INTERNATIONAL MONETARY FUND

IMF Country Report No. 12/5

REPUBLIC OF AZERBAIJAN

2011 ARTICLE IV CONSULTATION

January 18, 2012

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 2011 Article IV consultation with Azerbaijan, the following documents have been released and are included in this package:

- **Staff Report** for the 2011 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on November 2, 2011, with the officials of Azerbaijan on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on December 20, 2011. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- **Informational Annex** prepared by the IMF.
- **Public Information Notice** (PIN) summarizing the views of the Executive Board as expressed during its January 9, 2012 Lapse of Time (LOT) discussion of the staff report that concluded the ArticleIV consultation.

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

Selected Issues Paper

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

Copies of this report are available to the public from

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

Price: $18.00 a copy

International Monetary Fund
Washington, D.C.

INTERNATIONAL MONETARY FUND

REPUBLIC OF AZERBAIJAN

STAFF REPORT FOR THE 2011 ARTICLE IV CONSULTATION

December 20, 2011

KEY ISSUES

Context

A strong recovery of the non-hydrocarbon economy has offset a decline in oil output in 2011, but inflation pressures could emerge in 2012. The high oil fund savings should provide for an adequate buffer against a potential global shock.

Focus of consultation and recommendations

Diversifying the economy away from hydrocarbons and generating sustainable and inclusive growth, while preserving macro-financial stability. Staff recommends:

- Restraining budgetary spending to contain demand pressures that could emerge in the near term, and committing to medium-term fiscal consolidation to allow better sharing of hydrocarbon wealth across generations;
- Allowing greater exchange rate flexibility to counter inflation and lower output volatility, and strengthening monetary policy over the medium term;
- Strengthening supervision and taking steps to deepen the financial system; promptly addressing issues at the systemically important public bank;
- Improving the business environment and eliminating governance constraints on the private sector, especially for small and medium-sized enterprises (SMEs).

Previous Consultation

During the 2010 Article IV Consultation discussion, Directors stressed the need to preserve macroeconomic stability by securing fiscal sustainability; gradually exiting from crisis-related liquidity support; strengthening bank supervision and reforming the financial sector and the business environment. Since then, the authorities have adopted some macro-prudential measures and taken steps to improve the business climate. However, fiscal consolidation has not commenced and liquidity support to state enterprises and regulatory forbearance towards the systemic state bank have continued.

Approved By
Ratna Sahay and David D. Marston

Discussions were held in Baku on October 20 – November 2, 2011. The staff team comprised N. Ilahi (head), M. Albino-War, A. Shahmoradi, C. Yang (all MCD), and I. Song (MCM). A. Mursagulov (OED) joined some of the discussions.

CONTENTS

BOXES

ANNEXES

BACKGROUND AND CONTEXT

1. **Azerbaijan's economy has grown rapidly since the onset of the ongoing oil boom in 2003, and fared well through the 2009 global crisis.** Non-oil economic growth -averaged 13 percent in 2006–08. During the 2008–09 global shock, a fiscal stimulus and a stable exchange rate helped prevent non-oil growth from falling below 3 percent. The Central Bank of Azerbaijan (CBA) provided support to state enterprises, including provision for losses on investments abroad. Non-oil growth recovered to 7½ percent in 2010.

Azerbaijan's Economic and Social Indicators

	Pre-boom (2001-03)	Boom (2006-08) 1/
Non-oil GDP growth	11.4	13.0
Oil fund (percent of GDP) 2/	11.2	24.2
Deposit dollarization rate 2/	81.9	55.5
Poverty rate 3/	49.6	15.8
Business Competitiveness Ranking 4/	62	55

Sources: Azerbaijani authorities; and Fund staff estimates.

1/ The boom refers to the substantial increase in oil production.
2/ Data are for end 2003 and 2008.
3/ Share (percent) of population below the poverty line, (source: World Bank).
4/ World Economic Forum. Data are for 2005 and 2010.

2. **There has also been impressive poverty reduction since 2003.** Poverty has declined from near 50 percent before the oil boom to about 15 percent more recently, and inequality has also fallen. Gains in employment and wages and transfers through targeted social programs have contributed to these positive social outcomes.

3. **Notwithstanding those achievements, the following actions are needed to preserve macro-financial stability and promote sustainable and inclusive growth:**

- Removing the obstacles in the business environment and governance that constrain private sector–led growth, especially for SMEs;
- Conducting countercyclical fiscal policy while making the oil wealth available for future generations;
- Reducing the level and volatility of inflation; and
- Fostering financial intermediation and deepening, and promptly addressing issues at International Bank of Azerbaijan (IBA) to maintain near-term financial stability.

RECENT DEVELOPMENTS, OUTLOOK, AND RISKS

4. **Oil-financed public spending will continue to influence the near-term outlook:**

- **Non-hydrocarbon growth** could reach 9 percent in 2011, with actual output nearing potential by end–2011. Non-hydrocarbon growth is expected at 6 percent in 2012.

- **Oil output** fell sharply in 2011 because of maintenance problems and shortfalls in the delivery of new wells. The volume of hydrocarbon output could remain broadly the same next year, and over the next decade, before beginning to fall thereafter. As the price of a barrel of oil equivalent of Azerbaijani natural gas is about ¼ of oil prices, the increase in wealth associated with recent natural gas discoveries is significantly less than is implied by the volume increase.

- **Inflation** surged to 9.5 percent in February, but fell to 6.8 percent in October, mainly reflecting global food price developments. However, it could rise to 8 percent by end-2011 with planned public spending (under staff baseline scenario) and non-hydrocarbon output beginning to exceed potential (see Box 1).

- The manat **exchange rate** has been effectively fixed against the U.S. dollar—appreciating by less than 2 percent since November 2010—while the CBA made unsterilized purchases of foreign exchange.

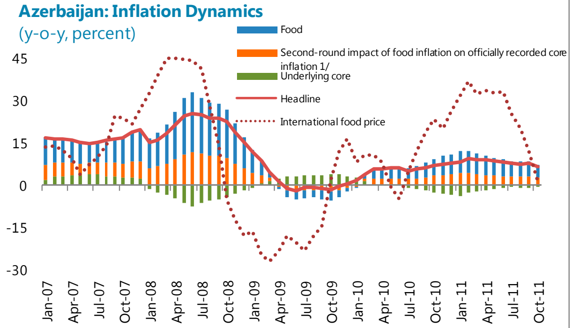
- **Fiscal policy.** Staff projects the non-hydrocarbon deficit to be 44 percent of non-hydrocarbon GDP in 2011, from 38 percent in 2010. The spending envisaged under the 2012 draft budget could increase it to above 50 percent, significantly raising the breakeven oil price. Recent high spending has also worsened fiscal sustainability.

Box 1. Azerbaijan: Inflation, Food Prices, and Output Gap

Food prices strongly influence headline inflation in Azerbaijan and spill over to core inflation. A 10 percent change in international food prices changes domestic food prices by about 3.2 percent. An exercise by IMF staff that splits the officially-recorded core inflation into (i) an underlying core (related to the output gap) and (ii) the spillover of food price inflation to expectations, suggests that about ¾ of the movement in core inflation in recent years was because of the latter.

In 2012, inflation could be increasingly driven by domestic demand. An output gap model suggests some slack in the non-hydrocarbon economy in 2011; but this gap is expected to close by end–year if supplementary fiscal spending is executed. With international food price growth moderating in the period ahead, headline inflation will be increasingly influenced by public spending–fueled domestic demand pressures.

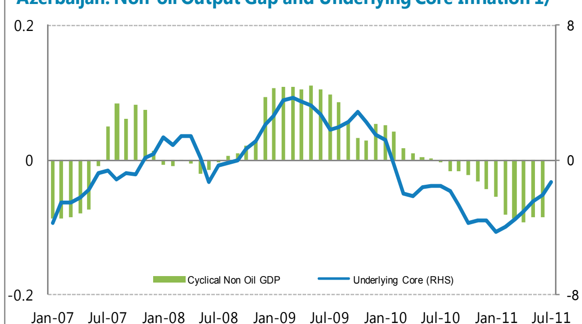
Azerbaijan: Inflation Dynamics
(y-o-y, percent)



Sources: Azerbaijani authorities; and Fund staff calculations.

1/ Second-round impact of food inflation has been 75 percent of domestic food price changes over the past year.

Azerbaijan: Non-oil Output Gap and Underlying Core Inflation 1/



1/ Based on HP filter, and monthly data.

- **Monetary policy**. As recovery took hold and there were signs of spillovers from rising global food prices on domestic inflation in early 2011, policy interest rates and reserve requirements were raised. Market rates, however, have been unresponsive and credit growth has remained sluggish (monetary transmission through policy rates is weak in the absence of well developed money and bond markets). The availability of securities for conducting monetary policy is also limited.

- A recent audit has confirmed capital adequacy and liquidity issues at the systemic public bank **IBA** (arising primarily from a deterioration in asset quality). While the authorities hired consultants to devise a privatization strategy, there has been little progress in this area over the last decade.

- Financial indicators of the **banking system** excluding IBA appear stable. Return on assets is recovering and capital exceeds 20 percent of risk–weighted assets. Nonperforming loans (NPLs) increased during the 2008–09 crisis, though it is unclear whether the cycle has peaked yet (disclosed NPL figures might be understated, as only the overdue portion of principal and interest is reported as NPL).

- While **spillovers** from the 2008–09 global financial crisis did not affect Azerbaijani banks, CBA bailed out troubled state enterprises through commercial banks, mainly to ease difficulties in rolling over short-term foreign liabilities. This credit has risen to about 5½ percent of projected non-hydrocarbon GDP and 20 percent of CBA's projected 2011 GIR, despite a strong economic recovery.

Azerbaijan: Banking Sector Financial Soundness Indicators 2005–11

(In percent)

	2005	2006	2007	2008	2009	2010	2011 1/
1. Regulatory Capital to Risk-Weighted Assets	20.7	18.7	19.9	19.6	17.7	16.9	16.1
2. Liquidity Assets to Total Assets	25.3	24.9	14.6	13.8	11.2	15.0	12.6
3. Nonperforming Loans to Total Loans 2/ 3/	6.7	6.6	3.0	3.3	3.5	4.7	5.1
4. Nonperforming Loans Net of Provisions to Total Loans	1.3	1.7	0.8	1.1	0.8	1.0	1.1
5. Bank Return on Assets	1.9	1.3	1.9	1.8	2.2	0.9	1.1
6. Bank Return on Equity	13.2	9.9	14.3	14.2	16.0	7.0	7.9

Source: Central Bank of Azerbaijan.

1/ Up to September 30, 2011.

2/ Excludes restructured loans. Impaired loan ratios are higher under IFRS.

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

5. **In the baseline scenario, medium-term economic prospects are favorable, though contingent on the implementation of staff's policy recommendations.** Structural reforms, including those related to business environment and governance, can yield gains in private non-oil investment, including FDI. Non-hydrocarbon GDP growth could be in the 5–5½ percent range if it is underpinned by medium-term fiscal consolidation and supported by non-oil FDI.

Azerbaijan: Selected Economic and Financial Indicators--Baseline Scenario, 2010–16

	2010	2011	2012 2/	2013	2014	2015	2016
	Est.	Proj.					
	(Annual percentage change)						
National income							
GDP at constant prices	5.0	-1.1	3.7	1.9	2.8	2.9	3.0
Of which: Oil sector	4.8	-10.9	1.0	-2.6	-0.1	-0.1	0.0
Non-oil sector	7.6	9.1	6.0	5.5	5.0	5.0	5.0
GDP at current prices	20.1	4.7	11.4	8.8	9.6	9.7	9.2
Implicit GDP deflator	14.4	5.8	7.5	6.8	6.6	6.6	6.1
Consumer price index (end-period)	7.9	8.3	7.4	6.7	6.5	6.5	6.0
Consumer price index (period average)	5.7	8.2	7.8	7.0	6.6	6.5	6.3
	(In percent of GDP, unless otherwise specified)						
Consolidated central government finance							
Total revenue and grants	46.7	48.1	43.0	39.8	37.8	36.9	36.9
Overall fiscal balance	15.0	8.5	6.3	3.7	4.0	4.5	5.4
Non-oil primary balance 1/	-37.6	-44.0	-39.5	-36.0	-30.4	-26.4	-23.1
External sector							
Current account balance	29.1	24.2	18.8	15.1	11.0	8.4	6.7
Non-oil current account balance 1/	-17.9	-20.6	-15.3	-12.4	-10.9	-10.1	-9.4
Public and publicly guaranteed external debt	7.5	8.4	8.7	8.1	7.5	7.1	6.9
Oil Fund Assets (in billions of U.S. dollars)	22.8	28.7	33.8	37.4	41.8	47.2	54.0

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

1/ In percent of non-oil GDP.

2/ Based on Fund staff baseline reform scenario and differs from the 2012 budget bill.

6. **Risks emanate from oil prices and regional developments, but can be mitigated by the large foreign assets cushion**. While Azerbaijan does not rely heavily on non-oil exports and remittances (these account for less than 10 percent of current account receipts), these links are primarily with CIS countries. Evidence from 2009 suggests that a regional slowdown could affect Azerbaijan's non-hydrocarbon economy. Nevertheless, foreign assets should provide sufficient buffer against future shocks, including to a sustained and sharp decline in the oil price to 50 dollars per barrel. Under this crisis scenario, non-hydrocarbon GDP growth could slow to 4 percent over the medium term and, if government spending is unchanged from the baseline scenario, could entail a substantial draw down of oil fund savings. Continued impasse on the Nagorno-Karabakh conflict could adversely affect the country's ability to attract non-hydrocarbon FDI over the medium term.

Azerbaijan: Selected Economic and Financial Indicators--Crisis Scenario, 2010–2016

(Impact of a sharp and sustained decline in oil prices 1/)

	2010	2011	2012	2013	2014	2015	2016
	Est.	Proj.					
	(Annual percentage change)						
National income							
GDP at constant prices	5.0	-1.1	3.8	1.5	2.1	2.1	2.1
Of which: Oil sector	4.8	-10.9	1.0	-2.6	-0.1	-0.1	0.0
Non-oil sector	7.6	9.1	6.2	4.8	3.8	3.6	3.6
Consumer price index (end-period)	7.9	7.8	7.7	5.8	5.3	5.1	5.3
Consumer price index (period average)	5.7	8.4	7.8	6.8	5.6	5.2	5.2
	(In percent of GDP, unless otherwise specified)						
Consolidated central government finance							
Total revenue and grants	46.7	48.4	26.1	25.8	26.1	26.9	27.6
Overall fiscal balance	15.0	8.6	-10.6	-10.6	-8.3	-6.4	-4.8
Non-oil primary balance 2, 3/	-37.6	-44.2	-39.6	-36.5	-31.6	-28.1	-25.1
External sector							
Current account balance	29.1	24.3	-0.4	-0.5	-1.2	-2.4	-3.3
Non-oil current account balance 2/	-17.9	-20.7	-15.4	-12.6	-11.6	-11.5	-11.6
Public and publicly guaranteed external debt	7.5	8.5	8.7	8.2	7.7	7.5	7.3
Oil Fund Assets (in billions of U.S. dollars)	22.8	28.7	22.7	15.7	9.7	4.8	1.0

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

1/ Oil price is assumed to fall to 50 dollars per barrel in 2012 and stay constant in real terms in 2013–16.

2/ In percent of non-oil GDP.

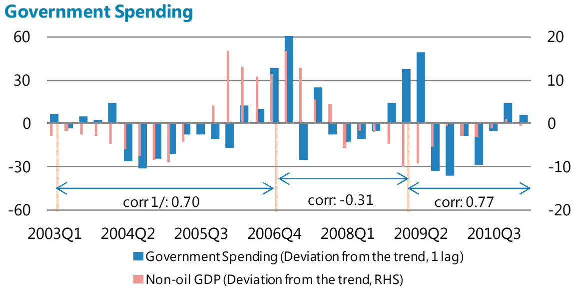
3/ Government spending is assumed to remain the same (in manats) as the baseline scenario.

POLICY PRIORITIES: DIVERSIFYING THE ECONOMY WHILE MAINTAINING MACRO-FINANCIAL STABILITY

A. Ensuring Growth is Inclusive and Sustainable

7. **Non-hydrocarbon growth and poverty reduction have been largely driven by high public spending.** Since the beginning of the oil boom, the non-hydrocarbon economy has become symbiotically dependent on public expenditures, with a sizable portion of the private non-farm sector reliant on government contracts, directly or indirectly. The gains in poverty reduction (Box 2) have come from construction and service sector growth, which in turn has benefited from heavy public capital spending.

Azerbaijan: Cyclical Movements of Non-oil GDP and Government Spending



Sources: Azerbaijani authorities; and Fund staff estimates.
1/ Corr: correlation coefficent.

