July 2005
IMF Country Report No. 05/259

Republic of Azerbaijan: Ex Post Assessment of Longer-Term Program Engagement—Staff Report and Public Information Notice on the Executive Board Discussion

In the context of the IMF Executive Board's discussion on longer-term program engagement for the Republic of Azerbaijan, the following documents have been released and are included in this package:

- the staff report on the Ex Post Assessment of Longer-Term Program Engagement for the Republic of Azerbaijan, prepared by a staff team of the International Monetary Fund, which was completed on **June 13, 2005**. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the government of the Republic of Azerbaijan or the Executive Board of the IMF.

- a Public Information Notice (PIN) summarizing the view of the Executive Board as expressed during its June 24, 2005 discussion of the staff report.

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

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

Copies of this report are available to the public from

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

Price: $15.00 a copy

International Monetary Fund
Washington, D.C.

INTERNATIONAL MONETARY FUND

REPUBLIC OF AZERBAIJAN

Ex Post Assessment of Longer-Term Program Engagement

Prepared by a staff team from the Middle East and Central Asia, Fiscal Affairs, and Policy Development and Review Departments [1]

Authorized for distribution by the Middle East and Central Asia and Policy Development and Review Departments

June 13, 2005

Contents Page

[1] This assessment was prepared by Vitali Kramarenko (MCD), Zia Ebrahim-Zadeh (PDR), and Joseph Ntamatungiro (FAD), and contributions from members of the MCD Azerbaijan team (Basil Zavoico, Mayra Zermeño, Koba Gvenetadze, and Sajjid Chinoy).

Figures

Text Boxes

Tables

Executive Summary

Fund-supported programs implemented over the last 10 years have helped Azerbaijan make progress in transition to a market economy, build national institutions, and develop technical capacity in policy formulation and implementation. Early programs (1995–96) appropriately focused on macroeconomic stabilization and first generation structural reforms. By 1997, annual inflation rates declined to single digits from hyperinflationary levels, while output growth resumed, following many years of continuous decline. The twin shocks of the Russian crisis (1998) and a decline in oil prices complicated macroeconomic management and slowed down the implementation of structural reforms. This, together with a tightening of the overall policy stance, which was not fully consistent with staff advice, led to deflation and a slow-down in non-oil output growth. In the early 2000s, a revival of structural reforms and a significant increase in oil-related investment led to an increase in GDP growth rates in a low-inflation environment. However, the inflation rate reached double digits by 2004, as fiscal and income policies were loosened, and the appropriate policy response to underlying inflationary pressures was delayed.

On balance, prolonged use of Fund resources by Azerbaijan was justified. The outcomes of the ten-year engagement with the Fund are quite positive. Growth objectives were largely achieved, poverty declined to 40 percent in 2004 from about 60 percent in 1994, and Azerbaijan's current fiscal and external positions are sustainable. While most annual inflation targets were met, at times, deviations from program inflation targets were large, reflecting in part, the non-observance by the authorities of their commitments under the program, and, in part, deficiencies in program design.

On the macroeconomic front, the main lesson is that a combination of exchange rate pegs, underdeveloped monetary policy instruments, and a lack of effective control on the consolidated public sector position is not conducive to maintaining macroeconomic stability in the presence of frequent, large exogenous shocks.

Progress in structural reform was mixed. Fund programs achieved significant progress in fiscal management, the privatization of small- and medium-size enterprises, and trade and price liberalization. However, advances in financial and energy sector reforms, as well as improvements in the business environment and governance, were slower than expected.

Structural reform conditionality was increasingly focused on Fund core reform areas and critical measures in non-core areas. While structural reform conditionality design was broadly adequate, stricter conditionality or follow-up structural benchmarks would have been needed in the areas whether there was a risk of nominal implementation.

Looking forward, Azerbaijan faces a medium-term challenge of ensuring sustainable growth of non-oil output, export diversification, and poverty reduction in a stable macroeconomic environment at a time when oil revenues are projected to increase substantially. Although there is no balance of payments need in the medium term, this report recommends a successor Fund arrangement, given the macroeconomic nature of the risks and the need to continue with Fund core reforms that will help Azerbaijan avoid the resource revenue curse.

I. INTRODUCTION

1. **Azerbaijan joined the Fund in September 1992 following the declaration of its independence in 1991.** As other newly independent states, the country faced the twin challenges of building independent institutions and initiating a transition to a market economy from the Soviet-type central planning. During the first years after independence, these challenges needed to be addressed in the face of internal political instability and a military conflict with a neighboring country. By 1994, the internal and external political situations stabilized, and Azerbaijan initiated discussions with the Fund on a macroeconomic stabilization and structural reform program to be supported by a Systemic Transformation Facility (STF).

2. **There were quite difficult initial conditions at the start of the STF.** The output collapse, which began in 1988, coupled with the war devastation and a refugee crisis, led to a significant increase in poverty. Although cash fiscal deficits were running at 6.5 percent of GDP, the government was unable to pay wages, pensions, utility bills, and external debt obligations on time, given poor revenue performance. Hyperinflation, which was fueled by the monetization of large fiscal deficits, weakened the financial system and destroyed savings, contributing to the propagation of barter and inter-enterprise arrears (Table 1). Attempts to stop hyperinflation through price controls and market intervention were largely futile. The majority of enterprises were state-owned and operated below capacity with little incentive for restructuring. The macroeconomic objectives of the STF were largely achieved, as month-on-month inflation rates were reduced to single digits from hyperinflation levels, and output decline was contained in 1995.

Table 1. Azerbaijan: Initial Conditions and Outcomes, 1994-2004

	1994	2004
GDP per capita, in US$	293	1,022
Non-oil GDP per capita, in US$	155	714
Non-oil exports, mln. US$ 1/	475	512
Poverty ratio, in percent 2/	60	40.2
Oil production, in millions barrels per day	0.2	0.3
Fiscal balance, in percent of GDP	-6.4	0.6
Annual CPI rate, in percent	1,787	10.4

Sources: Azerbaijan authorities; and Fund staff estimates.

1/ Excluding a one off sale of oil-drilling equipment to a neighboring country.
2/ Ratios are for 1995 and 2004, respectively.

3. **This *ex post* assessment provides a review of three successive Fund arrangements during 1995–2005 (Table 2) and draws lessons for the future. A Stand-By Arrangement** (SBA, November 1995—November 1996) was successfully implemented with all reviews completed. By contrast, the track record of implementation under a **blended Extended**

Financing Arrangement/Enhanced Structural Adjustment Facility (EFF/ESAF, December 1996–December 1999)[2] and a **Poverty Reduction and Growth Facility** (PRGF, July 2001–July 2004) was mixed. Both arrangements were extended by one year, owing to long delays in completing reviews. The EFF/ESAF expired without completion of the last review because of insufficient progress in structural reforms. Under the PRGF, the authorities requested reduced access, due to the lack of time for completing the sixth review. The fifth review is expected to be completed in June 2005.

Table 2. Azerbaijan: Fund Arrangements, 1995-2005

	Initial dates	Extended	Reviews		Amounts, SDR mln.	
			Initial number	Completed	Approved	Drawn
SBA	11/17/1995-11/16/1996	n.a.	3	3	58.50	58.50
EFF	12/20/1996-12/19/1999	3/19/2000	5	4	58.50	53.24
ESAF	12/20/1996-12/19/1999	3/19/2000	5	4	93.60	81.90
CCFF	1/25/1999	n.a.	n.a.	n.a.	56.32	56.32
PRGF	07/06/2001-07/05/2004	7/4/2005	6	4	80.45	54.71

Source: IMF's FIN Database.

4. **On balance, this assessment concludes that prolonged use of Fund resources by Azerbaijan was justified.** Fund-supported programs have made a substantial contribution to positive economic developments in Azerbaijan over the last 10 years: national institutions building has been largely completed, the transition to a market economy has advanced, poverty has declined, the potential of the hydrocarbon sector has been increased, and inflation has been reduced (Table 1). However, there has been little progress in export diversification and there remain important structural impediments to sustainable medium-term growth in the non-oil sector. Furthermore, macroeconomic stability has not fully taken root. This report recommends a successor Fund arrangement, given the macroeconomic nature of the risks facing Azerbaijan and the need to continue with Fund core reforms that will help the country avoid the resource revenue curse.

II. Overview of Program Objectives and Performance

A. Program Objectives

5. **The SBA arrangement focused on macroeconomic stabilization and first generation structural reforms.** In particular, the program targeted a reduction in the annual

[2] The EFF/ESAF was augmented with a purchase under **the Compensatory and Contingency Financing Facility** (CCFF) in 1999 to compensate for a shortfall in export oil revenues.

CPI rate to 24 percent in 1996 from a pinnacle of 1,787 percent in 1994 and a resumption in output growth. The decline in inflation was expected to be achieved through a significant tightening of financial policies. A reduction in the fiscal deficit to 2.6 percent of GDP in 1996 from 6.5 percent of GDP in 1994 was justified by the need to curtail the budget's reliance on central bank financing and slow down growth of credit and money. The structural reform agenda included banking sector restructuring, price liberalization, the alignment of most domestic energy prices with world market prices, trade reform, the hardening of budget constraints on public enterprises, and the privatization of small- and medium-size state-owned enterprises.

6. **The blended EFF/ESAF arrangement put an emphasis on a gradual increase in real GDP growth rates to 8 percent by 1999 in a low-inflation environment, building up on progress with macroeconomic stabilization and structural reforms under the SBA.** In particular, the program targeted a gradual reduction in annual inflation to single digits, using the exchange rate as the main instrument of controlling base money. A gradual movement of the overall fiscal position toward balance was also expected to support the program's disinflation objective. Structural reform plans were geared toward completing banking sector restructuring, continuing with fiscal reforms, implementing trade and exchange system liberalization, finishing the privatization of the remaining medium- and large-size state-owned enterprises, and revitalizing energy sector reforms.

