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REPUBLIC OF AZERBAIJAN

2014 ARTICLE IV CONSULTATION—STAFF REPORT; PRESS RELEASE

June 2014

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 2014 Article IV consultation with Azerbaijan, the following documents have been released and are included in this package:

- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on a lapse of time basis, following discussions that ended on March 17, 2014, with the officials of the Republic of Azerbaijan on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on May 13, 2014.
- An **Informational Annex** prepared by the IMF
- A **Press Release**

The following document has been or will be separately released.

Selected Issues Paper

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INTERNATIONAL MONETARY FUND

REPUBLIC OF AZERBAIJAN

STAFF REPORT FOR THE 2014 ARTICLE IV CONSULTATION

May 13 , 2014

KEY ISSUES

Context

Economic activity accelerated in 2013 as oil output stabilized while non-oil growth continued at close to 10 percent. Inflation remained low and the external position strengthened further. President Aliyev won a third term in the October election. Favorable economic prospects and large buffers provide an opportune environment to speed up reforms.

Focus of consultation and recommendations

In an environment of high oil prices but with a relatively short oil production horizon, the overarching challenge for Azerbaijan remains bringing fiscal policy to a sustainable position while accelerating structural reforms to foster broad-based private sector-led growth. Staff recommends:

- Pursuing a growth-friendly fiscal consolidation strategy by cutting investment projects with small growth returns and advancing decisive reforms to improve the business environment and thereby create opportunities for private investment;
- Maintaining monetary policy in a neutral stance while improving the transmission mechanism and taking steps to enable greater exchange rate flexibility in the medium term; and
- Fostering private sector–led growth in the non-oil sector by ensuring financial stability, promoting the deepening of financial markets, strengthening governance, and removing barriers to competition and trade.

Previous Consultation

During the 2013 Article IV Consultation, Directors encouraged the authorities to: (i) undertake a moderate front-loaded fiscal consolidation based on a rules-based fiscal framework; (ii) discontinue the Central Bank's direct lending to the real economy; (iii) strengthen the supervisory framework and adopt prudential measures to contain the growth of consumer credit; and (iv) advance ambitious structural reforms to reduce barriers to trade and competition. Since then, the authorities have signaled a change in the course of economic policies by approving a budget for 2014 that contains government spending, unwinding part of the central bank's directed lending to the real sector, and adopting measures to rein in consumer credit. 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 Mark Flanagan (SPR)

Discussions were held in Baku on March 4 – March 17, 2014. The staff team comprised R. Almarzoqi (head), M. Albino-War, B. Quillin, S. Ben Naceur (all MCD), and E. Akçakoca (MCM Expert). D. Heller and. S. Mirzayev (OED) joined some of the meetings. The mission met with the Minister of Finance, the Chairman of the Central Bank of Azerbaijan (CBA), other senior officials, and representatives of the private sector, civil society, and the diplomatic community. S. Salimi and R. Selim assisted in the preparation of this report.

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BACKGROUND AND CONTEXT

1. **Since the last consultation in early 2013, the government has succeeded in concluding historic agreements in the gas sector and in tapping the international financial markets.** The agreements extend cooperation with a BP-led consortium over the next 40 years and enable the implementation of the Shah Deniz-2 gas project, including the construction of pipelines to facilitate the delivery of Azeri gas to Europe beyond 2018. These positive developments in the gas sector along with the strong external position of the country paved the way for the issuance of a debut Eurobond by the Azerbaijani government last March, which was well received by investors amid market turbulence in the region.

2. **Notwithstanding these achievements, the overarching challenge for Azerbaijan remains to reduce its heavy dependence on the oil and gas sectors while fostering sustainable private sector–led growth**. Diversification is a priority given the relatively short horizon of oil reserves and the fact that the wealth associated with gas discoveries is estimated at about one-third of the oil wealth.[1] A more broad-based growth strategy will also help sustain the rapid decline in poverty and inequality since the early 2000s.[2]

RECENT DEVELOPMENTS, OUTLOOK, AND RISKS

3. **Recent developments and near-term economic prospects are favorable (see panel charts):** [3]

- The growth of **non-oil GDP** reached almost 10 percent in 2013 supported by high public spending and a rapid increase in consumer loans. Non-oil GDP growth will remain strong albeit somewhat slower in 2014–15, mostly reflecting the recently announced fiscal consolidation process. **Oil output** is likely to be flat for a number of years following the stabilization in 2013 that ended two consecutive years of decline.

[1] Currently, the shares of oil and gas in total exports are 87 percent and 7 percent, respectively. These shares could become 60 percent and 30 percent as Azerbaijan reaches the peak of gas production for delivery to Europe before 2020. The reserves to production ratio for oil and gas are 22 years and 57 years, respectively, according to the 2013 British Petroleum *Statistical Review of World Energy*. Major reasons behind the depletion of oil reserves are the age of the oil fields and limited investment in the oil sector.

[2] For a discussion of the marked decrease in the poverty rate (including gains in employment, wages and productivity, and social transfers), see "The Inclusiveness of Azerbaijan's Growth" in IMF Country Report 12/05 (Box 2) and 12/06 (Chapter 1).

[3] In the remaining part of this report, oil refers to oil and gas, except when gas is discussed explicitly.

- **Inflation** increased slightly to 2.4 percent in 2013, on the back of adjustments to the regulated price for petroleum products toward the end of the year.[4] Though the output gap turned positive in 2013, inflation is projected to remain in low single-digit levels during 2014–15, mainly on the back of the fiscal consolidation.

- The de facto exchange rate regime is classified as a stabilized arrangement and is the key anchor for monetary policy. The **manat exchange rate** has appreciated by less than 2 percent relative to the U.S. dollar since November 2010. The impact of depreciation pressures in a number of neighboring countries has been limited, with few signs of lower manat demand or capital flight. Moreover, the CBA has continued to intervene to prevent appreciation of the manat since the beginning of this year, increasing reserves by about $0.5 billion in the first quarter of 2014.

- **Fiscal policy.** Preliminary information suggests that the 2013 non-oil primary deficit in percent of non-oil GDP remained at 2012 levels at about 45 percent, but still well above the 35 percent sustainability level implied by the permanent income rule under a conservative scenario of oil and gas production.[5] The deficit would have been even larger had it not been for spending restraint towards the end of 2013 and some under-execution of spending at the state budget level and, particularly, on investments financed by the oil fund outside the budget. The spending restraint helped reduce the break-even fiscal oil price slightly to $77 dollars per barrel. Parliament approved a consolidated budget for 2014 that lowers the government-spending-to-GDP ratio and implies a decline in the non-oil fiscal deficit by about 2 percent of non-oil GDP. The overall fiscal surplus declined to 1 percent of GDP, on flat revenues, but this allowed the oil fund to continue to grow (its size now stands at 48 percent of GDP).

- **Monetary policy.** The Central Bank of Azerbaijan (CBA) kept the refinancing rate steady between February 2013 and end-April 2014, when it lowered the rate by 50 basis points to 4.25 percent and decreased the lower and upper limits of the interest rate corridor by 50–100 basis points (setting the floor at 0.5 percent and the ceiling at 6 percent). In August 2013, the CBA prompted a reduction in lending rates by cutting the interest rate ceiling of the Azerbaijan Deposit Insurance Fund (ADIF) from 12 percent to 10 percent. Following this reduction, private sector credit accelerated while remaining highly concentrated in personal loans. The CBA though has followed through with plans to stop lending to the real economy.

[4] The Tariff Council increased the prices of petrol, diesel fuel and some other petroleum products by 30 percent on average. This is the first adjustment to these prices since December 2007. The International Energy Agency (IEA) ranked Azerbaijan as one of the oil exporting countries in the world with lowest energy consumption subsidies in 2012 (about 3 percent of GDP).

[5] See IMF Country Reports 13/164 and 13/165 for an application of the FAD fiscal module of the Resource-rich Developing Countries Framework to Azerbaijan.

Azerbaijan: Banking Sector Excluding IBA—Financial Soundness

(In percent)

	2011	2012	2013
1. Regulatory Capital to Risk-Weighted Assets	21.0	19.9	21.6
2. Liquid Assets to Total Assets	17.4	15.0	13.2
3. Nonperforming Loans to Total Loans 1/	5.4	5.6	4.5
4. Bank Return on Assets	1.3	0.7	2.0
5. Bank Return on Equity	7.7	4.9	11.4

Source: Central Bank of Azerbaijan.

1/ Disclosed NPLs are somewhat underestimated, as only the overdue portion of principal and interest is disclosed as NPL.

- Several financial indicators of the **banking system** excluding the largely state-owned International Bank of Azerbaijan (IBA) improved in 2013. The capital ratio increased to 21.6 percent boosted by a fivefold increase in banks' minimum regulatory capital requirement. Though liquidity declined, bank profitability also improved on the back of the recent consumer lending boom. Disclosed nonperforming loans (NPLs) as a percentage of total loans decreased slightly to 4.5 percent, despite the rapid increase in consumer loans, reflecting the write-off of fully provisioned loans. NPL figures, though, only include the overdue portion of principal and interest, suggesting that NPLs are higher.

- Recent changes in **the regulatory framework of the banking system** include measures to tighten consumer loans and strengthen the provisioning rules and requirements for the accurate classification of NPLs.[6] The CBA also extended the deadline on the new capital requirements until January 1, 2015, giving some banks (comprising about 8 percent of total banking system assets) more time to fulfill this requirement. The largest bank, IBA, is in compliance with the capital adequacy ratio.[7] But as the financial position of IBA remains fragile, the shareholders' assembly decided to increase the bank's statutory capital over the next four years, even in the absence of clear plans for the restructuring of the bank. This increase will bring an additional burden of about $300 million (about 0.5 percent of GDP) on the government, which may double if the other (private) shareholders do not participate in the increase.

4. **The baseline scenario reflects the authorities' plans to sustain the recent change in the course of economic policies and tackle fiscal vulnerabilities over the medium term.** The government's plans to rein in spending, particularly in the public investment program, would enable a decline in the non-oil primary deficit to non-oil GDP ratio to the sustainable level of 35 percent by 2019. Over the medium term, non-oil GDP growth could be in the 5 percent range, if it is underpinned by fiscal consolidation and supported by non-oil foreign direct investment (FDI).

[6] In particular, the CBA tightened consumer loan extension procedures and limited the loan-to-value of car loans.

[7] For a discussion on IBA issues see IMF Country Report 12/05.

Azerbaijan: Selected Economic and Financial Indicators, 2012–19

	Est.			Proj.				
	2012	2013	2014 2/	2015	2016	2017	2018	2019
Current Policies Scenario								
(Annual percentage change)								
Overall GDP	2.2	5.8	5.0	4.6	3.5	3.2	4.0	4.2
Non-oil GDP	9.6	9.9	8.3	7.5	5.5	5.0	5.0	5.0
Consumer price index (period average)	1.0	2.4	3.5	4.0	4.3	5.0	4.9	5.0
(In percent of GDP, unless otherwise specified)								
Overall fiscal balance	4.9	1.0	0.3	-3.1	-4.8	-6.3	-6.6	-6.4
Non-oil primary balance 1/	-45.4	-45.0	-43.2	-41.8	-40.4	-38.3	-36.9	-34.2
Current account balance	21.8	19.7	15.0	9.9	5.6	5.5	5.0	4.6
Oil Fund Assets (in billions of U.S. dollars)	34.1	35.4	37.7	38.5	37.6	34.7	30.4	28.8

Sources: Azerbaijani authorities; and Fund staff estimates and projections.
1/ In percent of non-oil GDP.
2/ Based on the 2014 approved budget.

5. **Azerbaijan's external position is strong.** External buffers, namely the CBA reserves and the oil fund, now amount to about 33 months of import cover and provide strong support to the peg. The current account surplus is high and sovereign foreign assets are expected to reach $55 billion, or 64 percent of overall GDP, by 2015. These assets are projected to decline to about 40 percent of GDP by 2019 as the oil fund engages in the financing of some energy-related projects of strategic importance. Although the planned fiscal consolidation would tend to increase the current account surplus over the medium term, the dominating influence is expected to be a decline in oil exports, as oil prices soften and production begins to tail off. Staff projections assume moderate returns from the energy-related projects given the inherent uncertainty, but further investment in the oil sector could keep revenues higher than in the baseline scenario.

6. **Against this backdrop, which implies a lower underlying current account, there is no conclusive evidence of exchange rate misalignment (Box 1)**. The fact that Azerbaijan has been able to broadly maintain its share in global non-hydrocarbon exports also suggests that competitiveness is balanced. The authorities agreed with this assessment and stressed that improving competitiveness is a top policy priority. They saw public spending on infrastructure as critical to easing physical constraints on the business climate and improving the productivity of private investment.

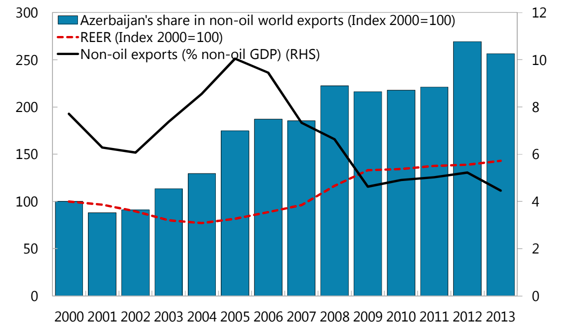
7. Risks to the baseline scenario are tilted to the downside but financial buffers are comfortable (Annex 1). Slippages in the fiscal adjustment and further deterioration of IBA would undermine prospects for reducing vulnerabilities and fostering sustainable growth. A disruption in oil production or a sustained decline in global oil prices associated with a potential deterioration in the global outlook and emerging markets could expose fiscal vulnerabilities.[8] Sharply slower growth in Russia would have, however, a relatively small impact. Azerbaijan's direct real linkages to Russia have substantially declined over the past decade, following the oil boom. The impact of the tapering of the quantitative easing of monetary policy in the United States on Azerbaijan should also be limited, given the low reliance on external savings and capital inflows (Box 2). While the authorities have room to use financial buffers if such risks materialize, strengthening the non-oil fiscal position and tightening financial supervision will also be crucial to help mitigate the impact of future shocks. The potential for higher oil prices is also possible given the risks of gas supply disruptions resulting from the geopolitical situation in Ukraine and the Middle East.

8. The authorities broadly agreed with the general assessment of risks to the medium-term outlook but did not rule out the near-term possibility of some inflows of capital from Azeris living in Russia if the situation deteriorates considerably. On the oil production time horizon, they mentioned that new wells and ongoing discussions on a possible extension of the production sharing agreement between the BP-led consortium and the government could help slow the decline in oil output. The authorities also downplayed the risks of the considerable softening of oil prices, given the trend of oil prices in recent years and geopolitical considerations going forward (if the level of oil prices over the last three years is maintained over the medium term, sovereign government assets could be near 55 percent of GDP by 2019).

[8] A 12 percent decline in the assumption for oil production in 2014 (about 100,000 barrels per day) could worsen the consolidated fiscal balance by 5 percentage points of GDP and, in the absence of spending adjustment, would result in a withdrawal of oil fund reserves by $4 billion. A similar impact on the budget would arise with US$20 decline in the oil price. The probability of such event this year is not small as pointed out by the analysis conducted by the IMF research department in the context of the 2014 Spring World Economic Outlook.

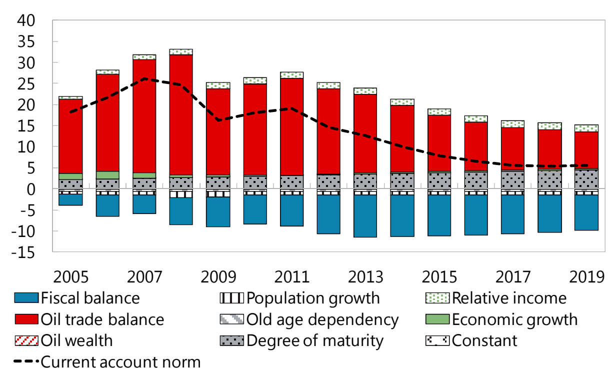
Box 1. Azerbaijan: Exchange Rate, External Stability, and Competitiveness Assessment

The manat real effective exchange rate (REER) appreciated during the oil boom years of 2004–8 though it has since stabilized, and there is no conclusive evidence of a loss of competitiveness. Between early 2004 and late 2008—the peak of the oil boom—the REER appreciated by about 78 percent. Following a sharp drop in inflation after the global financial crisis, the REER has been broadly steady. In terms of the competitiveness of non-oil exports, the share of non-oil exports to total exports has remained broadly stable, at about 5 percent, since the end of the oil boom. However, Azerbaijan has fairly steadily increased its share in global non-oil exports.