8. **Significant structural reforms would be required to make growth more inclusive and self sustaining.** There is need for a diverse economy with a self-sustaining private sector. Future growth would have to generate adequate employment, including through trade. The business environment and governance would have to be improved and the social protection net widened. On the former, reforms that enhance competition, ease trade barriers, and facilitate a SME access to finance would be key (Box 3). While the recent introduction of e-Government and one-stop windows for business would help, anti-corruption efforts need to be broadened and sustained.

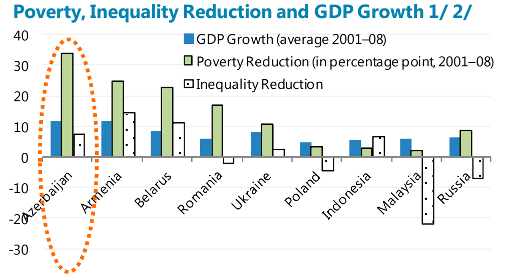
The Authorities' Views:

9. Reducing the economy's dependence on natural resources and encouraging non-hydrocarbon exports are both high on the authorities' list of priorities. They consider agro-industry, information technology, and tourism as promising sectors for increasing diversification and creating jobs, and view the heavy public spending on infrastructure as critical to easing physical constraints on the business climate and improving the productivity of private investment.

Box 2. Azerbaijan: The Inclusiveness of Growth[1]

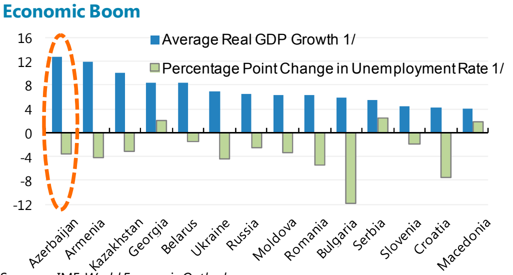
Poverty and inequality have declined rapidly during 2001–08 because of gains in employment, wages and productivity and social transfers (though official data indicate only a small drop in the unemployment rate). The poverty rate has fallen by more than 30 percentage points to 15 percent, and the Gini inequality index has declined by 8 percent to 34 percent. Both these achievements are made even more impressive by the fact that one in nine persons in Azerbaijan is internally displaced by the Nagorno-Karabakh conflict. The officially-recorded unemployment rate fell by only 3 percent during the period, raising doubts about the quality of such statistics and the definition of employment.[2] Household survey data suggest a substantial tightening of the labor market since the onset of the boom—average hours worked in non-agricultural jobs increased to 43 per week in 2008, from 38 in 2001, and real wages rose sharply.

Poverty, Inequality Reduction and GDP Growth 1/ 2/



Sources: World Development Indicators and national authorities' data.
1/ Non-oil growth is used for Azerbaijan. Poverty reduction is the drop in the poverty rate, from 2001 to 2008 or closest year available. For Poland, the poverty-at-risk rate in 2005 and 2009 are used. GDP growth is the average over the corresponding period.
2/ Inequality reduction is the Gini coefficient drop from 2001 to 2008 (in percent of base year). 2002 and 2008 data are used for Ukraine; 2005 and 2009 for Indonesia and Malaysia.

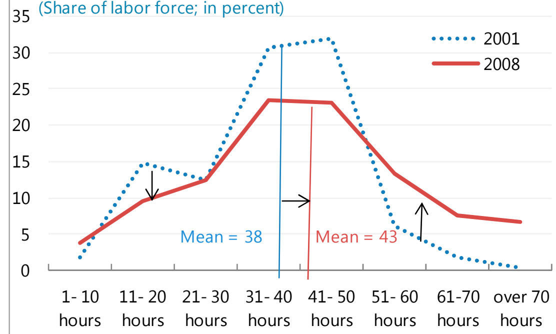
Economic Growth and Unemployment Change During the Economic Boom



Sources: IMF, *World Economic Outlook*.
1/ Average over 2001 through the year before the shock is used for GDP growth. Shock year is the year after 2001 when real GDP growth dropped most sharply. It is 2008 for Georgia and Kazakhstan, and 2009 for others. Non-oil GDP is used for Azerbaijan and Kazakhstan. The change in unemployment refers to the difference between 2001 and the year before the shock.

[1] See the Selected Issue Note, "The Inclusiveness of Azerbaijan's Growth."
[2] A person is defined as employed if they worked at least one hour in the week prior to the survey.

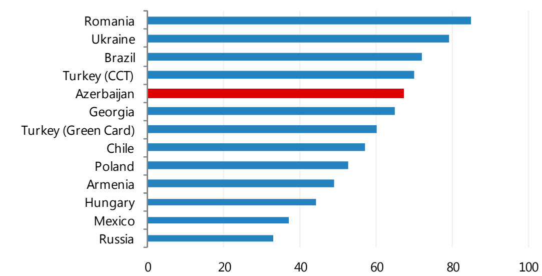
Azerbaijan: Distribution of Hours Worked per Week in Non-Agricultural Jobs
(Share of labor force; in percent)



Sources: Household Budget Survey (HBS) 2001 and Living Standard Measurement Study (LSMS) 2010.

Social protection is well targeted to the poor, though the coverage is narrow. The country does not rely on generalized subsidies on foods or fuels. Instead, there is a well–targeted assistance program (TSA) which, while having narrow coverage, has low "leakage" to the non-poor (with about half the benefits flowing to the bottom decile of the population).

Targeting of Social Assistance Programs 1/
(Share of benefits to poorest quintile, in percent)



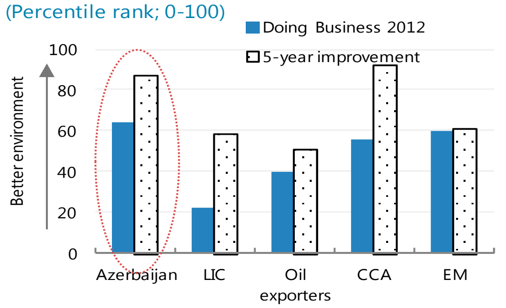
Sources: Living Standard Measurement Study (LSMS) 2010 for Azerbaijan; World Bank Europe and Central Asia Household Survey Database.
1/ The programs compared are: Russia (Child allow), Mexico (Oportunidades), Hungary (Aid Progs), Armenia (FB 2007), Poland (SW Ben.), Chile (Solidario), Turkey (Green Card and CCT), Georgia (Targeted Social Assistance), Azerbaijan (Targeted Social Assistance), Brazil (Bolsa Familia), Ukraine (XP program) and Romania (GMI).

Going ahead, there are signficant challenges in keeping growth inclusive. A youth bulge in the population underscores the need for significant job growth. Skills mismatches between labor supply and demand are an issue. Heavy investment and structural reforms in education and health are key.

Box 3. Azerbaijan: Business Environment and Governance

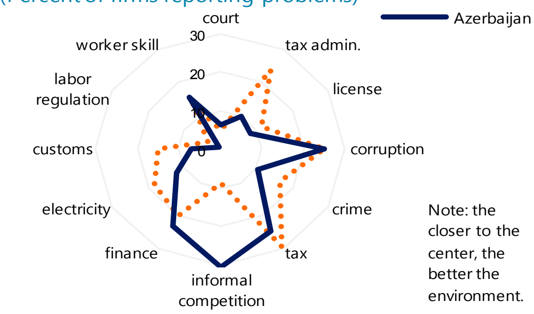
Azerbaijan ranks well globally on rules and regulations associated with business climate (e.g. on the World Bank's *Doing Business*), though significant challenges remain. Businesses report problems with local competition intensity and trade barriers. Weak financial infrastructure, such as the absence of a credit bureau, affects SMEs' access to finance. Governance is a particular concern. Notwithstanding some improvement in the past decade, the country ranks poorly on overall governance-related indicators (in the bottom third, globally), and it does particularly poorly on corruption.

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



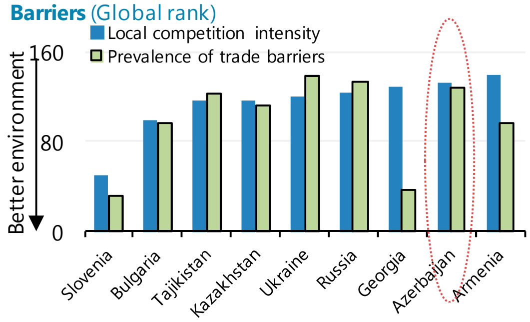
Sources: Doing Business (2012); and Fund staff calculations.
1/ LIC: Low-income countries; EM: Emerging markets.

Firm-level Business Constraints
(Percent of firms reporting problems)



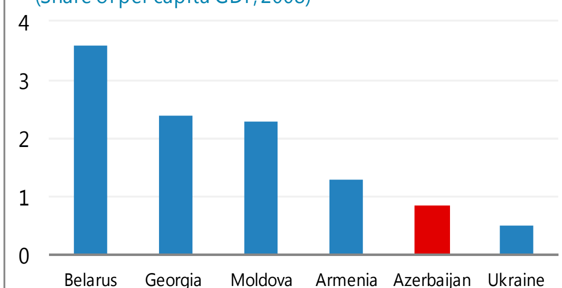
Sources: World Bank Enterprise Surveys; and Fund staff calculations.

Anti-monopoly Policy Effectiveness and Trade Barriers (Global rank)



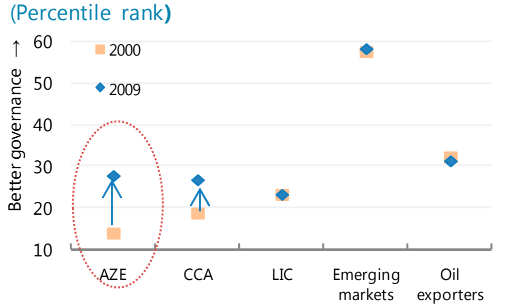
Source: The World Economic Forum, *Global Competitiveness Indicators* (2011).

Microfinance Average Loan Balance
(Share of per capita GDP, 2008)



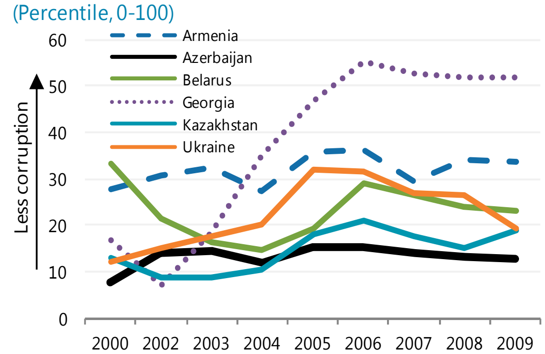
Sources: OECD 2011; and IMF staff calculations.

Changes in Governance 1/
(Percentile rank)



Sources: World Bank, Worldwide Governance Indicators. (Government effectiveness, Regulatory quality, Rule of law and control of corruption); and Fund staff calculations.
1/ LIC: Low-income countries.

Control of Corruption
(Percentile, 0-100)



Source: World Bank, *Worldwide Governance Indicators*.

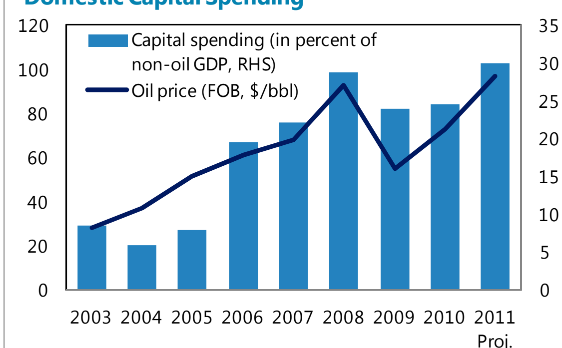
B. Fiscal Policy: Reconciling Near and Medium-Term Challenges

10. In recent years, fiscal policy has been pro-cyclical and has, as a result, built up risks to macroeconomic stability. Prior to 2012, the annual budget process had established appropriate levels of spending and oil fund saving. However, recent unanticipated increases in global oil prices have triggered supplemental government spending—mostly on capital projects. Combined with weakening tax discipline, this additional spending has sharply raised the non-hydrocarbon primary deficit and the 2012 consolidated budget bill, if fully implemented, would further raise this deficit, to more than 50 percent of non-hydrocarbon GDP.

11. Fiscal consolidation would be necessary in 2012 to avoid inflationary pressures. With output expected to have reached potential in late 2011, the large fiscal expansion planned for 2012 would lead to overheating pressures. Staff assumptions under the baseline scenario (Text Table and Table 4) support that a lower non-hydrocarbon deficit relative to the level envisaged in the draft budget—by about 10 percentage points of non-hydrocarbon GDP—would be consistent with the economy's absorptive capacity and macroeconomic stability, and would still allow for sizable investment spending.

12. Finite hydrocarbon resources and the need to achieve fiscal sustainability necessitate a commitment to medium-term fiscal consolidation. A sizable share of oil revenues should be saved to ensure that the benefits of hydrocarbon wealth are shared equitably across generations. To provide an anchor for consolidation efforts the government could employ a permanent-income fiscal rule, whereby it consumes a constant return on net hydrocarbon wealth. The rule would suggest a reduction of the non-hydrocarbon deficit from 44 percent of non-hydrocarbon GDP in 2011 to about 20 percent by 2017–18. Committing to a medium-term budget framework with indicative annual targets for the non-hydrocarbon fiscal deficit could help build public support for fiscal consolidation.

Correlation between Global Oil Price and Domestic Capital Spending



Sources: Azerbaijani authorities; and Fund staff estimates.

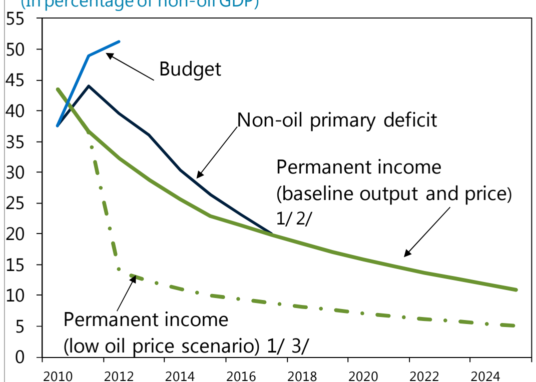
Azerbaijan: Consolidated Central Government Operations, 2010–12
(In percent of non-oil GDP)

	2010	2011	2012	
	Prel.	Staff Proj.	Draft Budget	Staff Proj.
Total revenue and grants	90.2	82.4	63.0	72.0
Of which : Oil revenue (SOFAZ)	60.9	52.4	37.0	42.5
Total expenditure	62.6	67.8	69.3	61.4
Consolidated government balance	28.9	14.6	-6.2	10.6
Non-oil primary balance	-37.6	-44.0	-51.2	-39.5
Memorandum items:				
Oil revenue	66.6	59.3		50.5
SOFAZ assets (in billions of US dollars)	22.8	28.7	27.1	28.6
Non-oil tax revenue	18.8	17.8		18.0

Sources: Azerbaijani authorities; and Fund staff estimates and baseline reform scenario projections.

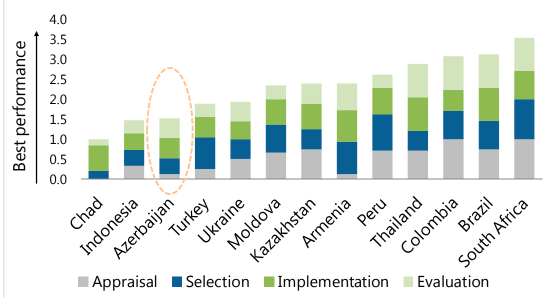
13. **Reforms of revenues and investment spending could underpin medium-term consolidation efforts.** Non-hydrocarbon revenues can be boosted, without raising tax rates, by streamlining exemptions, applying tax procedures uniformly and enhancing private–sector competition (Box 4). The ongoing modernization of the tax system, including the recent introduction of online filing, will help. Recent progress in increasing budget transparency should be supplemented with efforts to improve weaknesses in the selection and appraisal of public investment projects.

Sustainable Non-oil Primary Deficit 1/
(In percentage of non-oil GDP)



1/ Based on permanent income model. Permanent income is calculated as the real return on the public sector net assets, with discount factor and real investment return of 3.5 and 4 percent, respectively.
2/ Oil price in 2016-24 is assumed to be constant in real terms at the 2015 level.
3/ Assuming oil price drops to $50/bbl in 2012, and stays constant in real terms.

Quality of Public Investment
(Public Investment Management Index)



Source: Dabla-Norris et. al, 2011, "*Investing in Public Investment: An Index of Public Investment Efficiency*", IMF Working Paper/11/137.

