INTERNATIONAL MONETARY FUND

IMF Country Report No. 16/296

REPUBLIC OF AZERBAIJAN

2016 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; AND INFORMATIONAL ANNEX

September 2016

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 2016 Article IV consultation with the Republic of Azerbaijan, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its September 9, 2016 consideration of the staff report that concluded the Article IV consultation with the Republic of Azerbaijan.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on September 9, 2016, following discussions that ended on June 2, 2016, with the officials of the Republic of Azerbaijan on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on August 25, 2016.
- An **Informational Annex** prepared by the IMF staff.

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

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September 14, 2016

International Monetary Fund
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IMF Executive Board Concludes 2016 Article IV Consultation with the Republic of Azerbaijan

On September 9, 2016, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with the Republic of Azerbaijan.

A number of negative shocks have impaired economic performance in Azerbaijan. Lower oil prices, weak regional growth, currency devaluations in its main trading partners, and a contraction in hydrocarbon production rapidly erased the large current account surplus that the country enjoyed during the oil boom years.

Against this backdrop, the authorities have taken a number of actions. With reserves falling and external shocks intensifying, the Central Bank of Azerbaijan (CBA) devalued the manat and shifted to a managed float exchange rate regime. The devaluations helped to improve competitiveness but worsened bank balance sheets and increased dollarization. The authorities have started to close problematic banks, restructure the largest state bank, launched a reform of the financial supervision architecture and added new macro prudential limits on dollar lending. At the same time, a counter-cyclical stimulus tailored to promote growth and protect vulnerable populations is being implemented. Public sector wages, overall pensions, and social protection expenditures have been increased while in train capital expenditure projects will be completed. Fiscal consolidation is set to resume in 2017. To limit inflationary pressures, the CBA has tightened the monetary stance in 2016, raising the refinancing rate by 1,200 basis points to 15.0 percent.

[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.

Near-term economic prospects remain weak. Under current policies, growth is expected to contract this year and remain sluggish in the next few years, while inflation is expected to gradually decrease. Large fiscal surpluses during the oil boom years are projected to turn into deficits in the next three years. The current account balance should improve as the devaluations work to limit imports and support non-traditional exports. The authorities plan to utilize a small amount of assets from the Oil Fund to help finance balance of payments gaps. To ensure sustainable growth, the authorities are developing a strategy to rapidly diversify the economy by creating a more business friendly environment and pursuing structural reforms. Risks to the outlook are tilted to the downside as economic growth is still highly linked to oil shocks and government spending. The ongoing restructuring of the financial sector is a major risk to growth."

Executive Board Assessment[2]

Executive Directors welcomed the steps the authorities have taken to adjust to the decline in oil prices and weaker growth in trading partners. However, they noted that the difficult external environment could hamper macroeconomic outcomes in the near term. While Azerbaijan's policy buffers remain substantial, the balance of payments, fiscal position, and banking system would likely remain under pressure as the economy continues to adjust. Accordingly, Directors stressed the need to press ahead with reforms to secure macroeconomic and financial stability and promote a diversified and private sector-led economy.

Directors supported the authorities' adjustment efforts. While welcoming the implementation of a small counter-cyclical fiscal stimulus in 2016 to shore up economic activity and protect vulnerable segments of the population, they underscored the need to return to a consolidation path. They recommended placing the weight of the adjustment on spending cuts, while protecting priority social spending and enhancing the efficiency of capital expenditure. They took note of the new tax policy aimed at fostering non-oil activity and revenue, but stressed the need to reduce tax exemptions and strengthen tax administration. Directors considered that a rule-based fiscal framework supported by institutional arrangements and careful debt management would help preserve fiscal sustainability. They also encouraged the authorities to implement their pension reform plans.

Directors welcomed the authorities' move to a managed float exchange rate regime and recent interest rate increases aimed at containing inflation. They noted the importance of improving policy communication to help anchor expectations and reduce uncertainty. They urged the central bank to stand ready to adjust monetary conditions to reflect changes in the fiscal impulse and the bank restructuring process. Directors also noted that greater exchange rate flexibility would help preserve international reserve buffers, pave the way for modernizing the monetary

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[2] At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summing up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

and exchange rate frameworks, and allow adoption of the policy rate as a nominal anchor. Improving monetary transmission and the functioning of the foreign exchange market will also be crucial.

Directors highlighted the need to closely monitor the banking system. They were encouraged by ongoing efforts to close non-viable banks, and recommended further prompt actions to bolster financial sector resilience. They urged the authorities to move ahead with the restructuring of the largest state bank with a view to its privatization, and address the problems in the rest of the banking system. They emphasized the importance of completing the implementation of the FSAP recommendations including strengthening banking supervision and the macro-prudential framework.

Directors welcomed the authorities' efforts to diversify the economy away from oil toward non-traditional sectors. They emphasized that creating a private sector-led, non-oil economy requires reforms to reduce the costs of doing business and remove barriers to competition. They also highlighted the need to improve governance.

Azerbaijan: Selected Economic and Financial Indicators, 2013-2020

	2013	2014	Prel. 2015	Projections 2016	2017	2018	2019	2020
	(Annual percentage change, unless otherwise specified)							
National income								
GDP at constant prices	5.8	2.8	1.1	-2.4	1.4	2.3	2.9	2.5
Of which: Oil sector [1]	0.5	-2.4	0.3	-0.4	-0.1	3.0	4.3	1.0
Non-oil sector	9.9	6.9	1.1	-3.6	2.4	1.8	2.0	3.4
Consumer price index (period average)	2.5	1.5	4.1	10.2	8.5	4.2	4.1	4.0
Money and credit								
Domestic credit, net	4.3	20.4	10.1	4.8	3.1	7.8	10.9	10.8
Of which: Credit to private sector	27.6	26.7	14.0	-2.1	6.6	7.2	8.9	9.6
Manat base money	10.7	-0.9	-40.2	17.0	21.7	16.2	12.3	12.5
Manat broad money	19.0	6.1	-50.6	2.8	13.2	16.8	19.1	24.3
Total broad money	15.4	11.4	-1.1	1.3	7.9	6.9	5.6	4.6
External sector								
Exports f.o.b.	-1.9	-11.1	-44.8	-13.2	13.6	8.7	8.5	4.6
Of which: Oil sector	-2.1	-11.3	-47.1	-13.6	14.0	8.4	8.0	3.4
Imports f.o.b.	-0.8	-16.3	4.7	-13.7	10.9	10.7	2.3	6.3
Of which: Oil sector	9.3	23.3	67.1	-16.6	8.9	22.2	-1.5	5.7
Real effective exchange rate	0.3	4.4	-7.3	--	--	--	--	--
	(In percent of GDP, unless otherwise specified)							
Gross investment	25.7	23.1	26.5	29.8	25.6	24.4	22.3	21.4
Consolidated government	20.3	15.3	16.3	18.4	14.9	14.0	11.6	10.7
Private sector	5.4	7.8	10.1	11.4	10.7	10.4	10.7	10.7
Of which: Oil sector	2.9	3.6	4.7	6.6	5.5	4.6	3.8	4.0
Gross national savings	42.1	36.7	26.1	30.5	28.7	33.4	32.0	31.8
Consolidated government	21.3	18.5	9.6	8.5	11.0	13.6	18.0	18.7
Private sector [2]	20.8	18.2	16.5	22.0	17.8	19.8	14.0	13.1
Consolidated central government finances								
Total revenue and grants	39.5	38.9	33.8	35.0	37.6	40.3	44.4	45.3
Total expenditure	38.5	35.7	40.5	44.9	41.5	40.7	38.1	37.3
Overall fiscal balance	1.0	3.2	-6.8	-9.9	-3.9	-0.4	6.3	8.0
Non-oil primary balance, in percent of non-oil GDP	-46.5	-35.8	-34.4	-37.7	-32.6	-31.8	-28.3	-27.4
General government gross debt	12.7	11.2	28.3	37.5	37.4	36.0	32.6	30.0

Azerbaijan: Selected Economic and Financial Indicators, 2013-2020 (concluded)

External sector								
Current account (- deficit)	16.4	13.9	-0.4	0.7	3.1	9.0	9.6	10.4
Foreign direct investment (net)	1.5	2.9	1.6	2.4	1.8	1.6	1.4	2.1
Memorandum items:								
Gross official international reserves (in millions of U.S. dollars)	14,152	13,758	5,017	4,117	4,617	5,117	5,617	6,117
Nominal GDP (in millions of manat)	57,708	58,978	54,352	55,314	59,739	62,128	65,235	67,844
Nominal non-oil GDP (in millions of manat)	34,051	37,701	39,542	39,906	43,099	44,823	47,064	48,946
Nominal GDP (in millions of U.S. dollars)	73,537	75,254	54,048	35,686	38,541	40,083	42,087	43,770
Oil Fund Assets (in millions of U.S. dollars)	35,878	37,104	33,574	33,120	34,407	37,254	41,289	46,066
Exchange rate (manat/dollar, end of period)	0.785	0.784	1.550	--	--	--	--	--

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

[1] Includes the production and processing of oil and gas.
[2] Historical data includes statistical discrepancy.

INTERNATIONAL MONETARY FUND

REPUBLIC OF AZERBAIJAN

STAFF REPORT FOR THE 2016 ARTICLE IV CONSULTATION

August 25, 2016

KEY ISSUES

Context: Azerbaijan built large buffers and invested heavily during the oil boom years, but efforts to diversify the economy have lagged. The authorities have taken steps to adjust to slumping oil prices and weaker growth in trading partner countries. In 2015, the Central Bank of Azerbaijan (CBA) undertook two devaluations and switched to a managed float. Inflation rose while the large current account surplus evaporated and the budget moved to a deficit. Financial sector soundness deteriorated. Monetary policy has been tightened to address inflation and support the currency. The non-oil primary balanced improved in 2015, but is being reversed in 2016 with a revised budget that boosts capital and current spending. The largest bank is being restructured via a bad bank-special purpose vehicle (SPV) model, some smaller banks have been closed or intervened, and a new integrated financial supervisory agency has been created.

Focus of consultation and recommendations: The challenge is to align macro policies with the new external environment, while modernizing monetary and fiscal frameworks and accelerating structural reforms to foster diversification through private sector-led growth. This would require the adoption of an interest rate based monetary policy operational target and a rule-based fiscal framework. A small fiscal stimulus is helping to support growth in 2016, but consolidation needs to resume next year to safeguard medium-term fiscal sustainability. Exchange rate (ER) flexibility should be increased under the managed float to preserve buffers and absorb shocks. Non-viable banks should be closed and the banking system restructured, with financial sector supervision enhanced along the lines of Financial Sector Assessment Program (FSAP) and technical assistance (TA) recommendations. To expand the economy's potential, the structural reform agenda needs to be implemented, with governance strengthened, the cost of doing business reduced, and competition and trade barriers removed.

Progress from previous consultation: During the 2014 Article IV consultation, directors stressed the importance of tightening the macro-policy stance, strengthening the financial sector and accelerating structural reforms. Since then, the authorities have made some progress in fiscal consolidation in 2014-15, and have recently started to address financial sector vulnerabilities; they have also allowed greater ER flexibility in 2016. The pace of reforms aimed at strengthening the fiscal framework and improving governance and the business climate remains slow.

Approved By
Juha Kähkönen (MCD) and Sean Nolan (SPR)

Discussions were held in Baku on May 19—June 2, 2016. The staff team comprised M. El Qorchi (head), C. Castellanos, N. Imaralieva, V. Nguyen, K. Ross (all MCD), and M. Souto (MCM). D. Heller and. A. Ahmadov (OED) joined some of the meetings, and R. Andrawis (MCD) contributed from headquarters. The mission met with His Excellency, President Aliyev, Finance Minister Sharifov, CBA Chairman Rustamov, other senior officials, and representatives of the private sector, civil society, and the diplomatic community. S. Davis assisted in the preparation of this report.

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CONTEXT

1. **Oil and gas are central to Azerbaijan's economy.** During the oil price boom (2006-14) hydrocarbon (HC) activity accounted for three-quarters of GDP and government income, and 90 percent of exports. Oil production is expected to decline in 2016-19, with oil prices below historical averages. A pivot toward gas extraction and the building of a new pipeline network should raise gas output and exports (from 2018 onward). Oil reserves are estimated to be 7 billion barrels, while gas reserves are 35 trillion cubic feet. The authorities are negotiating a new production sharing agreement with the consortium of foreign oil companies (AIOC), who together with the state oil company (SOCAR) extract hydrocarbons in Azerbaijan.

2. **President Aliyev's New Azerbaijani Party (YAP) dominated 2015 parliamentary elections.** The main opposition parties opted not to participate. Constitutional amendments have been proposed to lengthen presidential terms from 5 to 7 years. To improve policy discussion and coordination, a high-level committee on economic policy planning and reforms was established in late 2015.

RECENT DEVELOPMENTS

3. **A series of negative shocks have dented economic performance.** Plummeting oil prices, weak regional growth, currency movements and a contraction in HC production quickly erased a large current account surplus. To preserve reserves, the central bank (CBA) undertook a 25 percent devaluation in February 2015 and a second 32 percent devaluation in December 2015, with a shift to a managed floating ER regime. Growth fell to 1.1 percent in 2015 and contracted by 3.4 percent in first half of 2016, given cuts in public investment, stagnant credit activity and flat oil production. Inflation averaged 4.1 percent in 2015 and rose to about 11 percent by mid-2016, reflecting exchange rate pass-through effects (ERPT) **(Annex I)**.

4. **Buffers remain substantial given Oil Fund (SOFAZ) assets.** Foreign exchange (FX) sales have lowered CBA reserves from $13.8 billion at end-2014 to $4.3 billion by end-June (3.5 months of projected 2016 imports of goods and services). Based on the IMF's composite reserve adequacy metric, Azerbaijan should hold about 8.4 months of current imports. SOFAZ assets, which can be used to support the ER, amounted to some $34 billion (close to 100 percent of 2016 projected GDP; about 28 months of current imports). Based on the Fund's EBA-lite methodology, the real effective exchange rate (REER) remained modestly overvalued as of end-2015 **(Annex II).**

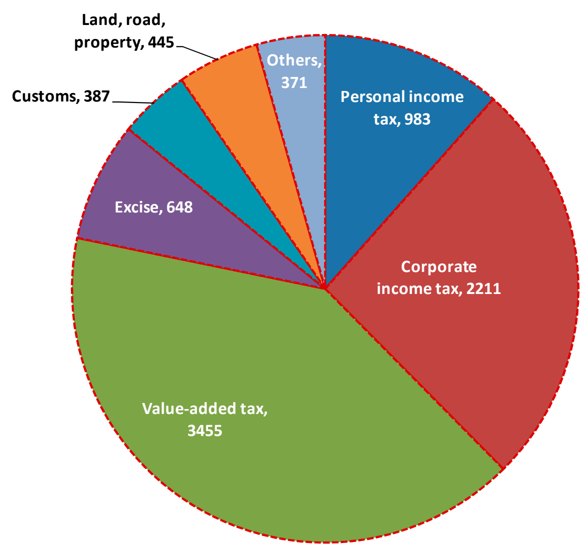
5. **A counter-cyclical stimulus tailored to promote growth and protect vulnerable populations is being implemented.** Public sector wages, overall pensions, and social protection expenditures have been increased by 10 percent (3 percent of non-oil GDP) in 2016. With the issuance of an external Southern Gas Corridor (SGC) bond in March for $1 billion, space was freed up in the state budget for an additional 3½ percent of non-oil GDP in capital spending to complete

ongoing projects. To ease social tensions, state-owned enterprises and local authorities have hired 35,000 minimum wage workers on temporary contracts.[1] Moreover, new non-oil tax measures are expected to reduce revenues by ¼ percent of GDP **(Box 1)**. Overall, current and capital expenditures rise by about 2 percent of GDP, while the consolidated government non-oil primary deficit as a percent of non-oil GDP rises by about 3 percentage points (pps), to 38 percent.[2]

Box 1. Azerbaijan: Non-Oil Tax Revenue

The authorities aim to raise non-oil tax revenues without adding new taxes or raising rates. The plan is focused on fostering non-oil activity (broadening the base), simplifying the tax system and encouraging compliance via accessible e-services. However, it is not clear the extent to which these measures will improve the tax intake in the long-run or Azerbaijan's low tax yield efficiency.

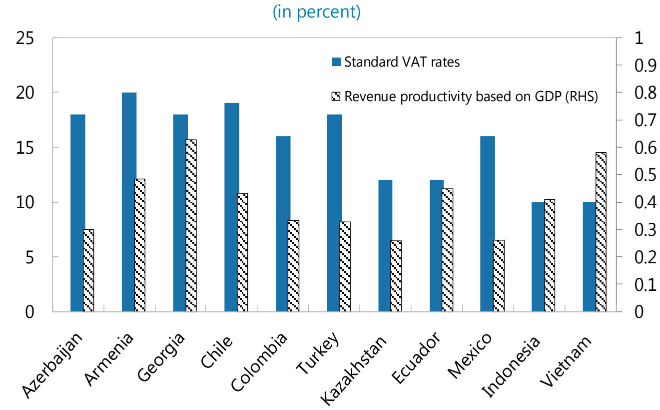
Revenue from different tax categories, 2015
(millions of AZN manat)



The current tax structure relies on value-added (VAT), and corporate (CIT) and personal (PIT) income taxes. The PIT rate is 14 percent for income up to AzN 2,500 per month and 25 percent thereafter. The CIT rate is 20 percent, but certain firms can opt to pay a simplified tax (ST) rate (4 percent in Baku, 2 percent elsewhere). ST payers do not pay property tax or VAT. The VAT rate is 18 percent, but firms participating in production sharing agreements and joint ventures in the hydrocarbon sector are exempt.

New tax policy changes focus on adjusting registration limits. For 2016 the qualifying income threshold have been raised (from AzN 200 to 2,500) while the standard deduction was held constant at AzN 136. The VAT registration and ST eligibility has been increased (from AzN 120,000 to 200,000). Traders or catering firms with turnover exceeding AzN 200,000 can now opt out of VAT and pay at the ST rate (albeit at 6 and 8 percent, respectively). Construction firms can now choose to pay a VAT or an average of AzN 45 per square meter.

VAT Rates and Productivity, 2014
(in percent)



Sources: IMF, VAT Database (Fiscal Affairs Department), Government Finance Statistics Yearbook (Statistics Department)

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[1] Less than 10 percent of these employments are part of the consolidated government accounts.

[2] Foreign currency expenditures (e.g., service on external debt) of about 1½ percent of GDP rose automatically following the devaluations.

Box 1. Azerbaijan: Non-Oil Tax Revenue (concluded)

Exemptions have been recently introduced to boost private investment. From March 2016, new investment projects within certain regions and sectors, and a minimum investment amount can qualify for an "*investment certificate*." Required investment amounts range from AzN 200,000 (rural regions) to 10 million (more urbanized). Among the priorities are industrial parks, manufacturing plants, and research activities. Valid for seven years, the certificate provides for a 50 percent reduction of income taxes, VAT-free import of technological equipment, and no property or land tax. A number of SMEs have applied, signaling a positive effect on investment.

Taxpayer services have been modernized. All formal labor contracts are registered in a database that is shared between the Ministry of Taxes and the Ministry of Labor and Social Protection. Business and individuals can now pay taxes and custom duties via e-services reducing compliance time. These efforts, together with a reduction in the number of required taxes, have resulted in a marked improvement (from 103rd in 2011 to 34th in 2016) in Azerbaijan's *Ease of Paying Taxes* indicator (from the World Bank's Doing Business survey).

6. Fiscal space has declined. More than 70 percent of Azerbaijan's public debt is denominated in foreign currencies. Given the devaluations and borrowing plans, the debt sustainability analysis (DSA) indicates that the debt to GDP ratio will move from 11 percent in 2014 to about 38 percent in 2016 (**Annex III**).

7. The CBA tightened the monetary policy stance in 2016 to limit inflationary pressures. In three separate moves (in February, March and August), the CBA increased its refinancing rate by 650 basis points (bps) (to 9.5 percent) and adjusted the interest rate corridor.[3] Since mid-2016, the CBA has held manat deposit auctions to withdraw liquidity. With the move to a managed float and periodic FX auctions, exchange rate volatility has increased.[4] Credit growth has turned negative in 2016 given weak economic activity, mismatches in banks' currency positions and expectations of additional devaluations.

8. The authorities have taken steps to repair the banking system (Annex IV). The devaluations led to an increase in dollarization, weakened bank balance sheets and deteriorated financial soundness indicators—raising significant financial stability concerns. In mid-2015, the government created a bad bank-SPV to manage and collect nonperforming loans (NPLs) from the largest state bank (IBA), while the CBA closed or merged a number of smaller banks. In March 2016, banking and insurance supervision was transferred from the CBA and Ministry of Finance (MOF), respectively, to a new supervisory and regulatory authority, the Financial Market Services Agency (FMSA). To support confidence, household bank deposits were afforded a blanket guarantee

[3] In May 2016, the corridor was narrowed, with the floor raised (from 2 to 4 percent) and the ceiling reduced (from 17 to 15 percent).

[4] However, tight bid-ask spreads (+/- 1 percent) at the CBA auctions constrain ER movements. The amount of FX offered is determined jointly by the CBA and SOFAZ.

backstopped through the CBA.[5] To address dollarization, new macro-prudential limits were placed on dollar lending and foreign currency reserve requirements were increased. The FMSA has put together a supervisory action plan and has started to address ailing institutions. A Financial Stability Board has also been created.[6]

Azerbaijan: Banking Sector Financial Soundness Indicators 2011–15
(In percent)

	2011	2012	2013	2014	2015 1/
Regulatory Capital to Risk-Weighted Assets	14.7	16.8	18.1	19.2	5.5
Liquid Assets to Total Assets	14.6	12.2	9.8	11.4	23.4
Nonperforming Loans (NPLs) to Total Loans 2/ 3/	6.0	5.7	4.5	4.4	17.2
NPLs Net of Provisions to Total Loans 2/ 3/	1.4	1.3	1.0	0.9	11.9
Bank Return on Assets	-1.1	0.7	1.5	1.7	-1.0
Bank Return on Equity	-9.3	6.2	11.7	11.3	-9.8

Sources: Central Bank of Azerbaijan and staff estimates.
1/ 2015 data reflects prudential FSIs.
2/ Excludes restructured loans. Impaired loan ratios are higher under IFRS.
3/ Disclosed NPLs are underestimated for 2011-14; only overdue portion of principal and interest is counted.

OUTLOOK AND RISKS

9. Near-term economic prospects are poor—with a recession projected in 2016. Under current policies, real GDP is expected to contract by -2.4 percent in 2016, and hover around 1-2 percent in the next few years, while inflation is expected to gradually fall under 8 percent. Large fiscal surpluses during the oil boom years are projected to turn into deficits in 2015-18. The current account balance should improve as the devaluations work to limit imports and support non-traditional exports. The authorities plan to utilize about $500 million in SOFAZ assets in 2016 to help finance balance of payments gaps.

10. Macro-financial risks to the outlook are substantial (Appendix I).

- **Given the economy's HC export structure and public investment framework, oil price shocks have a strong impact on the real economy, with spillover effects on the ER, bank profitability, and credit delivery systems (Box 2).** Macro-financial linkages have increased significantly over time, through rapid growth in bank credit during the oil boom years—notably to the household and construction sectors. **(Box 3)**. Dollarization—which increases vulnerabilities to liquidity and solvency shocks—has expanded. Weak bank capital and liquidity positions are also weighing on credit activity.

- **While the authorities are making progress in cleaning up the banking system at a difficult juncture, the bank restructuring strategy entails important risks**—notably the decision to inject substantial new resources into IBA—a large systemic public bank with a weak track record and a continued lending focus on oil-related industrial projects.

- **Staff projections seek to incorporate these financial sector risks.** So far, bank closures have been handled effectively and have occurred without provoking destabilizing deposit runs.

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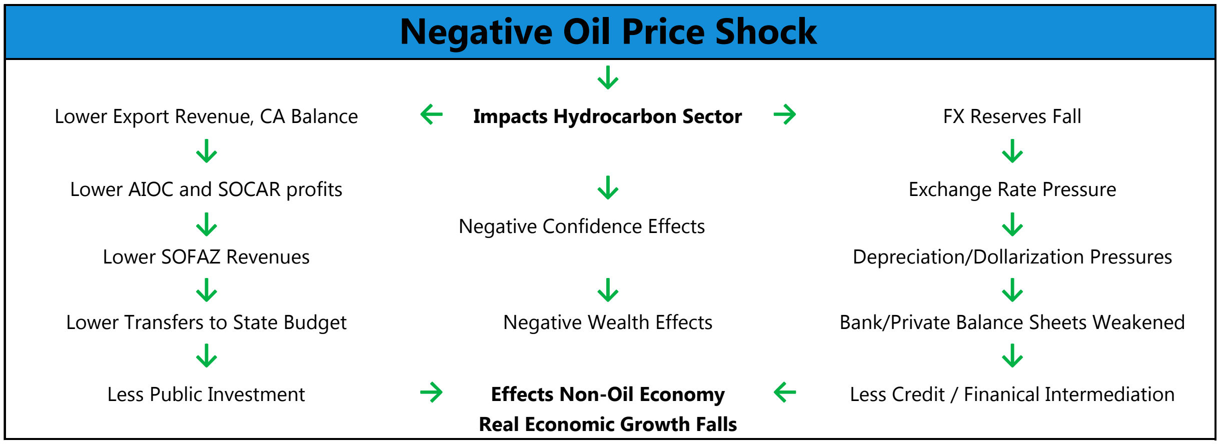
[5] In mid-2016, household deposits amounted to some 14 percent of projected 2016 GDP.

