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REPUBLIC OF AZERBAIJAN

2013 ARTICLE IV CONSULTATION

June 2013

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 2013 Article IV consultation with Azerbaijan, the following documents have been released and are included in this package:

- **Staff Report** for the 2013 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on March 12, 2013, with the officials of Azerbaijan on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on April 18, 2013. 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.
- **Informational Annex** prepared by the IMF.
- **Public Information Notice** (PIN) summarizing the views of the Executive Board as expressed during its May 3, 2013 discussion of the staff report that concluded the Article IV consultation.
- **Statement by the Executive Director** for Azerbaijan.

The document listed below has been or will be separately released.

Selected Issues Paper

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

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REPUBLIC OF AZERBAIJAN

STAFF REPORT FOR THE 2013 ARTICLE IV CONSULTATION

April 18, 2013

KEY ISSUES

Context and political setting

Economic activity recovered in 2012, reflecting a more moderate decline in oil output and continued strong non-oil growth, supported by government spending. Inflation reached record lows but overheating risks are increasing as a result of expansionary policy. Presidential elections are scheduled for October 2013.

Focus of consultation and recommendations

The overarching challenge for Azerbaijan, amid an environment of high oil prices but with a foreseeable decline in oil production, is to transform oil revenue into productive assets to generate sustainable and broad-based private sector-led growth in a way that is consistent with macroeconomic stability and absorptive capacity constraints. Staff recommends:

- Embarking on an up-front fiscal consolidation to pursue a sustainable non-oil fiscal position and provide room for private sector activity. This requires efforts to cut public spending, especially on investment, while improving its efficiency;
- Shifting to a more neutral monetary policy stance, ending the CBA's role in direct lending to the real sector, and preparing, in coordination with government agencies, for greater exchange rate flexibility over the long term;
- Capitalizing the banking system while strengthening supervisory safeguards, with a focus on restructuring the operations of IBA in line with international best practice;
- Promoting diversification by easing the entry and exit of companies in the non-oil sector, reducing corruption, improving access to finance, enacting a code of competition, and completing WTO accession.

Previous Consultation

During the 2011 Article IV consultation, Directors stressed the need to (i) unwind countercyclical policies adopted during the 2009 global crisis; (ii) delink fiscal policy from the global oil price cycle; (ii) strengthen the monetary policy framework; (iii) improve competition in the banking system; and (iv) enhance the business climate to achieve economic diversification. Though there has been little progress in unwinding countercyclical policies adopted during the 2009 global crisis and delinking fiscal policy from the global oil price cycle, the authorities have prepared an action plan with IMF TA to move towards greater exchange rate flexibility over the long term; adopted measures to increase competition in the banking system and some prudential regulations; and launched initiatives to further improve the business climate.

Approved By
Juha Kähkönen (MCD) and David D. Marston (SPR)

Discussions were held in Baku on February 27– March 12, 2013. The staff team comprised R. Almarzoqi (head), M. Albino-War, B. Quillin (all MCD), and I. Song (MCM), and E. Akçakoca (MCM Expert). Mr. J. Kähkönen, MCD Deputy Director, participated in final policy discussions. S. Mirzayev (OED) joined some of the meetings. The mission met with HE President Aliyev, Minister of Finance, Chairman of the Central Bank of Azerbaijan (CBA), Minister of Economic Development, chairmen of other government agencies (SOFAZ, Securities Commission, Statistics Committee, Social Protection Fund), other high level senior officials, and representatives of the private sector, civil society, and the diplomatic community.

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BACKGROUND AND CONTEXT

1. Using the oil revenue, Azerbaijan's economy has been one of the world's fastest growing over the last decade and fared well through the 2009 global crisis. Since the start of the boom, real GDP growth averaged over 13 percent annually, GDP per capita increased by six fold to nearly $6,000 by 2012, and poverty fell rapidly. The economy's reliance on oil is large: about 45 percent of GDP, over 70 percent of fiscal revenue, and 92 percent of exports.[1]

Azerbaijan: Social and Economic Indicators

	Pre-Boom (2001–03)	Boom (2006–08) 1/	Post-Crisis (2009–11)
Overall GDP growth	8.4	23.3	4.8
Non-oil GDP growth	11.4	13.0	6.7
Oil fund (percent of GDP) 2/	11.2	24.2	46.5
Poverty rate 3/	49.6	15.8	…
Business Competitiveness Ranking 4/	62	69	55

Sources: Azerbaijani authorities; and Fund staff estimates.
1/ The boom refers to the substantial increase in oil production.
2/ Data are for end 2003, 2008, and 2011.
3/ Share (percent) of population below the poverty line, (source: World Bank).
4/ World Economic Forum. Data are for 2005, 2008, and 2011.

2. Yet the country is at a critical juncture given the foreseeable decline in oil production and gas reserves amounting to only about 1/3 of oil wealth.[2] The current high oil prices provide an opportune environment to advance the 2020 government strategy for sustainable, broad-based and private sector led growth. The strategy would need to be underpinned by:

- Strong frameworks for conducting macro- economic policies, and careful management of the policy mix;
- A deep and efficient financial sector; and
- A favorable environment for private sector activity.

RECENT DEVELOPMENTS, OUTLOOK, AND RISKS

3. Near-term economic prospects are generally positive, albeit with an increasing risk of overheating:

- With strong growth of 9.6 percent, the **non-oil output** reached its potential last year and will remain near 9 percent in 2013, supported by public spending. **Oil output** is likely to drop in 2013 for a third year in a row, albeit at a slower pace, but should increase slightly next year with new well deliveries. **Overall GDP** growth is expected at 4 percent in 2013.

[1] In this note oil refers to oil and gas, except when discussing the oil production horizon, which only pertains to the oil sector. Oil reserves are expected to be depleted in 15-20 years. Sources: British Petroleum (BP) Statistical Review of World Energy, June 2012, and discussions with BP staff in the field. For a discussion of the factors behind the marked decrease in the poverty rate (including gains in employment, wages and productivity, and social transfers), see IMF reports for the 2011 Article IV Consultation with the Republic of Azerbaijan (IMF country reports 12/05 and 12/06).

[2] Major reasons behind the depletion of oil reserves are the age of the oil fields and limited investment in the oil sector.

- **Inflation** dropped sharply to an average of 1.1 percent in 2012, mainly reflecting the impact of global and domestic food price trends. But with the non-oil economy hitting capacity constraints and expansionary fiscal policy, headline inflation is projected to reach 7 percent by end-year, above the CBA's 5–6 percent target range, for an annual average of 3½ percent.

- The de facto exchange rate regime is classified as a stabilized arrangement, and the manat **exchange rate** has appreciated by less than 2 percent since November 2010 through the CBA's intervention.

- **Fiscal policy.** The non-oil fiscal primary deficit in percent of non-oil GDP—which has persistently been above the 35 percent implied by the permanent income rule—could increase from an estimated 45 percent in 2012 to 47 percent in 2013 with a full execution of the 2013 budget. The planned spending will significantly raise the break-even oil price and worsen fiscal sustainability. Parliament recently enacted some amendments to the tax code aimed mainly at fostering the non-oil sector development. The fiscal cost of 0.2–0.3 percent of GDP is likely to be offset through better tax enforcement enabled by the newly introduced online filing and auditing.[3]

- **Monetary policy** has turned expansionary, with two 250 basis point cuts in the benchmark refinancing rate since December 2012. Monetary transmission through policy rates is somewhat weak in the absence of well-developed money and bond markets. The availability of securities for conducting monetary policy is also limited.

- Financial indicators of the **banking system** excluding the International Bank of Azerbaijan (IBA) have deteriorated somewhat, particularly those associated with capitalization, liquidity, and profitability. While disclosed nonperforming loans (NPL) figures are still relatively low, they may be understated as only the overdue portion of principal and interest is reported as NPL. The largest bank, IBA, is in need of restructuring and received state support of ½ percent of GDP in 2012 to alleviate shortages in capital and liquidity, without any conditions. With a view to fostering consolidation and competition in banking system, the CBA increased the minimum capital requirements for banks fivefold (to $63 million, well above the Basel requirements) to be effective in 2014. An FSAP update is now scheduled for early 2014.

[3] Main amendments include the adoption of a 7-year-long income tax exemption for residents in new industrial and technological parks to foster the non-oil sector development; a cut in the maximum personal income tax rate from 30 per cent to 25 per cent; and an increase in the maximum monthly taxable income bracket from 2000 to 2500 manat (that had been kept at this level since 2008).

Azerbaijan: Banking Sector Excluding IBA—Financial Soundness Indicators, 2008–12

(In percent)

	2008	2009	2010	2011	2012
1. Regulatory Capital to Risk-Weighted Assets	21.1	22.6	21.4	21.0	19.9
2. Liquid Assets to Total Assets	14.1	15.8	17.3	17.4	15.0
3. Nonperforming Loans to Total Loans	2.3	3.7	5.1	5.4	5.6
4. Nonperforming Loans net of Provisions to Total Loans 1/ 2/	0.7	0.8	1.0	1.1	1.1
5. Bank Return on Assets	1.7	1.9	0.9	1.3	0.7
6. Bank Return on Equity	10.2	10.7	5.5	7.7	4.9

Source: Central Bank of Azerbaijan.
1/ Excludes restructured loans. Impaired loans ratio are higher under IFRS.
2/ Disclosed NPLs are somewhat underestimated, as only the overdue portion of principal and interest is disclosed as NPL.

4. The baseline scenario demonstrates that continuing with current policies would exacerbate fiscal vulnerabilities and further deter private sector investment. Oil dependence and fiscal vulnerabilities are rapidly increasing as reflected in the rising break-even oil price and oil fund transfers to the budget. The government's planned large public investment program, including in the 2013 budget, would maintain the non-oil primary deficit in percent of non-oil GDP well above the sustainable 35 percent level over the near term. This would severely limit the ability of the government to conduct near-term countercyclical fiscal policy. Implementing such plans could also result in overheating pressures and undermine the credibility of the government's goal of achieving fiscal sustainability by 2018. In the absence of structural reforms and substantial improvements in public investment management, the spending plans could also heighten concerns over efficiency (Box 1), exacerbate the vulnerability of public finances, and lead to a substantial drawdown of buffers against external shocks.

5. In the staff-recommended scenario, more prudent macro policies would tackle fiscal vulnerabilities and pave the way for economic diversification. Up-front fiscal consolidation, primarily by scaling down government spending, would still provide space for an ample level of public investment—above the average for developing economies. With a more credible medium-term fiscal consolidation path and structural reforms on the business environment, governance, and trade, non-oil sector growth would exceed that in the baseline scenario over the medium term.[4]

[4] Relative to the recommended staff scenario in the previous consultation, the current staff scenario factors in a considerable increase in the public investment program over 2012–13 and assumes that near-term deviations from the non-oil fiscal deficit benchmark of 35 percent under the permanent income rule would not all be offset before 2018.

6. **Risks to the baseline scenario are tilted to the downside (Annex 1).** Loose fiscal policy, a disorderly consolidation of the banking sector capital increase, and a delayed IBA restructuring would undermine prospects for reducing vulnerabilities and fostering sustainable growth. A fall in oil prices, triggered by trade spillovers resulting from an intensification of the recession in the euro area, is also a key risk. Direct exposure of the financial sector to euro area developments is mainly through assets of the oil fund. Regional conflicts, including increasing tensions over Nagorno-Karabakh, could affect the country's ability to attract non-oil FDI. The authorities agreed with the general assessment of risks to the medium-term outlook.

Azerbaijan: Selected Economic and Financial Indicators, 2011–18

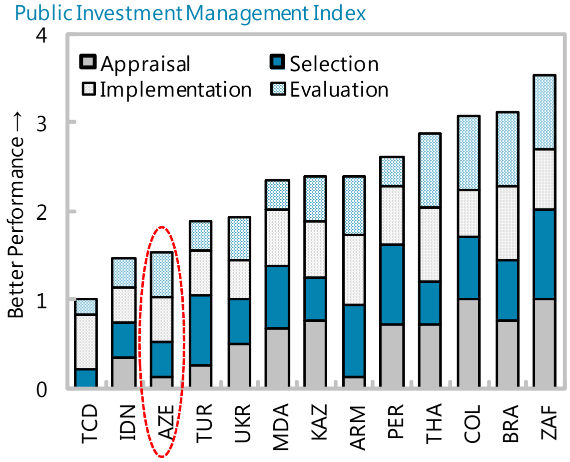
	Est.	Proj.						
	2011	2012	2013 2/	2014	2015	2016	2017	2018
Current Policies Scenario								
	(Annual percentage change)							
Overall GDP	0.1	2.2	4.1	5.8	4.8	3.5	3.2	4.0
Non-oil GDP	9.4	9.6	8.6	8.4	7.8	5.5	5.0	5.0
Consumer price index (period average)	7.9	1.1	3.4	6.7	6.5	6.5	6.3	6.0
	(In percent of GDP, unless otherwise specified)							
Overall fiscal balance	13.3	4.0	-2.7	-4.3	-8.1	-8.1	-6.3	-6.6
Non-oil primary balance 1/	-40.9	-45.0	-46.9	-44.3	-44.7	-40.8	-36.2	-34.8
Current account balance	26.5	20.3	10.6	6.0	3.0	0.6	0.4	-0.1
Oil Fund Assets (in billions of U.S. dollars)	29.8	33.3	32.5	29.7	25.7	19.9	15.3	8.8
Staff Recommended Scenario								
	(Annual percentage change)							
Overall GDP	0.1	2.2	3.5	5.2	3.7	3.7	4.1	5.0
Non-oil GDP	9.4	9.6	7.3	6.4	6.2	6.0	6.5	6.5
Consumer price index (period average)	7.9	1.1	2.9	6.0	5.8	5.5	5.3	5.0
	(In percent of GDP, unless otherwise specified)							
Overall fiscal balance	13.3	4.0	-0.1	-1.4	-3.2	-4.7	-4.3	-4.6
Non-oil primary balance 1/	-40.9	-45.0	-43.0	-41.5	-39.5	-38.1	-35.9	-34.5
Current account balance	26.5	20.3	13.6	7.4	5.2	2.5	1.8	1.2
Oil Fund Assets (in billions of U.S. dollars)	29.8	33.3	34.3	34.4	35.7	34.6	33.3	31.4

Sources: Azerbaijani authorities; and Fund staff estimates and projections.
1/ In percent of non-oil GDP.
2/ Based on the 2013 approved budget.

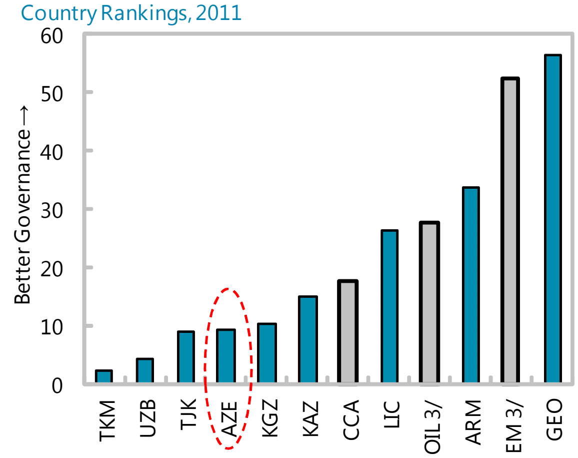
Box 1. Azerbaijan: The Level and Efficiency of Public Investment

The rapid increase in public investment may not have made a large development impact. The oil boom has enabled public investment levels, relative to GDP, that are as twice the average for resource rich developing countries (RRDC). Efficient use of public spending requires both investment within absorptive constraints and well-developed public financial management frameworks, but these are weak in Azerbaijan, particularly in investment project appraisals and selection. Moreover, rent seeking weakens the marginal impact of public investment, which is suggested by large infrastructure gaps in key services such as roads, water, and electricity relative to other RRDCs and the Caucasus and Central Asia (CCA) region (see Appendix II on Stylized Facts on the Azerbaijan Economy).

Quality of Public Investment 1/
Public Investment Management Index



Control of Corruption 2/
Country Rankings, 2011



1/ Source: Dabla-Norris et. al, 2011, "*Investing in Public Investment: An Index of Public Investment Efficiency*", IMF Working Paper/11/137.
2/ Source: Worldwide Governance Indicators.
3/ OIL indicates oil exporters; EM indicates emerging markets.

PAVING THE WAY FOR A DIVERSIFIED ECONOMY

A. Entrenching Fiscal Discipline

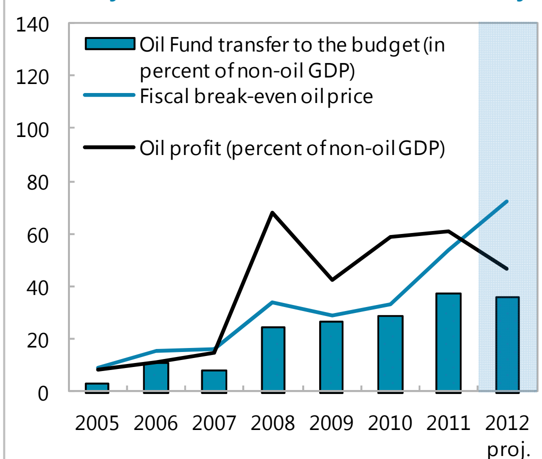
7. **A gradual fiscal tightening would reduce vulnerabilities and promote a self-sustaining expansion of private-sector activity.** Fiscal consolidation of 4 percent of non-oil GDP over 2013–14 is achievable if potential pressures for a mid-year supplementary budget are resisted and public investment is brought to levels consistent with macro stability and absorptive constraints. A more moderate investment path could support sustainable growth as suggested by the IMF Sustainable Investing Tool (Box 2). Ensuring that recent tax code amendments do not result in increased evasion, strengthening the appraisal and selection of investment projects in line with best practice, monitoring and containing fiscal risks arising from state-owned enterprises and IBA, and advancing

a sound pension reform in line with recent IMF technical assistance advice will be crucial to preserve the consolidation efforts.[5]

8. The authorities agreed that the non-oil deficit is unsustainable, but considered it infeasible to start consolidation in the near term. They saw rationalizing public investment as the main way to consolidate the non-oil fiscal position. But given existing large investment commitments (including projects by the oil company considered as a priority), they did not see the consolidation starting before 2015.

9. A new policy framework could promote fiscal discipline and sound oil revenue management (Box 3)**.** Continuing with the scaled-up public spending would not be appropriate given the weak non-oil fiscal position, the increasing overheating risks, and insufficient assurances of efficiency in public investment. In line with recent IMF policy advice for RRDC, a fiscal rule could provide deficit benchmarks to smooth the spending consolidation path to bring down the non-oil deficit in line with the 35 percent suggested by the permanent income model (PIH) by 2018. Credibility in the rule could be enhanced with reforms aimed at (i) streamlining exemptions and applying tax procedures uniformly; (ii) redirecting resources from a potential fuel subsidy reform to better targeted transfers; and (iii) strengthening the public financial management system to ensure high standards of fiscal control.

Azerbaijan: Indicators of Fiscal Vulnerabilty



Sources: Azebaijani authorities; and Fund staff estimates.

10. The authorities expressed interest in strengthening the fiscal framework to entrench fiscal discipline. They agreed on the need to prioritize and evaluate public investment, with World Bank support, to ensure efficiency. They also expressed willingness in developing a medium-term technical assistance program with the IMF to strengthen the fiscal framework and the public financial management system.