The Authorities' Views:

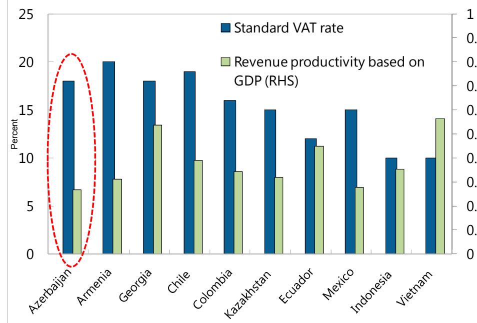
14. The authorities understand the role fiscal policy plays in maintaining macroeconomic stability, and intend to adjust infrastructure spending if demand pressures emerge. However, they also emphasized the need to spend over the next two years on critical infrastructure and other large projects (such as the Eurovision Song Contest) which will speed up the upgrading of public facilities, and plan to reduce such spending thereafter. They acknowledge the need to improve the selection and appraisal of public investment projects.

Box 4. Azerbaijan: The Oil Boom and Non-oil Taxes in Azerbaijan[1]

Azerbaijan's non-oil tax revenue to GDP ratio compares well with comparator countries, though VAT productivity and corporate income tax (CIT) performance could be strengthened. Non-oil revenues are in line with PPP per capita level of income and the share of oil in the economy. However, VAT productivity is low relative to other non-oil producing countries at similar income level, but also in comparison to other oil–producing countries. The 2011 *Doing Business* report points to a large spread between the standard CIT rate and the implied profit tax rate in Azerbaijan, and those in other countries.

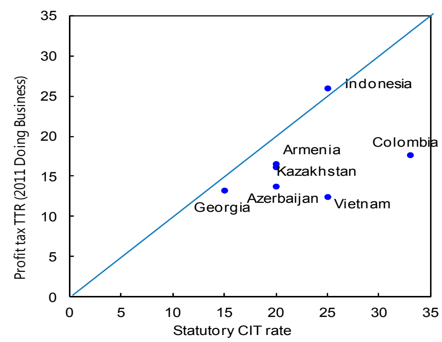
Non-oil revenue collection is undermined by loopholes in the tax base and weaknesses in tax and customs revenue collection processes. Over time, ad-hoc tax exemptions have eroded the tax base and affected the transparency and accountability of tax policy decisions. Despite ongoing plans to modernize the tax system, further efforts are needed on the uniform application of procedures, as the country still ranks low on the Ease of Paying Taxes indicator of *Doing Business* (2011).

VAT Rate and Productivity, 2010 1/



Sources: Fund staff, Fiscal Affairs Department, VAT Database.
1/ For some countries, data are for 2009.

CIT Rate: Statutory vs Doing Business



Sources: KPMG's Corporate and Indirect Tax Survey 2010; IMF, Fiscal Affairs Department; and 2011 *Doing Business*.

[1] See the Selected Issue Note, "Boosting Non-oil Tax Revenue in Azerbaijan."

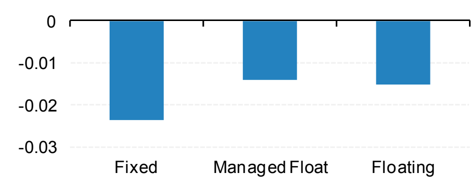
C. Monetary and Exchange Rate Policies: Dealing Effectively with Inflation

15. **The exchange rate could play a more active role in dealing with near-term inflation pressures emanating from increases in public spending.** With a de facto stabilized exchange rate, CBA has struggled to contain pressures emanating from fiscal spending and external shocks. Monetary tightening would be warranted in 2012 if demand pressures emerge and a move toward greater exchange rate flexibility than exists today could help alleviate such pressures, as would the introduction of a sufficiently wide exchange rate band (see Box 5). The economy's competitiveness can be adequately preserved by containing real exchange rate appreciation through keeping inflation low and stable rather than by resisting appreciation of the nominal exchange rate.

Box 5. Azerbaijan: Exchange Rate Policy—Insights from a DSGE Model[1]

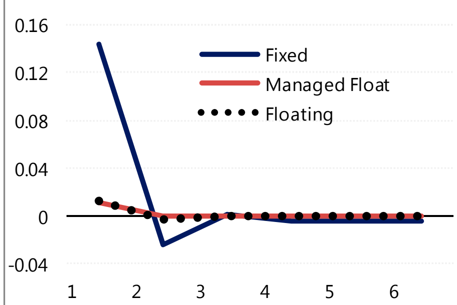
The model—calibrated and tailored to a small hydrocarbon economy with limited international capital interaction—suggests that a flexible exchange rate would entail lower macroeconomic costs (to inflation and output) than a fixed rate. By following a more flexible exchange rate than it currently does, the CBA could better mitigate the negative impacts of shocks emanating from changes in global oil prices and government spending, even under fiscal dominance. Given the limited financial intermediation and a paucity of instruments to hedge against exchange rate volatility, managed flexibility may be appropriate over the near term.

Macroeconomic Cost of Inflation and Output Fluctuations 1/

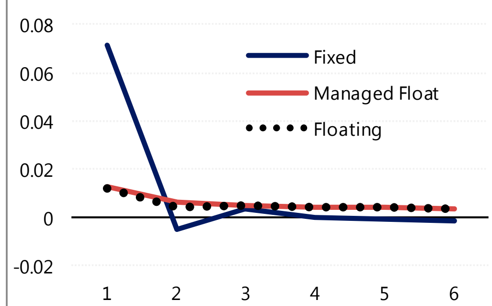


Source: Fund staff estimates.
1/ Based on a DSGE model tailored to Azerbaijan. Macroeconomic cost is defined as a quadratic cost function that measures the hypothetical cost of inflation and output fluctuations.

Inflation
(Percent deviation from steady state)



Real Non-oil GDP
(Percent deviation from steady state)



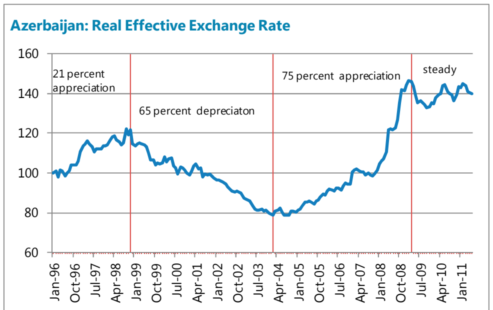
[1] See Selected Issue Note, "Exchange Rate Policy and Macroeconomic Costs in Azerbaijan: Insights from a DSGE Model."

16. **Over the medium term, further strengthening of monetary policy tools would be key to better controlling inflation.** A move away from the exchange rate as the nominal anchor, and greater reliance on interest rates and a more flexible exchange rate—would lower the volatility of output and inflation in the face of shocks (see Selected Issues Note, "Exchange Rate Policy and Macroeconomic Costs in Azerbaijan"). While greater exchange rate flexibility than exists today could help in the near term with inflation, a move to fuller exchange rate flexibility would require several actions. These include developing securities market (even in the absence of a need for financing); introducing currency risk mitigation instruments; deepening the interbank credit market; reducing distortions in interest rates and pricing of government securities; and improving the coordination between monetary and fiscal policies.

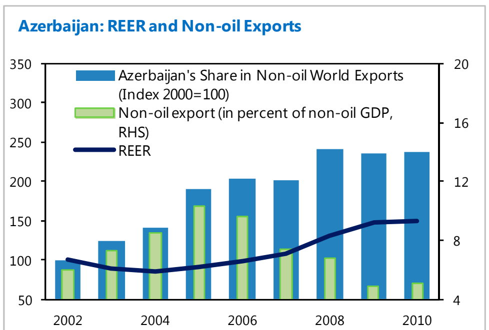
17. **Staff estimates do not suggest a misalignment of the real effective exchange rate.** The Macroeconomic Balance and the PPP approaches suggest an overvaluation, whereas the external sustainability and equilibrium real exchange rate approaches point to an undervaluation (See Box 6)**.**

Box 6. Azerbaijan: Exchange Rate Assessment

The manat REER appreciated substantially during the oil boom, but there is no concrete evidence of loss of competitiveness. With a fixed nominal exchange rate, adjustment in the REER has come mainly from changes in domestic inflation. 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, it has been broadly steady since late 2008. Notwithstanding the substantial real appreciation, the evidence on changes in competitiveness is mixed. While non-hydrocarbon exports have declined in relation to non-hydrocarbon GDP, Azerbaijan has been able to increase its share in global non-hydrocarbon exports.



Source: Azerbaijani authorities; and Fund staff estimates.



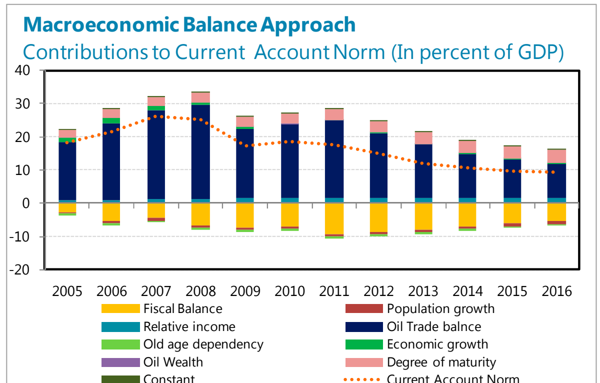
Sources: World Economic Outlook; and Fund staff calculations.

The exchange rate assessment does not suggest a misalignment. The Equilibrium Real Exchange Rate (ERER) and External Sustainability (ES) approaches indicate about 15 and 2 percent undervaluation, respectively. However, the Purchasing Power Parity (PPP) and the enhanced Macroeconomic Balance (MB approaches),[1] suggest an overvaluation of about 3 and 7 percent, respectively.

Azerbaijan : Exchange Rate Assessment

	MB 2/	ES 3/	ERER	PPP
Underlying current account	6.7	-6.1		
Current account norm	9.3	-6.8		
ER assessment, percent (-: undervalued) 1/	7.0	-1.8	-15.0	3.0

Source: Fund staff estimates and projections.
1/ Exchange rate elasticity is assumed to be 0.4.
2/ Current account as share of GDP.
3/ Non-oil current account as share of GDP.



Source: Azerbaijani authorities; and Fund staff estimates.

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

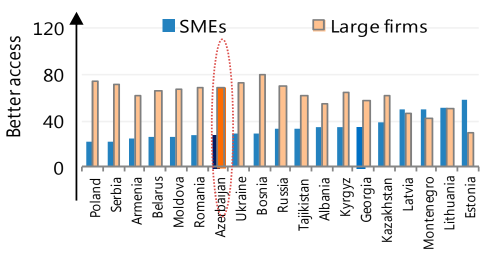
The Authorities' Views

18. The authorities agreed that monetary tightening would be warranted in case of emerging demand pressures. While acknowledging that introducing greater exchange rate flexibility could help in fighting inflation in the near term, they expressed concern that uneven execution of government spending, which entails heavy outlays in December, runs the risk of transmitting unnecessary volatility to the exchange rate. They also stated that it was a widely held public view, with which they did not necessarily agree, that a nominal appreciation, associated with greater exchange rate flexibility, might result in loss of competitiveness. Nevertheless they expressed an interest in receiving technical assistance from the Fund on operationalizing greater exchange rate flexibility.

D. Financial Sector: Managing Risks while Enabling the Sector to Support Private Sector–Led Growth

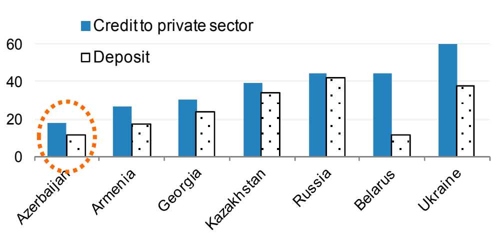
19. With weak intermediation and high concentration, the banking system is not well placed to support private sector–led growth. The sector is characterized by low deposit and credit in relation to the size of the economy, and domination by a large public bank, IBA. In addition, SMEs have lower access to finance than in many comparator countries, and microfinance lending is small (see Box 3).

Firms Reporting No Difficulty in Access to Finance
(Percent of firms surveyed)



Sources: World Bank Enterprise Surveys (2002–09).

Financial Intermediation
(Percent of GDP, 2010)



Sources: World Economic Outlook and International Financial Statistics.

20. IBA's soundness needs to be improved without delay, while preserving financial stability. Findings of the recent audit underscore the need to promptly strengthen the bank's liquidity and capital. To avoid exposing the central bank's balance sheet, liquidity support to IBA should be collateralized, and government recapitalization of the bank undertaken in line with implementation of a clear action plan to restore the bank to good health. IBA should limit additional financing from abroad, as such borrowing imposes contingent liability on sovereign resources. The appointment of consultants to devise a privatization strategy for IBA is a welcome step. Future plans should include ways to reduce IBA's systemic importance, and privatization undertaken transparently and with a clear timetable.

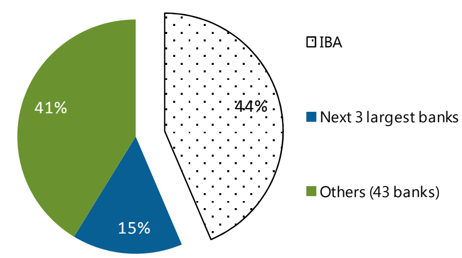
21. Recent macro–prudential measures are welcome, and banking supervision

should be strengthened and applied more proactively. The recent adoption of macro–prudential regulations, such as a leverage ratio—to prevent a rapid credit boom of the kind seen prior to the 2009 global crisis—and an increase in reserve requirement on foreign exchange deposits, should help reduce risks in the financial system. Enforcement of CBA supervision and prudential regulations should be applied uniformly across all banks, including the IBA.

22. CBA should unwind its support to state enterprises. It should narrowly limit its role to that of a "lender of last resort" for financial institutions. Support for troubled state enterprises should come directly from the budget.

23. Enhancing banking competition and deepening financial markets are key. As IBA accounts for 44 percent of system deposits, its persistent problems have hindered financial development in Azerbaijan. Offloading and downsizing IBA would bring the additional benefits of leveling the playing field across banks and enhancing financial intermediation. Encouraging the consolidation of private banks, particularly small ones, into competitive entities would also enhance competition. There is also a need to develop appropriate credit infrastructure (e. g., enforcement of contracts and setting up a credit bureau), particularly to enhance the role of SMEs. Ongoing efforts, including those undertaken in collaboration with the World Bank, to strengthen capital markets with the objective of developing long-term instruments for savers and investors, are appropriate.

Azerbaijan: Banking System Deposits, 2010



Source: Central Bank of Azerbaijan.

The Authorities' Views

24. The authorities agree on the need to improve competition in the banking system. While they are cognizant of IBA's fragile financial situation, they explained that prompt action is not likely till they have in hand a draft privatization strategy (expected from the consultants by mid-2012). They agreed that in the meantime the bank should limit its external borrowing. They see the need to use macro–prudential regulations more proactively to reduce system–wide risks.

OTHER ISSUES

Data Provision to the Fund

25. Timeliness and comprehensiveness of data provision to the Fund is considered adequate for surveillance. Actions are underway to bring fiscal and balance of payments statistics in line with international standards but more sustained effort is needed to improve the production of statistics, particularly for

GDP and International Investment Position (IIP). There is also a need to strengthen the quality of labor market statistics.

STAFF APPRAISAL

26. Until recently, Azerbaijan's strong economic performance has benefited from prudent economic policies. Since the early 2000s, government policies have contributed to keeping non-hydrocarbon growth high and the macroeconomic environment relatively stable. The policy of transparently saving a sizable portion of oil revenues has enabled the economy to avoid the adverse consequences of harvesting natural resources. In addition, non-hydrocarbon growth and well-targeted social assistance have contributed to significant reduction in poverty and inequality.

27. Nevertheless, significant actions would be needed for Azerbaijan to maintain the record of high growth and significant poverty reduction. Given the limited horizon of hydrocarbon resources, the economy needs to be reoriented from its symbiotic dependence on natural resource revenues. An important prerequisite for a successful transition to economic diversification and private sector–led growth is to improve governance and the business environment. The authorities' recent steps in this regard are welcome, but the anticorruption campaign needs to be extended widely and pursued resolutely. To improve the business climate, trade barriers should be eased and regulations made less restrictive with a view to enhancing competition.

28. Fiscal policy should be delinked from the global oil price cycle. Supplemental public spending, driven by changes in hydrocarbon prices, has exposed the economy to volatility and posed risks to macroeconomic stability. With the non-hydrocarbon economy recovering strongly and government spending likely to result in demand pressures in 2012, the non-hydrocarbon deficit should be lowered. The intra-year execution of government spending should be made less uncertain and more even.