[6] The Board will include representatives of deposit insurance fund (ADIF), CBA, MOF, FMSA, and SOFAZ, and will be chaired by the Prime Minister.

Deposit growth, which declined during the devaluations, has rebounded (due in part to the blanket guarantee), helping to support bank funding. Downgrades by international rating agencies have had little impact given limited dependence on external credit lines. Negative financial accelerator effects and increases in dollarization rates experienced in 2015-16, are assumed to reverse gradually as oil prices are expected to improve over the forecast period and as banking sector reform progresses. Staff's growth and private credit forecasts for 2016-2020 average 1.3 and 6.0 percent, respectively, well below historical averages and imply a relatively slow recovery.

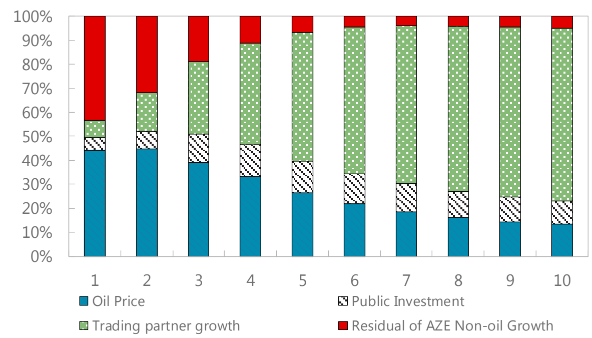
11. Overall, risks to the outlook are tilted to the downside. Additional oil price declines associated with a deteriorating global outlook would worsen external balances, increase ER pressures, expose fiscal vulnerabilities and further dent consumer and business confidence. Budgetary transfers from SOFAZ would diminish resulting in further spending cuts or larger fiscal deficits, which may require drawdowns from SOFAZ's stock of assets. Direct exposure to international financial markets is concentrated mostly on Oil Fund assets held abroad. As demonstrated above, complications in the bank restructuring process could also impact growth. Better than expected oil price developments constitute the main upside risk. The authorities broadly agreed with staff's macroeconomic projections and hold similar views on the risk outlook.

Box 2. Azerbaijan: Linkages and Spillovers



The oil price is the main channel linking Azerbaijan to the global economy. Oil profits are a key part of factor income, a share of which get reinvested in FDI by the consortium of foreign oil companies which is developing Azerbaijan's oil fields. Given the ad hoc fiscal rule, a portion of these profits were used to build up sovereign wealth fund (SOFAZ) buffers and recycled throughout the economy via budgetary transfers for public investments. Oil price shocks also put pressure on exchange rates and reserves and creating income/wealth and confidence effects, and affect financial intermediation.

Azerbaijan: Forecast Error Variance Decomposition of Non-Oil Growth

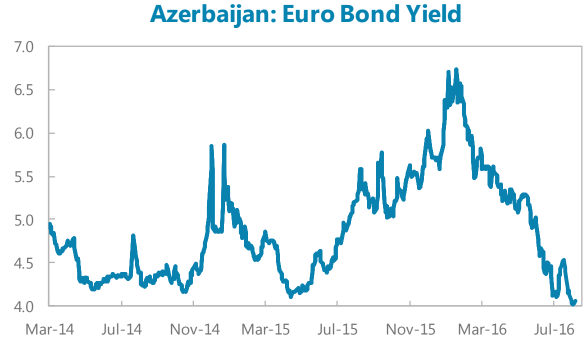


Source: IMF Staff estimates

Public investment is the main transmitting mechanism between the oil and non-oil sectors in Azerbaijan. An estimated vector auto regression (VAR) model using annual data from 1997 to 2015 shows that, net of public investment, the impact of trading partner growth on non-oil sector is negligible. Public investment and oil prices, however, explain the majority of variance in the non-oil growth rates, especially over the medium term.

While direct external linkages to the financial sector are small, indirect linkages have been substantial. Azerbaijan's financing needs have been low by international standards, given external and fiscal surpluses. Lending by global banks to Azerbaijan's financial sector has been minimal and corporations have relied mainly on their own resources. FDI, focused on the energy sector, remained strong due to new gas developments. However, the oil price-led devaluations have weakened the domestic banking system and raised the risk premium for Azerbaijan when borrowing in international markets. As a consequence, financing the new gas pipeline project faced higher costs as reflected in the yield of the 10-year bond issued in mid-March 2016.

Azerbaijan: Euro Bond Yield



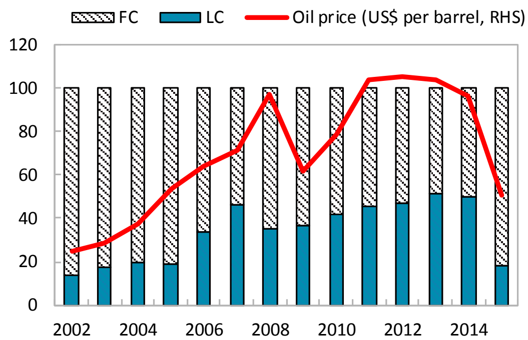
Source: Bloomberg

Box 3. Azerbaijan: Macro-Financial Linkages[7]

Oil and ER shocks have led to a rise in dollarization levels. Dollarization in Azerbaijan had fallen from 2002 to 2014, with a minor setback at the start of the financial crisis in 2008. It appears to move in line with oil prices, a key propagator of the business cycle (BC) in Azerbaijan.

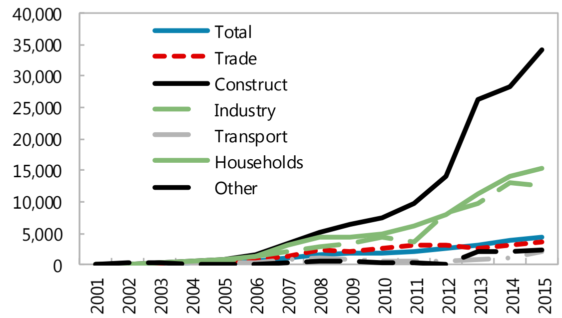
Starting from a very low base, bank credit has expanded rapidly over the last decade. Two separate growth phases—first from 2005-10, and a second dramatic acceleration in credit activity in 2011-15—appear to have occurred. The main growth sectors were in trade, construction, households and industry—with trade credit expanding at a slower rate in the second period and construction, industry and household credit surging.

Azerbaijan: Dollarization of Deposits



Sources: CBA and IMF staff estimates.

Azerbaijan: Credit Growth By Sector
(2001=100)

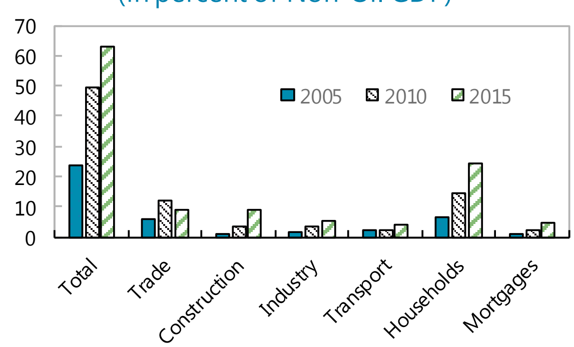


Sources: CBA and Staff estimates.

Total credit as a percent of non-oil GDP has almost tripled, going from 23 percent in 2005 to 63 percent by 2015. Over the same period, credit to households has increased from 6½ to 24½ percent of non-oil GDP, while credit to the construction sector has increased from 1½ to 9 percent of non-oil GDP. Mortgages have been a key component of the growth in household credit (now 4½ of non-oil GDP), with the remaining 20 percent stemming from consumer oriented lending (e.g., credit cards, auto loans and home appliances).

Sectoral credit gaps and BCs do not fully co-move together. The "credit gap", defined as the difference between a credit-to-GDP ratio and its long-term trend, reflects a financial cycle (FC). The last 3 BCs (trough-to-trough) were in 2001-05, 2005-09 and 2009-2016. In comparison, sectoral credit gaps appear to be more diverse with little movement during the first BC. Corporate and trade FCs appear to co-move and lag a bit the second BC. In the last BC, household, trade and construction FC respond sharply during the boom.

Azerbaijan: Credit by Sector
(in percent of Non-Oil GDP)

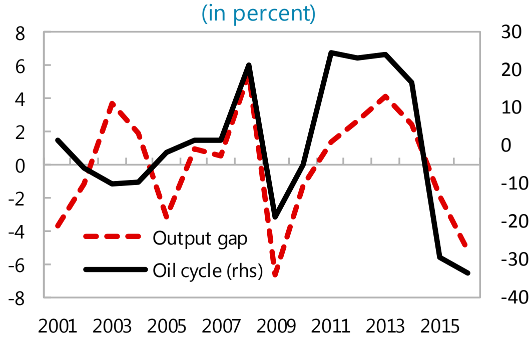


Sources: CBA and IMF staff estimates.

[7] See Morley (2015), "*Macro-Financial Linkages*", Journal of Economic Surveys, April.

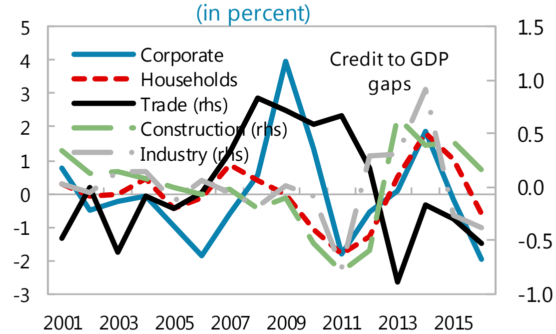
Box 3. Azerbaijan: Macro-Financial Linkages[8] (concluded)

Azerbaijan: Business Cycles
(in percent)



Sources: Haver and IMF Staff estimates.

Azerbaijan: Financial Cycles
(in percent)



Sources: Haver and IMF staff estimates.

Two sets of regressions are estimated to find evidence of a macro-financial linkage. One set focuses on credit regressions, looking to see how BCs affect the credit market. The other focus is on growth regressions, using individual sectoral credit growth or FCs to ascertain the impact of credit developments on real activity. A loan to deposit leverage ratio and oil price growth are used as financial and real sector conditioning variables. The data is quarterly (2006q1-2016q2). Regression results which found significant macro-financial linkages are reported below. They indicate that construction and industry credit growth are affected by non-oil growth, while growth in trade, construction, and household credit impact non-oil growth. For example, a one percentage point increase in overall credit growth is found to increase growth by 0.15 percent. At the same time, a one percentage point change in non-oil growth is related to an expansion in construction and industry credit growth by about 3½ and 2¾ percent, respectively.

Azerbaijan: Credit and Non-Oil Growth Regressions 1/

	Construction and real estate	Industry	Non-oil growth	Non-oil growth	Non-oil growth	Non-oil growth
Fitted values for non-oil growth	3.49**	2.84**				
	(1.6)	(1.2)				
Loan to deposit ratio	0.77	2.14	0.58	0.62	0.24	0.35
	(2.7)	(2.7)	(0.3)	(0.4)	(0.4)	(0.3)
Oil price growth	-0.03	-0.061	0.001	0.007	0.005	-0.015
	(0.2)	(0.2)	(0.0)	(0.0)	(0.0)	(0.0)
L1.Real credit growth			0.15**			
			(0.1)			
L1.Trade & services credit				0.13**		
				(0.1)		
Construction and real estate					0.041*	
					(0.02)	
Households						0.055*
						(0.03)
L2.Households						0.19**
						(0.09)
Constant	-22.76	-36.78	-1.70	-2.77	0.63	-0.65
	(17.39)	(15.2)	(1.9)	(2.4)	(2.4)	(1.8)
Quarterly observations	42	42	43	43	43	43
Adjusted R-squared	0.18	0.29	0.71	0.71	0.66	0.72

Sources: Haver and Staff estimates.

*1/Using quarterly data, 2005q1-2016q2. Quarterly dummies included. Three quarter lags of both dependent and independent variables included. Heteroskedastic-robust standard errors in brackets. * p<0.1, ** p<0.05, *** p<0.001.*

[8] See Morley (2015), "*Macro-Financial Linkages*", Journal of Economic Surveys, April.

POLICY DISCUSSIONS

A. Implementing a Sustainable Fiscal Consolidation

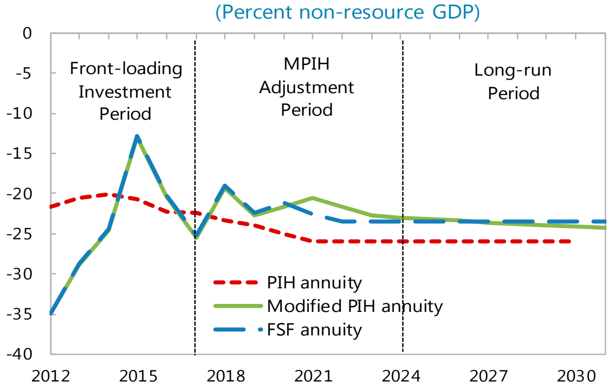
12. Staff argued that the composition of the stimulus was less than ideal but agreed an accommodative fiscal stance in 2016 was appropriate. The authorities acknowledged that fiscal space had shrunk and the stimulus could put added pressure on the ER. However, buffers were available to soften the impact of the recession on vulnerable populations and the stimulus only partially offset the effect of the devaluations. Moreover, the 2016 budget was based on a conservative $25 a barrel oil price.

13. Staff recommended targeting an additional 12 pps of adjustment in the non-oil primary deficit over 2017-20. This would be in line with the permanent income hypothesis (PIH) fiscal rule for Azerbaijan and bring the non-oil deficit in line with the estimated sustainable level **(Box 4)**.[9]

Box 4. Azerbaijan: Recommended Fiscal Rule Targets

Azerbaijan currently uses an ad-hoc fiscal policy framework. The framework contains three main elements: (i) an ad-hoc rule to save ½ of oil revenue abroad in a well-managed oil fund (SOFAZ); (ii) using ¾ of transferred oil-fund revenue to finance investment; and (iii) broad coverage of fiscal accounts, underpinned by rolling non-binding three-year budget plans. The system is pro-cyclical (tightly linked to oil prices), lacks focus on long-term non-oil sustainability and is biased toward excessive public investment.

Azerbaijan: Non-Resource Primary Balance
(Percent non-resource GDP)



Sources: IMF staff calculations.

Staff has recommended a rule-based framework to promote fiscal discipline and anchor expectations.
A modified permanent income (PIH) model, which relies on a non-resource primary balance (NRPB) target (as a percentage of non-resource GDP), can be used to guide optimal consumption-savings decisions.[10] Under the model, the initial years of scaled-up investment have to be fully reversed by fiscal adjustments. Between 2008 and 2016, Azerbaijan public investment has averaged about 15 percent of GDP. Based on expected oil prices, fiscal revenues, and the depletion of natural resource wealth by 2035, the modified PIH model computes a NRPB target of 26 percent in the long term. The projected 2016 NRPB was 38 percent.

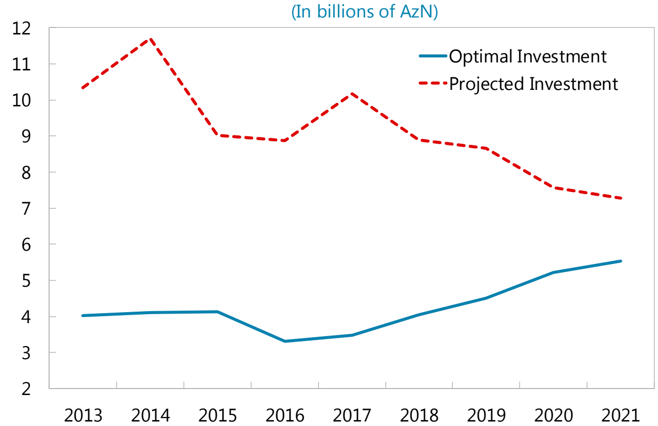
[9] The non-oil primary balance as a percent of GDP is projected to be about –38 percent of non-oil GDP in 2016, while the target based on the PIH fiscal rule (Box 4) is estimated to be -26 percent.

[10] IMF Country Report No. 13/165, *"Revamping the fiscal policy framework in Azerbaijan,"* June 2013.

Box 4. Azerbaijan: Recommended Fiscal Rule Targets (concluded)

To supplement the analysis, a "golden rule" investment rate has also been estimated. The model of Cherif and Hasanov (2013) provides an estimated optimal investment rate under different assumptions for productivity, planning horizons and initial buffers.[1] With an assumed 10 percent return on public investment, 45-year horizon, and initial wealth-to-revenue ratio of 2, the optimal investment rate is within the range of 15-18 percent of total government revenues. Recent estimates indicate that public investment as a percent of total government revenue could go from 52 percent in 2016 to 23 percent by 2020.

Azerbaijan: Optimal vs. Projected Investment Spending Paths, 2013–21
(In billions of AzN)



Source: IMF staff calculations.

- **The authorities stressed that fiscal policy would return to a consolidation path and outlined a number of measures.** In particular, they agreed that some parts of past capital expenditures have been inefficient, and that capital spending levels are high and needed to decrease. They also indicated that there was room to lower expenditures on goods and services. Going forward, the 2016 pension, wage and social spending increases would not be repeated, capital spending reductions would resume, and new pension legislation will lower pension deficits. Notably, the devaluation effects which automatically raised certain expenditures would be absent. Moreover, efforts are underway to raise non-oil revenues—not by increasing tax rates—but by expanding the non-oil tax base over time with investment incentives. In addition, overall fiscal balances would also improve based on WEO oil price projections and as gas production commences.

- **Staff and the authorities reached agreement on the fiscal adjustment path and the projections which incorporate policy measures.** While large and subject to implementation risks, the adjustment was broadly seen to be feasible given proposed policy measures which tilted toward spending cuts and new pension reforms. Staff stated that the authorities' non-oil tax measures reduce revenues in 2016—and it is premature to gauge their long run effect. Importantly, the temporary increase in public employments should not be made permanent, and if these recruits cannot find positions, they should be directed to targeted social assistance programs. Cash transfer programs to fight poverty could be made more effective by making them conditional (e.g., education/training).

[1] Cherif, R. & Hasanov, F., 2013. "*Oil Exporters' Dilemma: How Much to Save and How Much to Invest,*" World Development.

14. The government's plan to implement pension system reform is welcomed. The plan—expected to be enacted by end-2016—will increase the focus on social-insurance principles, linking benefits almost entirely to individual retirement accounts. Retirement ages and contribution periods will increase. The base pension—a flat benefit that accounts for more than half of pension spending—will be eliminated and replaced by an increase of the current defined-contribution benefit. A minimum pension will soften the impact on the low wage workers. Annual pension fund deficits (some 3 percent of GDP) should gradually be eliminated. Staff recommended the full implementation of the plan without delay.

15. There was consensus that a rule-based fiscal framework and strong institutional arrangements would preserve fiscal sustainability over the medium term. The authorities are aware of the underlying fiscal risks: (i) oil revenue volatility; (ii) an unsustainable level of public investment; (iii) uncertain recovery of IBA bad assets; (iv) Social Protection Fund (SPF) deficits; and (v) a growing debt stock. Staff stressed that a rule-based fiscal framework supplemented by a strong public financial management system, detailed multi-annual budgets, and a public debt strategy would entrench fiscal discipline and mitigate the volatility of oil revenue while promoting intergenerational equity. In this context, the authorities plan to request FAD TA on fiscal rules.

B. Modernizing Monetary and ER Policy Frameworks[2]

16. The CBA is informally targeting base money growth in 2016, with a desired move to IT in the long-run. A tighter monetary stance has helped to limit inflationary ERPT effects and pressure on the currency. However, the CBA is concerned that: (i) requests for financial stability loans linked to the bank restructuring process could disrupt monetary programming; (ii) liquidity injections could affect the ER; (iii) credit growth may not easily resume; and (iv) latent deflationary signals linked to slower growth were hidden by ERPT effects.

17. Staff indicated that the banking system still holds excess liquidity (concentrated in a few banks) and doubts about banking system soundness were stifling normal interbank intermediation. The problems in the interbank market highlight the need to restructure quickly the banking system and to develop financial markets. CBA interest rates remain negative in real terms and are below interbank, T-bill and retail deposit rates. This suggests that CBA interest rates may need to rise further (and informal interest rate caps eliminated) given market expectations. Consistent with its monetary policy stance, the CBA should stand ready to adjust monetary conditions to reflect unexpected changes in the fiscal impulse or bank restructuring process that put the money base and inflation objectives at risk.

[2] See IMF (2015), *"Evolving Monetary Policy Frameworks in Low-Income and Other Developing Countries"* Staff Report, and IMF (2016), *"Exchange Rate Developments and Policies in the Caucasus and Central Asia",* MCD Department Paper Series.

18. Staff emphasized the importance of modernizing monetary policy and ER frameworks. In particular, with the move to a new ER regime, markets are now seeking guidance on the future direction of monetary policy. In this regard, emphasizing the primacy of the inflation objective would help to anchor expectations. Given shallow money markets and ineffective monetary transmission, a formal move to monetary targeting would be an appropriate intermediate step. However, to meet its monetary targets, the CBA will need to improve liquidity forecasting and management, and enhance its instrument and analytical toolkit. Importantly, a true policy rate should be established, around which the CBA would carry out its main liquidity management operations.[3]

Azerbaijan: Key Monetary and ER Policy Recommendations
Formally introduce monetary targeting; identify intermediate and operational targets.
Implement liquidity forecasting and management.
Set policy rate around which it would carry out liquidity management operations.
Policy rate set as reference rate for CBA's OMOs.
Futher expand debt securities market.
Make CBA sole seller of FX through program of regular auctions.
Avoid pressure on the ER by eliminating market distortions.
Clearly communicate CBA's monetary and ER policy framework and toolkit.

19. The authorities are comfortable with the degree of exchange rate volatility experienced under the new FX regime. ER markets are thin and dominated by SOFAZ oil flows. While the AzN/US$ rate had been able to move within a wide range, too much variability could still negatively impact fragile bank and private sector balance sheets. At the same time, the CBA has been able to make some ad hoc purchase of reserves—without a clear reserve management strategy. Staff noted that greater ER flexibility would help to preserve buffers, while more clarity on CBA ER policy objectives and intervention strategy would improve the functioning of the FX market and guard against policy errors. Once the ER became fully market determined, the CBA should adopt the policy rate as a nominal anchor.

C. Reducing Financial Sector Vulnerabilities

20. Financial sector discussions focused on the best way to restructure the banking system.

- **The authorities stressed that IBA's management has been replaced, staffing and operating costs cut, new lending standards implemented, and the balance sheet gradually cleaned.** Privatization, however, would take time and would require returning the bank to full health through renewed lending. Staff noted that the SPV exchange of bad assets was at full face value, and a substantial amount of new financial assistance has been provided to IBA in the form of fresh SOFAZ dollar deposits, IBA deposits placed at the CBA at preferential rates, and new capital injections. Downsizing and privatizing IBA would reduce bank concentration, increase competition and improve efficiency in the system. Losses should be recognized quickly and

[3] The CBA refinancing rate has been more associated with CBA liquidity lending—including for financial stability purposes—and less linked to price stability objectives.

existing owners made to bear their fair share of the burden. Any residual shortfalls should be addressed by a transparent budget transfer-with no impact on the CBA balance sheet.

- **The FMSA indicated it was ready to remove regulatory forebearance and address problems in the rest of the system.** FMSA staffing and training had geared up, while basic on-site inspections and asset quality reviews have been completed. Banks have been classified into three categories (solvent, need capital/liquidity assistance or insolvent) and notifications for additional capital injections have been made. Staff argued that the process should proceed quickly and follow guiding principles, which would consist of (i) making sure bank resolution follows least-cost considerations—i.e., wiping out existing shareholders and bailing in related party deposits, before government support is contemplated; (ii) providing liquidity assistance only to economically viable banks on the basis of high quality collateral; and (iii) standing ready to pay out guaranteed deposits in closed banks.

21. Progress in implementing recommendations from the 2015 FSAP and a recent TA mission on banking supervision should accelerate with the establishment of the new regulator. There was agreement that the real-time switch in financial sector regulators as the banking system was being restructured had slowed momentum on supervisory reforms. However, the authorities pointed out that unlike the CBA, the FMSA's ability to conduct on-site inspections was not restricted and political support for an overhaul of financial sector regulation had strengthen. Staff has provided comments on drafts of new financial legislation.

Azerbaijan: Key FSAP Findings
Legal restrictions and limited capacity.
Lack of an explicit mandate for systemic financial stability.
Gaps in crisis management hampered bank resolution.
Poor information exchange between deposit insurance fund and banking supervision.
Rules on emergency lending assistance (ELA) unclear.
Specific resolution plans for systemic banks lacking.

D. Implementing Reforms to Raise Potential Growth

22. The government highlighted progress in implementing their "2020 development strategy". This included opening new e-government service centers; improving public construction tenders; simplifying customs clearance; increasing electronic payments; creating regional industrial zones; moving toward WTO accession and trade diversification; and extending agriculture and environmental reforms. Efforts have been made to diversify the economy away from oil toward non-traditional sectors such as agriculture and tourism, create a more business-friendly environment, and integrate Azerbaijan to the economies of the region through the establishment of agro and industrial parks. Further progress in these areas would promote sustainable and inclusive growth **(Annex V)**.

23. Staff noted that the reversal of positive tail winds—buoyant oil prices and investment—will slow the economy's growth potential unless reforms are implemented (Annex VI). Creating a private sector-led non-oil economy requires reforms to improve governance, reduce the costs of doing business, and remove barriers to competition. Azerbaijan's low rank on

World Bank governance-related indicators (lower half globally) suggests that further efforts are needed to improve government effectiveness, broaden anti-corruption efforts, and strengthen the rule of law as well as the independence of the judiciary. Efforts to diversify economy toward low productivity sectors (e.g. agriculture) are unlikely to boost growth unless productivity challenges are addressed (e.g., through better technology).

