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Republic of Azerbaijan: 2007 Article IV Consultation—Staff Report; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for the Republic of Azerbaijan

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 2007 Article IV consultation with the Republic of Azerbaijan, the following documents have been released and are included in this package:

- the staff report for the 2007 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on February 28, 2007 with the officials of the Republic of Azerbaijan on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on April 19, 2007. 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;

- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its May 9, 2007 discussion of the staff report that concluded the Article IV consultation; and

- a statement by the Executive Director for the Republic of Azerbaijan.

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

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INTERNATIONAL MONETARY FUND

REPUBLIC OF AZERBAIJAN

Staff Report for the 2007 Article IV Consultation

Prepared by the Staff Representatives for the 2007 Consultation with the Republic of Azerbaijan

Approved by Lorenzo Pérez and Adrienne Cheasty

April 19, 2007

Mission dates and place: February 14–28, 2007, Baku.

IMF team: Mr. Kramarenko (head), Ms. Zermeño, Mr. Ding, Ms. Koeda (all MCD), and Mr. Crowley (MCM). Mr. Pérez (MCD) and Mr. Moser (OED) attended policy discussions. Mr. Zavoico, resident representative, assisted the mission.

Exchange system: Azerbaijan accepted the obligations of Article VIII, Sections 2, 3, and 4 effective November 30, 2004 and maintains an exchange rate system that is free of restrictions on the making of payments and transfers for current international transactions. Azerbaijan has maintained a de facto crawling peg exchange rate system since early 2006.

Data: Azerbaijan has participated in the General Data Dissemination System since 2001. Azerbaijan's statistical base is broadly adequate for surveillance, but significant improvements are needed in selected areas, including CPI and external debt statistics (Annex III). The authorities requested technical assistance (TA) geared toward subscribing to the Special Data Dissemination Standard.

An arrangement under the PRGF ended on July 4, 2005. The authorities are not expected to request a new arrangement in the foreseeable future.

The previous consultation was concluded on March 27, 2006, and the PIN was made available at http://www.imf.org/external/np/sec/pn/2006/pn0644.htm on April 25, 2006.

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EXECUTIVE SUMMARY

Background

Azerbaijan is at the beginning of a large but temporary oil production boom that will peak in 2009–10 if no new oil deposits are discovered. The oil boom resulted in exceptionally high real GDP growth and a significant improvement in the external position during 2005–06. It also made it possible to increase government expenditure by almost 30 percent in 2005 and to ratchet it up by over 80 percent in 2006. The resulting massive fiscal expansion in the context of a de facto slowly appreciating exchange rate crawl contributed to an increase in inflation from 5.5 percent in December 2005 to 16.4 percent in March 2007. The non-oil economy continues to suffer from important structural rigidities and an unfavorable business climate.

Authorities' views

Appropriate pace of spending out of oil revenue. While the authorities acknowledged rising inflationary pressures and medium-term fiscal sustainability concerns, they only saw limited room for expenditure restraint in the short term. In the medium term, the authorities will consider implementing fiscal reforms to support a reduction in the non-oil primary fiscal deficit toward a sustainable level, but they have not made firm decisions on the pace of adjustment.

Reducing inflation to single digits in the medium term. The Azerbaijan National Bank (ANB) will consider tightening monetary policy gradually, if inflation continues to rise and if key cabinet members support this tightening. The authorities aim at reducing inflation to single digits over the medium term once fiscal adjustment has been initiated and institutional reforms underpinning the transition to inflation targeting have been advanced.

Key productivity-enhancing structural reforms. The authorities intend to privatize the two state-owned banks and improve the business climate.

Staff recommendations

- It would be appropriate to scale down expenditure increases in 2007 to support disinflation and put fiscal policy on a more sustainable path.
- A detailed medium-term fiscal strategy consistent with long-term fiscal sustainability should be prepared and adhered to.
- If fiscal restraint is not considered in 2007, it is all the more important to tighten monetary policy to facilitate the real exchange rate adjustment through nominal appreciation rather than through higher inflation.
- On the structural front, the banking privatization terms should be made attractive to reputable strategic investors, and higher priority should be given to effective measures to strengthen the oversight of the large spending program, reduce corruption, and improve governance at the customs and tax administration agencies.

I. Introduction

1. **Azerbaijan is at the beginning of a large but temporary oil production boom that will peak in 2009–10 if no new oil deposits are discovered.** The key challenge facing the country is to use the financial opportunity presented by the oil boom to ensure sustainable non-oil output growth and poverty reduction, in particular after the oil boom has peaked, in an environment of macroeconomic stability. Against the background of exceptionally rapid expenditure increases and rising inflation, the consultation discussions focused on the following issues:

- What is the appropriate pace of spending out of oil revenue?
- How to reduce inflation to single digits?
- What are the key productivity-enhancing structural reforms?

2. **In recent consultations, the Fund's advice has focused on the need to adopt a sustainable medium-term fiscal strategy, increase exchange rate flexibility, and implement macro critical structural measures.** After a long period of closely following the Fund's fiscal policy advice, the authorities did not moderate the pace of fiscal expansion in 2006, as recommended by the Fund, because they felt that infrastructure and other development needs should be addressed urgently despite rising inflation. Regarding exchange rate policy, in line with the Fund's advice, the authorities exited the fixed peg in early 2006, but they did not allow the exchange rate to appreciate sufficiently to contain inflation due to concerns regarding financial system stability and competitiveness. The Fund's structural policy advice has been only partially implemented in recent years.

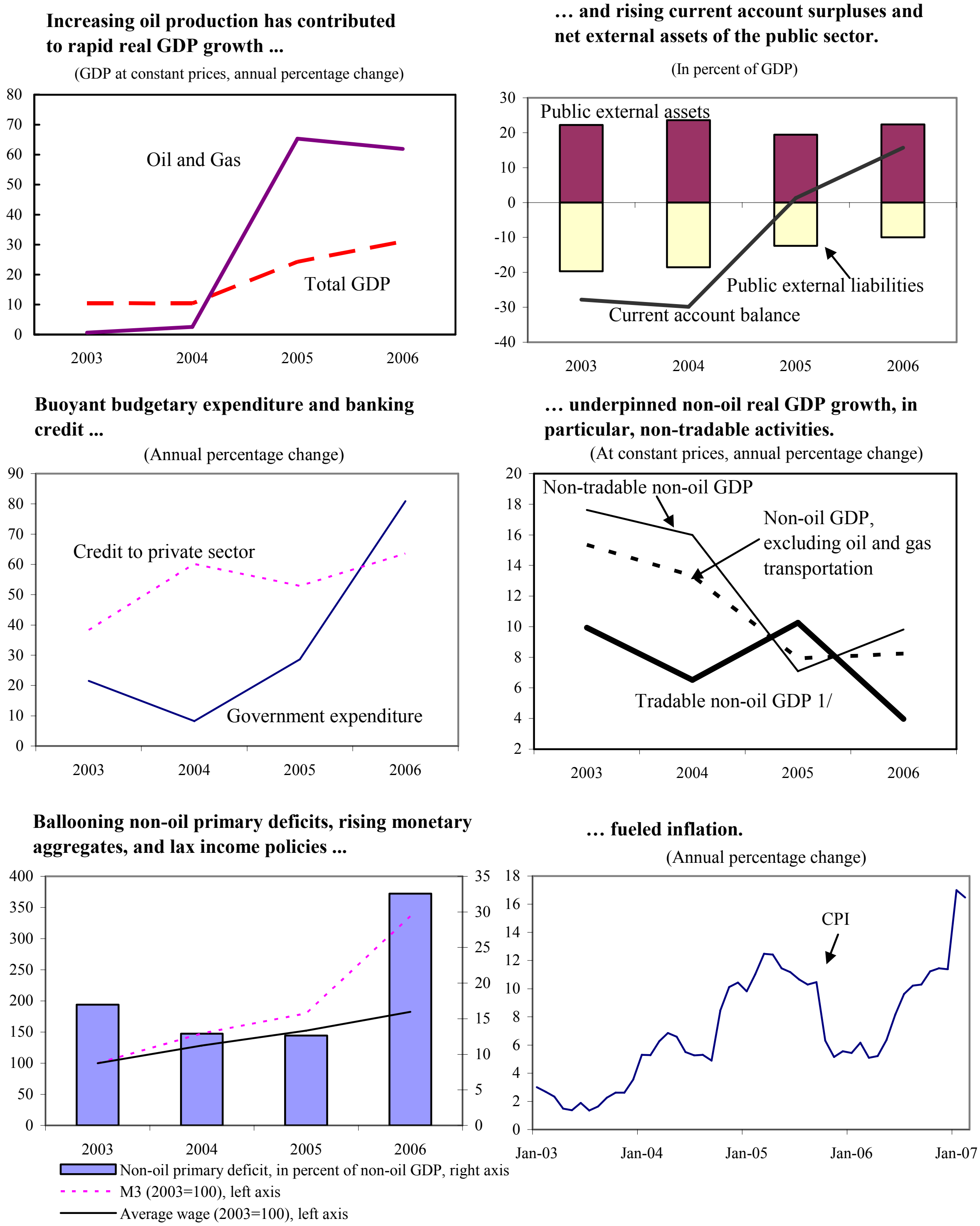
II. Recent Developments

3. **The oil production boom resulted in remarkably high growth and a strengthening of the external position in 2006.** Real GDP grew by 31 percent, and the current account surplus reached 16 percent of GDP, improving Azerbaijan's public sector net external asset position (Tables 1–2). Non-oil real GDP, excluding oil and gas transportation, grew by about 8 percent, as nontradable sectors benefited from buoyant budgetary expenditure and banking credit (Figure 1). According to official data, rapid growth contributed to a significant poverty reduction during 2003–06 (Text Table 1 and Table 3).

4. **The officially reported 12-month CPI rate rose to double digits by August 2006 and reached 16.4 percent in March 2007[1] (Figure 1).** This rise in the inflation rate was fueled by a significant relaxation of macroeconomic policies and substantial wage increases

[1] Alternative CPI measures compiled by nongovernmental organizations show much higher inflation.

Figure 1. Azerbaijan: Recent Developments, 2003-07



Sources: Azerbaijan authorities; and Fund staff estimates.
1/ The tradable non-oil sector includes agriculture, non-oil extraction, and non-oil industry.

against the background of capacity constraints, as well as by the one-off effect of a large adjustment to utilities and energy prices (4 percentage points).

Text Table 1. Azerbaijan: Selected Economic Indicators, 2003-07
(Annual percentage change, unless otherwise specified)

	2003	2004	2005	2006 Prel.	2007 Proj. 1/
Real GDP	10.5	10.4	24.3	31.0	29.1
Oil sector, including oil and gas transportation 2/	0.6	3.6	65.8	68.7	52.6
Non-oil sector, excluding oil and gas transportation	15.3	13.3	7.9	8.2	7.0
CPI (end-of-period)	3.6	10.4	5.5	11.4	18-22
CPI core (end-of-period) 3/	4.8	10.8	4.0	9.0	…
CPI (period average)	2.2	6.7	9.7	8.4	21.1
Poverty (in percent of population) 4/	39.7	28.5	24.0	…	…
Extreme poverty 4/	22.1	13.4	9.2	…	…
Overall fiscal balance (in percent of GDP)	-0.8	1.0	2.6	0.1	2.4
Non-oil primary fiscal balance (in percent of non-oil GDP)	-17.0	-12.9	-12.6	-32.6	-40.1
Manat base money	23.7	38.2	7.5	132.6	80.5
Manat broad money	28.0	31.9	15.8	168.3	83.3
Broad money	29.8	47.5	22.1	86.4	79.0
Credit to the economy	38.3	60.2	53.0	63.6	61.1

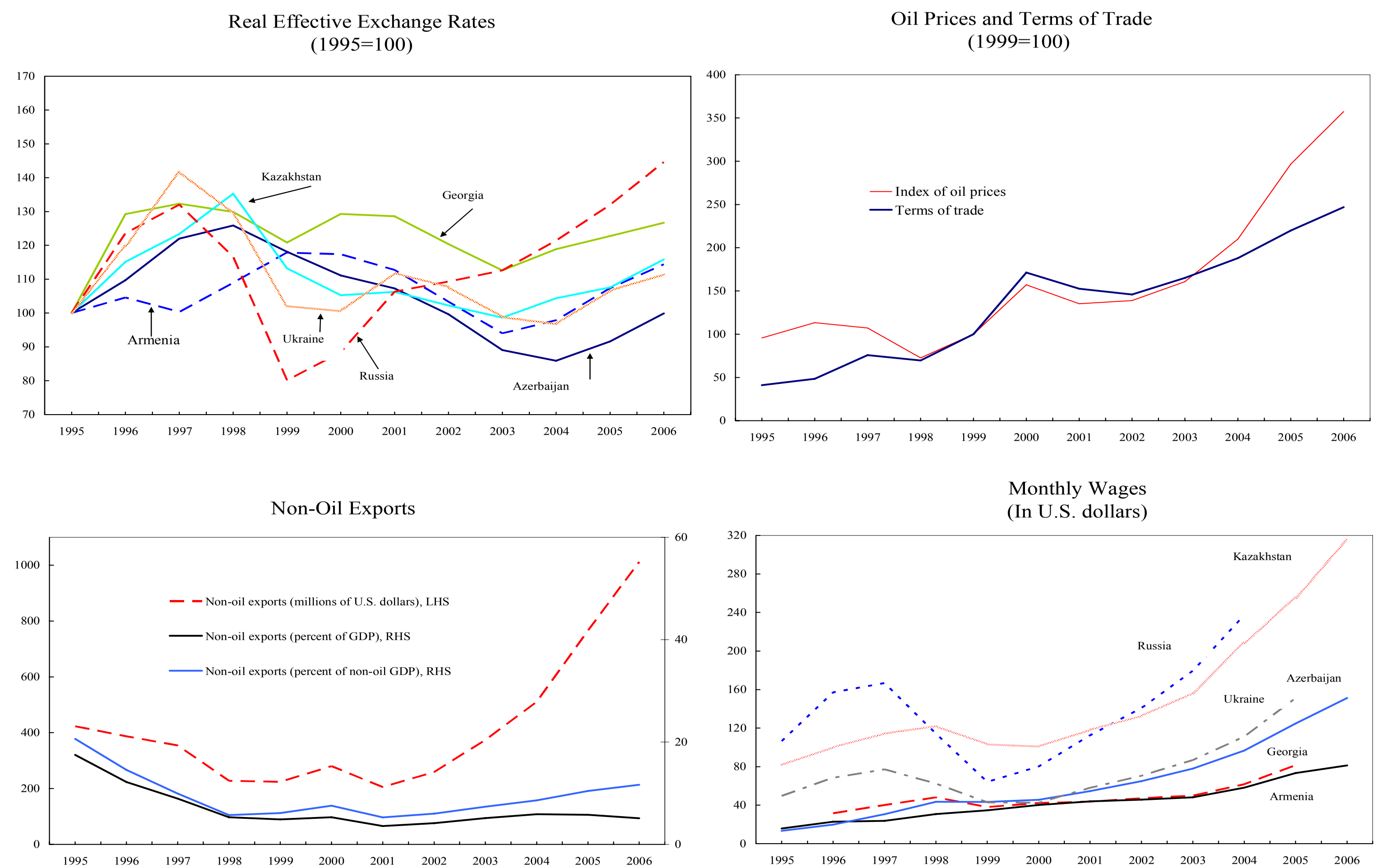
Sources: Azerbaijan authorities; World Bank; and Fund staff estimates and projections.
1/ This scenario assumes the continuation of current policies.
2/ Oil and gas transportation includes all pipelines except the western route. The Baku-Tbilisi-Ceyhan pipeline started operation in May 2006.
3/ Excludes administered prices for fuel, energy, transportation, water, and communications as well as prices for selected fruits and vegetables.
4/ Based on Household Budget Survey and World Bank staff estimates.

