial banks pertaining to banking sector liabilities, which would permit presentation of information with a breakdown by maturities and instruments.

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

AZERBAIJAN: TABLE OF COMMON INDICATORS REQUIRED FOR SURVEILLANCE
AS OF APRIL 15, 2008

| | Date of latest observation | Date received | Frequency of data ⁶ | Frequency of reporting ⁶ | Frequency of publication ⁶ | Memo Items: | |
|---|----------------------------|---------------|--------------------------------|-------------------------------------|---------------------------------------|--|--|
| | | | | | | Data Quality – Methodological soundness ⁷ | Data Quality Accuracy and reliability ⁸ |
| Exchange Rates | April 11, 2008 | 4/15/08 | D | D | D | | |
| International Reserve Assets and Reserve Liabilities of the Monetary Authorities ¹ | March 31, 2008 | 4/15/08 | D | W | M | | |
| Reserve/Base Money | March 31, 2008 | 4/15/08 | D | W | M | | |
| Broad Money | February 29, 2008 | 3/20/08 | M | M | M | O, O, O, O | O, O, O, O, LO |
| Central Bank Balance Sheet | March 31, 2008 | 4/15/08 | D | W | M | | |
| Consolidated Balance Sheet of the Banking System | February 29, 2008 | 3/20/08 | M | M | M | | |
| Interest Rates ² | March 2008 | 4/15/08 | M | M | M | | |
| Consumer Price Index | March 2008 | 4/4/08 | M | M | M | O, O, O, O | O, LO, O, O, O |
| Revenue, Expenditure, Balance and Composition of Financing ³ – General Government ⁴ | December 2007 | 1/15/08 | M | Q | Q | LO, LNO, LNO, LO | LO, LO, O, O, LO |
| Revenue, Expenditure, Balance and Composition of Financing ³ – Central Government | December 2007 | 1/15/08 | M | Q | Q | | |
| Stocks of Central Government and Central Government-Guaranteed Debt ⁵ | December 2007 | 3/01/08 | Q | Q | Q | | |
| External Current Account Balance | Q3 2007 | 1/08/08 | Q | Q | Q | | |
| Exports and Imports of Goods and Services | Q3 2007 | 1/08/08 | Q | Q | Q | LO, LO, LO, LO | O, LO, LO, O, LO |
| GDP/GNP | March 2008 | 4/15/08 | M | M | A | O, LO, O, LO | LO, LNO, O, O, O |

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

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

³ Foreign, domestic bank, and domestic nonbank financing.

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

⁵ Including currency and maturity composition.

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

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

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

Statement by the IMF Staff Representative
May 23, 2008

1. This statement summarizes information that has become available since the Staff Report on the Republic of Azerbaijan was circulated to the Executive Board on May 8, 2008. The new information points to heightened risk for further rise in the already high inflation rate, but does not change the thrust of the staff appraisal.

2. Inflation has accelerated since the beginning of the year. The 12-month inflation rate rose to 21.4 percent in April from 15.2 percent in January, with food inflation surging to 29.6 percent from 19.4 percent.

3. On May 7, 2008, the President of the Republic of Azerbaijan signed into law the supplementary budget of the central government for 2008. The revised budget indicates a much larger fiscal expansion than the one described in the baseline scenario of the staff report, which reflected preliminary information on government policy intentions at the time of the mission. The authorities justified the significant budget expansion on account of higher than previously expected oil revenue.¹ The revised budget has significantly increased the domestically financed investment expenditure, quoting higher investment costs because of rising commodity and building material prices, and the need to accelerate the execution of investment projects to support non-oil GDP growth. Allocations for wages, pensions and social transfers have also been augmented to counter the impact of inflation on real incomes.

4. Staff estimates that the 2008 supplementary budget would entail an increase in consolidated government expenditure of 12.7 percentage points of non-oil GDP, with respect to the staff report projections (Tables 1, 2 and 3). Non-oil revenue is now projected to be 1.7 percentage point of non-oil GDP higher, on account of higher inflation and growth. If fully executed, the revised budget would result in a widening of the non-oil primary deficit to 50 percent of non-oil GDP, from 32 percent in 2007; the staff report projected a non-oil primary deficit of 39 percent of non-oil GDP for 2008. The overall fiscal surplus would be lower than previously projected by about 1.9 billion manat (5 percent of total GDP), leading to less accumulation of oil fund assets.