STAFF APPRAISAL

24. The lower oil price environment provides an impetus for moving to a new economic growth model, based on a diversified non-oil private sector. This requires implementing structural reforms—the most pressing being a rapid and efficient cleanup of the banking system. Financial sector vulnerabilities currently constitute a major risk to the growth outlook. Once banking system health is restored, other reforms can take root, strengthening confidence. Improved communication among economic policymakers and the public would help to reduce uncertainty. Importantly, pressures to fall back to the old economic model of fixed exchange rates and unsustainable public investment linked to oil transfers should be resisted.

25. The 2016 counter-cyclical stimulus is appropriate, but there is a need to return to fiscal consolidation next year. Fiscal space is contracting and public investment spending remains high. Reducing the non-oil primary deficit over the medium-term in line with the PIH fiscal rule is key. The weight of the adjustment should tilt toward spending cuts, with some increase in non-oil tax revenues. The authorities should stand ready to lower current spending if the cuts in capital spending do not materialize. New public employments should not be made permanent. Cash transfer programs could also be made more effective by linking them to behavioral conditionality (e.g., training and education).

26. A rule-based fiscal framework would help to preserve fiscal sustainability. The framework should contain a strong PFM system, detailed multi-annual budgets, and a public debt strategy to entrench fiscal discipline and mitigate the volatility of oil revenue. Accelerated implementation of PEFA recommendations would also prove beneficial. In this context, the new pension reform reduces risks and improves overall fiscal sustainability.

27. The CBA would benefit from formally introducing monetary targeting and communicating the primacy of its inflation objective. The monetary stance was appropriately tightened in early 2016 to limit inflationary pressures and support the ER. However, markets now seek guidance on the future direction of policy. Policy uncertainty, coupled with slower economic activity, dollarization, and internal bank weaknesses, has negatively impacted credit activity. This has resulted in concentration of excess liquidity within a few banks. Given these difficulties, the CBA will need to modernize its policy substantially to be able to influence money supply and inflation via interest rates.

28. Monetary policy should be recalibrated as the CBA gradually moves to an interest rate-based operational framework. Consistent with its monetary policy stance, the CBA should stand ready to adjust monetary conditions to reflect changes in the fiscal impulse or bank restructuring process, which could put the money base and inflation objectives at risk. Greater ER flexibility will help to preserve buffers and pave the way for modernizing monetary and ER policy frameworks. Once the ER becomes market determined, the CBA should adopt the policy rate as a nominal anchor.

29. Following international best practices would help to ensure the success of the government's bank restructuring plans. Consideration should be given to downsizing and privatizing IBA. The amount of government support remains substantial—as evidenced by the ongoing bank bailout. While some actions have been taken to reform the bank, it is unclear when it will be able to return to profitability. Inflating IBA's loan portfolio—creating an overly large public bank which dominates the corporate loan market, and which faces the same long-standing political economy incentives—should be avoided. A detailed plan and preparations are needed to address the problems in the rest of the banking system. In particular, a sound communication strategy would help to mitigate the risk that a confidence shock jeopardizes financial stability. Finally, it is important to ensure the legal framework does provide the bank resolution authority with proper tools and power to deal with any problematic bank.

30. Financial vulnerabilities need to be addressed along the lines of FSAP recommendations. It is important to bolster on-site banking supervision, the macro-prudential framework, and bank ownership rules. Financial safety nets, including emergency lending assistance and deposit insurance, should be strengthened to ensure continued and timely provision of liquidity to viable banks and expeditious payment of deposits. A resolution authority should be established with wide powers to take corrective measures quickly without seeking shareholder permission or the need to resort to the court system.

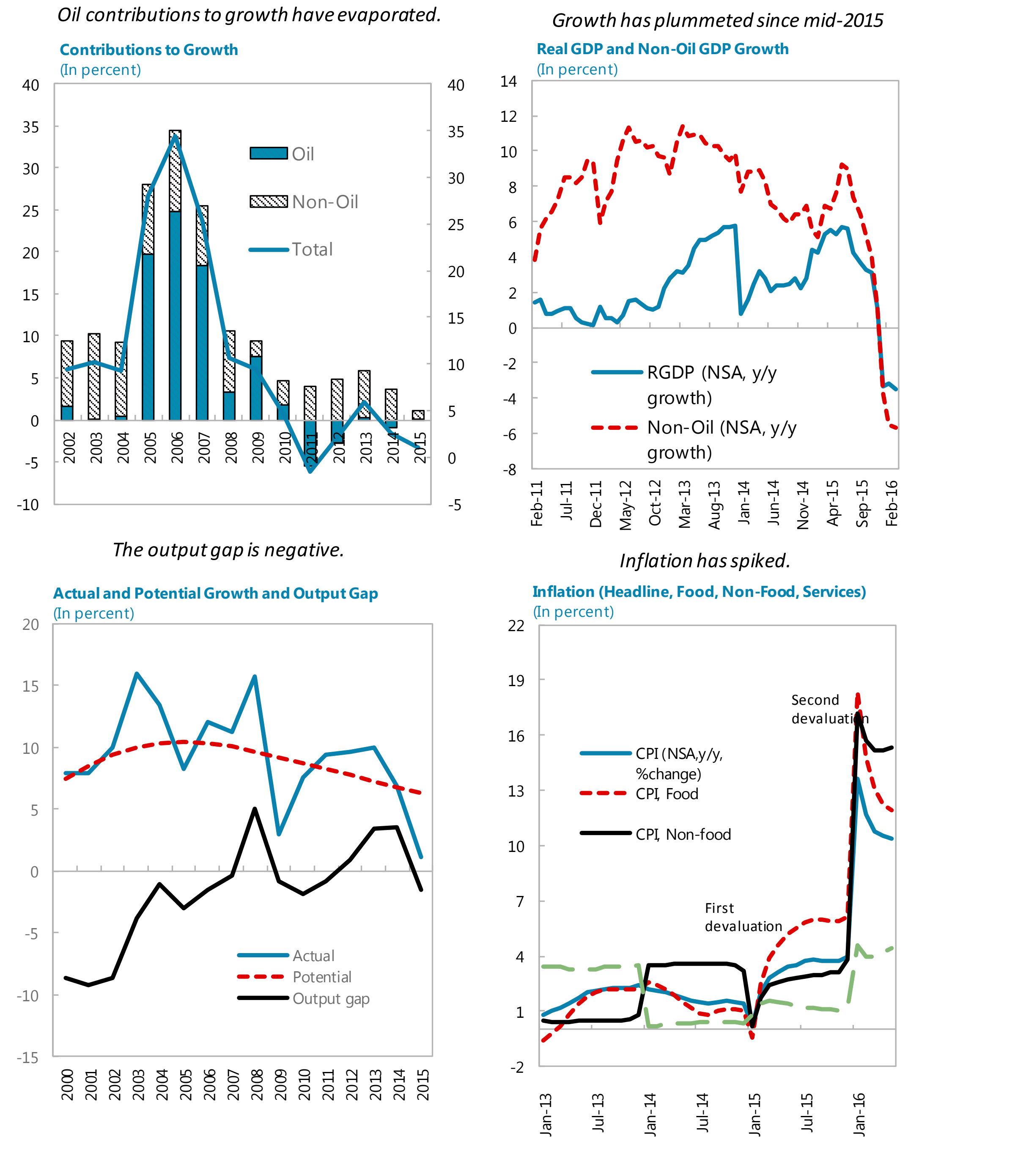
31. Implementation of the structural reform agenda has become even more critical given the end of the oil price boom. To expand the economy's potential, efforts are needed to improve governance, reduce corruption and the costs of doing business, and remove barriers to competition. The priority structural reforms contained in the government's "2020 development strategy" are appropriate although the issuance of investment certificates needs to be monitored closely to avoid abuse.

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

Figure 1. CCA Macroeconomic Outcomes

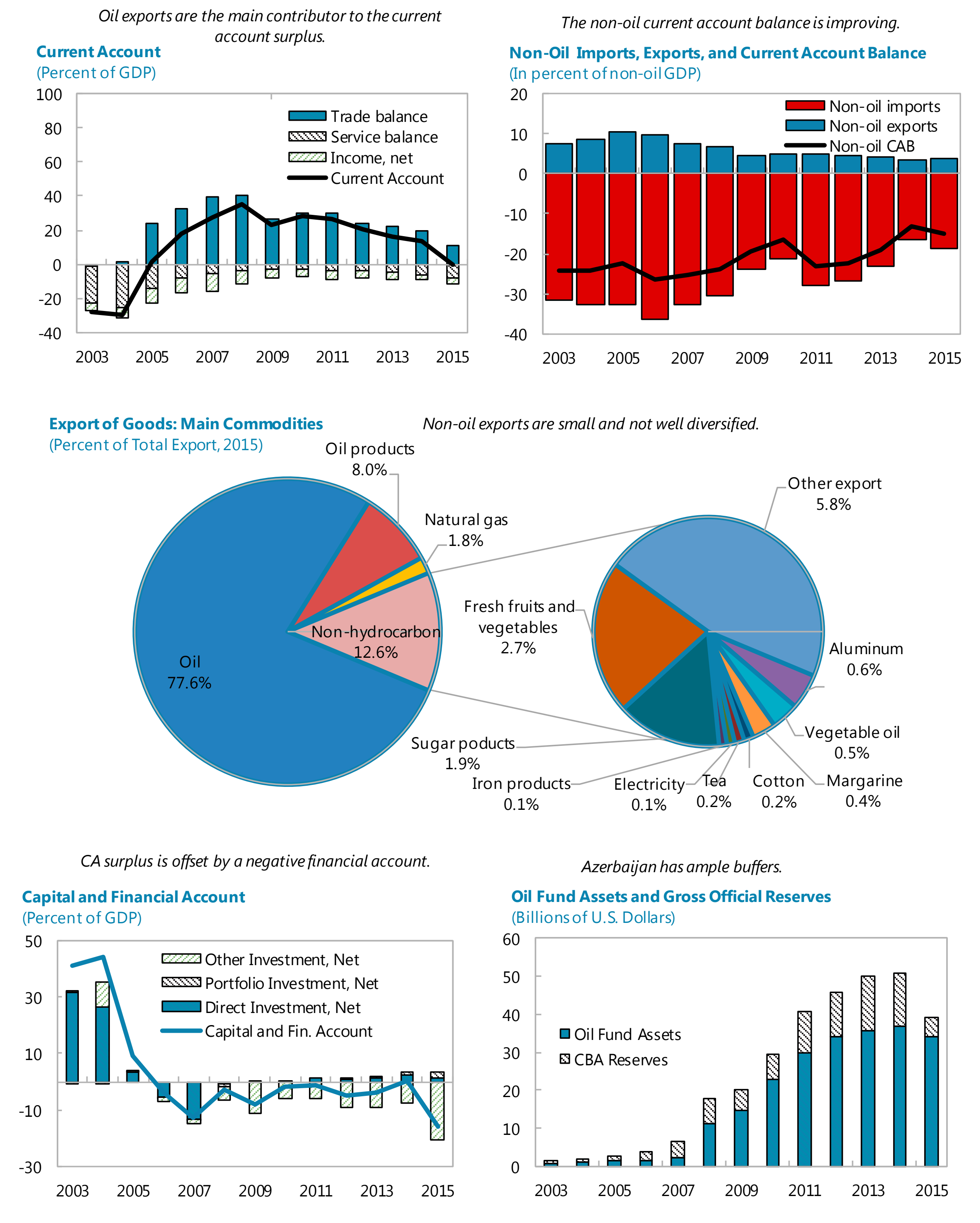
Sources: International Monetary Fund, World Economic Outlook.

Figure 2. Azerbaijan: Real Sector Indicators



Sources: Haver Analytics and IMF staff estimates.

Figure 3. Azerbaijan: External Sector

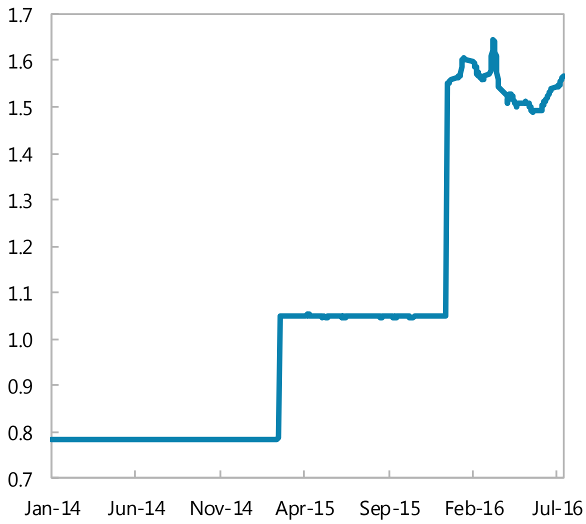


Sources: Haver Analytics and IMF Staff Estimates.

Figure 4. Azerbaijan: Real Exchange Rate

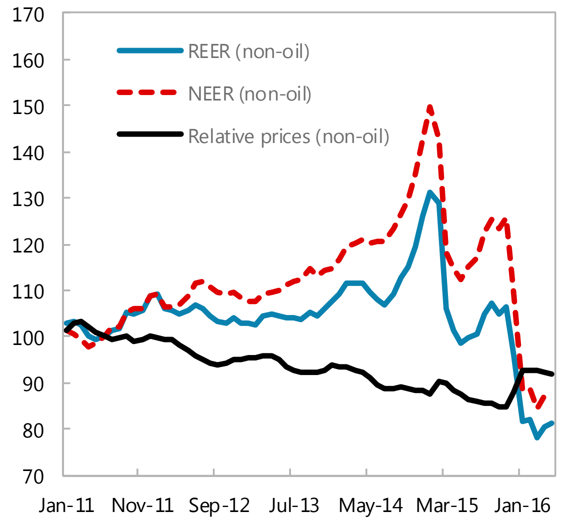
Two step devaluations and a new ER regime improved competitiveness.

Azerbaijan: Exchange Rate
(AzN per USD)



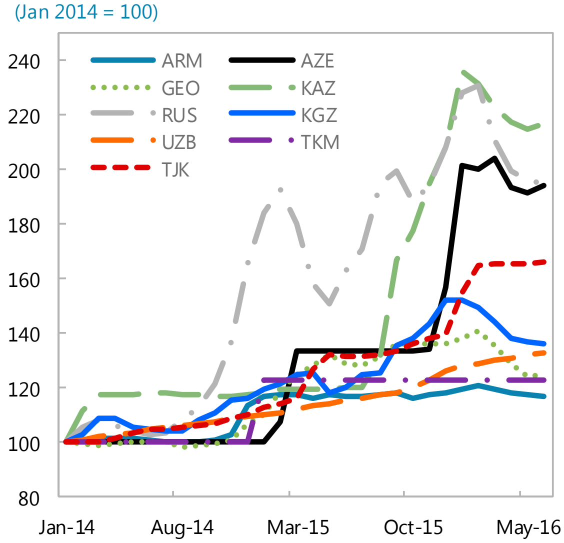
Lower prices in Azerbaijan restsrained real appreciation during oil boom.

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



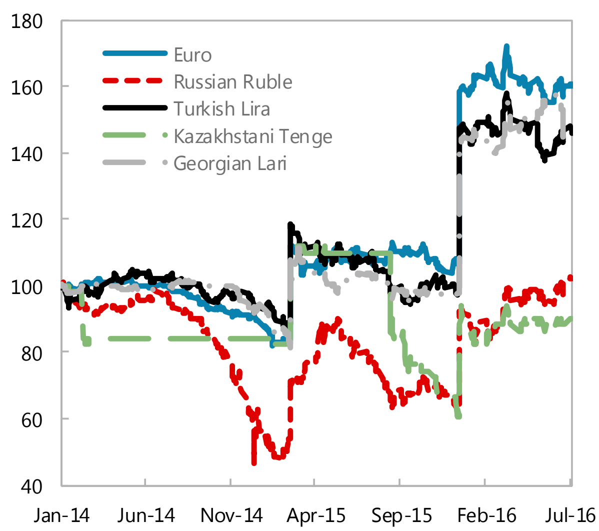
Currencies in the region were heavily depreciated against USD.

CCA Domestic Currency per USD
(Jan 2014 = 100)



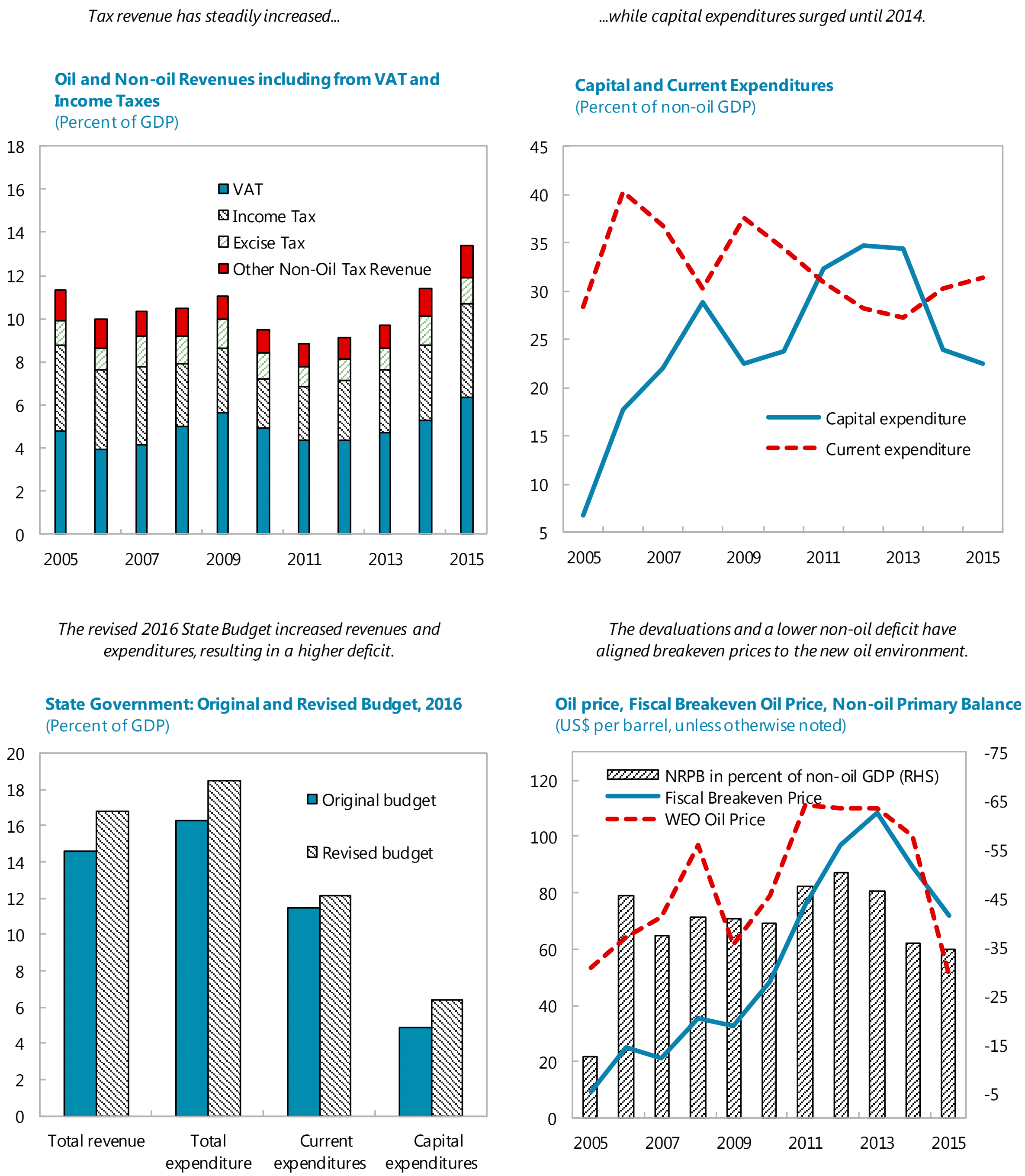
Azerbaijan's bilateral ERs to oil exporter's currencies returned back to an initial equilibrium.

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



Sources: Haver Analytics, National authorities, and IMF Staff Estimates.

Figure 5. Azerbaijan: Fiscal Sector

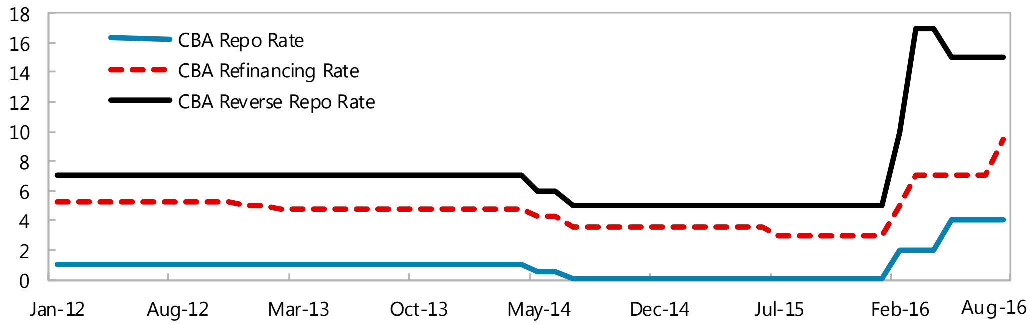


Sources: Haver Analytics and IMF staff estimates.

Figure 6. Azerbaijan: Monetary Sector

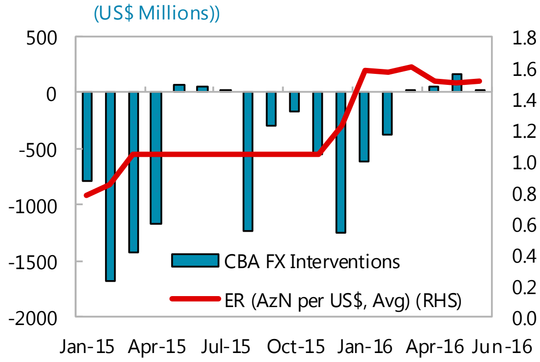
Sharp increase in monetary policy rates.

Azerbaijan: CBA Interest Rate Corridor
Percent



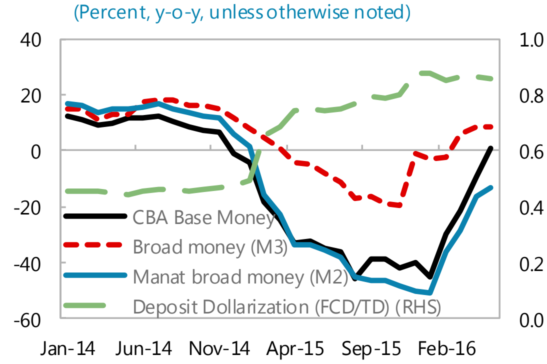
AzN stabilization required FX interventions.

CBA FX Interventions
(US$ Millions))



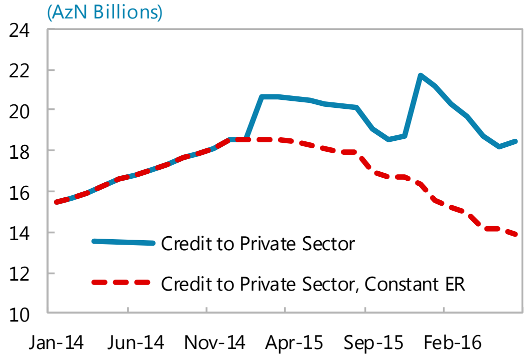
Weak growth in monetary aggregates.

Money Supply and Deposit Dollarization
(Percent, y-o-y, unless otherwise noted)



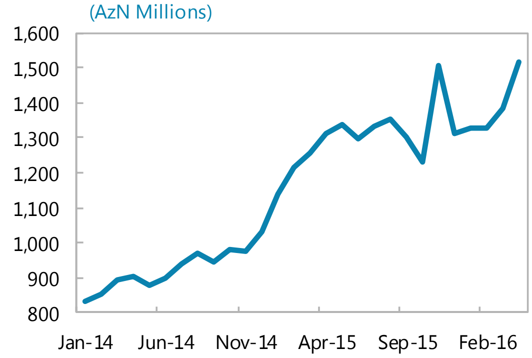
Credit to real economy has declined...

Credit to Private Sector 1/
(AzN Billions)



...and overdue loans have increased.

Overdue Loans 2/
(AzN Millions)



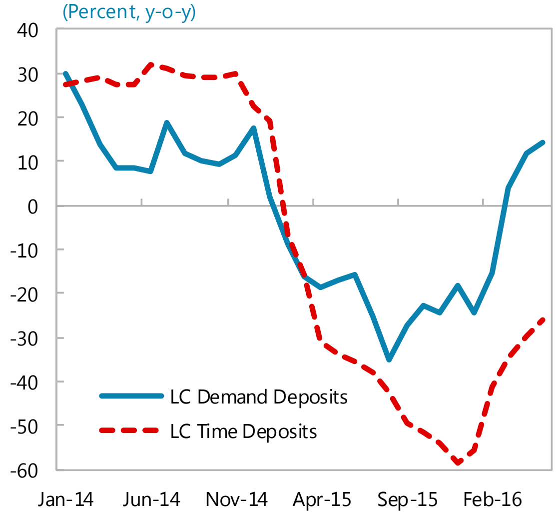
Sources: National authorities, Haver analytics, and IMF staff estimates.

1/ Reduction of credits in September and October 2015 due to one bank restructuring.
2/ According to the 2015 FSAP report, for statistical purposes only overdue payments are classified as non-performing loans (NPLs). The reported time series of NPLs does not fully reflect actual NPLs.