[5] Despite reforms to the pension system in 2006 and 2010, the pension system is not financially sustainable and its dependence on annual transfers from the budget has been steadily increasing over time (the deficit before budget transfers was about 4 percent of GDP in 2012). Reforming the system entails rationalizing the basic pension; restructuring the notional defined-contributions; separating contributions for old-age and disability benefits; and adopting a well-designed transition process and a plan for financing the residual unfunded liabilities.

Box 2. Azerbaijan: An Application of the Sustainable Investing Tool [1/] [2/]

The *IMF Sustainable Investing tool* was applied to Azerbaijan to analyze fiscal strategies that could better support the transformation of oil windfalls into long-term sustainable economic growth. The model—part of the IMF recent guidance for resource-rich developing countries (RRDC)—mainly captures two channels to induce higher non-oil GDP with higher public capital. First, high public capital raises the marginal productivity of private production factors. Higher productivity of these inputs "crowd in" private investment and output. Second, higher productivity raises households' income and private consumption.

Two fiscal approaches are analyzed under two scenarios of oil prices (WEO prices and an alternative scenario that subjects oil prices to large negative shocks between 2015–17):

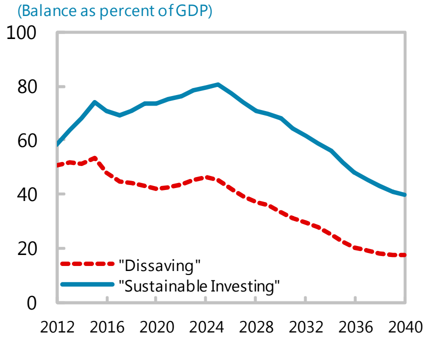
- **The dissaving approach** that keeps public investment at a very high level to a rapid buildup public capital. Public investment eventually winds down as the oil fund gradually depletes.
- **The sustainable investing approach** that enables public investment at moderate levels while sustaining the policy of saving some oil revenues in the oil fund.

The results suggest that the dissaving approach can outperform the sustainable investing approach in the near term but not without costs. This is provided that investment efficiency is not too low and public capital is productive, since government spending is much higher with dissaving. In the long term, the results suggest that the capital built with oil windfalls (and hence its growth benefits) may not be sustained and that private capital will eventually decline.

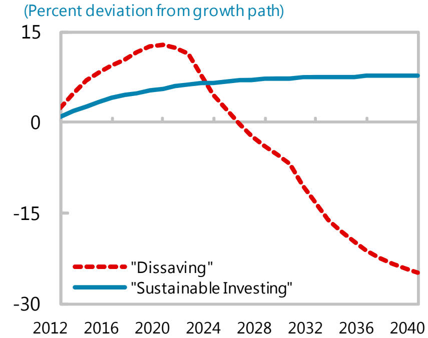
Only under the sustainable investment approach can the growth benefits from investing oil windfalls be sustained over time. Since the magnitude of investment path is rather moderate, investment efficiency is higher because lower investment levels are less likely to bump into absorptive capacity constraints. The continued savings of oil revenue in the oil fund helps support public investment spending, sufficient to cover the recurrent capital costs, and ensure oil windfalls are converted into sustainable physical assets.

The benefits of sustainable investing are more discernible in the alternative scenario of a negative oil prices shock. The oil fund serves as a buffer in supporting public investment, which prevents pro-cyclical fiscal policy. With a more stable fiscal regime, the oil fund can help maintain macroeconomic stability from the negative impact of volatile oil shocks and sustain both public and private capital and non-oil growth.

Alternative Stabilization Fund, 2012–2040
(Balance as percent of GDP)



Alternative Public Capital 2012–2040
(Percent deviation from growth path)



1/ Prepared in cooperation with S. Yang (RES).
2/ The SI tool was introduced by (i) Berg, A., R. Portillo, S.-C. Yang, and F. Zanna (forthcoming) "Public Investment in Resource-Abundant Developing Countries." IMF Economic Review.; and (ii) IMF, 2012, "Macroeconomic Policy Frameworks for RRDC".

Box 3. Azerbaijan: Revamping The Fiscal Policy Framework[1/]

In line with recent IMF guidance for RRDC, a **revamped fiscal framework—anchored on fiscal rules and strong institutional arrangements—**could boost the credibility in the Azerbaijani government's ability to achieve fiscal sustainability while dealing with the volatility and exhaustibility of oil resources. The RRDC fiscal toolkit was applied to Azerbaijan to simulate the impact of different fiscal rules.

Options for the fiscal rule:

- **A traditional Permanent Income Hypothesis (PIH) rule would be the first choice for a fiscal rule in Azerbaijan to anchor fiscal policy decisions.** Consistent with recent IMF guidance for RRDC, alternative PIH-based rules that allow a scaling up of expenditure such as the modified PIH (MPIH) or the Fiscal Sustainability Framework (FSF) do not seem advisable for Azerbaijan at this stage for three main reasons: (i) investment is already very high by developing country standards, and the authorities are thus likely bumping into absorptive capacity constraints; (ii) growing concerns about the low growth impact of government spending, given weaknesses in the management of investment programs and opportunities for corruption; and (iii) increasing overheating risks as a result of the combined effect of a closed output gap and expansionary fiscal policy as announced in the 2013 budget. The PIH, combined with an embedded price-based rule, could help smooth the volatility of oil revenue.

- **Price-based rules could also help smooth spending, when combined with a structural primary balance.** But calibration will be needed to align the performance of the rule with the desired mix of spending and savings.

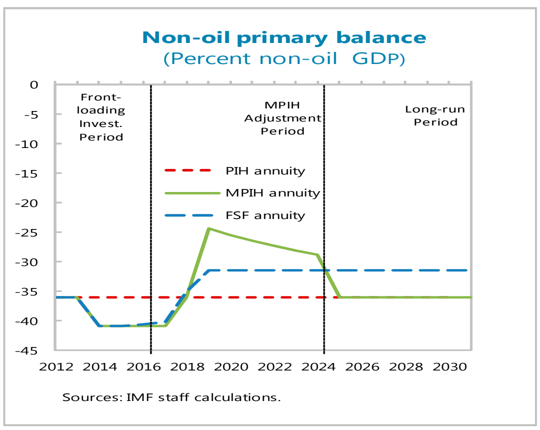
Strong fiscal institutions should supplement the fiscal rule:

- **The PFM system** should ensure the dissemination of the underlying non-oil fiscal position and break-even oil price, main contingent liabilities, and fiscal risks;

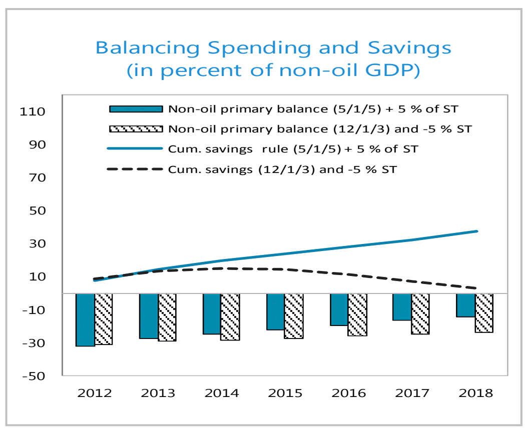
- **A fiscal responsibility law** could enforce fiscal decisions on a rules-based framework and help guide the flows to the fund, with some recalibration allowed at the beginning of a new government term.

- **The oil fund (SOFAZ) could establish one portfolio per objective** to increase the accountability in the achievement of different objectives. Funding for infrastructure projects in the budget needs to consult the available fiscal space, spending absorption capacity, and long-term sustainability. Investment could be guided by an "infrastructure needs assessments" developed with developmental partners (e.g., WB or ADB).

Whatever rule the authorities select, it would be important to abide by the rule and advance reforms to address the sustainability issues of the pension system and IBA.



Sources: IMF staff calculations.



1/ M. Poplawski provided support for the application of the fiscal sustainability framework and the FAD toolkit for simulation of different rules to Azerbaijan. See Selected issues note on "Revamping the Fiscal Policy Framework in Azerbaijan".

B. Dealing with Inflation

11. Shifting to a more neutral monetary policy stance in the near term, with a steady policy rate and preparedness to tighten if price pressures intensify, would help keep inflation within the CBA's 5–6 percent target range. With the output gap closed, demand pressures are rising as evidenced by the recent surge in non-food services and underlying inflation. Such pressures are likely to be exacerbated by the strong pace in consumption credit to the private sector and the expansionary 2013 approved budget. Though the monetary transmission mechanism is relatively weak, further policy rate cuts could generate the possibility of a round of higher inflation.

12. The CBA is ready to act if inflation threatens to rise above its 5–6 percent target range. The CBA emphasized that the rapid fall in inflation in late 2012 provided room for loosening policy and noted policy rate cuts were needed to help lower commercial banks' lending rates, which can exceed 20 percent. They noted their readiness to begin tightening monetary policy, if needed, this year.

13. Eliminating the CBA's role in direct lending to the real economy would promote CBA's independence. Notwithstanding earlier plans to unwind lending to the real sector launched in response to the 2009 global crisis, CBA's net credit to state-owned enterprises surged in 2012. This trend seems unjustified with the recovery in economic activity. The CBA should follow through on its planned prudential measures to cool down the acceleration in consumer loans, namely increasing the provisioning rate for non-performing loans in consumer lending and/or the coefficient of risk-weighted assets of consumer loans in foreign exchange for calculation of capital adequacy ratios.

14. While stressing the large import component and the short-term nature of the CBA's lending to the real sector, the authorities agreed on the need to stop this lending. The CBA noted that because of the large import component of the spending financed with this lending, its impact on aggregate demand is limited. They also reaffirmed their commitment to implement recent CBA initiatives to contain the rapid growth of consumer lending.

15. The authorities agreed that a more flexible exchange rate would enable a more independent monetary policy and an additional tool to absorb shocks, particularly over the long term as non-oil exports become more diversified. Very limited exchange rate flexibility may be beneficial at early stages of development, but costs of this regime are likely to increase as Azerbaijan diversifies and integrates with global financial markets, and faces the need to develop a more independent monetary policy. Staff stressed that the introduction of greater flexibility needs to be gradual and follow the implementation of pre-conditions and reforms in foreign exchange management and the monetary policy framework, as noted in the recent IMF technical assistance advice (Box 4). Over the longer term, plans to abandon the official exchange rate as the nominal anchor and introduce a target band with an explicit intervention strategy would pave the way for introducing inflation targeting as the main anchor for conducting monetary policy.

16. The CBA reiterated its willingness to move toward greater exchange rate flexibility over the longer term but emphasized this will require meeting the preconditions and establishing strong cooperation among agencies. The mission provided an opportunity to strengthen the direct dialog of the CBA with other agencies involved in this topic, namely the ministry of finance and the oil fund. All of these entities were receptive to the staff's proposal of creating a high-level committee or consultative group to move forward the implementation of the strategy developed with the support of IMF TA.

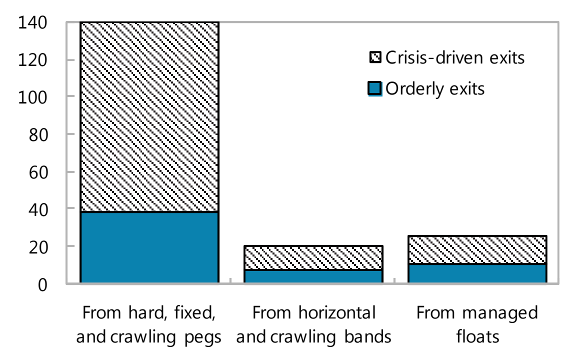
17. Competitiveness of the non-oil economy is undermined mainly by lack of decisive structural reforms and possibly some currency overvaluation. Staff estimates indicate that the real effective exchange rate may be overvalued but the results are not conclusive. Priorities for structural reforms are improving the business environment, deepening financial markets, and reducing barriers to trade and competition, particularly for SMEs (See Box 5). The authorities agreed that the ongoing government effort to improve the competitiveness of the non-oil sector is key to diversification.

Box 4. Azerbaijan: Sequencing in Exchange Rate Flexibility[1/]

Moving to a more flexible exchange rate in Azerbaijan requires the sequencing of pre-conditions and reforms in foreign exchange management and the monetary policy-setting framework. 2/ Cross-country experience suggest that orderly and durable transitions from fixed to more flexible exchange rate arrangements result from building this capacity, gradually introducing enhanced flexibility, and implementing policies to mitigate risks. In this direction, the pace and intended sequencing of reform should be clearly formulated and articulated to market participants and the public.

In the short run, market participants could be allowed to make FX trades at a progressively wider and explicit band around the official exchange rate, and a clear CBA intervention strategy should be announced. This will help price discovery, the monitoring of volatility, and the building of trading capacity in the banking sector. Systematic monitoring and forecasting liquidity and BOP projections by the CBA and also the Public Debt Management Agency and the Ministry of Finance will be important.

Exits by Exchange Rate Regime, 1990–2002



Source: Duttagupta, R., G. Fernandez, and C. Karacadag, 2005, "Moving to a Flexible Exchange Rate: How, When, and How Fast?," International Monetary Fund, Economic Issues, 38.

Over the medium and longer terms, a market-oriented approach will need to be developed to provide US dollars to the market. More commercial banks should be allowed to participate in the FX market and the transparency of the State Oil fund's role should be enhanced. Plans could then be announced to abandon the official exchange rate and set up a target band with an explicit intervention strategy while moving forward reforms that improve the transmission channel of monetary policy and the secondary debt trading. Ultimately, this will allow the authorities to move away from the exchange rate as a nominal anchor with the last stage objective of moving to inflation targeting.

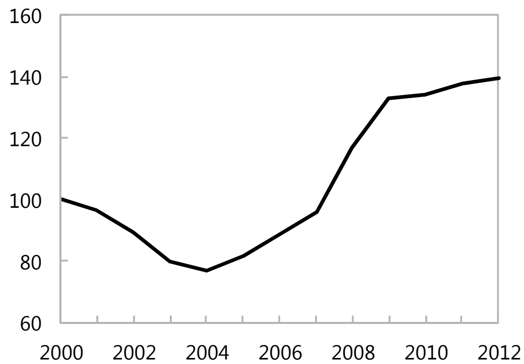
1/ This box reflects advice of a March 2012 Technical Assistance mission by the IMF's Monetary and Capital Markets department.
2/ See selected issues note on "Sequencing in Exchange Rate Flexibility in Azerbaijan."

Box 5. Azerbaijan: Exchange Rate, External Stability, and Competitiveness Assessment

The manat REER appreciated during the oil boom during 2004–8 and, though it has stabilized, there are signs of an overvaluation yet the results are not conclusive. An assessment made with the Macroeconomic Balance (MB) approach, based on current policies, indicates a roughly 15 percent overvaluation. This is broadly corroborated by the external stability (ES) approach. Yet, these results cannot be considered conclusive evidence of a loss of competitiveness as the reduced-form equilibrium real exchange rate (ERER) finds a 10 percent undervaluation by estimating the equilibrium rate as a function of a number of medium-term fundamentals.[1/]

Azerbaijan: Real Effective Exchange Rate

(Index, 2000=100)



Azerbaijan : Exchange Rate Assessment

	MB 2/	ES 3/	ERER
Underlying current account	-0.1	-14.1	
Current account norm	5.7	-7.9	
ER assessment, percent (-: undervalued) 1/	15.3	16.5	-17.2

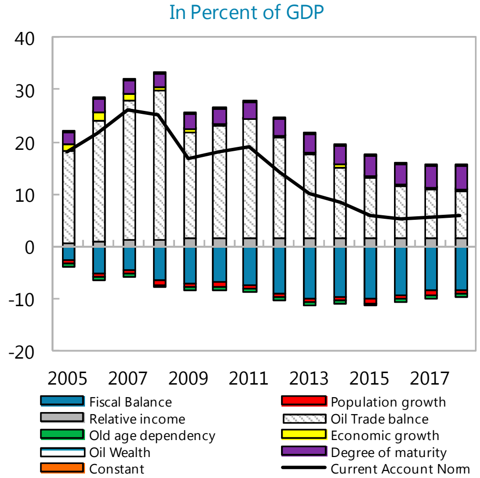
Source: Fund staff estimates and projections.

1/ Exchange rate elasticity is assumed to be 0.4.
2/ Current account as share of GDP.
3/ Non-oil current account as share of GDP.
4/ MB and ES approaches measures misallignment in 2018, ERER and PPP approaches are for 2012.

Macroeconomic Balance Approach

Contributions to Current Account Norm

In Percent of GDP

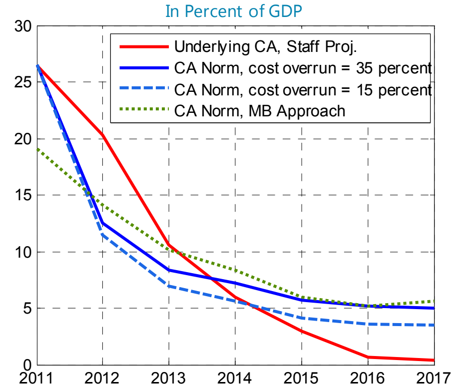


Source: Azerbaijani authorities; and Fund staff estimates.

Yet, the MB and ES results are consistent with the application of the External Assessment Framework to Azerbaijan as part of the IMFs recent guidance on macroeconomic policy frameworks in RRDCs.[2/] The current account (CA) norm estimated from this approach reflects CA dynamics under "frictions" such as investment inefficiencies and absorptive capacity constraints. The result shows a slightly lower CA surplus benchmark than the MB approach but still above the underlying CA. Moreover, it shows that a lower CA benchmark, closer to the underlying CA, would be associated with an environment of lower cost overruns (lower absorptive capacity constraints). These results provide support for the arguments, advanced in the Staff Report, that the authorities need to promote the competitiveness of the non-oil economy through structural reforms that improve the business environment and improve the volume and efficiency of private sector lending, particularly to SMEs.

Current Account Projection

In Percent of GDP



1/ See Beidas-Strom, S. and P. Cashin, 2011, "Are Middle Eastern Current Account Imbalances Excessive?," IMF WP/11/195.

2/ The application of the External Stability Framework to Azerbaijan was developed in cooperation with Juliana Araujo (SPR).

C. Strengthening the Financial Sector to Support Diversification

18. There was agreement that the ongoing capitalization process and ensuing consolidation are an opportunity to create a more viable and competitive banking sector. Ongoing CBA initiatives to strengthen corporate governance regulations, risk management practices, and prudential regulations to contain consumer lending are well placed to help preserve financial sector stability. To ensure the accurate classification of non-performing loans, with proper loan-loss provisioning, such initiatives could be supplemented with strengthened supervisory safeguards in line with international best practice. Approving a time-bound action plan—in line with IMF advice—to guide, in particular, the capitalization, recording of NPLs, and potential merger and acquisitions would be crucial to contain risks to financial stability in the system. While acknowledging the importance of properly classifying NPLs, the authorities noted that their relevant regulation provides for a comprehensive definition of NPLs.

19. The authorities welcomed IMF technical assistance in this area. They appreciated recommendations to contain risks to the capitalization process and agreed with the need to implement government initiatives to strengthen the soundness of the overall system.