5. In the context of already binding supply constraints and an accelerating inflation trajectory, staff expects that the additional increase in public spending will result in higher inflation, a marginal increase in non-oil growth, and higher imports compared with the staff report projections. With inflation now projected to rise to 26 percent at end-2008, the risk of

¹ The original budget law was based on a 50 dollar per barrel average oil price for 2008. The supplementary budget assumes an average oil price of 70 dollar per barrel. Staff's projections, both in the staff report and in this statement, are based on the Spring WEO oil price projection of 95.5 dollar per barrel.

a price-wage spiral has increased substantially. The supplementary budget will also exacerbate the existing problems with the quality and efficiency of public expenditure due to limited administrative and absorption capacity. In view of increasing risks to long-term macroeconomic stability, staff now considers as critical a more cautious approach to budget implementation in 2008 and significant fiscal adjustment in 2009 to support a credible disinflation process. In addition, during the remainder of 2008, exchange rate and monetary policy will need to be used proactively to avoid that the inflationary impact of the supplementary budget gets out of control.

Table 1. Azerbaijan: Selected Economic and Financial Indicators, 2005–08

| | 2005 | 2006 | Prel. 2007 | SM/08/140 2008 | Rev. Proj. 5/ 2008 |
|---|--------|--------|---------------|-------------------|-----------------------|
| (Annual percentage change, unless otherwise specified) | | | | | |
| National income | | | | | |
| GDP at current prices | 46.8 | 49.7 | 43.4 | 49.5 | 51.3 |
| GDP at constant prices | 24.3 | 30.5 | 23.4 | 18.6 | 19.1 |
| Oil GDP | 65.4 | 62.0 | 37.3 | 27.7 | 27.7 |
| Non-oil GDP 1/ | 8.4 | 11.9 | 11.5 | 9.0 | 10.0 |
| Implicit GDP deflator | 18.1 | 14.7 | 16.2 | 26.1 | 27.1 |
| Consumer price index (end-period) | 5.5 | 11.4 | 19.5 | 22.0 | 26.0 |
| Consumer price index (period average) | 9.7 | 8.4 | 16.6 | 19.6 | 22.3 |
| Consolidated central government finance | | | | | |
| Total revenue | 36.9 | 67.5 | 51.5 | 178.8 | 183.7 |
| <i>Of which:</i> non-oil revenue | 34.9 | 34.5 | 43.2 | 27.6 | 38.8 |
| Total expenditure | 28.7 | 80.9 | 43.3 | 42.4 | 72.8 |
| <i>Of which:</i> current expenditure | 22.8 | 50.9 | 33.5 | 34.8 | 53.9 |
| investment expenditure | 59.9 | 203.6 | 63.1 | 55.0 | 104.3 |
| Money and credit | | | | | |
| Net foreign assets | 7.5 | 89.3 | 46.9 | 75.0 | 105.6 |