29. Finite hydrocarbon resources underscore the need to achieve medium–term fiscal sustainability. The authorities understand the need to undertake medium-term fiscal consolidation, but near-term demands on public resources, especially for infrastructure and other large-project spending, have, to date, trumped longer–term considerations. The non-hydrocarbon fiscal stance in 2011 has worsened fiscal sustainability, and the 2012 draft budget could exacerbate it further. Fiscal consolidation should commence now, and there is considerable scope for trimming capital expenditures and boosting non-hydrocarbon revenues over the medium term. To build public support for the consolidation effort, the authorities could employ indicative annual targets on the non-hydrocarbon fiscal deficit. They should also strengthen the process underlying the selection and appraisal of public investment projects.

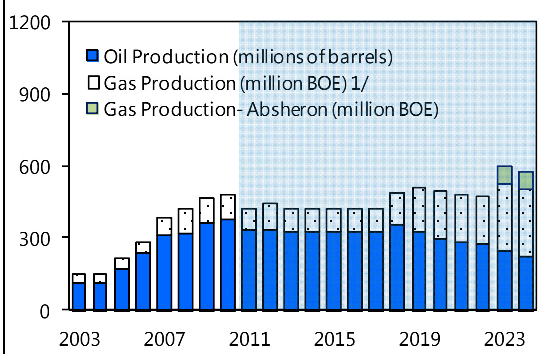
30. A tightening of monetary policy, through allowing greater exchange rate flexibility, may also be needed if demand pressures emerge. The de facto stabilized exchange rate has limited the effectiveness of monetary policy. Allowing greater exchange rate flexibility by employing a sufficiently wide exchange rate band would help contain inflation, and should be supplemented with other monetary policy tools, such as interest rates. However, staff does support the authorities' view that the exchange rate should not be used to absorb the shocks from an uneven and uncertain pattern of public spending. The monetary policy framework needs to be strengthened to better counter inflation over the medium term, and in addition to helping develop the associated infrastructure (e.g. debt markets), the central bank should improve the communication of monetary and exchange rate policies with the public.

31. Addressing financial sector weaknesses is key for supporting sustainable and inclusive growth. Effectively dealing with IBA would help maintain financial stability, contribute to transforming the financial sector by unlocking its resources and improving efficiency. To level the playing field and enhance competition, IBA should be downsized, and smaller banks encouraged to consolidate into competitive entities. Steps should also be taken to enhance SME access to finance. To minimize conflict of interest, the central bank should unwind the support it has been providing to state enterprises (through commercial banks), and limit its role to lender of last resort for financial institutions.

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

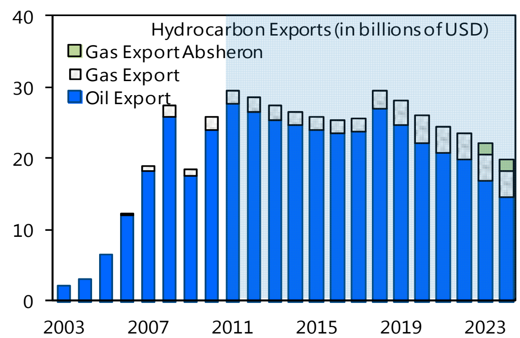
Figure 1. Azerbaijan: Output and Inflation

Despite the recent natural gas discovery which would add to hydrocarbon output starting in 2023...

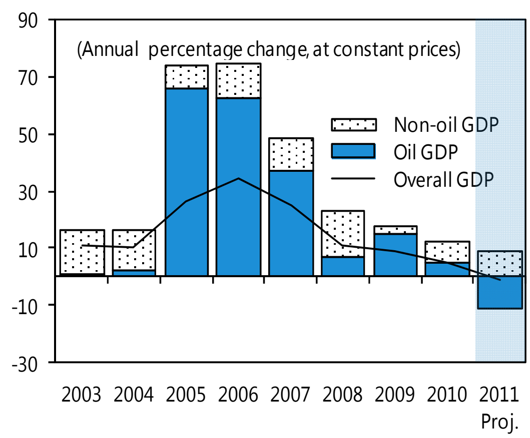


1/ Since a barrel of oil equivalent of natural gas sells at about 76 percent discount to oil, vertically stacking oil and natural gas volume does not reflect the value of hydrocarbon output.

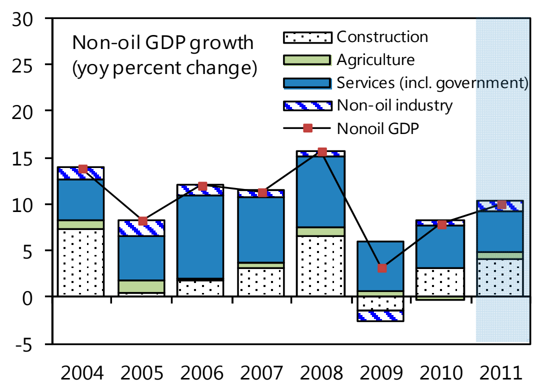
... hydrocarbon revenue would begin to decline shortly after 2018.



An unanticipated drop in oil production in 2011 has been offset by strong non-oil GDP growth...

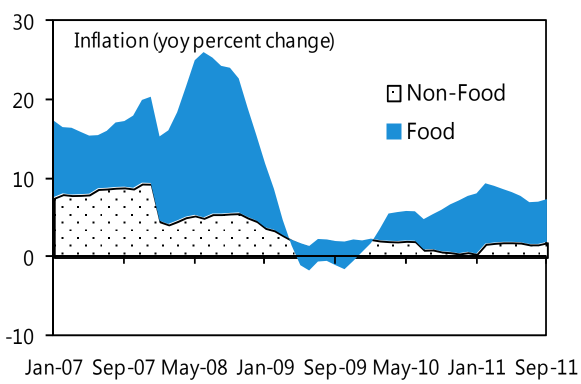


...the strength of which is, to a large extent, associated with government spending.1 /

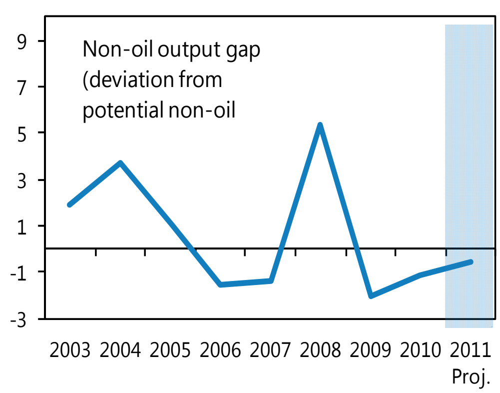


1/ 2011 refers to Oct 2011.

Headline inflation has been largely driven by global food prices....



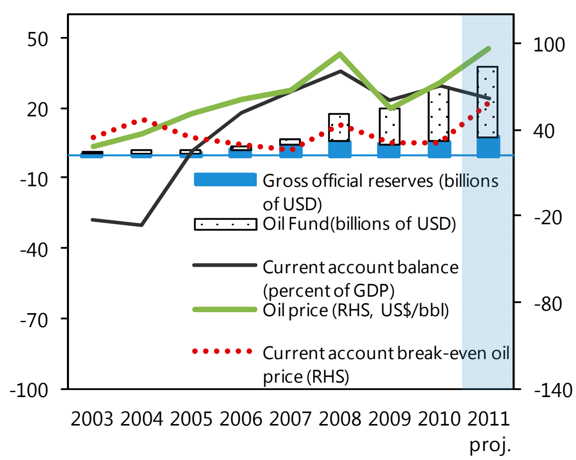
... and while food inflation is likely to decline with global trends, headline inflation could remain high as the non-oil output gap closes by end-2011.



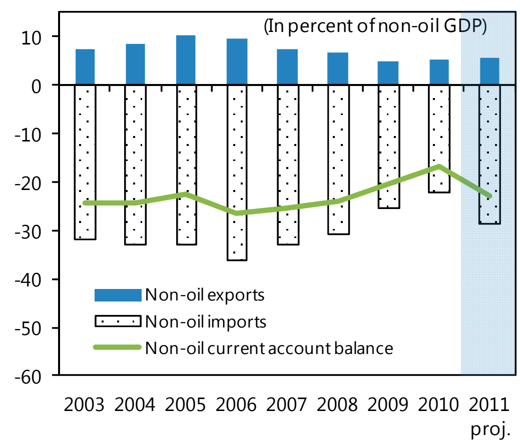
Sources: Azerbaijani authorities; and Fund staff estimates.

Figure 2. Azerbaijan: External and Fiscal Sectors

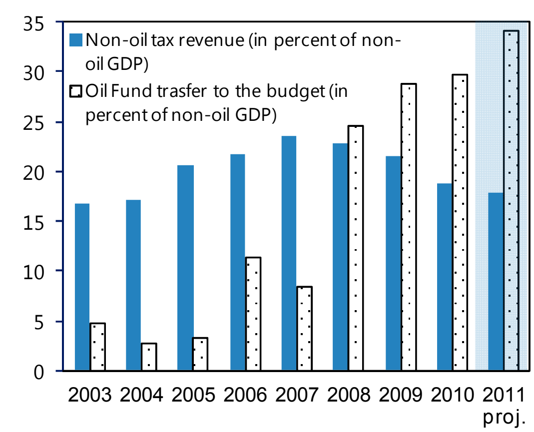
The external position remains strong, supported by oil prices and sizable public assets accumulation



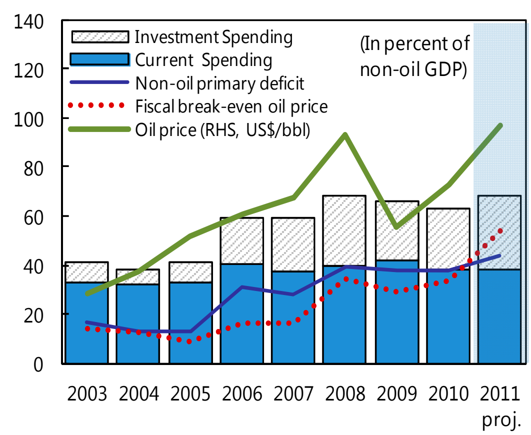
...but non-oil current account balance is expected to worsen in 2011 because of high growth in non-oil imports.



An increasing dependency on oil revenue and declining non-oil revenue...

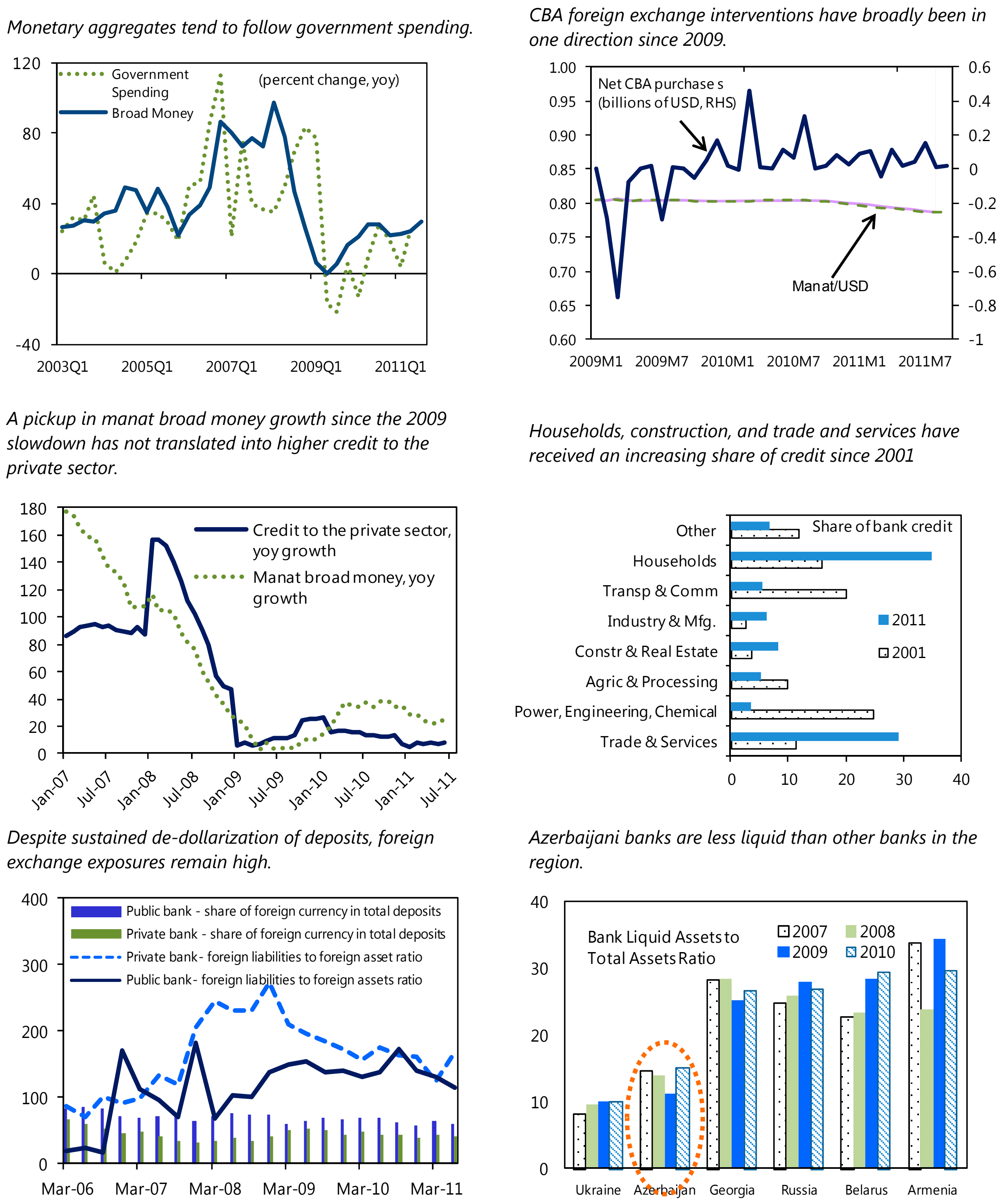


...have combined with high capital spending to increase the non-oil deficit.



Sources: Azerbaijani authorities; and Fund staff estimates.

Figure 3. Azerbaijan: Monetary and Financial Sector Developments



Sources: Azerbaijani authorities; and Fund staff estimates.

Table 1. Azerbaijan: Selected Economic and Financial Indicators, 2007–12

	2007	2008	2009	2010	2011	2012
				Prel.	Proj.	Proj.
	(Annual percentage change, unless otherwise specified)					
National income						
GDP at constant prices	25.0	10.8	9.3	5.0	-1.1	3.7
Of which: Oil sector 1/	37.3	6.9	14.8	4.8	-10.9	1.0
Non-oil sector 2/	11.3	15.7	3.0	7.6	9.1	6.0
Consumer price index (end of period)	19.5	15.4	0.7	7.9	8.3	7.4
Consumer price index (period average)	16.6	20.8	1.6	5.7	8.2	7.8
Money and credit						
Net foreign assets	46.9	47.2	-18.5	34.6	29.7	14.6
Net domestic assets	106.4	5.0	63.4	13.5	29.7	32.7
Domestic credit	95.5	24.5	42.2	8.4	17.8	19.6
Of which : Credit to private sector	87.3	47.6	25.6	6.6	16.7	18.5
Manat base money	101.4	48.5	1.7	31.6	21.9	21.9
Manat broad money	107.3	27.2	9.9	34.8	33.2	20.5
Total broad money	72.4	25.5	16.6	21.9	29.7	24.7
Foreign currency deposits ratio to broad money	25.4	24.3	28.7	21.2	19.0	21.7
Velocity of total broad money (M3) 3/	3.3	3.0	2.9	2.7	2.2	2.1
External sector (in US$)						
Exports f.o.b.	63.4	43.8	-31.0	25.5	19.7	-2.7
Of which: Oil sector	67.2	44.3	-31.5	25.7	18.9	-3.9
Imports f.o.b.	14.7	25.3	-14.0	3.6	67.2	-7.4
Of which: Oil sector	-33.0	-17.6	-34.2	19.6	136.1	-32.0
Export volumes	47.7	6.4	6.2	-1.4	-11.1	-3.3
Import volumes	5.6	17.0	-5.4	-4.0	53.2	-8.0
Terms of trade	4.3	26.1	-28.6	18.0	23.4	-0.1
Real effective exchange rate	8.4	21.4	14.0	1.1	...	...
	(In percent of GDP, unless otherwise specified)					
Gross investment	21.5	19.8	18.9	19.0	25.2	21.7
Consolidated government	9.7	13.2	12.7	12.7	17.6	13.0
Private sector	11.8	6.6	6.3	6.2	7.6	8.7
Of which: Oil sector	3.6	2.9	2.0	2.0	3.7	3.3
Gross domestic savings	61.1	64.4	49.0	53.8	54.4	44.4
Gross national savings	48.8	55.3	42.5	48.0	49.4	40.5
Consolidated government	12.4	33.5	19.8	27.7	26.1	19.4
Private sector 4/	36.4	21.8	22.7	20.3	23.3	21.1
Consolidated central government finance						
Overall fiscal balance	2.6	20.3	7.2	15.0	8.5	6.3
Non-oil primary balance, in percent of non-oil GDP	-28.3	-39.2	-37.9	-37.6	-44.0	-39.5
External sector						
Current account (- deficit)	27.3	35.5	23.6	29.1	24.2	18.8
Foreign direct investment (net)	-15.4	-1.2	0.3	0.2	0.2	-0.2
Public and publicly guaranteed external debt outstanding	7.7	6.5	7.9	7.5	8.4	8.7
Memorandum items:						
Gross official international reserves (in millions of U.S. dollars)	4,273	6,467	5,364	6,400	8,000	9,409
Nominal GDP (in millions of manat)	28,361	38,006	34,579	41,526	43,463	48,434
Nominal non-oil GDP (in millions of manat) 2/	12,446	17,431	18,322	21,492	25,391	28,900
Nominal non-oil GDP (in millions of USD) 2/	14,522	21,270	22,824	26,756	32,638	39,104
Nominal GDP per capita (in U.S. dollars)	3,663	5,213	4,798	5,713	6,125	7,128
Nominal GDP (in millions of U.S. dollars)	33,090	46,378	43,076	51,698	55,868	65,535
Oil Fund Assets (in millions of U.S. dollars) 5/	2,475	11,219	14,900	22,766	28,730	33,811
Population (mid-year, in millions)	8.8	8.9	9.0	9.0	9.1	9.2
Exchange rate (manat/dollar, end of period)	0.857	0.819	0.803	0.803		

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

1/ Includes the production and processing of oil and gas.
2/ Includes the transportation of oil and gas (except transportation through the western route), as well as the export tax paid by the state oil company.
3/ Defined as gross domestic demand (excluding oil sector-related imports) divided by average broad money.
4/ Historical data includes statistical discrepancy.
5/ The 2011 projection Includes the central government foreign exchange deposits managed by the Oil Fund.