Figure 7. Azerbaijan: Deposits and Interest Rates

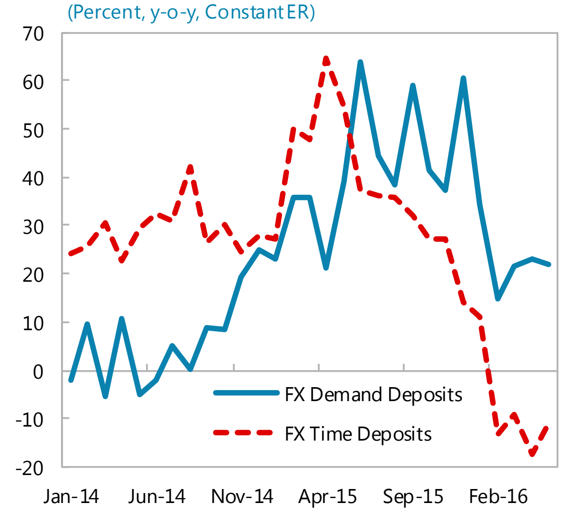
Introduction of the blanket gurantee has prevented further deterioration of Manat deposits.

Growth of Deposits in Local Currecny
(Percent, y-o-y)



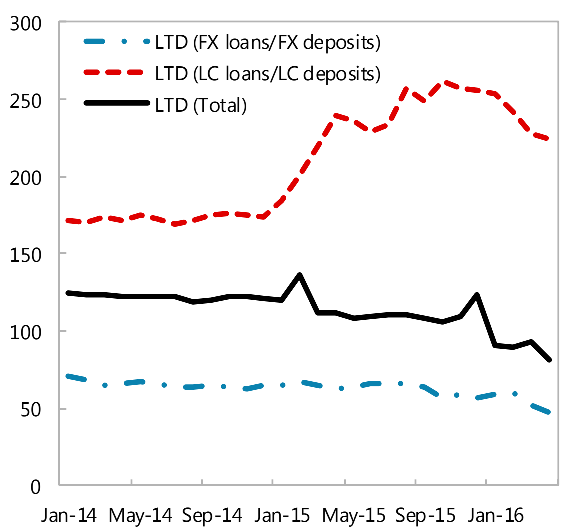
Foreign currency deposits have expanded.

Growth of Deposits in Foreign Currency
(Percent, y-o-y, Constant ER)



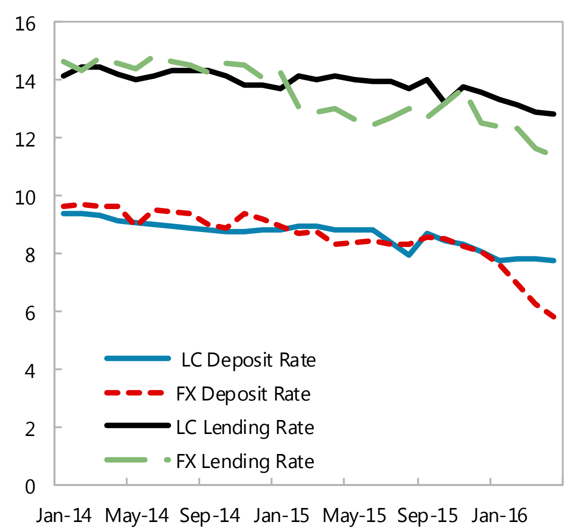
Liquidity risks have increased.

Loan-to-Deposit Ratio
(Percent)



Accomodative monetary policies were implemented after the first devaluation.

Deposit and Lending Interest Rates
(Percent, average, end of period)

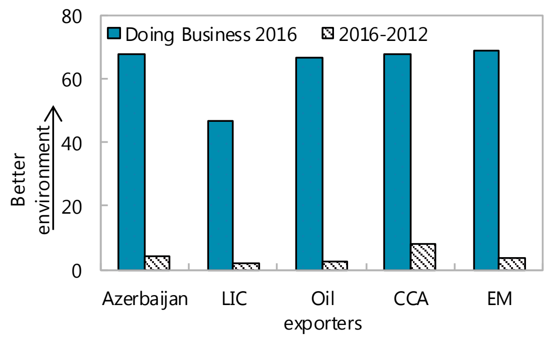


Sources: Haver analytics and IMF Staff estimates.

Figure 8. Azerbaijan: Business Environment and Governance

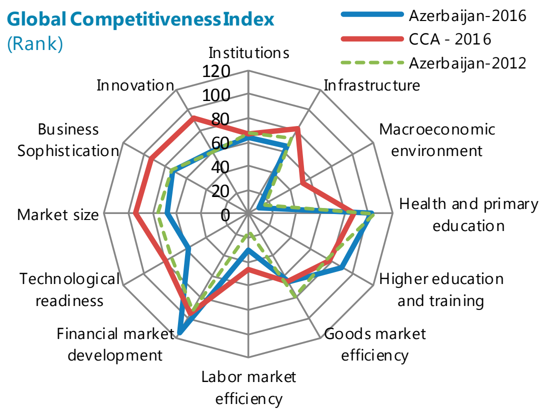
Improvements in "Doing Business" indicators.

Ease of Doing Business 1/
(Percentile rank; 0-100)



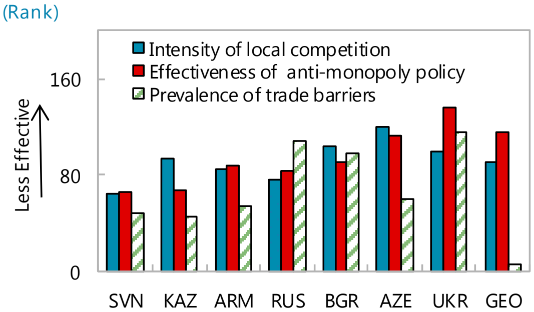
GCI shows deficiencies in health, education and finance.

Global Competitiveness Index
(Rank)



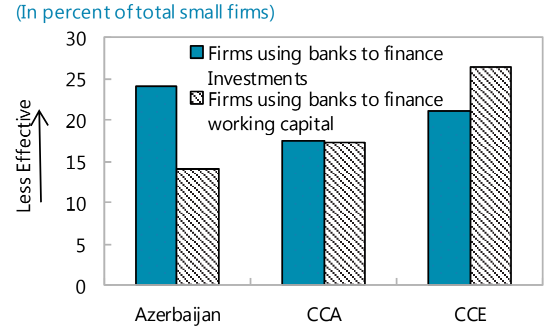
A need for competitive markets.

Anti-Monopoly Policy Effectiveness and Trade Barriers
(Rank)



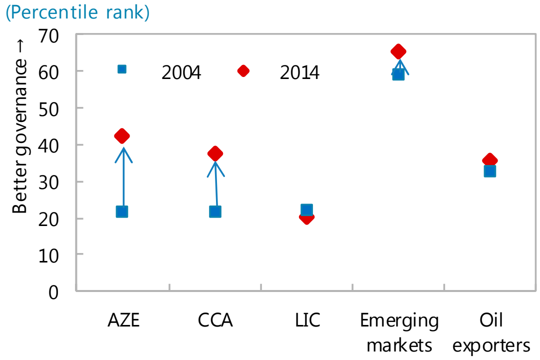
Limited access to long-term finance.

Small Firms Finance
(In percent of total small firms)



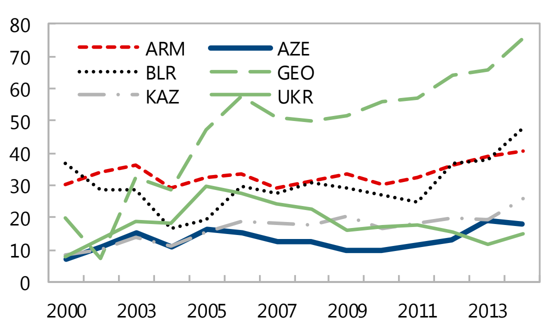
Governance has improved...

Changes in Governance 1/
(Percentile rank)



But corruption remains a concern.

Control of Corruption



Sources: World Bank, *Worldwide Governance Indicators*, World Economic Forum, and The World Bank Enterprise Surveys.
1/ LIC: Low-income countries.

Table 1. Azerbaijan: Selected Economic and Financial Indicators, 2013–20

	2013	2014	Prel. 2015	Projections 2016	2017	2018	2019	2020
	(Annual percentage change, unless otherwise specified)							
National income								
GDP at constant prices	5.8	2.8	1.1	-2.4	1.4	2.3	2.9	2.5
Of which: Oil sector 1/	0.5	-2.4	0.3	-0.4	-0.1	3.0	4.3	1.0
Non-oil sector	9.9	6.9	1.1	-3.6	2.4	1.8	2.0	3.4
Consumer price index (period average)	2.5	1.5	4.1	10.2	8.5	4.2	4.1	4.0
Money and credit								
Domestic credit, net	4.3	20.4	10.1	4.8	3.1	7.8	10.9	10.8
Of which : Credit to private sector	27.6	26.7	14.0	-2.1	6.6	7.2	8.9	9.6
Manat base money	10.7	-0.9	-40.2	17.0	21.7	16.2	12.3	12.5
Manat broad money	19.0	6.1	-50.6	2.8	13.2	16.8	19.1	24.3
Total broad money	15.4	11.4	-1.1	1.3	7.9	6.9	5.6	4.6
External sector								
Exports f.o.b.	-1.9	-11.1	-44.8	-13.2	13.6	8.7	8.5	4.6
Of which: Oil sector	-2.1	-11.3	-47.1	-13.6	14.0	8.4	8.0	3.4
Imports f.o.b.	-0.8	-16.3	4.7	-13.7	10.9	10.7	2.3	6.3
Of which: Oil sector	9.3	23.3	67.1	-16.6	8.9	22.2	-1.5	5.7
Real effective exchange rate	0.3	4.4	-7.3	--	--	--	--	--
	(In percent of GDP, unless otherwise specified)							
Gross investment	25.7	23.1	26.5	29.8	25.6	24.4	22.3	21.4
Consolidated government	20.3	15.3	16.3	18.4	14.9	14.0	11.6	10.7
Private sector	5.4	7.8	10.1	11.4	10.7	10.4	10.7	10.7
Of which: Oil sector	2.9	3.6	4.7	6.6	5.5	4.6	3.8	4.0
Gross national savings	42.1	36.7	26.1	30.5	28.7	33.4	32.0	31.8
Consolidated government	21.3	18.5	9.6	8.5	11.0	13.6	18.0	18.7
Private sector 2/	20.8	18.2	16.5	22.0	17.8	19.8	14.0	13.1
Consolidated central government finances								
Total revenue and grants	39.5	38.9	33.8	35.0	37.6	40.3	44.4	45.3
Total expenditure	38.5	35.7	40.5	44.9	41.5	40.7	38.1	37.3
Overall fiscal balance	1.0	3.2	-6.8	-9.9	-3.9	-0.4	6.3	8.0
Non-oil primary balance, in percent of non-oil GDP	-46.5	-35.8	-34.4	-37.7	-32.6	-31.8	-28.3	-27.4
General government gross debt	12.7	11.2	28.3	37.5	37.4	36.0	32.6	30.0
External sector								
Current account (- deficit)	16.4	13.9	-0.4	0.7	3.1	9.0	9.6	10.4
Foreign direct investment (net)	1.5	2.9	1.6	2.4	1.8	1.6	1.4	2.1
Memorandum items:								
Gross official international reserves (in millions of U.S. dollars)	14,152	13,758	5,017	4,117	4,617	5,117	5,617	6,117
Nominal GDP (in millions of manat)	57,708	58,978	54,352	55,314	59,739	62,128	65,235	67,844
Nominal non-oil GDP (in millions of manat)	34,051	37,701	39,542	39,906	43,099	44,823	47,064	48,946
Nominal GDP (in millions of U.S. dollars)	73,537	75,254	54,048	35,686	38,541	40,083	42,087	43,770
Oil Fund Assets (in millions of U.S. dollars)	35,878	37,104	33,574	33,120	34,407	37,254	41,289	46,066
Exchange rate (manat/dollar, end of period)	0.785	0.784	1.550	--	--	--	--	--

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

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

2/ Historical data includes statistical discrepancy.

Table 2. Azerbaijan: Balance of Payments, 2013–20
(In millions of U.S. dollars, unless otherwise specified)

	2013	2014	2015	Projections 2016	2017	2018	2019	2020
Exports, f.o.b.	31,776	28,260	15,586	13,534	15,370	16,708	18,133	18,970
Oil and oil products	30,003	26,627	14,088	12,175	13,875	15,034	16,232	16,785
Other	1,773	1,632	1,498	1,359	1,495	1,674	1,900	2,185
Imports, f.o.b.	-11,156	-9,332	-9,774	-8,431	-9,352	-10,351	-10,587	-11,253
Oil sector	-1,167	-1,438	-2,403	-2,005	-2,183	-2,668	-2,627	-2,776
Others	-9,989	-7,894	-7,371	-6,427	-7,168	-7,683	-7,960	-8,477
Trade balance	20,621	18,928	5,812	5,103	6,018	6,357	7,546	7,717
Services, net	-4,189	-6,090	-4,227	-2,820	-3,212	-1,370	-2,115	-1,697
Credit	4,131	4,297	3,118	3,228	3,811	4,589	4,727	5,137
Debit	-8,320	-10,387	-7,345	-6,049	-7,023	-5,959	-6,842	-6,834
Oil sector	-2,565	-4,058	-2,869	-3,259	-2,960	-2,786	-2,593	-2,593
Income	-4,355	-2,580	-2,028	-2,338	-2,007	-1,808	-1,785	-1,897
Investment income, net	-4,126	-2,294	-1,827	-2,191	-1,832	-1,602	-1,546	-1,620
Of which : profit of oil consortium	-4,742	-2,599	-1,827	-3,395	-3,581	-3,933	-4,085	-4,304
Compensation of employees, net	-229	-286	-201	-147	-175	-205	-239	-277
Transfers, net	-30	174	221	316	393	410	404	413
Of which : Private	-52	-34	221	289	365	369	378	385
Current account balance	12,047	10,432	-222	260	1,192	3,589	4,050	4,537
Non-oil currenct account balance	-9,482	-8,101	-7,210	-3,254	-3,954	-2,046	-2,861	-2,557
Capital account, net	15	-7	7	5	2	4	4	3
Direct investment, net	1,127	2,206	855	865	708	655	601	906
Of which : In reporting economy, net	1,916	4,414	3,563	3,573	3,416	2,668	2,650	3,012
Oil sector, net	1,876	3,133	2,282	3,192	2,676	1,868	1,750	1,762
Others, net	40	1,281	1,281	381	740	800	900	1,250
Portfolio investment, net	728	1,321	922	2,521	1,863	813	563	163
Other investment, net	-8,478	-6,963	-11,151	-5,005	-1,978	-1,714	-683	-331
Financial account, net	-6,623	-3,436	-9,374	-1,619	593	-246	481	737
Capital and financial account balance	-6,608	-3,442	-9,367	-1,614	595	-241	485	740
Errors and omissions	-1,975	-2,810	-2,307	--	--	--	--	--
Overall balance	3,464	4,180	-11,896	-1,354	1,787	3,347	4,534	5,277
Financing	-3,464	-4,180	11,896	1,354	-1,787	-3,347	-4,534	-5,277
Change in net foreign assets of CBA (increase -)	-2,410	996	9,000	900	-500	-500	-500	-500
Change in Oil Fund assets (increase -)	-1,654	-1,320	2,896	454	-1,287	-2,847	-4,034	-4,777
Change in other government FX assets (increase -)	600	-3,856	--	--	--	--	--	--
Memorandum items:								
Current account balance (in percent of GDP)	16.4	13.9	-0.4	0.7	3.1	9.0	9.6	10.4
Non–oil Current account balance (in percent of Non–oil GDP)	-21.9	-16.8	-18.3	-12.6	-14.2	-7.1	-9.4	-8.1
Gross official international reserves	14,152	13,758	5,017	4,117	4,617	5,117	5,617	6,117
in months of next year's non-oil imports f.o.b.	11.9	13.9	6.5	4.4	5.1	5.0	5.3	5.6
Oil Fund assets	35,878	37,104	33,574	33,120	34,407	37,254	41,289	46,066
Oil price (US$ per barrel)	110.0	100.0	50.8	43.3	50.4	53.3	55.5	57.4
Nominal GDP	73,537	75,254	54,048	35,686	38,541	40,083	42,087	43,770

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

Table 3. Azerbaijan: Balance of Payments, 2013–20

(In percent of GDP, unless otherwise specified)

	2013	2014	2015	Projections 2016	2017	2018	2019	2020
Exports, f.o.b.	43.2	37.6	28.8	37.9	39.9	41.7	43.1	43.3
Oil and oil products	40.8	35.4	26.1	34.1	36.0	37.5	38.6	38.3
Other	2.4	2.2	2.8	3.8	3.9	4.2	4.5	5.0
Imports, f.o.b.	-15.2	-12.4	-18.1	-23.6	-24.3	-25.8	-25.2	-25.7
Oil sector	-1.6	-1.9	-4.4	-5.6	-5.7	-6.7	-6.2	-6.3
Others	-13.6	-10.5	-13.6	-18.0	-18.6	-19.2	-18.9	-19.4
Trade balance	28.0	25.2	10.8	14.3	15.6	15.9	17.9	17.6
Services, net	-5.7	-8.1	-7.8	-7.9	-8.3	-3.4	-5.0	-3.9
Credit	5.6	5.7	5.8	9.0	9.9	11.4	11.2	11.7
Debit	-11.3	-13.8	-13.6	-16.9	-18.2	-14.9	-16.3	-15.6
Oil sector	-3.5	-5.4	-5.3	-9.1	-7.7	-7.0	-6.2	-5.9
Income	-5.9	-3.4	-3.8	-6.6	-5.2	-4.5	-4.2	-4.3
Investment income, net	-5.6	-3.0	-3.4	-6.1	-4.8	-4.0	-3.7	-3.7
Of which : profit of oil consortium	-6.4	-3.5	-3.4	-9.5	-9.3	-9.8	-9.7	-9.8
Compensation of employees, net	-0.3	-0.4	-0.4	-0.4	-0.5	-0.5	-0.6	-0.6
Transfers, net	--	0.2	0.4	0.9	1.0	1.0	1.0	0.9
Of which : Private	-0.1	--	0.4	0.8	0.9	0.9	0.9	0.9
Current account balance	16.4	13.9	-0.4	0.7	3.1	9.0	9.6	10.4
Non-oil currenct account balance	-12.9	-10.8	-13.3	-9.1	-10.3	-5.1	-6.8	-5.8
Capital account, net	--	--	--	--	--	--	--	--
Direct investment, net	1.5	2.9	1.6	2.4	1.8	1.6	1.4	2.1
Of which : In reporting economy, net	2.6	5.9	6.6	10.0	8.9	6.7	6.3	6.9
Oil sector, net	2.6	4.2	4.2	8.9	6.9	4.7	4.2	4.0
Others, net	0.1	1.7	2.4	1.1	1.9	2.0	2.1	2.9
Portfolio investment, net	1.0	1.8	1.7	7.1	4.8	2.0	1.3	0.4
Other investment	-11.5	-9.3	-20.6	-14.0	-5.1	-4.3	-1.6	-0.8
Financial account, net	-9.0	-4.6	-17.3	-4.5	1.5	-0.6	1.1	1.7
Capital and financial account balance	-9.0	-4.6	-17.3	-4.5	1.5	-0.6	1.2	1.7
Errors and omissions	-2.7	-3.7	-4.3	--	--	--	--	--
Overall balance	4.7	5.6	-22.0	-3.8	4.6	8.4	10.8	12.1
Financing	-4.7	-5.6	22.0	3.8	-4.6	-8.4	-10.8	-12.1
Change in net foreign assets of CBA (increase -)	-3.3	1.3	16.7	2.5	-1.3	-1.2	-1.2	-1.1
Change in Oil Fund assets (increase -)	-2.2	-1.8	5.4	1.3	-3.3	-7.1	-9.6	-10.9
Change in other government FX assets (increase -)	0.8	-5.1	--	--	--	--	--	--
Memorandum items:								
Current account balance (in percent of GDP)	16.4	13.9	-0.4	0.7	3.1	9.0	9.6	10.4
Non–oil Current account balance (in percent of Non–oil GDP)	-21.9	-16.8	-18.3	-12.6	-14.2	-7.1	-9.4	-8.1
Gross official international reserves (Millions of US$)	14,152	13,758	5,017	4,117	4,617	5,117	5,617	6,117
in months of next year's non-oil imports f.o.b.	11.9	13.9	6.5	4.4	5.1	5.0	5.3	5.6
Oil Fund assets (Millions of US$)	35,878	37,104	33,574	33,120	34,407	37,254	41,289	46,066
Oil price (US$ per barrel)	110.0	100.0	50.8	43.3	50.4	53.3	55.5	57.4
Nominal GDP (in Millions of US$)	73,537	75,254	54,048	35,686	38,541	40,083	42,087	43,770

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

Table 4. Azerbaijan: Statement of Consolidated Government Operations, 2013–20

(In millions of manat)

				Projections				
	2013	2014	2015	2016	2017	2018	2019	2020
Revenue	22,783	22,951	18,344	19,364	22,447	25,032	28,994	30,748
Tax revenue	7,908	8,851	8,976	10,055	11,135	11,597	12,258	12,534
Income taxes	3,235	3,283	3,194	3,523	3,959	4,217	4,523	4,513
Individual income tax	860	980	983	1,277	1,379	1,390	1,412	1,420
Enterprise profits tax	2,375	2,303	2,211	2,246	2,580	2,828	3,111	3,093
Value added tax (VAT)	2,710	3,120	3,455	3,811	4,188	4,285	4,529	4,706
Excise taxes	593	797	648	679	740	765	807	841
Taxes on international trade	670	828	759	819	925	977	1,001	1,045
Other taxes	320	369	445	604	652	678	712	741
Social security contributions	380	454	477	620	670	675	685	689
Nontax revenue 1/	14,875	14,100	9,164	9,078	11,116	13,249	16,556	18,041
Of which : Oil Fund revenues 2/	14,128	13,133	8,130	7,926	9,881	11,970	15,219	16,655
Tax credits for SOCAR energy subsidies	0	0	204	231	196	186	179	174
Grants	0	0	0	0	0	0	0	0
Expense	10,505	12,053	13,139	14,641	15,899	16,605	17,270	18,057
Compensation of employees	2,105	3,167	3,324	3,833	4,159	4,331	4,507	4,687
Use of goods and services	4,596	5,369	6,057	6,217	6,664	6,931	7,285	7,581
Social benefits	1,907	2,200	2,339	2,933	3,281	3,498	3,574	3,741
Of which : Social protection fund	1,077	1,142	1,100	1,246	1,374	1,490	1,552	1,615
Subsidies	1,567	988	1,018	965	1,094	1,149	1,200	1,344
Grants	158	148	122	137	115	95	78	65
Interest	124	88	199	374	405	373	352	321
Other expense	47	93	80	183	181	228	273	318
Net Acquisition of Nonfinancial Assets	11,713	9,015	8,880	10,176	8,890	8,673	7,581	7,277
Overall balance	564	1,883	-3,675	-5,453	-2,341	-247	4,142	5,414
Statistical discrepancy	0	0	0	0	0	0	0	0
Non-oil primary balance 3/	-15,818	-13,478	-13,616	-15,049	-14,038	-14,232	-13,305	-13,404
Net financial transactions	564	1,883	-3,675	-5,452	-2,341	-246	4,142	5,414
Net acquisition of financial assets	271	1,806	740	-1,507	274	4,406	6,761	7,919
Oil Fund	-1,446	1,477	-1,467	-701	2,002	4,432	6,280	7,432
Privatizations and other sale of assets	-40	0	-29	-100	-100	200	204	208
Banking system 4/	878	165	1,118	-353	-814	-113	138	140
Net incurrence of liabilities	-293	-77	4,415	3,945	2,615	4,653	2,619	2,505
Debt securities	-19	-36	-69	1,175	1,210	1,247	1,284	1,322
Of which: Domestic banking sector	-14	-31	-69	119	250	300	325	200
Loans (all external)	-274	-41	4,484	2,770	1,405	3,406	1,335	1,183
Memorandum items:								
Oil revenue	16,505	15,449	10,139	9,971	12,101	14,359	17,799	19,139
Non-oil revenue 5/	6,277	7,502	8,205	9,393	10,346	10,673	11,195	11,610
Non-oil tax revenue 6/	6,354	7,632	8,141	9,198	10,055	10,329	10,785	11,144
Non-oil GDP (in million of manats)	34,051	37,701	39,542	39,906	43,099	44,823	47,064	48,946

Sources: Azerbaijani authorities; and IMF 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 (excl. interest payments) and statistical discrepancies.

4/ Comprises government deposits in CBA and commercial banks.

5/ Excludes AIOC profit tax, profit oil, and SOCAR profit tax, but includes VAT and excise taxes on oil and gas, tax withholding on the AIOC's subcontractors, energy subsidies.