| Net domestic assets | 47.9 | 82.7 | 106.4 | 65.2 | 84.9 |
| Credit to the economy | 53.0 | 63.6 | 96.5 | 55.0 | 70.0 |
| Manat base money | 7.5 | 132.6 | 101.4 | 68.3 | 94.3 |
| Broad money | 22.1 | 86.4 | 72.4 | 70.0 | 95.0 |
| Foreign currency deposits ratio to broad money | 56.9 | 37.9 | 25.4 | 17.9 | 17.9 |
| Velocity of broad money (M3) 2/ | 5.2 | 4.8 | 3.5 | 2.8 | 2.9 |
| External sector (in U.S. dollars) | | | | | |
| Exports f.o.b. | 104.4 | 70.1 | 63.1 | 57.3 | 57.3 |
| <i>Of which:</i> oil sector | 113.0 | 75.4 | 66.5 | 59.7 | 59.7 |
| Imports f.o.b. | 21.4 | 21.1 | 14.1 | 30.4 | 51.1 |
| <i>Of which:</i> oil sector | 18.7 | -9.1 | -25.8 | -25.5 | -25.5 |
| Export volumes | 47.8 | 41.0 | 47.1 | 19.5 | 19.5 |
| Import volumes | 15.6 | 9.8 | 2.5 | 22.1 | 41.5 |
| Terms of trade | 17.0 | 11.6 | 4.3 | 23.3 | 23.3 |
| Real effective exchange rate (- deprec.) | 6.3 | 8.7 | 8.8 | ... | ... |
| (In percent of GDP, unless otherwise specified) | | | | | |
| Gross investment | 41.5 | 29.9 | 20.4 | 16.3 | 18.4 |
| Consolidated government | 4.1 | 8.6 | 10.3 | 10.6 | 13.9 |
| Private sector | 37.4 | 21.2 | 10.2 | 5.6 | 4.5 |
| <i>Of which:</i> oil sector | 17.6 | 7.8 | 3.7 | 1.5 | 1.5 |
| Gross national savings | 42.8 | 47.6 | 49.2 | 55.8 | 54.7 |
| Consolidated government | 7.0 | 8.8 | 12.7 | 39.7 | 38.0 |
| Private sector 3/ | 35.8 | 38.7 | 36.5 | 16.1 | 16.7 |
| Consolidated central government finance | | | | | |
| Overall fiscal balance | 2.6 | -0.2 | 2.4 | 29.1 | 24.2 |
| Non-oil primary balance, in percent of non-oil GDP | -12.6 | -31.1 | -32.1 | -39.0 | -50.0 |
| Implicit energy subsidies, in percent of non-oil GDP | 23.5 | 19.8 | 14.8 | 15.9 | 15.4 |
| External sector | | | | | |
| Current account (- deficit) | 1.3 | 17.7 | 28.8 | 39.5 | 36.3 |
| Foreign direct investment (net) | 3.5 | -6.2 | -16.6 | -4.1 | -4.1 |
| Public and publicly guaranteed external debt | 12.5 | 9.4 | 8.1 | 7.5 | 7.3 |
| Memorandum items: | | | | | |
| Nominal GDP (in millions of manats) | 12,523 | 18,746 | 26,884 | 40,204 | 40,678 |
| Nominal non-oil GDP (in millions of manats) 1/ | 7,002 | 8,655 | 11,131 | 14,462 | 14,936 |
| Population (mid-year, in millions) | 8.4 | 8.5 | 8.6 | 8.6 | 8.6 |
| Nominal GDP per capita (in U.S. dollars) | 1,574 | 2,469 | 3,663 | 5,689 | 5,756 |
| Gross official international reserves (in millions of U.S. dollars) | 1,178 | 2,500 | 4,273 | 7,410 | 8,528 |
| Oil Fund assets (in millions of U.S. dollars) 4/ | 1,394 | 1,869 | 3,019 | 18,241 | 15,938 |
| Exchange rate (manat/dollar, end-of-period) | 0.919 | 0.871 | 0.845 | ... | ... |