7. **The PRGF arrangement targeted an increase in real growth rates in the non-oil sector to 9 percent in a low-inflation environment and the preparation of the country to tackle important challenges associated with a significant but relatively short-lived increase in oil revenues.**[3] The growth potential of the non-oil sector was expected to be boosted by banking sector reforms, as well as improvements to the business environment and governance. The macroeconomic challenges associated with increased oil revenues were to be addressed through prudent fiscal management, focusing on the non-oil fiscal deficit in the context of a long-term strategy of oil revenue management, as well as a number of fiscal reforms, including the elimination of implicit energy subsidies and the development of targeted social assistance. The initial program targeted a broadly neutral fiscal stance. However, the program, subsequently, accommodated fiscal expansion[4] and large public sector wage increases. The government's objectives of poverty reduction were reflected in an Interim Poverty Reduction Strategy approved in 2001 and the State Program of Poverty Reduction (SPPRED) adopted in 2003.

---

[3] Oil production was 0.3 million barrels per day in 2004, and it is projected to increase to about 1.3 million barrels per day in 2011, and to decline thereafter.

[4] During 2002-03, fiscal expansion was partly attributable to government's financing of investment in the oil and gas sectors. By the end of the PRGF, fiscal expansion was in part justified by sustainability of larger non-oil fiscal deficits in the longer run.

B. Macroeconomic Performance

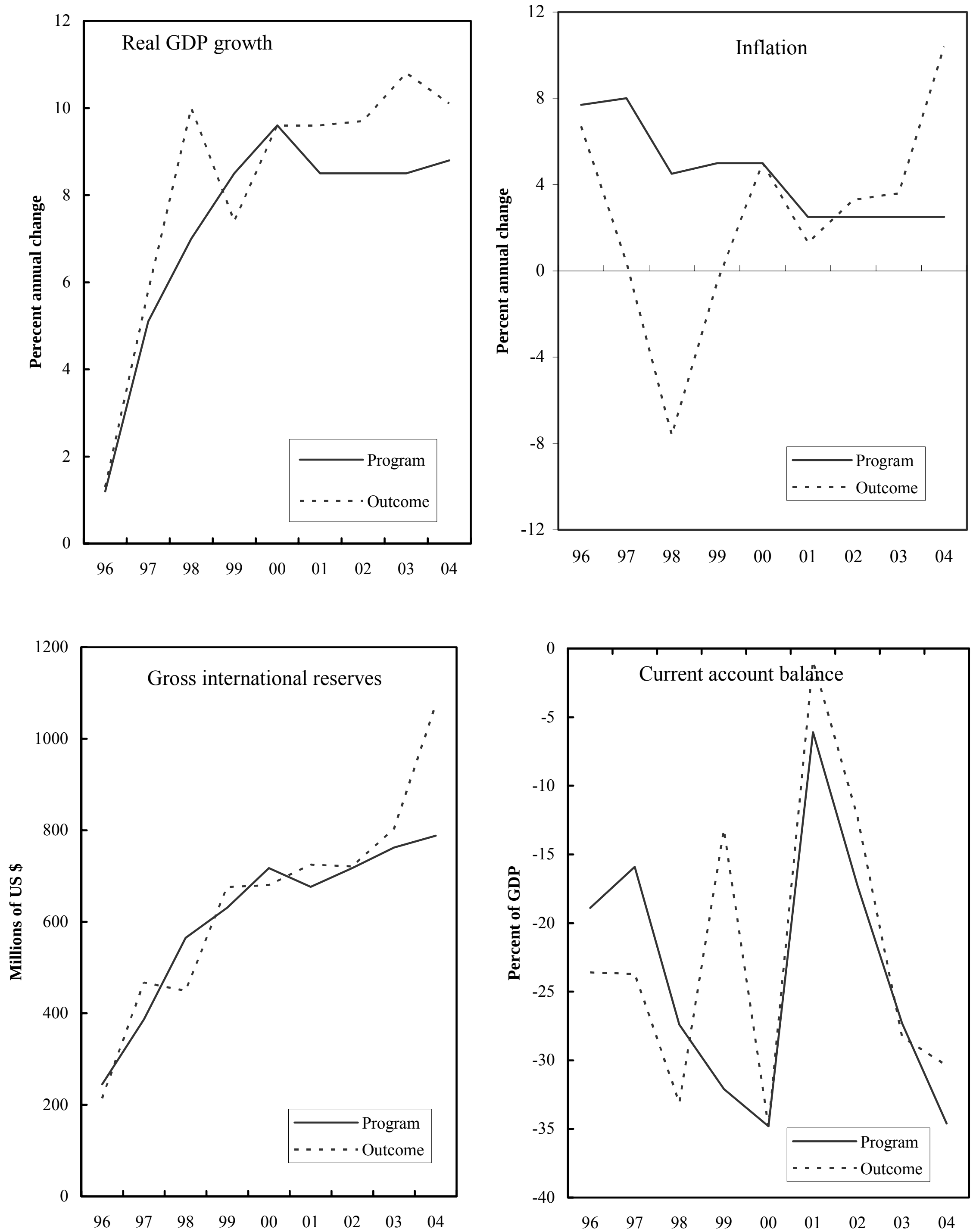
8. **Major macroeconomic objectives under the SBA were achieved.** In 1996, the rate of inflation decreased to about 20 percent, compared to the program objective of 24 percent, while real GDP grew by 1.2 percent (Figure 1 and Table 3). Rapid disinflation was largely predicated on the successful implementation of a significant reduction in the fiscal deficit. The programmed gradual exchange rate appreciation was also key to disinflation. Despite progress in macroeconomic stabilization and fiscal consolidation, the problem of external arrears persisted, which was reflected in the non-observance of the performance criterion on the non-accumulation of external arrears.

9. **During the EFF/ESAF period, the objectives for non-oil output growth and inflation were not achieved on account of exogenous shocks, whose negative impact was compounded by the authorities' inappropriate policy response**. In line with the initially designed macroeconomic framework, the authorities broadly complied with program objectives pertaining to further fiscal consolidation in 1997. This, together with nominal exchange rate appreciation, led to a further decline in the 12-month CPI inflation rate to 6.7 percent in 1997 (Table 4). However, in response to the twin shocks of the Russian crisis (1998) and a significant decline in oil prices, an overly restrictive policy stance, which was not recommended by the staff,[5] led to a decline in the CPI level by almost 11 percent from mid-1998 to mid-1999 (Figure 2). But this, in turn, contributed to a significant reduction in non-oil real GDP growth rates during 1998–99. However, a pick-up in oil production resulted in overall real growth rates exceeding program projections.

10. **Under the PRGF, non-oil GDP growth rates were higher than projected, but deficiencies in program design contributed to the failure to achieve inflation objectives by the end of the program period** (Figures 1 and 2 and Table 5). Initially, real growth mainly originated from the hydrocarbon sector, and oil-related construction, transportation, and services, but subsequently non-oil output growth became more broad-based. A significant increase in oil-related Foreign Direct Investment (FDI), which peaked at 40 percent of GDP in 2004, was an important engine of growth. The authorities generally complied with quantitative performance criteria under the program, focusing on the non-oil fiscal deficit and net international reserves (NIR) targets. However, the program supported the authorities' preference for a fixed exchange rate regime for too long. The central bank accommodated a sizable surge in capital inflows and increased spending of oil revenues at a fixed exchange rate, which led to rapid growth of money and credit in 2004. This, together with an 80-percent wage increase in the public sector since 2003, led to a significant pick-up in inflation.

[5] The staff recommended greater exchange rate flexibility immediately following the outbreak of the Russian crises. In early 1999, the staff advised to allow the exchange rate to depreciation, also indicating that there was room to maintain less restrictive fiscal policy under the program in the first half of 1999.

Figure 1.Azerbaijan: Program Targets and Outcomes, 1996-2004



Sources: MONA; and Fund staff estimates.

Table 3. Azerbaijan: Original Program Targets and Outcomes Under SBA, 1995-96

	1995			1996								
	Dec. 31 3/			Mar. 31			Jun. 31			Sep. 30		
	Program	Adjusted	Outcome	Program	Adjusted	Outcome	Program	Adjusted	Outcome	Program	Adjusted	Outcome
Real	(Percentage change over previous quarter, unless otherwise indicated)											
Real GDP	-16.4	…	-11.0	-4.0	-2.5	-2.4	-6.0	0.0	0.1	6.0	6.2	4.6
Inflation (end-period)	412.2	…	411.7	5.6	5.2	4.6	4.3	4.0	-3.1	3.3	3.0	2.7
Fiscal	(Percent of GDP)											
Fiscal balance (cash basis)	-6.9	…	-4.3	-3.0	-4.2	-0.3	-3.0	-2.1	-2.0	-2.5	-2.6	-1.9
Total revenue	23.4	…	15.2	22.8	14.7	13.2	23.3	15.4	15.5	21.3	16.3	16.4
Total expenditures 1/	30.2	…	19.5	25.8	18.8	13.5	26.3	17.6	17.5	23.8	18.8	18.3
Monetary	(Billions of manats; unless otherwise indicated)											
Net domestic assets	131	66	26	217	80	-34	300	201	85	436	372	230
Limit on net credit of the banking system to general government	290	208	214	290	209	122	290	209	120	290	211	95
Manat reserve money	709	710	742	743	786	752	776	818	790	839	931	896
Net international reserves (millions of US$)	141.6	156	163	136	162	182	128	143	164	112	133	160
External	(Percent of GDP; unless otherwise indicated)											
Current account balance 2/	-16.9	…	-11.2	…	-11.8	-18.5	…	-18.7	-23.6	…	-17.1	-19.6
Gross international reserves (millions of US$)	248.6	…	263.3	261.6	…	281.2	271.6	…	280.1	273.6	…	292.8
Current account balance excluding oil consortium	10.2	…	-7.4	…	…	-9.0	…	…	-12.7	…	…	-5.8
Memorandum Items:												
Nominal GDP (billions of manat)	7,907	…	12,264	2,151	2,598	3,518	2,213	2,699	3,543	2,532	2,953	3,721

Sources: The Azerbaijan authorities; and Fund staff estimates

1/ Including net lending.
2/ Including transfers.
3/ Percentage change over previous year.