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

Table 5. Azerbaijan: Statement of Consolidated Government Operations, 2013–20

(In percent of non-oil GDP)

	2013	2014	2015	Projections 2016	2017	2018	2019	2020
Revenue	66.9	60.9	46.4	48.5	52.1	55.8	61.6	62.8
Tax revenue	23.2	23.5	22.7	25.2	25.8	25.9	26.0	25.6
Income taxes	9.5	8.7	8.1	8.8	9.2	9.4	9.6	9.2
Individual income tax	2.5	2.6	2.5	3.2	3.2	3.1	3.0	2.9
Enterprise profits tax	7.0	6.1	5.6	5.6	6.0	6.3	6.6	6.3
Value added tax (VAT)	8.0	8.3	8.7	9.5	9.7	9.6	9.6	9.6
Excise taxes	1.7	2.1	1.6	1.7	1.7	1.7	1.7	1.7
Taxes on international trade	2.0	2.2	1.9	2.1	2.1	2.2	2.1	2.1
Other taxes	0.9	1.0	1.1	1.5	1.5	1.5	1.5	1.5
Social security contributions	1.1	1.2	1.2	1.6	1.6	1.5	1.5	1.4
Nontax revenue 1/	43.7	37.4	23.2	22.7	25.8	29.6	35.2	36.9
Of which: Oil Fund revenues 2/	41.5	34.8	20.6	19.9	22.9	26.7	32.3	34.0
Tax credits for SOCAR energy subsidies	0.0	0.0	0.5	0.6	0.5	0.4	0.4	0.4
Grants	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Expense	30.9	32.0	33.2	36.7	36.9	37.0	36.7	36.9
Compensation of employees	6.2	8.4	8.4	9.6	9.6	9.7	9.6	9.6
Use of goods and services	13.5	14.2	15.3	15.6	15.5	15.5	15.5	15.5
Social benefits	5.6	5.8	5.9	7.3	7.6	7.8	7.6	7.6
Of which: Social protection fund	3.2	3.0	2.8	3.1	3.2	3.3	3.3	3.3
Subsidies	4.6	2.6	2.6	2.4	2.5	2.6	2.6	2.7
Grants	0.5	0.4	0.3	0.3	0.3	0.2	0.2	0.1
Interest	0.4	0.2	0.5	0.9	0.9	0.8	0.7	0.7
Other expense	0.1	0.2	0.2	0.5	0.4	0.5	0.6	0.6
Net Acquisition of Nonfinancial Assets	34.4	23.9	22.5	25.5	20.6	19.4	16.1	14.9
Overall balance	1.7	5.0	-9.3	-13.7	-5.4	-0.6	8.8	11.1
Statistical discrepancy	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Non-oil primary balance 3/	-46.5	-35.8	-34.4	-37.7	-32.6	-31.8	-28.3	-27.4
Net financial transactions	1.7	5.0	-9.3	-13.7	-5.4	-0.5	8.8	11.1
Net acquisition of financial assets	0.8	4.8	1.9	-3.8	0.6	9.8	14.4	16.2
Oil Fund	-4.2	3.9	-3.7	-1.8	4.6	9.9	13.3	15.2
Privatizations and other sale of assets	-0.1	0.0	-0.1	-0.3	-0.2	0.4	0.4	0.4
Banking system 4/	2.6	0.4	2.8	-0.9	-1.9	-0.3	0.3	0.3
Net incurrence of liabilities	-0.9	-0.2	11.2	9.9	6.1	10.4	5.6	5.1
Debt securities	-0.1	-0.1	-0.2	2.9	2.8	2.8	2.7	2.7
Of which: Domestic banking sector	0.0	-0.1	-0.2	0.3	0.6	0.7	0.7	0.4
Loans (all external)	-0.8	-0.1	11.3	6.9	3.3	7.6	2.8	2.4
Memorandum items:								
Non-oil revenue 5/	18.4	19.9	20.8	23.5	24.0	23.8	23.8	23.7
Non-oil tax revenue 6/	18.7	20.2	20.6	23.0	23.3	23.0	22.9	22.8
Non-oil GDP (in billion of manats)	34.1	37.7	39.5	39.9	43.1	44.8	47.1	48.9

Sources: Azerbaijani authorities; and IMF 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 (excl. interest payments) and statistical discrepancies.

4/ Comprises government deposits in CBA and commercial banks.

5/ Excludes AIOC profit tax, profit oil, and SOCAR profit tax, but includes VAT and excise taxes on oil and gas, tax withholding on the AIOC's subcontractors, energy subsidies.

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

Table 6. Azerbaijan: Summary Accounts of the Central Bank, 2013–20

(In millions of manat, unless otherwise specified)

				Projections				
	2013	2014	2015	2016	2017	2018	2019	2020
Net foreign assets	11,907	12,458	11,395	10,000	10,775	11,550	12,325	13,100
Net international reserves of the CBA	11,907	12,459	11,283	10,001	10,776	11,551	12,326	13,101
Gross international reserves	11,913	12,461	11,284	10,006	10,780	11,554	12,328	13,102
Foreign liabilities	-5	-2	-1	-5	-4	-3	-2	-1
Other items, net	0	-1	112	-1	-1	-1	-1	-1
Net domestic assets	-114	-591	-3,834	-1,152	-10	722	1,228	1,764
Domestic credit	238	-565	3,523	5,772	4,499	4,613	4,997	5,404
Net claims on consolidated central government	-3,290	-4,193	-5,651	-6,090	-6,990	-7,190	-7,140	-7,090
Net claims on banks 1/	1,459	1,509	5,410	8,060	7,763	8,151	8,559	8,987
Credit to the economy	2,089	2,145	3,764	3,802	3,726	3,652	3,578	3,507
CBA notes	-20	-27	0	0	0	0	0	0
Other items, net	-353	-26	-7,358	-6,924	-4,509	-3,890	-3,769	-3,640
Reserve money	11,793	11,867	7,561	8,848	10,766	12,272	13,553	14,864
Manat reserve money	11,642	11,542	6,902	8,076	9,830	11,421	12,826	14,423
Currency outside CBA	11,033	10,846	5,417	7,276	9,069	10,798	12,040	13,366
Bank reserves and other deposits	555	688	1,478	796	757	619	781	1,053
Other deposits	53	8	7	4	4	4	4	4
Reserves in foreign currency	151	325	659	772	936	852	727	440

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

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

Table 7. Azerbaijan: Monetary Survey, 2013–20

(In millions of manat, unless otherwise specified)

	2013	2014	2015	Projections 2016	2017	2018	2019	2020
Net foreign assets	9,903	10,492	11,056	9,678	10,454	11,230	12,006	12,782
Net international reserves of the CBA	11,907	12,459	11,283	10,001	10,776	11,551	12,326	13,101
Net foreign assets of commercial banks	-1,842	-1,833	-554	-254	-254	-254	-254	-254
Other	-162	-134	327	-69	-68	-67	-66	-65
Net domestic assets	9,457	11,075	10,263	11,910	12,843	13,671	14,287	14,716
Domestic credit, net	14,155	17,037	18,757	19,659	20,269	21,859	24,243	26,850
Net claims on consolidated central government	-2,775	-3,366	-5,823	-4,522	-5,173	-5,074	-4,700	-4,450
Credit to the economy	16,930	20,402	24,581	24,180	25,442	26,933	28,943	31,300
Of which: private sector	14,409	18,257	20,816	20,378	21,716	23,281	25,364	27,793
Other items, net	-4,698	-5,962	-8,495	-7,749	-7,427	-8,188	-9,956	-12,134
Broad money	19,360	21,566	21,319	21,588	23,297	24,902	26,293	27,498
Manat broad money	16,435	17,436	8,613	8,851	10,018	11,704	13,935	17,324
Cash outside banks	10,459	10,152	4,776	4,871	4,969	5,515	6,122	6,796
Manat deposits	5,976	7,284	3,837	3,980	5,049	6,188	7,813	10,528
Foreign currency deposits	2,925	4,130	12,705	12,737	13,279	13,198	12,358	10,174
	(Annual percentage change)							
Net foreign assets	19.9	5.9	5.4	-12.5	8.0	7.4	6.9	6.5
Net domestic assets	11.4	17.1	-7.3	16.0	7.8	6.5	4.5	3.0
Credit to the economy	8.5	20.5	20.5	-1.6	5.2	5.9	7.5	8.1
Of which: private sector	27.6	26.7	14.0	-2.1	6.6	7.2	8.9	9.6
Broad money (M3)	15.4	11.4	-1.1	1.3	7.9	6.9	5.6	4.6
Manat broad money (M2)	19.0	6.1	-50.6	2.8	13.2	16.8	19.1	24.3
Reserve money	10.6	0.6	-36.3	17.0	21.7	14.0	10.4	9.7
Manat reserve money	10.7	-0.9	-40.2	17.0	21.7	16.2	12.3	12.5
Memorandum items:								
Gross official international reserves (US$ millions)	14,152	13,758	5,017	4,117	4,617	5,117	5,617	6,117
Velocity of total broad money (M3) 1/	2.3	2.2	2.2	2.0	2.1	1.9	1.9	1.9
Broad money in percent of non-oil GDP	56.9	57.2	53.9	54.1	54.1	55.6	55.9	56.2
Credit to private sector in percent of non-oil GDP	42.3	48.4	52.6	51.1	50.4	51.9	53.9	56.8
Share of foreign currency credits in total credit portfolio 2/	28.2	27.2	49.4	46.9	42.2	38.0	34.2	30.8
Currency to broad money ratio	54.0	47.1	22.4	22.6	21.3	22.1	23.3	24.7
Share of foreign currency deposits in total deposits 3/	32.9	36.2	76.8	76.2	72.5	68.1	61.3	49.1
Foreign currency deposits to broad money ratio	15.1	19.2	59.6	59.0	57.0	53.0	47.0	37.0

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

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

2/ Based on total credit portfolio of the banking system.

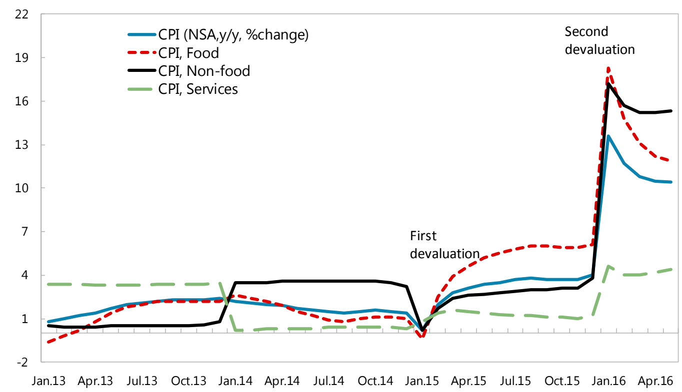
3/ Based on monetary survey data which only includes resident balances.

Annex I. Azerbaijan: Exchange Rate Pass-Through (ERPT) Effects

At first sight, ERPT effects in Azerbaijan appear to have been relatively muted. The AzN/US$ rate depreciated by some 50 percent in 2015, however, the headline inflation rate (y/y) as of June 2016 was only about 10 percent. After the first devaluation in January, *non-tradable* inflation (services) remained low but a component of tradable inflation (food inflation) jumped to above 5 percent. With the larger second devaluation in December, *tradable goods* (food and non-food) inflation rates jumped sharply (to about 17 percent) in early 2016—pushing up headline rates. Inflation has started to decline since January.

Azerbaijan: CPI Inflation

(Headline, Food, Non-Food, Services)



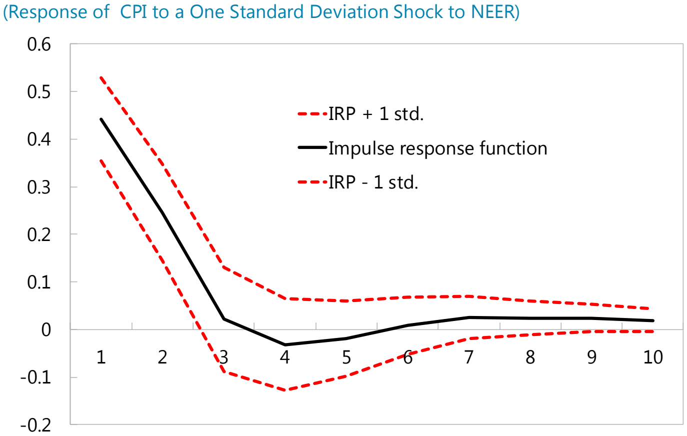
Sources: Haver Analytics

The composition and weights of the CPI basket play a role in ERPT dynamics. The import content of the CPI basket is estimated to be 34 percent. Tradable good weights in the CPI basket are high—with food good weights at 58 percent and the non-food goods weight at 22 percent. These two factors (high import and tradable good weights) would imply a strong ERPT. However, a large part of food stuffs is produced locally and priced to market in local currency with limited import content. These are also subject to high local distribution costs which do not move on ER changes. Moreover, during 2015 world food prices fell by some 3 percent, helping to reduce the pressure on food inflation in Azerbaijan. While non-tradable services only make up some 20 percent of the basket, a sizeable percentage (13 percent) is administratively controlled. After the devaluations, the authorities did not allow administrative prices to increase—keeping service inflation in check.

A vector auto-regression (VAR) model indicates that nominal exchange rate shocks impact inflation, but dissipate quickly. The VAR model included the log first differences of oil prices, nominal effective exchange rates (NEER), government expenditures, base money, and the CPI and used monthly data from January 2006 to April 2016. The results indicate that a one standard deviation Cholesky shock to the NEER raised headline inflation rates by 0.45 percent on impact and dissipated by the third month. The impulse response functions and variance decompositions demonstrate that shocks to other variables did not significantly impact headline inflation rates. These results were robust to changes in the order of variables in the VAR. With the NEER depreciated by some

Azerbaijan: Impluse Response Function

(Response of CPI to a One Standard Deviation Shock to NEER)



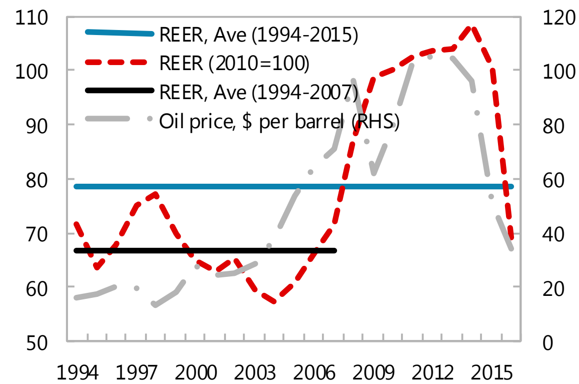
Source: Staff estimates

40 percent in 2015, the VAR model implies an 18 percent increase in inflation. These estimates are broadly in line with inflation outcomes in early 2016, particularly when one considers the factors mentioned above, the low inflationary environment prior to the devaluations, tighter CBA monetary policy to reduce second round effects, and weaker price pressures emanating from sluggish domestic demand in a highly dollarized economy.

Annex II. Azerbaijan: Assessment of Azerbaijan's External Position

Azerbaijan's external position has deteriorated. The current account (CA) and real effective exchange rate (REER) in Azerbaijan tend to move in line with oil prices.[1] With the oil prices falling, the CA position has worsened—shifting from a surplus of 14 percent of GDP in 2014, to a small deficit in 2015. However, the non-oil CA and the share of non-oil exports to total world exports have remained relatively flat. As of April 2016, the REER has depreciated by some 45 percent since January 2015 given the 2 step devaluations against the US$.

Azerbaijan: Real Effective Exchange Rate and Oil Price

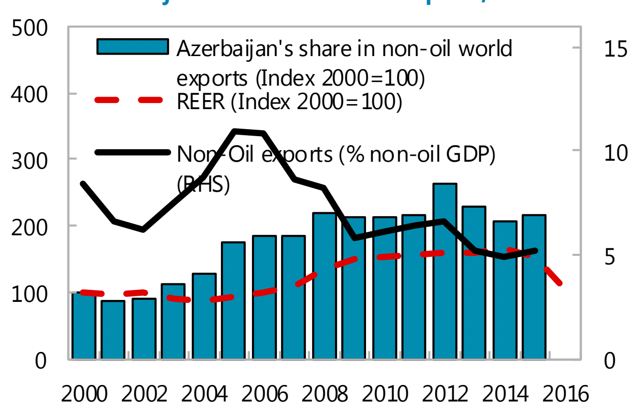


Sources: WEO and IMF staff estimates.

International reserves at the CBA have fallen sharply. CBA reserves have declined by $9.5 billion since end-2014, and stood at $4.3 billion (3.5 months of imports) as of end-June, 2016. The sovereign wealth fund had $34 billion as of end-2015 (close to 100 percent of projected 2016 GDP), and plans to fill balance of payments financing gaps may reduce the stock by some $500 million in 2016.

Based on the EBA-lite methodology, the REER is viewed as slightly overvalued. The EBA-lite analysis reflects values for cyclically-adjusted balances consistent with medium-term sustainability, and other policy variables (cyclically-adjusted fiscal balances, FX intervention, private credit and capital controls). Given the need to restrict the substantial use of expansionary fiscal policy and CBA intervention in the FX market, the desired targets for the change in international reserves and fiscal balance were set to zero. Private credit as a percent of GDP and the capital control index were not adjusted from current values. The results in the table indicate that the CA norm would be 0.81 percent of GDP based on economic fundamentals, relative to the actual -0.41 percent of GDP deficit. The estimated residual is substantial, with policy gaps large relative to the CA gap. Overall, this results in a small real exchange rate (RER)

Azerbaijan: REER and Non-Oil Exports, 2000-15



Sources: Azerbaijan Authorities, and IMF staff estimates.

[1] The CA balance averaged -12 percent of GDP in 2000-05, but shifted to a 23 percent of GDP surplus on average during 2006-15 as oil prices boomed and the REER appreciated sharply.

gap of 1.14 percent of GDP. Given an estimated RER elasticity of -0.21, the required change in the RER would be a depreciation of some 6 percent. The authorities plan to use SOFAZ assets to finance fiscal and CA gaps, which would also imply an external unsustainable position.

Azerbaijan: EBA-Lite Assessment

	Current	Desired Value
Current account (CA) 1/ 2/	-0.41	0.81
Cyclically adjusted fiscal balance 1/	-7.70	0.00
Change in reserves 1/	-10.48	0.00
Private credit 1/	30.7	30.7
Capital control index	0.53	0.53
Real exchange rate gap		**5.89**

1/ In percent of GDP

2/ Desired value reflects staff estimate of the CA norm.

Annex III. Public Sector Debt Sustainability Analysis

Shock to oil prices and consequently the budget deficit and two sharp devaluations of the manat have all contributed to an increase in Azerbaijan's public debt and a recent downgrade of its sovereign bonds. Between 2014 and early 2016, nominal gross public debt, largely denominated in foreign currencies or held by non-residents, doubled as a share of GDP. However, the majority of Azerbaijan's debt has long maturities, which can mitigate financing pressure. While the government could cover its budget deficit with transfers from the State Oil Fund (SOFAZ) in the medium term, such increase makes debt to GDP ratio more susceptible to various macro and financial shocks.

Baseline Scenarios

Azerbaijan's debt sustainability indicators worsened during 2015 and remained at similar levels throughout 2021. As a share of GDP, nominal gross debt for general government increased from about 11 percent in 2014 to 28 and 38 percent during the next two years. Downward projection for this ratio starts in 2018 with the return of fiscal surplus. Net debt to GDP ratio fluctuates depending on the assumed rate of financial asset acquisition by the government. Financing needs largely depend on projected hydrocarbon revenue and planned fiscal consolidation. To achieve debt stabilization, primary balance should anchor around 1.9 percent of GDP by 2021.

Exchange rate depreciation and an increase in primary deficit were main causes for the debt increase. As more than 80 percent of Azerbaijan's public debt is denominated in foreign currencies in 2014, the currency depreciation of 60 percent against the US dollar has significantly worsened its debt outlook. Still slightly over-valued, the exchange rate could depreciate further in 2016 and 2017, resulting in even higher debt ratios. In the medium term, primary deficit could improve due to an increase in gas production, the recovery of oil prices, and accelerating fiscal consolidation.

Unrecognized contingent liabilities by the government remain an important debt issue. Historical debt figures include risk-weighted guarantees by the central government. Explicitly guaranteed bonds issued by *Aqrarkredit* to recapitalize IBA (see Annex IV) are also included in the baseline for 2016. Additional guarantees to the banking sector and other state-owned enterprises could further complicate the debt sustainability analysis.

Realism of Projections

The realism of staff's baseline assumptions has improved over time. The median forecast error for growth over 2007–15 was around -3 percent. Staff tended to be overly optimistic about growth during the early years of this period. More recent growth forecasts have been closer to the final outturns. Inflation forecasts have been subject to larger errors, often on the pessimistic side while forecasts for primary balance have been overly optimistic. Adjustment in Azerbaijan's cyclically-adjusted primary balance (CAPB) appears larger than the cross-country median. The fiscal consolidation plan is mainly through a reduction in public investment. Boom-bust analysis applies to countries with three consecutive years of positive output gap or high credit growth. In the case of Azerbaijan, 2016 could be the trough of the business cycle with quick recovery.

Risk Assessment

The heat map indicates high risk to the debt profile. Shocks to real GDP growth and to contingent liabilities could impact the gross financing needs of the government and subsequently the debt level. The ratios of external debt and debt denominated in foreign currencies are above the upper threshold of early warning benchmark.

Market perception is another potential risk to the debt profile. Currently, the baseline scenario assumes the government's ability to roll over its short term debt every year while slowly amortizing its long-term debt. The recent downgrades of not only the sovereign bonds but also the guaranteed notes by state-owned corporations could challenge this assumption.

Stress Tests

The DSA stress tests indicate potentially high ratios of debt to GDP and to revenue, especially from shocks to real GDP growth and real exchange rate.

Seven scenarios were considered:

- Growth shock. Real GDP growth is subjected to a one standard deviation negative shock. Inflation is assumed to decline in line with lower growth, dropping ¼ percentage point for every 1 percentage point decrease in growth. Reflecting higher risk premiums, nominal interest rates rise by 25 basis points for every 1 percent of GDP worsening of the primary balance. Under this scenario, the debt to GDP ratio increases to over 70 percent of GDP in 2018 and remains high throughout 2021. Gross financing needs peak in 2018 at 20 percent of GDP.

- Interest rate shock. Based on the maximum historical level, a 1200 basis point increase in spreads is applied throughout the projection period. The debt to GDP ratio, however, is minimally affected.

- Real exchange rate shock. A 25 percent real exchange rate devaluation is applied to 2017 coupled with a 25 basis point increase in interest rates for each 1 percent of GDP reduction in the primary balance. With high level of external debt, the impact is significant with debt to GDP ratio peaking at above 56 percent in 2017.

- Primary balance shock. A 2 percent of GDP decline in revenues is applied over two years, coupled with a rise in nominal interest rates over the same period. The ratios of debt to GDP and to revenue both deteriorate moderately.

- Combined macro fiscal shock. This scenario combines the shocks to real growth, the interest rate, the real exchange rate, and the primary balance while eliminating double counting of the effects of the individual shocks. The debt ratio is on an unsustainable trajectory path throughout 2021.

- Contingent liabilities shock. For a standard non-interest expenditure shock of 10 percent of the size of the banking sector, with interest rates assumed to increase by 25 basis points for every 1 percent of GDP worsening in the primary balance, the primary balance will deteriorate in 2016 and 2017. The debt level is expected to peak in 2018 at 70 percent of GDP.

Azerbaijan Public Sector Debt Sustainability Analysis (DSA) – Baseline Scenario

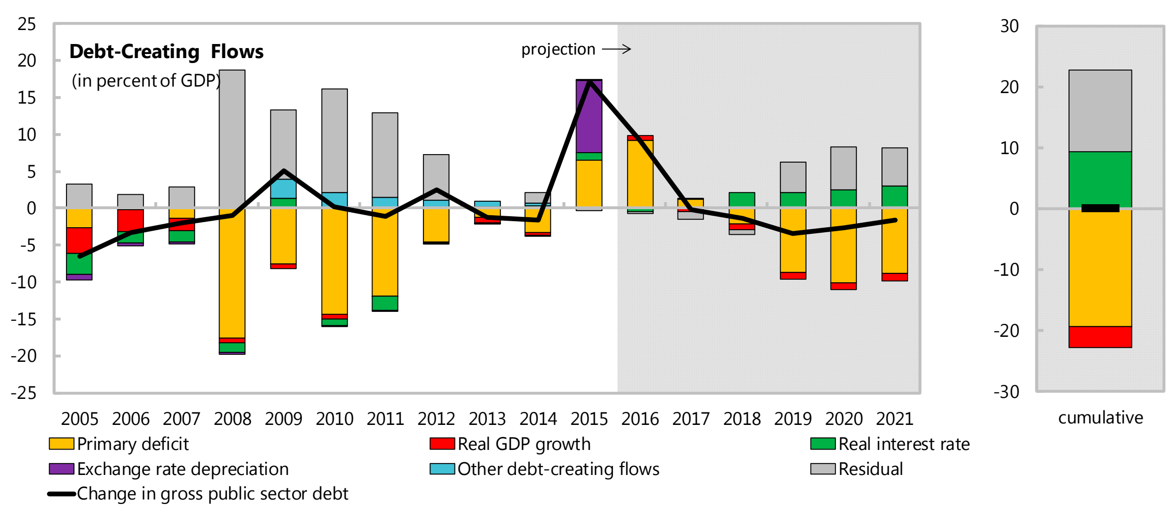
(in percent of GDP unless otherwise indicated)

Debt, Economic and Market Indicators [1]

	Actual			Projections						As of May 22, 2016		
	2005-2013 [2]	2014	2015	2016	2017	2018	2019	2020	2021			
Nominal gross public debt	11.4	11.2	28.3	37.5	37.4	36.0	32.6	30.0	28.3	Sovereign Spreads		
Of which: guarantees	1.6	2.5	10.3	15.6	14.5	13.9	13.2	12.7	12.3	EMBIG (bp) 3/		360
Public gross financing needs	-5.4	-2.6	7.7	13.0	7.4	3.2	-2.0	-4.8	-4.5	5Y CDS (bp)		n.a.
Net public debt	-25.9	-51.6	-34.5	-23.6	-21.8	-25.7	-32.4	-39.6	-45.2			
Public debt (in percent of potential GDP)	11.8	11.2	27.9	36.8	36.3	35.1	32.0	29.7	28.2			
Real GDP growth (in percent)	13.2	2.8	1.1	-2.4	1.4	2.3	2.9	2.5	3.7	Ratings	Foreign	Local
Inflation (GDP deflator, in percent)	10.8	-0.9	-6.3	4.2	6.5	1.6	2.0	1.4	0.3	Moody's	Caa1	Ba1
Nominal GDP growth (in percent)	25.3	2.2	-7.8	1.7	8.0	4.0	5.0	4.0	4.0	S&Ps	BB+	BB+
Effective interest rate (in percent) [4]	2.5	1.6	2.7	2.5	6.9	7.6	8.4	9.4	10.6	Fitch	BB+	BB+

Contribution to Changes in Public Debt

	Actual			Projections							
	2005-2013	2014	2015	2016	2017	2018	2019	2020	2021	cumulative	debt-stabilizing
Change in gross public sector debt	-0.8	-1.6	17.1	9.2	-0.1	-1.4	-3.4	-2.6	-1.7	0.0	primary
Identified debt-creating flows	-8.3	-3.0	17.3	9.4	0.9	-0.8	-7.5	-8.5	-6.9	-13.4	balance [9]
Primary deficit	-6.8	-3.3	6.5	9.2	1.2	-2.1	-8.7	-10.2	-8.8	-19.3	1.9
Primary (noninterest) revenue and gra	38.7	38.9	33.8	35.2	38.5	41.1	44.9	45.8	44.2	249.6	
Primary (noninterest) expenditure	31.9	35.6	40.3	44.4	39.7	39.0	36.2	35.6	35.4	230.3	
Automatic debt dynamics [5]	-2.4	0.0	10.7	0.2	-0.4	1.3	1.2	1.7	1.9	5.9	
Interest rate/growth differential [6]	-2.2	0.0	0.9	0.2	-0.4	1.3	1.2	1.7	1.9	5.9	
Of which: real interest rate	-1.0	0.3	1.1	-0.4	0.1	2.1	2.2	2.5	3.0	9.4	
Of which: real GDP growth	-1.2	-0.4	-0.1	0.7	-0.5	-0.8	-1.0	-0.8	-1.1	-3.5	
Exchange rate depreciation [7]	-0.2	0.0	9.7	…	…	…	…	…	…	…	
Other identified debt-creating flows	0.9	0.4	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Contingent liabilities	0.9	0.4	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes [8]	7.5	1.4	-0.1	-0.2	-1.0	-0.6	4.1	5.9	5.2	13.4	



Source: IMF staff.