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

1/ Includes oil and gas transportation.

2/ Defined as gross domestic demand (excluding oil sector-related imports) divided by average broad money.

3/ The historical data include the statistical discrepancy.

4/ Includes the central government's foreign exchange deposits managed by the Oil Fund.

5/ Includes the projected macroeconomic impact of the 2008 supplementary budget enacted on May 8, 2008.

Table 2. Azerbaijan: Consolidated Central Government Operations, 2005–08
(In millions of manats)

| | 2005 | 2006 | Prel. 2007 | SM/08/140 2008 | Rev. Proj. 7/ |
|---|-------|--------|---------------|-------------------|---------------|
| Total revenue and grants | 3,143 | 5,253 | 7,949 | 22,162 | 22,547 |
| Total revenue | 3,132 | 5,248 | 7,949 | 22,162 | 22,547 |
| Tax revenue | 1,902 | 3,341 | 5,634 | 6,548 | 6,961 |
| Income taxes | 673 | 1,768 | 3,046 | 3,111 | 3,326 |
| Individual income tax | 317 | 407 | 589 | 750 | 795 |
| Enterprise profits tax | 355 | 1,361 | 2,458 | 2,361 | 2,531 |
| Social security contributions | 198 | 294 | 551 | 572 | 611 |
| Value added tax (VAT) | 600 | 738 | 1,179 | 1,725 | 1,885 |
| Domestic | 346 | 386 | 644 | 980 | 1,130 |
| Imports | 254 | 351 | 535 | 745 | 755 |
| Excise taxes | 141 | 187 | 403 | 450 | 450 |
| Taxes on international trade | 205 | 239 | 287 | 457 | 457 |
| Other taxes | 85 | 115 | 167 | 233 | 233 |
| Nontax revenue 1/ | 938 | 1,499 | 2,152 | 15,614 | 15,585 |
| Of which: Oil Fund revenues 2/ | 596 | 984 | 1,813 | 15,233 | 15,204 |
| Tax credits for SOCAR energy subsidies | 292 | 408 | 163 | 0 | 0 |
| Total grants (current) | 11 | 5 | 0 | 0 | 0 |
| Total expenditure | 2,839 | 5,135 | 7,356 | 10,472 | 12,712 |
| Current expenditure | 2,281 | 3,442 | 4,595 | 6,192 | 7,070 |
| Primary current expenditure | 1,973 | 3,021 | 4,402 | 6,081 | 6,960 |
| Wages and salaries | 580 | 745 | 1,086 | 1,521 | 1,810 |
| Goods and services | 716 | 1,285 | 1,854 | 2,511 | 3,063 |
| Transfers | 640 | 884 | 1,297 | 1,851 | 1,884 |
| Of which: social protection fund | 495 | 566 | 1,038 | 1,409 | 1,406 |
| Subsidies | 28 | 41 | 161 | 188 | 193 |
| Oil Fund (operating expenditures) | 2 | 1 | 4 | 10 | 10 |
| Other | 7 | 66 | 0 | 0 | 0 |
| SOCAR energy-related subsidies | 292 | 408 | 163 | 0 | 0 |
| Interest | 16 | 13 | 30 | 111 | 110 |
| Current balance (-, deficit) | 862 | 1,811 | 3,354 | 15,970 | 15,477 |
| Investment expenditure and net lending | 558 | 1,693 | 2,761 | 4,280 | 5,642 |
| Domestically-financed | 438 | 1,427 | 2,613 | 3,754 | 5,116 |
| Foreign-financed | 120 | 266 | 148 | 526 | 526 |
| Statistical discrepancy | -17 | 155 | -54 | 0 | 0 |
| Non-oil primary balance | -884 | -2,691 | -3,571 | -5,637 | -7,465 |
| Consolidated government balance, cash basis | 321 | -37 | 646 | 11,690 | 9,835 |
| Excluding foreign project loans | 441 | 229 | 795 | 12,216 | 10,361 |
| Financing | -321 | 37 | -646 | -11,690 | -9,835 |
| Domestic (net) 3/ | -436 | -223 | -830 | -12,390 | -10,494 |
| External (net) | 115 | 260 | 183 | 700 | 659 |
| Memorandum items: | | | | | |
| Oil revenue 4/ | 1,221 | 2,667 | 4,247 | 17,438 | 17,410 |
| Non-oil revenue 5/ | 1,922 | 2,585 | 3,701 | 4,724 | 5,137 |
| Implicit subsidies 6/ | 1,647 | 1,710 | 1,647 | 2,295 | 2,295 |

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

1/ Includes contingent revenues accrued on the "deposit account" of budgetary organizations.

2/ 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.

3/ Includes changes in Oil Fund assets.

4/ Includes SOCAR tax credits for energy subsidies.

5/ Includes grants, VAT and excise taxes on oil and gas, and tax withholding on the Azerbaijan International Operating Company's subcontractors.

6/ Fund staff estimates.

7/ Fund staff projections reflecting the impact of the 2008 supplementary budget enacted on May 8, 2008.

Table 3. Azerbaijan: Consolidated Central Government Operations, 2005–08
(In percent of non-oil GDP)