20. With an unviable business model, the largest bank, IBA, needs major restructuring. An unreformed IBA undermines the stability and efficiency of the banking system as it faces heavy risks from large projects and could result in high costs for the shareholders, including the government. Restructuring IBA in line with internationally accepted principles would pave the way for the downsizing and transparent privatization of the bank in due course. This would entail a diagnostic assessment of IBA by a reputable international institution or company, and containing external borrowing until a viable business model is in place.[6]

21. Efforts to strengthen capital markets with the support of the World Bank would facilitate the financing of the non-oil sector. The authorities intend to develop the legal framework, infrastructure, and instruments for savers and investors. The recent expansion of the corporate bond market could help deepen the capital market but would need to be supplemented with actions to strengthen the consolidated supervision of banks and their brokerage subsidiaries, and develop an appropriate credit infrastructure. Staff also noted that the recent change in the Commercial Secrets Law, discouraging the disclosure of shareholders of companies, is a step in the wrong direction as it raises concerns about open competition for private sector activities and is against international disclosure principles.

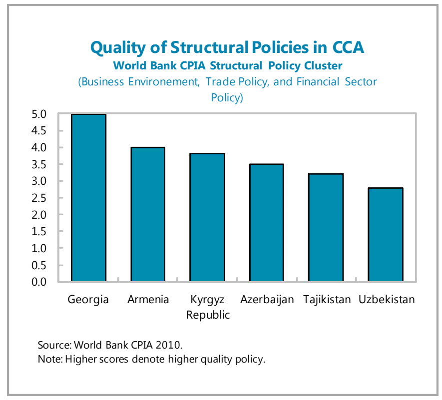
22. The authorities noted that addressing IBA issues and developing capital markets will require some time. Regarding IBA, they explained that actions to restructure this bank are important but should be carefully planned and proceed at a slow pace given the systemic

[6] For a discussion on IBA issues see IMF report for the 2011 Article IV Consultation with the Republic of Azerbaijan (IMF country report 12/05).

importance of this bank. They also noted that strengthening the credit infrastructure would entail coordinating the work of several agencies.

D. Advancing the Structural Reform Agenda to Promote Diversification

23. The authorities agreed that the government's 2020 strategy provides the platform for reforms in the business environment that could promote non-oil exports. The "easy service center" initiative (ASAN) has improved government services and should be expanded while phasing out more traditional and inefficient government services. E-government initiatives have the potential to reduce opportunities for corruption at the Ministry of Taxes and Customs but need to be supplemented with the legalization of e-signature to be effective. Improving structural policies and governance are critical for fostering non-oil FDI and private sector-led growth.



24. The authorities saw recent measures to promote diversification as promising. In this area, they noted that agro-industry, information technology, and tourism have potential to increase diversification and highlighted improvements in Azerbaijan's rankings, such as in the Global Competitiveness Index.[7] They also mentioned they are working on the introduction of e-signature in due course. They noted that the move towards electronic activities and the new ASAN model were considerably helping curb opportunities for corruption.

25. Reforms aimed at reducing informal and formal barriers to trade and competition would be crucial to promote a diversified and competitive economy. An independent international agency should provide a public evaluation of the draft competition code ahead of its enactment. Also, accelerating plans for WTO accession and the completion of regulations needed for the full implementation of the new customs code would encourage private sector investment and speed up integration with global markets. Substantial streamlining of government inspections, licenses, and permits—including for SMEs—could help sharply reduce non-oil companies' costs and opportunities for corruption (see Box 6).

26. The authorities regarded the recent tax amendments and government spending, particularly on infrastructure, as key actions to promote diversification. They noted recent amendments providing incentives for the development of industrial parks have worked well in other countries. They also saw the heavy public spending on infrastructure as critical to easing constraints on private investment and developing the non-oil sector. There was agreement on the importance of containing potential evasion arising from the new industrial parks, and also of advancing measures to ease barriers on trade and competition.

[7] Major drivers of the recent improvement in the latest World Economic Forum Global Competitiveness Index are improvements in the efficiency of goods markets, the availability of advanced technologies, and the capacity for innovation.

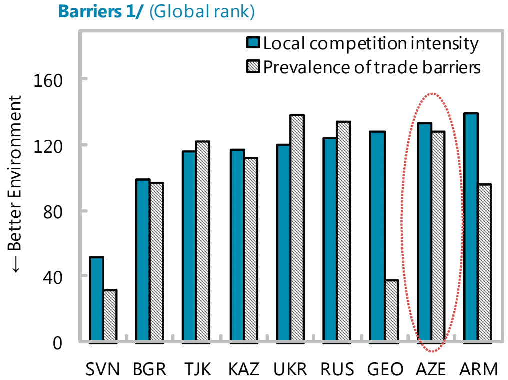
Box 6. Azerbaijan: Business Environment and Governance

An improved business environment will be crucial for a sustainable diversification strategy anchored on a strong role of external trade and a substantial reduction of the influence of public spending on non-oil growth. Since the onset of the oil boom, government spending seems to be stimulating a large share of non-oil private activities on services and construction. External non-oil trade has not been a driver of non-oil growth and FDI remains highly concentrated on oil and gas sectors.

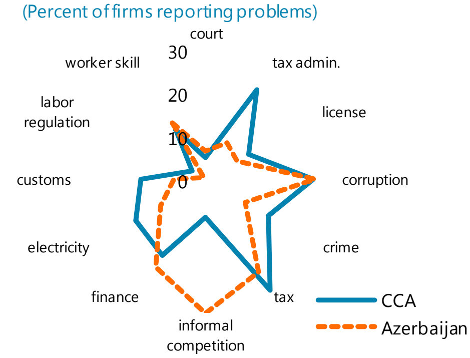
SMEs with substantial potential to support diversification and job creation are a much smaller contributor to growth in Azerbaijan than in comparator countries. Their share in GDP has remained in single digits, well below the average of more than 30–40 percent in Asian countries. Recent surveys by the OECD and IFC find that SMEs in Azerbaijan face high costs associated with entry and exit procedures, contract enforcement, government inspections, and property rights.

In round table discussions with IMF staff, private sector representatives and NGOs identified problems with competition and trade barriers. There are formal and informal monopolies, corporate governance problems, opportunities for corruption, and high cost of credit. The business community stressed the need to enact and enforce e-signature and a good competition law, complete WTO accession, and streamline government red tape, particularly for SMEs.

Anti-Monopoly Policy Effectiveness and Trade Barriers 1/ (Global rank)

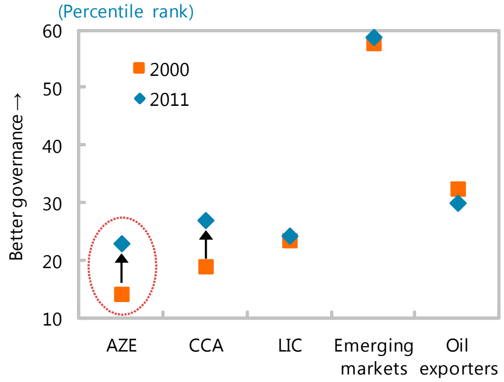


Firm-Level Business Constraints 2/
(Percent of firms reporting problems)

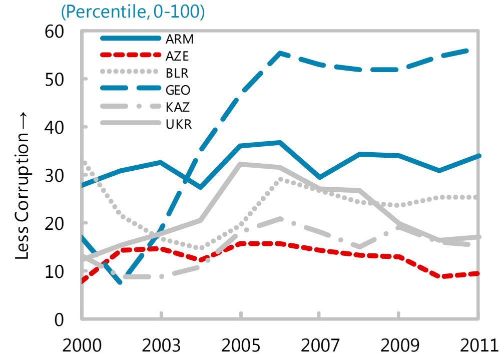


Note: the closer to the center, the better the environment.

Changes in Governance 3/
(Percentile rank)



Control of Corruption 3/
(Percentile, 0-100)



1/ Source: The World Economic Forum, *Global Competitiveness Indicators* (2011).
2/ Sources: World Bank Enterprise Surveys; and Fund staff calculations.
3/ Source: World Bank, *Worldwide Governance Indicators*; Governance includes government effectiveness, regulatory quality, rule of law and control of corruption. LIC indicates low-income countries.

OTHER ISSUES

Data Provision to the Fund

27. Timeliness of data provision to the Fund is broadly adequate for surveillance. Actions are underway to bring fiscal and external sector statistics in line with international standards. Sustained efforts are needed to strengthen data sharing among core government agencies and this could entail a technical memorandum of understanding among agencies. There is also a need to strengthen the production of statistics, particularly for GDP, fiscal accounts, and International Investment Position in line with recent IMF technical assistance.

STAFF APPRAISAL

28. Azerbaijan is at a critical juncture, and the authorities will need to make rapid progress toward the government's 2020 goal of making Azerbaijan a highly competitive economy. The benefits from the oil boom are temporary given the relatively short oil reserve horizon. The current high oil price presents an opportune environment to bring decisive changes in the current course of economic policies to reduce reliance on natural resources and promote a more sustainable and broad-based growth led by the private sector. Policy priorities are improving the efficiency of public spending while reducing its size, strengthening the financial sector, and improving the business climate, including by effectively implementing anti-corruption and anti-money laundering (AML) measures.[8]

29. A moderate upfront fiscal consolidation over 2013–14 would be manageable and could provide an important signal of change in the current course of fiscal policy. The government's planned spending program, including in the 2013 budget, is exacerbating oil dependence and increasing risks to a potential fall in global oil prices. The near-term fiscal position envisaged in the authorities' plans is also unsustainable over the longer term, given the short oil profile horizon. Reducing fiscal vulnerabilities while promoting a self-sustaining expansion of private-sector activity would thus require scaling down government spending, resisting pressures for a mid-year supplementary budget, and guarding against evasion from recent tax amendments. Lower government spending would support sustainable growth, particularly in the context of actions that aim to improve the efficiency of public spending, prioritize investment projects, and enhance the business climate for private sector activities.

[8] Recent IMF Technical Assistance on the AML/CFT focused on banking supervision tools on this area, including a risk-based supervision framework and on-site inspection procedures.

30. A revamped fiscal policy framework could help achieve fiscal sustainability and promote sound oil revenue management. A fiscal rule, along with the strengthening of supportive fiscal institutions, could bring fiscal discipline particularly during time of high oil prices, and would be crucial for Azerbaijan, given the relatively short oil reserve horizon. The new framework could establish a policy of saving part of the oil revenue for macro stability and intergenerational equity purposes. Against this background, the authorities' intention to seek IMF technical assistance for strengthening the fiscal framework and the public financial management system is welcome.

31. The CBA should undertake monetary tightening if price pressures intensify. Now that the impact of the 2009 global crisis has passed, the authorities would be well placed to eliminate the CBA's role in future direct lending to the real economy, which was meant to be temporary. Implementing the planned prudential measures to cool down the acceleration in consumer loans could help abate potential inflationary pressures while also contributing to financial sector stability.

32. A move toward greater exchange rate flexibility could improve the economy's ability to absorb shocks, particularly over the long term as non-oil exports become more diversified. The transition could be guided by recent IMF technical assistance in this area. But this move requires political will of the leadership of the country and strong cooperation among key government agencies. The creation of a high-level consultative group will be an important step in this regard.

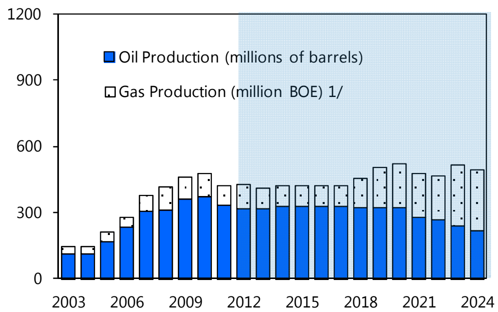
33. The ongoing capitalization provides an opportunity to create a more viable and competitive banking sector. The success of this process hinges on decisive actions to strengthen supervisory safeguards in line with international best practice. Developing a viable business model for the largest bank, IBA, will also be key to promote the stability and efficiency of the banking system. Efforts to strengthen capital markets, with the support of the World Bank, will also be crucial to facilitate the financing of the non-oil sector.

34. The long-run sustainability of the economy requires development of non-oil exports, and the government's 2020 strategy provides the platform for reforms to help achieve this objective. The "easy service center" and e-government initiative (ASAN) have the potential to reduce opportunities for corruption if supplemented with the legalization of e-signature. But fostering non-oil domestic and foreign private investment will require reducing informal and formal barriers to trade and competition, along with improvements in governance and rule of law.

35. It is recommended that the next Article IV consultation with Azerbaijan will be held on the standard 12-month cycle.

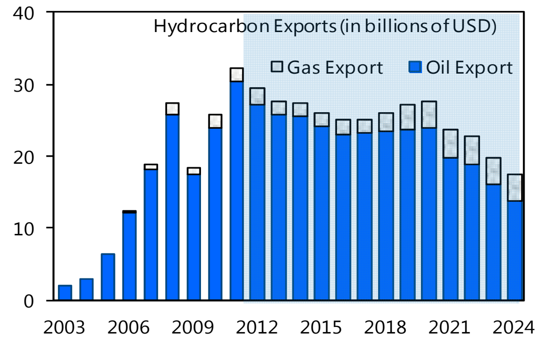
Figure 1. Azerbaijan: Output and Inflation

Despite the increase in natural gas production after 2018...

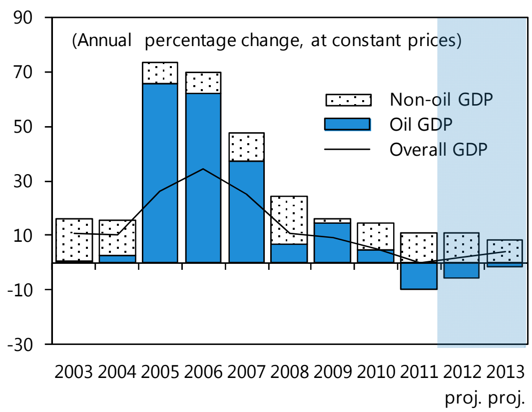


1/ Since a barrel of oil equivalent of natural gas sells at about 76 percent discount to oil, vertically stacking oil and natural gas volume does not reflect the value of hydrocarbon output.

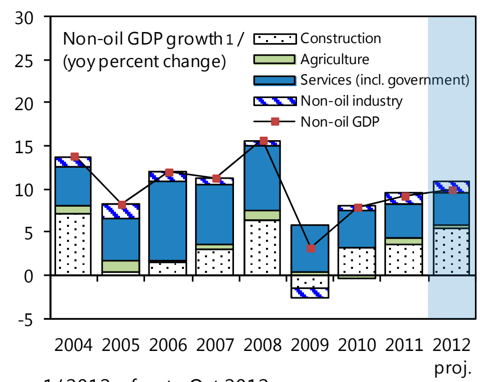
...hydrocarbon revenue will fall sharply in the mid-2020s.



The recent drop in oil production has been offset by strong non-oil GDP growth...

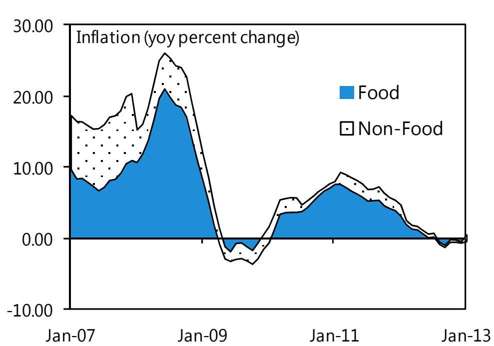


...the strength of which is, to a large extent, associated with government spending.

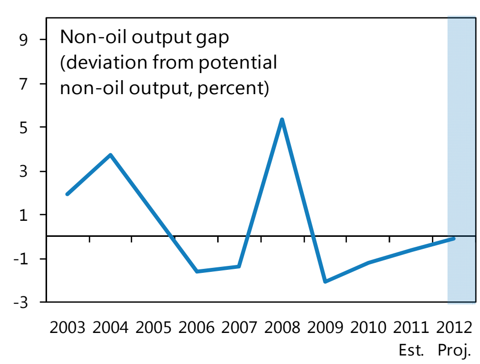


1/ 2012 refers to Oct 2012.

Headline inflation has fallen, largely driven by food...



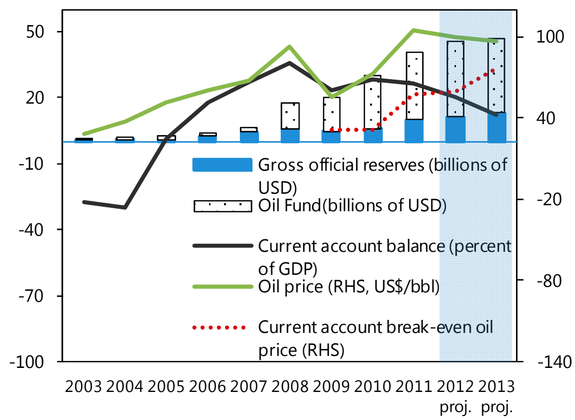
...but is expected to increase moderately with the non-oil economy hitting capacity constraints and expansionary fiscal policy.



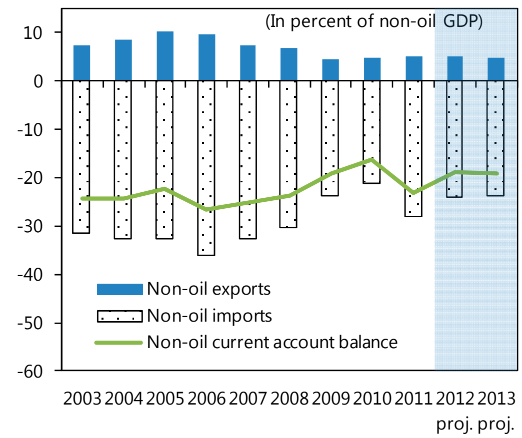
Sources: Azeri authorities and Fund staff estimates.

Figure 2. Azerbaijan: External and Fiscal Sectors

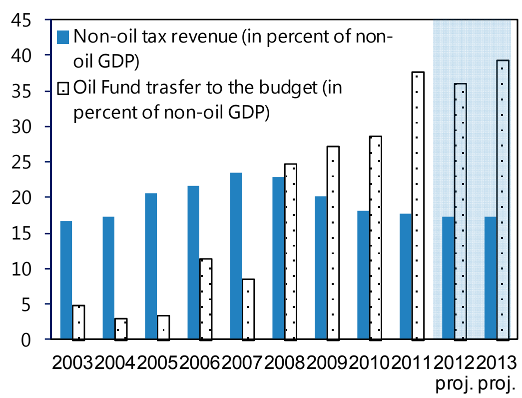
The external position remains strong, supported by oil prices and sizeable public assets accumulation...



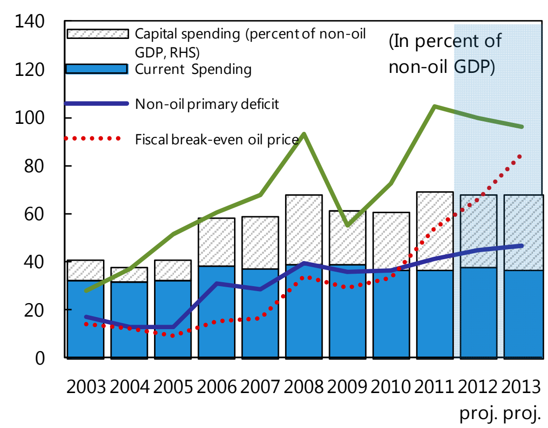
...but the non-oil CA deficit is expected to remain large on account of government-related non-oil imports and gas-related FDI.



An increasing dependency on oil revenue...