1/ Public sector is defined as general government and includes public guarantees, defined as explicit as well as ownership-weighted implicit guarantees.

2/ Based on available data.

3/ Long-term bond spread over German bonds.

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

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

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

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

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

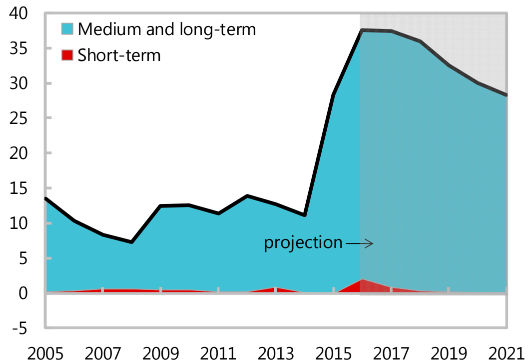
9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Azerbaijan Public DSA – Composition of Public Debt and Alternative Scenarios

Composition of Public Debt

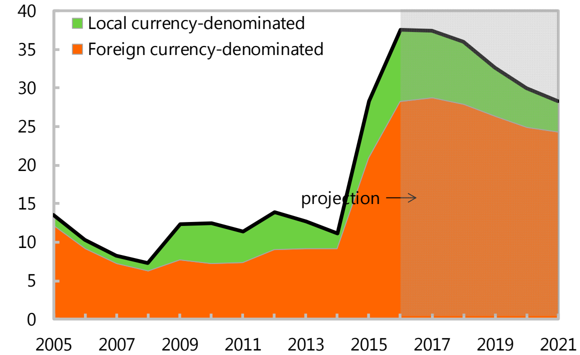
By Maturity

(in percent of GDP)



By Currency

(in percent of GDP)

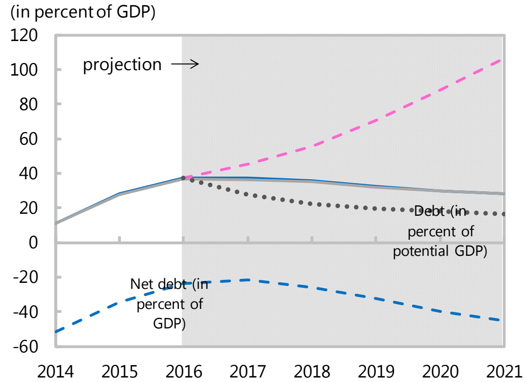


Alternative Scenarios

Baseline   Historical   Constant Primary Balance

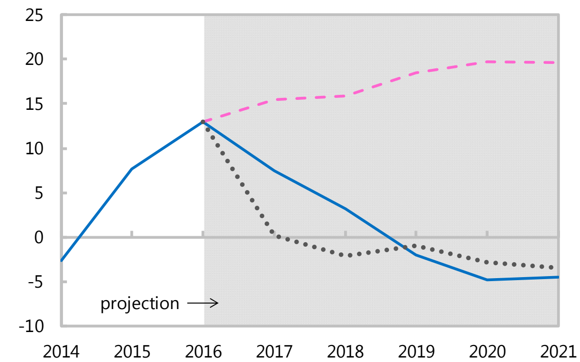
Gross Nominal Public Debt

(in percent of GDP)



Public Gross Financing Needs

(in percent of GDP)



Underlying Assumptions

(in percent)

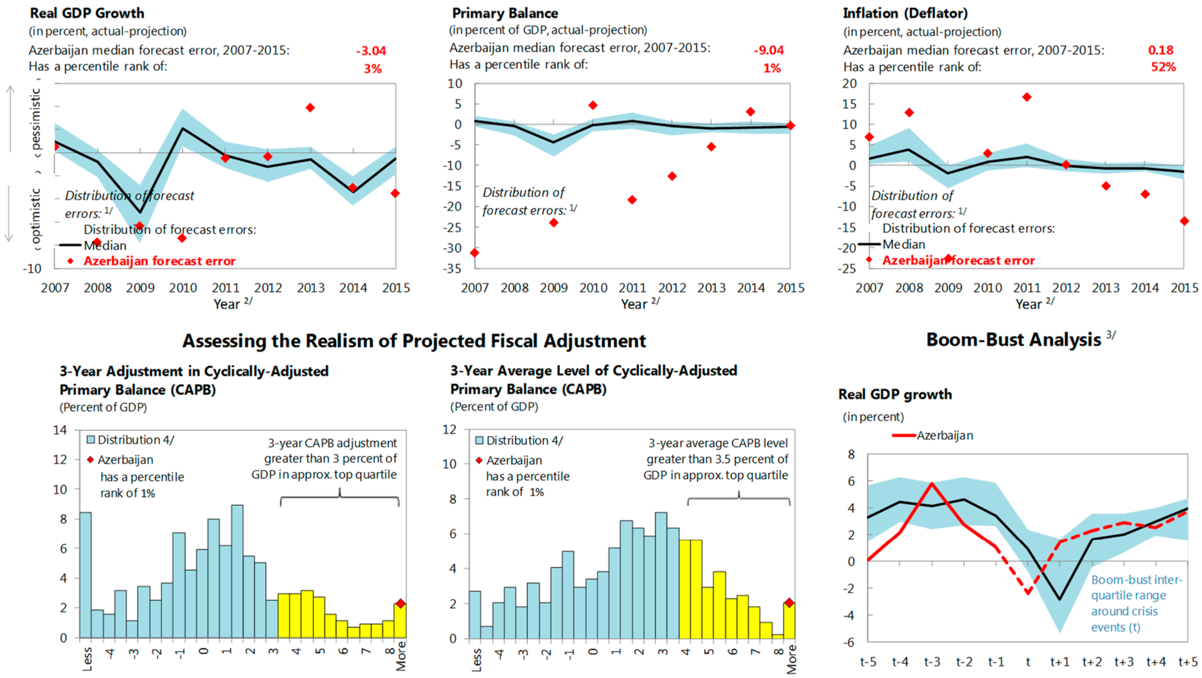
Baseline Scenario	2016	2017	2018	2019	2020	2021
Real GDP growth	-2.4	1.4	2.3	2.9	2.5	3.7
Inflation	4.2	6.5	1.6	2.0	1.4	0.3
Primary Balance	-9.2	-1.2	2.1	8.7	10.2	8.8
Effective interest rate	2.5	6.9	7.6	8.4	9.4	10.6
Constant Primary Balance Scenario						
Real GDP growth	-2.4	1.4	2.3	2.9	2.5	3.7
Inflation	4.2	6.5	1.6	2.0	1.4	0.3
Primary Balance	-9.2	-9.2	-9.2	-9.2	-9.2	-9.2
Effective interest rate	2.5	6.9	7.3	7.6	7.7	8.0

Historical Scenario	2016	2017	2018	2019	2020	2021
Real GDP growth	-2.4	9.7	9.7	9.7	9.7	9.7
Inflation	4.2	6.5	1.6	2.0	1.4	0.3
Primary Balance	-9.2	5.6	5.6	5.6	5.6	5.6
Effective interest rate	2.5	6.9	8.0	9.5	8.5	7.7

Source: IMF staff.

Azerbaijan Public DSA – Realism of Baseline Assumptions

Forecast Track Record, versus surveillance countries



Source : IMF Staff.

1/ Plotted distribution includes surveillance countries, percentile rank refers to all countries.

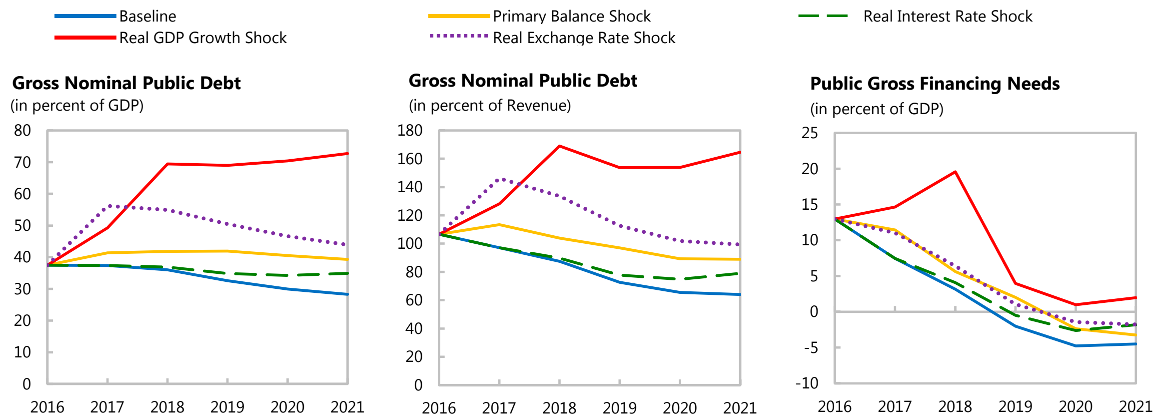
2/ Projections made in the spring WEO vintage of the preceding year.

3/ Azerbaijan has had a positive output gap for 3 consecutive years, 2013-2015 and a cumulative increase in private sector credit of 17 percent of GDP, 2012-2015. For Azerbaijan, t corresponds to 2016; for the distribution, t corresponds to the first year of the crisis.

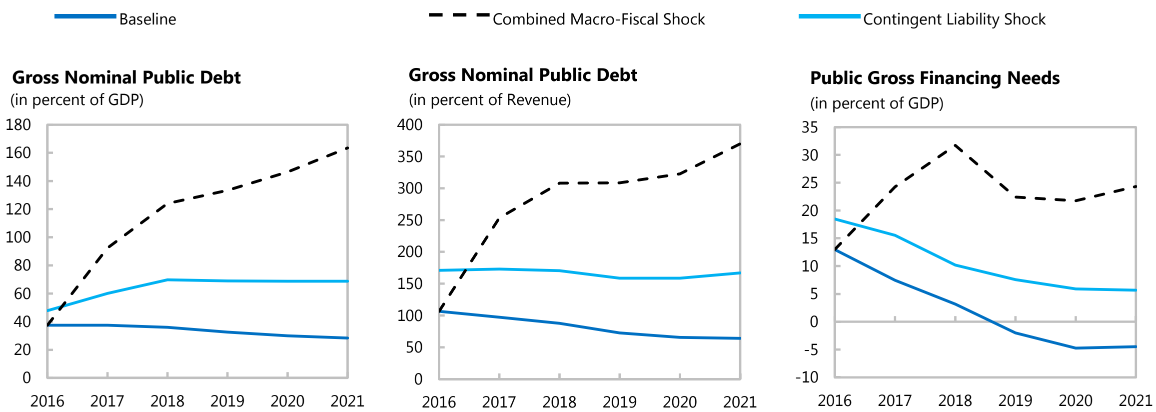
4/ Data cover annual obervations from 1990 to 2011 for advanced and emerging economies with debt greater than 60 percent of GDP. Percent of sample on vertical axis.

Azerbaijan Public DSA – Stress Tests

Macro-Fiscal Stress Tests



Additional Stress Tests



Underlying Assumptions
(in percent)

Primary Balance Shock	2016	2017	2018	2019	2020	2021
Real GDP growth	-2.4	1.4	2.3	2.9	2.5	3.7
Inflation	4.2	6.5	1.6	2.0	1.4	0.3
Primary balance	-9.2	-5.2	0.4	5.4	9.4	8.8
Effective interest rate	2.5	6.9	7.8	8.5	9.1	9.9
Real Interest Rate Shock						
Real GDP growth	-2.4	1.4	2.3	2.9	2.5	3.7
Inflation	4.2	6.5	1.6	2.0	1.4	0.3
Primary balance	-9.2	-1.2	2.1	8.7	10.2	8.8
Effective interest rate	2.5	6.9	11.8	14.5	18.1	20.8
Combined Shock						
Real GDP growth	-2.4	-9.9	-9.0	2.9	2.5	3.7
Inflation	4.2	3.7	-1.2	2.0	1.4	0.3
Primary balance	-9.2	-9.5	-11.9	5.4	9.4	8.8
Effective interest rate	2.5	14.6	10.2	13.6	16.3	18.3

Real GDP Growth Shock	2016	2017	2018	2019	2020	2021
Real GDP growth	-2.4	-9.9	-9.0	2.9	2.5	3.7
Inflation	4.2	3.7	-1.2	2.0	1.4	0.3
Primary balance	-9.2	-7.5	-11.1	8.7	10.2	8.8
Effective interest rate	2.5	6.9	8.1	9.3	9.7	10.0
Real Exchange Rate Shock						
Real GDP growth	-2.4	1.4	2.3	2.9	2.5	3.7
Inflation	4.2	39.0	1.6	2.0	1.4	0.3
Primary balance	-9.2	-1.2	2.1	8.7	10.2	8.8
Effective interest rate	2.5	14.6	6.4	7.0	7.7	8.6
Contingent Liability Shock						
Real GDP growth	-2.4	-9.9	-9.0	2.9	2.5	3.7
Inflation	4.2	3.7	-1.2	2.0	1.4	0.3
Primary balance	-9.2	-6.5	2.1	8.7	10.2	8.8
Effective interest rate	2.5	8.4	8.0	8.6	9.1	9.7

Source: IMF staff.

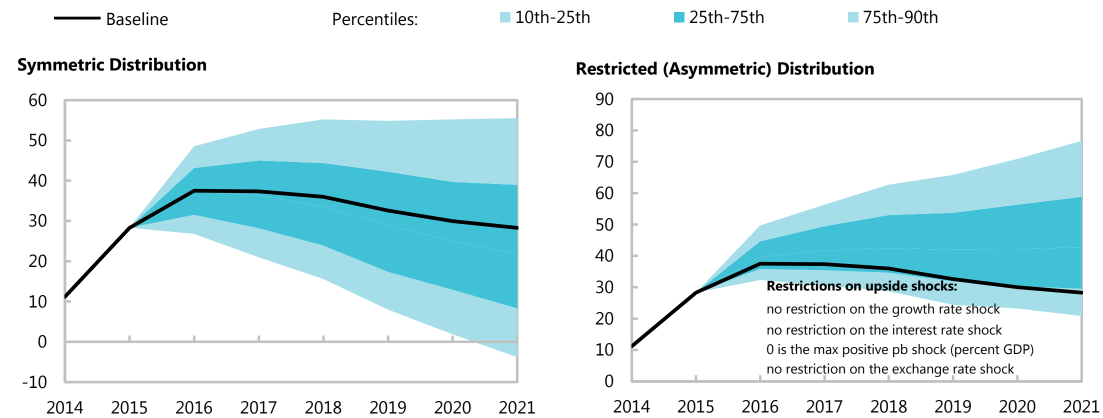
Azerbaijan Public DSA Risk Assessment

Heat Map

Debt level 1/	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability shock
Gross financing needs 2/	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability Shock
Debt profile 3/	Market Perception	External Financing Requirements	Change in the Share of Short-Term Debt	Public Debt Held by Non-Residents	Foreign Currency Debt

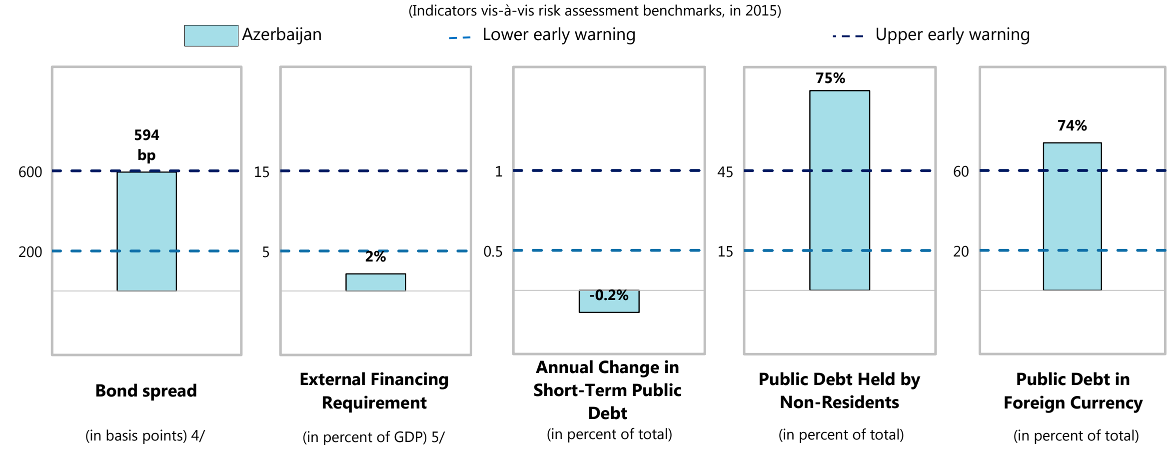
Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks, in 2015)



Source: IMF staff.

1/ The cell is highlighted in green if debt burden benchmark of 70% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

2/ The cell is highlighted in green if gross financing needs benchmark of 15% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

3/ The cell is highlighted in green if country value is less than the lower risk-assessment benchmark, red if country value exceeds the upper risk-assessment benchmark, yellow if country value is between the lower and upper risk-assessment benchmarks. If data are unavailable or indicator is not relevant, cell is white.
Lower and upper risk-assessment benchmarks are:

200 and 600 basis points for bond spreads; 5 and 15 percent of GDP for external financing requirement; 0.5 and 1 percent for change in the share of short-term debt; 15 and 45 percent for the public debt held by non-residents; and 20 and 60 percent for the share of foreign-currency denominated debt.

4/ Long-term bond spread over German bonds, an average over the last 3 months, 22-Feb-16 through 22-May-16.

5/ External financing requirement is defined as the sum of current account deficit, amortization of medium and long-term total external debt, and short-term total external debt at the end of previous period.

Annex IV. Azerbaijan: Bank Restructuring, Financial Sector Reforms and FSAP Recommendations

The banking system in Azerbaijan is relatively underdeveloped and heavily concentrated. At end-2015, the system consisted of 43 banks, with the International Bank of Azerbaijan (IBA), a majority state-owned bank, holding some 40 percent of system wide assets, mostly in industrial loans. There are eight majority foreign-owned banks and two majority state-owned banks. IBA profitability has been a persistent problem given a tendency to provide subsidized loans to government projects.

The reform process has proceeded along 4 integrated tracks. This includes (i) restructuring IBA; (ii) creating new supervisory institutions; (iii) cleaning up the rest of the banking system; and (iv) implementing new insurance fund and macro-prudential policies. An FSAP was completed in July 2015. The status of FSAP recommendations is presented in Table 1.

A. IBA

The authorities are restructuring the IBA mainly through the creation of a bad bank-SPV, new financial support, and implementation of management reforms.

- **Bad bank creation:** A joint CBA-MoF preliminary audit of IBA's loan portfolio found approximately AzN 7 billion in bad assets (70 percent of total assets). In mid-2015, *Aqrarkredit* (a small state-owned credit agency) was tasked with receiving and managing part of IBA's bad assets, and issuing state guaranteed bonds at a 0.15 percent interest rate, 30-year maturity, 5-year grace period, to the CBA. These funds—routed through the SPV—have been paid to the IBA in exchange for the bad assets, which have been placed in the SPV for debt collection. The first tranche of IBA's bad assets (AzN 2.5 billion) was transferred to the SPV in late 2015, and an additional AzN 4.6 billion has been moved in 2016.

- **Burden of losses:** The NPLs were bought at the full book value. Existing owners who had borrowed from the IBA to fund previous IBA bank equity purchases were forced to reverse those transactions and settle other liabilities. The remaining depositors were all protected. As the bonds sold to the CBA mature and the distressed assets recovery process unfolds, the government will inject financial resources into Aqrarkredit to service its debt on a timely manner.

- **Continued financial support:** SOFAZ has committed to deposit $2 billion in IBA. SOFAZ deposits have been used to repay some of IBA's most expensive foreign currency liabilities (about $1 billion), with the remaining foreign debt ($3 billion) on a more sustainable path. The IBA also expects the government to inject AzN 500 million in new capital. In addition, the CBA has provided 1 billion manat in subordinated loans to IBA. Finally, in order to provide IBA with an income stream, 3 billion manat was deposited in the CBA at 5 percent interest rate.

- **Greater government control:** At end-2014, the MOF and non-state entities owned 51 and 10 percent of IBA shares respectively, while undisclosed individuals account for 39 percent. The government's share increased to 85 percent by end-2015. Once an additional capital injection is finalized in late-2016, the government will own about 95 percent of IBA's shares. Nevertheless, the ultimate goal is to completely privatize the bank within five years.

- **New management:** The government has replaced the IBA's management and board, and is starting the process of reforming bank operations, investigating allegations of fraud and malfeasance and examining changes in governance, funding, and bank loan strategy. The new management is cutting costs with staff reductions of some 20 percent, foreign branch closures and paying off expensive foreign debt. Bank operations in 2016 indicate that IBA still remains heavily focused on larger industrial based activities. Current IBA management indicated that sustained substantial interest income is needed to ensure IBA profitability.

B. Supervision

A new integrated financial supervision agency, the FMSA, was created in March 2016. Its *mandate* covers the licensing, supervision and regulation of securities markets, investment funds, insurance companies, lotteries, banks and non-bank credit institutions (including the postal operator) and payment systems, including AML/CFT activities. Its main *objectives* are to (i) ensure effective operation and stability of financial markets; and (ii) protect creditors' rights, insured persons, investors and other consumers of financial markets. The *management structure* includes a five-person Board of Directors, and a CEO, all appointed by the president with five-year terms. Banking and financial supervision responsibilities have been removed from the CBA Law. The CBA, however, will still be directed to provide direct short-term (under 6 months) loan support to banks on the advice of the FMSA. Supervised institutions will pay a membership fee to the FMSA to fund its operations.

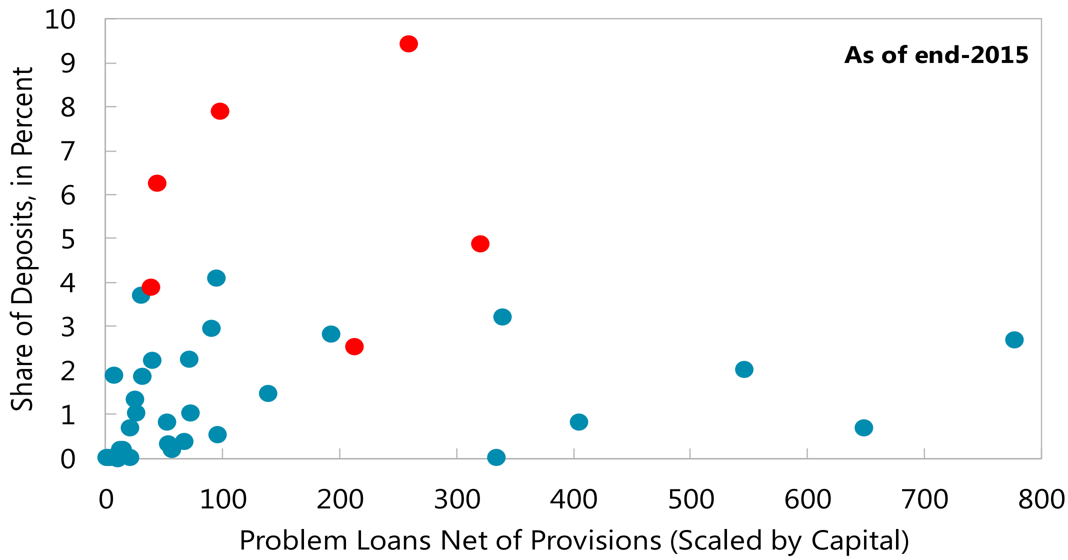
In line with FSAP recommendations, the authorities created a Financial Stability Board in mid-2016. The Board will include representatives of ADIF, CBA, MOF, FMSA, and SOFAZ, and will be chaired by the Prime Minister. The group has been meeting regularly on an informal basis.