5. **Continued real effective exchange rate (REER) appreciation and rising labor costs have intensified competitiveness pressures.** There are initial signs of Dutch disease, as the tradable non-oil sector only grew by 4.0 percent in 2006 compared with 10.4 percent in 2005. While non-oil exports grew by more than 30 percent per year in U.S. dollar terms in both 2005 and 2006, this rapid growth is in part explained by rising international agricultural and metal prices, as well as significant subsidies on energy inputs from which non-oil exporters benefited. Despite their recent rapid growth, non-oil exports still represented only about 10 percent of non-oil GDP in 2006 (Figure 2).

6. **Following a decade of cautious fiscal policy, there was an exceptionally large fiscal relaxation in 2006.** A 118 percent increase in oil revenue made it possible to ratchet up the non-oil primary deficit to 33 percent of non-oil GDP in 2006 compared with only 13 percent in 2005 (Tables 4–5). Non-oil revenue increased by 4 percent of non-oil GDP in 2006 compared with 2005 owing to booming consumption and incomes. Capital expenditure more than tripled, and wages, pensions, and other current expenditure increased by about 50 percent.

7. **There has been mixed progress in fiscal structural reforms.** The authorities put in place a new system of targeted social assistance in mid-2006, and increased energy and utilities prices as of January 8, 2007, which will contribute to a reduction in implicit energy subsidies from 21 percent of non-oil GDP in 2006 to an estimated 11 percent in 2007. However, some key state-owned enterprises (SOEs) operated without approved budgets in 2006, and there has been limited progress in improving budgetary expenditure management

Figure 2. Azerbaijan and Selected CIS Countries: Competitiveness Indicators, 1995-2006



Sources: Azerbaijan authorities; and Fund staff estimates.

or strengthening the auditing capacity of the chamber of accounts (the government's supreme audit institution), raising concerns about the quality of the rapidly increasing expenditure.

8. **At the time of the massive fiscal expansion, the ANB pursued an accommodating monetary policy in the context of the de facto crawling peg to the U.S. dollar initiated in early 2006.** With very limited instrument independence, the ANB undertook large unsterilized purchases of foreign exchange mainly from the government, in order to limit the annual exchange rate appreciation to the targeted 5 percent (Figure 3). Key policy interest rates have remained negative in real terms since mid-2006. These policies led to a 133 percent increase in manat base money in 2006. This rapid base money increase reflected, in part, a reversal of the negative shock to money demand that occurred in late 2005 and some dedollarization, but it also fueled inflation in 2006 and created large inflationary pressures spilling over into 2007. Broad money and credit increased by 86 and 64 percent, respectively, in 2006 (Tables 6–7).

9. **Despite recent progress, the financial system remains small and highly concentrated.** The banking system's assets, the main pillar of the Azerbaijan financial system, represented only 21 percent of GDP in 2006, significantly below the ratios for Russia (53 percent) and Kazakhstan (91 percent). The two state-owned banks controlled more than 50 percent of the banking system's assets in 2006.

10. **While the authorities continue to improve prudential regulations, significant vulnerabilities in the banking system remain.** In response to rising credit and foreign exchange risks, the ANB has tightened the prudential rules pertaining to loan collateral and open positions in foreign currencies, as well as increased the minimum capital requirement. However, as of January 1, 2007, many banks, including the two state-owned banks, failed to comply with one or more prudential regulations (Text Table 2). The two state-owned banks registered an increase in nonperforming loan ratios during 2006, reportedly due to previous under-reporting (Table 8).

11. **Business climate and governance reforms are losing momentum.** The implementation of the anti-corruption program has been delayed, and the drafts of the anti-monopoly code, the investment law, and the Anti-Money Laundering (AML) legislation remain in parliament. Several international surveys have reported on Azerbaijan's persistent problems with transparency, corruption, and the business climate (Figure 4).

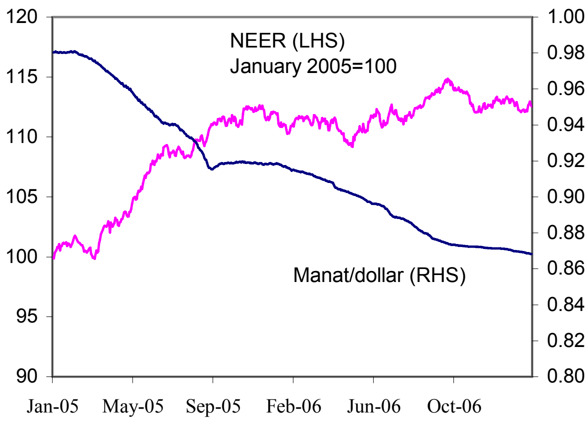
III. Macroeconomic Outlook

A. Short-Term Outlook

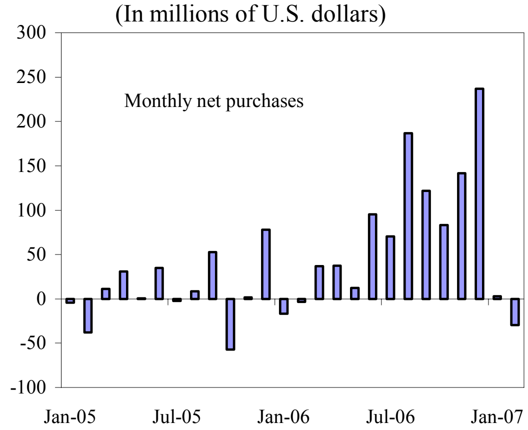
12. **Azerbaijan's growth and external outlooks for 2007 are exceptionally favorable.** Driven by further oil production increases, real GDP is set to expand by about 30 percent, and the current account surplus is expected to increase to 27 percent of GDP in 2007. Non-oil real GDP growth, excluding oil and gas transportation, is projected to

Figure 3. Azerbaijan: Monetary Indicators, 2003-07

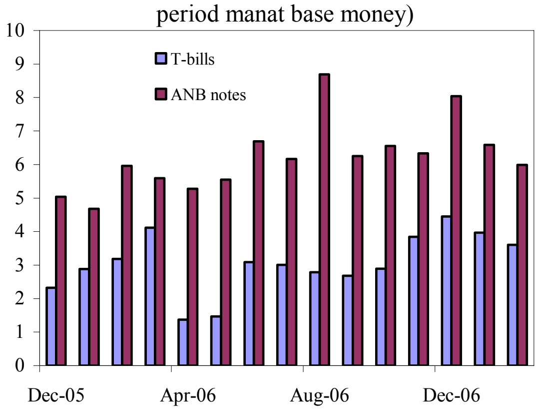
To maintain the crawling peg...



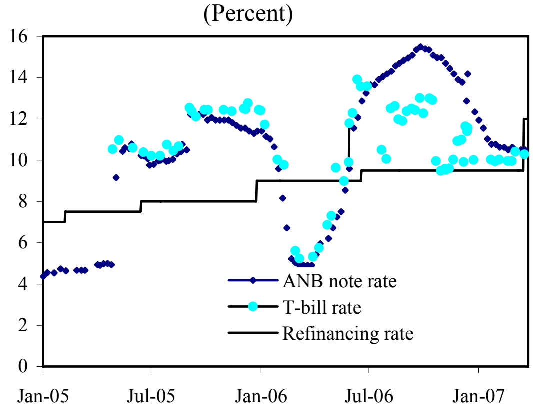
…the ANB had to undertake large purchases of foreign exchange from the government.
(In millions of U.S. dollars)



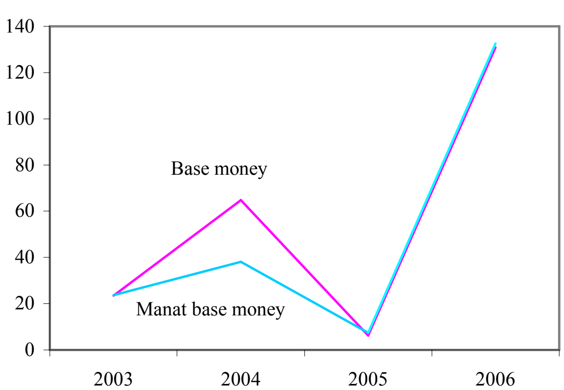
Because of limited sterilization…
(Stock in percent of the beginning of period manat base money)



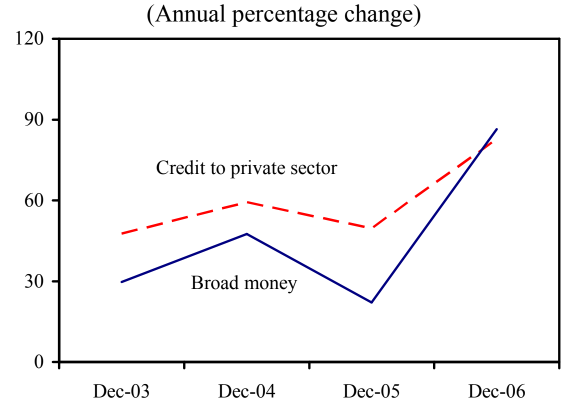
…interest rates remained low…
(Percent)



..base money expanded…
(Annual percentage change)



…and credit to the private sector and monetary aggregates increased rapidly.
(Annual percentage change)



Sources: Azerbaijan authorities; and Fund staff estimates.

decelerate to 7.0 percent in 2007 from 8.2 percent in 2006, in part reflecting the adverse impact of rising competitiveness pressures on the tradable non-oil sector (Table 1).

Text Table 2: Azerbaijan: Problem Banks, January 1, 2007 1/

Problems	Number of banks 2/	Share of problem banks' assets in total banking system assets (In percent)
Negative profits	7 (0)	6
Not meeting minimum capital requirement	8 (0)	4
Not meeting minimum capital adequacy ratio	2 (1)	52
Not meeting the limits on open foreign exchange position	1 (1)	46
Not meeting the 20 percent limit on lending to one group	10 (2)	63
Not meeting the 20 percent limit on loans to insiders	5 (1)	54
More than 10 percent of capital invested in one legal entity	1 (0)	1
More than 40 percent of capital invested in legal entities	1 (0)	1

Source: Azerbaijan National Bank.

1/ There were 43 banks in Azerbaijan at the beginning of 2007.
2/ Number of state-owned banks in parenthesis.

13. **The authorities intend to continue the ambitious fiscal expenditure program, which will maintain high domestic demand and liquidity growth and push inflation upward in 2007.** The non-oil primary fiscal deficit is projected to jump to 40 percent of non-oil GDP[2] from 33 percent in 2006 and 13 percent in 2005. If monetary policy remains accommodating, inflation will continue to increase in 2007 (Tables 1 and 6–7), potentially entering an inflation/indexation spiral and negatively affecting the poor who do not benefit from public sector wage increases.