Sources: Azerbaijani authorities; and IMF staff estimates.

The exchange rate assessment with three CGER-like methodologies provides a mixed picture. The Macroeconomic Balance (MB) approach, following the methodology set out in Beidas-Strom and Cashin (2011), suggests that with current policies, the exchange rate is broadly in line with fundamentals (slightly overvalued by two percent).[1/] This assessment is corroborated by the external stability (ES) approach, factoring in the need to stabilize the ratio of the net foreign asset position to output. However, estimating the equilibrium real exchange rate as a function of a number of medium-term fundamentals (ERER), finds a 20 percent undervaluation. The degree of undervaluation using the ERER has fluctuated between 10 and 20 percent since the beginning of the oil boom in the mid-2000s and is now at the levels observed in 2007 and 2010. This approach, however, does not incorporate diminishing oil reserves, an important fundamental, which may worsen the fit for Azerbaijan.



Sources: Azerbaijani authorities; and IMF staff estimates.

Azerbaijan : Exchange Rate Assessment

	MB 1/ 2/	ES 3/	ERER
Underlying current account	4.6	-8.6	
Current account norm	5.3	-8.9	
ER assessment, percent (-: undervalued) 1/ 4/	1.8	-0.6	-19.5

Source: IMf staff estimates and projections.

1/ Exchange rate elasticity is assumed to be 0.4.
2/ Current account as share of GDP.
3/ Non-oil current account as share of GDP.
4/ MB and ES approaches measures misallignment in 2019, ERER approach is for 2013.

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

Box 2. Azerbaijan: International Linkages and Spillovers

The oil price is the essential channel linking Azerbaijan to the global economy.[1/] With the oil boom since the mid-2000s, export-to-GDP ratios have increased and remained highly concentrated on the oil sector (94 percent of total exports in 2013). The exit from unconventional monetary policy in advanced economies along with its impact on the policy mix of most emerging market economies, will determine changes in global oil prices. A sharp slowdown in major emerging economies, for example, could reduce global GDP by 1¾ percent and oil prices by almost 20 percent.

Table 1: Openness Has Increased

(In percent of GDP)

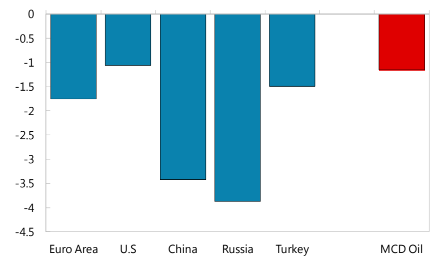
	Exports	
	1993-2002	2003-12
CCA Exporters	37	48
MENAP Exporters	37	53
Azerbaijan	36	57

Sources: National authorities; and IMF staff estimates.

Azerbaijan would share the adverse consequences of a fall in the oil price. The impact of such a shock in the GDP could be similar to the estimate for MCD oil exporters, at about 1 percent in the first year. The impact of a slowdown in emerging markets will be relatively small. Azerbaijan's non-oil export linkages to Russia and Turkey are substantial (44.6 percent and 7.5 percent respectively on average between 2007 and 2011), but total non-oil exports account only for 6 percent of total exports.

GDP Impact of Emerging Market Slowdown

(First Year, Percent change relative to baseline)

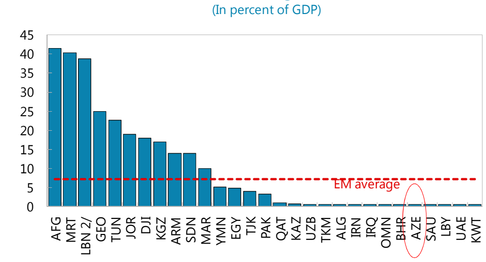


Sources: National authorities; and IMF staff calculations.

Azerbaijan's financial sector should be able to withstand moderate shocks. Azerbaijan's financing needs are generally low by international standards, given external and fiscal surpluses. Lending by global banks to Azerbaijan's financial sector is small and corporations rely mainly on their own resources. Higher global interest rates for Azerbaijan would be mostly felt through temporary changes in the book value of the oil fund—with assets close to $35.5 billion or about 50 percent of GDP in 2013, as about 40 percent of its portfolio has a maturity between one and five years, though higher rates will in general benefit the oil fund over time. Exposure of capital markets is nil given its underdevelopment. FDI, focused on the energy sector, will remain strong due to new gas developments.

Gross External Financing Needs in 2013 1/

(In percent of GDP)

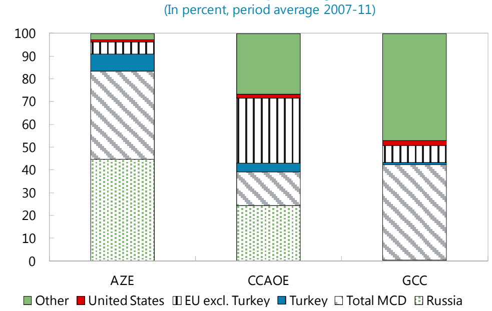


Sources: National authorities; and IMF staff calculations.
1/ Calculated as the sum of current account deficit (excluding official current transfers) and amortization scheduled, with a floor of zero.
2/ Excludes nonresident deposits.

An escalation of the Russia-Ukraine crisis will have a relatively small impact as Azerbaijan's direct real linkages to Russia have substantially declined over the past decade following the oil boom. Lower GDP growth in Russia could directly impact about less than 3 percent of total exports (or half of the total non-oil exports). The direct exposure of the financial sector is mainly through small assets of the state oil fund (SOFAZ) and the Russian subsidiary of the International Bank of Azerbaijan (IBA). Migrants' remittances originating from Russia are also relatively small.

Share of Non-oil Exports by Destination

(In percent, period average 2007-11)



Sources: UN Comtrade; and IMF staff calculations.

[1/] This box tailors the 2013 Fall MCD REO Annex 2 on International Linkages and Spillovers to Azerbaijan.

ENTRENCHING SOUND POLICIES

A. Ensuring Growth-friendly Fiscal Consolidation

9. Pursuing the planned fiscal consolidation should not significantly dampen growth and will help address fiscal vulnerabilities. While welcoming the approved 2014 consolidated budget, staff noted that sustained further efforts would be needed to bring the non-oil fiscal position to the sustainable level implied by the permanent income rule. Staff noted that with energy revenues set to sharply fall off, leading to a rising overall deficit and depletion of oil fund balances over the medium-term, it would be important not to delay the adjustment. To this end, staff advocated a cumulative reduction of about 5 percentage points in the non-oil primary deficit over 2014–15 and a further adjustment of at least 8 percentage points over 2016–19. Cutting investment projects with small growth returns as a main component of the adjustment should not hurt growth markedly as the public investment rate is well above the optimal path suggested by a precautionary saving and investment model (Box 3). Making the fiscal position sustainable could also entail rationalizing tax exemptions, better enforcing tax procedures, and to revamp non-oil tax revenue collection.[9] Efforts are also needed to streamline current spending while providing resources to expand the Targeted Social Assistance (TSA) program to help reduce the impact of shocks, including recent fuel price increases, on the most vulnerable groups.[10] Such measures should be complemented by reforms in the business environment (as discussed in section D) so that the private sector could use the freed-up financing from fiscal consolidation for growth-enhancing private investment.

10. The authorities stressed their commitment to consolidating the non-oil fiscal position. They noted their plans to further reduce the transfers from the oil fund in the context of the 2015 budget, as announced in the medium-term indicative targets presented to parliament in the context of the 2014 budget process. They also indicated that the recent agreement achieved with the World Bank and the European Commission to complete a public expenditure and financial accountability assessment (PEFA) by October 2014 will contribute to strengthen control over public spending and will help guide efforts in prioritizing and improving the efficiency of public investment. In this latter context, staff noted that along with a strong public investment management system, the selection of investments could place more emphasis on the impact of spending on the long-term growth of the non-oil export sector and fiscal revenue.

11. Staff highlighted the risks stemming from the absence of a fiscal rule given the oil revenue volatility and the unsustainable level of public investment. Additional fiscal risks are associated with the heavy oil dependence of the consolidated budget, the pension system, and

[9] For detailed discussion on options to strengthen the non-oil tax revenue see IMF Country Report 12/06 (chapter 2).

[10] The only non-contributory, means-tested safety net program is the Targeted Social Assistance (TSA) channeling about 10 percent of social transfer spending. According to the World Bank, the TSA is well targeted with about half the benefits flowing to the bottom decile of the population and less than one percent leaking to the top decile. Benefits, however, reach only about 4 percent of the population.

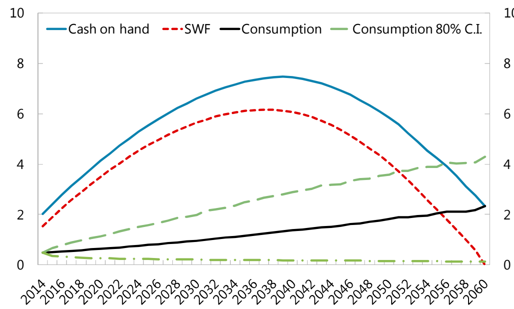
government activities outside the budget (Box 4). A rules-based fiscal framework (e.g., a structural primary balance rule with price smoothing) could help entrench fiscal discipline and mitigate the volatility of oil revenue while promoting intergenerational equity.[11] A statement of fiscal risks as part of the budget process could highlight the threats to macro stability and the government's resilient net asset position, and foster fiscal risk-reducing actions.

Box 3. Azerbaijan: In Pursuit of Optimal Fiscal Policy

The application of, the "Silo" model of Cherif and Hasanov (2012), a finite horizon precautionary saving-investment model under uncertainty, suggests that the current government consumption and investment in Azerbaijan are well above the optimal levels.[1/] The results are consistent with the application of the IMF's Sustainable Investing Tool underpinning the 2013 Article IV Consultation. The analysis stressed the need for a more moderate investment path to increase investment efficiency and sustain the growth benefits.

Average Consumption, SWF, and "Cash on Hand," 2014–60

(Wealth before consumption; expected values)



Source: IMF staff calculations.

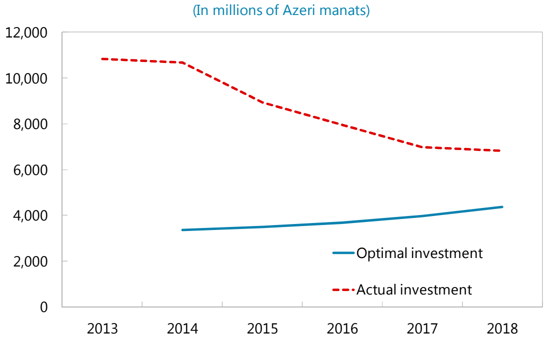
The Silo model suggests that in the face of highly volatile revenues, the optimal investment rate is 15 percent of total revenues while saving in safe assets is 37.3 percent initially. Given the expected decline in oil prices and production in the baseline, the projected current and capital spending exceed the optimal amount over the period 2014–18. The model also indicates that the Azeri government is saving less than optimal through its sovereign wealth fund.

The gap between projected and optimal investment is very large in 2014—around 20.5 percent of non-oil GDP—but it will start to shrink in 2015 to reach around 4.3 percent of non-oil GDP in 2018. The model also shows that government consumption is higher than the optimal level, and the gap is expected to widen over the period 2014–18, to reach around 7 percent of non-oil GDP) in 2018.

The results call for a rules-based fiscal policy framework that promotes fiscal discipline.

Optimal vs. Projected Investment Spending, 2013–18

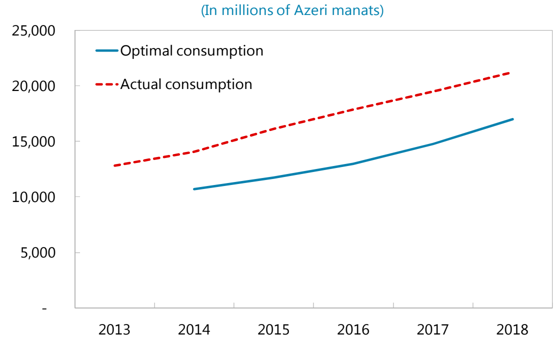
(In millions of Azeri manats)



Source: IMF staff calculations.

Optimal vs. Projected Current Spending, 2013–18

(In millions of Azeri manats)



Source: IMF staff calculations.

1/ Cherif, R. and F. Hasanov (2012), *The Volatility Trap: Precautionary Saving, Investment, and Aggregate Risk*, IMF Working Paper 12/134 (Washington: International Monetary Fund).

[11] For detailed discussion on options for fiscal policy rules in Azerbaijan see IMF Country Report 13/165 (chapter 1).

Box 4. Azerbaijan: A Framework for Managing Fiscal Risks

Sound management of fiscal risks could supplement the rules-based fiscal framework recommended to the authorities in the context of the 2013 Article IV Consultation by enforcing fiscal discipline and bringing attention to threats to macro stability and to the state's resilient net asset position.

Managing fiscal risks in Azerbaijan in line with best practices entails:[1/]

- **Identifying and quantifying key sources of fiscal risk**: there are four key sources of fiscal risks to the consolidated budget in Azerbaijan:

  Exposure to adverse oil sector developments: A US$20 decline in the oil price assumption for 2014 could worsen the fiscal balance in percent of GDP by 5 percent and entail a withdrawal of $4 billion from the oil fund. A similar impact on the budget would arise with a 12 percent decline in the assumption for oil production in 2014 (about 100,000 barrels per day).

  Implicit liabilities associated with pension obligations: Despite successive reform efforts, the funding gap of liabilities inherited from the Soviet regime is projected to increase to 2 percent of GDP by 2024. The NPV of these liabilities through 2050 was estimated by an IMF technical assistance mission in the order of 54 percent of 2012 GDP.

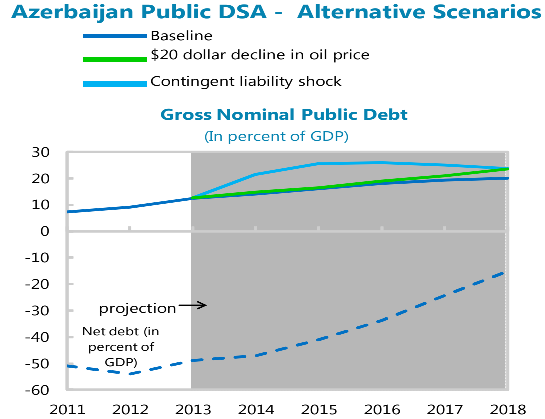
  Activities of the State Oil Company (SOCAR): Since 2008, SOCAR's net liabilities (including trade credits and excluding tax payments) have doubled, reaching about 12 percent of GDP in 2013. SOCAR successfully issued international bonds in 2012 and 2013.

  Activities of the systemic and largely state-owned bank: IBA holds about a third of the assets and loans of the banking system. IBA's financial situation remains fragile despite receiving government support. The new capitalization plan approved by the shareholders will bring an additional burden of about $300 million (about 0.5 percent of GDP) to the government over the next four years.

- **Disseminating a "Statement of Fiscal Risks" as part of the budget** to inform the fiscal policy decisions with sensitivity analysis to oil-related shocks and quantifying contingent liabilities arising from public entities.

- **Integrating fiscal risks in the fiscal analysis,** and in the medium-term fiscal framework and the public debt sustainability analysis (DSA) to prepare for the possibility that the risks may materialize. Under the assumption of a moderate level of government investment, the DSA points to an increase in the gross debt to GDP ratio from 13 percent in 2013 to 20 percent in 2018. The simulation of a contingent liability shock entailing a one-time increase in non-interest expenditures equivalent to 20 percent of banking sector assets (about half of the assets held by IBA) could add 4 percentage points of GDP to the stock of debt by 2018. The net asset position, while deteriorating, is projected to remain strong to about 20 percent of GDP by 2018.

Azerbaijan Public DSA - Alternative Scenarios



Source: IMF staff.

- **Adopting a legal framework to support the management of fiscal risks** by requiring sensitivity analysis to key assumptions and an annual statement of fiscal risk as part of the budget process.

1/ See Aliona Cebotari et. al. (2009), *Fiscal Risks: Sources, Disclosure, and Management*, Fiscal Affairs Department (Washington: International Monetary Fund). This box reflects helpful comments from A. Mineshima (FAD).