C. The Rest of the Banking System

- **Closing and merging problem banks.** The CBA revoked licenses for 2 insolvent banks in 2015, and moved quickly to close a further 6 banks in January-February 2016, while merging an additional 2 banks. The closed banks comprised about 6 percent of the total size of the banking system. The FMSA put provisional administrators in 4 more banks in July 2016—allowing 1 to become a non-bank finance company. The number of banks now stands at 31 as of end-July 2016, though three of the closed banks are challenging in court CBA's decision The new regulator has also intervened in a systemically important bank, imposing a deposit moratorium which was recently lifted.[1] Authorities are still considering a number of resolution alternatives.

- **Restructuring the banking sector.** The FMSA has concluded an asset and credit quality assessment of the banking sector loan portfolio. The diagnostics included a top-down stress test exercise as well as on-site inspections. The FMSA report groups the banks in three categories: (i) systemically important banks; (ii) medium-sized banks, some of which have capital and/or liquidity deficiencies that will need to be addressed by the banks following supervisory actions; and (iii) small and non-viable banks, which FMSA intends to close by the end of this year.[2] The chart below presents a quick snapshot of the status of problem loans within the system as of end 2015.[3]

Azerbaijan: Commercial Bank's Problem Loans Net of Provisions (Scaled by Capital) by Share of Deposits



Sources: FMSA and IMF Staff estimates. Data does not include the largest bank in the system. Red dots are banks with total assets that exceed AzN 1 billion.

D. Insurance Fund and Macro-Prudential Policies

The deposit insurance fund (ADIF) issued a blanket guarantee. Following a sharp drop in deposits (about 15 percent of total deposits), the ADIF removed the AzN 30,000 insured deposit

[1] Retail depositors still face some constraints as they can only withdraw up to 1,000 manat per day. Companies can only withdraw deposits if it relates to payment of salaries and other operational expenses.
[2] Banks in the third group (including the 4 placed in administration in July 2016) represent 22 percent of the system's deposits.
[3] The problem loans presented in the chart are FMSA "prudential" data, and differ from the "statistical" data reported in financial soundness indicators (FSI) which only present overdue payments.

limit in early February 2016, and provided a blanket guarantee on all individual deposits with an interest rate cap of 12 percent for manat deposits and 3 percent for U.S. dollar deposits. Total individual deposits amounted some 14 percent of GDP in mid-2016. The blanket guarantee is to be in place for 3 years from March 2016, after which it will be reviewed. ADIF has signed a Memorandum of Understanding (MOU) that allows it to borrow from CBA and the government, if the liquid assets of the ADIF fall below 1 percent of insured deposits.[4] The ADIF is working on a draft law that will provide it with powers to inspect banks on deposit-related matters, in coordination with the new regulator. The draft law also foresees a move to a risk-based fee system.

The FMSA passed a decision on *Responsible Lending*, effective May 6 2016, which sets out the conditions for granting foreign and local currency loans. Foreign currency mortgage loans are now prohibited and foreign currency consumer loans are only allowed to individual or entities who receive foreign currency revenues and who a have a bank account. Existing foreign currency loans can only be restructured in line with established prudential lending conditions, and new foreign currency consumer loans are limited by new debt load limits on borrowers. The FMSA is also working with banks to create a private credit bureau.

E. Epilogue: FSAP issues

Some of the financial reforms are in line with FSAP recommendations, while others are clearly not. For example, the FSAP had stressed the importance of moving quickly to close weak banks and to establish a SPV mechanism to handle IBA's bad loans. However, issuing a blanket deposit insurance guarantee, creating a new financial system regulator (FMSA) or undertaking full debt/equity swaps in the IBA were not part of FSAP recommendations.

Recommendations made in the 2015 FSAP still remains relevant. Key recommendations to enhance the financial safety net included (i) strengthening supervisor resolution powers to allow swift intervention, if needed, before a bank becomes insolvent and reducing the dependence on the court system; (ii) MOUs among agencies potentially involved in resolution, to permit efficient information sharing; (iii) formalize borrowing agreements between the deposit insurance fund and the CBA and the MOF, allowing resources from the ADIF to be applied for all resolutions and on a least-cost basis; (iv) set out ELA preconditions and require banks to be prepared for providing high quality collateral, if ELA is needed; and (v) develop bank-specific contingent plans for banks considered systemic.

[4] Total covered deposits of banks closed in 2015 and 2016 have amounted to AzN 300 million. This has depleted existing ADIF reserves. ADIF has already borrowed AzN 22 million from CBA, which will be enough to pay deposits in the 3 litigating banks. If any additional bank is closed, ADIF will need further financial support.

Table 1. Azerbaijan: Status of 2015 FSAP Recommendations

	Authority [1/]	Time [2/]	Status
Recommendations for Addressing the Current Situation			
Clearly communicate with the public the reasons behind the recent large devaluation and measures taken to support the banking system	CBA	I	
Minimize forbearance and require banks to prepare strict time-bound plans to address capital and liquidity gaps	CBA	I	Not done.
Perform a comprehensive review of the quality of bank loan portfolios with third party participation and require banks to share plans for ensuring capital adequacy	CBA, MoF, Government	I	Not done.
Set higher risk weights for foreign currency lending	CBA	I	Not done
Introduce differential reserve requirements and deposit insurance premia to encourage manat deposits	CBA, DIF	I	Partially done. Differential insurance premia introduce, but not differential reserve requirement.
Banking Oversight			
Facilitate on-site supervision by exempting regulated financial institutions from the Law of the Republic of Azerbaijan on Regulation of Business Inspections and Protection of Interests of Businesses	Parliament	I	Not done. There is a new supervisor and a draft law is being prepared and shared with the IMF for comments.
Introduce consolidated supervision as an overarching supervisory approach	Parliament	NT	Not done. There is a new supervisor and a draft law is being prepared and shared with the IMF for comments.
Remove ability of CBA to provide subordinated loans and gradually disinvest from IBA capital	Parliament, CBA	NT	Not done.
Enhance transparency on ultimate beneficiaries by revising the Commercial Secrets Law	Parliament	NT	Not done.
Enforce corrective measures, particularly in compliance with prudential norms	CBA	I	Not done.
Establish supervisory regimes for market, operational, interest rate and country risk	CBA	NT	Not done. There is a new supervisor and a draft law is being prepared and shared with the IMF for comments.
Raise quality of corporate governance, particularly by requiring independent and qualified non-executive directors	CBA, MoJ, Parliament	MT	Not done. Now there is a new supervisor and a draft law is being prepared and shared with the IMF for comments
Strengthen the governance structure of the CBA by appointing non-executives to the two vacant positions and establishing an Audit Committee	Parliament, CBA	NT	Not done. There is a new supervisor and a draft law is being prepared and shared with the IMF for comments.
Provide CBA power to raise prudential standards for individual banks and banking groups	Parliament, CBA	NT	Not done. There is a new supervisor and a draft law is being prepared and shared with the IMF for comments.
Strengthen identification and assessment of the suitability of shareholders, including ultimate beneficial owners	Parliament, CBA	NT	Not done. Now there is a new supervisor and a draft law is being prepared and shared with the IMF for comments
Systemic Financial Risk			
Establish interagency body for crisis preparedness and management, and sharing supervisory information on a regular basis	CBA, SCS, MoF, DIF	I	Not done
Provide CBA explicit mandate for financial stability, financial stability unit within CBA	CBA	NT	Not done. There is a new supervisor and a draft law is being prepared and shared with the IMF for comments.

Financial Safety Net, Resolution of NPLs, and Systemic Liquidity Management			
Give the CBA full powers for bank resolution without resorting to the court system and the full range of tools necessary for resolution	Parliament	I	Not done. There is a new supervisor and a draft law is being prepared and shared with the IMF for comments.
Formalize borrowing arrangements with the CBA, enabling DIF funds to be applied for all resolution procedures on a least-cost basis	CBA, DIF, MoF	NT	Not done. There is a new supervisor and a draft law is being prepared and shared with the IMF for comments. A new law for DIF also being prepared.
Sign an MOU between DIF and CBA to ensure automatic exchange of information with a view toward eventually introducing risk-differentiated deposit insurance premia	DIF, CBA	NT	Not done. There is a new supervisor and a draft law is being prepared and shared with the IMF for comments. A new law for DIF also being prepared.
Set out ELA preconditions, indicative term sheet for lending, and requiring banks to be pre-positioned for sale and repurchase arrangements with high quality assets	CBA	I	Partially done. There is some criteria and preconditions for ELA, but it does not fully address FSAP recommendations (e.g. banks not required to be pre-positioned for sale.
For systemic banks develop bank-specific resolution plans based on comprehensive resolvability assessments that seek to minimize fiscal risk and moral hazard	CBA	NT	Not done. There is a new supervisor, which should take care of this.
Anti-Money Laundering and Counter Financing of Terrorism			
Continue to address AML/CFT deficiencies on adequate criminalization of money laundering, transparency of beneficial ownership, and preventive measures, including sanctions.	Parliament, MoJ, MoF	NT	Not done

1/ The new financial market regulator (FMSA) has taken over banking supervision as of April, 2016.
2/ I – "Immediate": within one year. NT – "Near-term": one to three years. MT – "Medium-term": three to five years.

Annex V. Azerbaijan: Inclusive Growth

A 2012 SIP reported on the inclusiveness of Azerbaijan's growth.[1] It noted that the oil boom and associated rapid non-oil growth contributed to a substantial reduction in poverty and inequality. However, economic diversification, youth employment, governance reforms, and greater SME access to financing were seen as essential to keep growth inclusive.

While inclusive growth indicators show gains in poverty reduction, gaps in gender parity, health, education, and youth employment remain. The percent of the population in poverty in Azerbaijan in 2014 was 6 percent relative to the CCA average of 26 percent, and the *Human Development Index* was also above average. However, youth employment was only 23 percent relative to the regional average of 42 percent, and average years of schooling are below regional norms. Moreover, female representation in parliament and in education enrollment remains low. Cell phone subscriptions per 100 people are also below average—implying that access as well as availability may limit integration into the economy.

Azerbaijan: Inclusive Growth Indicators, 2014

	Under national poverty line 1/	Using Improved Health Facility 1/	Youth Employment Ratio	HDI 2/	Expected years of schooling	Female Members of Parliament 1/	Parity in Education 3/	Cell Phone Subscriptions 4/
Azerbaijan	6.0	82	23.1	0.75	11.9	15.6	1.05	107.6
Armenia	32.4	91	28.5	0.73	12.3	10.7	1.57	112.4
Georgia	22.4	93	27.6	0.75	13.8	12.0	1.27	115.0
Kazakhstan	2.9	97	48.4	0.79	15.0	25.2	1.43	180.5
Kyrgyzstan	38.0	92	51.0	0.66	12.5	23.3	1.24	121.4
Tajikistan	42.0	94	45.5	0.62	11.2	15.9	0.52	91.8
Turkmenistan	…	99	45.5	0.69	10.8	26.4	…	116.9
Uzbekistan	15.0	100	45.0	0.68	11.5	22.0	0.65	74.3
CCA average	**25.5**	**95.2**	**41.6**	**0.70**	**12.5**	**19.4**	**1.11**	**116.1**

Source: ADB 2014 Inclusive Growth Indicators,
1/ In percent
2/ HDI: Human Development Index
3/ Parity in education is the ratio of gross female to gross male school enrollment.
4/ Per 100 people.

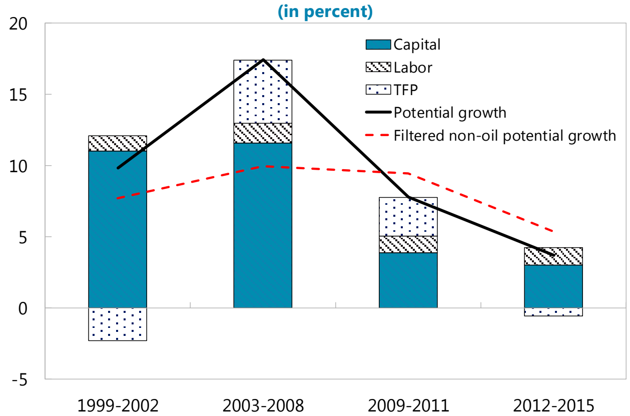
Azerbaijan's economic structure hinders the absorption of young job seekers—limiting inclusive growth. In 2015, under 25 (35) year olds constituted 40 (60) percent of the population, with 70 percent within the range of 15 to 64 years of age. The low-productivity, low-growth agricultural sector remains Azerbaijan's largest employer, absorbing 37 percent of the workforce, but contributing only about 5 percent of GDP. The capital-intensive mining sector contributes 40 percent of GDP, but employs only about 1 percent of the entire workforce.

[1] See IMF Country Report No. 12/6, "The Inclusiveness of Azerbaijan's Growth".

Annex VI. Azerbaijan: Potential Output in the New Normal

As in other emerging markets, Azerbaijan's potential growth slowed in the aftermath of the global financial crisis.[1] At first, the boom in oil prices led to a marked increase in (i) foreign direct investment (particularly in the oil sector); and (ii) public investment and infrastructure spending given rapidly rising budgetary transfers from the Oil Fund. At the same time, the authorities started to make headway in implementing structural reforms—which together with improved infrastructure—helped to raise productivity. As a result, estimates of potential growth from a simple production function rose to over 15 percent during 2003-08, while estimates of potential non-oil sector growth from statistical filter methods reached near 10 percent.[2] However, the economy's growth potential has receded sharply of late given lower investment rates (capital contributions), and more recently from reductions in total factor productivity (TFP). As of 2012-15, the economy's potential was seen to be around 3 percent while non-oil potential growth was around 5 percent.

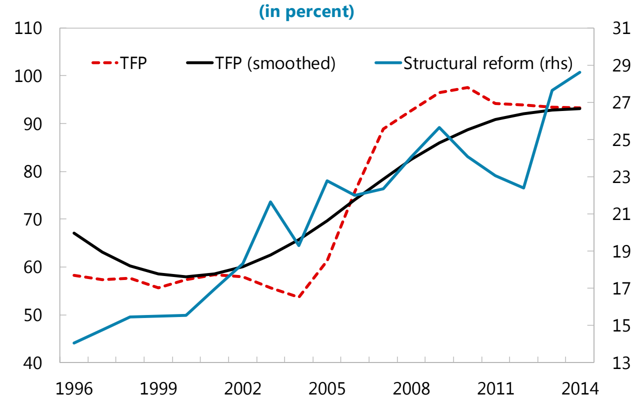
Azerbaijan: Total Economy Potential Growth Contributions
(in percent)



Sources: Staff estimates.

Changes in the external environment call for a further reassessment of potential growth. Going forward, lower oil prices (and perhaps higher interest rates) should translate into lower investment rates. To ascertain how potential growth may be affected, staff projected factors of production (capital and labor) and estimated a TFP regression model based on WEO changes in oil prices and an index of structural reforms (SRI) to forecast future TFP movements. Specifically, for 2016-21 it is assumed that capital accumulates at the now lower WEO projected investment growth rates and labor grows at recent historical rates (about 1 percent). Based on the TFP regressions, if structural reforms proceeded at the same pace as the oil

Azerbaijan: Productivity and Structural Reforms
(in percent)



Source: Staff estimates. The structural refom index is a weighted average of the World Bank's Governance indicators, which range from 0 to 100.

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[1] See IMF (2015), *"Where are we headed? Perspectives on potential output"*, WEO April.

[2] Production function estimates are based upon Burns, et.al (2014), *"Estimating potential output in developing countries"*, Journal of Policy Modeling. The filtered estimates of non-oil sector potential growth are an average of Hoderick-Prescott and Baxter-King statistical filters.

boom years, potential growth could reach about 6 percent. No change in reform trends suggest growth of some 3½ percent, while a reversal of reforms indicate potential growth would fall to about 1 percent. This analysis suggests that in an environment of low oil prices and reduced investment, the driver of growth will need to come from stepped up structural reforms.

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	
Surges in global financial market volatility, leading to economic and fiscal stress, and constraints on country policy settings.	**Medium**	**Medium** Channels of transmission from international financial markets to Azerbaijan are not strong. The biggest impact would be through the value of assets held by the oil fund.
Protracted period of slower growth in advanced economies (negative surprises on potential growth) **or emerging economies** (incomplete structural reforms).	**High** (Advanced economies) **High** (Emerging markets)	**High** A long period of slow growth in Europe could hurt oil export volumes in the short run and hurt plans to export gas directly to Europe. A slowing in emerging markets will have less impact.
Sustained decline in commodity prices triggered by deceleration of global demand and coming-on-stream of excess capacity.	**High**	**Medium/High** Given Azerbaijan's high oil dependence, the economy could go into recession. The oil fund savings could help cushion the shock. A prolonged price decline would necessitate a large fiscal adjustment.
Increasing geopolitical tensions surrounding Iran, Russia, Turkey and Ukraine lead to disruptions in financial, trade and commodity markets	**Medium**	**Medium/High** Disruptions in gas supply could raise oil prices by 15 percent. Such event would strengthen growth prospects as well as fiscal and external positions.

[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 ("low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 and 30 percent, and "high" a probability of 30 percent or more). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the 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)
	Country specific risks	
Oil production risk Disruptions in oil production if recent efforts to stabilize oil output cannot be sustained	**Medium**	**High** Disruptions in oil production would undermine growth prospects and result in deteriorations of the overall fiscal and external positions.
Financial sector risks (A further deterioration in banking sector profitability and capitalization (particularly in IBA) could compromise the stability and soundness of the system).	**High**	**Medium** A further deterioration in systemic banks would result in destabilizing deposit runs and bank closures. The government is likely to step in with important fiscal costs.
Escalation of the regional conflicts (Tensions with countries in the region could increase, following recent geopolitical events).	**Medium**	**High** Military conflict would entail severe economic and social impacts and damage FDI prospects, particularly in the non-oil sector.
Policy responses: With potential downside risks, staff will recommend that the authorities rebuild policy buffers. This would entail strengthening the non-oil fiscal position beyond the levels envisaged in the 2016 approved budget and allow further depreciation of the manat in line with ER fundamentals. Sustaining efforts to enhance banking sector performance and banking supervision combined with actions to restructure and privatize the public bank under a sustainable financial position will also help contain risks in the financial sector.		

INTERNATIONAL MONETARY FUND

REPUBLIC OF AZERBAIJAN

STAFF REPORT FOR THE 2016 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

August 25, 2016

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

CONTENTS

RELATIONS WITH THE FUND (AS OF JUNE 30, 2016)

Membership Status

Date of membership: September 18, 1992;

General Resources Account

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

SDR Department

	SDR Million	Percent Allocation
Net Cumulative Allocation	153.58	100.00
Holdings	95.87	62.43

Outstanding Purchases and Loans

	SDR Million	Percent of Quota
None	0.00	0.00

Latest Financial Arrangements

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

Projected Payments to the Fund

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

	Forthcoming				
	2016	2017	2018	2019	2020
Principal					
Charges/Interest	0.02	0.03	0.03	0.03	0.03
Total	**0.02**	**0.03**	**0.03**	**0.03**	**0.03**

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, including the establishment of an Audit Committee. KPMG conducted an independent auditor's report of the 2015 CBA financial statements by April 25, 2016. The audited financial statements along with audit opinion has been published on the central bank's website as an integral part of 2015 annual report.

Exchange Rate Arrangements

The currency of Azerbaijan is the manat, which became sole legal tender on January 1, 1994. A bilateral peg against the U.S. dollar had been in place since January 2011, but effective February 16, 2015, the CBA implemented an exchange rate policy based on the currency basket comprising the U.S. dollar and the euro. On February 21, 2015, the CBA devalued the currency by 25 percent relative to the U.S. dollar, and on December 21, 2015, by 32 percent. Since then, as a result of official action, the manat has been allowed to gradually depreciate based upon supply and demand factors vis-à-vis the U.S. dollar. According to Article IV, Section 2(a) of the Fund's Articles of Agreement, Executive Director Daniel Heller informed to the Secretary that effective December 21, 2015, the CBA changed the *de jure* exchange regime from "other managed" to "managed floating". The *de facto* regime is "other managed" based on the CBA's periodic weekly auctions (on Tuesdays and Thursdays of each week) with a prescribed +/- 1 percentage point corridor. The amount supplied at the auctions is determined jointly by the CBA and SOFAZ. A ER corridor of +/- 4 percent is also in effect for transactions between banks and their clients. The CBA also stands ready to intervene to smooth out an excess volatility in the market. The CBA publishes its foreign exchange intervention data quarterly.

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

Azerbaijan is on a 12-month Article IV consultation cycle. The 2016 Article IV Board date is set for September 9, 2016. The previous Article IV consultation finalized on May 27, 2014; it was delayed mainly as a result of the authorities' request for additional time to respond to economic developments.

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, 2003–16

Fund Dept.	Delivered Assistance	Mission Dates
FAD	Budget systems law	Feb/Mar 2003
STA	Consumer Price Statistics	Jun 2003
STA	National Accounts	Jul/Aug 2003
MFD	Regional Technical Assistance in Public Debt Management	Jul/Sep 2003
MFD	Payment and Settlement Systems	Sep 2003
FAD	Revenue Administration	Aug 2003
FAD	Tax Policy	Aug 2003
MFD	Payment and Settlement Systems	Jan 2004
STA	Balance of Payments Statistics	May 2004
MFD	Payment and Settlement Systems	May 2004
MFD	Regional Public Debt management	Apr 2004
FAD	Customs Administration	Sep 2004
STA	National Accounts	Sep/Oct 2004
FAD	Tax administration	Dec 2004
MFD	Public Debt Management	Dec 2004
STA	National Accounts	Mar/Apr 2005
LEG	AML/CFT Scoping	Jun 2005
FAD	Taxation of SOCAR Operations	Aug 2005
STA	Balance of Payments and External Debt Statistics	Nov/Dec 2005
STA	Consumer Price Statistics	Feb/Mar 2006
MFD	Monetary Operations	Aug 2006
FAD	Public Financial Management	Sep 2006
STA	Government Finance Statistics	Oct/Nov 2006
MCM	Banking Supervision	Apr 2007
FAD	Tax Administration Diagnostic	Feb 2008
FAD	Tax Administration (expert visits)	July 2008/Apr 2009
MCM	Domestic Securities Market Development	Sep 2008
MCM	Public Debt Management	Aug 2009
LEG	AML/CFT Diagnostic	Aug/Sep 2009
STA	External Sector Statistics	Oct 2009
LEG	AML/CFT Diagnostic	Feb/Mar 2011
LEG	AML/CFT Structures and tools	Feb/Mar/Oct/Dec 2011
LEG	AML/CFT Legislation	Jul/Dec 2011
STA	Government Finance Statistics	Sep 2011
STA	Balance of Payments Statistics	Mar 2012
MCM	Moving Towards Exchange Rate Flexibility	Mar 2012

Azerbaijan: Technical Assistance, 2003–16 (concluded)

Fund Dept.	Delivered Assistance	Mission Dates
LEG	AML/CFT Structures and tools	Jun/May/Sep/Dec 2012
FAD	Pension Reform	Jul 2012
STA	National Accounts	Feb 2013
LEG	AML/CFT Structures and tools	Mar 2013
FAD	Debt and Cash Management and Budget Classification	Jun 2013
FAD	Pension Reform Follow Up	Jul/Nov 2013
STA	Quarterly National Accounts Statistics	Sep 2013

Azerbaijan: Technical Assistance, 2003–16

Fund Dept.	Delivered Assistance	Mission Dates
MCM	Follow-up Mission-Bank Restructuring (with MCD staff visit)	Mar 2014
STA	Quarterly National Accounts Statistics	May 2014
STA	External Sector Statistics	May 2015
MCM	Bank Restructuring (with MCD staff visit)	Sep 2015
STA	External Sector Statistics	Nov 2015
STA	External Sector Statistics	Apr 2016
MCM	Multi-Topic: Monetary, FX Operations and Bank Supervision	Apr 2016
FAD	TADAT Workshops, Research and Training Consultations	Apr 2016

Fund Dept.	Planned Assistance	Mission Dates
LEG	Ongoing review of the Draft Law on Supervision of Financial Markets (requested by MCM)	May 2016
LEG	Ongoing review of the Draft Law on Deposit Insurance (requested by MCM)	Jun 2016
STA	Government Finance Statistics	H2 2016
FAD	PFM-Fiscal Rules (requested by the authorities)	H2 2016
FAD	Pension Reform (requested by the authorities)	H2 2016
MCM	Multi-Topic: Monetary, FX Operations and Bank Supervision	Q1 2017
MCM	Bank Restructuring	Q2 2017
MCM	Liquidity Forecasting	Q2 2017
MCM	Bank Restructuring and Bank Supervision	Q3 2017
MCM	Monetary Policy	Q3 2017
MCM	Multi-Topic: TA Program Assessment (follow up)	Q4 2017

Fund Dept.	Key Areas of Assistance
FAD	A. PFM Reform
	i. Formulation of macro-fiscal policy objectives and aggregates
	ii. Budget planning and preparation
	iii. Expenditure control and cash management, including fiscal rules
	B. Formulation and evaluation of tax policy and customs administration
	C. Development of a framework for oil and non-oil revenue management and taxation
	D. Development of revenue raising measures legislated by the Parliament
	E. Debt management strategy
LEG	A. Banking legislation (regulation, supervision and resolution)
MCM	A. Banking legislation, regulation and supervision
	B. Monetary and exchange operations and payment systems
	C. Reserve management
STA	A. External Sector Statistics
	B. Government Finance Statistics

RELATIONS WITH THE WORLD BANK

(As of June 2016)

Azerbaijan became a member of the International Bank for Reconstruction and Development (IBRD) in September 1992 and the International Development Association (IDA) in March 1995 and a member of the International Finance Corporation (IFC) in October 1995. In FY11 Azerbaijan graduated from IDA and became IBRD country.