Table 2. Azerbaijan: Balance of Payments, 2007–12

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

	2007	2008	2009	2010	2011	2012
				Est.	Proj.	Proj.
Exports, f.o.b.	21,269	30,586	21,097	26,476	31,696	30,832
Oil and oil products	20,190	29,143	19,970	25,108	29,858	28,680
Other	1,079	1,443	1,127	1,368	1,837	2,152
Imports, f.o.b.	-6,045	-7,575	-6,514	-6,746	-11,275	-10,442
Oil sector	-1,292	-1,064	-700	-838	-1,977	-1,344
Others	-4,753	-6,511	-5,814	-5,908	-9,298	-9,098
Trade balance	15,224	23,012	14,583	19,730	20,420	20,390
Services, net	-2,131	-2,343	-1,608	-1,733	-4,089	-5,484
Credit	1,248	1,547	1,750	2,065	2,092	2,251
Debit	-3,379	-3,889	-3,358	-3,798	-6,180	-7,735
Oil sector	-1,851	-1,970	-1,205	-1,240	-3,909	-5,419
Income	-5,079	-5,266	-3,519	-3,467	-3,746	-3,568
Investment income, net	-5,024	-5,200	-3,476	-3,418	-3,700	-3,506
Of which : profit of oil consortium	-4,815	-5,040	-2,884	-3,199	-3,719	-3,612
Compensation of employees, net	-55	-66	-43	-49	-46	-62
Transfers, net	1,005	1,050	722	509	938	969
Of which : Private	911	999	686	480	873	903
Current account balance	9,019	16,454	10,178	15,040	13,523	12,306
Non-oil currenct account balance	-3,214	-4,616	-5,002	-4,791	-6,731	-5,999
Capital account, net	-3	11	5	14	10	10
Direct investment, net	-5,035	-541	147	113	137	-126
Of which : In reporting economy, net	-4,749	15	473	391	919	649
Oil sector, net	-5,182	-581	-274	-187	-109	-151
Others, net	433	596	748	578	1,028	800
Portfolio investment, net	-26	-347	-139	-99	112	112
Other investment	-660	-2,658	-6,018	-3,796	-6,202	-5,798
Assets, net	-1,534	-3,585	-5,654	-5,594	-4,977	-5,377
Liabilities, net	875	927	-364	1,798	-1,225	-421
o/w General government	139	166	277	275	898	623
Financial account, net	-5,720	-3,547	-6,009	-3,606	-5,952	-5,812
Capital and financial account balance	-5,723	-3,536	-6,004	-3,592	-5,942	-5,802
Errors and omissions	-361	-846	-1,464	-989	--	--
Overall balance	2,935	12,072	2,710	10,459	7,581	6,504
Financing	-2,935	-12,072	-2,710	-8,916	-7,582	-6,503
Change in net foreign assets of CBA (increase -)	-1,781	-2,460	963	-1,051	-1,617	-1,423
Change in Oil Fund assets (increase -)	-1,021	-8,744	-3,681	-7,866	-5,964	-5,081
Memorandum items:						
Current account balance (in percent of GDP)	27.3	35.5	23.6	29.1	24.2	18.8
Non–oil Current account balance (in percent of Non–oil GDP)	-22.1	-21.7	-21.9	-17.9	-20.6	-15.3
Gross official international reserves	4,273	6,467	5,364	6,400	8,000	9,409
in months of next year's non-oil imports c.i.f.	6.1	9.7	7.6	6.6	8.4	9.7
Oil Fund assets	2,475	11,219	14,900	22,766	28,730	33,811
Public and publicly guaranteed external debt (in percent of GDF	7.7	6.5	7.9	7.5	8.4	8.7
Private sector debt (in percent of GDP)	13.6	13.7	12.9	13.8	9.4	9.6
Oil price (US$ per barrel)	71.1	97.0	61.8	79.0	103.2	100.0

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

Table 3a. Azerbaijan: Consolidated Central Government Operations, 2007–12

(In millions of manat)

	2007	2008	2009	2010	2011	2012	
						Draft	
				Prel	Proj.	Budget	Proj.
Total revenue and grants	8,007	19,426	14,368	19,386	20,927	18,220	20,820
Total revenue	8,007	19,426	14,368	19,383	20,927		20,820
Tax revenue	5,635	7,176	5,591	5,834	7,318		8,234
Income taxes	3,046	3,490	1,911	2,020	2,727		3,004
Social security contributions	551	599	582	697	705		831
Value added tax (VAT)	1,179	1,911	2,013	2,082	2,451		2,807
Excise taxes	403	487	485	515	495		591
Taxes on international trade	288	450	421	292	651		681
Other taxes	167	240	179	227	289		319
Nontax revenue 1/	2,209	12,250	8,777	13,549	13,609		12,586
Of which : Oil Fund revenues 2/	1,871	11,865	8,274	13,087	13,314	10,697	12,290
Total grants (current)	0	0	0	3	0	0	0
Total expenditure	7,356	11,829	12,027	13,451	17,226	20,026	17,747
Current expenditure	4,595	6,816	7,649	8,157	9,594		11,443
Primary current expenditure	4,565	6,783	7,613	8,118	9,422		11,347
Wages and salaries	1,086	1,567	1,825	1,884	2,433		3,066
Goods and services	1,770	3,034	3,105	3,540	3,586		4,081
Transfers	1,297	1,883	2,287	2,328	3,001		3,767
Of which: social protection fund	1,038	1,423	1,706	1,797	2,165		2,728
Subsidies	324	191	289	239	214		229
Oil Fund (operating expenditures)	4	7	10	14	15		16
Other	83	102	97	114	173		187
Interest	30	33	36	39	172		96
Investment expenditure and net lending	2,761	5,014	4,378	5,294	7,632		6,304
Domestically-financed	2,613	4,914	4,093	4,768	6,800		5,710
Foreign-financed	148	100	286	525	832		594
Statistical discrepancy	-100	-131	-142	-277	1		1
Consolidated government balance, cash basis	751	7,727	2,483	6,213	3,701	-1,806	3,072
Non-oil primary balance 3/	-3,525	-6,840	-6,942	-8,071	-11,177	-14,803	-11,428
Financing	-751	-7,727	-2,483	-6,213	-3,701		-3,072
Domestic (net)	-876	-7,752	-2,705	-6,686	-4,449		-3,568
Banking system	12	-659	-25	-133	-24		-25
Of which : Treasury bills	26	5	-3	31	10		15
Oil Fund (includes treasury balances)	-959	-7,185	-3,018	-6,700	-4,640		-3,755
Nonbank sector	65	69	304	148	160		172
Privatizations and other sale of assets	6	23	33	0	55		40
External (net)	125	25	222	473	748		496
Loans	154	130	287	526	833		594
Project loans	154	130	287	526	833		594
Eurobond	0	0	0	0	0		0
Amortization due	29	105	65	53	84		99
Memorandum items:							
Oil revenue	4,305	14,600	9,461	14,323	15,050		14,596
Non-oil revenue 4/	3,701	4,826	4,907	5,063	5,878		6,224
Non-oil tax revenue 5/	1,878	3,989	3,942	4,033	4,518		5,207
Non-oil GDP (in billion of manats)	12,446	17,431	18,322	21,492	25,391		28,900

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

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

2/ Includes profit oil, acreage fees, and income earned on Oil Fund assets.

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

4/ Excludes AIOC profit tax, profit oil, SOCAR profit tax, SOCAR export 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, SOCAR export tax and social contributions.

Table 3b. Azerbaijan: Statement of Consolidated Government Operations, 2007–12

(In millions of manat, presented in line with GFSM 2001)

	2007	2008	2009	2010	2011	2012
				Prel	Proj.	Proj.
Revenue	8,417	19,836	14,828	19,824	21,365	21,392
Tax revenue	5,247	6,577	5,009	5,137	6,613	7,403
Income taxes	3,046	3,490	1,911	2,020	2,727	3,004
Value added tax (VAT)	1,179	1,911	2,013	2,082	2,451	2,807
Excise taxes	403	487	485	515	495	591
Taxes on international trade	288	450	421	292	651	681
Other taxes	330	240	179	227	289	319
Social security contributions	961	1,008	1,042	1,135	1,143	1,403
Nontax revenue 1/	2,209	12,250	8,777	13,549	13,609	12,586
Of which : Oil Fund revenues 2/	1,871	11,865	8,274	13,087	13,314	12,290
Total grants (current)	0	0	0	3	0	0
Expense	5,005	7,225	8,109	8,595	10,032	12,015
Compensation of employees	1,086	1,567	1,825	1,884	2,433	3,066
Use of goods and services	1,770	3,034	3,105	3,540	3,586	4,081
Social benefits	1,297	1,883	2,287	2,328	3,001	3,767
Of which : social protection fund	1,038	1,423	1,706	1,797	2,165	2,728
Subsidies	324	191	289	239	214	229
Grants	493	511	557	552	611	759
Interest	30	33	36	39	172	96
Other expense	4	7	10	14	15	16
Net operating balance (-, deficit)	3,412	12,610	6,719	11,229	11,333	9,378
Net Acquisition of Nonfinancial Assets	2,761	5,014	4,378	5,294	7,632	6,304
Statistical discrepancy	-100	-131	-143	-277	1	1
Consolidated net lending and borrowing, cash basis	751	7,727	2,483	6,213	3,701	3,072
Non-oil primary net lending and borrowing 3/	-3,525	-6,840	-6,941	-8,071	-11,177	-11,428
Financing	-751	-7,727	-2,483	-6,213	-3,701	-3,072
Net acquisition of financial assets	-885	-7,731	-3,100	-6,938	-4,619	-3,755
Domestic	-885	-7,731	-3,100	-6,938	-4,619	-3,755
Oil Fund	-959	-7,185	-3,018	-6,700	-4,640	-3,755
Privatizations and other sale of assets	6	23	33	0	55	40
Change in deposits (+ withdrawal)	68	-569	-115	-237	-34	-40
Net incurrence of liabilities	134	4	617	725	918	683
Domestic	9	-22	395	252	170	187
Banking system	-55	-90	91	104	10	15
Nonbank sector	65	69	304	148	160	172
External	125	25	222	473	748	496
Memorandum items:						
Oil revenue	4,305	14,600	9,461	14,323	15,050	14,596
Non-oil revenue 4/	4,111	5,236	5,367	5,501	6,316	6,796
Non-oil tax revenue 5/	1,878	3,989	3,942	4,033	4,518	5,207
Non-oil GDP (in billion of manats)	12,446	17,431	18,322	21,492	25,391	28,900

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

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

2/ Includes profit oil, acreage fees, and income earned on Oil Fund assets.

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

4/ Excludes AIOC profit tax, profit oil, SOCAR profit tax, SOCAR export tax, but includes VAT and excise taxes on oil and gas, tax withholding on the AIOC's subcontractors, and grants for payment of social contributions.

5/ Tax revenue excluding AIOC and SOCAR profit tax, and SOCAR export tax.

Table 4a. Azerbaijan: Consolidated Central Government Operations, 2007–12

(In percent of non-oil GDP)

	2007	2008	2009	2010	2011	2012	
				Prel.	Proj.	Draft Budget	Proj.
Total revenue and grants	64.3	111.4	78.4	90.2	82.4	63.0	72.0
Total revenue	64.3	111.4	78.4	90.2	82.4		72.0
Tax revenue	45.3	41.2	30.5	27.1	28.8		28.5
Income taxes	24.5	20.0	10.4	9.4	10.7		10.4
Social security contributions	4.4	3.4	3.2	3.2	2.8		2.9
Value added tax (VAT)	9.5	11.0	11.0	9.7	9.7		9.7
Excise taxes	3.2	2.8	2.6	2.4	1.9		2.0
Taxes on international trade	2.3	2.6	2.3	1.4	2.6		2.4
Other taxes	1.3	1.4	1.0	1.1	1.1		1.1
Nontax revenue 1/	17.7	70.3	47.9	63.0	53.6		43.5
Of which : Oil Fund revenues 2/	15.0	68.1	45.2	60.9	52.4	37.0	42.5
Total grants (current)	0.0	0.0	0.0	0.0	0.0		0.0
Total expenditure	59.1	67.9	65.6	62.6	67.8	69.3	61.4
Current expenditure	36.9	39.1	41.7	38.0	37.8		39.6
Primary current expenditure	35.4	38.9	41.6	37.8	37.1		39.3
Wages and salaries	8.7	9.0	10.0	8.8	9.6		10.6
Goods and services	14.2	17.4	16.9	16.5	14.1		14.1
Transfers	10.4	10.8	12.5	10.8	11.8		13.0
Of which: social protection fund	8.3	8.2	9.3	8.4	8.5		9.4
Subsidies	1.3	1.1	1.6	1.1	0.8		0.8
Oil Fund (operating expenditures)	0.0	0.0	0.1	0.1	0.1		0.1
Other	0.7	0.6	0.5	0.5	0.7		0.6
Interest	0.2	0.2	0.2	0.2	0.7		0.3
Investment expenditure and net lending	22.2	28.8	23.9	24.6	30.1		21.8
Domestically-financed	21.0	28.2	22.3	22.2	26.8		19.8
Foreign-financed	1.2	0.6	1.6	2.4	3.3		2.1
Statistical discrepancy	-0.8	-0.7	-0.8	-1.3	0.0		0.0
Consolidated government balance, cash basis	6.0	44.3	13.6	28.9	14.6	-6.2	10.6
Non-oil primary balance 3/	-28.3	-39.2	-37.9	-37.6	-44.0	-51.2	-39.5
Financing	-6.0	-44.3	-13.6	-28.9	-14.6		-10.6
Domestic (net)	-7.0	-44.5	-14.8	-31.1	-17.5		-12.3
Banking system	0.1	-3.8	-0.1	-0.6	-0.1		-0.1
Of which : Treasury bills	0.2	0.0	0.0	0.1	0.0		0.1
Oil Fund	-7.7	-41.2	-16.5	-31.2	-18.3		-13.0
Nonbank sector	0.5	0.4	1.7	0.7	0.6		0.6
Privatizations and other sale of assets	0.0	0.1	0.2	0.0	0.2		0.1
External (net)	1.0	0.1	1.2	2.2	2.9		1.7
Loans	1.2	0.7	1.6	2.4	3.3		2.1
Eurobond	0.0	0.0	0.0	0.0	0.0		0.0
Memorandum items:							
Oil revenue	34.6	83.8	51.6	66.6	59.3		50.5
Non-oil revenue 4/	29.7	27.7	26.8	23.6	23.1		21.5
Non-oil tax revenue 5/	11.4	22.9	21.5	18.8	17.8		18.0

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

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

2/ Includes profit oil, acreage fees, and income earned on Oil Fund assets.

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

4/ Excludes AIOC profit tax, profit oil, SOCAR profit tax and SOCAR export 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, SOCAR export tax and social contributions.