| | 2005 | 2006 | Prel. 2007 | SM/08/140 2008 | Rev. Proj. 7/ 2008 |
|---|-------|-------|---------------|-------------------|-----------------------|
| Total revenue and grants | 44.9 | 60.7 | 71.4 | 153.2 | 151.0 |
| Total revenue | 44.7 | 60.6 | 71.4 | 153.2 | 151.0 |
| Tax revenue | 27.2 | 38.6 | 50.6 | 45.3 | 46.6 |
| Income taxes | 9.6 | 20.4 | 27.4 | 21.5 | 22.3 |
| Individual income tax | 4.5 | 4.7 | 5.3 | 5.2 | 5.3 |
| Enterprise profits tax | 5.1 | 15.7 | 22.1 | 16.3 | 16.9 |
| Social security contributions | 2.8 | 3.4 | 4.9 | 4.0 | 4.1 |
| Value added tax (VAT) | 8.6 | 8.5 | 10.6 | 11.9 | 12.6 |
| Domestic | 4.9 | 4.5 | 5.8 | 6.8 | 7.6 |
| Imports | 3.6 | 4.1 | 4.8 | 5.2 | 5.1 |
| Excise taxes | 2.0 | 2.2 | 3.6 | 3.1 | 3.0 |
| Taxes on international trade | 2.9 | 2.8 | 2.6 | 3.2 | 3.1 |
| Other taxes | 1.2 | 1.3 | 1.5 | 1.6 | 1.6 |
| Nontax revenue 1/ | 13.4 | 17.3 | 19.3 | 108.0 | 104.4 |
| Of which : Oil Fund revenues 2/ | 8.5 | 11.4 | 16.3 | 105.3 | 101.8 |
| Tax credits for SOCAR energy subsidies | 4.2 | 4.7 | 1.5 | 0.0 | 0.0 |
| Total grants (current) | 0.2 | 0.1 | 0.0 | 0.0 | 0.0 |
| Total expenditure | 40.5 | 59.3 | 66.1 | 72.4 | 85.1 |
| Current expenditure | 32.6 | 39.8 | 41.3 | 42.8 | 47.3 |
| Primary current expenditure | 28.2 | 34.9 | 39.5 | 42.0 | 46.6 |
| Wages and salaries | 8.3 | 8.6 | 9.8 | 10.5 | 12.1 |
| Goods and services | 10.2 | 14.8 | 16.7 | 17.4 | 20.5 |
| Transfers | 9.1 | 10.2 | 11.7 | 12.8 | 12.6 |
| Of which: social protection fund | 7.1 | 6.5 | 9.3 | 9.7 | 9.4 |
| Subsidies | 0.4 | 0.5 | 1.4 | 1.3 | 1.3 |
| Oil Fund (operating expenditures) | 0.0 | 0.0 | 0.0 | 0.1 | 0.1 |
| Other | 0.1 | 0.8 | 0.0 | 0.0 | 0.0 |
| SOCAR energy-related subsidies | 4.2 | 4.7 | 1.5 | 0.0 | 0.0 |
| Interest | 0.2 | 0.2 | 0.3 | 0.8 | 0.7 |
| Current balance (-, deficit) | 12.3 | 20.9 | 30.1 | 110.4 | 103.6 |
| Investment expenditure and net lending | 8.0 | 19.6 | 24.8 | 29.6 | 37.8 |
| Domestically-financed | 6.3 | 16.5 | 23.5 | 26.0 | 34.3 |
| Foreign-financed | 1.7 | 3.1 | 1.3 | 3.6 | 3.5 |
| Statistical discrepancy | -0.2 | 1.8 | -0.5 | 0.0 | 0.0 |
| Non-oil primary balance | -12.6 | -31.1 | -32.1 | -39.0 | -50.0 |
| Consolidated government balance, cash basis | 4.6 | -0.4 | 5.8 | 80.8 | 65.8 |
| Excluding foreign project loans | 6.3 | 2.6 | 7.1 | 84.5 | 69.4 |
| Financing | -4.6 | 0.4 | -5.8 | -80.8 | -65.8 |
| Domestic (net) 3/ | -6.2 | -2.6 | -7.5 | -85.7 | -70.3 |
| External (net) | 1.6 | 3.0 | 1.6 | 4.8 | 4.4 |
| Memorandum items: | | | | | |
| Oil revenue 4/ | 17.4 | 30.8 | 38.2 | 120.6 | 116.6 |
| Non-oil revenue 5/ | 27.5 | 29.9 | 33.3 | 32.7 | 34.4 |
| Implicit subsidies 6/ | 23.5 | 19.8 | 14.8 | 15.9 | 15.4 |

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

1/ Includes contingent revenues accrued on the "deposit account" of budgetary organizations.

2/ 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.

3/ Includes changes in Oil Fund assets.

4/ Includes SOCAR tax credits for energy subsidies.

5/ Includes grants, VAT and excise taxes on oil and gas, and tax withholding on the Azerbaijan International Operating Company's subcontractors.

6/ Fund staff estimates.

7/ Fund staff projections reflecting the impact of the 2008 supplementary budget enacted on May 8, 2008.



INTERNATIONAL MONETARY FUND

Public Information Notice

EXTERNAL
RELATIONS
DEPARTMENT

Public Information Notice (PIN) No. 08/79
FOR IMMEDIATE RELEASE
July 1, 2008

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

IMF Executive Board Concludes the 2008 Article IV Consultation with the Republic of Azerbaijan

On May 23, 2008, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Republic of Azerbaijan.¹

Background

Azerbaijan's economic growth remained strong, with real GDP expanding by 23 percent in 2007. The oil sector continued to be the main driving force, growing by 37 percent. The non-oil sector also grew rapidly at about 12 percent, propelled mostly by non-tradable activity, particularly construction, commerce, and communications. As a result, per capita GDP is estimated to have exceeded US\$3500, and officially reported poverty and unemployment level declined significantly.

However, 12-month inflation accelerated to 19.5 percent at end-2007, reflecting demand pressures from fiscal expansion, rising international food and commodity prices, increases in administered energy and utility prices, and an accommodative monetary policy. Inflation remained high at 21.4 percent in April 2008, despite the fact that the January 2007 adjustment of administered prices had already been absorbed in the base. Widening inflation differentials with Azerbaijan's trading partners resulted in a continuation of real effective exchange rate appreciation, clouding the growth prospect for the non-oil tradable sector.