12. The authorities agreed on the need to entrench fiscal discipline. They noted that an informal fiscal rule aimed at keeping the oil fund balance broadly unchanged will help gradually reduce the reliance of the state budget on oil revenue. Ongoing actions to develop a debt management strategy for the national oil company in line with international best practice will also help contain associated risks from major investment projects. Plans are also advanced to approve a reform of the pension system this year —consistent with recent IMF Technical Assistance (TA)—that would ensure a sustainable pension system that provides a sufficient degree of income replacement.

B. Increasing the Role of Monetary Policy as Anchor for Inflation Expectations

13. Staff supported the CBA's intention to keep monetary policy in a neutral stance and welcomed recent measures to slow consumer lending. The anchor of monetary policy is the maintenance of the stabilized exchange rate arrangement. Nonetheless, with Azerbaijan's exposure to large and destabilizing capital inflows from non-government sources quite limited to date, owing to the low level of development in the financial and capital markets, there is some room for monetary policy to operate. During the mission, the CBA stated its plans—with the staff concurring—to retain a neutral stance, given expectations for stable and low inflation amid tighter fiscal policy, soft international food prices, and slowing consumer credit growth. In the event, in late April the CBA lowered the policy rate by 50 basis points, noting that the rate cut was based on low inflation expectations and the need to diversify the economy and to boost investment activity. Staff cautions the CBA against further policy rate cuts in light of risks of slippages in the fiscal consolidation, implementation problems of recent measures to slowdown consumer lending, or potential reversals in soft global food prices due to regional tensions. Indeed, monetary tightening would be warranted in case slippages in implementing the fiscal consolidation plan caused demand pressures.

14. Strengthening the interest rate transmission mechanism is a precondition to making monetary policy more effective. Staff noted that this would entail continuing with plans to scale down the CBA's direct lending to the real economy, including to non-financial public entities, with a view to discontinuing such lending on a permanent basis. Actions in line with recent IMF technical assistance, including the publication of inflation notes and balance of payments projections, along with efforts to deepen the financial markets could pave the way for the adoption of greater exchange rate flexibility over the longer term. Staff stressed that steps to improve monetary-fiscal policy coordination and develop currency risk mitigation instruments will also facilitate a move toward inflation targeting and greater exchange rate flexibility. Notwithstanding the benefits of maintaining a managed exchange rate, including by providing an anchor for monetary policy, a flexible exchange rate regime would increase policy options (e.g. to deal with potential capital inflows as financial development proceeds) and contribute to reduce inflation and output volatility.[12]

[12] For detailed discussion on exchange rate policy in Azerbaijan, see IMF Country Report 12/06 (chapter 3) and 13/165 (chapter 2).

15. The CBA plans to sustain the unwinding of its directed lending and concurred that preparing for greater exchange rate flexibility over the medium term is important to develop a more independent monetary policy. The CBA is confident that its directed lending to the real sector will continue to decline over the next couple of years. In addition, by this summer, the CBA plans to launch the implementation of an action plan to prepare for greater exchange rate flexibility over the medium term, developed on the basis of IMF TA advice.

C. Promoting a Sound Deepening of the Financial Sector

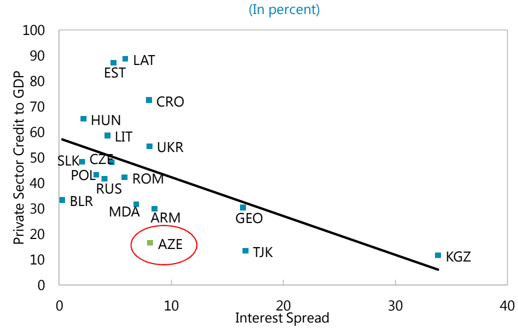
16. Staff encouraged the CBA to further strengthen banking sector regulations to ensure financial stability. Staff stressed that notwithstanding the government's strong financial position and the relatively underdeveloped banking sector, actions are needed to tackle vulnerabilities. Recent measures taken on the strengthening of provisioning rules and requiring the accurate classification of NPLs are steps in the right direction and will help ensure correct capital needs but further efforts are needed to strengthen the regulatory framework. As pointed out by recent IMF technical assistance, developing the interbank money market, reducing connected lending and exposure to single large borrowers, and discouraging banks from taking on foreign-exchange exposure to un-hedged borrowers would go a long way to increase the resilience of the system. The relatively small size of the banking system by international standards, combined with recent increases in capitalization, lessen somewhat the concerns that these foreign exchange, credit, and interest rate risks give rise to. A thorough assessment of financial stability and development aspects of the financial sector will be carried out in the upcoming 2015 FSAP update.

17. Developing the banking system requires measures by the CBA to increase competition in the banking sector. The ongoing capitalization process provides an opportunity for the CBA to encourage some consolidation in the system. This could entail reducing bureaucratic and judicial formality for mergers and acquisitions of healthier banks, introducing debt/equity swaps, and offering incentives to banks in the form of lower deposit insurance premia or tax advantages. Banks that do not meet the minimum capital requirement by the newly established deadline should be liquidated or converted into non-bank financial institutions. Restructuring the largely state-owned bank IBA so as to reduce its dominance of the sector is also a priority for achieving a more level playing field in the banking system. Actions by the CBA to increase competition in interest margins (e.g., creating a private credit bureau) and help banks reduce their costs (e.g., protecting creditors' rights) would also place the system in a better position to support private sector–led growth, particularly for SMEs, which face high costs of borrowing (Boxes 5 and 6).

Box 5. Azerbaijan: Determinants of Bank Spreads

Bank-level data on 20 commercial banks can shed light on the determinants of bank interest spreads in Azerbaijan over the period 2002–13.[1/] The application of the dealership model of Ho and Saunders, supplemented by market structure and macroeconomic environment variables, helped assess the extent to which high spreads of banks in Azerbaijan are related to bank-specific variables or to a low degree of competition, controlling for macroeconomic factors.

Financial Deepening and Interest Spread
(In percent)



Sources: Global Financial Database; and IMF staff calculations.

The analysis suggests that lowering bank interest margins would require reducing operating costs, increasing competition, consolidating the small bank segments and maintaining a stable macroeconomic environment. Specifically, *reducing operating costs* could be achieved by strengthening bank corporate governance, adopting the best banking technologies, improving staff productivity, and introducing organizational changes. *Enhancing competition* in the banking sector would need actions to downsize the IBA (either by sale of assets or by splitting it into areas of businesses), promote non-banking financial institutions and capital markets, reduce loan concentration though stricter supervision of large exposures, and improve transparency and disclosure of bank products. As small banks in Azerbaijan are operating with significant unrealized economies of scale, the authorities could *allow for market-led consolidation of smaller banks*, which will contribute to greater cost efficiency and lower interest rate spreads. Promoting *a stable macroeconomic environment* (low and stable inflation) should contribute to lower equilibrium interest rates; lowering reserve requirements is likely to reduce the cost of intermediation.

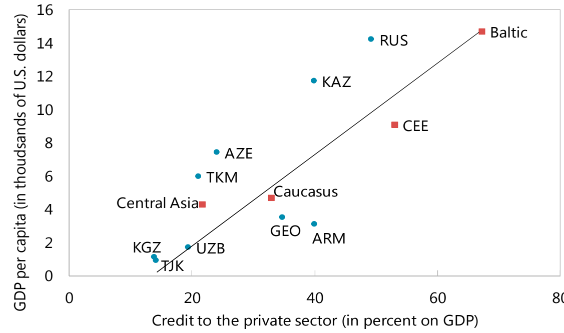
[1/] See Selected Issues Paper "Determinants of Bank Spreads in Azerbaijan".

18. The CBA noted that plans are underway to sustain the recent progress in strengthening banking sector regulations. While indicating that liquidations should not be ruled out, the CBA stressed that only a few banks may be unable to meet the new capital requirement by end-2014. The authorities also mentioned that exposures of banks to foreign exchange risks are well contained in light of the low share of external debt liabilities in bank balance sheets (below 20 percent) and did not see it possible to extend further the January 1, 2015 deadline for the minimum capital requirement. They looked forward to the upcoming FSAP, as a useful roadmap for further improvements in this area.

Box 6. Azerbaijan: Financial Development and Non-Oil Growth

The deepening of financial systems is particularly important for natural resource–exporting economies.[1/] Cross-country analyses suggest that hydrocarbo– rich developing economies (HRDCs) often have lower levels of financial development, perhaps due to weaker financial and business climate policies and institutions. Robust financial systems can support economic diversification by promoting private sector development. Moreover, the relationship between financial depth and diversification can be mutually reinforcing so that increased diversification can spur further financial development.

Credit to the Private Sector
(In percent of GDP)



Sources: National authorities; and IMF staff estimates.

Azerbaijan lags behind other transition economies in credit to the private sector and the level of deposits. Cross-country comparisons assembled by the EBRD show that Azerbaijan may be on par with other economies in Central Asia and the Caucasus in financial development, yet Azerbaijan lags other transition economies in Central and Eastern Europe and Russia by large margins.

Moreover, much of the financial sector growth experienced in the past decade or so has been in consumer credit. Growth in credit to the private sector increased from just under 5 percent of GDP in 2000 to around 13 percent in 2013. Yet, a large portion of the growth in credit came from growth in household lending which accelerated from around 9 percent of total bank lending in 2000 to around 40 percent in 2013. Mortgages have been an important component of banks' credit to consumers as these comprised about 14 percent of banks' portfolios in 2013, up from 8 percent in 2006.

Empirical tests conducted by Fund staff found that the Azerbaijan financial sector is not contributing to the development of the non-oil economy. Despite some caveats, time series regressions found that public spending is highly correlated with the growth of the non-oil economy, yet credit from the banking system was not correlated when controlling for growth in public spending and real changes in oil prices.

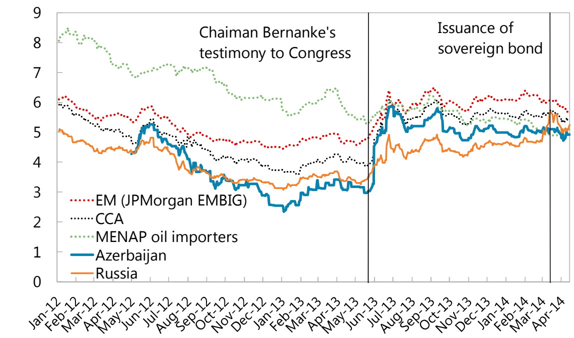
The absence of a link between finance and non-oil growth may reflect a number of factors, including the lack of adequate lending opportunities and institutional bottlenecks. Given the importance that the financial sector needs to play in supporting the growth of the non-oil economy, looking at constraints on the development of the sector, and designing a well sequenced program that supports financial development while also managing the risks that come with financial sector policy reform all require the attention of policy makers.

[1] See Selected Issues Paper "Azerbaijan: Financial Development and Non-Oil Growth".

D. Developing a Competitive Economy

19. The authorities noted ongoing efforts to improve the business climate. Azerbaijan continues to move up in the Global Competitiveness Index list and is ahead of most transition economies, owing to its strengths in the areas of macroeconomic environment and labor market efficiency.[13] In addition, the successful sovereign issuance will contribute to the development of a yield curve and support the development of the capital market and the financing of companies in the non-oil sector.[14] The authorities also mentioned the progress in tackling corruption with the implementation of initiatives such as e-government, the one-stop window, and the "easy service centers" (ASAN). As part of the anti-corruption program, the authorities are working on a legislative initiative to establish and develop a national mechanism for asset recovery, including possible amendments to the Criminal Procedural Code. In addition, the fourth assessment by MONEYVAL began in October 2013 and is ongoing. The authorities also noted they plan to conduct an AML/CFT risk assessment during 2014.

Bond Yields
(In percent)



Sources: Bloomberg.

20. While noting recent progress, staff stressed that accelerating structural reforms in governance and the business climate is critical to diversifying the economy and promoting private non-oil investment (Box 7)**.** Azerbaijan's low rank on governance-related indicators in surveys of firms carried out by the World Bank and the World Economic Forum suggests considerable scope for improving government effectiveness and widening anti-corruption efforts. Measures to put in place an effective anti-monopoly policy, including by creating an independent competition agency, will help reduce formal and informal barriers to competition. The authorities will also need to ensure that the ongoing education reform brings curricula in line with market needs and removes the existing bottlenecks in higher education to take advantage of relatively flexible labor market regulations. Such measures could help foster non-oil private investment, including FDI, particularly if combined with World Trade Organization (WTO) accession over the near term to facilitate the opening of new markets. This latter process seems to be gaining momentum following the adoption of the new customs code in line with WTO requirements and the 11th meeting of the working party in February 2014.

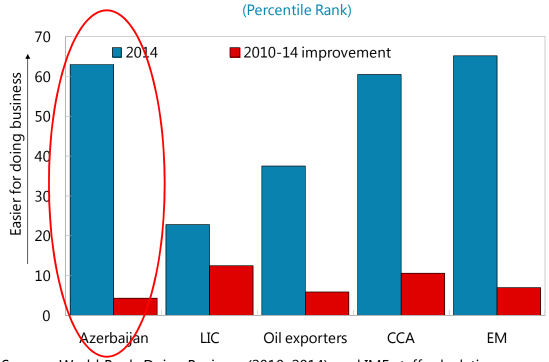
[13] See IMF Country Report 13/164 for recent amendments to the tax code aimed at providing some tax incentives to foster the non-oil sector development.

[14] Prior to March 2014, bonds from the State Oil Company of the Azerbaijan Republic (SOCAR) were the country's only benchmark-sized international bonds. SOCAR issued bonds in February 2012 and March 2013.

Box 7. Azerbaijan: Business Environment and Governance

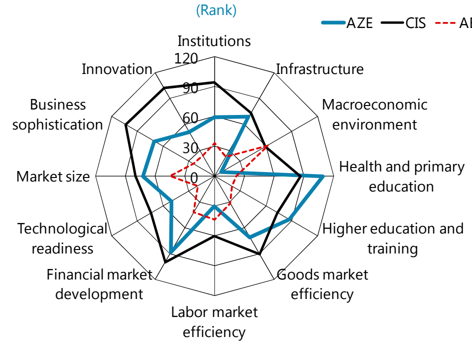
Azerbaijan continues to move quickly up the Global Competitiveness Index (within the top 40) list. But cross-country comparisons suggest that challenges posed by informal monopolies, access to finance, and corruption are still substantial. Despite some progress in tackling small-scale corruption, the country continues to rank poorly on the World Bank's governance-related indicators (in the bottom third, globally).

Ease of Doing Business
(Percentile Rank)



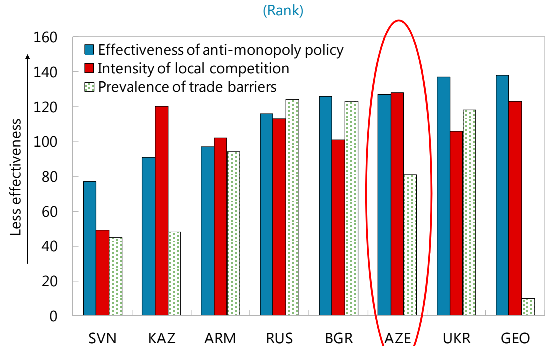
Sources: World Bank, Doing Business (2010, 2014); and IMF staff calculations.

Global Competitiveness Index
(Rank)



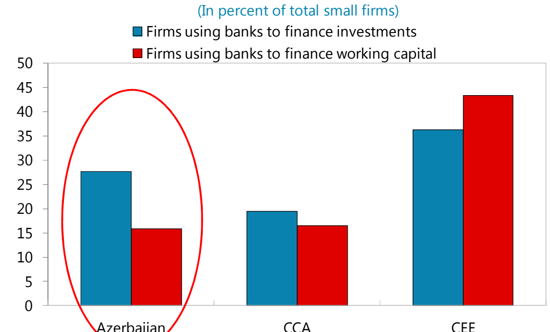
Sources: World Economic Forum, Global Competitiveness Report 2013-14; and IMF staff calculations.