Box 1. Definitions of the Fiscal Deficit

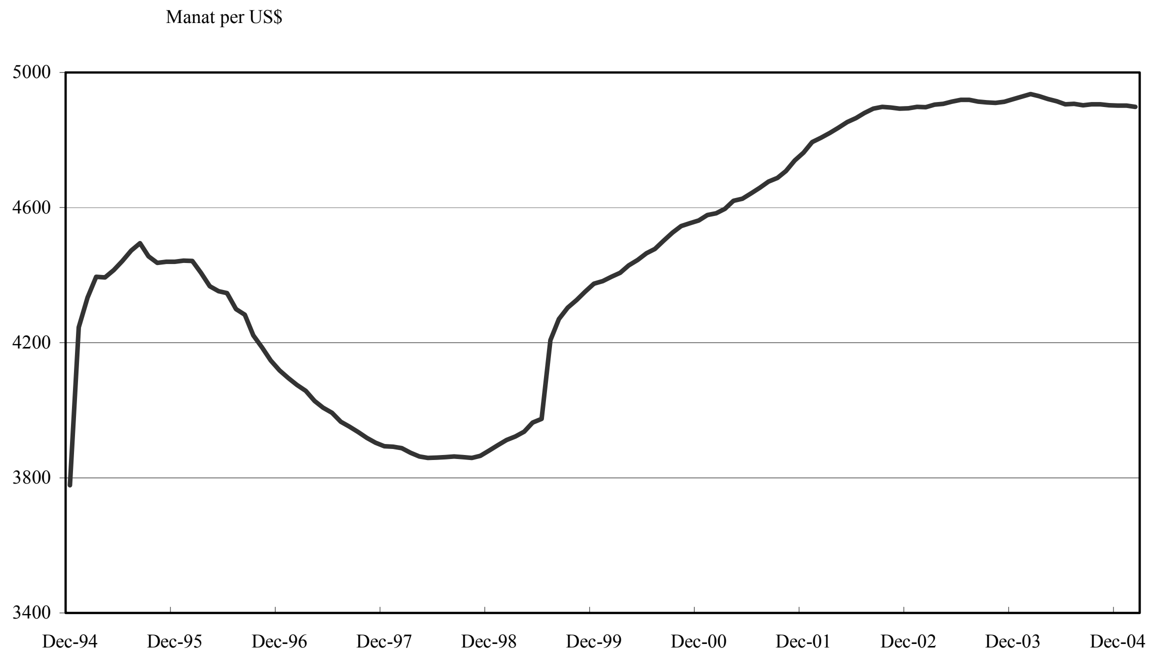
The SBA and EFF/ESAF targeted the fiscal deficit relative to GDP, including oil bonuses paid by foreign oil companies and privatization receipts in financing. This methodology was also used during the first two years under the PRGF, but subsequently the PRGF started to target the non-oil fiscal deficit relative to non-oil GDP by excluding from total government revenues all oil revenues, including those originating from the State Oil Company of the Republic of Azerbaijan (SOCAR) and the Azerbaijan International Oil Consortium (AIOC), and returns on Oil Fund assets. The transition to the new definition was appropriate, given the fact that the non-oil primary balance provides a better measure of the fiscal stance, as well as a more relevant indication of long-run fiscal sustainability in oil-producing countries.

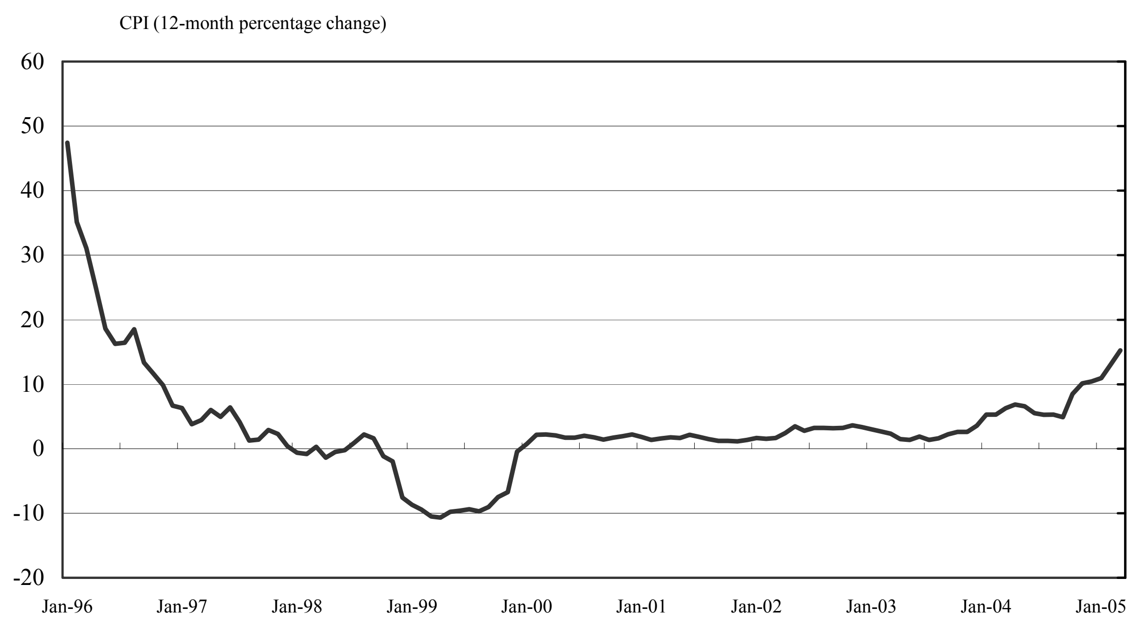
However, the program definition of the non-oil fiscal deficit was not an accurate measure of the primary non-oil balance: (i) explicit and implicit energy subsidies were not reflected in the program definition of the non-oil deficit, despite the fact that the subsidy stemming from poor collection of utility payments was made explicit in the budget starting from 2002; (ii) oil revenues comprised some non-oil revenues paid by SOCAR, including excises, VAT, and profit taxes on downstream activities because the prevailing accounting framework made it impractical to single out separate tax items from SOCAR's tax payments; and (iii) interest expenditure should have been excluded. These drawbacks, in combination with the absence of an effective mechanism to ensure that SOCAR's activities, including revenues, expenditure, and tax payments, are properly monitored, limited somewhat the relevance of the program definition of the non-oil deficit. Also, it was difficult to analyze the justification for the fiscal stance presented in staff reports, due to the lack of the recompilation of historical numbers based on a consistent methodology.

C. Fiscal Policy

11. **During the SBA and EFF/ESAF, fiscal deficit targets were met for most test dates (see Box 1 for definitions), but the fiscal adjustment mix deviated from program projections.** Under the SBA, the targeted decline in the cash fiscal deficit from 6.5 percent of GDP in 1994 to 2.6 percent in 1996 was mainly achieved through larger-than-expected expenditure compression, as revenue targets were not met. Under the EFF/ESAF, in 1997, the fiscal deficit was further reduced to 1.7 percent of GDP, in line with program conditionality, but both revenue and expenditure were above targets. Following the Russian crisis and the fall in oil prices during 1998-99, the program appropriately accommodated higher fiscal deficit targets. Actual fiscal deficits were somewhat tighter than assumed under the program in 1998 and in the first half of 1999, reflecting the authorities' preference for a restrictive policy stance. Under the SBA and EFF/ESAF, expenditure arrears were a recurrent issue, but the situation gradually improved, owing to better expenditure management, the strengthening of revenue administration, and stricter conditionality on expenditure arrears.

Figure 2. Azerbaijan: Exchange Rate and CPI, 1994-2005





Source: Azerbaijan authorities; and Fund staff estimates.

Table 4. Azerbaijan: Original Program Targets and Outcomes Under ESAF/EFF, 1996-99

	1996			1997			1998			1999		
	Program	Adjusted	Outcome	Program	Adjusted	Outcome	Program	Adjusted	Outcome	Program	Adjusted	Outcome
Real	(Annual percent change)											
Real GDP	1.2	…	1.3	5.1	5.0	5.8	7.0	8.0	10.0	8.5	3.8	7.4
Inflation (end-period)	7.7	…	6.7	8.0	3.9	0.4	4.5	0.5	-7.6	5.0	5.0	-0.5
Fiscal	(Percent of GDP)											
Fiscal balance (cash basis)	-2.7	…	-2.6	-2.0	-1.8	-1.7	-3.4	-4.3	-4.2	-1.1	-4.0	-4.8
Total revenue	16.2	…	16.2	16.9	18.0	19.7	19.3	17.2	17.3	21.4	20.1	18.2
Total expenditures 1/	18.9	…	18.8	18.9	19.8	21.4	22.3	21.5	21.5	22.5	24.1	23.7
Non-oil fiscal balance	…	…	-7.7	…	…	-9.0	…	…	-8.4	…	…	-9.0
Monetary	(Billions of manats; unless otherwise indicated)											
Net domestic assets	816	803	806	763	576	572	460	613	580	557	490	158
Limits on the stock of net credit from ANB to the general government	358	358	346	358	13	-6	223	111	64	35	-35	-281
Manat reserve money	972	959	991	1,132	1,177	1,339	1,317	1,065	1,057	1,172	1,172	1,257
Net international reserves (millions of US$)	39	39	46	101	156	200	227	118	126	161	178	268
External	(Percent of GDP; unless otherwise indicated)											
Current account balance 2/	-18.9	…	-23.6	-15.9	-21.7	-23.7	-27.4	-29.8	-33.1	-32.1	-26.9	-13.2
Gross international reserves (millions of US$)	245	…	214	387	422	467	565	432	449	631	605	676
Non-oil exports	…	…	…	…	…	10.1	…	7.5	10.5	…	16.2	4.9
Current account balance excluding oil sector developments 3/	-7.4	…	-12.6	-6.0	-8.1	-8.8	-9.9	-16	-17.5	-10.4	-18.3	-4.8
Memorandum Items:												
Nominal GDP (billions of manat)	14,800	…	14,807	17,169	16,399	15,352	18,407	16,580	15,930	21,242	16,700	18,771

Sources: The Azerbaijan authorities; and Fund staff estimates.