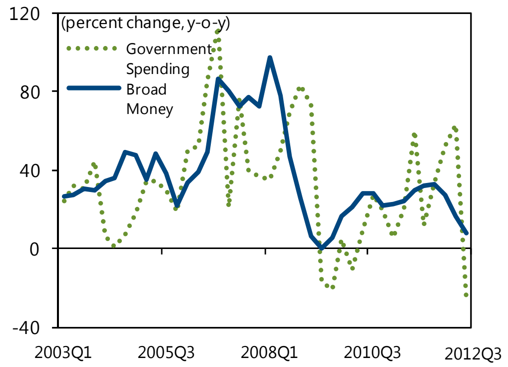
...has combined with high capital spending to result in a rapid increase in the non-oil deficit and the fiscal breakeven price.



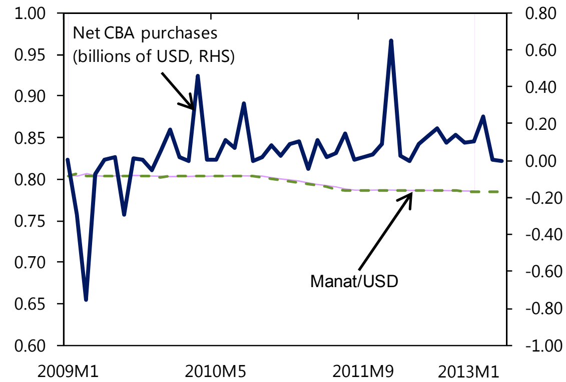
Sources: Azeri authorities and Fund staff estimates.

Figure 3. Azerbaijan: Monetary and Financial Sector Developments

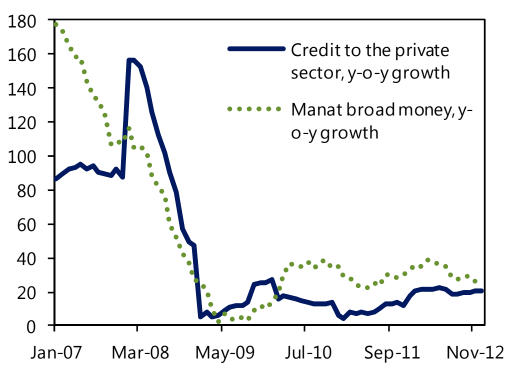
Monetary aggregates reflect movements in government spending.



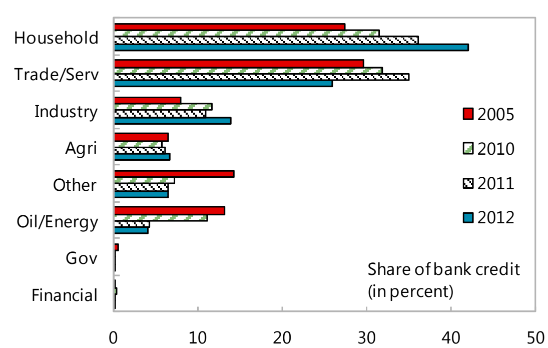
CBA foreign exchange interventions were large in 2012 and continue to support a stable exchange rate.



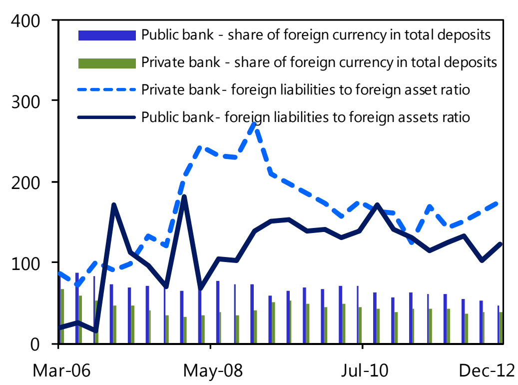
A pickup in manat broad money has accompanied rising levels of credit to the private sector



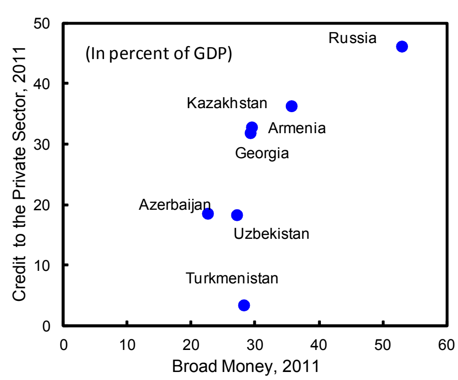
Households and industries have received an increasing share of credit since 2005 and credit is also high for trade and services.



Banks' foreign exchange exposures are high and rising...



And their level of intermediation remains low relative to regional comparators...



Sources: WEO data and Fund staff estimates

Sources: Azeri authorities and Fund staff estimates.

Table 1. Azerbaijan: Selected Economic and Financial Indicators, 2008–14

	2008	2009	2010	2011	2012	2013	2014
				Prel.		Proj.	
	(Annual percentage change, unless otherwise specified)						
National income							
GDP at constant prices	10.8	9.3	5.0	0.1	2.2	4.1	5.8
Of which: Oil sector 1/	6.9	14.8	5.0	-9.8	-5.3	-1.9	2.0
Non-oil sector 2/	15.7	3.0	7.6	9.4	9.6	8.6	8.4
Consumer price index (end of period)	15.4	0.7	7.9	5.6	-0.3	7.0	6.5
Consumer price index (period average)	20.8	1.6	5.7	7.9	1.1	3.4	6.7
Money and credit							
Net foreign assets	47.2	-18.5	34.6	68.7	5.6	18.5	13.7
Net domestic assets	5.0	63.4	13.5	2.8	40.3	32.3	28.5
Domestic credit	24.5	42.2	8.4	7.9	39.6	20.1	20.1
Of which : Credit to private sector	47.6	25.6	6.6	18.1	20.8	17.4	17.6
Manat base money	48.5	1.7	31.6	29.4	27.1	17.7	18.8
Manat broad money	27.2	9.9	34.8	32.5	25.5	28.4	30.2
Total broad money	25.5	16.6	21.9	32.1	20.6	25.4	21.6
Foreign currency deposits ratio to broad money	24.3	28.7	21.2	20.9	17.7	15.7	9.8
Velocity of total broad money (M3) 3/	3.0	3.0	2.8	2.6	2.4	2.5	2.4
External sector (in US$)							
Exports f.o.b.	43.8	-31.0	25.5	30.3	-8.5	-3.8	-1.2
Of which: Oil sector	44.3	-31.5	25.7	30.9	-10.0	-4.7	-2.5
Imports f.o.b.	25.3	-14.0	3.6	50.7	3.8	31.5	12.1
Of which: Oil sector	-17.6	-34.2	19.6	35.5	-5.9	71.0	4.9
Export volumes	6.4	6.2	-1.4	-3.3	-9.1	-1.6	2.8
Import volumes	17.0	-5.4	-4.0	38.2	6.2	32.5	12.5
Terms of trade	26.1	-28.6	27.1	30.7	3.0	-1.5	-3.6
Real effective exchange rate	21.4	14.0	1.1	2.5	1.0	...	...
	(In percent of GDP, unless otherwise specified)						
Gross investment	19.8	18.4	18.5	21.2	22.9	24.3	24.0
Consolidated government	13.2	12.3	12.5	16.0	16.3	18.0	17.7
Private sector	6.6	6.1	6.1	5.1	6.6	6.2	6.3
Of which: Oil sector	2.9	1.9	1.9	2.1	3.1	2.9	2.6
Gross domestic savings	64.4	47.7	52.5	54.1	48.5	39.9	34.7
Gross national savings	55.3	41.4	46.6	47.6	43.2	34.9	30.0
Consolidated government	33.5	19.3	27.1	29.4	20.3	15.3	13.4
Private sector 4/	21.8	22.1	19.5	18.3	22.9	19.5	16.6
Consolidated central government finance							
Overall fiscal balance	20.3	7.0	14.6	13.3	4.0	-2.7	-4.3
Non-oil primary balance, in percent of non-oil GDP	-39.2	-35.5	-36.3	-40.9	-45.0	-46.9	-44.3
External sector							
Current account (- deficit)	35.5	23.0	28.0	26.5	20.3	10.6	6.0
Foreign direct investment (net)	-1.2	0.3	0.6	1.4	0.2	0.4	1.2
Public and publicly guaranteed external debt outstanding	6.5	7.7	7.4	7.3	9.2	11.5	11.0
Memorandum items:							
Gross official international reserves (in millions of U.S. dollars)	6,467	5,364	6,721	10,887	12,087	14,087	14,587
Nominal GDP (in millions of manat)	38,006	35,602	42,465	51,158	53,968	58,936	66,325
Nominal non-oil GDP (in millions of manat) 2/	17,431	19,536	22,243	25,393	29,766	34,596	39,947
Nominal non-oil GDP (in millions of USD) 2/	21,761	24,326	27,877	32,286	37,919	45,801	53,964
Nominal GDP per capita (in U.S. dollars)	5,213	4,933	5,847	7,106	7,538	8,334	9,494
Nominal GDP (in millions of U.S. dollars)	46,378	44,289	52,913	64,819	68,804	77,236	88,694
Oil Fund Assets (in millions of U.S. dollars)	11,219	14,900	22,766	29,800	33,294	32,505	29,691
Population (mid-year, in millions)	8.9	9.0	9.0	9.1	9.2	9.3	9.3
Exchange rate (manat/dollar, end of period)	0.801	0.803	0.798	0.787			

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

1/ Includes the production and processing of oil and gas.
2/ Includes the transportation of oil and gas (except transportation through the western route)
3/ Defined as gross domestic demand (excluding oil sector-related imports) divided by average broad money.
4/ Historical data includes statistical discrepancy.

Table 2. Azerbaijan: Balance of Payments, 2008–14
(in millions of U.S. dollars, unless otherwise specified)

	2008	2009	2010	2011	2012	2013	2014
				Prel.		Proj.	
Exports, f.o.b.	30,586	21,097	26,476	34,494	31,579	30,371	30,003
Oil and oil products	29,143	19,970	25,108	32,871	29,600	28,216	27,501
Other	1,443	1,127	1,368	1,623	1,979	2,155	2,503
Imports, f.o.b.	-7,575	-6,514	-6,746	-10,166	-10,550	-13,875	-15,558
Oil sector	-1,064	-700	-838	-1,135	-1,067	-1,825	-1,915
Others	-6,511	-5,814	-5,908	-9,031	-9,483	-12,049	-13,643
Trade balance	23,012	14,583	19,730	24,328	21,028	16,496	14,446
Services, net	-2,343	-1,608	-1,734	-2,995	-3,419	-4,416	-4,967
Credit	1,547	1,750	2,077	2,720	3,213	3,926	4,435
Debit	-3,889	-3,358	-3,811	-5,715	-6,632	-8,342	-9,402
Oil sector	-1,970	-1,205	-1,240	-1,594	-2,345	-2,374	-2,477
Income	-5,266	-3,519	-3,657	-4,859	-3,609	-3,620	-3,880
Investment income, net	-5,200	-3,476	-3,618	-4,840	-3,546	-3,539	-3,780
Of which : profit of oil consortium	-5,040	-2,884	-3,199	-4,622	-3,726	-3,764	-4,121
Compensation of employees, net	-66	-43	-39	--	-62	-80	-100
Transfers, net	1,050	722	495	673	-27	-286	-274
Of which : Private	999	686	470	649	-50	-309	-301
Current account balance	16,454	10,178	14,834	17,146	13,973	8,174	5,324
Non-oil currenct account balance	-4,616	-5,002	-4,996	-8,374	-8,489	-12,079	-13,664
Capital account, net	11	5	14	18	13	15	15
Direct investment, net	-541	147	331	933	158	346	1,074
Of which : In reporting economy, net	15	473	563	1,465	977	1,090	1,695
Oil sector, net	-581	-274	-187	489	-223	490	1,495
Others, net	596	748	750	976	1,200	600	200
Portfolio investment, net	-347	-139	-139	413	598	1,618	4,089
Other investment	-2,658	-6,018	-3,784	-4,655	-10,092	-8,759	-12,664
Financial account, net	-3,547	-6,009	-3,591	-4,038	-9,336	-6,795	-7,501
Capital and financial account balance	-3,536	-6,004	-3,577	-4,020	-9,324	-6,780	-7,486
Errors and omissions	-846	-1,464	-990	-770	--	--	--
Overall balance	12,072	2,710	10,268	12,356	4,649	1,394	-2,162
Financing	-12,072	-2,710	-9,236	-11,519	-4,707	-1,222	2,310
Change in net foreign assets of CBA (increase -)	-2,460	963	-1,370	-4,185	-1,214	-2,010	-504
Change in Oil Fund assets (increase -)	-8,744	-3,681	-7,866	-7,034	-3,494	789	2,814
Memorandum items:							
Current account balance (in percent of GDP)	35.5	23.0	28.0	26.5	20.3	10.6	6.0
Non–oil Current account balance (in percent of Non–oil GDP)	-21.7	-20.6	-18.0	-26.0	-22.4	-26.6	-25.6
Gross official international reserves	6,467	5,364	6,721	10,887	12,087	14,087	14,587
in months of next year's non-oil imports c.i.f.	9.7	7.6	6.1	9.5	8.1	8.2	7.7
Oil Fund assets	11,219	14,900	22,766	29,800	33,294	32,505	29,691
Public and publicly guaranteed external debt (in percent of GDP)	6.5	7.7	7.4	7.3	9.2	11.5	11.0
Oil price (US$ per barrel)	97.0	61.8	79.0	111.0	110.0	107.7	103.5

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

Table 3a. Azerbaijan: Consolidated Central Government Operations, 2008–14
(in millions of manat)

	2008	2009	2010	2011	2012	2013	2014
				Prel		Proj.	
Total revenue and grants	19,426	14,368	19,386	23,292	21,940	21,949	23,244
Total revenue	19,426	14,368	19,383	23,285	21,932	21,940	23,234
Tax revenue	7,176	5,591	5,834	7,016	7,651	8,540	9,572
Income taxes	3,490	1,911	2,020	2,850	3,104	3,251	3,436
Social security contributions	599	582	697	744	902	1,048	1,211
Value added tax (VAT)	1,911	2,013	2,082	2,223	2,355	2,758	3,214
Excise taxes	487	485	515	480	569	661	757
Taxes on international trade	450	421	292	440	402	447	521
Other taxes	240	179	227	280	318	375	433
Nontax revenue 1/	12,250	8,777	13,549	16,269	14,281	13,400	13,662
Of which : Oil Fund revenues 2/	11,865	8,274	13,087	15,521	13,929	13,028	13,257
Total grants (current)	0	0	3	7	8	9	11
Total expenditure	11,829	12,028	13,450	17,514	20,256	23,565	26,150
Current expenditure	6,816	7,649	8,157	9,305	11,442	12,939	14,414
Interest	33	36	39	210	238	190	111
Investment expenditure and net lending	5,014	4,379	5,293	8,209	8,814	10,626	11,736
Domestically-financed	4,914	4,093	4,768	7,442	7,839	9,799	11,129
Foreign-financed	100	286	525	767	975	828	607
Statistical discrepancy	-131	-142	-277	-1,043	-481	-27	-35
Consolidated government balance, cash basis	7,727	2,482	6,213	6,821	2,166	-1,590	-2,871
Non-oil primary balance 3/	-6,840	-6,942	-8,070	-10,391	-13,405	-16,225	-17,684
Financing	-7,727	-2,482	-6,213	-6,821	-2,166	1,590	2,871
Domestic (net)	-7,752	-2,705	-6,686	-7,508	-3,036	872	2,374
O/w Banking system	-659	-25	-133	-1,631	93	50	50
Oil Fund (includes treasury balances)	-7,185	-3,018	-6,700	-5,943	-3,179	602	2,104
External (net)	25	223	473	687	870	718	497
Loans	130	288	526	768	975	828	607
Amortization due	105	65	53	81	105	110	110
Memorandum items:							
Oil revenue	14,600	9,461	14,323	17,422	15,809	14,825	14,924
Non-oil revenue 4/	4,826	4,907	5,063	5,870	6,131	7,124	8,321
Non-oil tax revenue 5/	3,989	3,942	4,033	4,508	4,996	5,816	6,810
Non-oil GDP (in billion of manats)	17,431	19,536	22,243	25,393	29,766	34,596	39,947

Sources: Azerbaijani 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.
3/ Defined as non-oil revenue minus total expenditure (excluding interest payments) and statistical discrepancies.
4/ Excludes AIOC profit tax, profit oil, and SOCAR profit tax.
but includes VAT and excise taxes on oil and gas, tax withholding on the AIOC's subcontractors.
5/ Tax revenue excluding AIOC and SOCAR profit tax, and social contributions.

Table 3b. Azerbaijan: Statement of Consolidated Government Operations, 2008–14
(in millions of manat, presented in line with GFSM 2001)

	2008	2009	2010	2011	2012	2013	2014
				Prel.		Proj.	
Revenue	19,836	14,828	19,824	23,730	22,512	22,521	23,754
Tax revenue	6,577	5,009	5,137	6,272	6,749	7,492	10,082
Income taxes	3,490	1,911	2,020	2,850	3,104	3,251	3,436
Value added tax (VAT)	1,911	2,013	2,082	2,223	2,355	2,758	3,214
Excise taxes	487	485	515	480	569	661	757
Taxes on international trade	450	421	292	440	402	447	521
Other taxes	240	179	227	280	318	375	433
Social security contributions	1,008	1,042	1,135	1,182	1,474	1,620	1,721
Nontax revenue 1/	12,250	8,777	13,549	16,269	14,281	13,400	13,662
Of which : Oil Fund revenues 2/	11,865	8,274	13,087	15,521	13,929	13,028	13,257
Total grants (current)	0	0	3	7	8	9	11
Expense	7,225	8,109	8,595	9,743	12,014	13,511	14,924
Compensation of employees	1,567	1,825	1,884	1,934	2,716	3,069	3,407
Use of goods and services	3,034	3,105	3,540	3,870	4,272	4,927	5,610
Social benefits	1,883	2,287	2,328	2,747	3,635	4,114	4,576
Subsidies	191	289	239	210	232	269	311
Grants	511	557	552	571	715	730	683
Interest	33	36	39	210	238	190	111
Other expense	7	10	14	203	205	212	226
Net operating balance (-, deficit)	12,610	6,719	11,229	13,987	10,499	9,010	8,830
Net Acquisition of Nonfinancial Assets	5,014	4,379	5,293	8,209	8,814	10,626	11,736
Statistical discrepancy	-131	-143	-277	-1,043	-481	-27	-35
Consolidated net lending and borrowing, cash basis	7,727	2,483	6,213	6,821	2,166	-1,590	-2,871
Non-oil primary net lending and borrowing 3/	-6,840	-6,941	-8,070	-10,391	-13,405	-16,225	-17,684
Financing	-7,727	-2,483	-6,213	-6,821	-2,166	1,590	2,871
Net acquisition of financial assets	-7,731	-3,100	-6,938	-7,418	-3,001	592	2,094
Domestic	-7,731	-3,100	-6,938	-7,418	-3,001	592	2,094
Oil Fund	-7,185	-3,018	-6,700	-5,943	-3,179	602	2,104
Privatizations and other sale of assets	23	33	0	56	40	40	40
Change in deposits (+ withdrawal)	-569	-115	-237	-1,531	138	-50	-50
Net incurrence of liabilities	4	617	724	596	835	998	777
Domestic	-22	395	252	-90	-35	280	280
Banking system	-90	91	104	-100	-45	100	100
Nonbank sector	69	304	148	10	10	180	180
External	25	223	473	687	870	718	497
Memorandum items:							
Oil revenue	14,600	9,461	14,323	17,422	15,809	14,825	14,924
Non-oil GDP (in billion of manats)	17,431	19,536	22,243	25,393	29,766	34,596	39,947

Sources: Azerbaijani 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.