B. Medium- and Long-Term Outlook

Baseline scenario

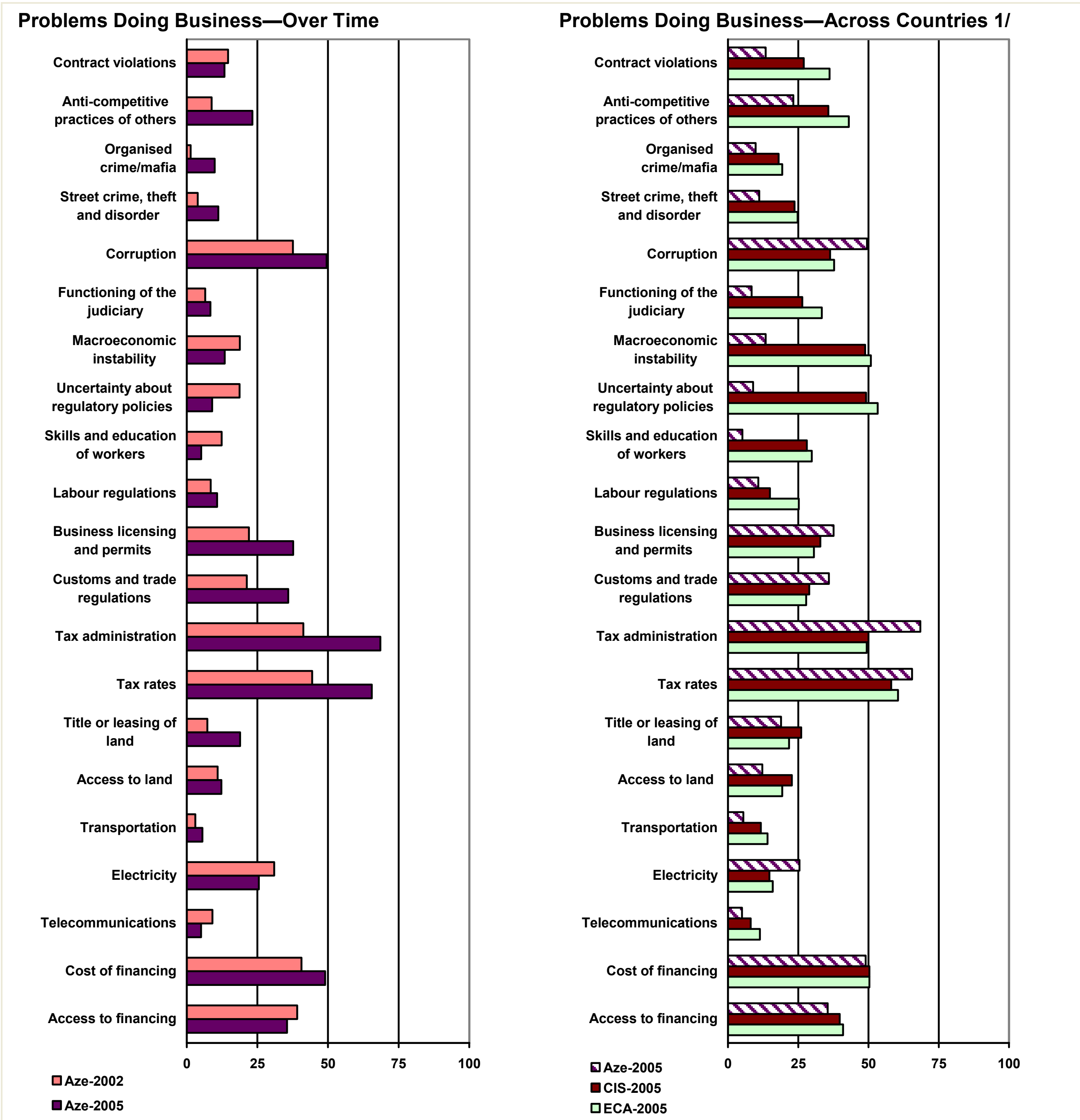
14. **Rising inflation and a slow pace of reforms would lead to intensified political pressures for further large nominal expenditure increases in the medium term.** Given these political economy risks, the staff developed a scenario of continued fiscal expansion in the context of slow reforms.[3] Under this scenario, the non-oil primary deficit, including implicit energy subsidies, is projected to deviate from the sustainable level starting in 2008 (Figure 5)[4] based on the current World Economic Outlook (WEO) oil price assumptions

[2] This estimate accounts for the effects of a forthcoming 2007 budget revision (paragraph 18).

[3] The authorities have not concluded their internal discussions on various medium-term fiscal policy options.

[4] Staff's estimates of the sustainable non-oil primary deficit are based on the principle of constant real expenditure out of oil wealth envisaged in the authorities' long-term oil revenue management strategy.

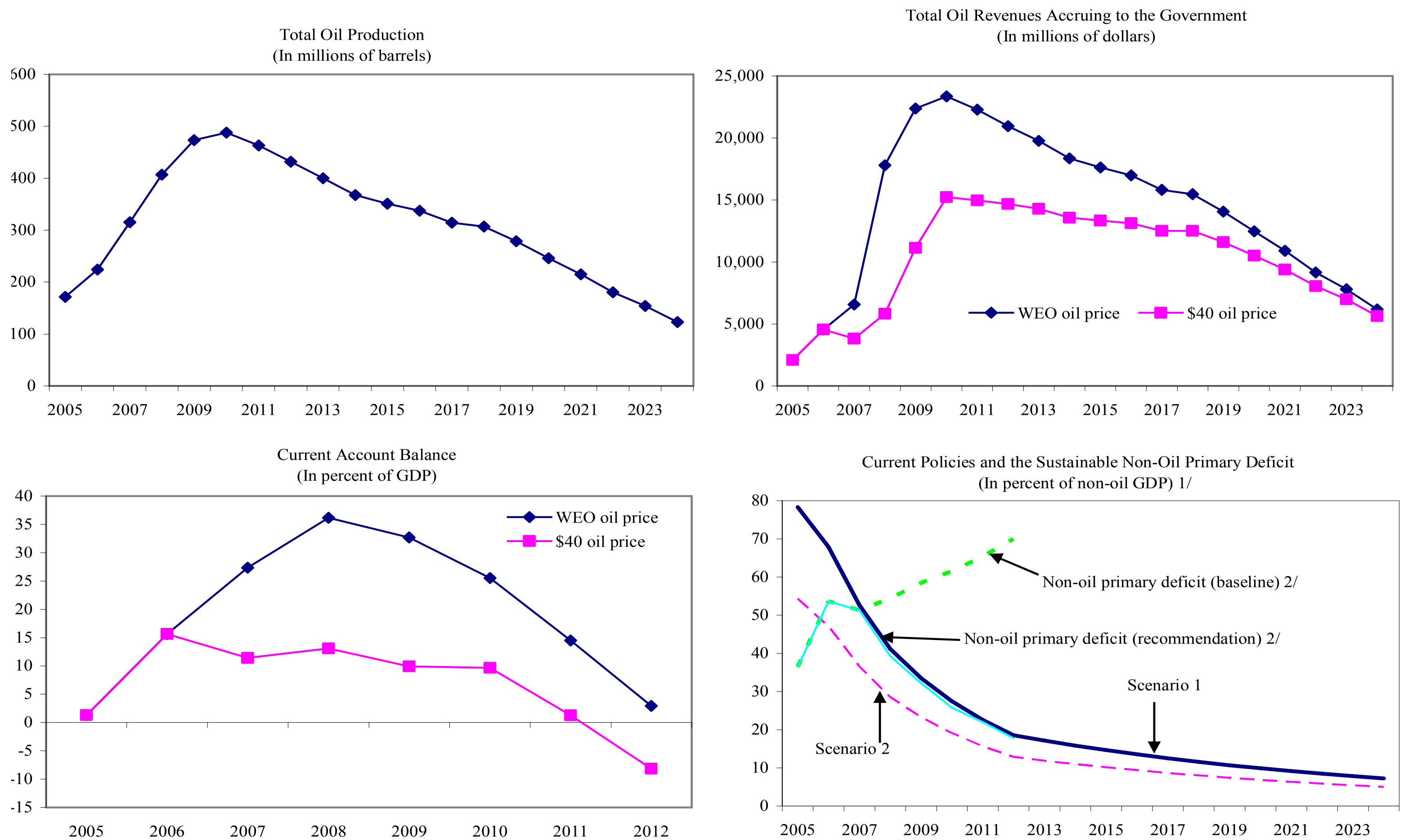
Figure 4: Azerbaijan: Problems Doing Business, 2002 and 2005
(Percent of firms indicating a problem)



Source: EBRD-World Bank Business Environment and Enterprise Performance Survey (BEEPS).

1/ Compared with Commonwealth of Independent States (CIS) and Eastern Europe and Central Asia (ECA).

Figure 5. Azerbaijan: Selected Oil-Related Indicators, 2005-24



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

1/ **Scenario 1**: Sustainable primary non-oil deficit to non-oil GDP (WEO, February 2007 oil prices).

Scenario 2: Sustainable primary non-oil deficit to non-oil GDP (oil price at US$40 per barrel in 2004 dollars).

2/ According to a broader definition of the primary non-oil deficit (including estimates of implicit subsidies).

(Table 9 and Appendix). Driven by relatively large budget expenditure increases, real non-oil GDP would grow by 6–7 percent during 2008–12, mainly on account of nontradable activities. Under the projected oil revenue path, both the external and government's net asset positions would strengthen during 2008–12, but current account surpluses would decline significantly and the overall fiscal balance would shift into a deficit by 2012.

15. **Under the baseline medium-term scenario, the economy is still vulnerable to a decline in oil prices.** Should oil prices decline to $40–$50 per barrel, current account and fiscal deficits would emerge and the oil fund assets would be depleted by the early 2010s (Figure 6).

16. **Oil prices aside, the deviation of the non-oil primary deficit from the sustainable path during 2008–12 carries significant long-term risks.** By the mid-2010s, a sharp decline in oil production and revenue would necessitate a large fiscal adjustment and import compression, even if oil prices remained at about $60 per barrel. The ensuing substantial expenditure cuts may lead to prolonged economic stagnation and a deterioration in living standards.

Illustrative sustainable scenario

17. **The staff also presented to the authorities an illustrative medium-term scenario consistent with fiscal sustainability.** In particular, it suggested a significant reduction in the pace of expenditure increases starting not later than in 2008, so as to bring the non-oil primary deficits to sustainable levels (about 18 percent of non-oil GDP by 2012). The recommended fiscal adjustment would also help accumulate larger foreign assets and reduce competitiveness pressures during the peak oil production years, strengthening medium- and long-term external sustainability (Table 10).

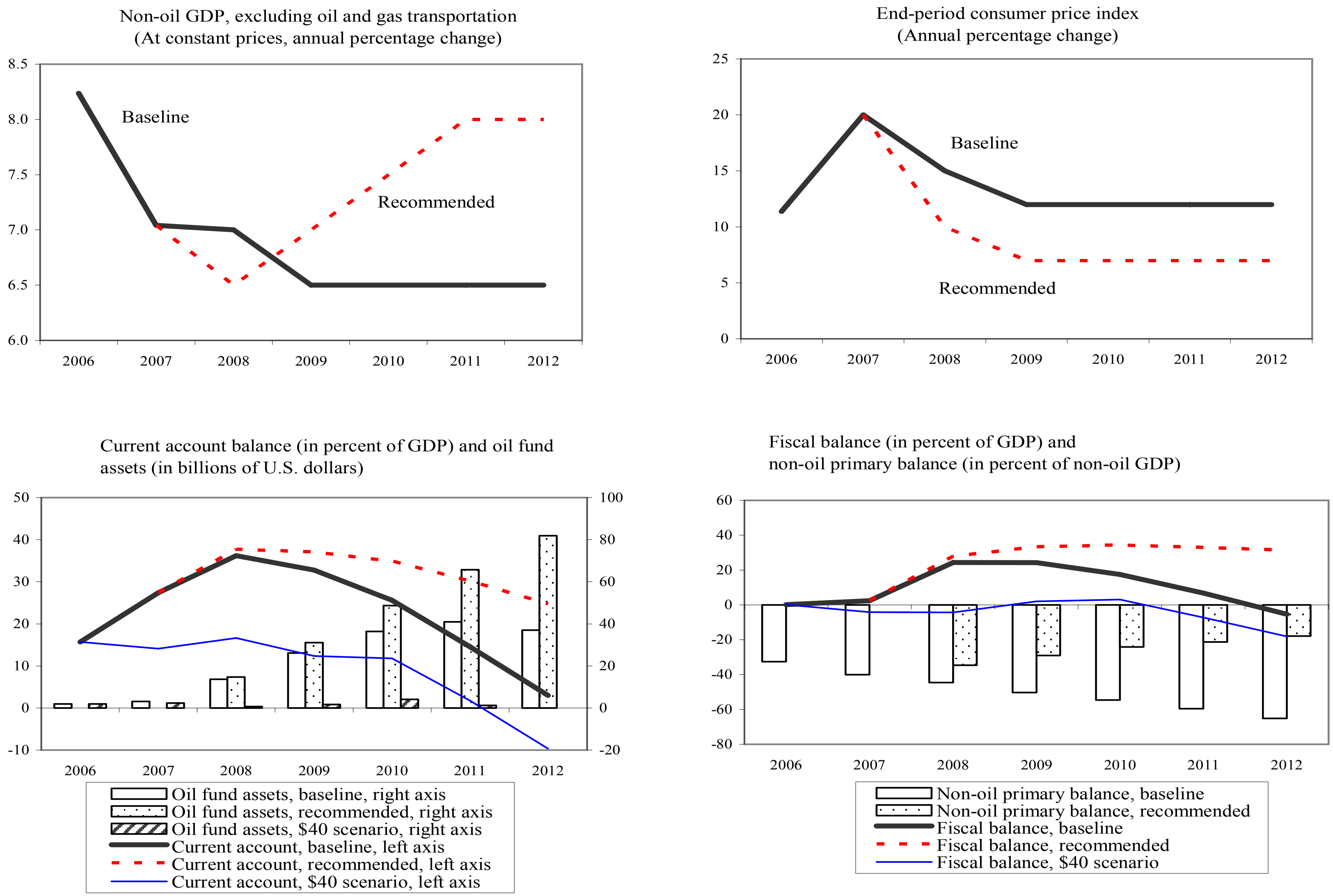
IV. Report on the Authorities' Views

A. What is the Appropriate Pace of Spending out of Oil Revenue?

18. **The authorities will revise the budget in mid-2007, mainly to account for higher revenue associated with the increased utilities and energy tariffs which they intend to use to increase expenditure.** After these revisions, in 2007, expenditure is projected to increase by 47 percent, including a 59 percent increase in the wage bill and 40 percent increase in capital expenditure, compared with 2006. The authorities were confident that they would be able to increase non-oil revenue by 28 percent compared with 2006. In line with the staff projection, the authorities expected the non-oil primary deficit to increase to about 40 percent of non-oil GDP in 2007.

19. **While the authorities acknowledged rising inflationary pressures and medium-term sustainability concerns, they saw only limited room for reducing expenditure growth in the short term.** They indicated that they could not adjust current expenditure downward in light of their desire to raise wages and pensions to improve living standards at the beginning of the oil boom. The authorities also maintained that the public investment

Figure 6. Azerbaijan: Medium-Term Macroeconomic Scenarios, 2006-12



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

program included the most critical projects in the social sectors (schools and hospitals) and basic infrastructure (power stations, highways, railroads, irrigation), which needed to be implemented after years of under-investment and neglect. They recognized that there was significant room for improving capital expenditure management, but they felt that they could address this issue without delaying project implementation.