Anti-Monopoly Policy Effectiveness and Trade Barriers
(Rank)



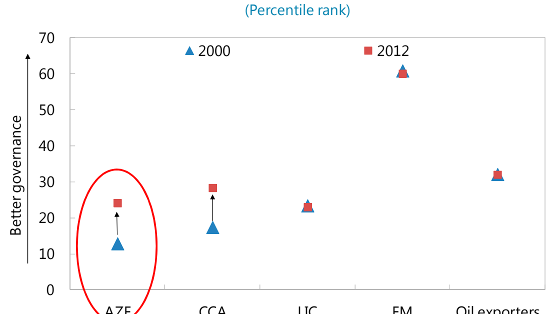
Source: World Economic Forum, Global Competitiveness Report 2013-14.

Small Firms Finance
(In percent of total small firms)



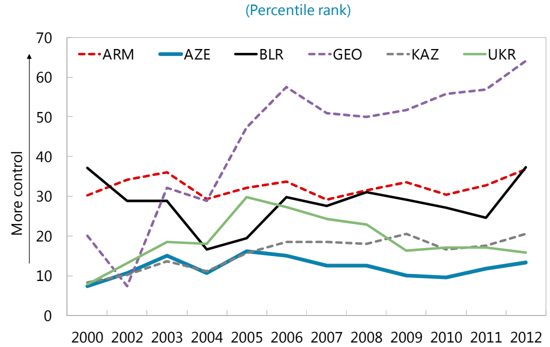
Sources: The World Bank, Enterprise Surveys (http://www.enterprisesurveys.org); and IMF staff calculations.

Change in Governance 1/
(Percentile rank)



Sources: World Bank, Worldwide Governance Indicators; and IMF staff calculations.
1/ Average of government effectiveness, regulatory quality, rule of law and control of corruption.

Control of Corruption
(Percentile rank)



Source: World Bank, Worldwide Governance Indicators.

OTHER ISSUES

Data Provision to the Fund

21. Azerbaijan's data provision to the Fund has some shortcomings but is broadly adequate for surveillance. Actions are underway to bring fiscal and external sector statistics in line with international standards. Ongoing efforts supported with IMF technical assistance will help strengthen the production of statistics, particularly for GDP, fiscal accounts, and the International Investment Position. The authorities noted that joint work by the Ministry of Finance, State Statistics Committee, and the CBA will help speed up the legislation needed for the compilation and dissemination of external debt and the IIP. The CBA thus expects to start the compilation and dissemination of International Investment Position (IIP) in coming months. Staff urged the authorities to resume the compilation and dissemination of the IIP by the CBA, as required under Article VIII, Section 5, ahead of the next Article IV Consultation.

STAFF APPRAISAL

22. The government's recent achievements provide an impetus to advance toward the goal of becoming a dynamic emerging market. Recent agreements in the gas sector will help transform Azerbaijan into a strategic gas supplier for the European market. In addition, the government's successful debut Eurobond, issued amid market turbulence in the region, is testimony of investors' confidence in the prudent management of the oil revenues as reflected in large buffers and macroeconomic stability. This vote of confidence, along with the benign environment of high oil prices, provides an opportunity to build on the recent progress in changing the course of macroeconomic policies and take decisive steps to improve governance and the business climate. Actions in these areas will be crucial to fostering sustainable and diversified private sector-led growth that will ensure a sustained improvement in living standards.

23. Continued efforts to rein in government spending are needed to reduce fiscal vulnerabilities and achieve sustainability of the non-oil fiscal position in the medium term. Staff welcomes the approved 2014 budget that contains government spending, and encourages the authorities to complement their plans to improve public investment efficiency with decisive business climate reforms to create opportunities for private investment. Moving ahead decisively with the planned reform of the pension system, along with the adoption of a rules-based fiscal framework and sound fiscal risk management, will also help safeguard the consolidation efforts and preserve fiscal sustainability over the medium term. Given the prospects of flat oil production and softer oil prices, public announcement of and strict adherence to the informal fiscal rule would help build a track record for the adoption of a formal fiscal rule.

24. The current monetary policy stance is appropriate if supported by prudent fiscal and financial sector policies. Inflationary pressures are likely to remain subdued if the authorities' plans to tighten fiscal policy and cool down consumer credit growth are fully implemented. Monetary tightening would be warranted if demand pressures arise in the event of slippages in the fiscal consolidation plan or a reversal in soft global food prices due to regional tensions. Going forward, strengthening the role of monetary policy as anchor for inflation expectations requires discontinuing the CBA's direct lending on a permanent basis and decisive progress to develop the interbank money and foreign exchange markets in line with past IMF technical assistance. These actions would facilitate a move toward inflation targeting and pave the way for adopting greater exchange rate flexibility over the medium term when the costs of the current exchange rate regime will increase as Azerbaijan further diversifies its economy and increases its financial integration.

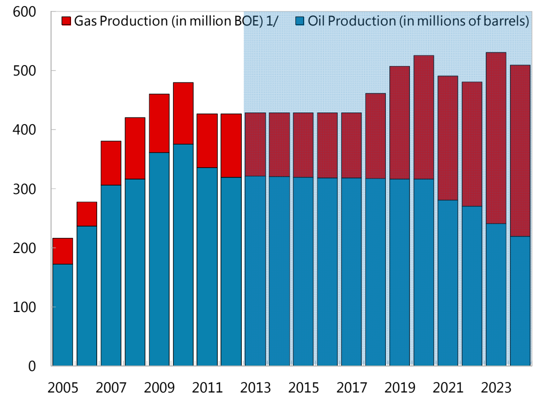
25. Enhancing the regulatory framework while promoting financial deepening is critical for the development of the non-oil economy. Recent measures by the CBA to strengthen banking regulations will help ensure correct capital needs; but increasing the resilience of the banking system also requires reducing the exposure of banks to connected lending and to un-hedged borrowers. Strengthening the banking system to facilitate a sustainable and broad-based growth led by the private sector will require actions aimed at encouraging market-led consolidation of banks without extending the new deadline to meet the capital requirement; creating a private bureau to promote competition in interest margins; protecting creditors' rights to help banks reduce their costs; and ensuring a level playing field in the banking system by further reducing the IBA's dominance in the system. Restructuring the IBA is also needed to help strengthen the monetary transmission mechanism and contain the associated fiscal risks.

26. Achieving sustainable growth of the non-oil output and export diversification in the medium term also entails accelerating reforms to attract private investment. Building on recent efforts to reduce corruption, including the introduction of e-government and "ASAN" public services, the authorities could broaden the anti-corruption efforts beyond small-scale corruption, strengthen the rule of law, and reduce formal and informal constraints to business environment in the non-oil sector. Such efforts will be crucial to foster a competitive economy and reap the full benefits of complementary efforts aimed at developing the domestic capital market and opening up new export markets.

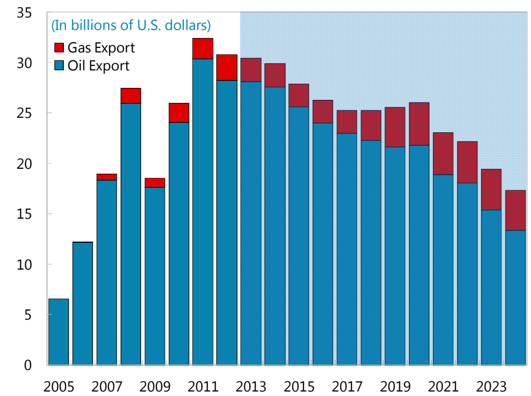
27. It is recommended that the next Article IV consultation with Azerbaijan will be held on the standard 12-month cycle.

Figure 1. Azerbaijan: Output and Inflation

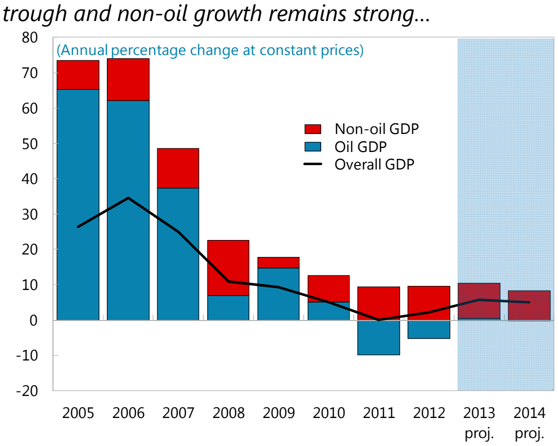
Natural gas will become increasingly important as oil production declines after 2020….



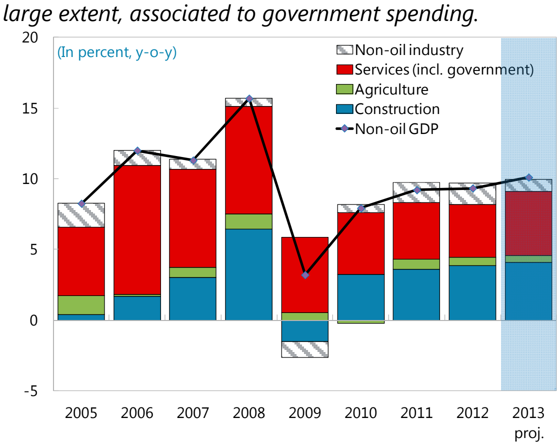
……and hydrocarbon export revenues will continue to decline given the lower price of gas versus oil.



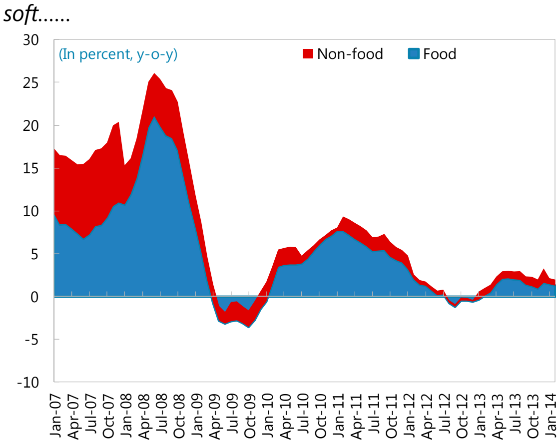
Oil production levels are recovering from their 2011 trough and non-oil growth remains strong…



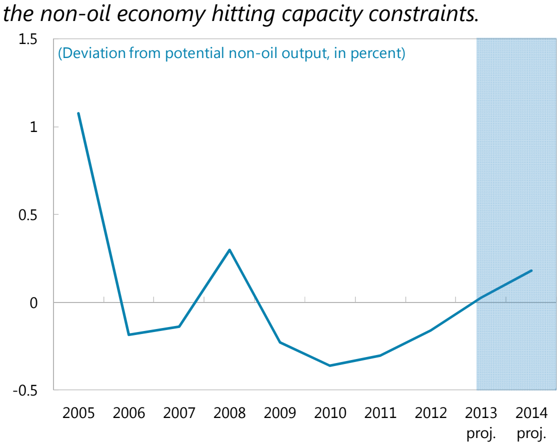
… driven by construction and service sector growth, to a large extent, associated to government spending.



Inflation remains subdued as food prices continue to be soft……

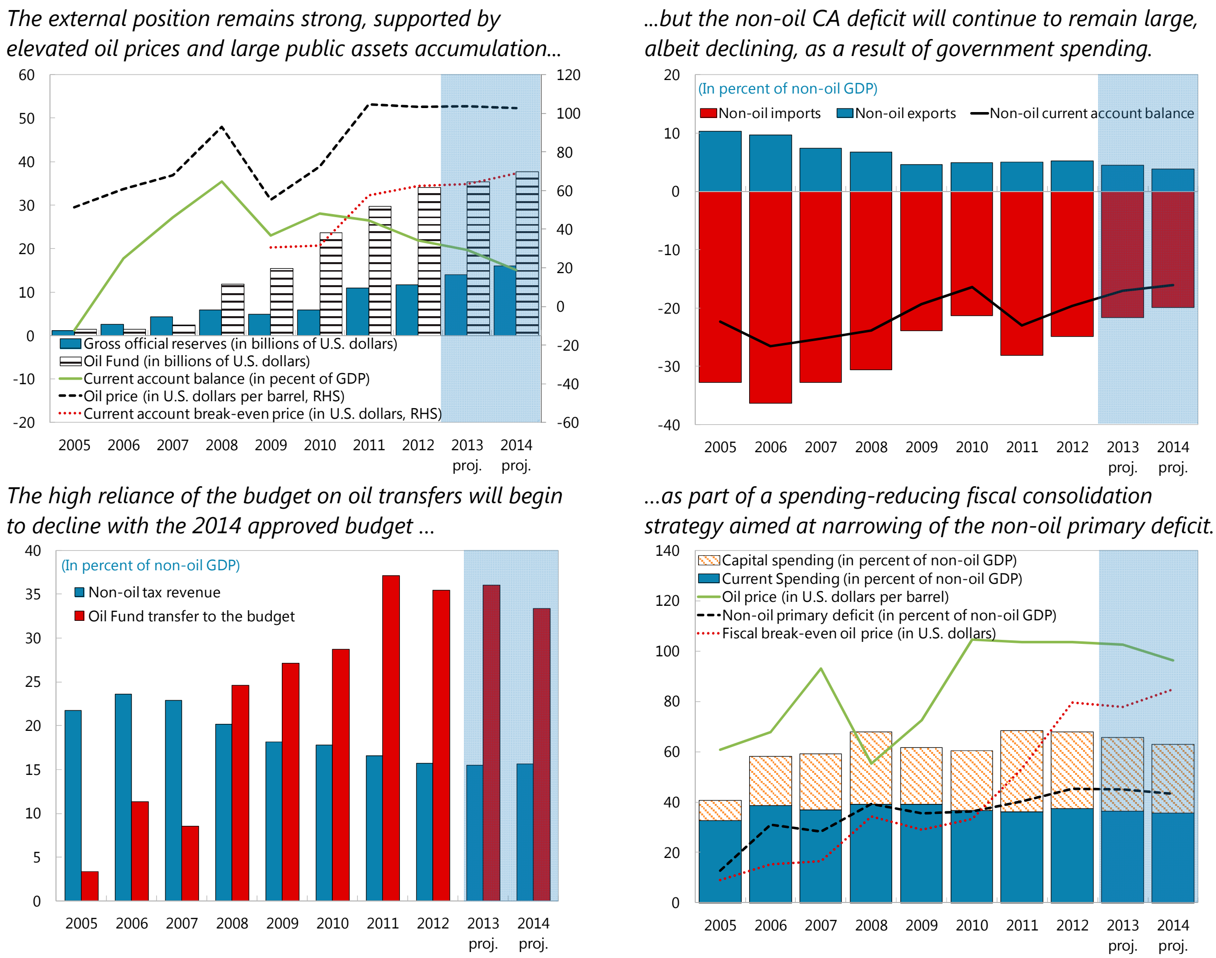


…… though upward pressure on prices may emerge with the non-oil economy hitting capacity constraints.



Sources: Azerbaijani authorities and Fund staff estimates.

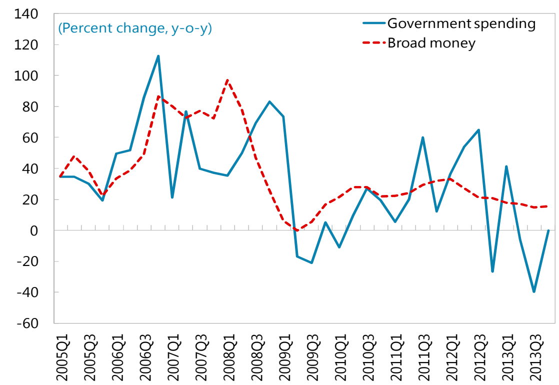
Figure 2. Azerbaijan: External and Fiscal Sectors



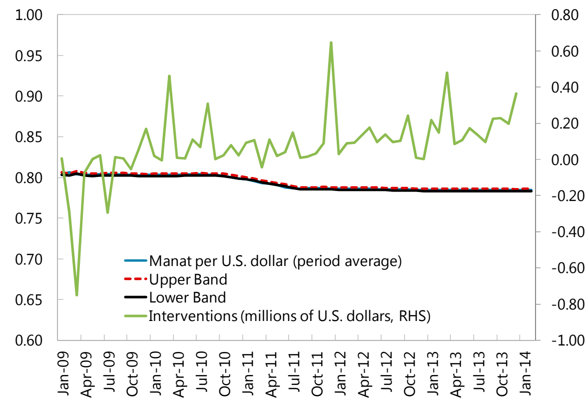
Sources: Azerbaijani authorities and Fund staff estimates.