1/ Including net lending.
2/ Including transfers.
3/ Excludes imports of goods and nonfactor services.related to oil sector development
.

Table 5. Azerbaijan: Original Program Targets and Outcomes Under PRGF, 2001-04

	2001			2002			2003			2004		
	Program	Adjusted	Outcome	Program	Adjusted	Outcome	Program	Adjusted	Outcome	Program	Adjusted	Outcome
Real	(Annual percent change)											
Real GDP	8.5	8.5	9.6	8.5	8.5	9.7	8.5	9.3	10.8	8.8	7.8	10.2
Inflation (end-period)	2.5	2.5	1.3	2.5	3.0	3.3	2.5	2.5	3.6	2.5	10.0	10.4
Fiscal	(Percent of GDP, unless otherwise indicated)											
Overall fiscal deficit	-0.5	-0.5	-0.4	-0.5	-0.1	0.5	-0.6	-2.0	-1.2	-0.4	0.9	0.8
Total revenue	22.1	22.2	18.7	22.0	23.6	22.0	22.5	22.4	21.7	22.9	22.6	22.8
Total expenditures	22.7	22.7	18.7	22.5	23.7	22.4	23.3	24.7	23.4	23.3	21.8	22.0
Non-oil deficit as a share of non-oil GDP	12.2	...	-10.4	-10.5	-11.8	-14.9	-9.5	-17.4	-16.0	-13.8	-14.4	-12.6
Non-oil deficit as a share of non-oil GDP, excluding BTC financing 1/	...	...	...	-9.4	-10.6	-13.7	-7.2	-15.0	-13.6	-13.8	-14.4	-12.2
Monetary	(Billions of manats; unless otherwise indicated)											
Net domestic assets	128	128	-174	-3,193	-144	-85	-4,215	194	-160	-36	...	-56
Limits on the stock of net credit from ANB to the general government	-111	-111	-162	80	-210	-151	56	315	75	-202	...	112
Manat reserve money	1,695	1,695	1,684	1,892	1,855	1,866	2,254	2,231	2,316	2,588	...	3,200
Net international reserves (millions of US$)	369	369	427	717	461	463	762	465	582	610	...	905
External	(Percent of GDP; unless otherwise indicated)											
Current account balance	-6.1	-6.1	-0.9	-17.3	-23.4	-12.3	-27.3	-27.4	-28.3	-34.6	-27.1	-30.3
Gross international reserves (millions of US$)	676	676	725	717	749	721	762	732	803	788	923	1,075
Non-oil exports	4.5	...	3.6	4.6	3.8	4.2	4.9	4.3	5.2	4.4	8.0	7.6
Current account balance excluding oil exports, oil imports and oil services	-22.8	...	-19.8	-22.7	-21.3	-20.3	-24.5	-17.7	-17.8	-21.3	-14.9	-18.6
Memorandum Items:												
Nominal GDP (billions of manat)	26,457	26,457	26,578	28,731	27,887	30,312	30,626	34,252	35,054	35,937	42,246	41,873

Sources: The Azerbaijan authorities; and Fund staff estimates.

1/ BTC--Baku-Tbilisi-Ceyhan pipeline-related expenditure.

12. **Compliance with program fiscal targets was satisfactory under the PRGF.** All non-oil fiscal deficit targets were met under the PRGF, due to improving non-oil revenue performance, in particular on account of VAT. The government had to use expenditure sequestration only in 2001, owing to revenue shortfalls. While capital spending increased relative to GDP and spending on health and education grew in real terms by 14 percent per year on average (Table 6),[6] links among the annual budget, the SPPRED, and Medium-Term Expenditure Framework (MTEF) remained weak, in part reflecting implementing capacity limitations. Moreover, the wage bill to GDP ratio was on an increasing trend, as public sector wages have increased by about 80 percent since 2003. While some wage increases occurred during the program interruption in 2004, the program for 2005 accommodated significant public sector wage increases in the context of the 2005 budget.

13. **Control over fiscal policy was weakened somewhat under the PRGF, owing to ineffective conditionality on SOCAR's oil revenue[7].** In line with revised program targets, the non-oil deficit increased from 10 percent of non-oil GDP in 2001 to 13 percent in 2004, and it is projected to increase further to 15.4 percent in 2005. However, developments in the non-oil deficit, based on program definitions, do not capture accurately the evolution of the fiscal stance, mainly due to the exclusion of energy subsidies (Box 1) and the impact of SOCAR's spending of an increasing share of oil revenues during the PRGF. In an environment of higher-than-budgeted oil prices, not only did SOCAR keep an increasing share of oil revenues, consistent with the current tax regime,[8] but also it maintained tax arrears. SOCAR reportedly used additional oil revenues to finance investment, contributing to a larger demand impulse from the consolidated public sector than intended under the program.

14. **Azerbaijan's current fiscal position appears to be broadly consistent with the long-run objective of maintaining constant real consumption out of oil wealth**. The non-oil primary fiscal deficit (as defined in Box 1) is projected at about 30 percent of non-oil GDP in 2005. This projection lies between a conservative scenario (based on a $30 per barrel oil price) and a baseline scenario (based on the most recent WEO oil prices) for the sustainable permanent income level. However, it should be noted that the non-oil primary fiscal deficit would need to start to decline in the medium term, once its level has converged with the sustainable permanent income on oil wealth.

---

[6] The decline in social spending relative to GDP occurred mainly because of rapid nominal GDP growth.

[7] While SOCAR's oil revenues were excluded from non-oil deficit targets, compliance with SOCAR's tax obligations were expected to be monitored under the performance criterion on net domestic credit to the government through adjustors related to the oil price and export tax liabilities. However, the desired effects of this adjustor were not fully achieved. All in all, it would have been more straightforward to have a performance criterion on SOCAR's compliance with its tax liabilities.

[8] In 2005, SOCAR keeps a large portion of the windfall oil revenue at the currently prevailing export tax rate of 25 percent of the difference between the actual oil price and the domestic price of $8 per barrel. A profit tax of 24 percent should be paid in 2006 on the remaining 75 percent of the difference.

Table 6. Azerbaijan: Composition of Expenditures Under Fund-Supported Programs
(In percent of GDP)

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004 Est.
Current expenditure	15.6	17.7	19.6	19.5	20.0	17.9	16.6	16.8	17.3	17.6
Wages	3.2	3.3	4.6	5.1	5.1	4.6	4.5	4.2	4.5	5.0
Other	12.4	14.4	15.0	14.4	14.9	13.3	12.1	12.6	12.8	12.6
Of which: health and education	...	...	...	...	5.2	4.7	4.3	4.5	4.1	4.6
Capital expenditure and net lending 1/	3.9	1.1	1.8	2.0	3.7	3.0	2.1	5.6	6.1	4.4
Total expenditure	19.5	18.8	21.4	21.5	23.7	20.9	18.7	22.4	23.4	22.0

Sources: Azeri authorities; an staff estimates.

1/ Investment expenditure includes equity investment in BTC Azerbaijan (0.8 percent of GDP in 2002, and 1.7 percent of GDP in 2003).

D. Monetary and Exchange Rate Policies

15. **For the most part of the period under review, the exchange rate had de facto fixed or crawling pegs to the dollar, while monetary policy remained passive** (Figure 2).[9] This contributed to inflation/deflation cycles in the presence of large external shock, including the Russian crisis, and the volatility of capital flows and oil prices, as well as fiscal policy shocks.

16. **The central bank pursued a policy of gradual smooth nominal appreciation of the exchange rate vis-à-vis the dollar during 1995–97, *de facto* establishing an appreciating crawl, to achieve disinflation.** The cumulative nominal appreciation vis-à-vis the dollar reached 16 percent during this period. Given faster-than-expected remonetization of the economy, the achieved rates of inflation were below program projections, despite a breach of indicative base money targets for many test dates. The accumulation of NIR was the main counterpart to rapid base money growth during 1995–97.

17. **The exchange rate was fixed in the wake of the Russian crisis (1998), in part owing to political reasons associated with the illness of the President.** The combination of the fixed exchange rate regime and massive capital outflows, which were triggered by shattered confidence in the banking system, led to a significant contraction in monetary aggregates, contributing to deflation. The latter was also caused by supply-side factors, as cheap Russian imports flooded the country. The program NIR targets were not met following the Russian crisis in part because the central bank did not follow the staff advice to let the exchange rate depreciate to stop deflation.

18. **Following the Russian crisis, programs ended up accommodating the authorities' preference for maintaining a de facto depreciating exchange rate crawl.** In May 1999, following staff advice, the central bank reduced interventions in the foreign exchange market, which led to a seven percent step devaluation. During June 1999–June 2002, the exchange rate was allowed to depreciate by 10 percent along a smooth path, indicating that the authorities *de facto* pursued a policy of crawling peg again. The gradual exchange rate depreciation helped stop deflation. While the staff called for greater exchange rate flexibility in both directions, the authorities argued that it was difficult to achieve, owing

---

[9] *De jure* Azerbaijan has a managed float exchange rate regime because there is no legal commitment to an exchange rate target. However, PRGF program documents clearly indicated that the exchange rate was used as an anchor.

to the limited ability of the central bank to use indirect instruments of monetary policy[10] and the lack of competition on the supply side of the foreign exchange market.[11]

19. **The move to a de facto fixed exchange rate vis-à-vis the dollar in mid-2002 was initially consistent with low inflation, but an emerging inconsistency between the inflation objective and the fixed exchange rate was detected too late.** Once the 12-month CPI rate exceeded 2.5 percent by mid-2002, the central bank discontinued its policy of gradual nominal depreciation and fixed the exchange rate vis-à-vis the dollar.[12] During 2002–04, the staff supported the anchor role of the exchange rate and its informal fixing based on a judgment that exchange rate stability was consistent with the program objective of low single-digit inflation. This judgment proved right during 2002-03. But by 2004, the central bank accommodated increasing capital inflows and higher spending of oil revenues by the government and SOCAR at a fixed exchange rate. Resulting money and credit growth were initially interpreted as signs of deepening financial intermediation, while rising inflation was ascribed to one-off supply-side factors. Based on this analysis, no immediate changes to exchange rate policy were recommended by the staff in response to a significant increase in inflation by October 2004. There was consensus between the staff and the authorities that the exchange rate would need to appreciate modestly in 2005.