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 May 23, 2008 Executive Board discussion based on the staff report.

The oil production boom and rising international oil prices further strengthened Azerbaijan's external position. The current account surplus is estimated to have risen to 29 percent of GDP in 2007, from 18 percent in 2006. Despite very large profit and investment repatriation by foreign oil companies, the government's oil fund assets and international reserves at the Azerbaijan National Bank (ANB) together reached about US\$7.3 billion—triple the amount of external public sector debt outstanding at end-2007.

Fiscal policy continues to be expansionary in 2007. Total expenditure grew by 43 percent, with wages and transfers increasing by 46 percent and investment spending rising by 63 percent. As a result, the non-oil primary deficit widened slightly to 32 percent of non-oil GDP, despite a robust performance of non-oil revenues. The consolidated fiscal balance returned to surplus mostly owing to a 60 percent growth in oil revenues, but also reflecting improved tax administration. However, progress to strengthen public expenditure planning, execution, and monitoring was limited.

The monetary policy response to the fiscal-induced overheating was insufficient. In the context of a slowly appreciating crawling peg to the dollar, the ANB undertook large purchases of foreign exchange from the government, leading to a doubling of manat base money in 2007. The policy interest rate was kept negative in real terms.

In March 2008, the ANB introduced a basket peg aimed at stabilizing the nominal effective exchange rate. The manat is now pegged to a dollar/euro currency basket, in which the weight of the euro will gradually increase. The new arrangement and the envisaged weight adjustments are intended to mitigate imported inflation, and as a first step towards more nominal exchange rate flexibility.

Banks' soundness indicators and compliance with prudential regulations improved in 2007, but credit risks intensified amid an extraordinary credit boom. Private banks' share in the banking system surpassed 50 percent during the year. At end-2007, all banks met the requirements on capital adequacy and foreign currency exposure, and the non-performing loan ratios were lower than a year before. Meanwhile, abundant liquidity and increased foreign borrowing by banks boosted credit growth by 97 percent, with increasing exposure to the property sector. In general, the financial sector is still underdeveloped, providing few long-term instruments for savers and investors.

Structural reforms to promote a competitive non-oil sector remained slow. The work to upgrade legislations in line with World Trade Organization (WTO) accession requirements is under way. The one-stop facility for business registration is now operational, facilitating the establishment of new companies. Licensing requirements, though, remain heavy and governance issues—particularly in customs—are perceived as major impediments. Parliamentary approval of important bills to strengthen governance and the business environment (e.g. anti-monopoly, investment and Anti-Money Laundering/Combating the Financing of Terrorism laws) has been pending for more than a year.

The short-term growth and external outlook remains strong, but high inflation is here to stay under the current policy stance. Real GDP is projected to grow by 19 percent on the strength

of higher oil production. Non-oil growth—driven by large public expenditure—would moderate to a still high 10 percent. The current account surplus would rise to 36 percent of GDP on higher oil export volumes and prices. Oil fund assets and international reserves are projected to more than triple from the end-2007 level, to reach US\$24 billion at end 2008. However, the continuation of the fiscal expansion would fuel domestic demand growth and inflation would stay high in 2008.

Executive Board Assessment

Executive Directors welcomed the impressive growth performance over the past three years, the rapidly improving living standards and declining poverty, and the generally favorable medium-term economic prospects. Directors agreed that the current oil boom holds the promise of modernizing Azerbaijan's economy, but cautioned that sustainable improvements in economic conditions require cautious management. They were concerned about the acceleration of inflation associated with the current expansionary policies, and called on the authorities to adjust promptly macroeconomic policies to prevent high inflation expectations from becoming entrenched.

Directors agreed that fiscal policy should shoulder most of the burden of adjustment to help reverse high inflation expectations and stifle the emerging wage-price spiral. While acknowledging the need for investments in infrastructure and human capital to promote nonoil sector growth and reduce poverty over the medium term, Directors underscored the need to moderate the planned fiscal expansion for 2008 and to embark on fiscal tightening from 2009 to contain aggregate demand, focusing on reducing the pace of expenditure increases. They were concerned that the recent adoption of a sizeable supplementary budget would add to the inflation risk.