Table 4b. Azerbaijan: Statement of Consolidated Government Operations, 2007–12

(In percent of non-oil GDP, presented in line with the GFSM 2001)

	2007	2008	2009	2010	2011	2012
				Prel	Proj.	Proj.
Revenue	67.6	113.8	80.9	92.2	84.1	74.0
Tax revenue	42.2	37.7	27.3	23.9	26.0	25.6
Income taxes	24.5	20.0	10.4	9.4	10.7	10.4
Value added tax (VAT)	9.5	11.0	11.0	9.7	9.7	9.7
Excise taxes	3.2	2.8	2.6	2.4	1.9	2.0
Taxes on international trade	2.3	2.6	2.3	1.4	2.6	2.4
Other taxes	2.7	1.4	1.0	1.1	1.1	1.1
Social security contributions	7.7	5.8	5.7	5.3	4.5	4.9
Nontax revenue 1/	17.7	70.3	47.9	63.0	53.6	43.5
Of which : Oil Fund revenues 2/	15.0	68.1	45.2	60.9	52.4	42.5
Total grants (current)	0.0	0.0	0.0	0.0	0.0	0.0
Expense	40.2	41.5	44.3	40.0	39.5	41.6
Compensation of employees	8.7	9.0	10.0	8.8	9.6	10.6
Use of Goods and services	14.2	17.4	16.9	16.5	14.1	14.1
Social benefits	10.4	10.8	12.5	10.8	11.8	13.0
Of which : social protection fund	8.3	8.2	9.3	8.4	8.5	9.4
Subsidies	2.6	1.1	1.6	1.1	0.8	0.8
Grants	4.0	2.9	3.0	2.6	2.4	2.6
Interest	0.2	0.2	0.2	0.2	0.7	0.3
Other expense	0.0	0.0	0.1	0.1	0.1	0.1
Net operating balance (-, deficit)	27.4	72.3	36.7	52.2	44.6	32.4
Net Acquisition of Nonfinancial Assets	22.2	28.8	23.9	24.6	30.1	21.8
Statistical discrepancy	-0.8	-0.7	-0.8	-1.3	0.0	0.0
Consolidated net lending and borrowing, cash basis	6.0	44.3	13.6	28.9	14.6	10.6
Non-oil primary net lending and borrowing 3/	-28.3	-39.2	-37.9	-37.6	-44.0	-39.5
Financing	-6.0	-44.3	-13.6	-28.9	-14.6	-10.6
Net acquisition of financial assets	-7.1	-44.4	-16.9	-32.3	-18.2	-13.0
Domestic (net)	-7.1	-44.4	-16.9	-32.3	-18.2	-13.0
Oil Fund	-7.7	-41.2	-16.5	-31.2	-18.3	-13.0
Privatizations and other sale of assets	0.0	0.1	0.2	0.0	0.2	0.1
Change in deposits (+ withdrawal)	0.5	-3.3	-0.6	-1.1	-0.1	-0.1
Net incurrence of liabilities	1.1	0.0	3.4	3.4	3.6	2.4
Domestic	0.1	-0.1	2.2	1.2	0.7	0.6
Banking system	-0.4	-0.5	0.5	0.5	0.0	0.1
Nonbank sector	0.5	0.4	1.7	0.7	0.6	0.6
External	1.0	0.1	1.2	2.2	2.9	1.7
Memorandum items:						
Oil revenue	34.6	83.8	51.6	66.6	59.3	50.5
Non-oil revenue 4/	33.0	30.0	29.3	25.6	24.9	23.5
Non-oil tax revenue 5/	15.1	22.9	21.5	18.8	17.8	18.0
Non-oil GDP (in billion of manats)	12.4	17.4	18.3	21.5	25.4	28.9

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

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

2/ Includes profit oil, acreage fees, and income earned on Oil Fund assets.

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

4/ Excludes AIOC profit tax, profit oil, SOCAR profit tax, SOCAR export tax, but includes VAT and excise taxes on oil and gas, tax withholding on the AIOC's subcontractors and grants for payment of social contributions.

5/ Tax revenue excluding AIOC and SOCAR profit tax, and SOCAR export tax.

Table 5. Azerbaijan: Summary Accounts of the Central Bank, 2007–12
(In millions of manat, unless otherwise specified)

	2007	2008	2009	2010	2011 Proj.	2012 Proj.
Net foreign assets	3,527	5,113	4,257	5,488	6,714	7,738
Net international reserves of the CBA	3,524	5,115	4,257	5,488	6,712	7,736
Gross international reserves	3,612	5,180	4,308	5,527	6,774	7,745
Foreign liabilities	-88	-65	-50	-39	-62	-9
Other items, net 1/	3	-3	0	0	2	2
Net domestic assets	-87	-149	651	1,033	1,687	1,797
Domestic credit	-60	-390	875	1,087	1,741	1,846
Net claims on consolidated central government	93	-476	-591	-828	-592	-611
Of which : claims on central government	137	134	390	430	430	430
manat deposits of central government	-33	-522	-870	-932	-966	-1,006
Claims on banks	97	233	1,473	1,550	750	835
Credit to the economy	1	2	2	399	1,653	1,638
CBA notes	-251	-149	-8	-34	-70	-16
Other items, net	-27	241	-225	-54	-54	-49
Reserve money	3,441	4,964	4,908	6,521	8,401	9,536
Manat reserve money	3,221	4,781	4,861	6,397	7,801	9,509
Currency outside CBA	2,911	4,426	4,513	5,793	6,898	8,609
Bank reserves and other deposits	310	355	345	602	901	898
Reserves in foreign currency	220	183	47	124	600	27

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

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

Table 6. Azerbaijan: Monetary Survey, 2007–12

(In millions of manat, unless otherwise specified)

	2007	2008	2009	2010	2011 Proj.	2012 Proj.
Net foreign assets	2,870	4,225	3,444	4,636	6,013	6,888
Net international reserves of the CBA	3,524	5,115	4,257	5,488	6,712	7,736
Net foreign assets of commercial banks	-468	-808	-731	-779	-651	-779
Other	-186	-82	-83	-73	-48	-70
Net domestic assets	3,026	3,176	5,189	5,889	7,639	10,133
Net claims on consolidated central government	48	-647	-637	-777	-805	-831
Credit to the economy	4,644	6,488	8,946	9,786	11,416	13,527
Of which: private sector	4,007	5,912	7,429	7,919	9,238	10,946
Other items, net	-1,667	-2,665	-3,120	-3,119	-2,973	-2,563
Broad money	5,897	7,401	8,633	10,527	13,652	17,021
Manat broad money	4,402	5,600	6,157	8,297	11,051	13,321
Cash outside banks	2,714	4,189	4,253	5,456	6,547	7,333
Manat deposits	1,688	1,411	1,904	2,842	4,505	5,988
Foreign currency deposits	1,496	1,801	2,476	2,230	2,600	3,700
			(Annual percentage change)			
Net foreign assets	46.9	47.2	-18.5	34.6	29.7	14.5
Net domestic assets	106.4	5.0	63.4	13.5	29.7	32.7
Credit to the economy	96.5	39.7	37.9	9.4	16.7	18.5
Of which: private sector	87.3	47.6	25.6	6.6	16.7	18.5
Broad money (M3)	72.4	25.5	16.6	21.9	29.7	24.7
Manat broad money (M2)	107.3	27.2	9.9	34.8	33.2	20.5
Reserve money	68.3	44.3	-1.1	32.9	28.8	13.5
Manat reserve money	101.4	48.5	1.7	31.6	21.9	21.9
Memorandum items:						
Gross official international reserves (US$ millions)	4,273	6,467	5,364	6,927	8,936	10,756
Velocity of total broad money (M3) 1/	3.3	3.0	2.9	2.7	2.2	2.1
Broad money in percent of non-oil GDP	42.9	43.5	43.2	46.2	58.8	55.6
Credit to private sector in percent of non-oil GDP	32.2	33.9	40.5	36.8	36.4	37.9
Currency to broad money ratio	46.0	56.6	49.3	51.8	48.0	43.1
Share of foreign currency deposits in total deposits	47.0	56.1	56.5	44.0	36.6	38.2
Foreign currency deposits to broad money ratio	25.4	24.3	28.7	21.2	19.0	21.7

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

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

Table 7. Azerbaijan: Selected Economic and Financial Indicators, 2010–16

	2010 Prel.	2011 Proj.	2012 Proj.	2013 Proj.	2014 Proj.	2015 Proj.	2016 Proj.
	(Annual percentage change, unless otherwise specified)						
National income							
GDP at constant prices	5.0	-1.1	3.7	1.9	2.8	2.9	3.0
Of which: Oil sector 1/	4.8	-10.9	1.0	-2.6	-0.1	-0.1	0.0
Non-oil sector 2/	7.6	9.1	6.0	5.5	5.0	5.0	5.0
Consumer price index (end-period)	7.9	8.3	7.4	6.7	6.5	6.5	6.0
Consumer price index (period average)	5.7	8.2	7.8	7.0	6.6	6.5	6.3
External sector (in U.S. dollars)							
Exports f.o.b.	25.5	19.7	-2.7	-2.1	-0.7	1.2	2.6
Of which: Oil sector	25.7	18.9	-3.9	-3.8	-3.1	-2.1	-2.2
Non-oil sector	21.4	34.3	17.1	20.5	25.5	28.8	32.4
Imports f.o.b.	3.6	67.2	-7.4	5.5	10.0	14.3	14.7
Of which: Oil sector	19.6	136.1	-32.0	37.7	5.1	3.9	3.6
Non-oil sector	1.6	57.4	-2.2	0.7	11.0	16.2	16.7
Export volumes	-1.4	-11.1	-3.3	0.3	0.4	0.9	1.7
Import volumes	-4.0	53.2	-8.0	5.8	10.4	14.1	13.9
Terms of trade	18.0	23.4	-0.1	-2.1	-0.7	0.2	0.2
Real effective exchange rate	1.1	...	...	...	...	...	...
	(In percent of GDP, unless otherwise specified)						
Gross investment	19.0	25.2	21.7	20.9	19.3	18.6	18.5
Consolidated government	12.7	17.6	13.0	11.6	9.1	7.7	6.8
Private sector	6.2	7.6	8.7	9.3	10.2	11.0	11.7
Of which: Oil sector	2.0	3.7	3.3	3.0	2.7	2.5	2.4
Gross national savings	48.0	49.4	40.5	36.0	30.4	27.1	25.1
Consolidated government	27.7	26.1	19.4	15.3	13.1	12.2	12.2
Private sector 3/	20.3	23.3	21.1	20.7	17.3	14.9	12.9
Consolidated central government finance							
Overall fiscal balance	15.0	8.5	6.3	3.7	4.0	4.5	5.4
Non-oil primary balance, in percent of non-oil GDP 4/	-37.6	-44.0	-39.5	-36.0	-30.4	-26.4	-23.1
External sector							
Current account balance	29.1	24.2	18.8	15.1	11.0	8.4	6.7
Non-oil current account balance (in percent of non-oil GDP)	-17.9	-20.6	-15.3	-12.4	-10.9	-10.1	-9.4
Foreign direct investment (net)	0.2	0.2	-0.2	0.9	4.0	5.1	6.0
Of which: Non-oil sector	1.1	1.8	1.2	1.3	2.9	3.6	4.2
Public and publicly guaranteed external debt outstanding	7.5	8.4	8.7	8.1	7.5	7.1	6.9
Memorandum items:							
Gross official international reserves (in billions of U.S. dollars)	6.4	8.0	9.4	10.8	11.9	13.1	14.2
Gross official reserves (in months of next year's imports c.i.f.)	4.4	5.3	6.1	6.4	6.3	6.1	6.6
Nominal GDP (in billions of manat)	41.5	43.5	48.4	52.7	57.8	63.3	69.2
Nominal GDP (in billions of US. dollars)	51.7	55.9	65.5	75.1	86.6	97.5	106.4
Nominal non-oil GDP (in billions of manat) 2/	21.5	25.4	28.9	32.5	36.4	40.7	45.3
Nominal non-oil GDP (in billions of US. dollars) 2/	26.8	32.6	39.1	46.3	54.5	62.6	69.7
Nominal GDP per capita (in U.S. dollars)	5,713	6,125	7,128	8,099	9,269	10,349	11,214
Oil Fund Assets (in billions of U.S. dollars) 5/	22.8	28.7	33.8	37.4	41.8	47.2	54.0
Population (mid-year, in millions)	9.0	9.1	9.2	9.3	9.3	9.4	9.5

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

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

Annex I. Azerbaijan: External Debt Sustainability Assessment

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

External debt has declined substantially since the onset of the oil boom, halving by 20 percentage points to about 21 percent in 2010 relative to 2004. This reflects, in large part, rapid real GDP growth and the government's decision to finance domestic investment projects from oil revenue.

Under the baseline scenario, external debt is projected to decline slightly to about 15 percent of GDP by 2016, mainly from increasing non-oil FDI (attracted by progress on structural reforms and substantial strengthening of the non-oil fiscal position).

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

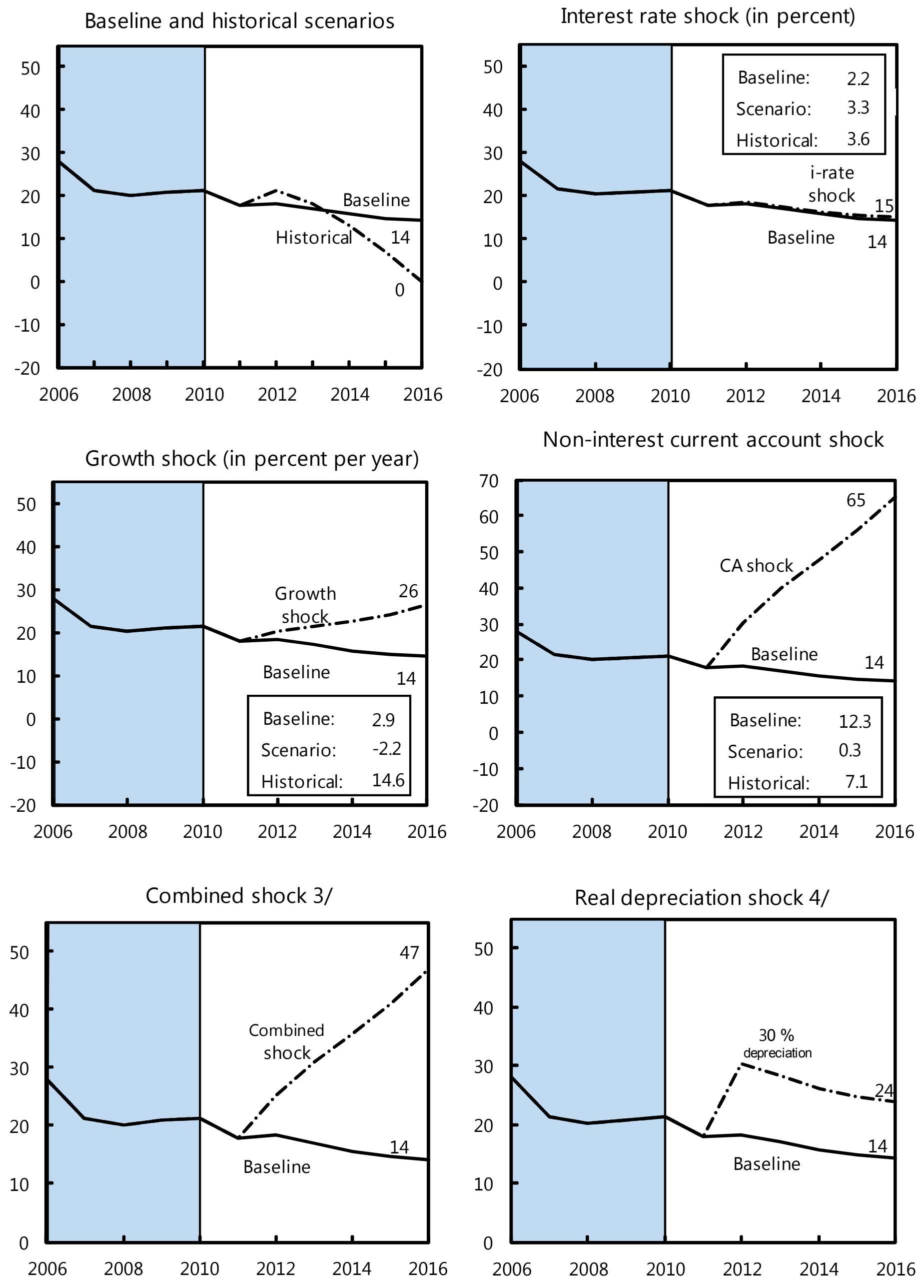
Bound tests suggest that under standard shocks to interest rates, growth, and real exchange rate, external debt will remain relatively low, at less than 26 percent of GDP by 2016.