3/ Defined as non-oil revenue minus total expenditure (excluding interest payments) and statistical discrepancies.

Table 4a. Azerbaijan: Consolidated Central Government Operations, 2008–14
(in percent of non-oil GDP)

	2008	2009	2010	2011	2012	2013	2014
				Prel.		Proj.	
Total revenue and grants	111.4	73.5	87.2	91.7	73.7	63.4	58.2
Total revenue	111.4	73.5	87.1	91.7	73.7	63.4	58.2
Tax revenue	41.2	28.6	26.2	27.6	25.7	24.7	24.0
Income taxes	20.0	9.8	9.1	11.2	10.4	9.4	8.6
Social security contributions	3.4	3.0	3.1	2.9	3.0	3.0	3.0
Value added tax (VAT)	11.0	10.3	9.4	8.8	7.9	8.0	8.0
Excise taxes	2.8	2.5	2.3	1.9	1.9	1.9	1.9
Taxes on international trade	2.6	2.2	1.3	1.7	1.3	1.3	1.3
Other taxes	1.4	0.9	1.0	1.1	1.1	1.1	1.1
Nontax revenue 1/	70.3	44.9	60.9	64.1	48.0	38.7	34.2
Of which : Oil Fund revenues 2/	68.1	42.4	58.8	61.1	46.8	37.7	33.2
Total grants (current)	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total expenditure	67.9	61.6	60.5	69.0	68.0	68.1	65.5
Current expenditure	39.1	39.2	36.7	36.6	38.4	37.4	36.1
Primary current expenditure	38.9	39.0	36.5	35.8	37.6	36.9	35.8
Interest	0.2	0.2	0.2	0.8	0.8	0.5	0.3
Investment expenditure and net lending	28.8	22.4	23.8	32.3	29.6	30.7	29.4
Domestically-financed	28.2	20.9	21.4	29.3	26.3	28.3	27.9
Foreign-financed	0.6	1.5	2.4	3.0	3.3	2.4	1.5
Statistical discrepancy	-0.7	-0.7	-1.2	-4.1	-1.6	-0.1	-0.1
Consolidated government balance, cash basis	44.3	12.7	27.9	26.9	7.3	-4.6	-7.2
Non-oil primary balance 3/	-39.2	-35.5	-36.3	-40.9	-45.0	-46.9	-44.3
Financing	-44.3	-12.7	-27.9	-26.9	-7.3	4.6	7.2
Domestic (net)	-44.5	-13.8	-30.1	-29.6	-10.2	2.5	5.9
Banking system	-3.8	-0.1	-0.6	-6.4	0.3	0.1	0.1
Oil Fund	-41.2	-15.4	-30.1	-23.4	-10.7	1.7	5.3
External (net)	0.1	1.1	2.1	2.7	2.9	2.1	1.2
Loans	0.7	1.5	2.4	3.0	3.3	2.4	1.5
Memorandum items:							
Oil revenue	83.8	48.4	64.4	68.6	53.1	42.9	37.4
Non-oil revenue 4/	27.7	25.1	22.8	23.1	20.6	20.6	20.8
Non-oil tax revenue 5/	22.9	20.2	18.1	17.8	16.8	16.8	17.0

Sources: Azerbaijani 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.

3/ Defined as non-oil revenue minus expenditure (excluding interest payments) and statistical discrepancies.

4/ Excludes AIOC profit tax, profit oil, and SOCAR profit tax.

but includes VAT and excise taxes on oil and gas, tax withholding on the AIOC's subcontractors.

5/ Tax revenue excluding AIOC and SOCAR profit tax and social contributions.

Table 4b. Azerbaijan: Statement of Consolidated Government Operations, 2008–14
(in percent of non-oil GDP, presented in line with the GFSM 2001)

	2008	2009	2010	2011	2012	2013	2014
			Prel		Proj.		
Revenue	113.8	75.9	89.1	93.5	75.6	65.1	59.5
Tax revenue	37.7	25.6	23.1	24.7	22.7	21.7	25.2
Income taxes	20.0	9.8	9.1	11.2	10.4	9.4	8.6
Value added tax (VAT)	11.0	10.3	9.4	8.8	7.9	8.0	8.0
Excise taxes	2.8	2.5	2.3	1.9	1.9	1.9	1.9
Taxes on international trade	2.6	2.2	1.3	1.7	1.3	1.3	1.3
Other taxes	1.4	0.9	1.0	1.1	1.1	1.1	1.1
Social security contributions	5.8	5.3	5.1	4.7	5.0	4.7	4.3
Nontax revenue 1/	70.3	44.9	60.9	64.1	48.0	38.7	34.2
Of which : Oil Fund revenues 2/	68.1	42.4	58.8	61.1	46.8	37.7	33.2
Total grants (current)	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Expense	41.5	41.5	38.6	38.4	40.4	39.1	37.4
Compensation of employees	9.0	9.3	8.5	7.6	9.1	8.9	8.5
Use of Goods and services	17.4	15.9	15.9	15.2	14.4	14.2	14.0
Social benefits	10.8	11.7	10.5	10.8	12.2	11.9	11.5
Of which : social protection fund	8.2	8.7	8.1	8.4	8.9	8.7	8.3
Subsidies	1.1	1.5	1.1	0.8	0.8	0.8	0.8
Grants	2.9	2.9	2.5	2.2	2.4	2.1	1.7
Interest	0.2	0.2	0.2	0.8	0.8	0.5	0.3
Other expense	0.0	0.0	0.1	0.8	0.7	0.6	0.6
Net operating balance (-, deficit)	72.3	34.4	50.5	55.1	35.3	26.0	22.1
Net Acquisition of Nonfinancial Assets	28.8	22.4	23.8	32.3	29.6	30.7	29.4
Statistical discrepancy	-0.7	-0.7	-1.2	-4.1	-1.6	-0.1	-0.1
Consolidated net lending and borrowing, cash ba	44.3	12.7	27.9	26.9	7.3	-4.6	-7.2
Non-oil primary net lending and borrowing 3/	-39.2	-35.5	-36.3	-40.9	-45.0	-46.9	-44.3
Financing	-44.3	-12.7	-27.9	-26.9	-7.3	4.6	7.2
Net acquisition of financial assets	-44.4	-15.9	-31.2	-29.2	-10.1	1.7	5.2
Domestic (net)	-44.4	-15.9	-31.2	-29.2	-10.1	1.7	5.2
Oil Fund	-41.2	-15.4	-30.1	-23.4	-10.7	1.7	5.3
Privatizations and other sale of assets	0.1	0.2	0.0	0.2	0.1	0.1	0.1
Change in deposits (+ withdrawal)	-3.3	-0.6	-1.1	-6.0	0.5	-0.1	-0.1
Net incurrence of liabilities	0.0	3.2	3.3	2.3	2.8	2.9	1.9
Domestic	-0.1	2.0	1.1	-0.4	-0.1	0.8	0.7
Banking system	-0.5	0.5	0.5	-0.4	-0.2	0.3	0.3
Nonbank sector	0.4	1.6	0.7	0.0	0.0	0.5	0.5
External	0.1	1.1	2.1	2.7	2.9	2.1	1.2
Memorandum items:							
Oil revenue	83.8	48.4	64.4	68.6	53.1	42.9	37.4
Non-oil GDP (in billion of manats)	17.4	19.5	22.2	25.4	29.8	34.6	39.9

Sources: Azerbaijani 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.

3/ Defined as non-oil revenue minus total expenditure (excluding interest payments) and statistical discrepancies.

Table 5. Azerbaijan: Summary Accounts of the Central Bank, 2008–14
(in millions of manat, unless otherwise specified)

	2008	2009	2010	2011 Prel.	2012 Proj.	2013 Proj.	2014 Proj.
Net foreign assets	5,113	4,257	5,488	8,549	9,411	10,929	12,265
Net international reserves of the CBA	5,115	4,257	5,488	8,549	9,412	10,925	12,260
Gross international reserves	5,180	4,308	5,527	8,572	9,425	10,933	12,267
Foreign liabilities	-65	-50	-39	-23	-13	-8	-7
Other items, net 1/	-3	0	0	0	-1	4	5
Net domestic assets	-149	651	1,033	-59	1,249	1,627	2,600
Domestic credit	-390	875	1,087	-7	1,388	1,866	2,839
Net claims on consolidated central government	-476	-591	-828	-2,083	-1,934	-1,953	-1,982
Of which : claims on central government	134	390	430	424	418	424	424
manat deposits of central government	-522	-870	-932	-2,389	-2,246	-2,301	-2,351
Claims on banks	233	1,473	1,550	607	972	1,722	2,200
Credit to the economy	2	2	399	1,520	2,470	2,346	2,229
CBA notes	-149	-8	-34	-50	-120	-250	391
Other items, net	241	-225	-54	-52	-139	-239	-239
Reserve money	4,964	4,908	6,521	8,489	10,660	12,556	14,865
Manat reserve money	4,781	4,861	6,397	8,275	10,515	12,372	14,694
Currency outside CBA	4,426	4,513	5,793	7,658	9,778	11,373	13,265
Bank reserves and other deposits	355	345	602	612	723	985	1,415
Reserves in foreign currency	183	47	124	214	145	185	171

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

1/ In 2009, Azerbaijan received general and special SDR allocations from the IMF in the amount of SDR 153.6 millions.

Table 6. Azerbaijan: Monetary Survey, 2008–14
(in millions of manat, unless otherwise specified)

	2008	2009	2010	2011 Prel.	2012	2013 Proj.	2014
Net foreign assets	4,225	3,444	4,636	7,823	8,262	9,791	11,127
Net international reserves of the CBA	5,115	4,257	5,488	8,549	9,412	10,925	12,260
Net foreign assets of commercial banks	-808	-731	-779	-674	-1,063	-1,063	-1,063
Other	-82	-83	-73	-52	-86	-67	-65
Net domestic assets	3,176	5,189	5,889	6,053	8,492	11,237	14,436
Net claims on consolidated central government	-647	-637	-777	-2,098	-2,038	-2,037	-1,988
Credit to the economy	6,488	8,946	9,786	11,814	15,603	18,323	21,551
Of which: private sector	5,912	7,429	7,919	9,352	11,296	13,265	15,602
Other items, net	-2,665	-3,120	-3,119	-3,663	-5,073	-5,049	-5,127
Broad money	7,401	8,633	10,527	13,903	16,774	21,032	25,567
Manat broad money	5,600	6,157	8,297	10,997	13,806	17,726	23,073
Cash outside banks	4,189	4,253	5,456	7,158	9,257	11,571	14,232
Manat deposits	1,411	1,904	2,842	3,839	4,550	6,155	8,841
Foreign currency deposits	1,801	2,476	2,230	2,906	2,967	3,306	2,494
	(Annual percentage change)						
Net foreign assets	47.2	-18.5	34.6	68.7	5.6	18.5	13.7
Net domestic assets	5.0	63.4	13.5	2.8	40.3	32.3	28.5
Credit to the economy	39.7	37.9	9.4	20.7	32.1	17.4	17.6
Of which: private sector	47.6	25.6	6.6	18.1	20.8	17.4	17.6
Broad money (M3)	25.5	16.6	21.9	32.1	20.6	25.4	21.6
Manat broad money (M2)	27.2	9.9	34.8	32.5	25.5	28.4	30.2
Reserve money	44.3	-1.1	32.9	30.2	25.6	17.8	18.4
Manat reserve money	48.5	1.7	31.6	29.4	27.1	17.7	18.8
Memorandum items:							
Gross official international reserves (US$ millions)	6,467	5,364	6,927	10,899	12,087	14,087	14,587
Velocity of total broad money (M3) 1/	3.0	3.0	2.8	2.6	2.4	2.5	2.4
Broad money in percent of non-oil GDP	43.5	41.1	44.3	52.9	52.9	54.1	54.1
Credit to private sector in percent of non-oil GDP	15.6	20.9	18.6	36.8	37.9	38.3	39.1
Currency to broad money ratio	56.6	49.3	51.8	51.5	55.2	55.0	55.7
Share of foreign currency deposits in total deposits	56.1	56.5	44.0	43.1	39.5	34.9	22.0
Foreign currency deposits to broad money ratio	24.3	28.7	21.2	20.9	17.7	15.7	9.8

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

1/ Velocity is defined as the ratio of gross domestic demand (excluding oil–related imports) and average broad money.

Table 7. Azerbaijan: Selected Economic and Financial Indicators, 2012–18

	2012	2013	2014	2015	2016	2017	2018
				Proj.			
	(Annual percentage change, unless otherwise specified)						
National income							
GDP at constant prices	2.2	4.1	5.8	4.8	3.5	3.2	4.0
Of which: Oil sector 1/	-5.3	-1.9	2.0	-0.1	0.0	0.0	2.2
Non-oil sector 2/	9.6	8.6	8.4	7.8	5.5	5.0	5.0
Consumer price index (period average)	1.1	3.4	6.7	6.5	6.5	6.3	6.0
External sector (in U.S. dollars)							
Exports f.o.b.	-8.5	-3.8	-1.2	-2.7	-1.3	2.9	4.9
Of which: Oil sector	-10.0	-4.7	-2.5	-4.7	-4.0	0.4	2.3
Non-oil sector	21.9	8.9	16.1	19.2	22.6	20.0	20.0
Imports f.o.b.	3.8	31.5	12.1	9.1	9.0	2.6	5.5
Of which: Oil sector	-5.9	71.0	4.9	3.7	3.5	-20.0	-58.3
Non-oil sector	5.0	27.1	13.2	9.8	9.8	5.4	11.5
Export volumes	-9.1	-1.6	2.8	1.0	1.7	5.6	6.7
Import volumes	6.2	32.5	12.5	9.2	9.1	1.9	4.8
	(In percent of GDP, unless otherwise specified)						
Consolidated central government finance							
Overall fiscal balance	4.0	-2.7	-4.3	-8.1	-8.1	-6.3	-6.6
Non-oil primary balance, in percent of non-oil GDP 4/	-45.0	-46.9	-44.3	-44.7	-40.8	-36.2	-34.8
External sector							
Current account balance	20.3	10.6	6.0	3.0	0.6	0.4	-0.1
Non-oil current account balance (in percent of non-oil GDP)	-22.4	-26.6	-25.6	-23.6	-22.5	-22.2	-22.5
Foreign direct investment (net)	0.2	0.4	1.2	2.9	3.1	1.7	1.2
Of which: Non-oil sector	1.7	0.8	0.2	1.5	1.5	1.6	1.8
Public and publicly guaranteed external debt outstanding	9.2	11.5	11.0	10.6	10.4	10.3	10.0
Memorandum items:							
Gross official international reserves (in billions of U.S. dollars)	12.1	14.1	14.6	15.1	15.6	16.1	16.6
Nominal GDP (in billions of manat)	54.0	58.9	66.3	73.8	81.2	88.7	97.6
Nominal GDP (in billions of US. dollars)	68.8	77.2	88.7	99.7	109.7	119.8	131.9
Nominal non-oil GDP (in billions of manat) 2/	29.8	34.6	39.9	45.9	51.5	57.4	63.8
Nominal non-oil GDP (in billions of US. dollars) 2/	37.9	45.3	53.4	62.0	69.6	77.5	86.2
Oil Fund Assets (in billions of U.S. dollars) 5/	33.3	32.5	29.7	25.7	19.9	15.3	8.8

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

1/ Includes the production and processing of oil and gas.
2/ Includes oil and gas transportation (except through the western route), and export tax paid by the state oil company.
3/ Historical data includes statistical discrepancy.
4/ Defined as non-oil revenue minus total expenditure (excluding interest payments) and statistical discrepancies.
5/ Includes the central government foreign exchange deposits managed by the Oil Fund.

APPENDIX I. RISK ASSESSMENT MATRIX[1]

Nature/Source of Main Threats	Overall Level of Concern	
	Likelihood of Severe Realization of Threat in the Next 1–3 years (high, medium, or low)	**Expected Impact if Threat Materializes** (high, medium, or low)
	Global Risks	
Stalled or incomplete delivery of Euro area policy commitments (financial stress re-emerges and bank-sovereign links re-intensify)	**Medium**	**Medium** Trade with the European periphery economies is fairly small while financial linkages are not strong. The largest risk is that a sharp slowing of European growth could ultimately lower oil prices and slow non-oil investment.
Deeper than excepted slowdown in Ems (synchronized growth shock triggered by financial sector stresses or setbacks in fiscal and structural reforms)	**Medium**	**Low** The largest impact would be if a slowing of EM growth contributed to lower oil prices.
	Country specific risks	
Sharp global oil price decline **(**A deepening of the recession in the euro area could result in a slowdown of global demand and a sharp decline in commodity prices)	**Medium**	**Medium** In light of Azerbaijan's high dependence on oil, the economy could go into recession, though oil fund savings could help cushion the impact.
Financial sector risks (The weak position and supervision of the systemic public bank (International Bank of Azerbaijan) could compromise the stability and soundness of the system)	**Medium**	**Medium/Low** A further deterioration of this bank could create systemic problems in the banking system. Though the government is likely to step in with important fiscal costs.

[1] The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood of risks listed is the staff's subjective assessment of the risks surrounding the baseline. The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with authorities.

Nature/Source of Main Threats	Overall Level of Concern	
	Likelihood of Severe Realization of Threat in the Next 1–3 years (high, medium, or low)	**Expected Impact if Threat Materializes** (high, medium, or low)
Escalation of the conflict with Armenia over Nagorno-Karabakh (Tensions with Armenia remain elevated, including frequent incidents on the cease-fire line)	**Medium**	**High** Military conflict would entail severe economic and social impacts.
Internal conflict, particularly in the run up to the presidential elections (Protests could arise from economic pressures as oil output begins to decline)	**Low**	**Medium** Political and social unrest could prompt populist measures and delayed needed reforms.

Policy responses: With potential downside risks, staff will recommend that the authorities rebuild policy buffers. This would entail strengthening the non-oil fiscal position during the present good times of high oil prices. Enhancing banking supervision and speeding up plans to bring the public bank under a sustainable financial position will also help contain risks in the financial sector. The room to relax monetary policy in response to a domestic shock is closing, particularly after recent CBA actions.

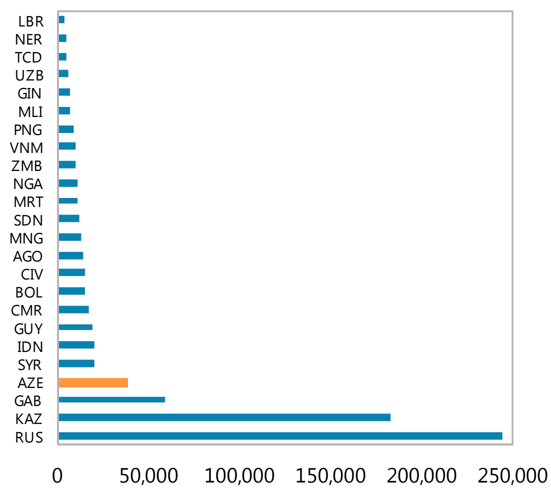
APPENDIX II. STYLIZED FACTS ON THE AZERBAIJAN ECONOMY

Azerbaijan: Endowments and GDP Growth Performance

Adapted from the "Stylized Facts in Resource-Rich Developing Countries" (IMF, 2012)

Azerbaijan's endowment of natural resources is large...