20. **The government will strengthen the SOEs' budgetary discipline to restrain domestic demand growth.** In particular, the government intended to enhance collection on utility payments and approve and enforce the 2007 SOEs' budgets, including those of major utilities and energy companies. Notwithstanding these measures and higher electricity tariffs, the authorities believed that it would be premature to remove the electricity subsidy (3.2 percent of non-oil GDP) from the 2007 budget.

21. **The authorities agreed that the pace of expenditure increases would need to be moderated in the medium term to ensure fiscal sustainability, but did not provide a firm indication of the appropriate pace of adjustment at the time of the consultation discussions.** Furthermore, they underlined that it would be difficult to contain expenditure increases in 2008 due to the forthcoming presidential elections. However, by end-2008, the authorities expected that many infrastructure projects would be close to completion and the level of wages and pensions would be consistent with their social objectives, reducing the need for further large real expenditure increases. Over the medium term, the government intended to make a transition to program budgeting, implement reforms in health and education, and eliminate energy subsides. The authorities will also continue to improve revenue administration with a view to broadening the tax base and reducing tax rates (Box 1). Moreover, they will expand oil revenue coverage under the Extractive Industry Transparency Initiative (EITI). While the authorities were still working on concrete plans for implementing these measures and evaluating their fiscal impact, they believed that the non-oil primary deficit could be reduced significantly by 2012.

B. How to Reduce Inflation to Single Digits in the Medium Term?

22. **The authorities acknowledged that it would be challenging to reduce inflation by end-2007.** The ANB forecast that the expected increase in the non-oil primary deficit would lead to 60–70 percent manat base money growth in 2007, if it maintained a slowly appreciating crawling peg. This, according to the ANB, would fuel continued rapid growth of banking credit and monetary aggregates.

23. **The authorities indicated that they needed to weigh the benefits of an increase in policy interest rates and faster exchange rate appreciation against the attendant risks.** They maintained that the benefits would be limited because of the ineffectiveness of the interest rate channel, and a low pass-through of exchange rate appreciation to prices, which they explained by structural bottlenecks at the customs and in the retail sector.

At the same time, the authorities were of the view that the risks to financial system stability[5] and competitiveness were high under more proactive exchange and interest rate policies. On balance, they will consider a gradual increase in interest rates and faster exchange rate appreciation later in 2007, if inflation continues to rise, provided there is consensus among the ANB and key cabinet members on the appropriateness of these measures. As a first step, the ANB has recently increased the refinancing rate to 12 percent from 9.5 percent. In any event, the ANB will most likely maintain the de facto crawling peg as its key operating target while paying increasing attention to manat base money during 2007.

Box 1. Non-Oil Taxation Issues

In recent years, non-oil revenues have increased as a share of non-oil GDP (Table 5) but they are below potential. VAT and customs duty revenue losses arise from costly tax exemptions and tax administration problems (Text Tables 3 and 4). The authorities also face tax administration problems with other non-oil taxes mainly due to the importance of the informal economy.

In the short term, the authorities are considering to expand the non-oil tax base by (i) phasing out some tax exemptions; (ii) improving the tax administration infrastructure for the taxpayers' self-assessment and voluntary compliance; and (iii) reinforcing the pre-registration requirements for VAT refunds. In addition, the staff advises the authorities to quantify the value of existing and newly proposed exemptions, if any, annually, and seek parliamentary approval of new exemptions and their duration.

Over the medium term, the authorities will consider reducing some tax rates once the tax base has been expanded and revenues increased. In this regard, the staff recommends assessing if a simpler tax system with flat personal income and lower corporate income taxes could work in Azerbaijan, drawing on the experience of the Baltics, Russia, and some other former Soviet Union countries.

Text Table 3. Azerbaijan: Estimates of VAT Revenue Losses, 2006 1/

Actual VAT and simplified tax	
In millions of manats	766
In percent of non-oil GDP	9.5
Estimated revenue losses due to exemptions 2/	
In millions of manats	373
In percent of non-oil GDP	4.6
Estimated revenue losses excluding exemptions	
In millions of manats	121
In percent of non-oil GDP	1.5

Sources: Azerbaijan authorities; and Fund staff estimates.

1/ Fund staff estimates based on the authorities' data.
2/ The exemption rate (29.4 percent) was provided by the Ministry of Taxes.

Text Table 4. Azerbaijan: Estimates of Customs Duties Losses, 2006 1/

Actual import duty revenue	
In millions of manats	139
In percent of non-oil GDP	1.7
Estimated revenue losses due to exemptions 2/	
In millions of manats	36
In percent of non-oil GDP	0.4
Estimated revenue losses excluding exemptions	
In millions of manats	25
In percent of non-oil GDP	0.3

Sources: Azerbaijan authorities; and Fund staff estimates.

1/ Fund staff estimates based on the authorities' data.
2/ The exemption rate (18.2 percent) and average statutory import tariff rate (5.7 percent) were provided by the Customs officials.

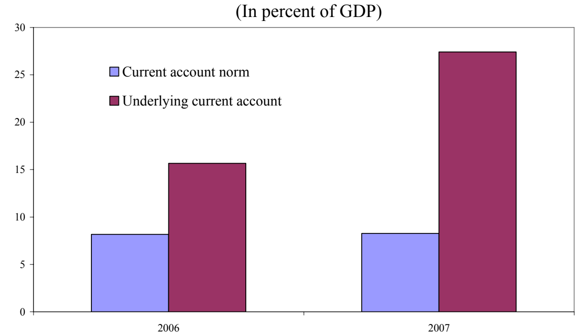
[5] While the authorities' stress tests showed that the direct impact of faster appreciation and higher interest rates was manageable for the banking system, they expressed concern that rapid dedollarization, which might be triggered by further exchange rate appreciation, may put undue stress on the banking system that still suffers from insufficient expertise in risk management.

24. **The authorities broadly agreed that the real exchange rate was undervalued (Box 2).** However, they did not intend to accelerate the real exchange rate adjustment process through rapid nominal appreciation. Rather, the authorities will seek to offset the impact of fiscal policy on the REER through structural measures, such as gradual capital account liberalization, improvements to customs administration and WTO accession, a reduction in red tape in the retail sector, and increased scrutiny of "unjustified" price increases by monopolists.

Box 2. Assessing the Exchange Rate Level

The macroeconomic balance approach estimates how much the real exchange rates would have to adjust to move the current account balance (CAB) to its medium-term equilibrium level—the norm consistent with a number of fundamental variables. The CAB norms for Azerbaijan in 2006 and 2007 are computed by applying the coefficients estimated by the Consultative Group on Exchange Rate Issues. The CAB norms are then compared with the underlying CAB—the estimated CAB for 2006, and the CAB for 2007 projected to emerge under the current exchange rate policy. For both years, the underlying current account surplus is substantially larger than the CAB norm (Figure 7), suggesting significant undervaluation of Azerbaijan's REER.

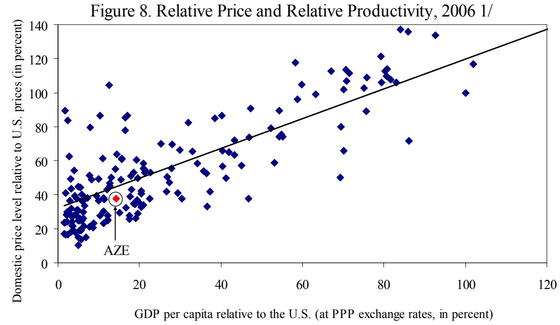
Figure 7. Azerbaijan: Current Account Balance, 2006-07
(In percent of GDP)



Source: Fund staff estimates and projections.

The Purchasing Power Parity (PPP) approach relies on a cross-country regression measuring the relationship between a country's price level relative to the U.S. and a country's GDP per capita relative to the U.S. level at PPP exchange rates (a proxy for productivity) to account for the Balassa-Samuelson effect. The regression for 2006 shows that Azerbaijan falls below the regression line (Figure 8), with its domestic prices relative to the U.S. prices lower than warranted by its relative per capita income, suggesting a 15 percent REER undervaluation.

Figure 8. Relative Price and Relative Productivity, 2006 1/



Sources: IMF, World Economic Outlook; and staff calculations.
1/ The line is derived from a regression for 180 economies. A few outliers are not shown in the figure.

25. **The authorities stated that it would be desirable to reduce inflation to single digits in the medium term.** They fully agreed that moderating expenditure increases in the

medium term was key to reducing the fiscal dominance of monetary policy and achieving low inflation. Even before fiscal dominance has been fully eliminated, the ANB will continue to lay the institutional foundations for a transition to inflation targeting, including through (i) fostering the development of money markets by introducing an interest rate corridor and a key policy rate close to the middle of this corridor in line with MCM TA as of April 1, 2007; (ii) improving its communication policies through the publication of forward-looking inflation reports; (iii) enhancing its forecasting capacity; and (iv) further improving banking supervision drawing on inputs from forthcoming MCM TA. In addition, the authorities will recapitalize the ANB, if a capital shortfall arises, to strengthen the credibility of its policies.

C. What are the Key Productivity-Enhancing Structural Reforms?

26. **The authorities intended to improve financial intermediation by reviving banking sector privatization.** A recent presidential decree calls for the privatization of the Kapital Bank (the smaller of the two state-owned banks) through the tender of five 10 percent ownership stakes. The authorities said that they would build on the experience of the Kapital Bank sale to begin the privatization of the much larger International Bank of Azerbaijan.

27. **The authorities were aware of domestic and foreign investors' growing concerns regarding the recent deterioration in the investment climate, and considered remedial action in selected areas.** They fully recognized that rapid progress in this area was essential to help the non-oil economy cope with the inevitable real exchange rate appreciation. In particular, the authorities were considering a number of steps to simplify the licensing and business registration requirements in cooperation with the World Bank. They also expected parliament to pass the anti-monopoly code, the investment law, and AML legislation in the near future. As part of their anti-corruption program, the authorities have submitted the draft laws on the Code of Conduct of Civil Servants and on Preventing the Conflict of Interest of Public Officials to parliament, and will continue to work on other anti-corruption legislative acts.

V. Staff Appraisal

28. **The current oil production boom has spurred growth, but rapidly increasing spending has posed important challenges.** During 2005–06, rising oil production resulted in record-high real GDP growth and sizeable current account surpluses, which helped further increase the Azerbaijan public sector's net external assets and reduce poverty. However, against the background of capacity constraints and deep-rooted structural problems, the combination of the ballooning non-oil primary fiscal deficit and the accommodating monetary policy stance has led to rising inflation.

29. **Going forward, the temporary oil boom presents a unique opportunity to modernize the country and reduce poverty significantly, but continuing with current policies poses significant risks to the achievement of these objectives.** In the absence of a moderation in expenditure increases and a monetary policy tightening in 2007, inflation will

most likely continue to increase in 2007. In the medium term, further rapid expenditure increases in the context of slow reforms would intensify Dutch disease problems and jeopardize long-term growth and fiscal sustainability, and may even reverse recent progress in poverty reduction.

30. **It is regrettable that there is no political consensus on the need for moderating expenditure increases in 2007 to contain domestic demand growth as the staff recommends.** Bringing down inflation close to single digits by end-2007 would require a reduction in the non-oil primary fiscal deficit to somewhat below its 2006 level of 33 percent of non-oil GDP from the expected 40 percent. This fiscal adjustment could be achieved through a significant reduction in explicit energy subsidies following the recent increase in electricity tariffs, better selectivity and control of the execution of investment projects, and cuts in non-essential purchases of goods and services.

31. **At the same time, the authorities' intent to consider slowing down expenditure increases in the medium term to reestablish macroeconomic stability and ensure long-term fiscal sustainability is welcome.** The structural measures that the government is currently implementing or considering, including stricter controls on SOEs' spending, the transition to program budgeting, the elimination of energy subsidies, reforms in health and education, improvements to revenue administration, and continued adherence to the EITI principles, deserve full support.

32. **There is a risk, however, that the authorities could delay the fiscal adjustment beyond 2008 as political pressures for higher spending are rising in the run-up to the 2008 presidential elections.** Such a delay heightens the probability of an inflation/indexation spiral and increases resistance to fiscal reforms, which could jeopardize the reduction of the non-oil primary fiscal deficit to a more sustainable level (about 18 percent of non-oil GDP by 2012). To avoid slippages, it is essential to approve a credible medium-term expenditure framework and a sustainable path for the non-oil primary fiscal deficit consistent with the long-term oil revenue management strategy which is yet to be operationalized. Furthermore, expenditure management and control should be enhanced substantially by strengthening the auditing capacity of the chamber of accounts and ensuring full compliance with tendering and procurement regulations, in order to reduce the risk of waste and opportunities for corruption.

33. **Since reducing the non-oil primary deficit in 2007 is not considered feasible by the authorities, an immediate monetary policy tightening is all the more important to prevent further significant increases in inflation.** Allowing for greater exchange rate flexibility and adopting manat base money as the primary operating target of monetary policy will help regain monetary control. Moreover, the ANB, which is de jure independent, should be granted de facto instrument independence. To tighten monetary conditions, the ANB should scale down its unsterilized purchases of foreign exchange, which is key to reducing the 12-month manat base money growth rate to below 50 percent by year-end consistent with the objective of keeping inflation below 20 percent in 2007. This would lead

to faster nominal exchange rate appreciation. While the interest rate transmission mechanism is weak, it will still be important to continue to increase the refinancing rate until it becomes positive in real terms for signaling purposes.