External debt, however, could increase rapidly, to about 65 percent, if there were a standard shock to the non-interest external current account.

If key variables, including real GDP growth and current account surplus, remain at the historical 10–year average (15 percent and 7 percent of GDP, respectively), external debt would continue to decline rapidly relative to the baseline scenario. But given the prospects for oil production and prices, this scenario seems unlikely.

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

(External debt in percent of GDP)



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

1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ For historical scenarios, the historical averages are calculated over the ten-year period, and the information is used to project debt dynamics five years ahead.
3/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.
4/ One-time real depreciation of 30 percent occurs in 2010.

Azerbaijan: External Debt Sustainability Framework, 2007–16

(In percent of GDP, unless otherwise indicated)

		Actual				Projections						
		2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	**Debt-stabilizing non-interest current account 6/**
1	**Baseline: External debt**	21.3	20.2	20.8	21.3	**17.8**	**18.2**	**17.0**	**15.7**	**14.7**	**14.2**	**-6.8**
2	Change in external debt	-6.7	-1.1	0.6	0.5	-3.5	0.4	-1.3	-1.3	-0.9	-0.5	
3	Identified external debt-creating flows (4+8+9)	-22.5	-40.3	-22.6	-32.4	-24.2	-19.1	-16.3	-15.4	-13.9	-13.0	
4	Current account deficit, excluding interest payments	-28.3	-36.2	-24.2	-29.5	-24.6	-19.1	-15.4	-11.3	-8.7	-7.0	
5	Deficit in balance of goods and services	-96.5	-94.0	-76.0	-75.6	-91.7	-78.2	-67.8	-60.7	-57.3	-56.4	
6	Exports	68.0	69.3	53.0	55.2	60.5	50.5	43.1	37.4	34.0	32.2	
7	Imports	-28.5	-24.7	-22.9	-20.4	-31.2	-27.7	-24.7	-23.3	-23.3	-24.2	
8	Net non-debt creating capital inflows (negative)	15.2	1.2	-0.3	-0.2	-0.2	0.2	-0.9	-4.0	-5.1	-6.0	
9	Automatic debt dynamics 1/	-9.5	-5.2	1.9	-2.7	0.6	-0.2	0.0	-0.2	-0.1	0.0	
10	Contribution from nominal interest rate	1.0	0.8	0.6	0.4	0.4	0.3	0.3	0.3	0.3	0.4	
11	Contribution from real GDP growth	-4.4	-1.7	-2.0	-0.9	0.2	-0.6	-0.3	-0.4	-0.4	-0.4	
12	Contribution from price and exchange rate changes 2/	-6.1	-4.3	3.3	-2.2	...	...	...	...	...	...	
13	Residual, incl. change in gross foreign assets (2-3) 3/	15.8	39.2	23.3	32.9	20.8	19.5	15.1	14.1	13.0	12.5	
	External debt-to-exports ratio (in percent)	31.3	29.2	39.2	38.6	29.5	36.1	39.4	41.9	43.4	44.2	
	Gross external financing need (in billions of US dollars) 4/	-8.9	-16.2	-9.9	-14.8	-13.2	-11.9	-10.9	-9.1	-7.8	-6.7	
	in percent of GDP	-27.0	-35.0	-23.1	-28.6	-23.7	-18.2	-14.6	-10.5	-8.0	-6.3	
	Scenario with key variables at their historical averages 5/					**17.8**	**21.1**	**18.0**	**13.2**	**6.9**	**-0.1**	**-6.2**
	Key Macroeconomic Assumptions Underlying Baseline											
	Real GDP growth (in percent)	25.0	10.8	9.3	5.0	-1.1	3.7	1.9	2.8	2.9	3.0	
	GDP deflator in US dollars (change in percent)	27.5	25.6	-14.1	12.1	9.3	13.1	12.4	12.2	9.4	6.1	
	Nominal external interest rate (in percent)	5.7	5.0	2.7	2.5	2.1	2.1	1.9	1.7	2.2	2.8	
	Growth of exports (US dollar terms, in percent)	61.4	42.7	-28.9	24.9	18.4	-2.1	-2.1	0.0	2.2	3.6	
	Growth of imports (US dollar terms, in percent)	15.9	21.7	-13.9	6.8	65.6	4.1	1.8	9.1	12.7	13.3	
	Current account balance, excluding interest payments	28.3	36.2	24.2	29.5	24.6	19.1	15.4	11.3	8.7	7.0	
	Net non-debt creating capital inflows	-15.2	-1.2	0.3	0.2	0.2	-0.2	0.9	4.0	5.1	6.0	

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

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

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

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

5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

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

Annex II. Azerbaijan: Public Debt Sustainability Assessment

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

Public debt has declined substantially since the onset of the oil boom, halving to about 11 percent in 2010, relative to 2004. As in the case of external debt, this reflects rapid real GDP growth and the government's decision to finance domestic investment projects from oil revenue.

Under the baseline scenario, public debt is projected to remain broadly unchanged at about 10 percent of GDP by 2016. The scenario assumes substantial efforts to consolidate the non-oil fiscal position and reduced spending on investment financed with oil resources.

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

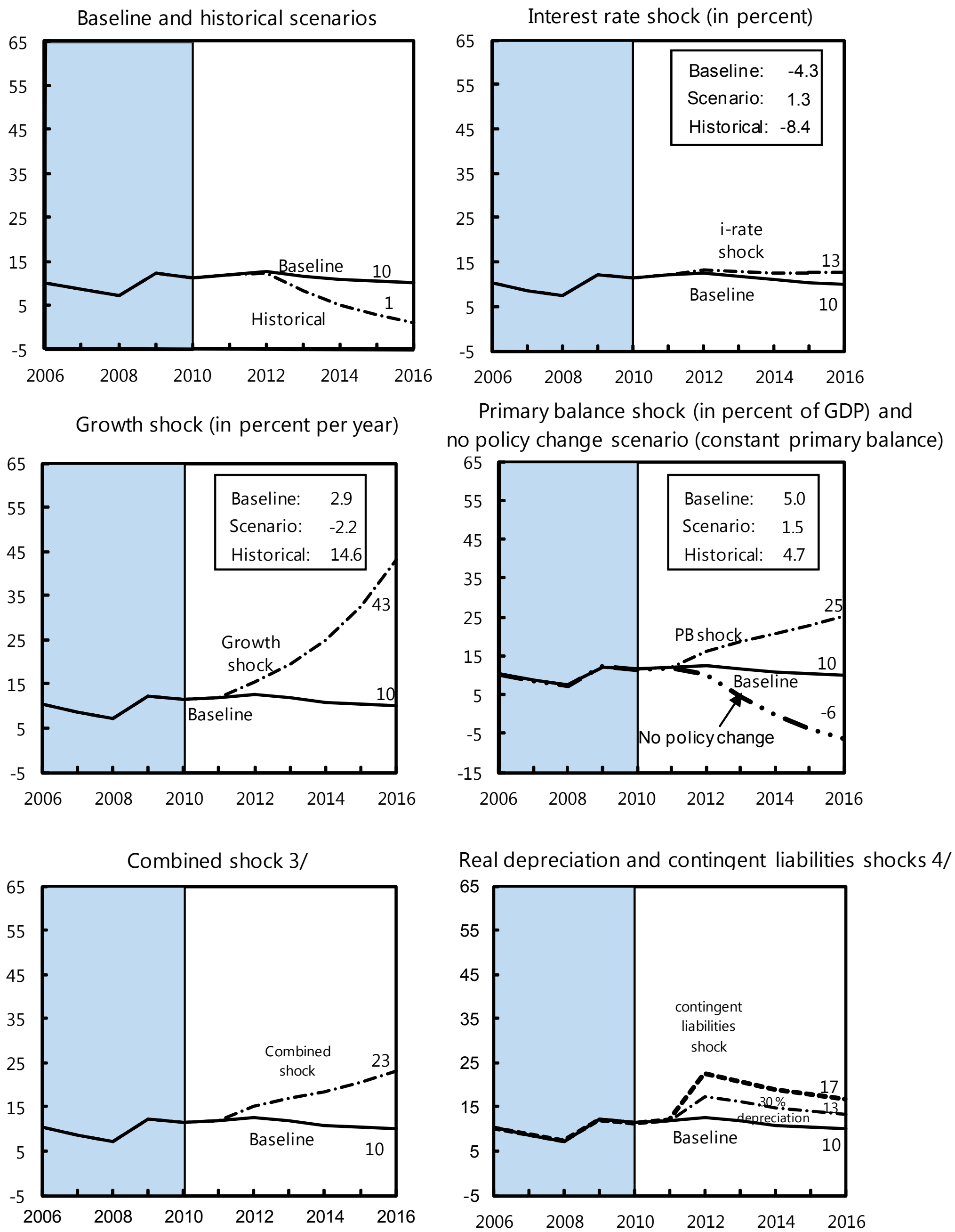
Bound tests suggest that under standard shocks to interest rates, primary balance, and real exchange rate, public debt would remain relatively manageable at about 25 percent of GDP or less by 2016.

However, the public debt ratio seems more vulnerable to shocks to real growth than the external debt, as under this bound test, public debt would rise to 43 percent by 2016.

If key variables, including real GDP growth and primary surplus, remain at the historical 10 year average (15 percent and 5 percent of GDP, respectively), public debt would continue to rapidly decline relative to the baseline scenario. However, prospects for oil production and oil prices are expected to have a substantial impact on oil fund revenue going forward, so the likelihood of such scenario is low at this stage.

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

(Public debt in percent of GDP)



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

1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ For historical scenarios, the historical averages are calculated over the ten-year period, and the information is used to project debt dynamics five years ahead.
3/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and primary balance.
4/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2010, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Azerbaijan: Public Sector Debt Sustainability Framework, 2007–16

(In percent of GDP, unless otherwise indicated)

	Actual				Projections						
	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	**Debt-stabilizing primary balance 9/**
Baseline: Public sector debt 1/	8.6	7.3	12.1	11.4	**12.0**	**12.6**	**11.8**	**10.9**	**10.4**	**10.1**	**-0.8**
o/w foreign-currency denominated	7.6	6.3	7.9	7.5	8.2	9.2	8.5	7.9	7.6	7.3	
Change in public sector debt	-1.6	-1.3	4.8	-0.7	0.6	0.6	-0.9	-0.9	-0.5	-0.3	
Identified debt-creating flows (4+7+12)	-6.2	-22.4	-4.0	-14.0	-7.5	-6.5	-4.0	-4.7	-5.4	-6.3	
Primary deficit	-2.4	-20.1	-7.0	-14.5	-9.0	-6.6	-3.9	-4.2	-4.8	-5.7	
Revenue and grants	28.2	51.1	41.6	46.7	48.1	43.0	39.8	37.8	36.9	36.9	
Primary (noninterest) expenditure	25.8	31.0	34.6	32.2	39.2	36.4	35.8	33.5	32.2	31.2	
Automatic debt dynamics 2/	-3.8	-2.2	0.4	-1.6	-0.1	-1.0	-0.8	-0.8	-0.7	-0.6	
Contribution from interest rate/growth differential 3/	-3.5	-2.0	0.8	-1.7	-0.1	-1.0	-0.8	-0.8	-0.7	-0.6	
Of which contribution from real interest rate	-1.8	-1.4	1.6	-1.2	-0.2	-0.6	-0.6	-0.5	-0.4	-0.3	
Of which contribution from real GDP growth	-1.7	-0.7	-0.7	-0.5	0.1	-0.4	-0.2	-0.3	-0.3	-0.3	
Contribution from exchange rate depreciation 4/	-0.3	-0.2	-0.4	0.0	...	...	...	...	...	...	
Other identified debt-creating flows	0.0	-0.1	2.5	2.1	1.5	1.1	0.7	0.3	0.0	-0.1	
Privatization receipts (negative)	0.0	-0.1	-0.1	0.0	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	
Recognition of implicit or contingent liabilities	0.0	0.0	2.6	2.1	1.7	1.2	0.8	0.4	0.1	0.0	
Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes (2-3) 5/	4.6	21.1	8.9	13.2	8.0	7.1	3.2	3.8	5.0	6.1	
Public sector debt-to-revenue ratio 1/	30.5	14.3	29.2	24.4	24.9	29.3	29.6	28.8	28.2	27.4	
Gross financing need 6/	-2.0	-19.5	-6.1	-14.0	-7.5	-5.2	-2.5	-2.8	-3.4	-4.3	
in billions of U.S. dollars	-0.6	-8.6	-2.6	-7.2	-4.0	-3.2	-1.8	-2.3	-3.2	-4.6	
Scenario with key variables at their historical averages 7/					**12.0**	**12.4**	**8.3**	**5.0**	**2.7**	**1.0**	**-0.2**
Scenario with no policy change (constant primary balance) in 2011-2016					**12.0**	**10.2**	**4.6**	**-0.3**	**-3.9**	**-6.4**	**0.4**
Key Macroeconomic and Fiscal Assumptions Underlying Baseline											
Real GDP growth (in percent)	25.0	10.8	9.3	5.0	-1.1	3.7	1.9	2.8	2.9	3.0	
Average nominal interest rate on public debt (in percent) 8/	1.5	1.3	2.3	1.6	4.1	2.2	2.1	2.4	2.6	2.9	
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	-21.1	-18.7	18.2	-10.6	-1.7	-5.3	-4.7	-4.2	-3.9	-3.2	
Nominal appreciation (increase in US dollar value of local currency, in percent)	5.4	3.1	5.5	-0.3	...	...	...	...	...	...	
Inflation rate (GDP deflator, in percent)	22.6	20.0	-15.9	12.2	5.8	7.5	6.8	6.6	6.6	6.1	
Growth of real primary spending (deflated by GDP deflator, in percent)	16.7	34.1	20.6	-0.3	20.2	-3.7	0.3	-3.7	-1.4	0.0	
Primary deficit	-2.4	-20.1	-7.0	-14.5	-9.0	-6.6	-3.9	-4.2	-4.8	-5.7	

1/ Refers to gross public sector debt.

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

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

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

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

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

7/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.

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

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

INTERNATIONAL MONETARY FUND

REPUBLIC OF AZERBAIJAN

December 20, 2011

STAFF REPORT FOR THE 2011 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

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

CONTENTS

ANNEX I. RELATIONS WITH THE FUND

(As of October 31, 2011)

Membership Status

Date of membership: September 18, 1992;
Status: Article VIII

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	153.64	100.04

Outstanding Purchases and Loans

	SDR Million	Percent of Quota
ECF Arrangements	21.40	13.30

Latest Financial Arrangements

Type	Approval Date	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
ECF [1]	Jul. 06, 2001	Jul. 04, 2005	67.58	54.71
ECF [1]	Dec. 20, 1996	Mar.19, 2000	93.60	81.90
EFF	Dec. 20, 1996	Mar.19, 2000	58.50	53.24

[1] Following the Low Income Countries (LIC) reforms, effective January 7, 2010, the PRGF arrangements were renamed the Extended Credit Facility (ECF) Arrangements.

Projected Payments to the Fund

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

	Forthcoming				
	2011	2012	2013	2014	2015
Principal	2.57	8.53	6.44	2.57	1.29
Charges/Interest		0.05	0.03	0.02	
Total	2.57	8.58	6.46	2.59	1.29

Safeguards Assessment

Under the Fund's safeguards assessment policy, the Central Bank of Azerbaijan (CBA) was subject to an assessment with respect to the PRGF arrangement that was approved on July 06, 2001, and expired on July 5, 2004. The assessment was completed on March 11, 2002, and it was concluded that the external audit and financial reporting were adequate. The assessment proposed a set of measures to strengthen internal control, data reporting to the Fund, and the legal framework. The majority of the recommendations were implemented, except for the recommendation to establish an Audit Committee. The external audit of 2010 CBA financial statements was completed by May 2011, and the audit report has been published.

Exchange Rate Arrangements

The currency of Azerbaijan is the manat, which became sole legal tender on January 1, 1994.

The *de jure* exchange rate regime is "other managed arrangement" since March 2011, but the *de facto* regime remains as "stabilized arrangement", based on the authorities' policy to allow greater exchange rate flexibility since late 2010.

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

Article IV Consultation

The 2010 Article IV consultation with Azerbaijan was concluded on May 3, 2010.