On July 2015, the World Bank's Board of Executive Directors endorsed the new Country Partnership Framework (CPF) for Azerbaijan covering FY2016–2020. It is a joint strategy of the World Bank Group aiming to support Azerbaijan on its path toward sustainable, inclusive, and private sector–led growth. The CPF proposed three strategic pillars: (i) Effective Public Service Delivery; (ii) Economic Competitiveness and Growing the Role of the Private Sector; and (iii) Sustainability and Resilience of the economy. Under the two focus areas— Public Sector Management and Service Delivery and Economic Competitiveness— the Bank will help the country strengthen public resource management, facilitate public service delivery, and improve the quality of environmental assets, as well as improve selected infrastructure networks, increase the country's financial inclusion, reduce the regulatory burden on the private sector, and support economic activities in rural areas.

The CPF envisaged the IBRD indicative financing program for FY2016-2017 in the range of US$300-500 million per annum. Lending volume and composition of projects for outer years would depend on country demand, global economic developments, and portfolio performance as well as IBRD's lending capacity and demand from other borrowers. The indicative lending program for FY16 included five projects, of which only two – the Third Highway Additional Financing and the IDPs Livelihood Additional Financing have been approved the Bank's Board of Directors in FY16. Due to the impact of the sharp drop of oil prices and deterioration of the overall economic situation, the originally planned program for FY16-17 has been revisited following to the client's request.

As of June 2016, the IBRD investment portfolio comprised of fifteen projects under implementation with a total commitment of US$2.185 million, of which US$1.28 million or 58 percent of total commitment has been disbursed. By the end of FY16, five projects will exit the portfolio including the last three IDA projects, leaving the operations entirely with under IBRD going forward. The transport sector dominates the Bank financing, amounting to 50 percent of net commitments. Along with investments in the reconstruction of the road network, the Bank supports a major institutional reform of the motorway operation and maintenance system. Water and sanitation make up 29 percent and 6 percent covers projects focusing on Internally Displaced Persons (IDPs) and rural investments. These projects help to improve both the physical and social infrastructure for IDPs and promote the development of more economic opportunities to contribute to greater economic self-reliance for IDPs. Other sectors include public administration, agriculture, and financial and private sector development.

In addition to IDA/IBRD operations, the portfolio consists of one active trust fund project in the amount of US$2 million – the Swiss State Secretariat for Economic Affairs (SECO) Trust Fund for Azerbaijan – in support of the Financial Sector Modernization.

Bank lending is complemented by a strong program of advisory and knowledge services to inform the country growth strategy and policy choices as well as the design of investment operations. The Bank continues to support education and health sectors through the series of analytical and TA activities as well as the preparation of the Employment Strategy through another TA activity. Extensive technical assistance has been provided to the authorities on capital markets reform, consumer protection, financial inclusion and expansion of services by Azerpost, financial literacy, and stability. The focus of the Advisory Services and Analytics (ASA) is on assessing the constraints to access to finance for non-oil enterprises in Azerbaijan in support of private sector and economic growth.

IFC's current strategy and operations in Azerbaijan, also guided by the CPF for FY2016-2020, is to support the economic competitiveness agenda and advance economic diversification, particularly in non-oil sectors. Reflecting these priorities, IFC's focus is on strengthening the financial sector, improving investment climate, and promoting good corporate governance. More efforts will be dedicated to support development of growth-enhancing infrastructure, including through pilot Public-Private Partnership projects, and to invest in competitive private companies, particularly in export-oriented sub-sectors, and the success of these efforts will largely be conditional on the opening of the infrastructure sector to private sector participation and the progress in business climate reforms to reduce regulatory burden for private businesses and encourage greater corporate transparency.

Since the beginning of its operations in Azerbaijan in 1995, IFC has provided long-term financing of about US$460 million, of which about US$70 million was mobilized from partners, to 55 private sector projects in financial sector, agribusiness, manufacturing, and infrastructure[1]. In addition, IFC has provided trade finance guarantees through local financial intermediaries that facilitated over US$80 million of trade flows. As of June 2016, IFC's active committed portfolio in Azerbaijan stood at about US$70 million.

IFC's investments have been complemented by a range of advisory projects aiming to facilitate private sector growth, which are aligned with three broad priorities: (i) *Improving the business climate* through facilitation of regulatory reforms in the areas of business inspections, licensing, transfer pricing and investment climate for the agri-business sector. Additional advisory programs will be developed to deepen the business climate reforms in the areas of trade facilitation, investment policy and investment promotion. (ii) *Expanding access to finance for businesses and individuals* by improving the financial infrastructure and regulatory environment related to private credit bureaus and secured transactions, increasing financial literacy, and assisting

[1] This amount does not include project finance of $500 million provided for the construction of Baku-Tbilisi-Ceyhan Pipeline, which in addition to Azerbaijan, also covered Georgia and Turkey.

partner banks to improve risk management, develop sustainable SME banking business, and lend to underserved segments including farmers and women entrepreneurs. Going forward, IFC will also support the development of agricultural insurance system. (iii) *Enhancing corporate transparency* by helping private companies and financial institutions to improve corporate governance practices, building capacity of local institutions on corporate governance services, training and reporting, and working with regulatory institutions to improve relevant laws and regulations.

In addition to investment and advisory services, IFC has been also working with the State Oil Fund of the Republic of Azerbaijan (SOFAZ), which has committed US$350 million to three funds managed by IFC's Asset Management Company: the IFC Global Infrastructure Fund, which invests alongside IFC in infrastructure projects in emerging markets; the IFC Catalyst Fund, which invests in funds and projects focused on low-carbon power generation, energy and water efficiency and the resource efficiency sector; and the IFC African, Latin American, and Caribbean Fund, which invests alongside IFC in equity and equity like projects in these regions. This engagement supports SOFAZ's efforts to diversify its portfolio into sustainable projects by providing access to IFC's expertise and track record in private equity as well as access to new markets.

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

(As of June 2016)

As at first quarter of 2016, the EBRD has signed a total of 161 projects with cumulative investment value of €2,459 million since initiating its operations in Azerbaijan in 1993. 44 percent of the EBRD's cumulative investments were made in the energy sector, 11 percent in the financial institutions sector, 36 percent in the infrastructure sector and 8 percent in the corporate sector.
In 2015, the EBRD invested a total of €268.8 million in 9 projects in Azerbaijan, all in the private sector, a record number for the EBRD in Azerbaijan.

Amid economic challenges in Azerbaijan, the EBRD remains committed to supporting market-driven diversification of the economy. The EBRD's focus will be on small and medium enterprises (SME) and financial sector development. The EBRD continues to support the real private sector and stands ready to do more if further reforms are implemented.

Demand for local currency lending has risen sharply since devaluation. In order to support the existing and future clients with local currency loans, the EBRD is working with the authorities on a possible manat bond issue.

The main challenges for the EBRD's current strategy period (2014-17) in Azerbaijan are as follows:

- promoting market-driven diversification;
- developing a sustainable financial sector to support private sector development; and,
- improving corporate governance and transparency to promote competition and address distortions in the non-oil, non-financial sectors.

The pipeline for 2016 is strong, with the potential ABI of around €1 billion in natural resources (Southern Gas Corridor project), transport sector, municipal and environmental infrastructure and mainly restructuring projects in agribusiness, manufacturing and services.

Azerbaijan will become an important source of gas for the European Union in the next few years. EBRD involvement in strategically important hydrocarbons projects such as Shah Deniz helps to ensure that Azerbaijani SMEs benefit as suppliers and contractors on large projects and that the economy as a whole gains from improved governance and transparency which such projects require. The EBRD has provided two loans to Lukoil, a 10 percent consortium member for Shah Deniz phase I and a syndicated loan for Shah Deniz Phase II, also to Lukoil (EBRD A Loan US$250 million). The EBRD was approached to finance the Southern Gas Corridor to deliver the gas via Turkey and Greece to Italy.

The Institutional Investment Partnership Programme is in late stage negotiations with the State Oil Fund of the Azerbaijan Republic (SOFAZ) to become a limited partner in the EBRD's first Equity Participation Fund.

The pipeline for the rest of 2016 is dominated by two large transactions: the second tranche of the regional roads program and a further loan for phase one of the Shah Deniz off-shore gas field. Other core transactions are shared equally between industry, commerce and agribusiness (ICA) and financial institutions (FI) sectors, reflecting a healthy balance of opportunities in the developing private sector.

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RELATIONS WITH THE ASIAN DEVELOPMENT BANK (ADB)

(As of June 2016)

The ADB has provided extensive assistance to Azerbaijan to strengthen its capacity. The ADB helped improve poverty analyses, prepare a strategic development plan, develop policy frameworks, streamline the management of public debt, analyze macroeconomic data, and develop medium-term policies for the rural economy. The ADB also provided advisory assistance to enhance its lending operations in selected sectors, such as water supply and sanitation, transport, and energy.

Projects supported by the ADB in Azerbaijan have seen 240,000 people protected from the effects of flooding, while about 350,000 residents of regional and rural towns have received high-quality and reliable drinking water for the first time. The ADB has helped construct approximately 200 kilometers of new and upgraded highways and rural roads, benefiting the country's entire population, and it has invested in improved power transmission to deliver energy more reliably and reduce power outages. Other ADB assistance in Azerbaijan has helped raise the living conditions of hundreds internally displaced families, rehabilitated several schools, and provided small loans to those displaced, many of whom are women.

ADB's assistance to improve Azerbaijan's transport and energy infrastructure will increase the economy's efficiency and competitiveness. It will also boost the country's connectivity within the Central Asia Regional Economic Cooperation (CAREC) region and beyond. The ADB continues to assist with the development of modern urban infrastructure and services across the country, which will provide a platform for a more diversified economy and improve living conditions. Technical support to improve solid waste management and develop renewable energy sources will improve the urban environment and quality of life in Azerbaijan's regional cities and rural towns. The ADB is also working to further enhance the country's power distribution network and ensure stable power supply to households and industry.

As of June 16 2016, cumulative public sector loan commitments to Azerbaijan amounted to about US$2.32 billion, of which about US$1.29 billion has been disbursed. Commitments cover 26 public sector loan operations in agriculture and natural resources, health, finance, transport, energy, and water supply and sanitation. These loans were complemented with 32 technical assistance (TA) projects amounting to about US$22.0 million. Since 2014 Azerbaijan is eligible for the ordinary capital resources (OCR) only.

Non-sovereign operations

As a catalyst for private investments, the ADB provides direct financial assistance to non-sovereign public sector and private sector transactions in the form of direct loans, equity investments, guarantees, B loans, and trade finance. Since its inception, the ADB has approved US$738 million in non-sovereign financing for 10 private sector transactions in Azerbaijan. In 2015, the ADB approved a direct loan of US$250 million and US$225 million in B loans to construct offshore gas production platforms as well as subsea wells and pipelines, and to expand an onshore gas-processing terminal. Gas extracted from the second stage development of the Shah Deniz gas field will be delivered to Europe via the Southern Gas Corridor.

The ADB's Trade Finance Program (TFP) fills market gaps by providing guarantees and loans through partner banks in support of trade. In Azerbaijan, the TFP works with one bank and has supported US$43.8 million in trade for 54 transactions. In addition to filling market gaps, the TFP's objective is to mobilize private sector capital and involvement in developing Asia. In Azerbaijan, 9.1 percent of trade supported through the TFP was co-financed by the private sector.

Co-financing

Co-financing operations enable ADB's financing partners, governments or their agencies, multilateral financing institutions, and commercial organizations, to participate in financing ADB projects. The additional funds are provided in the form of official loans and grants, technical assistance, other concessional co-financing, and commercial co-financing such as B loans, risk transfer arrangements, parallel loans and equity, guarantee co-financing, and co-financing for transactions under ADB's TFP.

By the end of 2015, cumulative direct value-added (DVA) official co-financing for Azerbaijan amounted to US$2.5 million for one investment project and US$2.7 million for six technical assistance projects. Cumulative DVA commercial co-financing for Azerbaijan amounted to US$802.3 million for five investment projects. A summary of projects with co-financing from January 1, 2011 to December 31, 2015 is available at www.adb.org/countries/azerbaijan/cofinancing.

Partnerships

As well as collaborating closely with the Government of Azerbaijan and its agencies, the ADB plays an important role in fostering the country's membership in CAREC. The ADB facilitates partnerships and encourages dialogue between Azerbaijan and other CAREC countries on issues of transport, energy, trade negotiation, and policy development.

The ADB also collaborates with other multilateral and bilateral development partners, such as the European Bank for Reconstruction and Development, KfW, the Islamic Development Bank, the Japan International Cooperation Agency, the Korean International Cooperation Agency, the State Secretariat for Economic Affairs of Switzerland, the United Nations agencies (including UNIDO, UNICEF and the FAO), and the World Bank.

The ADB works with civil society organizations in Azerbaijan to strengthen the effectiveness, quality, and sustainability of its assistance, while also providing guest lecturers and specialist spokespeople to the country's leading universities and media outlets.

Procurement

- ***Share of ADB's Procurement Contracts***

Each year, the ADB provides loans, grants, and technical assistance to fund projects and activities in its developing member countries, and several billion dollars in contracts to procure goods, works, and consulting services. Most contracts were awarded on the basis of international competition, which is open to firms and individuals from any ADB member, regional or nonregional.

Procurement contracts for goods, works, and related services under loan and grant operations totaled $8.4 billion in 2014 and US$11.12 billion in 2015. Cumulative procurement, as of December 31 2015, was US$145.92 billion.

Procurement contracts for consulting services under loan, grant, and technical assistance operations totaled US$556.05 million in 2014 and US$637.4 million in 2015. Cumulative procurement, as of December 31 2015, was US$10.64 billion.

- ***Goods, Works, and Related Services***

From January 1, 1966 to December 31, 2015, contractors and suppliers were involved in 199,625 contracts for goods, works, and related services under ADB loan and grant projects worth US$145.92 billion. 107 contracts were awarded to contractors and suppliers from Azerbaijan worth US$915.46 million.

- ***Consulting Services***

From January 1, 1966 to December 31, 2015, consultants were involved in 48,767 contracts for consulting services under ADB loan, grant, and technical assistance projects worth US$10.64 billion. 102 contracts were awarded to consultants from Azerbaijan worth US$22.18 million.

Future direction

Development priorities for Azerbaijan in the short to medium term will include projects in transport, energy, water and other urban infrastructure services as well as private sector development. The ADB will support the construction of transport corridors, providing linkages with neighboring countries and expanding opportunities for rural communities. ADB's assistance will help expand the electricity network, and to improve energy efficiency by enhancing power distribution and integrating renewable energy sources. The ADB will provide financing over construction of Shah Deniz Stage II gas developing project to expand production and processing and, diversify regional energy sources. Upgrades to urban infrastructure and services—including public transport, water supply and sanitation, and solid waste management in regional towns and peri-urban areas—will be a priority. Assistance to education sector will help increase level of technical and vocation education, increase supply of skilled labor and provide support to the transition to 12-year education system. The ADB will also leverage in-country expertise to produce and distribute knowledge products and services in Azerbaijan. The ADB will promote regional cooperation, governance and capacity development, environmental sustainability, and the mitigation of climate change. Private sector opportunities will continue to be explored to further diversify the economy, and to help private enterprise play a greater role in industry, trade, small and medium-sized enterprises, and infrastructure.

Azerbaijan and the ADB

ADB Membership:	Joined in 1999
Shareholding and Voting Power	
Number of shares held:	47,208 (0.445% of total shares)
Votes:	86,772 (0.655% of total membership, 1.004% of total regional membership)
Overall capital subscription:	$654.71 million
Paid-in capital subscription:	$32.81 million

ADB Contacts:

The Azerbaijan government agency handling ADB affairs is the Ministry of Finance.

Mathew Fox is the Director and **Richard Sisson** is the Alternate Director representing Azerbaijan on the ADB Board of Directors.

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STATISTICAL ISSUES

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, government finance statistics and external sector statistics. With the exception of government finance statistics, STA has provided extensive technical assistance and recommendations in these areas.

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

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 most recent national accounts mission took place in Baku in May 2014 at the request of the State Statistical Committee (SSC). The mission identified the following problems: (i) the staff of the National Accounts and Macroeconomic Statistics Department (NAMSD) is not familiar with the Quarterly National Accounts (QNA) techniques. These techniques are totally different from the procedures used in the existing monthly system. Unfortunately, there are insufficient staff resources dedicated to national accounts (handled by the Deputy Head of the division and one other staff member, both of whom are also engaged in other activities); (ii) there are significant problems with the estimates of agriculture, manufacturing and energy. In particular, the volumes of agriculture have increased significantly faster than the existing annual estimates. The SSC has been investigating these industries' issues, but has not yet fully resolved the problems; (iii) there are inconsistencies between the annual and quarterly estimates for public administration and the construction industry. Additionally, the benchmark indicator ratios for the construction industry are extremely erratic over all years. There is no obvious reason for this, so the mission recommended that the NAMSD investigate the figures with the data providers; (iv) the treatment of oil production in the industrial production index is not in line with that in the national accounts; (v) the SSC does not have sufficient information to make reliable estimates of remittances from domestic residents working abroad; and (vi) there are no estimates of informal sector activity.

Price Statistics

In 2010, the CPI was revised to update the consumption basket (561 items) and expenditure weights that reflect recent consumption patterns. Prices are collected from 54 geographic areas and disseminated at the national and regional level (nine regional indexes). CPI metadata lack sufficient detail and should be augmented. There is need to expand CPI coverage to include housing (rentals and owner occupied) and to develop a residential property price index.

The SSC compiles a number of producer price indices (PPI) covering agriculture, fishing, forestry, mining, manufacturing, utilities, transportation, postal and communication services, and construction. Ideally, the SSC should compile and release a total out-put PPI that includes all activities. Finally, export and import price indices (XMPI) are also compiled and released. Metadata describing PPI and XMPI lack detail and should be augmented.

B. Fiscal Sector

The Ministry of Finance has worked recently on the delineation of government and built limited capacity on Government Finance Statistics (GFS) compilation and reporting. This has enabled the authorities to report annual general government data according to the methodology of the Government Finance Statistics Manual 2001 (GFSM 2001) for inclusion in the GFS Yearbook. However, the stock positions in assets and liabilities have yet to be reported. The compilation of longer time series, including sub-annual series, to support surveillance and fiscal analysis and policy making, is also needed. While further work is required to improve the source data for the compilation of these statistics, the present level of development of budgetary accounting and reporting system, makes it possible a preliminary compilation and dissemination of the GFS on a quarterly basis.

To address the fiscal reporting issues, Azerbaijan will participate in a new STA's three-year regional project to build capacity and improve GFS reporting to be used for fiscal analysis, policy making, and Fund surveillance. STA will assist the authorities to move to the updated GFSM 2014 methodology, strengthen reporting of financial transactions and begin reporting balance sheet positions in assets and liabilities. It is excepted that by the end of the project, Azerbaijan will make progress on the requirements to subscribe to the Fund's Special Data Dissemination Standard (SDDS) and starts reporting to the World Bank's Quarterly Public Sector Debt Database (QPSD), which will enhance fiscal transparency and fiscal risk assessment.

C. Monetary Sector

The CBA compiles monetary statistics according to the methodology of the *Monetary and Financial Statistics Manual*. The CBA reports monetary *data* to STA for the central bank and the other depositary corporations, which includes commercial banks. The authorities report monetary data within three weeks after the end of the reference month, via Standardized Report Forms. Monetary data have also been included in the *International Financial Statistics (IFS)*publication since December 2006.

D. Financial Sector

The authorities do not report financial soundness indicators (FSIs) to STA for the Fund's publications. The authorities were encouraged to report FSI data and metadata. Countries participating in the FSI submission are expected to compile 12 core FSIs on deposit takers and 28 additional indicators on other financial corporations, nonfinancial corporations, households, and real estate markets.

E. External Sector

Azerbaijan's balance of payments (BOP) statistics are compiled and disseminated by the CBA and are broadly in accordance with the sixth edition of the *Balance of Payments Manual (BPM6).* The CBA has also 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.

The CBA benefited from the TA provided by a regional advisor in ESS stationed in Baku during November 2006-November 2008, and by missions conducted in 2009 and 2012. The missions found that appropriate statistical legislation to assign responsibilities for compilation and dissemination of IIP and gross external debt had yet to be developed. Also, lack of institutional cooperation and staff turnover affected the pace of implementation of the strategic framework for the improvement of ESS.

Against that background, Azerbaijan was one of the countries targeted by the 20-month project (November 2014-June 2016) financed by the Swiss Government (SECO) "Improvement of ESS in three Central Asian Countries – Azerbaijan, Kyrgyz Republic, and Tajikistan". Within the SECO project, three TA mission have been conducted to Azerbaijan focused on improving the methodological soundness, expanding the coverage of ESS, and bringing dissemination practices to international standards. The compilers also participated in three regional workshops which were attended by representatives from the CBA and of three other public institutions - the main data providers for ESS purposes (the State Statistical Committee, Ministry of Finance, and Customs). During the third, closing workshop, conducted in June 2016 the accomplishments of the project have been assessed and the follow-up activities for achieving a full transfer of ownership on the project's products to the authorities have been identified.

During the project, the CBA made some progress in improving the system for collecting and compiling ESS. A resolution of the Cabinet of Ministers of the Republic of Azerbaijan, adopted in April 2015, assigns responsibility to the CBRA for compiling IIP and external debt statistics. Based on the resolution, the Central Bank Law was amended, which states that the CBRA is responsible for compiling the country's external debt statistics (public and private) and IIP. Also a number of recommendations of TA missions were implemented, in particular: agreements were reached regarding the provision of information by a number of large enterprises and consortiums from the oil and gas sector; the State

Statistical Committee (SSC) implemented a comprehensive survey form on the foreign economic activity of enterprises; work is being completed on the implementation of closed international transactions reporting system; and a number of technical issues concerning the ESS have been implemented. In addition, the first draft of the quarterly IIP and gross external debt statistics for all institutional sectors have been compiled that are yet to be approved by the authorities and disseminated

The most recent external sector mission visited Baku in April 2016. Despite the progress achieved during the TA project (comprised of 3 missions: May 2015, November 2015 and April 2016), there are still many deficiencies in the balance of payments compilation. For instance, significant under-coverage has been identified in balance of payments components such as trade in goods and services (specifically in import of goods), investment income (including reinvested earnings), and some financial account components (like debt liabilities within the direct investment, debt securities in portfolio investment, and loan liabilities for other sectors). A number of methodological inconsistencies have also been identified in estimating assets in trade credit and advances; currency and deposits for other sectors; and reserve assets. These shortcomings affect a number of indicators used for assessing the country's performance such as debt sustainability and reserve assets adequacy.

There is need to take decisive measures for compiling and disseminating the IIP and external debt statistics. The TA missions assisted in compiling the draft IIP and external debt statements but the methodological inconsistencies mentioned above in estimating some financial account components lead to the accumulation of unrealistic stocks for those components in the IIP. In order to address the inconsistencies between balance of payments and the IIP, revising the estimation techniques and addressing the identified classification issues is required. However, compilers are reluctant to conduct such revisions and classification changes.

The main challenge in implementing the recommended actions during the project changes to the ESS includes gaining high-level national officials' support for implementing the new international standards, and allowing the use of new data sources and estimation techniques that, in some instances, may result in the revised ESS indicators portraying trends less favorable than the previous data vintage.

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.

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

Azerbaijan: Table of Common Indicators Required for Surveillance

(As of August 12, 2016)

	Date of latest observation	Date received	Frequency of data[6]	Frequency of reporting[6]	Frequency of publication[6]	Memo Items: Data Quality – *Methodological soundness*[7]	*Data Quality Accuracy and reliability*[8]
Exchange Rates	05/2016	06/06/2016	D	D	M		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	07/2016	08/04/2016	M	M	M		
Reserve/Base Money	06/2016	08/04/2016	M	M	M		
Broad Money	06/2016	08/04/2016	M	M	M	O, O, O, O	O, O, O, O, LO
Central Bank Balance Sheet	06/2016	08/04/2016	M	M	M		
Consolidated Balance Sheet of the Banking System	06/2016	08/04/2016	M	M	M		
Interest Rates[2]	06/2016	08/01/2016	M	M	M		
Consumer Price Index	06/2016	07/12/2016	M	M	M	O, O, O, O	O, LO, O, O, O
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	06/2016	06/16/2016	Q	Q	Q		
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	06/2016	06/16/2016	M	M	M		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	06/2016	06/16/2016	A	A	A		
External Current Account Balance	Q1/2016	06/16/2016	Q	Q	Q		
Exports and Imports of Goods and Services	Q1/2016	06/16/2016	Q	Q	Q		
GDP/GNP	Q4/2014	05/27/2015	Q	Q	M	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.