34. **Despite recent appreciation, the real exchange rate appears undervalued.** This, together with further fiscal expansion, will intensify real appreciation pressures in the near term. As demonstrated by Azerbaijan's recent experience, these pressures would manifest through higher inflation if the nominal exchange rate were not allowed to appreciate sufficiently. The contemplated capital account and trade liberalization, as well as an improved business climate in the retail sector, might reduce somewhat real appreciation pressures in the medium term. However, these measures alone would not be sufficient to alleviate real appreciation pressures in the short term.

35. **Faster exchange rate appreciation and higher interest rates pose manageable risks to banking system stability.** The authorities' stress tests indicate low direct vulnerability of the banking system to exchange and interest rate shocks. The residual risks that are not captured by the stress tests should be manageable in case of a gradual acceleration of exchange rate appreciation, provided the authorities immediately address the remaining banking system vulnerabilities through zero tolerance to noncompliance with prudential regulations. Absent monetary policy tightening and strict enforcement of prudential regulations, unchecked credit growth in the context of insufficient risk management expertise in banks may carry a higher risk to banking system stability.

36. **To reduce inflation to single digits in the medium term, the ANB and the government should prepare and implement a joint disinflation strategy and communicate it to the public.** Adopting a sustainable medium-term fiscal framework should be a key component of such a strategy. The ANB's current plans to develop the institutional preconditions for transition to inflation targeting are fully in line with previous staff advice. The government should also support these efforts by engaging in closer coordination with the ANB on the matters of treasury cash flow management, and government securities market development, drawing on MCM regional TA in this area. Moreover, the State Statistical Committee will need to address methodological issues in CPI compilation following up on the conclusions of the forthcoming STA CPI assessment mission. In addition, to strengthen the ANB's credibility, it should be recapitalized through tradable dated government securities bearing market interest rates in case its 2006 audited financial statement reveals a capital shortfall.

37. **Deepening financial intermediation is essential for ensuring sustainable non-oil growth.** The authorities' renewed interest in speeding up the privatization of the two state-owned banks is welcome. However, they should reconsider their privatization strategy to make these banks more attractive to reputable strategic investors by offering larger ownership stakes in individual tenders and ensuring that only fit and proper investors participate.

38. **Other productivity-enhancing reforms should be revived to help the non-oil economy withstand rising competitiveness pressures.** The staff fully supports the envisaged steps to improve the business climate and governance. However, greater efforts and strong political support are need to strictly enforce the implementation of the anti-corruption program, and improve governance at the customs and tax administration agencies.

39. It is proposed that the next Article IV consultation be held on the standard 12-month cycle.

Table 1. Azerbaijan: Selected Economic and Financial Indicators, 2003–07

	2003	2004	2005	2006 Prel.	2007 Proj. 1/
	(Annual percentage change, unless otherwise specified)				
National income					
GDP at current prices	17.9	19.4	46.8	41.6	37.5
GDP at constant prices	10.5	10.4	24.3	31.0	29.1
Of which: oil sector, excluding oil and gas transportation 2/	0.6	2.5	65.4	61.9	52.9
non-oil sector, including oil and gas transportation	15.3	13.8	8.4	12.8	8.9
non-oil sector, excluding oil and gas transportation	15.3	13.3	7.9	8.2	7.0
Implicit GDP deflator	6.7	8.1	18.1	8.1	6.5
Consumer price index (end-period)	3.6	10.4	5.5	11.4	18-22
Consumer price index (period average)	2.2	6.7	9.7	8.4	21.1
Core consumer price index (end-period) 3/	4.8	10.8	4.0	9.0	...
Consolidated central government finance					
Total revenue	16.0	20.0	36.9	67.6	54.9
Of which: non-oil revenue	11.2	29.1	34.9	34.5	28.2
Total expenditure	21.5	8.3	28.7	80.9	47.1
Of which: current expenditure	20.3	15.4	22.8	50.9	50.0
investment expenditure	26.1	-18.6	59.9	203.6	41.2
Money and credit					
Net foreign assets	21.4	47.9	7.5	89.3	97.5
Net domestic assets	47.6	46.9	47.8	82.7	54.3
Domestic credit	26.1	39.5	50.2	74.4	45.7
Of which: credit to the economy	38.3	60.2	53.0	63.6	61.1
Manat base money	23.7	38.2	7.5	132.6	80.5
Manat broad money	28.0	31.9	15.8	168.3	83.3
Total broad money	29.8	47.5	22.1	86.4	79.0
Foreign currency deposits ratio to broad money	49.1	54.5	56.9	37.9	36.4
Velocity of total broad money (M3) 4/	7.7	6.3	5.2	4.4	3.6
External sector (in US$)					
Exports f.o.b.	13.9	42.6	104.4	70.1	33.9
Of which: oil sector	10.0	43.6	113.0	74.4	35.7
Imports f.o.b.	49.3	31.5	21.4	21.1	15.0
Of which: oil sector	230.1	46.5	18.7	-9.1	-40.8
Export volumes	-4.8	12.1	64.8	40.9	43.7
Import volumes	41.3	17.7	14.6	17.1	11.2
Terms of trade	13.2	13.9	17.0	12.3	-6.4
Real effective exchange rate (- deprec.)	-10.7	-3.5	6.6	8.9	…
	(In percent of GDP, unless otherwise specified)				
Gross investment	53.2	58.0	40.7	27.7	24.4
Consolidated government	3.2	3.9	4.1	9.1	9.8
Private sector	50.0	54.1	36.6	18.6	14.6
Of which: oil sector	41.4	38.5	17.6	5.2	2.9
Gross domestic savings	29.6	34.1	50.7	57.1	58.7
Gross national savings	25.4	28.2	41.9	43.4	51.9
Consolidated government	3.9	5.1	7.0	9.6	12.2
Private sector 5/	21.5	23.0	34.9	33.7	39.7
Consolidated central government finance					
Overall fiscal balance	-0.8	1.0	2.6	0.1	2.4
Non-oil primary balance, in percent of non-oil GDP	-17.0	-12.9	-12.6	-32.6	-40.1
Implicit energy subsidies, in percent of non-oil GDP	17.7	20.1	23.5	21.1	11.2
External sector					
Current account (- deficit)	-27.8	-29.8	1.3	15.7	27.4
Foreign direct investment (net)	31.5	26.8	3.5	-4.7	-17.4
Public and publicly guaranteed external debt outstanding	19.7	18.5	12.5	10.0	10.3
Memorandum items:					
Gross official international reserves (in millions of U.S. dollars)	803	1,075	1,178	2,500	4,712
Nominal GDP (in millions of manats)	7,147	8,530	12,523	17,736	24,383
Nominal non-oil GDP, including oil and gas transportation (in millions of manats)	4,997	5,858	7,002	8,102	10,386
Nominal GDP per capita (in U.S. dollars)	880	1,040	1,574	2,336	3,356
Oil Fund assets (in millions of U.S. dollars) 6/	821	972	1,394	1,936	3,093
Population (mid-year, in millions)	8.3	8.3	8.4	8.5	8.6
Exchange rate (manat/dollar, end-of-period)	0.985	0.981	0.919	0.871	…

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

1/ For 2007, the scenario assumes the continuation of current policies in Tables 1-2, Tables 4-7, and Tables 9-10.

2/ Oil and gas transportation includes all pipelines except the western route. The Baku-Tbilisi-Ceyhan (BTC) pipeline started operation in May 2006.

3/ Excludes administered prices for fuel, energy, transportation, water, and communications as well as prices for selected fruits and vegetables.

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

5/ The historical data include the statistical discrepancy.

6/ Includes the central government's foreign exchange deposits managed by the Oil Fund.

Table 2. Azerbaijan: Balance of Payments, 2003–07

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

	2003	2004	2005	2006 Est.	2007 Proj.
Exports, f.o.b.	2,625	3,743	7,649	13,014	17,420
Oil and oil products	2,250	3,232	6,883	12,002	16,292
Other	374	511	766	1,012	1,127
Imports, f.o.b.	-2,723	-3,582	-4,350	-5,269	-6,057
Oil sector	-1,109	-1,624	-1,927	-1,751	-1,037
Others	-1,614	-1,958	-2,423	-3,518	-5,020
Trade balance	-98	161	3,299	7,745	11,362
Services, net	-1,615	-2,238	-1,970	-1,924	-1,518
Credit	432	492	683	939	1,025
Debit	-2,047	-2,730	-2,653	-2,863	-2,543
Of which : oil sector	-1,510	-1,909	-1,658	-1,602	-1,214
Income	-442	-701	-1,646	-4,362	-4,646
Investment income, net	-390	-605	-1,666	-4,365	-4,650
Of which : profit of oil consortium	-387	-521	-1,422	-4,056	-4,612
Compensation of employees, net	-52	-95	21	3	4
Transfers, net	134	188	484	1,646	2,667
Private	78	131	369	1,584	2,597
Public	57	57	115	62	70
Current account balance	-2,021	-2,589	167	3,105	7,866
Capital account, net	-23	-4	41	0	12
Direct investment, net	2,352	2,351	459	-924	-4,963
Abroad, net	-933	-1,205	-1,221	-705	-213
Of which : oil sector, net	-931	-1,202	-1,217	-689	-197
In reporting economy, net	3,285	3,556	1,680	-219	-4,750
Oil sector, net	3,246	3,461	1,459	-573	-5,198
Credit	3,962	4,615	4,246	4,096	2,756
Debit	-716	-1,154	-2,787	-4,669	-7,953
Others, net	39	96	221	354	447
Portfolio investment, net	0	-18	31	-11	392
Other investment	51	754	64	-330	99
Assets, net	-46	-233	-890	-1,116	-1,041
Liabilities, net	97	987	954	786	1,140
General government	32	35	38	99	396
Government guaranteed	-41	-41	74	191	263
Others, net	106	993	842	496	481
Oil sector	0	1,095	768	274	300
Others	106	-101	74	222	181
Financial account, net	2,403	3,087	554	-1,265	-4,473
Capital and financial account balance	2,380	3,083	595	-1,265	-4,460
Errors and omissions	-112	-50	-126	62	0
Overall balance	247	444	636	1,902	3,406
Financing	-247	-444	-636	-1,902	-3,406
Change in net foreign assets of ANB (increase -)	-124	-317	-161	-1,360	-2,249
Net credit from the Fund	-42	-60	-29	-37	-37
Disbursements/purchases	37	0	20	0	0
Repayments/repurchases	-79	-60	-48	-37	-37
Change in gross official international reserves (increase -)	-82	-257	-132	-1,323	-2,212
Change in Oil Fund assets (increase -) 1/	-123	-127	-476	-542	-1,157
Memorandum items:					
Current account balance (in percent of GDP)	-27.8	-29.8	1.3	15.7	27.4
Gross official international reserves	803	1,075	1,178	2,500	4,712
Gross official international reserves (in months of next year's non-oil imports c.i.f.)	3.5	3.8	3.0	4.7	6.9
Oil Fund assets 1/	816	972	1,394	1,936	3,093
Public and publicly guaranteed external debt stock (in percent of GDP)	19.7	18.5	12.5	10.0	10.3
Private sector debt (in percent of GDP)	18.7	22.3	22.2	17.5	15.0
WEO oil price (US$ per barrel)	29.0	37.8	53.3	64.3	60.8

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

1/ Includes the central government's foreign exchange deposits managed by the Oil Fund.

Table 3. Azerbaijan: Millennium Development Goals, 1990-2004 1/

	1990	1995	1998	2001	2004
Goal 1: Eradicate extreme poverty and hunger					
Income share held by lowest 20 percent	...	...	...	12	...
Malnutrition prevalence, weight for age (percent of children under 5)	...	*10*	...	7	...
Poverty gap at $1 a day (PPP) (percent)	...	3	...	1	...
Poverty headcount ratio at $1 a day (PPP) (percent of population)	...	11	...	4	...
Poverty headcount ratio at national poverty line (percent of population)	...	68	...	49	...
Prevalence of undernourishment (percent of population)	...	34	...	...	*10*
Goal 2: Achieve universal primary education					
Literacy rate, youth total (percent of population ages 15-24)	...	...	...	...	100
Primary completion rate, total (percent of relevant age group)	...	*81.3*	*88.7*	93.2	96.1
School enrollment, primary (percent, net)	*89*	...	*85*	83	84
Goal 3: Promote gender equality and empower women					
Proportion of seats held by women in national parliament (percent)	...	...	12	*11*	11
Ratio of girls to boys in primary and secondary education (percent)	*100.3*	...	99.8	97.5	97.3
Ratio of young literate females to males (percent of population ages 15-24)	...	...	...	...	100
Share of women employed in the nonagricultural sector (percent of total nonagricultural employment)	34	39	43	45	*49*
Goal 4: Reduce child mortality					
Immunization, measles (percent of children ages 12-23 months)	...	97	98	99	98
Mortality rate, infant (per 1,000 live births)	84	80	...	*77*	75
Mortality rate, under-5 (per 1,000)	105	98	...	*93*	90
Goal 5: Improve maternal health					
Births attended by skilled health staff (percent of total)	...	...	99.8	*84.1*	...
Maternal mortality ratio (modeled estimate, per 100,000 live births)	...	...	...	*94*	...
Goal 6: Combat HIV/AIDS, malaria, and other diseases					
Contraceptive prevalence (percent of women ages 15-49)	...	...	...	55	...
Incidence of tuberculosis (per 100,000 people)	34.9	...	...	...	75.3
Prevalence of HIV, total (percent of population ages 15-49)	...	...	...	...	*0*
Tuberculosis cases detected under DOTS (percent)	...	5.2	6.7	0.2	47.1
Goal 7: Ensure environmental sustainability					
CO2 emissions (metric tons per capita)	7.5	4.2	3.8	3.4	...
Forest area (percent of land area)	...	...	...	*11*	*11*
GDP per unit of energy use (constant 2000 PPP $ per kg of oil equivalent)	...	1	1	2	*2*
Improved sanitation facilities (percent of population with access)	...	...	...	...	54
Improved water source (percent of population with access)	68	...	...	...	77
Nationally protected areas (percent of total land area)	...	...	...	...	6.4
Goal 8: Develop a global partnership for development					
Aid per capita (current US$)	*0*	15.5	15.2	28.6	21.1
Fixed line and mobile phone subscribers (per 1,000 people)	86.6	84	94.2	196.6	333.1
Internet users (per 1,000 people)	0	0	0.4	3.1	49.1
Personal computers (per 1,000 people)	...	...	...	...	17.9
Other					
Fertility rate, total (births per woman)	2.7	2.3	2	*2.1*	2
GNI per capita, Atlas method (current US$)	...	400	510	660	930
GNI, Atlas method (current US$) (billions)	...	3	4	5.3	7.7
Life expectancy at birth, total (years)	70.8	69	71.4	71.8	72.3
Literacy rate, adult total (percent of population ages 15 and above)	...	...	...	...	98.8
Population, total (millions)	7.2	7.7	7.9	8.1	8.3

Source: World Development Indicators database, September 2006.