Figure 3. Azerbaijan: Monetary and Financial Sector Developments

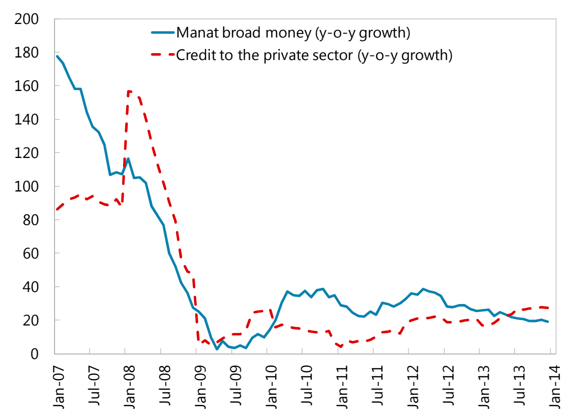
Monetary aggregates reflect movements in government spending.



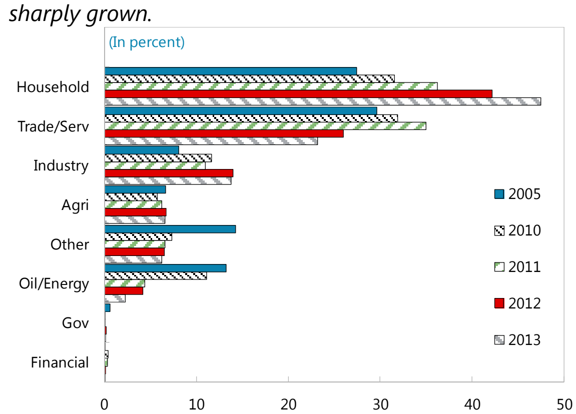
The nominal exchange rate remains stable, supported by CBA intervention.



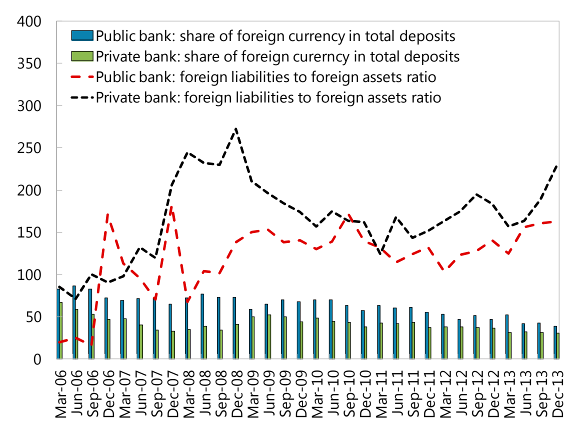
Growth in credit to the private sector has been robust…



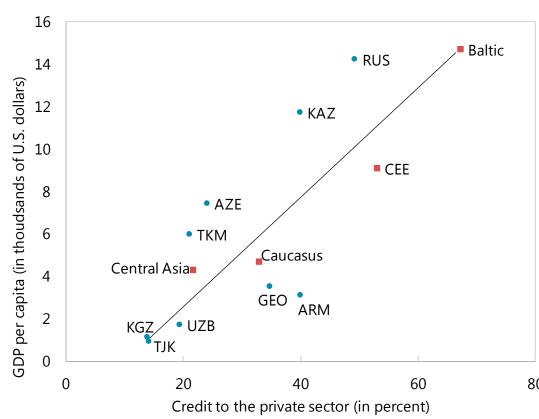
…through the share of credit to households, which has sharply grown.



Despite the fall in dollarization, banks' foreign exchange exposure continues to growth rapidly.



Financial development though generally remains low.



Sources: Azerbaijani authorities and Fund staff estimates.

Table 1. Azerbaijan: Selected Economic and Financial Indicators, 2009–15

	2009	2010	2011	Prel. 2012	Proj. 2013	2014	2015
	(Annual percentage change, unless otherwise specified)						
National income							
GDP at constant prices	9.3	5.0	0.1	2.2	5.8	5.0	4.6
Of which: Oil sector 1/	14.8	5.0	-9.8	-5.3	0.5	-0.1	-0.1
Non-oil sector 2/	3.0	7.6	9.4	9.6	9.9	8.3	7.5
Consumer price index (end of period)	0.7	7.9	5.6	-0.3	3.6	3.4	4.5
Consumer price index (period average)	1.6	5.7	7.9	1.0	2.4	3.5	4.0
Money and credit							
Net foreign assets	-18.5	34.6	68.7	5.6	19.9	16.4	3.4
Net domestic assets	63.4	13.5	2.8	40.3	8.7	13.8	38.2
Domestic credit	42.2	8.4	7.9	39.6	4.3	10.8	15.4
Of which: Credit to private sector	25.6	6.6	18.1	20.8	27.6	10.3	15.1
Manat base money	1.7	31.6	29.4	27.1	10.7	12.7	9.5
Manat broad money	9.9	34.8	32.5	25.5	19.0	14.7	14.1
Total broad money	16.6	21.9	32.1	20.6	15.4	13.9	20.0
Foreign currency deposits ratio to broad money	28.7	21.2	20.9	17.7	15.1	14.5	13.2
Velocity of total broad money (M3) 3/	3.0	2.8	2.6	2.3	2.3	2.3	2.3
External sector (in US$)							
Exports f.o.b.	-31.0	25.5	30.3	-5.4	-1.0	-1.9	-5.8
Of which: Oil sector	-31.5	25.7	30.9	-6.7	-1.0	-1.9	-6.7
Imports f.o.b.	-14.0	3.6	50.7	3.1	0.2	7.2	8.8
Of which: Oil sector	-34.2	19.6	35.5	-5.9	6.8	31.0	32.1
Export volumes	6.2	-1.4	-3.3	-6.0	-0.1	-1.9	0.0
Import volumes	-5.4	-4.0	38.2	6.1	0.9	9.2	9.9
Terms of trade	-28.6	27.1	30.7	3.6	-0.2	1.8	-4.9
Real effective exchange rate	14.0	1.1	2.6	0.8	3.0	...	...
	(In percent of GDP, unless otherwise specified)						
Gross investment	18.4	18.5	21.2	22.7	23.7	23.2	22.6
Consolidated government	12.3	12.5	16.0	16.1	17.3	17.0	16.5
Private sector	6.1	6.1	5.1	6.7	6.4	6.3	6.1
Of which: Oil sector	1.9	1.9	2.1	3.1	3.0	2.9	2.8
Gross domestic savings	47.7	52.5	54.1	50.7	48.2	43.9	37.2
Gross national savings	41.4	46.6	47.6	44.5	43.4	38.2	32.5
Consolidated government	19.3	27.1	29.7	20.9	18.3	17.3	13.3
Private sector 4/	22.1	19.5	18.0	23.6	25.1	21.0	19.2
Consolidated central government finance							
Total revenue and grants	40.4	45.7	45.5	40.5	39.5	39.2	36.1
Non-oil primary balance, in percent of non-oil GDP	-35.5	-36.3	-40.3	-45.4	-45.0	-43.2	-41.8
External sector							
Current account (- deficit)	23.0	28.0	26.5	21.8	19.7	15.0	9.9
Foreign direct investment (net)	0.3	0.6	1.4	1.1	-0.9	0.5	1.9
Public and publicly guaranteed external debt outstanding	7.7	7.4	7.3	9.2	11.7	14.0	14.2
Memorandum items:							
Gross official international reserves (in millions of U.S. dollars)	5,364	6,721	10,887	11,587	13,987	15,987	16,487
Nominal GDP (in millions of manat)	35,602	42,465	51,158	53,968	57,708	61,638	67,473
Nominal non-oil GDP (in millions of manat) 2/	19,536	22,243	25,393	29,766	34,051	38,144	42,850
Nominal non-oil GDP (in millions of USD) 2/	24,326	27,877	32,286	37,919	43,405	49,614	55,735
Nominal GDP per capita (in U.S. dollars)	4,933	5,847	7,106	7,538	8,160	8,823	9,679
Nominal GDP (in millions of U.S. dollars)	44,289	52,913	64,819	68,700	73,537	79,363	87,763
Oil Fund Assets (in millions of U.S. dollars)	14,900	22,766	29,800	34,058	35,448	37,723	38,484
Population (mid-year, in millions)	9.0	9.0	9.1	9.2	9.3	9.3	9.4
Exchange rate (manat/dollar, end of period)	0.803	0.798	0.787	0.785	0.785		

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

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

2/ Includes the transportation of oil and gas (except transportation through the western route)

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

4/ Historical data includes statistical discrepancy.

Table 2. Azerbaijan: Balance of Payments, 2009–15

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

				Prel.		Proj.	
	2009	2010	2011	2012	2013	2014	2015
Exports, f.o.b.	21,097	26,476	34,494	32,638	32,305	31,675	29,824
Oil and oil products	19,970	25,108	32,871	30,659	30,362	29,781	27,783
Other	1,127	1,368	1,623	1,979	1,943	1,894	2,041
Imports, f.o.b.	-6,514	-6,746	-10,166	-10,480	-10,501	-11,261	-12,250
Oil sector	-700	-838	-1,135	-1,067	-1,140	-1,493	-1,973
Others	-5,814	-5,908	-9,031	-9,412	-9,361	-9,767	-10,277
Trade balance	14,583	19,730	24,328	22,158	21,804	20,415	17,574
Services, net	-1,608	-1,734	-2,995	-2,915	-3,772	-4,021	-4,760
Credit	1,750	2,077	2,720	4,285	3,239	3,414	3,198
Debit	-3,358	-3,811	-5,715	-7,200	-7,011	-7,435	-7,958
Oil sector	-1,205	-1,240	-1,594	-2,945	-2,374	-2,477	-2,609
Income	-3,519	-3,657	-4,859	-4,258	-3,291	-4,252	-3,851
Investment income, net	-3,476	-3,618	-4,840	-4,196	-3,211	-4,152	-3,729
Of which: profit of oil consortium	-2,884	-3,199	-4,622	-4,359	-3,757	-4,684	-4,469
Compensation of employees, net	-43	-39	--	-62	-80	-100	-123
Transfers, net	722	495	673	-27	-252	-227	-248
Of which: Private	686	470	649	-50	-275	-254	-275
Current account balance	10,178	14,834	17,146	14,958	14,488	11,914	8,715
Non-oil currenct account balance	-5,002	-4,996	-8,374	-7,330	-8,602	-9,213	-10,016
Capital account, net	5	14	18	13	15	15	14
Direct investment, net	147	331	933	787	-643	432	1,632
Of which: In reporting economy, net	473	563	1,465	1,606	101	2,108	3,126
Oil sector, net	-274	-187	489	906	-799	1,608	1,986
Others, net	748	750	976	700	900	500	1,140
Portfolio investment, net	-139	-139	413	298	-1,282	889	2,609
Other investment	-6,018	-3,784	-4,655	-9,102	-8,838	-8,976	-11,705
Financial account, net	-6,009	-3,591	-4,038	-8,017	-10,763	-7,656	-7,464
Capital and financial account balance	-6,004	-3,577	-4,020	-8,005	-10,748	-7,640	-7,450
Errors and omissions	-1,464	-990	-770	-1,880	--	--	--
Overall balance	2,710	10,268	12,356	5,073	3,740	4,274	1,265
Financing	-2,710	-9,236	-11,519	-4,972	-3,800	-4,279	-1,269
Change in net foreign assets of CBA (increase -)	963	-1,370	-4,185	-714	-2,410	-2,004	-508
Change in Oil Fund assets (increase -)	-3,681	-7,866	-7,034	-4,258	-1,390	-2,275	-761
Memorandum items:							
Current account balance (in percent of GDP)	23.0	28.0	26.5	21.8	19.7	15.0	9.9
Non–oil Current account balance (in percent of Non–oil GDP)	-20.6	-18.0	-26.0	-19.3	-19.8	-18.8	-18.0
Gross official international reserves	5,364	6,721	10,887	11,587	13,987	15,987	16,487
in months of next year's non-oil imports c.i.f.	7.6	6.1	9.6	9.9	11.4	12.3	10.7
Oil Fund assets	14,900	22,766	29,800	34,058	35,448	37,723	38,484
Public and publicly guaranteed external debt (in percent of GDP)	7.7	7.4	7.3	9.2	11.7	14.0	14.2
Oil price (US$ per barrel)	61.8	79.0	111.0	110.0	110.1	109.2	102.9

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

Table 3a. Azerbaijan: Consolidated Central Government Operations, 2009–15
(in millions of manat)

	2009	2010	2011	Prel. 2012	Proj. 2013	2014	2015
Total revenue and grants	14,368	19,386	23,292	21,832	22,807	24,153	24,385
Total revenue	14,368	19,383	23,285	21,832	22,807	24,153	24,385
Tax revenue	5,591	5,834	7,016	7,004	7,739	8,252	9,097
Income taxes	1,911	2,020	2,850	3,065	3,038	3,008	3,067
Social security contributions	582	697	744	158	380	407	436
Value added tax (VAT)	2,013	2,082	2,223	2,367	2,688	3,041	3,487
Excise taxes	485	515	480	531	607	665	746
Taxes on international trade	421	292	440	590	686	750	933
Other taxes	179	227	280	293	340	381	428
Nontax revenue 1/	8,777	13,549	16,269	14,828	15,067	15,901	15,287
Of which: Oil Fund revenues 2/	8,274	13,087	15,521	14,183	14,132	14,874	14,153
Total grants (current)	0	3	7	0	0	0	0
Total expenditure	12,028	13,450	17,368	19,782	22,332	24,130	26,387
Current expenditure	7,649	8,157	9,160	11,108	12,360	13,680	15,272
Interest	36	39	210	98	172	177	124
Investment expenditure and net lending	4,379	5,293	8,209	8,674	9,971	10,450	11,115
Domestically-financed	4,093	4,768	7,442	7,697	8,895	8,427	9,988
Foreign-financed	286	525	767	977	1,076	2,023	1,126
Statistical discrepancy	-142	-277	-1,043	-581	-247	-159	121
Consolidated government balance, cash basis	2,482	6,213	6,967	2,630	722	183	-2,123
Non-oil primary balance 3/	-6,942	-8,070	-10,245	-13,504	-15,171	-16,355	-17,905
Financing	-2,482	-6,213	-6,967	-2,630	-722	-183	2,123
Domestic (net)	-2,705	-6,686	-7,654	-3,502	-1,286	-2,092	1,115
O/w Banking system	-25	-133	-1,631	93	-240	-370	700
Oil Fund (includes treasury balances)	-3,018	-6,700	-6,088	-3,608	-1,091	-1,767	-585
External (net)	223	473	687	872	564	1,909	1,008
Loans	288	526	768	977	1,076	2,023	1,126
Amortization due	65	53	81	105	512	114	118
Memorandum items:							
Oil revenue	9,461	14,323	17,422	16,231	16,065	16,714	15,907
Non-oil revenue 4/	4,907	5,063	5,870	5,600	6,741	7,439	8,478
Non-oil tax revenue 5/	3,942	4,033	4,508	4,924	5,339	5,911	6,707
Non-oil GDP (in billion of manats)	19,536	22,243	25,393	29,766	34,051	38,144	42,850

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/ Excludes AIOC profit tax, profit oil, and SOCAR profit tax.
but includes VAT and excise taxes on oil and gas, tax withholding on the AIOC's subcontractors.
5/ Tax revenue excluding AIOC and SOCAR profit tax, and social contributions.