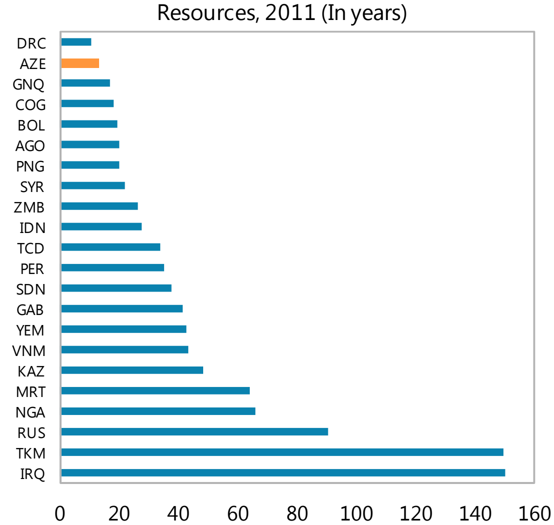
Resource Wealth Per Capita
(In 2005 per capita values, U.S. dollars)



Sources: World Bank (2011); and British Petroleum (2011).

… but with a very short depletion horizon.

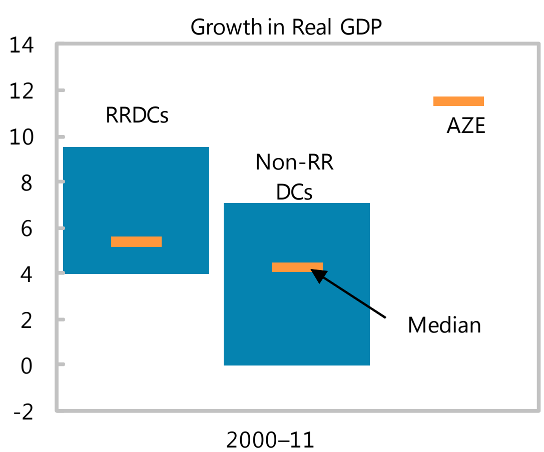
Reserves over Annual Production of Natural Resources, 2011 (In years)

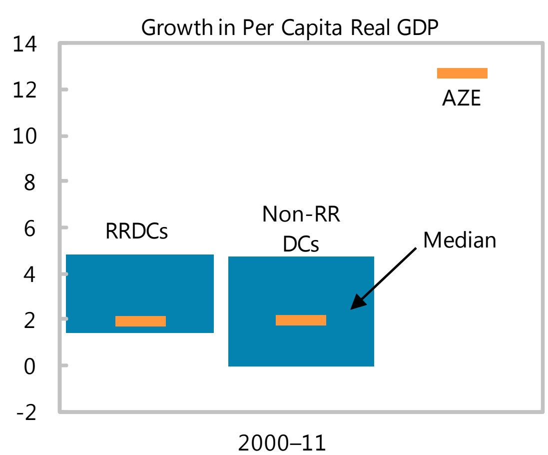


Sources: World Bank (2011); and British Petroleum (2011).

Azerbaijan's prudent management of the oil boom has enabled high real GDP growth and GDP per capita rates ...

Growth in Real GDP and Per Capita Real GDP for RRDCs and Non-RRDCs: 2000-11
(Median and interquartile range, in percent)





Sources: World Economic Outlook; and IMF staff estimates.

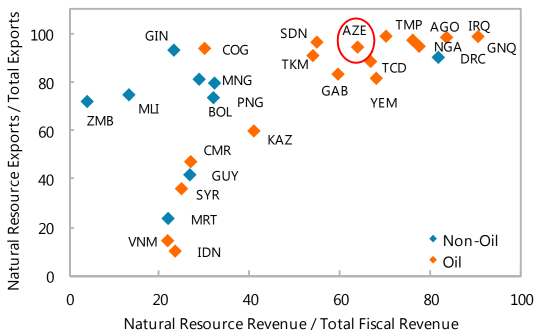
1/ IMF Macroeconomic Policy Frameworks for Resource-Rich Developing Countries, 2012.

Azerbaijan: Oil Dependence and Social Development

Adapted from the "Stylized Facts in Resource-Rich Developing Countries" (IMF, 2012)

Azerbaijan's exports and fiscal revenue are highly dependent on exhaustible natural resources

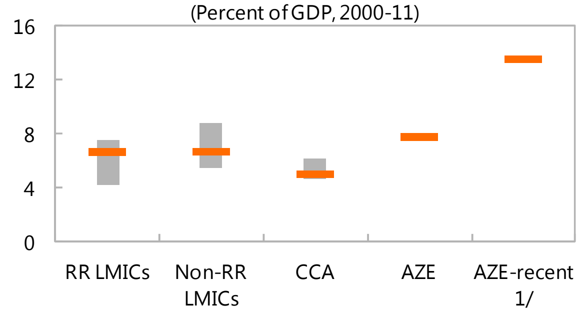
Share of Exports and Fiscal Revenue from Natural Resources
(Average 2006–10, in percent) 1/



Sources: World Development Indicators, World Bank; World Economic Outlook, IMF; and IMF staff estimates.

The oil boom has also enabled a relatively high public investment that has now surpassed double digit levels

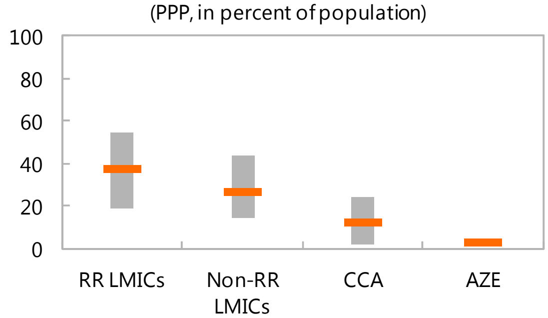
Public Investment
(Percent of GDP, 2000-11)



Sources: World Economic Outlook; and IMF staff estimates.
[1]Using average data over 2008 - 2011. The others are 2000-2011. RR: Resource-rich; NRR: Non-resource-rich. CCA includes CCA countries and Ukraine when the data is available.

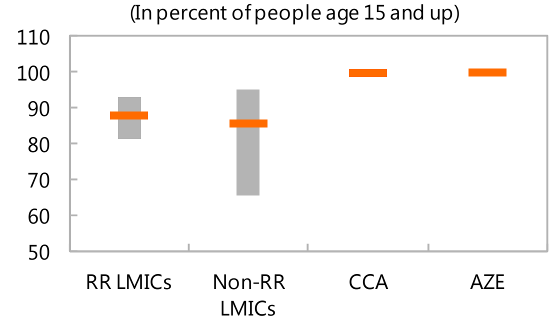
Oil revenue has helped reduce poverty …

Poverty Headcount Ratio at US$2 Per Day
(PPP, in percent of population)



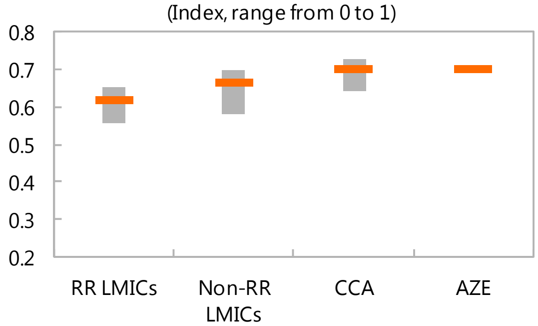
..and promoted literacy, though there are concerns on education service delivery.

Adult Literacy Rate
(In percent of people age 15 and up)

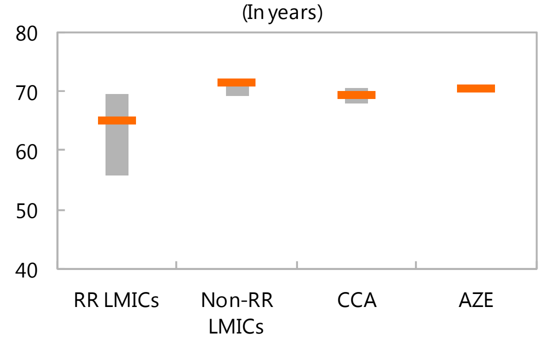


Azerbaijan's human development index and other development indicators are high relative to other resource-rich countries.

Human Development Index (HDI)
(Index, range from 0 to 1)



Life Expectancy at Birth
(In years)



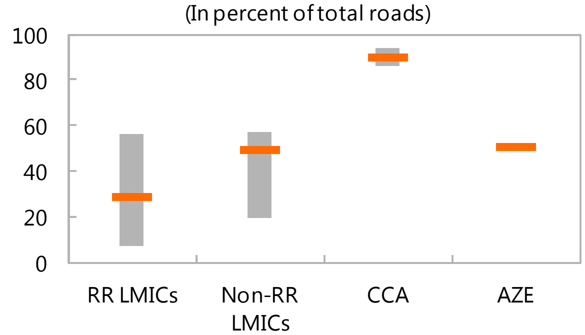
Sources for development indicators: World Bank; UNDP; and IMF staff estimates. Using latest available data since 2000. RR: Resource-rich; Non-RR: Non-resource-rich. CCA includes CCA countries and Ukraine if data is available.

Azerbaijan: Infrastructure and Management of Investment

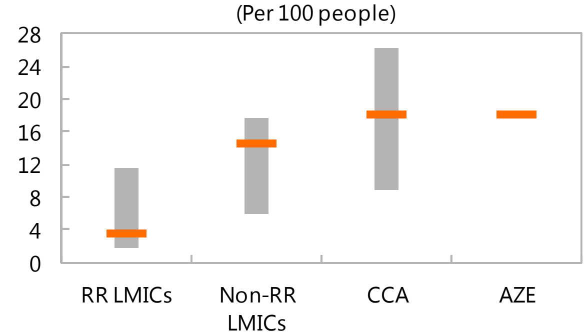
Large infrastructure gaps in some key services point to capacity constraints in absorbing high levels of public investment…

Infrastructure Indicators for Resource-Rich and Non-Resource Rich Developing Countries
Median and Interquartile Range 1/

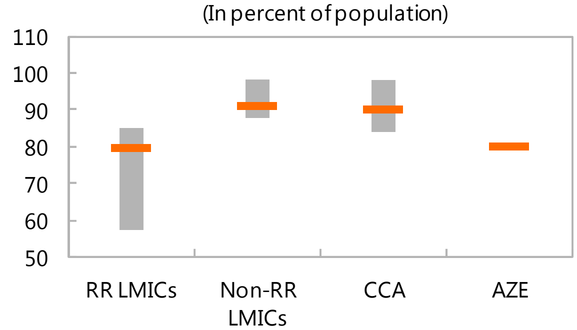
Paved Roads
(In percent of total roads)



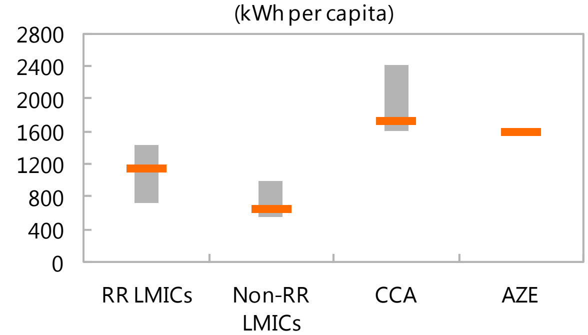
Telephone Line
(Per 100 people)



Access to Improved Water
(In percent of population)

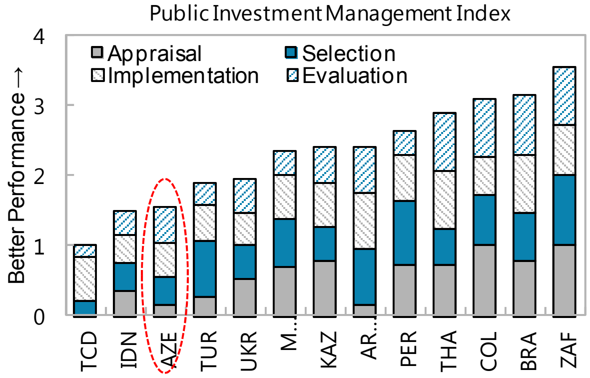


Electric Power Consumption
(kWh per capita)

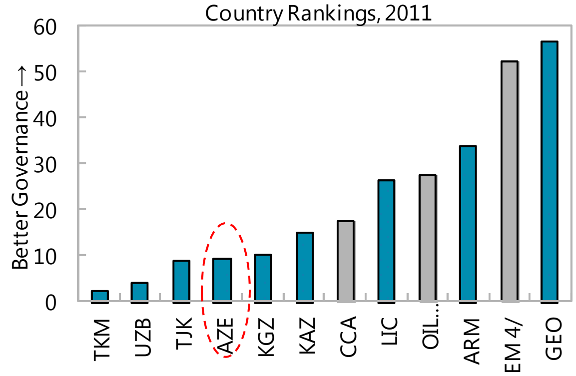


…And insufficient efforts to improve the public investment management system and contain opportunities for corruption.

Quality of Public Investment 2/
Public Investment Management Index



Control of Corruption 3/
Country Rankings, 2011



1/ Infrastructure indicators are adapted from the "Stylized Facts in Resource-Rich Developing Countries" (IMF, 2012)
2/ Source: Dabla-Norris et. al, 2011, "*Investing in Public Investment: An Index of Public Investment Efficiency*", IMF Working Paper/11/137.
3/ Source: Worldwide Governance Indicators.
4/ OIL indicates oil exporters; EM indicates emerging markets.

APPENDIX III. DEBT SUSTAINABILITY ASSESSMENT

Box 1. Azerbaijan: External Debt Sustainability Assessment

External debt is low and risks of debt distress over the medium term are similarly low.

External debt has declined substantially since the onset of the oil boom, halving by 20 percentage points to about 20 percent in 2011 relative to 2004. This reflects, in large part, rapid real GDP growth and the government's decision to finance domestic investment projects from oil revenue.

Under the baseline scenario, external debt is projected to decline slightly to about 15 percent of GDP by 2017, mainly from increasing non-oil FDI (attracted by progress on structural reforms and strengthening of the non-oil fiscal position).

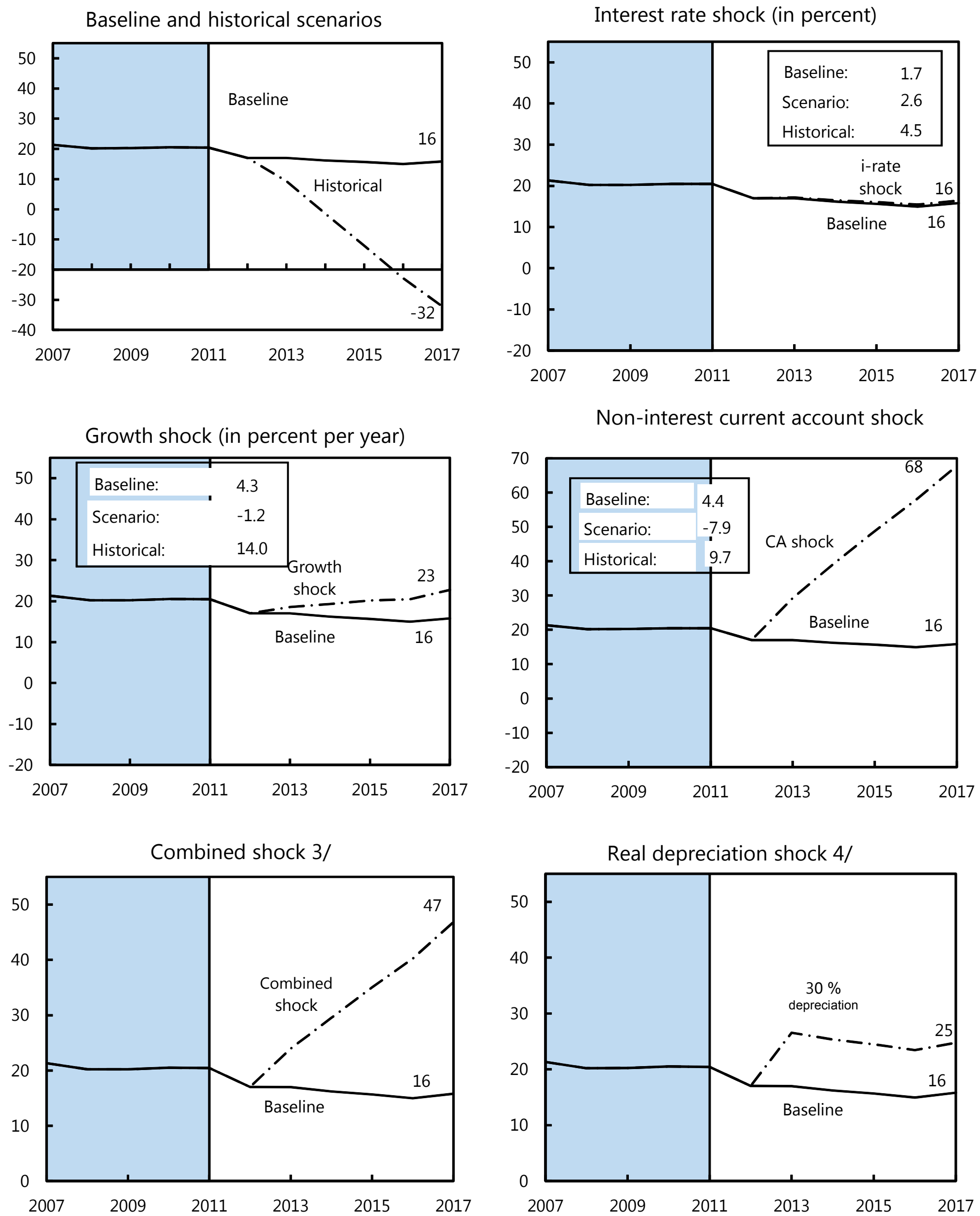
Azerbaijan's external debt appears resilient to most adverse external shocks.

Bound tests suggest that under standard shocks to interest rates, growth, and real exchange rate, external debt will remain relatively low, at less than 25 percent of GDP by 2017.

External debt, however, could increase rapidly, to about 68 percent, if there were a standard shock to the non-interest external current account.

If key variables, including real GDP growth and current account surplus, remain at the historical 10–year average (14 percent and 10 percent of GDP, respectively), external debt would continue to decline rapidly relative to the baseline scenario. But given the prospects for oil production and oil prices, this scenario is unlikely.

Azerbaijan: External Debt Sustainability: Bound Tests 1/ 2/
(External debt in percent of GDP)



Sources: Fund country desk data, and Fund staff estimates.