1/ Figures in italics refer to periods other than those specified.

Table 4. Azerbaijan: Consolidated Central Government Operations, 2003–07

(In millions of manats)

	2003	2004	2005	2006 Prel.	2007 Proj.
Total revenue and grants	1,912	2,288	3,143	5,253	8,127
Total revenue	1,906	2,288	3,132	5,248	8,127
Tax revenue	1,099	1,317	1,902	3,341	5,460
Income taxes	329	445	673	1,768	3,061
Individual income tax	150	222	317	407	550
Enterprise profits tax	178	223	355	1,361	2,511
Social security contributions	149	182	198	294	464
Value added tax (VAT)	410	453	600	738	1,075
Domestic	266	281	346	386	665
Imports	144	171	254	351	410
Excise taxes	67	72	141	187	325
Taxes on international trade	93	101	205	239	373
Of which : SOCAR additional revenue	25	30	10	0	0
Other taxes	52	64	85	115	162
Nontax revenue 1/	413	592	938	1,499	2,337
Of which : Oil Fund revenues 2/	242	303	596	984	1,996
Tax credits for SOCAR energy subsidies 3/	394	379	292	408	330
Total grants (current)	6	0	11	5	0
Total expenditure	2,038	2,207	2,839	5,135	7,552
Current expenditure	1,610	1,858	2,281	3,441	5,161
Primary current expenditure	1,199	1,459	1,973	3,021	4,757
Wages and salaries	316	423	580	745	1,187
Goods and services	402	496	716	1,285	1,958
Transfers	438	503	640	884	1,278
Of which: social protection fund	371	404	495	566	1,024
Subsidies	32	27	28	41	150
Oil Fund (operating expenditures)	1	1	2	1	7
Other	9	9	7	66	177
SOCAR energy-related subsidies 3/	394	379	292	408	330
Interest	16	19	16	13	74
Current balance (-, deficit)	302	431	862	1,811	2,966
Investment expenditure and net lending	428	349	558	1,693	2,391
Domestically-financed	304	244	438	1,427	2,042
without BTC financing	189	226	397	1,352	2,042
Foreign-financed	124	105	120	266	349
Statistical discrepancy	-70	-8	-17	102	0
Non-oil primary balance	-849	-755	-884	-2,639	-4,164
Consolidated government balance, cash basis	-56	90	321	16	575
Excluding foreign project loans	68	195	441	282	924
Financing	56	-90	-321	-16	-575
Domestic (net) 4/	-151	-212	-436	-277	-1,218
External (net)	207	122	115	260	643
Memorandum items:					
Oil revenue 5/	809	864	1,221	2,667	4,813
Non-oil revenue 6/	1,103	1,425	1,922	2,585	3,314
Implicit subsidies	885	1,179	1,647	1,710	1,168

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

1/ Starting in 2004 includes contingent revenues accrued on the "deposit account" of budgetary organizations.
2/ Includes profit oil, acreage fees, and income earned on Oil Fund assets. Oil bonuses also enter in the Oil Fund, but these are treated as a financing item.
3/ Tax credits for SOCAR energy subsidies for 2006 have been calculated pending final approval.
4/ Includes changes of Oil Fund deposits abroad.
5/ Includes SOCAR tax credits for energy subsidies.
6/ Includes grants, VAT and excise taxes on oil and gas, and tax withholding on the Azerbaijan International Operating Company's subcontractors.

Table 5. Azerbaijan: Consolidated Central Government Operations, 2003–07

(In percent of non-oil GDP)

	2003	2004	2005	2006 Prel.	2007 Proj.
Total revenue and grants	38.3	39.1	44.9	64.8	78.3
Total revenue	38.1	39.1	44.7	64.8	78.3
Tax revenue	22.0	22.5	27.2	41.2	52.6
Income taxes	6.6	7.6	9.6	21.8	29.5
Individual income tax	3.0	3.8	4.5	5.0	5.3
Enterprise profits tax	3.6	3.8	5.1	16.8	24.2
Social security contributions	3.0	3.1	2.8	3.6	4.5
Value added tax (VAT)	8.2	7.7	8.6	9.1	10.4
Domestic	5.3	4.8	4.9	4.8	6.4
Imports	2.9	2.9	3.6	4.3	3.9
Excise taxes	1.3	1.2	2.0	2.3	3.1
Taxes on international trade	1.9	1.7	2.9	2.9	3.6
Of which : SOCAR additional revenue	0.5	0.5	0.1	0.0	0.0
Other taxes	1.0	1.1	1.2	1.4	1.6
Nontax revenue 1/	8.3	10.1	13.4	18.5	22.5
Of which : Oil Fund revenues 2/	4.8	5.2	8.5	12.1	19.2
Tax credits for SOCAR energy subsidies 3/	7.9	6.5	4.2	5.0	3.2
Total grants (current)	0.1	0.0	0.2	0.1	0.0
Total expenditure	40.8	37.7	40.5	63.4	72.7
Current expenditure	32.2	31.7	32.6	42.5	49.7
Primary current expenditure	24.0	24.9	28.2	37.3	45.8
Wages and salaries	6.3	7.2	8.3	9.2	11.4
Goods and services	8.1	8.5	10.2	15.9	18.9
Transfers	8.8	8.6	9.1	10.9	12.3
Of which: social protection fund	7.4	6.9	7.1	7.0	9.9
Subsidies	0.6	0.5	0.4	0.5	1.4
Oil Fund (operating expenditures)	0.0	0.0	0.0	0.0	0.1
Other	0.2	0.2	0.1	0.8	1.7
SOCAR energy-related subsidies 3/	7.9	6.5	4.2	5.0	3.2
Interest	0.3	0.3	0.2	0.2	0.7
Current balance (-, deficit)	6.0	7.4	12.3	22.4	28.6
Investment expenditure and net lending	8.6	6.0	8.0	20.9	23.0
Domestically-financed	6.1	4.2	6.3	17.6	19.7
without BTC financing	3.8	3.9	5.7	16.7	19.7
Foreign-financed	2.5	1.8	1.7	3.3	3.4
Statistical discrepancy	-1.4	-0.1	-0.2	1.3	0.0
Non-oil primary balance	-17.0	-12.9	-12.6	-32.6	-40.1
Consolidated government balance, cash basis	-1.1	1.5	4.6	0.2	5.5
Excluding foreign project loans	1.4	3.3	6.3	3.5	8.9
Financing	1.1	-1.5	-4.6	-0.2	-5.5
Domestic (net) 4/	-3.0	-3.6	-6.2	-3.4	-11.7
External (net)	4.1	2.1	1.6	3.2	6.2
Memorandum items:					
Oil revenue 5/	16.2	14.7	17.4	32.9	46.3
Non-oil revenue 6/	22.1	24.3	27.4	31.9	31.9
Implicit subsidies	17.7	20.1	23.5	21.1	11.2

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

1/ Starting in 2004 includes contingent revenues accrued on the "deposit account" of budgetary organizations.
2/ Includes profit oil, acreage fees, and income earned on Oil Fund assets. Oil bonuses also enter in the Oil Fund, but these are treated as a financing item.
3/ Tax credits for SOCAR energy subsidies for 2006 have been calculated pending final approval.
4/ Includes changes of Oil Fund deposits abroad.
5/ Includes SOCAR tax credits for energy subsidies.
6/ Includes grants, VAT and excise taxes on oil and gas, and tax withholding on the Azerbaijan International Operating Company's subcontractors.

Table 6 . Azerbaijan: Summary Accounts of the National Bank, 2003–07

(In millions of manats)

	2003	2004	2005	2006	2007 Proj.
Net foreign assets	535	850	930	2,071	3,824
Net international reserves	535	850	931	2,061	3,815
Gross international reserves	790	1,054	1,082	2,179	3,901
Foreign liabilities	-255	-205	-151	-118	-87
Other items, net	0	0	-1	9	10
Net domestic assets	-29	-16	-44	-26	-424
Domestic credit	60	64	-9	8	-420
Net claims on central government	12	20	-52	25	-341
Of which : claims on central government	131	142	140	138	128
manat deposits of central government	-84	-94	-158	-74	-430
Claims on banks	47	63	73	94	120
Credits to the economy	0	1	1	1	1
ANB bills	0	-20	-31	-113	-200
Other items, net	-89	-80	-35	-34	-4
Reserve money	506	834	886	2,045	3,400
Manat reserve money	463	640	688	1,600	2,887
Currency outside ANB	434	526	594	1,449	2,536
Bank reserves and other deposits	29	114	94	150	351
Reserves in foreign currency	43	194	198	445	513

Sources: Azerbaijan National Bank; and Fund staff estimates and projections.

Table 7. Azerbaijan: Monetary Survey, 2003–07

(In millions of manats, unless otherwise specified)

	2003	2004	2005	2006	2007 Proj.
Net foreign assets	650	961	1,033	1,954	3,861
Net international reserves of the ANB	535	850	931	2,061	3,815
Net foreign assets of commercial banks	114	114	109	-103	50
Other	1	-3	-7	-3	-3
Net domestic assets	369	542	802	1,466	2,261
Net claims on central government	67	-29	-69	36	-310
Credit to the economy	590	945	1,445	2,364	3,807
Other items, net	-287	-373	-574	-935	-1,236
Broad money	1,019	1,503	1,835	3,420	6,122
Manat broad money	518	684	791	2,123	3,891
Cash outside banks	408	478	547	1,311	2,295
Manat deposits	110	206	244	812	1,596
Foreign currency deposits	500	819	1,043	1,297	2,230
		(Annual percentage change)			
Net foreign assets	21.4	47.9	7.5	89.3	97.5
Net domestic assets	47.6	46.9	47.9	82.7	54.3
Credit to the economy	38.3	60.2	53.0	63.6	61.1
Broad money (M3)	29.8	47.5	22.1	86.4	79.0
Manat broad money (M2)	28.0	31.9	15.8	168.3	83.3
Reserve money	23.5	64.7	6.3	130.8	66.3
Manat reserve money	23.7	38.2	7.5	132.6	80.5
Memorandum items:					
Gross official international reserves (US$ millions)	803	1,075	1,178	2,500	4,712
Velocity of total broad money (M3) 1/	7.7	6.3	5.2	4.4	3.6
Currency as a ratio to broad money	40.1	31.8	29.8	38.3	37.5
Foreign currency deposits as a ratio to broad money	49.1	54.5	56.9	37.9	36.4

Sources: Azerbaijan National Bank; and Fund staff estimates and projections.

1/ Velocity is defined as gross domestic demand (excluding oil sector-related imports) divided by average broad money.

Table 8. Azerbaijan: Financial Soundness Indicators, 2003–06

		2003	2004	2005	2006
		(In percent, unless otherwise specified)			
	Core Set				
Capital Adequacy	Regulatory capital to risk-weighted assets	10.9	19.9	20.7	18.7
	Private banks	29.9	30.0	29.3	24.0
	Public banks	1.6	8.8	10.8	11.7
	Regulatory Tier I capital to risk-weighted assets	10.4	17.0	16.5	15.1
	Private banks	26.6	26.7	24.0	20.0
	Public banks	2.5	6.4	7.9	8.5
Asset Quality	Nonperforming loans net of provisions to total gross loans	1.4	1.7	1.3	1.7
	Private banks	2.0	1.8	1.2	0.9
	Public banks	0.8	1.6	1.4	2.6
	Nonperforming loans to total gross loans	15.1	9.5	6.7	6.6
	Private banks	14.0	6.4	4.2	4.0
	Public banks	16.1	12.4	8.8	9.5
	Sectoral distribution of loans to total loans				
	Nonfinancial corporations	48.7	46.5	57.6	52.0
	Households	27.9	30.5	27.4	30.5
	Of which: mortgage loans	6.3	6.0	5.0	3.6
	Other sectors	23.4	23.0	15.0	17.5
Earnings and Profitability	Return on assets	1.8	1.9	1.9	1.3
	Private banks	2.4	1.0	2.5	1.5
	Public banks	1.4	2.6	1.3	1.9
	Return on equity	13.7	12.9	13.2	9.9
	Private banks	9.7	3.9	10.6	5.8
	Public banks	30.5	39.1	20.7	21.0
Liquidity	Liquid assets to total assets	30.5	31.8	25.3	24.9
	Private banks	27.3	27.1	21.0	17.3
	Public banks	32.9	35.6	28.9	32.3
	Liquid assets to short-term liabilities	93.0	100.2	83.6	72.6
	Private banks	107.2	123.8	99.4	78.2
	Public banks	85.7	90.0	76.4	70.0
	Encouraged Set				
	Deposit Takers				
	Capital to assets	11.1	11.9	11.9	11.1
	Foreign currency-denominated loans to total loans	76.8	70.5	64.9	54.5
	Private banks	58.0	56.6	51.8	32.1
	Public banks	93.9	83.5	75.8	68.6
	Foreign currency-deposits to total deposits	77.6	80.1	81.4	63.3
	Private banks	67.8	80.6	78.3	53.0
	Public banks	82.4	79.9	82.9	70.0
	Other Indicators				
	Private banks' share of total assets (percent)	43.8	43.9	44.9	49.0
	Public banks' share of total assets (percent)	56.2	56.1	55.1	51.0
	Interest income to non-interest income (percent)	92.8	125.5	188.0	209.3
	Private banks	124.9	168.6	251.9	266.9
	Public banks	70.0	93.2	142.3	160.4

Source: Azerbaijan National Bank.