20. **When inflation continued to rise in 2005, the staff insisted on allowing the exchange rate to appreciate and sterilizing a portion of foreign exchange inflows.** While the authorities shifted to an appreciating crawl in early 2005 and increased sterilization, the pace of exchange rate appreciation was initially slow. As a result, the 12-month CPI rate reached 15.5 percent in April 2005,[13] well above the initial program medium-term inflation objective of 2.5 percent and the revised program target for 2005 of 5 percent.

E. External Position

21. **Azerbaijan's external position gradually strengthened under the three IMF arrangements, mainly on account of increasing oil export volumes and prices.** Outcomes

---

[10] The legal basis and the infrastructure for a wide range of indirect instruments of monetary policy was developed by 1998-99. However, the use of indirect instruments of monetary policy was limited, in part reflecting the authorities' reluctance to develop government securities' markets in the absence of budget financing need and in part difficulties of developing money markets in the presence of one large bank with a significant market power.

[11] The banking system is dominated by one large state-owned bank, and SOCAR is by far the largest supplier of foreign exchange to the market.

[12] From mid-2002 to February 2005, the nominal exchange rate vis-à-vis the dollar fluctuated within a +/-1 percent band.

[13] Administered energy price increases implemented in late 2004—early 2005 only added 1.5 percentage points to headline inflation. In addition, governance issues in customs might have contributed to price increases for some imported goods.

for current account deficits understandably deviated from program projections (Figure 1), given large external shocks related to the volatility of oil prices and FDI in the oil sector and FDI-related imports. In fact, the current account deficit fluctuated in the range of 1 to 35 percent of GDP during 1995–2004, complicating macroeconomic management (Tables 3–5). Because oil-related imports were financed by FDI and oil prices increased during 2000–04, the external position strengthened substantially. Gross official reserves increased to about $1 billion (about 3 ½ months of non-oil-related imports) at end-March 2005. Moreover, the government accumulated about $1 billion in the Oil Fund by end-March 2005. The authorities generally have pursued a cautious external debt strategy and have had an excellent record in servicing the external debt following difficulties in servicing external debt in the mid-1990s. Under the three Fund arrangements, performance criteria on limiting non-concessional external borrowing have been met with comfortable margins. A large portion of external debt, which amounted to 19 percent of GDP at end-2004, was concessional.

22. **At times, exchange rate policy was not supportive of export diversification, in part reflecting an overly optimistic judgment of the staff and the authorities on competitiveness and the structural reform momentum.** The nominal appreciation under the SBA and EFF/ESAF was not considered by the staff to be undermining competitiveness, as judged by the relatively low dollar wages in Azerbaijan in comparison with other trading partner countries. In retrospect, this judgment proved overly optimistic, as non-oil exports declined by 23 percent in dollar terms from 1994 to 1997. While the repercussions of the war in Chechnya affected Azerbaijan's access to markets, unfavorable exchange rate developments might have also contributed to the sluggish non-oil export performance, given a slower-than-expected pace of structural reforms. Immediately after the Russian crisis (1998), non-oil exports plummeted from already reduced levels, as the authorities attempted to maintain a fixed exchange rate. Following a transition to a depreciating crawl (mid-1999–mid-2002), the real effective exchange rate index (REER) declined by 30 percent, but subsequently flattened under the de facto fixed exchange rate (mid-2002–February 2005). This real depreciation contributed to a pick-up in non-oil exports growth. But by 2004, non-oil exports were only 8 percent above their 1994 level in dollar terms (Figure 3).

F. Structural Reforms

Fiscal structural reforms

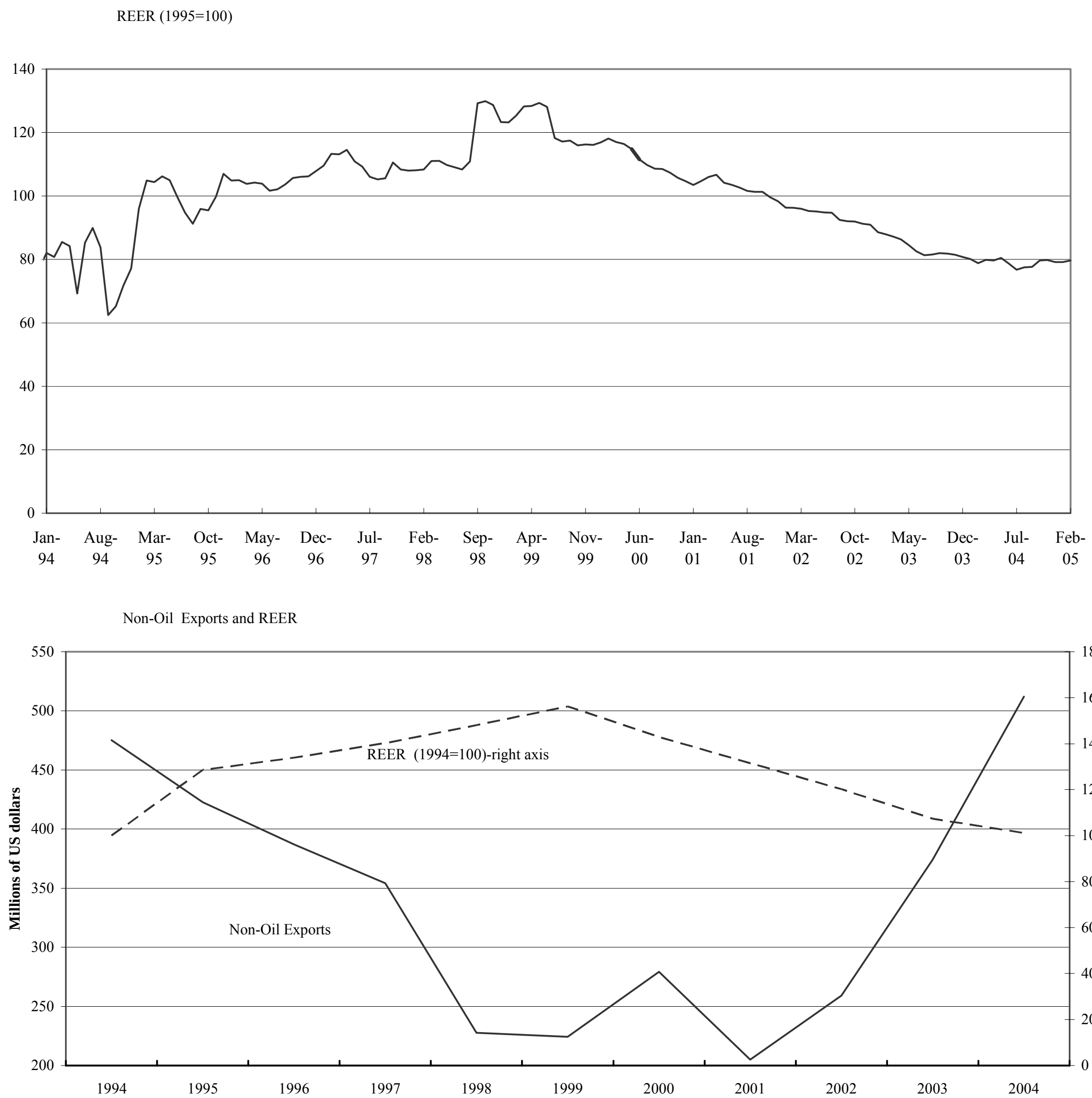
23. Despite implementation delays, there was substantial progress in fiscal reforms related to Fund core areas of expertise, which had a positive impact on fiscal policy implementation. The SBA and EFF/ESAF conditionality focused on the establishment of the treasury, and the reorganization of the tax and customs administrations, and improvements to expenditure management. Many of these reforms were implemented with delays. Under the PRGF, the reorganization of the tax and customs administrations were largely completed, a single treasury account was established, and a new tax code and a new budget system law were passed. However, at times, the implementation of laws and regulations related to fiscal management was uneven.

24. **There was a strong emphasis on governance in fiscal management in program conditionality, but corruption remains an important issue**. Under the PRGF, a number of performance criteria, benchmarks, and prior actions were implemented to improve governance in customs and government procurement. Moreover, a law on the chamber of accounts (the government's supreme audit institution) was approved, providing a legal basis for improved governance. However, surveys in the local press continue to report on important corruption issues in connection with government's operations, in particular in customs; and the chamber of accounts does not have capacity to assure transparency in fiscal operations.

25. **Many crucial fiscal reforms were implemented to prepare the country for transparent management of a significant increase in oil revenues.** The Oil Fund was established in 1999 to preserve oil wealth for future generations. The design of Fund operations is generally compliant with principles of transparent fiscal management; however, the fact that only the government's share of oil revenues from production sharing agreements (PSA) is deposited in the Oil Fund, while SOCAR's tax payments and PSA's income taxes are made directly to the Treasury, is not fully consistent with the program focus on the non-oil deficit. The staff urged consolidating all oil revenues in the Oil Fund, but the government resisted this recommendation. In addition to establishing the Oil Fund, in 2004, the authorities adopted a long-term oil revenue management strategy targeting constant real spending out of oil wealth. This strategy appropriately focuses fiscal policy implementation on the non-oil primary balance and calls for avoiding sharp changes in the fiscal stance. In application of this strategy, the authorities have started to approve a medium-term path for non-oil deficits in the context of the annual budget process. Finally, Azerbaijan was the first oil-producing country to issue an Extractive Industry Transparency Initiative report in early 2005.