ROSCs

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

Resident Representative

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

Resident Advisers

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

AZERBAIJAN: TECHNICAL ASSISTANCE, 2003–11

Fund. Dept.	Area of Assistance	Mission Dates
FAD	Budget systems law	Feb/March 2003
STA	Consumer Price Statistics	June 2003
STA	National Accounts	Jul/Aug. 2003
MFD	Regional Technical Assistance in Public Debt Management	Jul/Sep. 2003
MFD	Payment and Settlement Systems	September 2003
FAD	Revenue Administration	August 2003
FAD	Tax Policy	August 2003
MFD	Payment and Settlement Systems	January 2004
STA	Balance of Payments Statistics	May 2004
MFD	Payment and Settlement Systems	May 2004
MFD	Regional Public Debt management	April 2004
FAD	Customs Administration	September 2004
STA	National Accounts	Sep/Oct. 2004
FAD	Tax administration	December 2004
MFD	Public Debt Management	December 2004
STA	National Accounts	Mar/Apr. 2005
LEG	AML/CFT Legislation	June 2005
FAD	Taxation of SOCAR Operations	August 2005
STA	Balance of Payments and External Debt Statistics	Nov/Dec. 2005
STA	Consumer Price Statistics	February/March 2006
MFD	Monetary Operations	August 2006
FAD	Public Financial Management	September 2006
STA	Government Finance Statistics	Oct/Nov. 2006
MCM	Banking Supervision	April 2007
FAD	Tax Administration Diagnostic	February 2008
FAD	Tax Administration (expert visits)	July 2008/April 2009
MCM	Domestic Securities Market Development	September 2008
MCM	Public Debt Management	August 2009
LEG	AML/CFT Legislation	Aug/Sep. 2009
STA	External Sector Statistics	October 2009
LEG	AML/CFT Legislation	February 2010
STA	Government Finance Statistics	September, 2011
FAD	Pension system	October 2011

ANNEX II: RELATIONS WITH THE WORLD BANK

(As of November 2011)

1. The World Bank is currently implementing a two-pillar Country Partnership Strategy (CPS) that focuses on: (i) building a competitive non-oil economy; and (ii) strengthening social and municipal services; with a strong cross-cutting theme of governance and anticorruption. Results under the previous CPS (2007–2010) were mixed. As a result of learning from this experience, during the current CPS period, the Bank will increase its focus on implementation of existing operations, and only consider new operations in selected areas with a strong record of sufficient institutional capacity. The Bank will re-emphasize its focus on those areas where there is clear country demand and ownership and new operations will be brought to the Board only when ready for immediate implementation. The Bank will rebalance activities towards more analytical work and policy dialogue and further strengthen its support for capacity building.

2. The specific areas of focus for the CPS build on the Governments own development strategies and include: (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. For the full CPS period the lending envelope will be about $1 billion. Actual funding would be back-loaded and lending volumes will be adjusted to performance. Over FY11-12, lending is anticipated to amount to about $300 million in IBRD, plus about $80 million in IDA in FY11. FY11 is the last year of IDA, after which Azerbaijan will become IBRD-only.

3. Bank lending will be complemented by a strong program of knowledge services to inform the country growth strategy and policy choices as well as the design of investment operations. The Bank will increase analytic work in the areas of job creation and growth, poverty and inequality, the financial sector, agriculture and irrigation, wastewater, and public expenditures. The Government has agreed in principle to partner with the Bank through a fee-based Joint Economic Research Program (JERP). The Bank and the Government have also established a strong vehicle for policy dialogue in the high level policy forum held for the first time in 2009. The next high-level forum is tentatively scheduled for early March, 2012.

4. IFC expects to increase significantly its investment program in Azerbaijan during the CPS period. Based on its track record in implementing projects in Azerbaijan and the slowly improving business environment, IFC will seek to increase its investment program from $132 million during the last CPS period to around $200 million over the new CPS period. Financing during the last CPS was heavily concentrated in the banking sector. During this CPS period, IFC will continue to support the financial sector but also look more actively for investment opportunities in the real sector and in infrastructure. This will be complemented by continued advisory services through its advisory services to improve the investment climate, increase access to finance and strengthen financial infrastructure, and to support improved corporate governance practices. Additional opportunities to address CPS objectives through IFC Advisory Services may be explored if there is demand, including possibly agribusiness related, energy efficiency finance, and private participation in infrastructure. Close coordination between the Bank and IFC on both lending and analytic work will support effective implementation.

5. 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 Bank's investment operations and analytical activities will continue to focus on the areas of competitiveness and sustainability of economic outcomes, infrastructure provision, budgeting and public expenditure management, education, private sector development, and other sectoral issues, as well as some financial sector issues as outlined in the two pillars of the CPS. The Fund will continue to focus on macro-critical areas, and will share responsibilities with the Bank on banking and financial sector soundness, taking care to coordinate closely so as to minimize overlap and ensure harmonization of policy advice.

World Bank contacts:

Larisa Leshchenko (lleshchenko@worldbank.org); Country Program Coordinator, South Caucasus Management Unit Phone (202) 458-1297

Rashmi Shankar (RShankar@worldbank.org), Senior Country Economist for Azerbaijan. Phone (202) 473-4601

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

(As of December 31, 2010, Update as of September 2011 in paragraph 5)

1. As of December 2010, the EBRD has invested approximately US$1.6 billion in 108 projects (excluding regional projects and Trade Facilitation Programme) to date. The current portfolio stock amounts to US$801 million of which 85% has been disbursed and US$658 million are operating assets. The ratio of private sector projects in the portfolio now stands at 61 percent.

2. The energy and natural resources sector dominates EBRD's portfolio, representing 46% of total assets. EBRD financed several landmark transactions such as BTC, ACG and Shah Deniz. EBRD also financed three power projects for a total of US$281 million, making Azerenerji, Azerbaijan's state-owned power utility, EBRD's single largest client. The industry, commerce and agribusiness (ICA) sector represents 23% of EBRD's portfolio. EBRD financed 15 projects including two projects with Garadagh Cement, EBRD's second largest client in Azerbaijan. The financial sector represents 18% of EBRD's portfolio but covers 69 projects, more than any other sector. The infrastructure sector constitutes 13% of EBRD's portfolio. It includes 5 transport projects and one municipal project.

3. In 2010 EBRD invested a total of US$79 million in 13 projects. EBRD financed seven projects in the ICA sector. All projects were financed through ETC instruments. The average investment size was less than US$3 million highlighting the relevance of the ETC initiative for Azerbaijan. Four projects were in the agribusiness sector and three in the manufacturing and services sector. In the financial sector EBRD signed 6 projects. Together with IFC, EBRD made a small equity investment in a second-tier bank subject to corporate governance improvements. EBRD also provided mortgage financing to one of its partner banks. The four remaining projects consisted of MSME credit facilities to existing partner banks. EBRD also continued to provide technical assistance in the areas of institution building, credit appraisal and risk management. No new public energy or infrastructure investment occurred in 2010.

4. Azerbaijan is part of 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.

5. In the first nine months of 2011, EBRD has signed 9 projects (excluding regional and TFP) for approximately US$91 million. This includes two restructurings, three ICA projects and four FI transactions. EBRD expects to sign three FI transactions by end 2011 as well as multi-tranche facility for road rehabilitation in Azerbaijan in total of USD 750 million. This facility is expected to be signed by end 2011 with committing the first tranche of USD 250 million in 2011 and the next two tranches in 2012 and 2013 depending on fulfillment of conditionalities under the first tranche.

ANNEX IV. 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.

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.

C. Monetary Sector

8. The Azerbaijan National Bank (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

9. Azerbaijan's balance of payments (BOP) statistics are compiled and disseminated by the CBA and are broadly in accordance with the fifth edition of the *Balance of Payments Manual (BPM5)*. The CBA has also initiated compilation of International Investment

Position (IIP) statistics. The IIP data for 2002–2008 have been published in *IFS;* however, the authorities have indicated that they have discontinued the compilation of IIP data effective 2009.

10. 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.

11. 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).

12. 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. Moreover, given the outstanding issues related to data sharing and data provision by various respondents, and non-reporting by major market participants, the mission considered that the existing International Transactions Reporting System (ITRS) should be further developed, including by changing the ITRS design to introduce a closed ITRS, and by further improving ITRS verification procedures via the on-site inspection of reporting banks.

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

14. Monthly data on total official reserve assets and daily 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 December 2, 2011)

	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	12/2/2011	12/2/2011	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	9/30/2011	10/12/2011	D	W	M		
Reserve/Base Money	9/30/2011	10/12/2011	D	W	M	O, O, O, O	O, O, O, O, LO
Broad Money	9/30/2011	10/12/2011	M	M	M		
Central Bank Balance Sheet	9/30/2011	10/12/2011	D	W	M		
Consolidated Balance Sheet of the Banking System	9/01/2011	9/13/2011	M	M	M		
Interest Rates[2]	Dec 2011	06/05/2011	M	M	M		
Consumer Price Index	Oct 2011	11/11/11	M	M	M	O, O, O, O	O, LO, O, O, O
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	Sep 2011	11/15/11	M	M	M	LO, LNO, LNO, LO	LO, LO, O, O, LO
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	Sep 2011	11/15/11	M	M	M		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	Jun 2011	8/3/11	Q	Q	Q		
External Current Account Balance	Q2 2011	9/15/11	Q	Q	Q	LO, LO, LO, LO	O, LO, LO, O,LO
Exports and Imports of Goods and Services	Q3 2011	11/14/11	Q	Q	Q		
GDP/GNP	Oct 2011	11/16/11	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.

Public Information Notice (PIN) No. 12/2
FOR IMMEDIATE RELEASE
January 18, 2012

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

IMF Executive Board Concludes 2011 Article IV Consultation with Azerbaijan

On January 9, 2012, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Azerbaijan on a lapse of time basis. Under the IMF's lapse of time procedures, the Executive Board completes Article IV consultations without convening formal discussions.[1]

Background

Non-oil economic growth continues to be strong; it could reach 9 percent in 2011, up from 7½ percent in 2010, largely supported by oil-financed government spending. Though output shortfall from new wells and maintenance issues will result in a sharply reduced oil output for 2011, the external position is projected to remain strong. Inflation fell to 6.8 percent in October after surging early this year, because of global food price developments, but could rise with planned public spending and non-hydrocarbon output beginning to exceed potential. The manat exchange rate has appreciated by less than 2 percent against the U.S. dollar since November 2010.

Strong fiscal stimulus continued in 2011 triggered by unanticipated increases in global oil prices. With the substantial increase in capital spending, staff projects the non-hydrocarbon fiscal

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

deficit could increase to 44 percent of non-hydrocarbon GDP in 2011, from 38 percent in 2010, and could exceed 50 percent if the 2012 draft budget is fully implemented.

In 2011 there was some unwinding of supportive monetary and financial sector policies adopted in response to the 2009 global crisis. Policy rates and reserve requirement were raised modestly, as recovery took hold and signs of spillovers from rising global food prices emerged on domestic inflation. Market interest rates, however, have been unresponsive and credit growth has remained sluggish. Support provided by the Central Bank to state enterprises has continued, albeit at a slower pace, and there has been little progress with the privatization of the systemic public bank.

Near and medium–term economic prospects are favorable and non-hydrocarbon growth could reach 6 percent in 2012 and remain in the 5–5½ percent range thereafter, if underpinned by medium–term fiscal consolidation and supported by non-oil Foreign Direct Investment. This outlook assumes a substantive adjustment in the non-hydrocarbon fiscal position beginning in 2012 and progress with structural reforms, including on business environment and governance to foster private non-hydrocarbon investment. Risks emanate mainly from a fall in oil prices given Azerbaijan's low reliance on non-oil exports and remittances. But large foreign assets could provide sufficient buffer to mitigate the impact of future shocks, including a sharp and sustained decline in oil prices.

Executive Board Assessment

In concluding the 2011 Article IV consultation with Azerbaijan, Executive Directors endorsed staff's appraisal, as follows:

Until recently, Azerbaijan's strong economic performance has benefited from prudent economic policies. Since the early 2000s, government policies have contributed to keeping non-hydrocarbon growth high and the macroeconomic environment relatively stable. The policy of transparently saving a sizable portion of oil revenues has enabled the economy to avoid the adverse consequences of harvesting natural resources. In addition, non-hydrocarbon growth and well-targeted social assistance have contributed to significant reduction in poverty and inequality.

Nevertheless, significant actions would be needed for Azerbaijan to maintain the record of high growth and significant poverty reduction. Given the limited horizon of hydrocarbon resources, the economy needs to be reoriented from its symbiotic dependence on natural resource revenues. An important prerequisite for a successful transition to economic diversification and private sector–led growth is to improve governance and the business environment. The authorities' recent steps in this regard are welcome, but the anticorruption campaign needs to be extended widely and pursued resolutely. To improve the business climate, trade barriers should be eased and regulations made less restrictive with a view to enhancing competition.

Fiscal policy should be delinked from the global oil price cycle. Supplemental public spending, driven by changes in hydrocarbon prices, has exposed the economy to volatility and posed risks to macroeconomic stability. With the non-hydrocarbon economy recovering strongly and government spending likely to result in demand pressures in 2012, the non-hydrocarbon deficit should be lowered. The intra-year execution of government spending should be made less uncertain and more even.

Finite hydrocarbon resources underscore the need to achieve medium–term fiscal sustainability. The authorities understand the need to undertake medium–term fiscal consolidation, but near-term demands on public resources, especially for infrastructure and other large-project spending, have, to date, trumped longer– term considerations. The non-hydrocarbon fiscal stance in 2011 has worsened fiscal sustainability, and the 2012 draft budget could exacerbate it further. Fiscal consolidation should commence now, and there is considerable scope for trimming capital expenditures and boosting non-hydrocarbon revenues over the medium term. To build public support for the consolidation effort, the authorities could employ indicative annual targets on the non-hydrocarbon fiscal deficit. They should also strengthen the process underlying the selection and appraisal of public investment projects.

A tightening of monetary policy, through allowing greater exchange rate flexibility, may also be needed if demand pressures emerge. The de facto stabilized exchange rate has limited the effectiveness of monetary policy. Allowing greater exchange rate flexibility by employing a sufficiently wide exchange rate band would help contain inflation, and should be supplemented with other monetary policy tools, such as interest rates. However, staff does support the authorities' view that the exchange rate should not be used to absorb the shocks from an uneven and uncertain pattern of public spending. The monetary policy framework needs to be strengthened to better counter inflation over the medium term, and in addition to helping develop the associated infrastructure (e.g. debt markets), the central bank should improve the communication of monetary and exchange rate policies with the public.

Addressing financial sector weaknesses is key for supporting sustainable and inclusive growth. Effectively dealing with IBA would help maintain financial stability, contribute to transforming the financial sector by unlocking its resources and improving efficiency. To level the playing field and enhance competition, IBA should be downsized, and smaller banks encouraged to consolidate into competitive entities. Steps should also be taken to enhance SME access to finance. To minimize conflict of interest, the central bank should unwind the support it has been providing to state enterprises (through commercial banks), and limit its role to lender of last resort for financial institutions.

It is expected that the next Article IV consultation with Azerbaijan will be held on the standard 12–month cycle.

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. The staff report (use the free Adobe Acrobat Reader to view this pdf file) for the 2011 Article IV Consultation with Azerbaijan is also available.

Azerbaijan: Selected Economic Indicators, 2007–12

	2007	2008	2009	2010 Prel.	2011 Proj.	2012 Proj.
	(Annual percentage change)					
Real economy						
GDP at constant prices	25.0	10.8	9.3	5.0	-1.1	3.7
Oil sector 1/	37.3	6.9	14.8	4.8	-10.9	1.0
Non-oil sector 2/	11.3	15.7	3.0	7.6	9.1	6.0
CPI (end-of-period)	19.5	15.4	0.7	7.9	8.3	7.4
	(In percent of GDP, unless otherwise)					
Consolidated government						
Fiscal balance	2.6	20.3	7.2	15.0	8.5	6.3
Non-oil primary fiscal balance (in percent of non-oil GDP)	-28.3	-39.2	-37.9	-37.6	-44.0	-39.5
	(Annual percentage change)					
Money and credit						
Manat base money	101.4	48.5	1.7	31.6	21.9	21.9
Manat broad money	107.3	27.2	9.9	34.8	33.2	20.5
Banking sector credit to the private sector	87.3	47.6	25.6	6.6	16.7	18.5
Velocity of total broad money (M3) 3/	3.3	3.0	2.9	2.7	2.2	2.1
	(In percent of GDP, unless otherwise)					
Balance of payments						
Current account balance (-, deficit)	27.3	35.5	23.6	29.1	24.2	18.8
External public debt	7.7	6.5	7.9	7.5	8.4	8.7
Gross official international reserves						
In millions of US$, end of period	4,273	6,467	5,364	6,400	8,000	9,409
In months of imports, c.i.f.	4.5	7.9	6.1	4.4	5.3	6.1
Exchange rate						
End-of-period (Manat/US$)	0.857	0.819	0.803	0.803	…	…
Real effective exchange rate (percentage change, "-"=depreciation)	8.4	21.4	14.0	1.1	…	…

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), as well as the export tax paid by the state oil company.

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