Table 9. Azerbaijan: Selected Economic and Financial Indicators, 2005–12

(Baseline)

	2005	2006	2007	2008	2009	2010	2011	2012
		Prel.	Proj.					
	(Annual percentage change, unless otherwise specified)							
National income								
GDP at current prices	46.8	41.6	37.5	33.2	16.1	8.6	5.2	7.1
GDP at constant prices	24.3	31.0	29.1	23.1	13.6	4.5	-0.8	-0.7
Of which: oil sector, excluding oil and gas transportation 1/	65.4	61.9	52.9	35.2	17.8	3.4	-4.7	-5.0
non-oil sector, including oil and gas transportation	8.4	12.8	8.9	8.6	7.4	6.2	5.5	5.4
non-oil sector, excluding oil and gas transportation	7.9	8.2	7.0	7.0	6.5	6.5	6.5	6.5
Implicit GDP deflator	18.1	8.1	6.5	8.2	2.2	3.9	6.0	7.9
Consumer price index (end-period)	5.5	11.4	18-22	15.0	12.0	12.0	12.0	12.0
Consumer price index (period average)	9.7	8.4	21.1	17.0	13.0	12.0	12.0	12.0
Core consumer price index (end-period) 2/	4.0	9.0	...	...	...	...	...	...
Consolidated central government finance								
Total revenue	36.9	67.6	54.9	123.2	23.6	6.1	-0.3	-0.8
Of which: non-oil revenue	34.9	34.5	28.2	26.8	21.2	19.0	18.3	18.3
Total expenditure	28.7	80.9	47.1	35.3	30.1	25.1	25.0	24.9
Of which: current expenditure	22.8	50.9	50.0	35.1	30.1	25.1	24.9	24.9
investment expenditure	59.9	203.6	41.2	35.7	30.2	25.3	25.2	25.1
External sector (in US$)								
Exports f.o.b.	104.4	70.1	33.9	40.1	16.7	2.8	-5.4	-6.2
Of which: oil sector	113.0	74.4	35.7	42.1	17.0	2.3	-6.4	-7.4
Imports f.o.b.	21.4	21.1	15.0	22.1	31.9	31.2	32.5	32.7
Of which: oil sector	18.7	-9.1	-40.8	-40.8	-23.9	-19.3	-7.3	-7.7
Export volumes	64.8	40.9	43.7	30.1	16.7	3.0	-5.0	-6.6
Import volumes	14.6	17.1	11.2	20.7	30.5	29.5	29.8	29.9
Terms of trade	17.0	12.3	-6.4	6.5	-1.1	-1.5	-2.5	-1.7
Real effective exchange rate (- deprec.)	6.6	8.9	…	…	…	…	…	…
	(In percent of GDP, unless otherwise specified)							
Gross investment	40.7	27.7	24.4	20.9	22.6	25.8	30.5	35.5
Consolidated government	4.1	9.1	9.8	10.0	11.2	12.9	15.4	18.0
Private sector	36.6	18.6	14.6	10.9	11.4	12.9	15.2	17.6
Of which: oil sector	17.6	5.2	2.9	0.9	0.6	0.4	0.4	0.3
Gross domestic savings	50.7	57.1	58.7	60.7	58.7	53.2	45.7	38.2
Gross national savings	41.9	43.4	51.9	57.1	55.3	51.4	45.1	38.5
Consolidated government	7.0	9.6	12.2	34.4	35.4	30.4	22.1	12.6
Private sector 3/	34.9	33.7	39.7	22.8	19.9	21.0	23.0	25.9
Consolidated central government finance								
Total revenue and grants	25.1	29.6	33.3	55.9	59.5	58.1	55.0	50.9
Oil revenue	9.8	15.0	19.7	42.9	46.0	43.3	38.4	32.6
Non-oil revenue	15.3	14.5	13.6	12.9	13.5	14.8	16.6	18.4
Total expenditure	22.7	29.0	31.0	31.5	35.3	40.6	48.3	56.3
Current expenditure	18.2	19.4	21.2	21.5	24.1	27.7	32.9	38.3
Investment expenditure	4.5	9.5	9.8	10.0	11.2	12.9	15.4	18.0
Overall fiscal balance 3/	2.6	0.1	2.4	24.4	24.2	17.4	6.7	-5.4
Non-oil primary balance, in percent of non-oil GDP	-12.6	-32.6	-40.1	-44.6	-50.3	-54.6	-59.6	-65.1
Implicit energy subsidies, in percent of non-oil GDP	23.5	21.1	11.2	9.8	8.2	6.9	5.8	4.9
External sector								
Current account (- deficit)	1.3	15.7	27.4	36.2	32.8	25.6	14.6	3.0
Foreign direct investment (net)	3.5	-4.7	-17.4	-4.3	-0.9	-0.5	0.4	0.6
Public and publicly guaranteed external debt outstanding	12.5	10.0	10.3	9.3	9.3	9.6	10.0	9.6
Memorandum items:								
Gross official international reserves (in millions of U.S. dollars)	1,178	2,500	4,712	6,187	8,282	11,260	15,492	21,505
Nominal GDP (in millions of manats)	12,523	17,736	24,383	32,470	37,695	40,941	43,076	46,131
Nominal non-oil GDP, including oil and gas transportation (in millions of manats)	7,002	8,102	10,386	13,169	15,957	18,985	22,460	26,565
Nominal GDP per capita (in U.S. dollars)	1,574	2,336	3,356	4,667	5,658	6,418	7,051	7,886
Oil Fund assets (in millions of U.S. dollars) 4/	1,394	1,936	3,093	13,659	26,120	36,387	40,918	36,967
Population (mid-year, in millions)	8.4	8.5	8.6	8.6	8.7	8.8	8.8	8.9

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

1/ Oil and gas transportation includes all pipelines except the western route. The Baku-Tbilisi-Ceyhan pipeline started operation in May 2006.

2/ Excludes administered prices for fuel, energy, transportation, water, and communications as well as prices for selected fruits and vegetables.

3/ The historical data include the statistical discrepancy.

4/ Includes the central government's foreign exchange deposits managed by the Oil Fund.

Table 10. Azerbaijan: Selected Economic and Financial Indicators, 2005–12

(Recommended Scenario)

	2005	2006	2007	2008	2009	2010	2011	2012
		Prel.			Proj.			
	(Annual percentage change, unless otherwise specified)							
National income								
GDP at current prices	46.8	41.6	37.5	31.6	13.8	6.3	3.0	4.4
GDP at constant prices	24.3	31.0	29.1	22.9	13.8	4.8	-0.2	-0.1
Of which: oil sector, excluding oil and gas transportation 1/	65.4	61.9	52.9	35.2	17.8	3.4	-4.7	-5.0
non-oil sector, including oil and gas transportation	8.4	12.8	8.9	8.2	7.8	7.1	6.8	6.8
non-oil sector, excluding oil and gas transportation	7.9	8.2	7.0	6.5	7.0	7.5	8.0	8.0
Implicit GDP deflator	18.1	8.1	6.5	7.1	0.0	1.4	3.2	4.4
Consumer price index (end-period)	5.5	11.4	18-22	10.0	7.0	7.0	7.0	7.0
Consumer price index (period average)	9.7	8.4	21.1	14.0	8.0	7.0	7.0	7.0
Core consumer price index (end-period) 2/	4.0	9.0	...	...	...	...	...	...
Consolidated central government finance								
Total revenue	36.9	67.6	54.9	116.9	22.3	8.4	2.4	2.2
Of which: non-oil revenue	34.9	34.5	28.2	24.6	18.8	16.6	11.2	13.1
Total expenditure	28.7	80.9	47.1	15.0	8.0	7.0	7.0	6.0
Of which: current expenditure	22.8	50.9	50.0	11.5	8.4	7.4	7.3	6.5
investment expenditure	59.9	203.6	41.2	22.8	7.1	6.0	6.5	4.9
External sector (in US$)								
Exports f.o.b.	104.4	70.1	33.9	40.7	17.5	3.8	-4.0	-4.1
Of which: oil sector	113.0	74.4	35.7	42.1	17.0	2.3	-6.4	-7.4
Imports f.o.b.	21.4	21.1	15.0	13.9	17.8	17.4	17.8	19.1
Of which: oil sector	18.7	-9.1	-40.8	-40.8	-23.9	-19.3	-7.3	-7.7
Export volumes	64.8	40.9	43.7	30.8	17.5	4.0	-3.6	-4.6
Import volumes	14.6	17.1	11.2	12.6	16.5	15.9	15.3	16.4
Terms of trade	17.0	12.3	-6.4	6.4	-1.0	-1.5	-2.5	-1.7
Real effective exchange rate (- deprec.)	6.6	8.9	…	…	…	…	…	…
	(In percent of GDP, unless otherwise specified)							
Gross investment	40.7	27.7	24.4	20.5	21.2	23.7	27.6	31.7
Consolidated government	4.1	9.1	9.8	9.2	8.6	8.6	8.9	8.9
Private sector	36.6	18.6	14.6	11.3	12.6	15.1	18.7	22.7
Of which: oil sector	17.6	5.2	2.9	0.9	0.6	0.4	0.4	0.4
Gross domestic savings	50.7	57.1	58.7	61.7	61.5	60.0	57.5	54.4
Gross national savings	41.9	43.4	51.9	58.2	58.4	58.6	57.7	56.4
Consolidated government	7.0	9.6	12.2	37.0	42.0	42.9	41.9	40.3
Private sector 3/	34.9	33.7	39.7	21.2	16.4	15.6	15.8	16.1
Consolidated central government finance								
Total revenue and grants	25.1	29.6	33.3	55.0	59.1	60.2	59.9	58.6
Oil revenue	9.8	15.0	19.7	42.1	45.6	45.5	44.0	41.4
Non-oil revenue	15.3	14.5	13.6	12.9	13.4	14.7	15.9	17.2
Total expenditure	22.7	29.0	31.0	27.1	25.7	25.8	26.9	27.3
Current expenditure	18.2	19.4	21.2	17.9	17.1	17.3	18.0	18.3
Investment expenditure	4.5	9.5	9.8	9.2	8.6	8.6	8.9	8.9
Overall fiscal balance 3/	2.6	0.1	2.4	27.9	33.4	34.4	33.0	31.4
Non-oil primary balance, in percent of non-oil GDP	-12.6	-32.6	-40.1	-34.6	-29.0	-24.1	-21.2	-17.8
Implicit energy subsidies, in percent of non-oil GDP	23.5	21.1	11.2	4.7	3.2	1.7	0.7	0.0
External sector								
Current account (- deficit)	1.3	15.7	27.4	37.7	37.1	34.9	30.2	24.8
Foreign direct investment (net)	3.5	-4.7	-17.4	-4.2	-0.6	0.2	1.5	2.6
Public and publicly guaranteed external debt outstanding	12.5	10.0	10.3	9.2	9.3	10.0	11.3	11.6
Memorandum items:								
Gross official international reserves (in millions of U.S. dollars)	1,178	2,500	4,712	5,697	6,992	8,627	10,639	13,113
Nominal GDP (in millions of manats)	12,523	17,736	24,383	32,077	36,502	38,818	39,964	41,705
Nominal non-oil GDP, including oil and gas transportation (in millions of manats)	7,002	8,102	10,386	12,775	14,859	17,038	19,513	22,346
Nominal GDP per capita (in U.S. dollars)	1,574	2,336	3,356	4,683	5,658	6,126	6,257	6,478
Oil Fund assets (in millions of U.S. dollars) 4/	1,394	1,936	3,093	14,715	31,072	48,726	65,781	81,916
Population (mid-year, in millions)	8.4	8.5	8.6	8.6	8.7	8.8	8.8	8.9

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

1/ Oil and gas transportation includes all pipelines except the western route. The Baku-Tbilisi-Ceyhan pipeline started operation in May 2006.

2/ Excludes administered prices for fuel, energy, transportation, water, and communications as well as prices for selected fruits and vegetables.

3/ The historical data include the statistical discrepancy.

4/ Includes the central government's foreign exchange deposits managed by the Oil Fund.

Appendix. Analysis of Long-Term Sustainability of the Baseline Scenario

1. Given the temporary nature of the oil production boom, this appendix analyzes whether the continuation of expansionary policies is consistent with growth, fiscal, and external sustainability by (i) presenting the standard debt sustainability template for emerging market countries; (ii) using a theoretical growth model; and (iii) drawing on lessons from the experience of Nigeria and Saudi Arabia.

2. **The baseline fiscal scenario assumes the continuation of expansionary policies in the medium term.** Against the background of slow reforms and rapidly rising oil revenue, there is a risk that the government will maintain a relatively rapid pace of nominal expenditure increases in the medium term in response to persistent double-digit inflation, entering an inflation/indexation spiral. Based on these considerations, nominal expenditure is assumed to increase by over 45 percent in 2007, 35 percent in 2008, 30 percent in 2009, and about 25 percent annually during 2010–12. Under the current WEO oil price assumptions and the expected oil production profile, oil revenue is projected to rise rapidly through 2010 and to decrease continuously afterwards, as oil production declines. On current policies, non-oil revenue as a percentage of non-oil GDP is projected to remain broadly stable (Table 9).

3. **The temporary oil production spike masks emerging sustainability problems during 2008–12.** Under the current WEO oil price assumptions, the central government is projected to generate overall fiscal surpluses through 2011, but a deficit will emerge by 2012. Despite sizeable surpluses, the government is expected to borrow from international financial institutions to implement a number of large-scale investment projects and float Eurobonds to provide a benchmark yield for the corporate sector. Public and publicly guaranteed debt is projected to remain at 10–11 percent of GDP through 2012 (Table A1), and the oil fund assets are expected to increase to about $37 billion (51.3 percent of GDP) by 2012. However, rapid import growth, which is needed to satisfy booming domestic demand, is expected to contribute to a precipitous decline in the external current account surplus from 27 percent of GDP in 2007 to 3 percent in 2012. Under this scenario, the private non-oil sector has only modest access to foreign financing. This, together with broadly constant public debt ratios, will lead to a decline in total external debt ratios during 2007–12 (Table A2).