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

Azerbaijan: External Debt Sustainability Framework, 2011–17
(In percent of GDP, unless otherwise indicated)

	Actual	Projections						
	2011	2012	2013	2014	2015	2016	2017	Debt-stabilizing non-interest current account 6/
1 **Baseline: External debt**	20.4	**17.0**	**17.0**	**16.2**	**15.7**	**15.0**	**15.8**	**-2.9**
2 Change in external debt	-0.1	-3.4	0.0	-0.8	-0.6	-0.7	0.8	
3 Identified external debt-creating flows (4+8+9)	-31.7	-21.0	-11.7	-8.1	-6.6	-4.3	-2.6	
4 Current account deficit, excluding interest payments	-26.9	-20.8	-11.0	-6.3	-3.2	-0.9	-0.5	
5 Deficit in balance of goods and services	-81.9	-75.9	-73.5	-67.3	-61.9	-58.8	-56.3	
6 Exports	57.4	50.8	44.6	39.0	34.3	31.3	29.7	
7 Imports	-24.5	-25.1	-28.9	-28.3	-27.6	-27.5	-26.6	
8 Net non-debt creating capital inflows (negative)	-1.4	-0.2	-0.5	-1.2	-2.9	-3.1	-1.7	
9 Automatic debt dynamics 1/	-3.4	0.0	-0.3	-0.6	-0.4	-0.2	-0.3	
10 Contribution from nominal interest rate	0.4	0.4	0.3	0.2	0.2	0.3	0.2	
11 Contribution from real GDP growth	0.0	-0.4	-0.6	-0.9	-0.7	-0.5	-0.4	
12 Contribution from price and exchange rate changes 2/	-3.8	...	...	...	...	...	...	
13 Residual, incl. change in gross foreign assets (2-3) 3/	31.7	17.6	11.7	7.3	6.0	3.6	3.4	
External debt-to-exports ratio (in percent)	35.6	33.5	38.1	41.6	45.6	47.8	53.3	
Gross external financing need (in billions of US dollars) 4/	-16.8	-13.6	-7.8	-4.9	-2.5	-0.3	0.0	
in percent of GDP	-26.0	-19.8	-10.1	-5.6	-2.5	-0.3	0.0	
Scenario with key variables at their historical averages 5/		**17.0**	**9.3**	**-1.5**	**-12.1**	**-22.8**	**-32.1**	**0.2**
Key Macroeconomic Assumptions Underlying Baseline								
Real GDP growth (in percent)	0.1	2.2	4.1	5.8	4.8	3.5	3.2	
GDP deflator in US dollars (change in percent)	22.9	3.4	7.8	8.5	7.3	6.3	5.8	
Nominal external interest rate (in percent)	2.5	2.1	2.1	1.6	1.7	1.9	1.2	
Growth of exports (US dollar terms, in percent)	30.3	-6.5	-1.4	0.4	-1.0	0.4	3.5	
Growth of imports (US dollar terms, in percent)	50.4	8.2	29.3	12.3	9.7	9.7	5.7	
Current account balance, excluding interest payments	26.9	20.8	11.0	6.3	3.2	0.9	0.5	
Net non-debt creating capital inflows	1.4	0.2	0.5	1.2	2.9	3.1	1.7	

1/ Derived as [r - g - r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock, with r = nominal effective interest rate on external debt; r = change in domestic GDP deflator in US dollar terms, g = real GDP growth ra
e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.
2/ The contribution from price and exchange rate changes is defined as [-r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock. r increases with an appreciating domestic currency (e > 0) and rising inflation.
3/ For projection, line includes the impact of price and exchange rate changes.
4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.
5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.
6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

Box 2. Azerbaijan: Public Debt Sustainability Assessment

Public debt is small, thus, risks of debt distress in the medium–term are low.

Public debt has declined substantially since the onset of the oil boom, halving to about 10 percent in 2011, relative to 2004. As in the case of external debt, this reflects rapid real GDP growth and the government's decision to finance domestic investment projects from oil revenue.

Under the baseline scenario, public debt is projected to increase while remaining moderate at about 16 percent of GDP by 2017. The scenario assumes efforts to consolidate the non-oil fiscal position, reduced spending on investment financed with oil resources, and some build up of domestic debt, consistent with the objective of developing the capital markets.

Azerbaijan's public debt appears resilient to most adverse shocks.

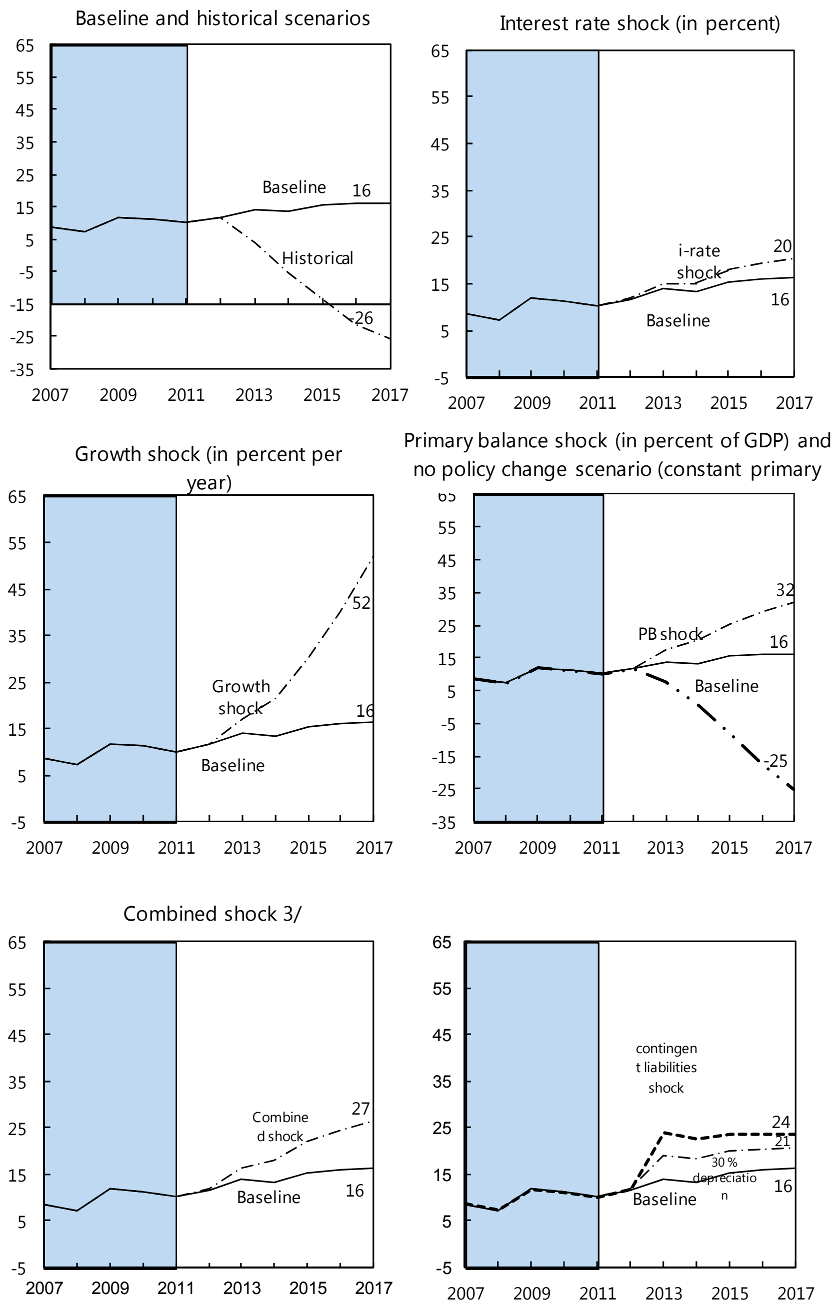
Bound tests suggest that under standard shocks to interest rates, primary balance, and real exchange rate, public debt would remain relatively manageable at about 25 percent of GDP or less by 2017.

However, the public debt ratio seems more vulnerable to shocks to real growth than the external debt, as under this bound test, public debt would rise to 52 percent by 2017.

If key variables, including real GDP growth and primary surplus, remain at the historical 10 year average (14 percent and 6 percent of GDP, respectively), public debt would continue to rapidly decline relative to the baseline scenario. However, with current prospects for oil production and oil prices, this scenario is unlikely.

Azerbaijan: Public Debt Sustainability: Bound Tests 1/ 2/

(Public debt in percent of GDP)



Sources: International Monetary Fund, country desk data, and staff estimates.

1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ For historical scenarios, the historical averages are calculated over the ten-year period, and the information is used to project debt dynamics five years ahead.
3/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and primary balance.
4/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Azerbaijan: Public Sector Debt Sustainability Framework, 2011–17
(In percent of GDP, unless otherwise indicated)

		Actual	Projections						
		2011	2012	2013	2014	2015	2016	2017	**Debt-stabilizin primary balance 9/**
1	**Baseline: Public sector debt 1/**	10.1	**11.6**	**13.9**	**13.4**	**15.5**	**16.0**	**16.2**	**-0.7**
	o/w foreign-currency denominated	6.1	9.2	8.4	10.1	9.7	9.6	9.5	
2	Change in public sector debt	-1.0	1.5	2.3	-0.5	2.1	0.5	0.3	
3	Identified debt-creating flows (4+7+12)	-11.6	-2.5	2.8	3.6	7.4	7.2	4.9	
4	Primary deficit	-11.8	-3.6	2.4	4.2	7.8	7.6	5.6	
5	Revenue and grants	45.5	40.7	37.2	35.0	33.9	33.0	33.2	
6	Primary (noninterest) expenditure	33.8	37.1	39.6	39.2	41.7	40.6	38.8	
7	Automatic debt dynamics 2/	-1.6	0.0	-0.6	-1.4	-1.0	-0.9	-0.7	
8	Contribution from interest rate/growth differential 3/	-1.5	0.0	-0.6	-1.4	-1.0	-0.9	-0.7	
9	Of which contribution from real interest rate	-1.5	0.2	-0.2	-0.6	-0.4	-0.4	-0.3	
10	Of which contribution from real GDP growth	0.0	-0.2	-0.4	-0.7	-0.6	-0.5	-0.5	
11	Contribution from exchange rate depreciation 4/	-0.1	...	...	...	...	...	...	
12	Other identified debt-creating flows	1.7	1.1	1.0	0.8	0.6	0.4	0.0	
13	Privatization receipts (negative)	0.0	-0.1	-0.1	-0.1	-0.1	0.0	-0.3	
14	Recognition of implicit or contingent liabilities	1.7	1.2	1.1	0.8	0.7	0.5	0.4	
15	Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
16	Residual, including asset changes (2-3) 5/	10.5	4.0	-0.5	-4.1	-5.3	-6.7	-4.7	
	Public sector debt-to-revenue ratio 1/	22.2	28.5	37.3	38.3	45.6	48.4	48.9	
	Gross financing need 6/	-12.5	-3.0	3.7	5.3	8.9	8.9	7.0	
	in billions of U.S. dollars	-8.1	-2.0	2.8	4.7	8.9	9.7	8.4	
	Scenario with key variables at their historical averages 7/		**11.6**	**3.9**	**-5.5**	**-13.8**	**-21.3**	**-25.8**	**5.3**
	Scenario with no policy change (constant primary balance) in 2012-2017		**11.6**	**7.9**	**0.3**	**-8.0**	**-17.5**	**-25.0**	**1.2**
	Key Macroeconomic and Fiscal Assumptions Underlying Baseline								
	Real GDP growth (in percent)	0.1	2.2	4.1	5.8	4.8	3.5	3.2	
	Average nominal interest rate on public debt (in percent) 8/	4.9	5.0	3.3	1.5	2.9	3.8	4.2	
	Average real interest rate (nominal rate minus change in GDP deflator, in percent)	-15.9	2.2	-1.5	-4.8	-3.4	-2.5	-1.7	
	Nominal appreciation (increase in US dollar value of local currency, in percent)	1.4	...	...	...	...	...	...	
	Inflation rate (GDP deflator, in percent)	20.9	2.8	4.9	6.3	6.3	6.3	5.8	
	Growth of real primary spending (deflated by GDP deflator, in percent)	6.8	12.6	11.4	4.8	11.4	0.7	-1.2	
	Primary deficit	-11.8	-3.6	2.4	4.2	7.8	7.6	5.6	

1/ Refers to gross public sector debt.

2/ Derived as [(r - p(1+g) - g + ae(1+r)]/(1+g+p+gp)) times previous period debt ratio, with r = interest rate; p = growth rate of GDP deflator; g = real GDP growth rate; a = share of for 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 - π (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/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.

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.

INTERNATIONAL MONETARY FUND

REPUBLIC OF AZERBAIJAN

April 18, 2013

STAFF REPORT FOR THE 2013 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

Prepared By

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

CONTENTS

RELATIONS WITH THE FUND

(As of February 28, 2013)

Membership Status

Date of membership: September 18, 1992;

General Resources Account

	SDR Million	Percent Quota
Quota	160.90	100.00
Fund Holdings of Currency	160.80	99.94
Reserve position in Fund	0.13	0.08

SDR Department

	SDR Million	Percent Allocation
Holdings	158.13	102.96

Outstanding Purchases and Loans

	SDR Million	Percent of Quota
ECF Arrangements	9.01	5.60

Latest Financial Arrangements

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

Projected Payments to the Fund

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

	Forthcoming				
	2013	2014	2015	2016	2017
Principal	5.15	2.57	1.29		
Charges/Interest	0.00	0.00	0.00	0.00	0.00
Total	**5.15**	**2.58**	**1.29**	**0.00**	**0.00**

Safeguards Assessment

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

Exchange Rate Arrangements

The currency of Azerbaijan is the manat, which became sole legal tender on January 1, 1994. The *de jure* exchange rate regime is "other managed arrangement" since March 2011, but the *de facto* regime remains as "stabilized arrangement", based on the authorities' policy to allow greater exchange rate flexibility since late 2010.

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.

Article IV Consultation

The 2011 Article IV consultation with Azerbaijan was concluded on January 9, 2012.

ROSCs

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

Resident Representative

In October 2009, Mr. Koba Gvenetadze ended his term as IMF Resident Representative in Azerbaijan. Since November 2009, the IMF no longer has a Resident Representative in Azerbaijan, but the IMF Office in Baku, located in the building of the Ministry of Finance of Azerbaijan, continues to operate, headed by Ms. Aghgun Gadirli (Office Manager).

Resident Advisers

An adviser on the establishment of the Treasury in the Ministry of Finance, Mr. Nurcan Aktürk, was stationed in Baku from December 1994 to September 1996. He was succeeded by Mr. B.K. Chaturvedi, whose assignment was extended twice, first through August 2000, and then through May 2001. Mr. B.K. Chaturvedi was replaced by Mr. A. Khan, whose assignment started in May 2001 and ended in August 2002. A technical long-term adviser for tax administration, Mr. Mark Zariski, was stationed in Baku from April 1995 to April 1996. He was succeeded by Mr. Peter Barrand, who was stationed in Baku from January 2001 to December 2002. Mr. Isaac Svartsman was resident advisor in the CBA for bank supervision and restructuring from September 1998 to April 2001. Ms. Nataliya Ivanik was stationed in Baku as a STA regional external sector statistics advisor from November 2006 to November 2008.

AZERBAIJAN: TECHNICAL ASSISTANCE, 2003–13

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
STA	Consumer Price Statistics	February/March 2006
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 Administration Diagnostic	February 2008
FAD	Tax Administration (expert visits)	July 2008/April 2009
MCM	Domestic Securities Market Development	September 2008
MCM	Public Debt Management	August 2009
LEG	AML/CFT Legislation	Aug/Sep. 2009
STA	External Sector Statistics	October 2009
LEG	AML/CFT Legislation	February 2010
STA	Government Finance Statistics	September 2011
STA	Balance of Payments Statistics	March 2012
MCM	Moving Towards Exchange Rate Flexibility	March 2012
FAD	Pension Reform	July 2012
LEG	AML/CFT Legislation	2012
STA	National Accounts	February 2013

RELATIONS WITH THE WORLD BANK

(As of March 2013)

1. The World Bank is currently implementing a two-pillar Country Partnership Strategy (CPS) that focuses on: (i) building a competitive non-oil economy; and (ii) strengthening social and municipal services; with a strong cross-cutting theme of governance and anticorruption.

2. This strategy builds on the Governments own development strategies and includes: (a) Under Pillar I, strengthening the non-oil economy, primarily through an improved business environment, better infrastructure and agriculture improvements, and (b) Under Pillar 2, improving the effectiveness of social and community services, including health, education, social protection and water supply.

3. During the current CPS period, the Bank has increased its focus on implementation of existing operations and only considered new operations in selected areas with a strong record of sufficient institutional capacity and ownership.

4. The ongoing FY11–14 CPS Progress Report (CPS PR) assesses the objectives of the CPS as relevant in the long run and refines the WBG program for FY13–14 to adjust to the changing environment

5. The Progress Report confirms the Bank's stance on modest and selective lending. The program for FY13–14 is expected to be in line with the Government's own borrowing plans of US$120–150 million per year from IBRD. This program will focus on sectors in which external borrowing from international financial institutions is economically and socially justified based on expected returns, knowledge and technology transfer, and proven implementation capacity. Specifically, projects to be proposed by the Bank will support improved competitiveness in agriculture, solid waste management, water supply and sanitation, judicial modernization, roads and health sectors.

6. IFC's active portfolio as of June 30, 2012 consisted of five projects focused on improving the business enabling environment, strengthening bank financial markets infrastructure, and helping microfinance institutions to reduce their reliance on grants and operate on a commercial basis. IFC remains engaged in the areas of capital market modernization, crisis management and corporate governance through the regional programs, such as ECA Corporate Governance Project and ECA Banking Advisory.

7. Bank lending will be complemented by a strong program of knowledge services to inform the country growth strategy and policy choices as well as the design of investment operations. The Bank will increase analytic work in the areas of job creation and growth, poverty and inequality, the financial sector, agriculture and irrigation, wastewater, and public expenditures. The set of Policy Notes prepared for the High Level Economic Policy Forum (HELP) focused on economic diversification, agriculture, education, and institutional development. Two important analytical pieces have been delivered within the Programmatic Poverty Assessment. The first Programmatic Public Expenditure Review (PPER) is planned for FY13. Two more analytical pieces have been delivered in FY13, namely on *National Solid Waste Strategy* and *Private Sector Participation in Solid Waste Management*, and two more will be delivered, namely, *Economic Diversification for Growth*, and *Fostering Entrepreneurship in South Caucasus*.

8. The Government has agreed in principle to partner with the Bank through a reimbursable Joint Economic Research Program (JERP). The Bank and the Government have also established a strong vehicle for policy dialogue in two high level policy fora held for the first time in 2009 and then in March 2012.

9. Relations between the Bank and the Fundconcerning Azerbaijan are very good in terms of coordinated policy advice and collaboration on macroeconomic monitoring. There is also broad agreement between the Bank and the Fund on the division of labor between the two institutions.

10. The Fund will continue to focus on macro-critical areas, and will share responsibilities with the Bank on banking and financial sector soundness, taking care to coordinate closely so as to minimize overlap and ensure harmonization of policy advice.

World Bank contacts:

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RELATIONS WITH THE EUROPEAN BANK FOR RECONSTRUCTION AND DEVELOPMENT (EBRD)

(As of December 31, 2012, Update as of March 2013 in paragraph 5)

1. As of 31 December 2012, the EBRD has invested approximately US$2.1 billion in 130 projects. The current active portfolio amounts to US$861 million of which 85 percent has been disbursed, and operating assets amount to US$559 million. The ratio of private sector projects in the portfolio now stands at around 70 percent.