26. **Some non-core fiscal reform areas—targeted social assistance and public sector employment reform—were included in program measures and conditionality under EFF/ESAF and PRGF.** This was justified by their critical importance for achieving program objectives. Some progress has been achieved in reforming central government administration and establishing some targeted assistance for utility payments. Measures related to large segments of public sector employment, including health and education, were included in conditionality and implemented under the EFF/ESAF. There was also a structural benchmark for end-March 2005 envisaging a preparation of a timetable for public sector employment reform under the PRGF, which was implemented.

Figure 3. Azerbaijan: Real Effective Exchange Rate and Non-Oil Exports, 1994-2005



Sources: Azerbaijan authorities; and Fund staff estimates.

Exchange and trade system reforms

27. **Substantial progress was made in trade and exchange liberalization under the three Fund arrangements.** The structural performance criteria and benchmarks pertaining to these areas were appropriately sequenced and were largely implemented in a timely manner. Under EFF/ESAF, all exchange restrictions under Article XIV were removed and substantial progress was made towards the adoption of Article VIII status. Under the PRGF, the authorities accepted obligations of Article VIII, Sections 2(a), 3, and 4. Efforts to further liberalize the trade system initiated under the SBA continued in the context of the EFF/ESAF

and PRGF arrangements. At present, Azerbaijan maintains a trade system that is free of any non-tariff restrictions and has a relatively low average tariff of 6 percent.

Monetary and exchange rate framework and financial sector reforms

28. **While many structural measures were implemented in Fund core reform areas, actual use of indirect instruments of monetary policy has been limited.** The authorities approved many laws and regulations to develop indirect instruments of monetary policy and strengthen the operational independence of the central bank in accordance with their commitments under the programs. These included a new central bank law, a new commercial banks law, and central bank regulations on credit auctions, the interbank credit and foreign exchange markets, and open market operations with treasury securities. However, as mentioned before, the use of indirect instruments of monetary policy has been limited.

29. **A large number of structural measures were implemented in the financial sector, but progress in achieving the objective of deepening financial intermediation has been slow.** The broad money-to-GDP ratio only increased to 17 percent of GDP in 2004 from 12 percent in 1995. The SBA and EFF/ESAF programs, as well as the World Bank SAL, appropriately focused on strengthening banking supervision and banking system restructuring. Significant advances have been achieved in improving banking supervision and its enforcement, which contributed to the exit of smaller non-viable banks. However, banking system restructuring measures were implemented only partially and with substantial delays. Contrary to the initial program expectations, only one out of four large public banks––International Bank of Azerbaijan (IBA)—has emerged as a viable bank following the banking system crisis of 1995. The restructuring of the other three banks was only completed in early 2000, when they were consolidated into one bank. The latter started to operate as a full-fledged bank only in 2004. Owing to the lack of competition for a prolonged period, the IBA strengthened its market power substantially, and smaller private banks were not able to exercise any effective competition pressures.

30. **Under the EFF/ESAF and PRGF, the implementation of program conditionality on IBA privatization (in which EBRD participated) was delayed on a number of occasions, as vested interest groups controlling the IBA strongly resisted the process.** By late 2004, negotiations on IBA privatization reached a dead-end, mainly owing to insufficient cooperation on the part of IBA management and waning political support for this deal. The recent focus of program conditionality on reducing entry barriers and stimulating the development of smaller banks is appropriate, but these measures were included in conditionality too late, not least because of unrealistic expectations on IBA privatization.

Price liberalization, privatization, and the business environment

31. **Fund programs succeeded in ensuring a significant increase in the size of the private sector.** The SBA and EFF/ESAF appropriately included conditionality related to privatization and price liberalization because they were critical for achieving the program's objective of private sector development. The privatization of small-size enterprises was completed by 1997. Most medium- and some large-size state-owned enterprises were

privatized in the late 1990s to early 2000s, using a voucher scheme. Moreover, land reform was completed in the late 1990s.

32. **However, corruption continues to hamper economic development.** Issues directly related to corruption and the business environment were included in Fund conditionality for the SBA and EFF/ESAF, but excluded from structural benchmarks and performance criteria under the PRGF,[14] given the World Bank active involvement in this area. While many laws and regulations have been passed, targeting an improvement in the business environment, including the anti-corruption law and streamlined business registration procedures, their actual implementation has been limited, in part owing to lack of commitment from the highest political authorities. The overall negative perception about governance and the business environment is reflected in the current low ranking of Azerbaijan in terms of governance and corruption (for example, the 2004 report by *Transparency International* ranks Azerbaijan 140 out of 145 countries included in the survey).

Energy sector

33. **Progress in energy sector reform fell short of program expectations, which ultimately maintained an inefficient allocation of resources in the economy.** Although the energy sector is not considered a Fund core reform area, its macroeconomic importance fully justified the inclusion of structural measures related to it in program conditionality. Structural benchmarks and performance criteria related to monitoring and auditing of SOCAR and other public enterprises have not been sufficiently effective in reforming their opaque corporate governance, mainly on account of "nominal" implementation. Equally important, a performance criterion on SOCAR's budget approval was introduced only at end-December 2004, despite the critical importance of SOCAR's operations for macroeconomic performance. Notwithstanding some reduction in energy subsidies through a series of energy price increases and better collection on energy tariffs, the initial PRGF objective of largely eliminating energy subsidies has not been achieved.[15] As a result, social and investment spending was crowded out by inefficient non-targeted energy subsidies.

G. Technical Assistance

34. **Azerbaijan has benefited from Fund technical assistance in a wide range of areas, which played an important role in building national institutions.** Since 1995 TA departments (FAD, LEG, MFD, and STA) have participated in more than 80 missions, and a number of resident and peripatetic advisors have assisted the authorities in building their technical capacity. Given the extent of the twin challenges of nation building and transition to the market economy, this large amount of technical assistance was fully justified and

[14] Under the PRGF, Fund conditionality in the area of fiscal reforms addressed many governance issues.

[15] The performance criteria related to domestic energy prices were modified and postponed to accommodate the government's gradualist approach, owing to rising world market oil prices and a lack of a comprehensive system of targeted social assistance.

contributed to a development of technical capacity in policy formulation and implementation virtually from scratch. The track record in implementing Fund TA recommendations mirrored the trends in compliance with structural conditionality to which they were often linked.

H. Collaboration with the World Bank and Other International Financial Institutions (IFIs)

35. **The collaboration between the Fund and the World Bank has been close.** During the last 10 years, there have been significant advances in some areas, where the World Bank took the lead, including privatization, private sector development, infrastructure, sectoral polices, and regulatory reforms. In the areas of shared responsibility, there was close collaboration between the Fund and World Bank staffs and mutually reinforcing conditionality on energy tariff adjustments, utilities reforms, fiscal management, banking legislation and supervision, and the definition of priorities in financial sector reforms in the context of an FSAP. This said, some Fund conditionality (e.g., budget formulation and expenditure management) could have been streamlined, given World Bank involvement in this area. However, in some critical reform areas, to which the World Bank assigned a low priority owing to assistance from other donors (e.g., public sector employment reform), or where the World Bank saw the need for longer implementation periods (e.g., targeted social assistance), Fund programs contained their own measures and conditionality.

36. **The Fund staff has collaborated closely with the EBRD, the Asian Development Bank and bilateral donors on many structural reforms**, including in the areas of financial sector reforms, the restructuring of energy companies, and fiscal management.

III. Assessment of Outcomes and Program Conditionality

37. **On balance, prolonged program engagement with Azerbaijan appears justified and has been beneficial.** Program outcomes are quite positive, which attests to a broad consistency of program objectives with recommended policies. On the macroeconomic front, growth resumed in 1995 and gradually spilled over from the oil sector to non-oil sectors, contributing to a significant decline in poverty (Table 1). External debt ratios have been reduced, and the external liquidity position has strengthened with the accumulation of about $1 billion in gross official reserves (3 ½ months of non-oil related imports) and $1 billion in Oil Fund assets by end-March 2005. The non-oil primary fiscal balance is broadly consistent with the authorities' long-run objective of keeping spending out of oil wealth constant in real terms. These achievements are in part attributable to high oil prices, but they also reflect progress in certain reform areas and generally cautious macroeconomic management. Although the recent increase in inflation to double digits is worrisome, the country does not face the task of fighting hyperinflation as it did in 1994.

38. **Structural reforms advanced unevenly.** The Fund contributed to the strengthening of national institutions, such as the central bank, tax administration, and the ministry of finance. Jointly with the World Bank, Fund programs achieved significant progress in fiscal reforms, the privatization of small- and medium-size enterprises, and trade and price liberalization. However, slow progress in financial and energy sector reforms, as well as

problems with the business environment and governance, raise doubts over the medium-term growth sustainability in non-oil sectors.

39. **Quantitative projections under all three programs were subject to a great degree of uncertainty, and as a result, major macroeconomic parameters and policy recommendations were revised frequently.** These uncertainties stemmed from the complexity of transition to a market economy, lack of reliable data, the volatility of oil prices and investments in the hydrocarbon sector, as well as a large magnitude of other external shocks (e.g., the war in Chechnya and the Russian crisis). Exogenous shocks were accommodated through adjustors to quantitative performance criteria, program reviews, changes in program definitions of performance criteria, and augmented financing (e.g., CCFF). However, despite compliance with 94 percent of quantitative performance criteria, Azerbaijan failed to avoid a pronounced deflation/inflation cycle and encountered difficulties in fiscal policy implementation.