Table 3b. Azerbaijan: Statement of Consolidated Government Operations, 2009–15
(in millions of manat, presented in line with GFSM 2001)

	2009	2010	2011	2012	2013	2014	2015
				Prel.		Proj.	
Revenue	14,828	19,824	23,730	22,403	23,378	24,663	24,385
Tax revenue	5,009	5,137	6,272	6,846	7,359	8,762	9,097
Income taxes	1,911	2,020	2,850	3,065	3,038	3,008	3,067
Value added tax (VAT)	2,013	2,082	2,223	2,367	2,688	3,041	3,487
Excise taxes	485	515	480	531	607	665	746
Taxes on international trade	421	292	440	590	686	750	933
Other taxes	179	227	280	293	340	381	428
Social security contributions	1,042	1,135	1,182	730	952	917	436
Nontax revenue 1/	8,777	13,549	16,269	14,828	15,067	15,901	15,287
Of which : Oil Fund revenues 2/	8,274	13,087	15,521	14,183	14,132	14,874	14,153
Expense	8,109	8,595	9,598	11,680	12,932	14,189	15,873
Compensation of employees	1,825	1,884	1,934	1,863	2,105	2,442	2,663
Use of goods and services	3,105	3,540	3,870	5,484	5,833	6,534	7,140
Social benefits	2,287	2,328	2,747	3,201	3,714	3,934	4,735
Subsidies	289	239	210	289	330	370	416
Grants	557	552	571	715	730	683	684
Interest	36	39	210	98	172	177	184
Other expense	10	14	57	30	47	49	51
Net operating balance (-, deficit)	6,719	11,229	14,133	10,723	10,446	10,474	8,511
Net Acquisition of Nonfinancial Assets	4,379	5,293	8,209	8,674	9,971	10,450	11,115
Statistical discrepancy	-143	-277	-1,043	-581	-247	-159	-480
Consolidated net lending and borrowing, cash basis	2,483	6,213	6,967	2,630	722	183	-2,123
Non-oil primary net lending and borrowing 3/	-6,941	-8,070	-10,245	-13,504	-15,171	-16,355	-17,905
Financing	-2,483	-6,213	-6,967	-2,630	-722	-183	2,123
Net acquisition of financial assets	-3,100	-6,938	-7,563	-3,466	-1,651	-2,077	-185
Domestic	-3,100	-6,938	-7,563	-3,466	-1,651	-2,077	-185
Oil Fund	-3,018	-6,700	-6,088	-3,608	-1,091	-1,767	-585
Net incurrence of liabilities	617	724	596	836	929	1,894	2,308
Domestic	395	252	-90	-35	365	-15	1,300
External	223	473	687	872	564	1,909	1,008
Memorandum items:							
Oil revenue	9,461	14,323	17,422	16,231	16,065	16,714	15,907
Non-oil GDP (in billion of manats)	19,536	22,243	25,393	29,766	34,051	38,144	42,850

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 (excluding interest payments) and statistical discrepancies.

Table 4a. Azerbaijan: Consolidated Central Government Operations, 2009–15

(in percent of non-oil GDP)

	2009	2010	2011	Prel. 2012	Proj. 2013	Proj. 2014	Proj. 2015
Total revenue and grants	73.5	87.2	91.7	73.3	67.0	63.3	56.9
Total revenue	73.5	87.1	91.7	73.3	67.0	63.3	56.9
Tax revenue	28.6	26.2	27.6	23.5	22.7	21.6	21.2
Income taxes	9.8	9.1	11.2	10.3	8.9	7.9	7.2
Social security contributions	3.0	3.1	2.9	0.5	1.1	1.1	1.0
Value added tax (VAT)	10.3	9.4	8.8	8.0	7.9	8.0	8.1
Excise taxes	2.5	2.3	1.9	1.8	1.8	1.7	1.7
Taxes on international trade	2.2	1.3	1.7	2.0	2.0	2.0	2.2
Other taxes	0.9	1.0	1.1	1.0	1.0	1.0	1.0
Nontax revenue 1/	44.9	60.9	64.1	49.8	44.2	41.7	35.7
Of which: Oil Fund revenues 2/	42.4	58.8	61.1	47.6	41.5	39.0	33.0
Total expenditure	61.6	60.5	68.4	66.5	65.6	63.3	61.6
Current expenditure	39.2	36.7	36.1	37.3	36.3	35.9	35.6
Primary current expenditure	39.0	36.5	35.2	37.0	35.8	35.4	35.4
Interest	0.2	0.2	0.8	0.3	0.5	0.5	0.3
Investment expenditure and net lending	22.4	23.8	32.3	29.1	29.3	27.4	25.9
Domestically-financed	20.9	21.4	29.3	25.9	26.1	22.1	23.3
Foreign-financed	1.5	2.4	3.0	3.3	3.2	5.3	2.6
Statistical discrepancy	-0.7	-1.2	-4.1	-2.0	-0.7	-0.4	0.3
Consolidated government balance, cash basis	12.7	27.9	27.4	8.8	2.1	0.5	-5.0
Non-oil primary balance 3/	-35.5	-36.3	-40.3	-45.4	-44.6	-42.9	-41.8
Financing	-12.7	-27.9	-27.4	-8.8	-2.1	-0.5	5.0
Domestic (net)	-13.8	-30.1	-30.1	-11.8	-3.8	-5.5	2.6
Banking system	-0.1	-0.6	-6.4	0.3	-0.7	-1.0	1.6
Oil Fund	-15.4	-30.1	-24.0	-12.1	-3.2	-4.6	-1.4
External (net)	1.1	2.1	2.7	2.9	1.7	5.0	2.4
Loans	1.5	2.4	3.0	3.3	3.2	5.3	2.6
Memorandum items:							
Oil revenue	48.4	64.4	68.6	54.5	47.2	43.8	37.1
Non-oil revenue 4/	25.1	22.8	23.1	18.8	19.8	19.5	19.8
Non-oil tax revenue 5/	20.2	18.1	17.8	16.5	15.7	15.5	15.7

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 expenditure (excluding interest payments) and statistical

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

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

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

Table 4b. Azerbaijan: Statement of Consolidated Government Operations, 2009–15
(in percent of non-oil GDP, presented in line with the GFSM 2001)

	2009	2010	2011	2012	2013	2014	2015
				Prel.		Proj.	
Revenue	75.9	89.1	93.5	75.3	68.7	64.7	56.9
Tax revenue	25.6	23.1	24.7	23.0	21.6	23.0	21.2
Income taxes	9.8	9.1	11.2	10.3	8.9	7.9	7.2
Value added tax (VAT)	10.3	9.4	8.8	8.0	7.9	8.0	8.1
Excise taxes	2.5	2.3	1.9	1.8	1.8	1.7	1.7
Taxes on international trade	2.2	1.3	1.7	2.0	2.0	2.0	2.2
Other taxes	0.9	1.0	1.1	1.0	1.0	1.0	1.0
Social security contributions	5.3	5.1	4.7	2.5	2.8	2.4	1.0
Nontax revenue 1/	44.9	60.9	64.1	49.8	44.2	41.7	35.7
Of which : Oil Fund revenues 2/	42.4	58.8	61.1	47.6	41.5	39.0	33.0
Expense	41.5	38.6	37.8	39.2	38.0	37.2	37.0
Current expenditure	41.5	38.6	36.8	39.2	38.0	37.2	37.0
Primary current expenditure	41.3	38.5	36.4	38.9	37.5	36.7	36.6
Interest	0.2	0.2	0.8	0.3	0.5	0.5	0.4
Other expense	0.0	0.1	0.2	0.1	0.1	0.1	0.1
Net operating balance (-, deficit)	34.4	50.5	55.7	36.0	30.7	27.5	19.9
Net Acquisition of Nonfinancial Assets	22.4	23.8	32.3	29.1	29.3	27.4	25.9
Statistical discrepancy	-0.7	-1.2	-4.1	-2.0	-0.7	-0.4	-1.1
Consolidated net lending and borrowing, cash basis	12.7	27.9	27.4	8.8	2.1	0.5	-5.0
Non-oil primary net lending and borrowing 3/	-35.5	-36.3	-40.3	-45.4	-44.6	-42.9	-41.8
Financing	-12.7	-27.9	-27.4	-8.8	-2.1	-0.5	5.0
Net acquisition of financial assets	-15.9	-31.2	-29.8	-11.6	-4.8	-5.4	-0.4
Domestic (net)	-15.9	-31.2	-29.8	-11.6	-4.8	-5.4	-0.4
Net incurrence of liabilities	3.2	3.3	2.3	2.8	2.7	5.0	5.4
Domestic	2.0	1.1	-0.4	-0.1	1.1	0.0	3.0
External	1.1	2.1	2.7	2.9	1.7	5.0	2.4
Memorandum items:							
Non-oil GDP (in billion of manats)	19.5	22.2	25.4	29.8	34.1	38.1	42.8

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 (excluding interest payments) and statistical discrepancies.

Table 5. Azerbaijan: Summary Accounts of the Central Bank, 2009–15

(in millions of manat, unless otherwise specified)

	2009	2010	2011	Prel. 2012	Proj. 2013	2014	2015
Net foreign assets	4,257	5,488	8,549	9,411	11,907	13,448	13,839
Net international reserves of the CBA	4,257	5,488	8,549	9,412	11,907	13,443	13,832
Gross international reserves	4,308	5,527	8,572	9,425	11,913	13,450	13,838
Foreign liabilities	-50	-39	-23	-13	-5	-7	-6
Other items, net 1/	0	0	0	-1	0	5	6
Net domestic assets	651	1,033	-59	1,249	499	-169	702
Domestic credit	875	1,087	-7	1,388	852	283	1,055
Net claims on consolidated central government	-591	-828	-2,083	-1,934	-2,677	-3,032	-2,912
Claims on banks	1,473	1,550	607	972	1,306	1,500	2,401
Credit to the economy	2	399	1,520	2,470	2,089	1,776	1,510
CBA notes	-8	-34	-50	-120	-20	40	57
Other items, net	-225	-54	-52	-139	-353	-453	-353
Reserve money	4,908	6,521	8,489	10,660	11,793	13,279	14,541
Manat reserve money	4,861	6,397	8,275	10,515	11,642	13,121	14,374
Currency outside CBA	4,513	5,793	7,658	9,778	11,033	12,152	13,473
Bank reserves and other deposits	345	602	612	723	555	958	891
Reserves in foreign currency	47	124	214	145	194	158	167

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

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

Table 6. Azerbaijan: Monetary Survey, 2009–15
(in millions of manat, unless otherwise specified)

	2009	2010	2011	Prel. 2012	Proj. 2013	Proj. 2014	Proj. 2015
Net foreign assets	3,444	4,636	7,823	8,262	9,903	11,532	11,923
Net international reserves of the CBA	4,257	5,488	8,549	9,412	11,907	13,443	13,832
Net foreign assets of commercial banks	-731	-779	-674	-1,063	-1,842	-1,842	-1,842
Other	-83	-73	-52	-86	-162	-65	-63
Net domestic assets	5,189	5,889	6,053	8,492	9,232	10,507	14,524
Net claims on consolidated central government	-637	-777	-2,098	-2,038	-2,775	-3,141	-2,989
Credit to the economy	8,946	9,786	11,814	15,603	16,930	18,830	21,086
Of which: private sector	7,429	7,919	9,352	11,296	14,409	15,890	18,294
Other items, net	-3,120	-3,119	-3,663	-5,073	-4,922	-5,182	-3,573
Broad money	8,633	10,527	13,903	16,774	19,360	22,043	26,451
Manat broad money	6,157	8,297	10,997	13,806	16,435	18,853	21,518
Cash outside banks	4,253	5,456	7,158	9,257	10,459	12,864	15,952
Manat deposits	1,904	2,842	3,839	4,550	5,976	5,989	5,566
Foreign currency deposits	2,476	2,230	2,906	2,967	2,925	3,190	3,492
	(Annual percentage change)						
Net foreign assets	-18.5	34.6	68.7	5.6	19.9	16.4	3.4
Net domestic assets	63.4	13.5	2.8	40.3	8.7	13.8	38.2
Credit to the economy	37.9	9.4	20.7	32.1	8.5	11.2	12.0
Of which: private sector	25.6	6.6	18.1	20.8	27.6	10.3	15.1
Broad money (M3)	16.6	21.9	32.1	20.6	15.4	13.9	20.0
Manat broad money (M2)	9.9	34.8	32.5	25.5	19.0	14.7	14.1
Reserve money	-1.1	32.9	30.2	25.6	10.6	12.6	9.5
Manat reserve money	1.7	31.6	29.4	27.1	10.7	12.7	9.5
Memorandum items:							
Gross official international reserves (US$ millions)	5,364	6,927	10,899	11,587	13,987	15,987	16,487
Velocity of total broad money (M3) 1/	3.0	2.8	2.6	2.3	2.3	2.3	2.3
Broad money in percent of non-oil GDP	41.1	44.3	52.9	53.5	53.9	54.1	55.4
Credit to private sector in percent of non-oil GDP	20.9	18.6	36.8	37.9	42.3	41.7	42.7
Currency to broad money ratio	49.3	51.8	51.5	55.2	54.0	58.4	60.3
Share of foreign currency deposits in total deposits	56.5	44.0	43.1	39.5	32.9	34.8	38.6
Foreign currency deposits to broad money ratio	28.7	21.2	20.9	17.7	15.1	14.5	13.2

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.

Table 7. Azerbaijan: Selected Economic and Financial Indicators, 2013–19

				Proj.			
	2013	2014	2015	2016	2017	2018	2019
	(Annual percentage change, unless otherwise						
National income							
GDP at constant prices	5.8	5.0	4.6	3.5	3.2	4.0	4.2
Of which: Oil sector 1/	0.5	-0.1	-0.1	0.0	0.0	2.1	2.7
Non-oil sector 2/	9.9	8.3	7.5	5.5	5.0	5.0	5.0
Consumer price index (period average)	2.4	3.5	4.0	4.3	5.0	4.9	5.0
External sector (in U.S. dollars)							
Exports f.o.b.	-1.0	-1.9	-5.8	-4.7	-3.0	0.7	1.9
Of which: Oil sector	-1.0	-1.9	-6.7	-5.8	-3.9	-0.1	1.3
Non-oil sector	-1.8	-2.5	7.7	10.7	8.0	8.0	8.0
Imports f.o.b.	0.2	7.2	8.8	9.4	7.1	6.4	6.3
Of which: Oil sector	6.8	31.0	32.1	18.6	10.3	5.1	2.4
Non-oil sector	-0.5	4.3	5.2	7.7	6.4	6.6	7.2
Export volumes	-0.1	-1.9	0.0	0.1	0.1	2.7	3.6
Import volumes	0.9	9.2	9.9	9.5	6.4	5.8	5.9
	(In percent of GDP, unless otherwise specified)						
Consolidated central government finance							
Overall fiscal balance	1.0	0.3	-3.1	-4.8	-6.3	-6.6	-6.4
Non-oil primary balance, in percent of non-oil GDP 4/	-45.0	-43.2	-41.8	-40.4	-38.3	-36.9	-34.2
External sector							
Current account balance	19.7	15.0	9.9	5.6	5.5	5.0	4.6
Non-oil current account balance (in percent of non-oil GDP)	-19.8	-18.8	-18.0	-18.8	-14.7	-13.3	-12.8
Foreign direct investment (net)	-0.9	0.5	2	2.3	2.1	2.1	1.2
Of which: Non-oil sector	1.2	0.6	1.3	1.8	2.0	2.2	2.4
Public and publicly guaranteed external debt outstanding	11.7	14.0	14.2	14.8	15.0	15.5	15.8
Memorandum items:							
Gross official international reserves (in billions of U.S. dollars)	14.0	16.0	16.5	17.0	17.5	18.0	18.5
Nominal GDP (in billions of manat)	57.7	61.6	67.5	72.7	79.8	86.1	93.9
Nominal GDP (in billions of US. dollars)	73.5	79.4	87.8	94.6	103.8	112.0	122.1
Nominal non-oil GDP (in billions of manat) 2/	34.1	38.1	42.8	47.0	52.3	57.1	63.4
Nominal non-oil GDP (in billions of US. dollars) 2/	43.4	49.1	55.7	61.2	68.0	74.2	82.5
Oil Fund Assets (in billions of U.S. dollars) 5/	35.4	37.7	38.5	37.6	34.7	30.4	28.8

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

APPENDIX I. Risk Assessment Matrix[1]

Nature/Source of Main Threats	Overall Level of Concern	
	Likelihood of Severe Realization of Threat in the Next 1–3 years (high, medium, or low)	**Expected Impact if Threat Materializes** (high, medium, or low)
	Global Risks	
Surges in global financial market volatility (related to UMP exit), leading to economic and fiscal stress, and constraints on country policy settings.	**High**	**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 (medium-term).	**Medium**	**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 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.