Directors emphasized the importance of increasing the effectiveness of public spending. They observed that expenditure moderation would help address the government's concern about the quality and efficiency of public investment. Effective institutional mechanisms need to be established to ensure proper planning, execution, and monitoring of public projects. Directors called on the authorities to adopt a comprehensive medium-term expenditure framework in the context of the 2009 budget that reflects transparently the government's priorities and that evaluates the costs and benefits of projects and their recurrent maintenance costs.

Directors noted the role of monetary and exchange rate policies in preventing inflation from spiraling upward. They welcomed the authorities' intention to move toward a more flexible exchange rate system over time and the recent adoption of the two-currency basket peg—a step that supports the necessary development of the domestic foreign exchange market. Directors encouraged the Azerbaijan National Bank (ANB) to use exchange rate policy more actively to ward off imported inflation, and to allow the manat to appreciate somewhat against the basket.

Directors agreed that the exceptionally fast credit growth observed in the past few years entails substantial risks that may not have yet manifested themselves in the traditional banking soundness indicators. They welcomed the prudential measures recently adopted by the ANB

to strengthen banking regulation and supervision, and encouraged it to monitor the situation closely, take additional steps when necessary, and implement the prudential regulations forcefully across the banking system.

Directors underscored the importance of developing further the financial system to facilitate the growth of the non-oil economy. They took note of the renewed initiatives to privatize the state-owned banks, and encouraged the authorities to follow international best practices and complete the process transparently. They recommended consolidating the banking system further, while attracting established foreign banks to promote competition and increase efficiency. Directors encouraged the authorities to develop other sectors of the financial system, including the bond, insurance, and private pension market, to provide additional financing channels, investment vehicles, and savings instruments.

Directors considered a coherent structural reform agenda to be a critical component for supporting non-oil growth over the medium term. They called on the authorities to intensify efforts to strengthen corporate governance of the largest state-owned enterprises, remove obstacles to competition to increase the supply response of the economy, and implement anti-corruption programs. They welcomed the introduction of a one-stop facility for business registration, and called for a reduction in licensing requirements. They encouraged the authorities to proceed with reforming customs legislation and administration in line with WTO rules.

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

Azerbaijan: Selected Economic Indicators, 2004–08

| | 2004 | 2005 | 2006 | Prel. 2007 | Proj. 2008 |
|---|---|-------|-------|---------------|---------------|
| | (Annual percentage change) | | | | |
| Real economy | | | | | |
| GDP at constant prices | 10.4 | 24.3 | 30.5 | 23.4 | 19.1 |
| Oil sector | 2.5 | 65.4 | 62.0 | 37.3 | 27.7 |
| Non-oil sector 1/ | 13.8 | 8.4 | 11.9 | 11.5 | 10.0 |
| CPI (end-of-period) | 10.4 | 5.5 | 11.4 | 19.5 | 26.0 |
| | (In percent of GDP, unless otherwise specified) | | | | |
| Consolidated government | | | | | |
| Total revenue and grants 2/ | 26.8 | 25.1 | 28.0 | 29.6 | 55.4 |
| Total expenditure 2/ | 25.9 | 22.7 | 27.4 | 27.4 | 31.3 |
| Fiscal balance 3/ | 1.0 | 2.6 | -0.2 | 2.4 | 24.2 |
| Non-oil primary fiscal balance (in percent of non-oil GDP) | -12.9 | -12.6 | -31.1 | -32.1 | -50.0 |
| | (Annual percentage change) | | | | |
| Money and credit | | | | | |
| Manat reserve money | 38.2 | 7.5 | 132.6 | 101.4 | 94.3 |
| Manat broad money | 31.9 | 15.8 | 168.3 | 107.3 | 114.4 |
| Banking sector credit to the economy | 60.2 | 53.0 | 63.6 | 96.5 | 70.0 |
| Velocity of total broad money (M3) 4/ | 6.3 | 5.2 | 4.8 | 3.5 | 2.9 |
| | (In percent of GDP, unless otherwise specified) | | | | |
| Balance of payments | | | | | |
| Current account balance (-, deficit) | -29.8 | 1.3 | 17.7 | 28.8 | 36.3 |
| External public debt | 18.5 | 12.5 | 9.4 | 8.1 | 7.3 |
| Gross official international reserves | | | | | |
| In millions of US\$, (end of period) | 1,075 | 1,178 | 2,500 | 4,273 | 8,528 |
| In months of next year's non-oil imports c.i.f. | 3.8 | 3.0 | 4.8 | 4.7 | 6.8 |
| Exchange rate | | | | | |
| End-of-period (Manat/US\$) | 0.98 | 0.92 | 0.87 | 0.85 | ... |
| Real effective exchange rate (percentage change, "-="depreciation) | -3.8 | 6.3 | 8.7 | 8.8 | ... |

Sources: Azerbaijan authorities; and Fund staff estimates.