40. **The undershooting and overshooting of the inflation targets reflected, in part, the non-observance by the authorities of their commitments under the program, and, in part, problems with program design.** The deflation under the EEF/ESAF was mainly attributable to the fact that in response to the exogenous shocks during 1998–99, the authorities did not follow the staff advice on exchange rate policy. However, a significant increase in inflation under the PRGF occurred despite compliance with most quantitative performance criteria under the program and full agreement between the staff and the authorities on the anchor role of the exchange rate, suggesting that deficiencies in program design contributed to the failure to reach inflation objectives. In hindsight, it appears that the authorities and the staff were too late to acknowledge incipient inflationary pressures in 2004, and the appropriate exchange rate policy advice was delayed. Moreover, the program assumption that a "modest" exchange rate appreciation in 2005 would offset the inflationary effects of fiscal relaxation and large public sector wage increases seems to have been overly optimistic, not least because the PRGF program conditionality did not ensure effective control on consolidated public sector demand. Even when inflationary pressures had been properly diagnosed, the authorities initially hesitated to appreciate the nominal exchange rate beyond a "modest" level out of concern with competitiveness and banking system stability.

41. **There were also some issues with the design of fiscal targets and their consistency with the overall macroeconomic framework.** Expenditure arrears were a recurrent problem under the SBA and EFF/ESAF, undermining the relevance of deficit targets. The situation in this area gradually improved, as conditionality on expenditure arrears was strengthened under the EFF/ESAF. However, problems with oil revenue collection have persisted. In this regard, the ineffective conditionality on oil revenues and the failure to monitor SOCAR's activities did not help. While the focus on the non-oil deficit is conceptually correct, the PRGF conditionality could have included a quantitative performance criterion on SOCAR's payments to the budget, in order to prevent the emergence of a larger demand impulse from the consolidated public sector than envisaged under the program. The end-December 2004 structural performance criterion on approval of SOCAR's budget was a step in the right direction, but its inclusion in the program conditionality was long overdue. Finally, a more thorough analysis of the impact of the

recommended medium-term fiscal expansion under the PRGF on the equilibrium REER should have been undertaken, if competitiveness issues represented an overriding concern for the authorities.

42. **Structural reform conditionality was increasingly focused on Fund core reform areas and critical measures in non-core areas.** Recommended measures were broadly consistent with program objectives and staff reports adequately justified their choice. Following the 2002 review of conditionality, there was some streamlining of conditionality, as the PRGF program increasingly focused on Fund core reform areas and critical reforms in non-core areas (Tables 7–8). However, some overlapping conditionality with the World Bank (e.g., fiscal management reforms) could have been streamlined.

Table 7. Azerbaijan: Number of Structural Conditions Normalized per Program Year, 1995-2005.

	Azerbaija				Fund average for 2002-2004
	Duration in	Number SPC and SBM per year	Number of per year	Tota	
SB	1	30.0	1.0	31.0	...
EFF/ESAF	4	15.8	5.5	19.5	...
PRGF	3.75	8.3	6.4	14.7	13.5

Sources: Fund staff estimates.

SPC: Structural Performance Criterion
SBM: Structural Benchmark
PA: Prior Action

Table 8. Azerbaijan: Composition of Structural Conditionality

	Total Number	Percent of total
SBA	30	100
Core areas	6	20
Monetary framework	2	7
Fiscal policy	4	13
Shared responsibility	12	40
Of which: financial sector	4	13
Non-core areas	12	40
EFF/ESAF	85	100
Core areas	19	22
Monetary framework	2	2
Fiscal policy	17	20
Shared responsibility	29	34
Of which: financial sector	18	21
Non-core areas	37	44
PRGF	57	100
Core areas	22	39
Monetary framework	3	5
Fiscal policy	19	33
Shared responsibility	22	39
Of which: financial sector	13	23
Non-core areas	13	23

Sources: MONA; and staff reports on Azerbaijan.

43. **The track record of compliance with structural performance criteria and benchmarks has been mixed.** Delays in completing reviews under the EFF/ESAF and PRGF, a large number of prior actions, and sizable share of waivers for structural performance criteria—60 percent[16]—reflected uneven ownership and weaknesses in implementation capacity. Adequate ownership of structural measures in the areas of privatization, foreign exchange system and trade liberalization, and some fiscal reforms led to better compliance with deadlines and contributed to the achievement of program objectives. However, uneven ownership was the root cause of implementation delays in IBA privatization and revisions in energy tariff policy. In these areas of weak ownership, a number of ambitious reforms included in program conditionality were not implemented according to initial schedules and subsequently replaced with more realistic measures over longer periods. Another issue is that conditionality in certain areas (some fiscal measures related to governance and reform of energy enterprises) focused on adoption of laws, regulations, and plans, which were not effectively implemented in the absence of follow-up conditionality, undermining the achievement of desired outcomes. Implementation capacity has improved thanks to extensive TA from the Fund and other donors.

[16] This number is comparable to an average PRGF arrangement.

IV. Lessons and Future Fund Engagement

44. The main lessons from the ten year engagement of the Fund with Azerbaijan are summarized as follows:

- Longer-term program engagement made a substantial contribution to the process of nation building and progress in transition to a market economy in Azerbaijan. However, the transition process turned out to be more complex and took longer than expected, and the reform agenda is by no means completed.

- Rapid growth of non-oil output in recent years has been key to reducing poverty. Therefore, structural reforms would need to accelerate to ensure growth sustainability and continued poverty reduction in the medium term, as the oil-related investment boom is expected to end soon.

- A combination of exchange rate pegs, underdeveloped monetary policy instruments, and a lack of effective control on the consolidated public sector position is not conducive to maintaining macroeconomic stability in the presence of frequent, large exogenous shocks. The program design, monitoring, and quantitative conditionality framework should have embedded appropriate incentives and mechanisms for timely adjustment to shocks.

- Fund programs contributed to a significant improvement in fiscal policy formulation and implementation well ahead of the projected significant increase in oil revenues. However, there was scope for improving the definition of the non-oil primary fiscal balance, strengthening conditionality on SOCAR's operations, and linking better budgeted expenditure to SPPRED and MTEF priorities.

- While Azerbaijan's external position has strengthened, the issue of competitiveness should have been analyzed more thoroughly in light of lack of progress in export diversification. To the extent competitiveness was an issue of concern and the pace of structural reforms was slower than expected, the staff and the authorities should have explored options of a tighter fiscal policy stance by the end of PRGF to limit real appreciation pressures.

- While structural reform conditionality design was broadly adequate, stricter conditionality or follow-up structural benchmarks would have been needed in the areas whether there was a risk of nominal implementation. This is particularly relevant for governance issues and restructuring of energy enterprises.

45. **Looking forward,** Azerbaijan faces a medium-term challenge of ensuring sustainable growth of non-oil output, export diversification, and poverty reduction in a stable macroeconomic environment at a time when oil revenues are projected to increase substantially.

46. **Important macroeconomic risks remain.** Double-digit inflation can persist if the authorities continue to delay the appropriate policy response and increase spending,

including wages, in the run-up to the November 2005 Parliamentary elections. A deterioration in the macroeconomic situation, in particular if compounded by a possible slow-down in structural reforms, would negatively affect growth of non-oil output, curtail employment opportunities, and reverse positive trends in poverty reduction.

47. **Although there is no balance of payments need, a Fund-supported program would be beneficial.** It could usefully strengthen the credibility of macroeconomic policies and government's efforts to continue growth-promoting structural reforms by providing a strong positive signal to domestic and foreign investors. Moreover, Fund program involvement is justified by the macroeconomic nature of the risks facing Azerbaijan and the need to continue with Fund core reforms that will help the country benefit from the forthcoming oil boom and avoid the resource revenue curse.

48. A Fund-supported program should focus on the following issues:

- **Sustained disinflation** will require the development of a new operational framework for monetary and exchange rate policies. The coherence between the exchange rate regime and macroeconomic and structural policies is essential for successful disinflation. The Fund should assume the primary responsibility for these issues.

- **Fiscal policy should focus on an improved definition of the non-oil primary balance in the context of the authorities' long-run oil revenues management strategy.** Strict monitoring of SOCAR's revenues and expenditures should be implemented, and the quality of expenditure should be improved to derive the benefits from increased spending out of oil wealth. Reform efforts should be geared toward raising social expenditure, establishing targeted social assistance, further improving the budget formulation process, enhancing transparency, and reducing energy-related subsidies. The World Bank is better placed to assume primary responsibility for these areas. The Fund could focus on one or two key elements of these broader reforms.

- **Financial sector reforms should focus on fostering competition, innovation, and growth in the banking system.** The market power of the only large bank should be curtailed through reduced barriers to entry and a more favorable business environment, which are essential for rapid growth of smaller private banks and an eventual return of foreign banks to the country. The IBA will also need to be subjected to anti-monopoly regulations and compliance with prudential regulations, and eventually privatized. In addition, further work needs to be done on developing capital markets and their supervision. The Fund should focus mainly on the issues of banking system stability and supervision, and additional support from bilateral donors and IFIs for other reforms in this area should be mobilized.

- **Other institutional and sectoral reforms** will need to be accelerated. Key measures include effective enforcement of the anti-corruption law, the passage of the new investment law and anti-monopoly law, and the continuation of reforms in the energy and transportation sectors. The World Bank should continue to take the lead in these areas. This said, the Fund should consider including one or two key measures related to governance and corruption in program conditionality.

49. **A precautionary stand-by arrangement appears to be the most appropriate vehicle to address policy challenges facing the authorities.** Another PRGF arrangement is not advised because there is no balance of payments need and the expectation is that GNP per capita will increase significantly during the next couple of years. To ensure sound program implementation, a new Fund arrangement can only be contemplated if the authorities demonstrate a strong commitment to address implementation weaknesses under the previous arrangements and strengthen ownership of policies. Therefore, it is recommended that negotiations on a new arrangement, if requested, be only initiated upon clear demonstration by the authorities of strong ownership through concrete policy steps, including sustained efforts to reduce inflation rates, activation of indirect instruments of monetary policy, and the strengthening of monitoring of SOCAR.