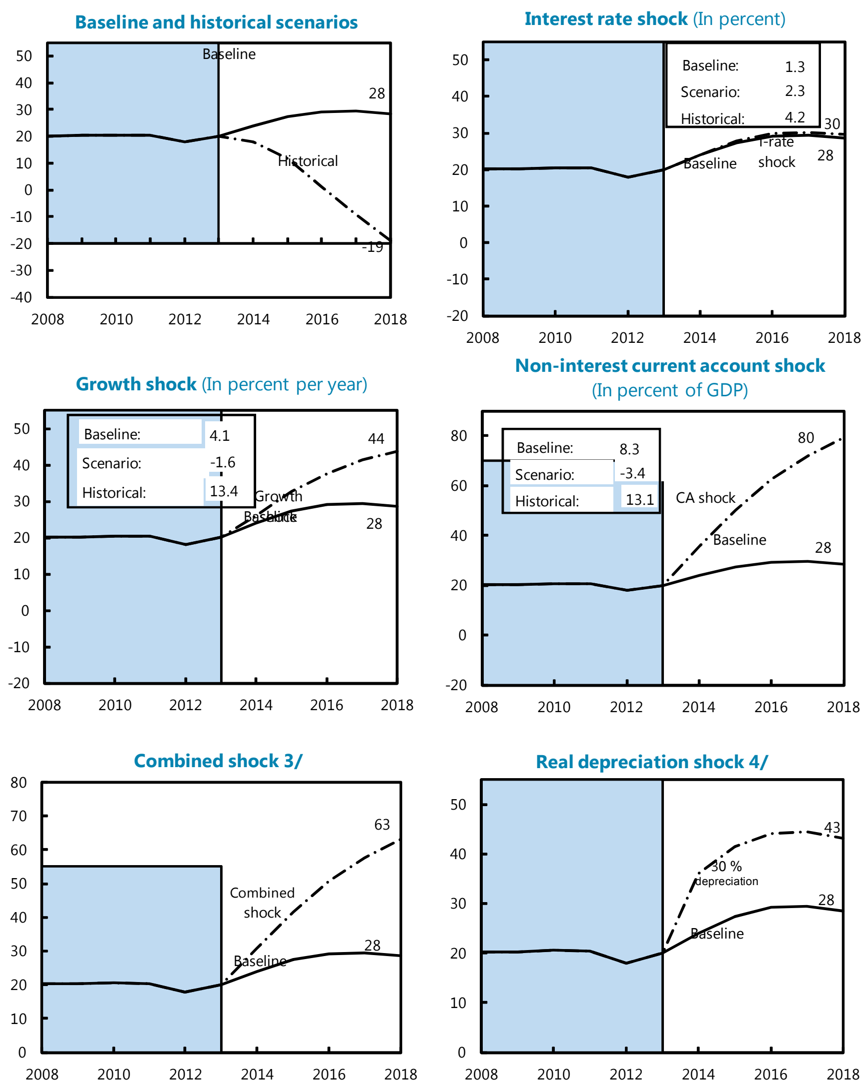
Nature/Source of Main Threats	Overall Level of Concern	
	Likelihood of Severe Realization of Threat in the Next 1–3 years (high, medium, or low)	**Expected Impact if Threat Materializes** (high, medium, or low)
	Country specific risks	
Oil production risk Disruptions in oil production if recent efforts 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 (The weak position and supervision of the systemic public bank (IBA) could compromise the stability and soundness of the system)	**Medium**	**Medium** A further deterioration of this bank could create systemic problems in the banking system. Though the government is likely to step in with important fiscal costs.
Fiscal risks Slippages in the fiscal adjustment due to investment commitments for the 2015 Euro Olympic games in Baku.	**Medium**	**Medium/Low** Delays in undertaking the fiscal adjustment could exacerbate fiscal vulnerabilities to a potential oil price decline.
Escalation of the conflict with Armenia over Nagorno-Karabakh (Tensions with Armenia could increase, following recent geopolitical events surrounding Ukraine)	**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 2014 approved budget. Sustaining efforts to enhance banking supervision combined with development of plans to bring the public bank under a sustainable financial position will also help contain risks in the financial sector.

APPENDIX II. Debt Sustainability Assessment

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

(External debt in percent of GDP)



Sources: Azerbaijan desk data, and IMF staff estimates.

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

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

(In percent of GDP, unless otherwise indicated)

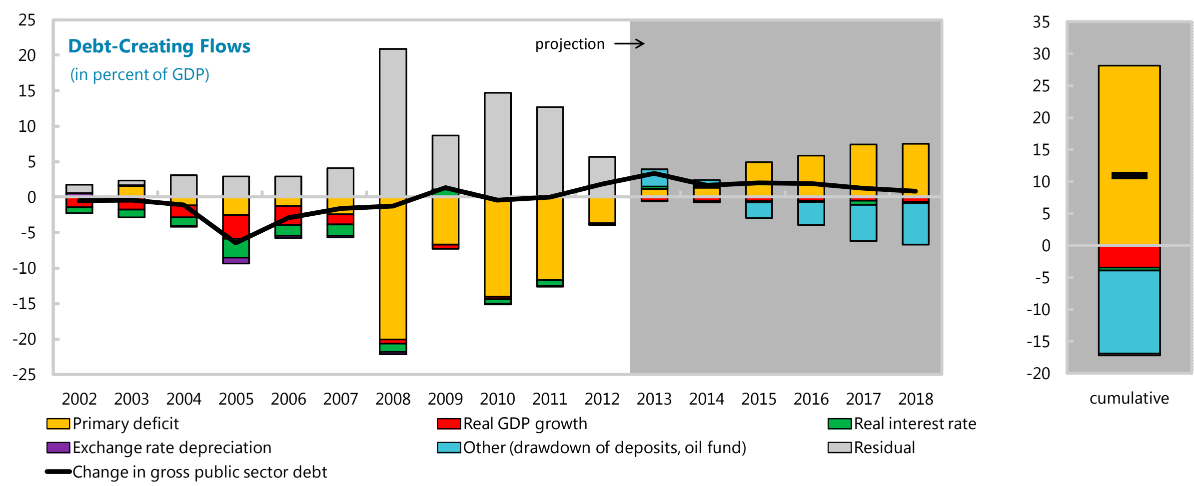
Debt, Economic and Market Indicators [1/]

	Actual			Projections					
	2002-2010 [2/]	2011	2012	2013	2014	2015	2016	2017	2018
Nominal gross public debt	12.0	7.3	9.2	12.5	14.1	16.1	18.0	19.3	20.1
Public gross financing needs	-4.6	-10.7	-2.8	1.7	2.8	6.1	7.5	9.3	10.2
Real GDP growth (in percent)	15.5	0.1	2.2	5.8	5.0	4.6	3.5	3.2	4.0
Inflation (GDP deflator, in percent)	10.4	20.9	2.8	0.1	1.8	4.6	4.1	6.3	3.8
Nominal GDP growth (in percent)	27.3	20.5	5.5	6.9	6.8	9.5	7.8	9.7	8.0
Effective interest rate (in percent) [4/]	1.4	6.8	2.6	4.2	3.6	3.4	3.2	3.1	3.1

As of March 31, 2014		
Sovereign Spreads		
EMBIG (bp) 2/		215
5Y CDS (bp)		n.a.
Ratings	Foreign	Local
Moody's	Baa3	Baa3
S&Ps	BBB-	BBB-
Fitch	BBB-	BBB-

Contribution to Changes in Public Debt

	Actual			Projections							
	2002-2010	2011	2012	2013	2014	2015	2016	2017	2018	cumulative	debt-stabilizing primary balance [9/]
Change in gross public sector debt	-1.5	0.0	1.9	3.3	1.6	2.0	2.0	1.2	0.8	10.9	
Identified debt-creating flows	-7.9	-12.7	-3.8	3.4	1.9	2.0	2.0	1.2	0.8	11.2	
Primary deficit	-5.2	-11.7	-3.7	1.1	1.3	4.9	5.9	7.4	7.5	28.2	-6.7
Primary (noninterest) revenue and grant	33.3	45.5	40.5	39.5	39.2	36.1	34.4	32.1	31.5	212.8	
Primary (noninterest) expenditure	28.1	33.8	36.8	40.6	40.5	41.0	40.3	39.5	39.0	241.0	
Automatic debt dynamics [5/]	-2.8	-0.9	-0.2	-0.1	-0.4	-0.8	-0.7	-1.1	-0.9	-4.0	
Interest rate/growth differential [6/]	-2.6	-0.9	-0.2	-0.1	-0.4	-0.8	-0.7	-1.1	-0.9	-4.0	
Of which: real interest rate	-1.1	-0.9	0.0	0.4	0.2	-0.2	-0.2	-0.6	-0.2	-0.5	
Of which: real GDP growth	-1.6	0.0	-0.2	-0.5	-0.6	-0.6	-0.5	-0.5	-0.7	-3.4	
Exchange rate depreciation [7/]	-0.1	-0.1	0.0	…	…	…	…	…	…	…	
Other identified debt-creating flows	0.0	0.0	0.0	2.4	0.9	-2.1	-3.2	-5.1	-5.8	-13.0	
Drawdown of deposits in oil fund (nega	0.0	0.0	0.0	2.4	0.9	-2.1	-3.2	-5.1	-5.8	-13.0	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Please specify (2) (e.g., ESM and Euroar	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes [8/]	6.5	12.7	5.7	-0.1	-0.2	0.0	0.0	0.0	0.0	-0.3	



Source: IMF staff.

1/ Public sector is defined as general government.

2/ Based on available data.

3/ Long-term bond spread over U.S. 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 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.

INTERNATIONAL MONETARY FUND

REPUBLIC OF AZERBAIJAN

STAFF REPORT FOR THE 2014 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

May 13, 2014

Prepared By

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

CONTENTS

RELATIONS WITH THE FUND

(As of March 31, 2014)

Membership Status

Date of membership: September 18, 1992;

General Resources Account

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

SDR Department

	SDR Million	Percent Allocation
Holdings	154.88	100.85

Outstanding Purchases and Loans

	SDR Million	Percent of Quota
ECF Arrangements	2.57	1.60

Latest Financial Arrangements

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

Projected Payments to the Fund

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

	Forthcoming				
	2014	2015	2016	2017	2018
Principal	1.29	1.29			
Charges/Interest	0.00	0.00	0.00	0.00	0.00
Total	**1.29**	**1.29**	**0.00**	**0.00**	**0.00**

Safeguards Assessment

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

Exchange Rate Arrangements

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

3. 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

4. The 2013 Article IV consultation with Azerbaijan was concluded on May 3, 2013.

ROSCs

5. 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

6. 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

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

Azerbaijan: Technical Assistance, 2003–13

Fund. Dept.	Area of Assistance	Mission Dates
FAD	Budget systems law	Feb/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
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

RELATIONS WITH THE WORLD BANK

(As of March 2014)

1. The World Bank Group is currently implementing a two-pillar Country Partnership Strategy (CPS) that covers FY2011–14 and focuses on: (i) building a competitive non-oil economy; and (ii) strengthening social and municipal services; with a strong cross-cutting theme of governance and anticorruption. A new Country Partnership Framework for Azerbaijan expected to be delivered in spring 2015 will target achieving the World Bank Group's twin goals of Poverty Reduction and Shared Prosperity.

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

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

4. The FY2011–14 CPS Progress Report (CPS PR) assessed the objectives of the CPS as relevant in the long run.

5. The Bank program for FY2013–14 has been in line with the Government's own borrowing plans of US$300–400 million per year from IBRD. This program focuses on sectors in which external borrowing from international financial institutions has been economically and socially justified based on expected returns, knowledge and technology transfer, and proven implementation capacity. Specifically, projects proposed by the Bank support aim at improved competitiveness in agriculture, solid waste management, water supply and sanitation, judicial modernization, railways, roads and rural investments program.

- Bank lending is complemented by a strong program of knowledge services to inform the country growth strategy and policy choices as well as the design of investment operations. The Bank will increase analytic work in the areas of job creation and growth, poverty and inequality, the financial sector, PFM and tax policy. The first Programmatic Public Expenditure Review (PPER) was delivered in FY13 and, following the client's request in FY14, the focus will shift towards tax policy. Poverty Assessment and Country Gender Study are under preparation and will be delivered in FY14. A Medium Term Debt Management Strategy (MTDS), Industrial Parks Technical Assistance are underway and also to be delivered in FY14.

6. Two more analytical pieces have been delivered in FY14, namely on *Economic Diversification for Growth, and Fostering Entrepreneurship in South Caucasus.* The Bank in partnership with the government, EU and SECO launched preparation of PEFA. It is expected to be delivered in fall 2014.

7. The partnership with the Government through a reimbursable Joint Economic Research Program (JERP) will be established on a case-by-case basis and start with engagement in ICT area. The Bank and the Government have also established a strong vehicle for policy dialogue in two high level policy fora held for the first time in 2009 and then in March 2012. The next high level policy forum is under preparation and expected to take place in September 2014.

8. Relations between the Bank and the Fund concerning Azerbaijan are very good in terms of coordinated policy advice and collaboration on macroeconomic monitoring. There is also broad agreement between the Bank and the Fund on the division of labor between the two institutions. The Fund will continue to focus on macro-critical areas, and will share responsibilities with the Bank on banking and financial sector soundness, taking care to coordinate closely so as to minimize overlap and ensure harmonization of policy advice.

9. IFC's program aligned with the joint World Bank Group strategy continues to focus on supporting sustainable growth and diversification of economy through investments and advisory support to the non-oil sectors, with a focus on agribusiness, MSMEs and infrastructure. During the current CPS period (FY2011–14) IFC's annual commitments have averaged at about $30–40 million and have been primarily in the financial sector in the areas of micro, small and medium enterprises and trade finance.

10. To address barriers to private sector investments in these and other areas, IFC implements several advisory programs focused on improving the business climate, strengthening financial markets, and increasing resource efficiency. This includes implementation of policy reforms related to business registration, inspections and permitting regime, strengthening competitiveness of agribusiness sector through analysis and regulatory reforms, and extending policy reforms to tax administration. IFC is also working on strengthening financial infrastructure through development of credit bureaus and collateral registries. In addition, IFC has also pioneered promotion of sustainable energy finance through investment and advisory projects with Bank Respublika aimed at developing SME lending capacity for energy efficient projects. IFC also remains engaged in the areas of banking sector capacity-building with the focus on risk management and SME lending, corporate

governance, food safety standards and resource efficiency through the regional programs, such as ECA Corporate Governance Project, ECA Banking Advisory, ECA Resource Efficiency Program and ECA Agribusiness Standards Program.

11. The State Oil Fund of the Republic of Azerbaijan has committed US$350 million to three funds managed by the IFC 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 resource efficiency sector; and the IFC African, Latin American and the Caribbean Fund, which invests alongside IFC in equity and equity-like projects in Africa and Latin America and the Caribbean.

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

(As of December 31, 2013, Update as of March 2014 in paragraph 5)

As set out in the current Country Strategy for Azerbaijan, the Bank's strategic priorities are:

1. The EBRD has operated in Azerbaijan since 1993. As of 31 December 2013, it invested approximately US$2.3[1] billion in 142 projects.[2] The current active portfolio amounts to US$930 million of which 57 percent has been disbursed, and operating assets amount to US$500 million. The ratio of private sector projects in the portfolio now stands at around 63 percent[3].

2. Strategic priorities for the EBRD's activities in Azerbaijan, set out in the country strategy published for public consultation in February 2014, include:

- Promoting market-driven economic diversification support leading local corporates with direct financing while helping EBRD partner banks to remain active in the corporate segment and a special emphasis on SMEs in the agribusiness sector, Support local banks to develop their capacity to support agricultural and regional lending. Regional roads development will also help facilitate the development of a viable agricultural sector while facilitating integration of smaller communities.

- Developing a sustainable financial sector to support private sector development, strengthening financial intermediation to ensure efficient financing of the private sector, particularly SMEs and MSEs, including in the regions. Promoting high standards of corporate governance and risk management: increased competition, new standards and markets for banks, consolidation. Extending co-operation with existing partner banks and assist in the development and promotion of new financial instruments to target improved access to finance for women-owned and women-run businesses, energy efficiency, local capital markets, and local currency

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[1] 1 USD=0.7259 Euro EBRD Exchange rate as of 31 December 2013.

[2] Excluding trade facilitation transactions.

[3] Based on 5 year rolling commitments.

- Improving governance and the business environment. Working closely with the Government of Azerbaijan to deepen institutional and regulatory reform. Using lessons of hydrocarbons and financial sectors, strive to create a more favorable investment climate in the real sector. Pursuing investments in energy projects that improve energy security, create new generating capacity, stimulate competition, diversify energy sources, increase efficiency, and create wider and larger markets through regional integration.

3. In the energy and natural resources sectors, the EBRD financed several landmark transactions such as the BTC pipeline, AZDRES Power Rehabilitation and the Shah Deniz gas field. The EBRD also financed three power sector projects for a total of US$281 million, making Azerenerji, Azerbaijan's state-owned power utility, EBRD's second largest client in the country. Energy and natural resources represents 30 percent of the overall portfolio. The industry, commerce and agribusiness (ICA) sector represents about 10 percent by volume, but 30 percent by number of transactions and includes major investments across a broad range of segments from building materials to mineral water bottling. In the financial sector (one fifth of the portfolio), EBRD has equity stakes in three Azerbaijani banks and provides funding for on-lending to the MSME sector to a further six banks and four micro-finance institutions. The infrastructure sector, which constitutes 40 percent of EBRD's portfolio, includes US$ 250 million for Regional Roads Reconstruction and Upgrading Project, EBRD's largest investment in Azerbaijan to date.