1/ Includes oil and gas transportation.

2/ Includes tax credits allocated to SOCAR.

3/ Includes statistical discrepancy.

4/ Defined as gross domestic demand (excluding hydrocarbon imports) divided by average broad money.

**Statement by Thomas Moser, Executive Director for Republic of Azerbaijan
and Martin Lanz, Advisor to Executive Director
May 23, 2008**

1. On behalf of our Azerbaijan authorities, we would like to thank the staff for the constructive discussions and the candid staff report. In these for Azerbaijan exciting but challenging times, the staff's policy advice provides valuable input to the authorities' efforts to address the population's manifold expectations. The authorities are committed to preserve macroeconomic stability and agree that, going forward, fiscal moderation will be needed. Managing a sudden surge in oil wealth, however, is and remains a challenging balancing act.

2. Azerbaijan has experienced spectacular growth during the recent years, with GDP per capita more than doubling over the last three years alone. The authorities are determined to use this unique opportunity for the rapid development of the country and to make fast progress in the living standards of the population. Given the still large needs and expectations of the population, the authorities have scaled up development spending. Not only infrastructure, but also such sectors as health and education are receiving necessary increases in funding.

3. The authorities are fully aware of the macroeconomic challenges that the oil boom creates. In 1999, in anticipation of the oil boom, the State Oil Fund of the Republic of Azerbaijan (SOFAZ) was established to save energy-related windfalls both for future generations and to avoid excessive spending. In 2003, the government established a Committee on Extractive Industries Transparency Initiative (EITI) to implement its obligations under the initiative, and Azerbaijan has since then published annual and semi annual EITI reports. The authorities have also made significant improvements in increasing non-oil revenues and are putting policies in place to support the development of medium-sized companies and the diversification of the economy.

4. The authorities are also aware that the rapid scaling up of public expenditure is testing the absorptive capacity of the country. They agree that the quality of public investment is crucial and are committed to improve project selection and monitoring to avoid wasteful, inflationary spending. The government is building up domestic capacity to conduct cost-benefit analysis for project proposals, and the adoption of IFRS accounting starting in 2008 will enhance the transparency of SOEs' operations and their financial discipline.

5. Rising food prices and energy price increases are contributing to the inflationary pressures. In March, the authorities replaced the crawling peg to the US dollar with a peg to a dollar/euro currency basket, whereby the weight of the euro will be adjusted in light of experience with the basket arrangement. Moreover, in April the National Bank of Azerbaijan (NBA) raised the refinancing rate by 1 percentage point to 14 percent. Both measures should help to contain inflation. Moreover, the introduction of a new system which requires VAT

taxpayers to maintain a sub-account with the ANB is expected to raise VAT collection above projections and should thus have a cooling effect on aggregate demand. The establishment of a macroeconomic coordination committee with the aim to improve policy coordination is also expected to help preserve macroeconomic stability.

6. Our Azerbaijan authorities consider the development and strengthening of the financial sector a priority. Azerbaijan's banking sector has grown substantially over the last years, with private banks now accounting for a larger share of total assets than state-owned banks. Soundness indicators and compliance with prudential regulations have improved in 2007, and the ANB is taking several measures to contain the risks stemming from high credit growth.

7. Measures on the structural front to develop entrepreneurship and improve the business environment are expected to boost competitiveness. The organization of entrepreneurship under the "one window" principle, loans given to investment projects of entrepreneurs by the National Fund on Support of Entrepreneurship, and preferential loans to farmers play a significant role in the development of the private sector. The establishment of special economic zones is also one of the major initiatives of state support to entrepreneurship. Efforts are made to create the first industrial city, business incubators and a network of business centers in the country to establish a market infrastructure of entrepreneurship. A new State Program is expected to be adopted that will cover the state policy on the development of entrepreneurship and the methods of its implementation. The Program will cover 2008-2013. WTO accession is now a top priority of the government of Azerbaijan, and the harmonization of legislation with WTO rules is expected to provide additional impetus to the efforts to improve the business environment.

8. The authorities would finally like to thank the Fund for the recently concluded CPI ROSC mission. Concerns about the CPI methodology have repeatedly been the subject of discussions between the authorities and stakeholders in past years. The authorities are currently studying the draft ROSC paper, but they appreciate the preliminary finding that there are no issues with their CPI methodology. Of course, the authorities will be keen on further improving their assessments of prices, based on the finding of the report.