50. **The decision about an eventual graduation of Azerbaijan from Fund programs should be made upon completion of the recommended precautionary Stand-By Arrangement.** If the authorities continue to express interest in Fund program engagement because of its positive signaling effects, considerations could be given to another precautionary arrangement.

Table 9. Azerbaijan: Overview of Compliance Under IMF-Supported Programs

	Prior Actions			Quantitative Performance Criteria			Structural Performance Criteria			Structural Benchmarks		
	O	NO	Total	O	NO	Total	O	NO	Total	O	NO	Total
SBA (1995-1996)												
1st Review	1		1	6	2	8				13	4	17
2nd Review				8		8				2	1	3
3rd Review				8		8				8	1	9
Total	1		1	22	2	24				23	6	29
ESAF/EFF (1996-99)												
1st Review	7		7	17	1	18	0	1	1	15	2	17
2nd Review				17	1	18	2		2	12	2	14
3rd Review				16		16	1		1	10	2	12
4th Review	13		13	14	2	16				8	2	10
5th Review	2		2	14		14				4	2	6
Total	22		22	78	4	82	3	1	4	49	10	59
PRGF (2001-2005)												
Approval	13		13									
1st Review	3		3	8	1	9	1	3	4	2	1	3
2nd Review	4		4	9		9	1	3	4	2	1	3
3rd Review				9		9	2		2	1	1	2
4th Review	4		4	9		9	3	7	10	2	1	3
Total	24		24	35	1	36	7	13	20	7	4	11
Grand total	47		47	135	7	142	10	14	24	79	20	99

Sources: MONA; and staff reports on Azerbaijan.

O: Observed (Modified); NO: Not Observed (or waived for performance criteria).

Table 10. Azerbaijan: Compliance with Prior Actions,. Performance Criteria and Structural Conditions under SBA, 1995-96

	First Review	Second Review	Third Review
Prior Actions			
Trade systems	O	-	-
Quantitative performance Criteria			
Domestic credit	O	O	O
Credit to government/public sector	W	O	O
BOP/reserve test	O	O	O
Medium/long-term ext. debt ceiling	O	O	O
Medium/long-term ext. debt-sub ceiling	O	O	O
Short-term debt	O	O	O
No new external arrears	W	O	O
Limit on foreign Financing of budget	Mod	O	O
Structural Benchmarks			
Exchange systems	O	-	-
Financial sector	-	-	3O
Fiscal sector	2O, 1NO	-	-
Pricing & marketing policies	O	O	2O
Public enterprises	2O	-	O
System/ownership reform	3NO, 2O	O	O, NO
Tax/expenditure reform	3O	NO	-
Other	2O	-	O

Sources: MONA; and staff reports on Azerbaijan.

O: Observed; Mod: Observed with modification; NO: Not Observed; W: Waived for performance criteria.

Table 11. Azerbaijan: Compliance with Prior Actions, Performance Criteria, and Structural Conditionality Under EFF and ESAF (1996-99)Arrangements.

	EFF 1st Review		EFF 2nd Review		EFF 3rd Review		EFF 4th Review		EFF 5th Review	
	Midterm Rev. under 1st Annual ESAF				Midterm Rev. under 2nd Annual ESAF				Midterm Rev. under 3rd Annual ESAF	
	12/31/1996	3/31/1997	6/30/1997	9/30/1997	12/31/1997	3/31/1998	6/30/1998	9/30/1998	12/31/1998	3/31/1999
Prior Actions		-						4O		O
Tax/expenditure reform		-						-		-
Financial sector		-						5O		O
Systemic/ownership reform		O						-		-
Other (fiscal reforms)		O						-		-
Other (trade systems)		5O						-		-
Other		-						4O		-
Quantitative Performance Criteria										
Domestic credit	W	O	O	O	O	O	O	O	O	O
Credit to government/public sector	O	O	O	O	O	O	O	O	O	O
BOP/reserve test	O	O	O	O	O	O	O	NO	O	O
Medium/long-term ext. debt ceiling	O	O	O	O	O	O	O	O	O	O
Medium/long-term ext. debt-sub ceiling	O	O	O	O	O	O	O	O	O	O
Short-term debt	O	O	O	O	O	O	O	O	O	O
No new external arrears	O	O	O	O	O	O	O	O	-	-
Fiscal deficit	O	O	O	O	O	O	O	NO	O	O
Sub-limit on foreign financing of budget	O	O	O	W	-	-	-	-	-	-
Structural Performance Criteria										
Start voucher privatization auctions		W	O	-		-				
Eliminate pension and cash compensations arrears		-	O	-		-				
Complete comprehensive survey of govt. employment and pay		-	-	-		O				
Structural Benchmarks										
Exchange systems		O		O		-		-		-
Trade systems		2O		-		-		-		-
Pricing and marketing policies		2O		O		-		-		-
Public enterprises		O		O		-		-		-
Financial sector		3O		2O,1NO		6O		3O, 1NO		2O
of which: Monetary and exchange rate framework		O		-		O		3O		-
Tax/expenditure reform		4O,1NO		3O	O	O		O		O
Systemic and ownership reform		1O,1NO		4O		2NO		1O, 1NO		NO
Other		-		NO		2O		-		1O,1NO

Sources: MONA; and staff reports on Azerbaijan.

O: Observed; NO: Not Observed; W: Waived

Table 12. Azerbaijan: Compliance with Prior Actions, Performance Criteria and Structural Conditions Under PRGF, 2001-05

	Approval	First Review	Second Review	Third Review	Fourth Review
Prior Actions					
Governance	4O	O			
Fiscal sector	3O	O	2O		O
Financial sector	3O		2O		3O
Public enterprises	2O				
Systematic/ownership reform	O				
Tax/expenditure reform		O			
Quantitative Performance Criteria					
BOP/reserves test		O	O	O	O
Domestic credit		O	O	O	O
Credit to government		O	O	O	O
Fiscal deficit		O	O	O	O
External debt		O	O	O	O
Short-term debt		O	O	O	O
Medium-term debt		O	O	O	O
Long-term debt		O	O	O	O
No new external arrears		W	O	O	O
Structural Performance Criteria					
Tax/expenditure reform		W		O	2O
Financial sector		W			3W
Governance		W			
Fiscal sector		O	W	O	W
Pricing & marketing policies			W		W
Trade systems			O		O
Systematic/ownership reform			W		
Public enterprises					2W
Structural Benchmarks					
Fiscal sector		NO	NO	O	O
Tax/expenditure reform		O			O
Governance		O			
Financial sector			O	NO	
Trade systems			O		
Public enterprises					NO

Sources: MONA; and staff reports on Azerbaijan.

O: Observed; NM: Not Observed; W: Waived.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 05/99
FOR IMMEDIATE RELEASE
July 29, 2005

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

IMF Executive Board Reviews the Republic of Azerbaijan's Performance Under Past Fund-Supported Programs

On June 24, 2005, the Executive Board of the International Monetary Fund (IMF) conducted an Ex Post Assessment of Azerbaijan's Longer-Term Program Engagement. Ex Post Assessments are prepared for countries with a longer-term program engagement in order to evaluate the success of past programs and implications for possible future Fund involvement.

Background

Azerbaijan has had almost continuous program engagement with the Fund during the last 10 years. Early programs (1995–96) focused on macroeconomic stabilization and first generation structural reforms. By 1997, annual inflation rates declined to single digits from hyperinflationary levels, while output growth resumed, following many years of continuous decline. The twin shocks of the Russian crisis (1998) and a decline in oil prices complicated macroeconomic management and slowed down the implementation of structural reforms. In the early 2000s, a revival of structural reforms and a significant increase in oil-related investment led to an increase in GDP growth rates in a low inflation environment. However, the inflation rate reached double digits by 2004, as fiscal and income policies were loosened.

Azerbaijan has made substantial progress in economic development during the last 10 years. Program growth objectives were largely achieved, poverty declined to 40 percent in 2004 from about 60 percent in 1994, and Azerbaijan's current fiscal and external positions are sustainable. While most annual inflation targets were met, at times, there were deviations from program targets. On the structural front, significant progress was achieved in fiscal management, the privatization of small- and medium-size enterprises, and trade and price liberalization. However, advances in financial and energy sector reforms, as well as improvements in the business environment and governance have been slower than expected.

Executive Board Assessment

Directors noted that, with Fund support, Azerbaijan has made significant progress over the past 10 years in national institution-building, switching to a market economy, and improving economic management. As a result, Azerbaijan's growth and its fiscal and external positions strengthened during this period.

On balance, Directors considered that Azerbaijan's longer-term program engagement with the Fund was justified by the challenges of transition and nation building, high poverty, major economic dislocation caused by war and the disintegration of the Soviet economy, and inadequate policy implementation capacity. However, they believed that uneven ownership of, and commitment to, some structural reforms helped prolong Fund involvement. They noted, in particular, the mixed results with financial and energy sector reforms and with improvements to the business environment and governance.

Looking forward, Directors underscored that Azerbaijan faces the challenge of achieving sustainable growth of non-oil output, diversifying the economy, and reducing poverty while maintaining macroeconomic stability, at a time when oil revenue is projected to increase substantially. Although there is no balance of payments need, Directors felt that a successor low-access precautionary arrangement with Azerbaijan, or some form of non-financial support, will be beneficial, given the macroeconomic nature of risks and the need to continue with core reforms.

Directors stressed that any future Fund-supported program should focus on the development of a coherent framework for monetary and exchange rate policies, prudent management of oil wealth, enhanced monitoring of state-owned enterprises, banking system reforms, and improvements to the business environment and governance. Furthermore, strong ownership of reforms will be required to ensure successful implementation of the program.

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