4. In 2013, EBRD invested a total of US$225 million in 18 projects. EBRD financed eight projects in the corporate sector with the average investment size of less than US$5 million. Three projects were in the agribusiness sector and four in the manufacturing and services sector. In the financial sector, EBRD signed eight projects, including credit lines with four *(*existing partner banks to be onlent to micro companies and SMEs. EBRD also signed a US$120 million second tranche of the Roads Reconstruction project. EBRD also continued to provide technical assistance in the areas of institution building, credit appraisal and risk management to financial institutions, and accountancy standards, corporate governance to corporate clients.

5. During the first three months of 2014, the EBRD has already signed US$220 million in four projects of which Shah Deniz Natural Resource project was the largest at US$200 million. The Bank expects to sign a further 10 transactions by end-2014, including projects with financial institutions and corporate clients.

6. Azerbaijan is a part of the EBRD's Early Transition Countries (ETC) initiative. Launched in April 2004, this initiative aims to increase investments in EBRD's eight countries of operation in the early transition stage, while building on international efforts to address poverty in these countries.

Through this initiative, the EBRD focuses its efforts on private sector business development and selected public sector interventions. It aims to stimulate market activity by using a streamlined approach to financing, focusing on smaller projects, mobilizing more investment, and encouraging ongoing economic reform. EBRD will accept higher risk in the projects it finances in the ETCs, while still respecting the principles of sound banking.

STATISTICAL ISSUES

1. Economic and financial statistics provided to the Fund are broadly adequate for surveillance purposes. Although the authorities have made significant progress in improving the quality and timeliness of their macroeconomic statistics, a number of weaknesses should be addressed, particularly in the areas of national accounts, price statistics, and external sector statistics. STA has provided extensive technical assistance and recommendations in these areas.

2. Azerbaijan has participated in the GDDS since mid-2001. In April 2002, a data ROSC mission reviewed Azerbaijan's data dissemination practices against GDDS guidelines and conducted an assessment of the quality of national accounts, consumer price index (CPI), producer price index (PPI), government finance, monetary, and balance of payments statistics. The data module of the ROSC is available on the IMF's external website. Azerbaijan nominated a national SDDS Coordinator in August 2005. An SDDS assessment mission in April 2007 provided technical assistance on the outstanding issues required for SDDS subscription. A data ROSC module to reassess the Consumer Price Index (CPI) completed in July 2008.

A. Real Sector

National accounts and price statistics

3. Under STA's national accounts project, significant technical assistance has been provided to the State Statistics Committee (SSC) and progress has been made in a number of areas. Methods for compiling gross national income have been improved and revised estimates disseminated; quarterly national account estimates at constant prices for 1998–2004 have been compiled; capital investment data have been revised; estimates of undeclared wages have been made; and a new methodology for calculating price indices for the construction and transportation sectors is well underway. The March-April 2005 mission identified the following problems: (i) the Oil Fund's transactions are not adequately reflected in the national accounts due to lack of information from the Oil Fund; (ii) the SSC does not have sufficient information to make reliable estimates of remittances from domestic residents working abroad; and (iii) there are no estimates of informal sector activity. The February 2013 mission that visited Baku at the request of the authorities prepared an action plan for the development and publication of discrete quarterly national account statistics.

4. In January 2005, the CPI was revamped—the consumption basket was expanded to cover 585 items and expenditure weights updated to reflect recent consumption patterns. With respect to regional coverage, which is now expanded to 54 regions, the SSC used population-based weights in

the aggregation of elementary price indices. However, this treatment raised methodological questions, because (i) international best practices suggest the use of expenditure-based weights in every stage of aggregation in CPI compilation, and (ii) population shares are not reliable proxies for regional expenditure shares. The recent reassessment of the CPI found that, although the SSC did use population weights for regional aggregation through 2006, it has weighted regional indexes by expenditure since 2007, using 2006 Household Budget Survey results on household expenditure, while 2009 data are based on 2008 expenditure weights.

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

B. Fiscal Sector

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

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

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

C. Monetary Sector

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

D. External Sector

10. Azerbaijan's balance of payments (BOP) statistics are compiled and disseminated by the CBA and are broadly in accordance with the 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.

11. During November 2006–November 2008, a Regional Advisor in External Sector Statistics to Azerbaijan and Georgia was stationed in Baku to (i) facilitate activities carried out by different government agencies in the development of external sector statistics; (ii) assist with statistical capacity building; (iii) coordinate the technical assistance activities of STA with the MCD's work program; and (iv) assist the authorities in coordinating with other international institutions and bilateral agencies involved in technical assistance in statistics in Azerbaijan and Georgia. Moreover, Azerbaijan has benefited from a STA technical assistance mission in external sector statistics, which visited Baku in October 2009 to further assist the authorities with addressing a number of outstanding issues related to the compilation and dissemination of external sector statistics.

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

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

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

14. The 2012 STA mission found low prospects for restarting work on the IIP (annual data were last published for 2008) as the legal position has not changed since STA's previous mission in 2009 and the data sharing and data provision across government agencies remain a challenge. The mission also discussed the BOP compilation methodology and assumptions, and made several recommendations in the areas of data validation, and in fine tuning the data to the BPM6 specifications.

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

16. Monthly data on total official reserve assets and daily CBA net interventions in the foreign exchange market are provided within 15 days of the end of each month. Data on official reserves during the month are provided on request from Fund staff. Azerbaijan does not disseminate International Reserves and Foreign Currency Liquidity Template data, but the CBA and the government have stated that there have not been any forward or futures transactions that could give rise to contingent short-term net drains on foreign currency assets. STA has recently advised the authorities on the definition and coverage of gross official reserve assets. As the authorities indicated that several definitions of gross official reserve assets are used, STA stressed the importance of using only one definition, more specifically the definition that follows the sixth edition of the *Balance of Payments and International Investment Position Manual (BPM6).* STA will continue to provide advice to the authorities for the correct compilation of Azerbaijan's gross official reserve assets.

Azerbaijan: Table of Common Indicators Required for Surveillance

(As of March, 2014)

	Date of latest observation	Date received	Frequency of data[6]	Frequency of reporting[6]	Frequency of publication[6]	Memo Items: Data Quality – *Methodological soundness*[7]	*Data Quality Accuracy and reliability*[8]
Exchange Rates	02/28/2014	03/15/2014	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	12/31/2014	01/22/2014	D	W	M		
Reserve/Base Money	12/31/2013	01/22/2014	D	W	M		
Broad Money	12/31/2013	01/22/2014	M	M	M	O, O, O, O	O, O, O, O, LO
Central Bank Balance Sheet	12/31/2013	01/22/2014	D	W	M		
Consolidated Balance Sheet of the Banking System	12/31/2013	01/22/2014	M	M	M		
Interest Rates[2]	Feb 2014	02/08/2014	M	M	M		
Consumer Price Index	Feb 2014	03/05/2014	M	M	M	O, O, O, O	O, LO, O, O, O
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	Oct 2013	12/17/13	M	M	M	LO, LNO, LNO, LO	LO, LO, O, O, LO
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	Oct 2013	12/17/13	M	M	M		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	Oct 2013	12/13/13	Q	Q	Q		
External Current Account Balance	Q3 2013	12/17/13	Q	Q	Q	LO, LO, LO, LO	O, LO, LO, O,LO
Exports and Imports of Goods and Services	Q3 2013	12/17/13	Q	Q	Q		
GDP/GNP	Feb 2014	03/15/2014	M	M	A	O, LO, O, LO	LO, LNO, O, O, O

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] The general government consists of the central government (budgetary funds, extrabudgetary funds, and social security funds) and state and local governments.
[5] Including currency and maturity composition.
[6] Daily (D); Weekly (W); Monthly (M); Quarterly (Q); Annually (A); Irregular (I); Not Available (NA).
[7] Reflects the assessment provided in the data ROSC published on March 20, 2003 and based on the findings of the mission that took place during April 8–23, 2002 for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning (respectively) concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O), largely observed (LO), largely not observed (LNO), or not observed (NO).
[8] Same as footnote 7, except referring to international standards concerning (respectively) source data, statistical techniques, assessment and validation of source data, assessment and validation of intermediate data and statistical outputs, and revision studies.

INTERNATIONAL MONETARY FUND
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IMF Executive Board Concludes 2014 Article IV Consultation with the Republic of Azerbaijan

On May 29, 2014, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Azerbaijan[1] and considered and endorsed the staff appraisal without a meeting.[2]

Recent economic developments have been favorable. In 2013, a stabilization of oil output and strong non-oil growth at nearly 10 percent helped lift overall GDP growth to 5.8 percent. Inflation remained low, averaging 2.4 percent, restrained by soft food prices and a stable exchange rate. High oil prices helped keep the current account in significant surplus. The impact of regional market turbulence in early 2014 has been limited, with few signs of lower manat demand or capital flight. Financial indicators of the banking system excluding the largely state-owned public bank, the International Bank of Azerbaijan (IBA), appear stable.

Since last year, the authorities have begun to unwind the supportive macroeconomic policies put in place during the 2008/09 global crisis. Preliminary data suggest that the 2013 non-oil primary deficit in percent of non-oil GDP remained at the 2012 level, below the announced target, reflecting some spending restraint. The approved budget for 2014 would contribute to consolidate further the non-oil primary deficit. On monetary policy, the Central Bank of Azerbaijan (CBA) kept the refinancing rate steady until end-April 2014, when it lowered the rate by 50 basis points. The CBA has also reduced its direct lending to the real economy, and

[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.

[2] Article IV consultations are concluded without a Board meeting when the following conditions apply: (i) there are no acute or significant risks, or general policy issues requiring Board discussion; (ii) policies or circumstances are unlikely to have significant regional or global impact; (iii) in the event a parallel program review is being completed, it is also being completed on a lapse-of-time basis; and (iv) the use of Fund resources is not under discussion or anticipated.

early this year tightened consumer loan conditions to cool down the acceleration of private sector credit.

Economic prospects over the near and medium term are positive, if underpinned by fiscal consolidation and supported by reforms to spur non-oil private sector activity. Growth of non-oil GDP is projected to remain strong at about 8 percent in 2014–15, before declining to 5 percent through 2019. With the non-oil economy hitting capacity constraints, inflation is set to rise, but tighter fiscal policy and soft food prices would allow it to stay at low single digit levels. High oil prices will help sustain comfortable sovereign foreign assets. Prospects could be affected by a disruption in oil production, slippages in the fiscal adjustment, and further weakening of the financial situation of the IBA. Risks from a potential deterioration in the global outlook emanate mainly from a fall in global oil prices but large sovereign foreign assets provide a buffer to help mitigate the impact of any shocks.

Executive Board Assessment

In concluding the 2014 Article IV consultation with Azerbaijan, Executive Directors endorsed staff's appraisal, as follows:

The government's recent achievements provide an impetus to advance toward the goal of becoming a dynamic emerging market. Recent agreements in the gas sector will help transform Azerbaijan into a strategic gas supplier for the European market. In addition, the government's successful debut Eurobond, issued amid market turbulence in the region, is testimony of investors' confidence in the prudent management of the oil revenues as reflected in large buffers and macroeconomic stability. This vote of confidence, along with the benign environment of high oil prices, provides an opportunity to build on the recent progress in changing the course of macroeconomic policies and take decisive steps to improve governance and the business climate. Actions in these areas will be crucial to fostering sustainable and diversified private sector-led growth that will ensure a sustained improvement in living standards.

Continued efforts to rein in government spending are needed to reduce fiscal vulnerabilities and achieve sustainability of the non-oil fiscal position in the medium term. Staff welcomes the approved 2014 budget that contains government spending, and encourages the authorities to complement their plans to improve public investment efficiency with decisive business climate reforms to create opportunities for private investment. Moving ahead decisively with the planned reform of the pension system, along with the adoption of a rules-based fiscal framework and sound fiscal risk management, will also help safeguard the consolidation efforts and preserve fiscal sustainability over the medium term. Given the prospects of flat oil production and softer oil prices, public announcement of and strict adherence to the informal fiscal rule would help build a track record for the adoption of a formal fiscal rule.

The current monetary policy stance is appropriate if supported by prudent fiscal and financial sector policies. Inflationary pressures are likely to remain subdued if the authorities' plans to tighten fiscal policy and cool down consumer credit growth are fully implemented. Monetary tightening would be warranted if demand pressures arise in the event of slippages in the fiscal consolidation plan or a reversal in soft global food prices due to regional tensions. Going forward, strengthening the role of monetary policy as anchor for inflation expectations requires discontinuing the CBA's direct lending on a permanent basis and decisive progress to develop the interbank money and foreign exchange markets in line with past IMF technical assistance. These actions would facilitate a move toward inflation targeting and pave the way for adopting greater exchange rate flexibility over the medium term when the costs of the current exchange rate regime will increase as Azerbaijan further diversifies its economy and increases its financial integration.

Enhancing the regulatory framework while promoting financial deepening is critical for the development of the non-oil economy. Recent measures by the CBA to strengthen banking regulations will help ensure correct capital needs; but increasing the resilience of the banking system also requires reducing the exposure of banks to connected lending and to un-hedged borrowers. Strengthening the banking system to facilitate a sustainable and broad-based growth led by the private sector will require actions aimed at encouraging market-led consolidation of banks without extending the new deadline to meet the capital requirement; creating a private bureau to promote competition in interest margins; protecting creditors' rights to help banks reduce their costs; and ensuring a level playing field in the banking system by further reducing the IBA's dominance in the system. Restructuring the IBA is also needed to help strengthen the monetary transmission mechanism and contain the associated fiscal risks.

Achieving sustainable growth of the non-oil output and export diversification in the medium term also entails accelerating reforms to attract private investment. Building on recent efforts to reduce corruption, including the introduction of e-government and "ASAN" public services, the authorities could broaden the anti-corruption efforts beyond small-scale corruption, strengthen the rule of law, and reduce formal and informal constraints to business environment in the non-oil sector. Such efforts will be crucial to foster a competitive economy and reap the full benefits of complementary efforts aimed at developing the domestic capital market and opening up new export markets.

Azerbaijan: Selected Economic Indicators, 2010–15

	2010	2011	2012 Prel.	2013 Proj.	2014 Proj.	2015 Proj.
	(Annual percentage change)					
Real economy						
GDP at constant prices	5.0	0.1	2.2	5.8	5.0	4.6
Oil sector 1/	5.0	-9.8	-5.3	0.5	-0.1	-0.1
Non-oil sector 2/	7.6	9.4	9.6	9.9	8.3	7.5
CPI (average)	5.7	7.9	1.0	2.4	3.5	4.0
	(In percent of GDP, unless otherwise)					
Consolidated government						
Fiscal balance	14.6	13.6	4.9	1.0	0.3	-3.1
Non-oil primary fiscal balance (in percent of non-oil GDP)	-36.3	-40.3	-45.4	-45.0	-43.2	-41.8
	(Annual percentage change)					
Money and credit						
Manat base money	31.6	29.4	27.1	10.7	12.7	9.5
Manat broad money	34.8	32.5	25.5	19.0	14.7	14.1
Banking sector credit to the private sector	6.6	18.1	20.8	27.6	10.3	15.1
Velocity of total broad money (M3) 3/	2.8	2.6	2.3	2.3	2.3	2.3
	(In percent of GDP, unless otherwise)					
Balance of payments						
Current account balance (-, deficit)	28.0	26.5	21.8	19.7	15.0	9.9
External public debt	7.4	7.3	9.2	11.7	14.0	14.2
Gross official international reserves						
In billions of US$, end of period	6.7	10.9	11.6	14.0	16.0	16.5
In months of next year non-oil imports, c.i.f.	6.1	9.6	9.9	11.4	12.3	10.7
Exchange rate						
End-of-period (Manat/US$)	0.798	0.787	0.785	0.785	...	...
Real effective exchange rate (percentage change, "-"=depreciation)	1.1	2.6	0.8	3.0	...	...

Sources: Azerbaijani authorities; and IMF staff estimates.

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

2/ Includes the transportation of oil and gas (except transportation through the western route).

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