2. Strategic priorities for the EBRD's activites in Azerbaijan, set out in the country strategy approved by the Board in 2010, include (i) development of the non-oil sector through investments in the enterprise sector, with an emphasis on agribusiness, and acting as a catalyst to attract much needed foreign investment and know-how; (ii) promoting competition, consolidation as well as foreign investment in the financial sector and assisting in the development of new financial instruments; (iii) supporting the development of microfinance, particularly in the regions, and promoting the expansion of the non-bank financial sector; (iv) supporting infrastructure development with a particular focus on power and energy savings, promoting transparent procurement practices, instilling commercial discipline and improving financial transparency and corporate governance; and (iv) providing advisory services to companies through its Small Business Support (SBS) programmes. The Bank is working on a new three-year strategy for Azerbaijan, expected to be discussed by the Board by end-2013

3. In the energy and natural resources sectors, the EBRD financed several landmark transactions such as the BTC pipeline, AZDRES Power Rehabilitation and the Shah Deniz gas field. The EBRD also financed three power sector projects for a total of US$281 million, making Azerenerji, Azerbaijan's state-owned power utility, EBRD's second largest client in the country. Energy and natural resources represents 30 percent of the overall portfolio. The industry, commerce and agribusiness (ICA) sector represents about 10 percent by volume, but 30 percent by number of tranactons and includes major investments across a broad range of segments from building materials to mineral water bottling. In the financial sector (one fifth of the portfolio), EBRD has equity stakes in three Azerbaijani banks and provides funding for on-lending to the MSME sector to a further six banks and four micro-finance institutions. The infrastructure sector, which constitutes

40 percent of EBRD's portfolio, includes US$250 mln for Regional Roads Reconstruction and Upgrading Project, EBRD’s largest investment in Azerbaijan to date.

4. In 2012, EBRD invested a total of US$109 million in 16 projects. EBRD financed seven projects in the ICA sector including food processing and the development of a retail chain, with the average investment size of less than US$5 million. Four projects were in the agribusiness sector and three in the manufacturing and services sector. In the financial sector, EBRD signed eight projects, including credit lines with two micro-finance organizations and four existing partner banks to be onlent to micro companies and SMEs. There was a marked increase in the amount of EBRD lending in local currency. Subordinated debt was provided to one EBRD investee banks to support tier II capital. EBRD also continued to provide technical assistance in the areas of institution building, credit appraisal and risk management to financial institutions, and accountancy standards, corporate governance to ICA clients.

5. During the first two months of 2013, the EBRD has signed three projects with financial institutions for approximately US$12 million, including first energy efficiency loan in the sector. The Bank expects to sign a further 13 transactions by end-2013, including projects with natural resources, financial institutions, infrastructure and ICA clients.

6. Azerbaijan is a part of the EBRD’s Early Transition Countries (ETC) initiative. Launched in April 2004, this initiative aims to increase investments in EBRD’s eight countries of operation in the early transition stage, while building 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. EBRD will accept higher risk in the projects it finances in the ETCs, while still respecting the principles of sound banking

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) completed in July 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. The February 2013 mission that visited Baku at the request of the authorities prepared an action plan for the development and publication of discrete quarterly national account statistics.

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, although the SSC did use population weights for regional aggregation through 2006, it has weighted regional indexes by expenditure since 2007, using 2006 Household Budget Survey results on household expenditure, while 2009 data are based on 2008 expenditure weights.

5. It is important for the SSC to measure both the asset and rental prices of housing. Accordingly, the 2008 CPI reassessment mission suggested compiling a house price index, which would provide an estimate of inflation for the capital formation component of household final expenditure. The SSC has been considering proposing such an index for its statistical development program, as a new price indicator distinct from its consumption-based CPI.

B. Fiscal Sector

6. 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.

7. 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.

8. The 2012 STA mission that visited Baku at the request of the authorities, provided assistance with the preparation of financial reports based on the Government Finance Statistics Manual 2001 (GFSM 2001). The mission concluded that while further work is needed on improving the source data for the compilation of these statistics, the present level of development of budgetary accounting and reporting system makes it possible a preliminary compilation and dissemination of the GFS in accordance with the GFSM 2001 on an annual and quarterly basis.

C. Monetary Sector

9. The Central Bank of Azerbaijan (CBA) compiles monetary statistics according to the methodology of the *Monetary and Financial Statistics Manual.* The CBA 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

10. Azerbaijan's balance of payments (BOP) statistics are compiled and disseminated by the CBA and are broadly in accordance with the fifth edition of the *Balance of Payments Manual (BPM5).* The CBA has also initiated compilation of International Investment Position (IIP) statistics. The IIP data for 2002–2008 have been published in *IFS;* however, the authorities have indicated that they have discontinued the compilation of IIP data effective 2009.

11. During November 2006–November 2008, a Regional Advisor in External Sector Statistics to Azerbaijan and Georgia was 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 (iv) assist the authorities in coordinating with other international institutions and bilateral agencies involved in technical assistance in statistics in Azerbaijan and Georgia. Moreover, Azerbaijan has benefited from a STA technical assistance mission in external sector statistics, which visited Baku in October 2009 to further assist the authorities with addressing a number of outstanding issues related to the compilation and dissemination of external sector statistics.

12. The 2009 mission found that appropriate statistical legislation to assign responsibilities for compilation and dissemination of external sector stocks statistics (IIP and gross external debt) has yet to be developed. A draft Presidential Decree *On Improvement of the Gross External Debt and International Investment Position Statistics of Azerbaijan* was developed in order to authorize the CBA to compile private and public debt data from relevant agencies, but still has not been approved. As a result, the CBA temporarily discontinued dissemination of IIP statistics and the development of the compilation system for the IIP and gross external debt statistics. The mission recommended the authorities to address these issues, as they would affect the timing of Azerbaijan's subscription to the SDDS. The mission also expressed concerns with regard to the pace of implementation of the strategic framework for the development of external sector statistics,

which may be affected by recent staff turnover and a change in the status of the BOP Department (now a division).

13. The 2009 mission also found that, in spite of the CBA's efforts, data sharing and data provision remain a challenge for the compilation of external sector statistics. Consequently, the mission recommended to set up a formal, high-level structure for data sharing and data provision.

14. The 2012 STA mission found low prospects for restarting work on the IIP (annual data were last published for 2008) as the legal position has not changed since STA's previous mission in 2009 and the data sharing and data provision across government agencies remain a challenge. The mission also discussed the BOP compilation methodology and assumptions, and made several recommendations in the areas of data validation, and in fine tuning the data to the BPM6 specifications. Work on the transition to BPM6 is well underway, with technical assistance provided by the State Secretariat for Economic Affairs (SECO, based in Switzerland).

15. 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. 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.

16. Monthly data on total official reserve assets and daily CBA 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 CBA 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. STA has recently advised the authorities on the definition and coverage of gross official reserve assets. As the authorities indicated that several definitions of gross official reserve assets are used, STA stressed the importance of using only one definition, more specifically the definition that follows the sixth edition of the *Balance of Payments and International Investment Position Manual (BPM6).* STA will continue to provide advice to the authorities for the correct compilation of Azerbaijan's gross official reserve assets.

AZERBAIJAN: TABLE OF COMMON INDICATORS REQUIRED FOR SURVEILLANCE

(As of March, 2013)

	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	02/28/2013	03/14/2013	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	12/31/2012	01/22/2013	D	W	M		
Reserve/Base Money	12/31/2012	01/22/2013	D	W	M		
Broad Money	12/31/2012	01/22/2013	M	M	M	O, O, O, O	O, O, O, O, LO
Central Bank Balance Sheet	12/31/2012	01/22/2013	D	W	M		
Consolidated Balance Sheet of the Banking System	12/31/2012	01/22/2013	M	M	M		
Interest Rates[2]	Feb 2013	02/08/2013	M	M	M		
Consumer Price Index	Feb 2012	03/06/2013	M	M	M	O, O, O, O	O, LO, O, O, O
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	Nov 2012	2/21/13	M	M	M	LO, LNO, LNO, LO	LO, LO, O, O, LO
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	Nov 2012	2/21/13	M	M	M		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	Sept 2012	12/13/12	Q	Q	Q		
External Current Account Balance	Q3 2012	12/13/12	Q	Q	Q	LO, LO, LO, LO	O, LO, LO, O,LO
Exports and Imports of Goods and Services	Q3 2012	12/13/12	Q	Q	Q		
GDP/GNP	Feb 2012	03/15/2013	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, extrabudgetary funds, and social security funds) and state and local governments.

[5] Including currency and maturity composition.

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

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

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

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL
RELATIONS
DEPARTMENT

Public Information Notice (PIN) No. 13/57
FOR IMMEDIATE RELEASE
May 21, 2013

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

IMF Executive Board Concludes 2013 Article IV Consultation with the Republic of Azerbaijan

On May 3, 2013, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Azerbaijan.[1]

Background

Economic growth recovered in 2012, reaching 2.2 percent on the back of a more moderate decline in oil output than in 2011 and continued strong non-oil growth of 9.6 percent, supported by public spending. Shortfalls from new wells and maintenance issues continue to reduce oil output for a second year in a row. Inflation dropped sharply to an average of 1.1 percent in 2012, mainly reflecting the impact of global and domestic food price trends. The manat exchange rate has appreciated by less than 2 percent against the U.S. dollar since November 2010. The external position remains strong, supported by high oil prices and sizeable public assets accumulation which could reach about 66 percent of GDP by the end of 2012.

Expansionary fiscal policy continued in 2012 with the non-oil fiscal primary deficit increasing to 45 percent of non-oil GDP from 41 percent in 2011. The non-oil deficit will increase further in 2013 if the government implements the large public investment program approved in the budget.

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

Monetary policy turned accommodative in late 2012 and early 2013 as the Central Bank of Azerbaijan (CBA) lowered its benchmark refinancing rate by 250 basis points in December and then again in February, partly in response to low inflation. Direct lending to the real economy by the CBA surged in 2012, though macro prudential measures are being developed to slow the rapid growth in private sector credit, particularly consumer loans. With a view to foster consolidation and competition in the banking system, the CBA increased the minimum capital requirements for banks by fivefold. There remains little progress in the restructuring of the International Bank of Azerbaijan, the systemic public bank

Near-term economic prospects are generally positive, though with an increasing risk of overheating and the deepening of fiscal vulnerabilities. Overall GDP growth is expected at around 4 percent in 2013 and similar levels over the medium term, driven by government spending. With the non-oil economy hitting capacity constraints and expansionary fiscal policy, headline inflation is projected to reach 7 percent by end-year, above the CBA's 5–6 percent target range, for an annual average of 3½ percent. Inflation could rise to above 6 percent over the medium term. Projections for the external position remain favorable, sustained by continued high oil prices. Risks emanate mainly from a fall in oil prices given Azerbaijan's low reliance on non-oil exports. But large foreign assets could provide sufficient buffer to mitigate the impact of future shocks, including a sharp and sustained decline in oil prices.

Executive Board Assessment

Executive Directors welcome Azerbaijan's rapid growth in recent years and its strong buffers against external instability, but noted that critical challenges lie ahead. Continued expansionary policies may be fueling short-term risks to macroeconomic stability, while the depletion of oil reserves undermines the medium-term viability of the development strategy. Directors considered that high oil prices at present offer a good opportunity to adjust the course of economic policies from a position of relative strength.

Directors cautioned that continued growth in public spending is exacerbating the budgetary dependence on oil revenues and increasing the risks from a fall in global oil prices. Accordingly, most Directors encouraged the authorities to undertake a moderate front-loaded fiscal consolidation, which would create room for private sector activity. Fiscal adjustment could be achieved by improving the efficiency of public spending, including through a better selection of capital projects, and by strengthening public financial management and revenue collection.

More broadly, Directors encouraged the authorities to revamp the fiscal policy framework in line with recent IMF guidance for resource-rich developing countries. A fiscal rule and strong institutional arrangements consistent with international best practice could strengthen fiscal discipline, particularly at times of high oil prices, boost fiscal sustainability, and promote a sound management of oil revenue.

Directors supported the readiness of the Central Bank of Azerbaijan (CBA) to tighten monetary policy if price pressures intensify. They also suggested that the CBA discontinue its direct lending to the real economy, which was meant to be a temporary response to the global economic crisis. Looking ahead, they agreed that a gradual move toward greater exchange rate flexibility would improve the economy's ability to absorb shocks as the share of non-oil exports grows.

Directors noted the assessment that the financial sector remains sound. They welcomed ongoing efforts to preserve financial sector stability, including by recapitalizing some banks and adopting prudential measures to contain the growth of consumer credit. Directors encouraged the authorities to continue strengthening the supervisory framework and to restructure the largest bank.

Directors supported the government's 2020 vision of making Azerbaijan a competitive and diversified economy. They observed that the development of non-oil exports will require ambitious structural reforms to reduce formal and informal barriers to trade and competition, improve the business climate, facilitate access of private companies to capital, and combat corruption and money laundering.

Azerbaijan: Selected Economic Indicators, 2009–14

	2009	2010	2011 Prel.	2012 Proj.	2013 Proj.	2014 Proj.
	(Annual percentage change)					
Real economy						
GDP at constant prices	9.3	5.0	0.1	2.2	4.1	5.8
Oil sector 1/	14.8	5.0	-9.8	-5.3	-1.9	2.0
Non-oil sector 2/	3.0	7.6	9.4	9.6	8.6	8.4
CPI (end-of-period)	0.7	7.9	5.6	-0.3	7.0	6.5
	(In percent of GDP, unless otherwise)					
Consolidated government						
Fiscal balance	7.0	14.6	13.3	4.0	-2.7	-4.3
Non-oil primary fiscal balance (in percent of non-oil GDP)	-35.5	-36.3	-40.9	-45.0	-46.9	-44.3
	(Annual percentage change)					
Money and credit						
Manat base money	1.7	31.6	29.4	27.1	17.7	18.8
Manat broad money	9.9	34.8	32.5	25.5	28.4	30.2
Banking sector credit to the private sector	25.6	6.6	18.1	20.8	17.4	17.6
Velocity of total broad money (M3) 3/	3.0	2.8	2.6	2.4	2.5	2.4
	(In percent of GDP, unless otherwise)					
Balance of payments						
Current account balance (-, deficit)	23.0	28.0	26.5	20.3	10.6	6.0
External public debt	7.7	7.4	7.3	9.2	11.5	11.0
Gross official international reserves						
In billions of US$, end of period	5.3	6.7	10.9	12.1	14.1	14.6
In months of next year non-oil imports, c.i.f.	7.6	6.1	9.5	8.1	8.2	7.7
Exchange rate						
End-of-period (Manat/US$)	0.803	0.798	0.787	…	…	…
Real effective exchange rate (percentage change, "-"=depreciation)	14.0	1.1	2.5	…	…	…

Sources: Azerbaijani authorities; and IMF staff estimates.

1/ Includes the production and processing of oil and gas.
2/ Includes the transportation of oil and gas (except transportation through the western route)
3/ Defined as gross domestic demand (excluding hydrocarbon imports) divided by average broad money.

Statement by René Weber, Executive Director for the Republic of Azerbaijan
And Sebastien Waelti, Advisor to Executive Director
May 3, 2013

On behalf of our Azerbaijani authorities, we thank staff for the constructive policy discussions and their report. The authorities welcome the continued productive dialogue with the Fund and consider the staff's recommendations pertinent. They would like to express their appreciation to staff for choosing Azerbaijan as a pilot country to apply the Resource-Rich Developing Countries toolkit.

Since the last Executive Board meeting on Azerbaijan three years ago, the authorities have made further progress in reforms, while sustaining macroeconomic stability. Azerbaijan's external position has improved further, the process of economic diversification has accelerated, its foreign currency reserves have increased, and the country's standing has been upgraded by the major credit rating agencies. The authorities would like to stress that the strong and sustained growth in non-oil output, recovering oil production, and substantial current account surplus allow the country to maintain macroeconomic stability. Substantial financial buffers in excess of USD 46 billion (70 percent of GDP), very low external public debt levels (below 9 percent of GDP), and market access provide ample policy space in case downside risks should materialize.

Fiscal Policy

The authorities remain committed to transforming oil revenue into productive assets, including human capital, to promote sustained and inclusive growth. The medium term fiscal strategy focuses on reducing the non-oil budget deficit through enlarging the revenue base and prioritizing expenditures. The recent updates to the tax code aim at broadening the tax base and improving the effectiveness of tax administration. The government targets to cover recurrent expenditures with non-oil sector revenue. On the expenditure side, the authorities believe that rationalizing public investment through prioritization and the effective evaluation of projects will significantly contribute to the fiscal consolidation objective. The fiscal framework thus supports a stable environment for economic activity, encourages private sector development, and is conducive to foreign investment.

The authorities reiterate their commitment to ensure medium-term fiscal sustainability and highlight the need for flexibility to adjust their fiscal stance, should domestic or international developments call for it. They anticipate reduced transfers from the State Oil Fund to the budget in the medium term, but emphasize that the current buffer in the State Oil Fund allows to deal adequately with adverse external shocks, while supporting macroeconomic objectives.

The authorities express their concern that the data used in Box 1 in the staff report do not present an accurate description of the current level and efficiency of public investment. The IMF working paper, on which the analysis in Box 1 is based upon, relies on PEFA data for 2007 in the case of Azerbaijan. Since then, Azerbaijan has embarked on a large-scale infrastructure investment program. The authorities caution against the extrapolation of a single data point several years ago to draw conclusions about the current level and efficiency of public investment. It should also be noted that the bulk of these infrastructure investments was conducted in cooperation with international development institutions, such as the World Bank and the Asian Development Bank.

Monetary and Foreign Exchange Rate Policies

The main goal of monetary policy in 2013 is to maintain the inflation rate within the 5-6 percent target range. The rapid fall in inflation during 2012 provided room for loosening monetary policy. This being said, the Central Bank is ready to act swiftly, if inflation threatens to exceed its target range. The authorities are eager to maintain inflation in low single-digits and to strengthen the transmission channels of monetary policy.

The authorities agree with staff that a more flexible exchange rate regime would enable a more effective monetary policy and provide additional tools to weather potential shocks as the economy diversifies. They stress, however, that the switch to greater exchange rate flexibility is a longer term goal and must be gradual, sequenced correctly, and coordinated with all relevant agencies. Fund technical assistance in this area is very much appreciated by the authorities.

The authorities consider that the expected current account surplus will be the main factor in affecting the manat/US dollar exchange rate in 2013. They reiterate their commitment to a stable external value of the manat and stand ready to intervene in response to potential sharp fluctuations. This commitment is credibly underpinned by the significant international foreign exchange reserves at the disposal of Azerbaijan.

Financial Sector Reforms

The banking sector remains fundamentally sound. The ratio of non-performing loans is low, capital adequacy ratios are high, and banks' liquidity positions are strong. During 2012, the authorities took measures to further tighten corporate governance regulations, risk management practices, and prudential regulations to strengthen financial sector stability. They believe that the ongoing capitalization and consolidation process will create a more competitive banking sector. Even after a five-fold increase in minimum capital requirements, banks that combine for 89 percent of total banking sector assets already meet the new requirements.

The authorities are determined to continue closely monitoring the banking system, strengthen banking supervision, and improve corporate governance in this sector. They also look forward to to the forthcoming FSAP and thank staff for their readiness to assist. Increasing non-cash transaction volumes in the economy significantly will be one of the reform priorities of the authorities. The authorities acknowledge the importance of restructuring IBA, but they stress that the process should be carefully planned and proceed at a pace consistent with maintaining banking sector stability. The authorities highlight that they will continue taking steps in 2013 to accelerate the integration into global financial markets and to create a risk-based prudential framework harmonized with Basel III standards.