4. **The medium-term sustainability assessment is sensitive to oil price assumptions.** Should oil prices decline to $40 per barrel (at constant 2004 dollars) and with other assumptions remaining unchanged, the oil fund assets will most likely be depleted by 2012, and public and external debt ratios will start to increase rapidly starting in 2012 (Tables A1–A2).

5. **Even if oil prices remained at about $60 per barrel in the long term, large expenditure cuts and import compression would be needed in the mid-2010s in response to a rapid decline in oil production and revenue.** For illustrative purposes, the current

Table A1. Azerbaijan: Public Sector Debt Sustainability Framework, 2002–12
(In percent of GDP, unless otherwise specified)

	Actual					Projections						
	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	**Debt-stabilizing primary balance 9/**
Baseline: Public sector debt 1/	23.0	21.8	20.2	13.3	10.8	**11.1**	**10.1**	**10.2**	**10.6**	**11.2**	**11.0**	**-0.8**
Of which: foreign-currency denominated	20.2	19.7	18.5	12.1	9.7	10.0	9.0	9.0	9.3	9.7	9.3	
Change in public sector debt	-1.4	-1.2	-1.7	-6.8	-2.5	0.3	-1.0	0.1	0.5	0.6	-0.3	
Identified debt-creating flows (4+7+12)	-2.5	-1.9	-4.9	-9.8	-5.0	-5.3	-27.2	-25.6	-18.3	-7.3	4.6	
Primary deficit ("-" = surplus)	0.1	1.5	-1.2	-2.6	-0.7	-2.7	-24.8	-24.7	-18.0	-7.3	4.9	
Revenue and grants	27.3	26.8	26.8	25.1	29.6	33.3	55.9	59.5	58.1	55.0	50.9	
Primary (noninterest) expenditure	27.4	28.3	25.6	22.5	28.9	30.7	31.0	34.8	40.1	47.7	55.9	
Automatic debt dynamics 2/	-2.3	-3.2	-3.4	-7.1	-4.3	-2.6	-2.4	-0.9	-0.3	0.0	-0.3	
Contribution from interest rate/growth differential 3/	-2.7	-3.3	-3.3	-6.3	-3.8	-2.6	-2.4	-0.9	-0.3	0.0	-0.3	
Of which: contribution from real interest rate	-1.0	-1.2	-1.4	-3.0	-0.9	-0.4	-0.4	0.2	0.1	-0.1	-0.4	
contribution from real GDP growth	-1.7	-2.0	-1.9	-3.3	-2.9	-2.3	-1.9	-1.2	-0.4	0.1	0.1	
Contribution from exchange rate depreciation 4/	0.5	0.1	-0.1	-0.8	-0.4	...	...	...	...	...	...	
Other identified debt-creating flows	-0.4	-0.3	-0.4	-0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Privatization receipts (negative)	-0.4	-0.3	-0.4	-0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	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	0.0	
Residual, including asset changes (2-3) 5/	1.2	0.7	3.3	3.0	2.5	5.6	26.1	25.7	18.7	7.9	-4.9	
Of which: increase in official foreign assets (including oil fund assets)	3.2	1.8	1.7	3.2	2.7	4.0	26.3	25.3	18.3	7.3	-5.6	
Public sector debt-to-revenue ratio 1/	84.3	81.6	75.2	53.1	36.6	33.4	18.1	17.1	18.3	20.4	21.5	
Gross financing need 6/	3.7	5.6	2.7	0.9	1.8	0.0	-22.4	-22.4	-15.6	-4.9	7.1	
in billions of U.S. dollars	0.2	0.4	0.2	0.1	0.4	0.0	-9.0	-11.0	-8.8	-3.0	5.0	
Scenario with oil prices at $40 per barrel 7/: Public sector debt 1/						**13.7**	**12.9**	**12.6**	**12.8**	**13.1**	**26.8**	
Key Macroeconomic and Fiscal Assumptions Underlying Baseline												
Real GDP growth (in percent)	8.1	10.5	10.4	24.3	31.0	29.1	23.1	13.6	4.5	-0.8	-0.7	
Average nominal interest rate on public debt (in percent) 8/	1.3	1.2	1.2	0.9	0.8	3.9	5.0	5.2	5.4	5.3	4.1	
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	-4.2	-5.5	-6.9	-17.2	-7.3	-2.6	-3.2	3.0	1.5	-0.7	-3.7	
Nominal appreciation (increase in U.S. dollar value of local currency, in percent)	-2.4	-0.6	0.4	6.7	5.4	...	...	...	...	...	...	
Inflation rate (GDP deflator, in percent)	5.5	6.7	8.1	18.1	8.1	6.5	8.2	2.2	3.9	6.0	7.9	
Growth of real primary spending (deflated by GDP deflator, in percent)	61.0	14.0	-0.1	15.2	59.2	37.2	24.6	27.4	20.4	18.0	16.2	
Primary deficit	0.1	1.5	-1.2	-2.6	-0.7	-2.7	-24.8	-24.7	-18.0	-7.3	4.9	

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

1/ Central government domestic and external debt, including government guaranteed 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 central government deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.

7/ $40 per barrel in 2004 dollars, starting from 2007.

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.

Table A2. Azerbaijan: External Debt Sustainability Framework, 2002–12
(In percent of GDP, unless otherwise specified)

	Actual					Projections						
	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	**Debt-stabilizing non-interest current account 6/**
Baseline: External debt	36.9	38.4	40.8	34.7	27.4	**25.3**	**21.4**	**20.3**	**20.3**	**20.6**	**19.3**	**-1.7**
Change in external debt	1.7	1.5	2.4	-6.2	-7.2	-2.1	-3.9	-1.1	0.0	0.3	-1.3	
Identified external debt-creating flows (4+8+9)	-7.8	-9.8	-3.5	-18.8	-22.5	-15.6	-36.0	-34.1	-25.9	-14.7	-3.4	
Current account deficit, excluding interest payments	11.7	27.4	28.7	-2.5	-16.9	-28.7	-37.4	-33.9	-26.7	-15.7	-4.1	
Deficit in balance of goods and services ("-" = surplus)	7.3	23.5	23.9	-10.0	-29.4	-34.3	-39.7	-36.0	-27.3	-15.1	-2.6	
Export of goods and services	42.8	42.0	48.8	62.9	70.4	64.2	63.6	60.4	54.4	46.7	39.1	
Import of goods and services	50.0	65.6	72.7	52.8	41.0	30.0	23.9	24.4	27.1	31.6	36.5	
Net non-debt creating capital inflows (negative)	-17.1	-32.3	-27.1	-3.5	4.7	17.3	4.3	0.9	0.5	-0.4	-0.6	
Automatic debt dynamics 1/	-2.4	-4.8	-5.1	-12.8	-10.3	-4.2	-2.9	-1.2	0.4	1.3	1.3	
Contribution from nominal interest rate	0.6	0.4	1.1	1.3	1.3	1.4	1.2	1.2	1.2	1.2	1.2	
Contribution from real GDP growth	-2.6	-3.3	-3.4	-6.5	-7.2	-5.5	-4.2	-2.4	-0.8	0.1	0.1	
Contribution from price and exchange rate changes 2/	-0.4	-2.0	-2.9	-7.6	-4.3	...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	9.4	11.3	5.9	12.6	15.3	13.5	32.1	33.1	25.8	15.1	2.1	
Of which: increase in gross official foreign assets (including oil fund assets)	3.2	2.9	4.9	4.6	9.4	11.7	29.9	29.6	23.6	14.1	2.9	
External debt-to-exports ratio (in percent)	86.3	91.5	83.7	55.2	39.0	39.4	33.6	33.6	37.3	44.2	49.5	
Gross external financing need (in billions of U.S. dollars) 4/	1.0	2.3	2.9	0.2	-2.7	-7.3	-13.9	-15.4	-13.6	-8.2	-1.2	
in percent of GDP	15.6	31.6	33.4	1.8	-13.4	-25.3	-34.6	-31.3	-24.2	-13.2	-1.8	
Scenario with oil prices at $40 per barrel 5/ : External debt						**26.6**	**22.3**	**21.1**	**20.9**	**21.2**	**33.9**	
Key Macroeconomic Assumptions Underlying Baseline												
Real GDP growth (in percent)	8.1	10.5	10.4	24.3	31.0	29.1	23.1	13.6	4.5	-0.8	-0.7	
GDP deflator in U.S. dollars (change in percent)	1.0	5.6	8.1	22.8	14.2	12.2	13.9	7.6	9.4	11.6	13.5	
Nominal external interest rate (in percent)	1.9	1.3	3.4	4.8	5.4	7.2	6.8	6.7	6.6	6.6	6.3	
Growth of export of goods and services (U.S. dollar terms, in percent)	12.6	14.6	38.6	96.7	67.5	32.2	38.8	16.2	2.9	-5.0	-5.7	
Growth of import of goods and services (U.S. dollar terms, in percent)	46.5	52.8	32.3	10.9	16.1	5.9	11.7	24.9	26.7	29.3	30.2	
Current account balance, excluding interest payments	-11.7	-27.4	-28.7	2.5	16.9	28.7	37.4	33.9	26.7	15.7	4.1	
Net non-debt creating capital inflows	17.1	32.3	27.1	3.5	-4.7	-17.3	-4.3	-0.9	-0.5	0.4	0.6	

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

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 U.S. 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 deflator).

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/ $40 per barrel in 2004 dollars, starting from 2007.

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.

policy scenario is extended for 2013–24,[6] assuming that nominal expenditure continues to increase by about 20 percent per year until the oil fund dries up in 2015. In the face of declining oil revenue and the depletion of the oil fund assets, a significant fiscal adjustment will be needed by the mid-2010s to avoid explosive debt dynamics (Figure A1). During the fiscal adjustment period, for illustrative purposes, current expenditure is kept at the previous year's nominal level, and capital expenditure is reduced so as to keep primary balances consistent with an assumed public external debt ceiling of 40 percent of GDP.

6. **A neo-classical growth model is used to assess the impact of fiscal policy assumptions on economic growth.** This model has the following features: (i) public investment increases the non-oil sector's total factor productivity (TFP);[7] (ii) fiscal decisions and hydrocarbon production are given exogenously in the baseline scenario; (iii) there is a ceiling on government borrowing; and (iv) the private sector reacts to fiscal decisions and the profile of hydrocarbon production. The model calibrated for Azerbaijan shares many features with the model presented in the IMF's 2006 Selected Issues Paper for the Russian Federation (Box A1 and Country Report No. 06/429).

7. **Because the model is very stylized, several caveats should be noted.** First, the model does not have nominal variables, such as prices or an exchange rate, and thus does not capture the real effects of these variables. Inflation and exchange rates are projected outside the model, and all nominal indicators are converted into real variables in local currency terms. Second, the model has only one non-oil sector and does not distinguish between tradable and non-tradable goods; thus it does not explicitly capture the potential impact of Dutch disease.

8. **The main result of the model simulation is that once the fiscal adjustment starts in the mid-2010s, there is a high risk of low non-oil GDP growth over a prolonged period (Figure A1).** The relatively high non-oil growth projected for 2007–12 is driven by increased public sector investment and its attendant positive impact on the TFP, which also stimulates a gradual pick-up in private investment. Subsequently, there is a prolonged growth deceleration in the non-oil sector (to 2–3 percent). This deceleration mainly stems from a reduction in private investment induced by a rapid tightening of the resource constraint

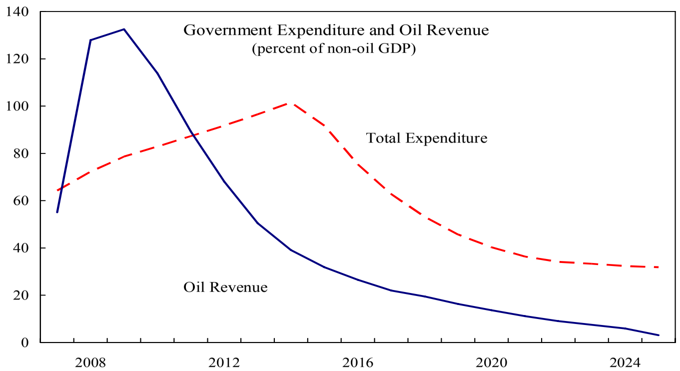
[6] It is expected that oil production will end in 2024 in the absence of new discoveries.

[7] The model assumes a moderate impact of public investment on the TFP, given slow progress in improving expenditure management. However, because of the relatively short duration of the capital expenditure growth spurt, the model is more sensitive to the assumption on the pace of the subsequent capital expenditure decline rather than to the assumed measure of the public investment impact on the TFP. Indeed, even well-implemented infrastructure projects will have a limited impact on long-term growth if public investment falls short of depreciation and adequate maintenance is not undertaken following the completion of these projects.

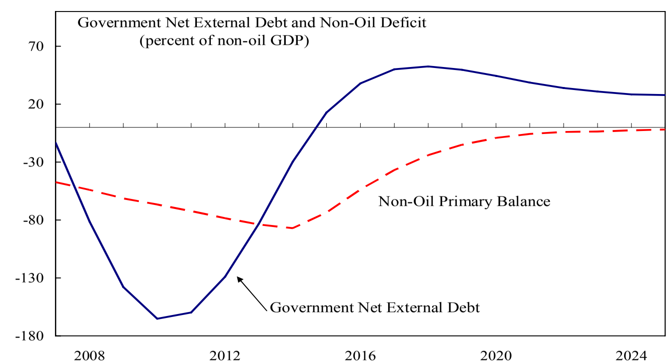
Figure A1. Azerbaijan: Baseline Policy Scenario - Growth Model Simulation Results, 2007-25

Baseline Policy Scenario

Given the temporary nature of oil revenue and the continued expansionary policies, ...

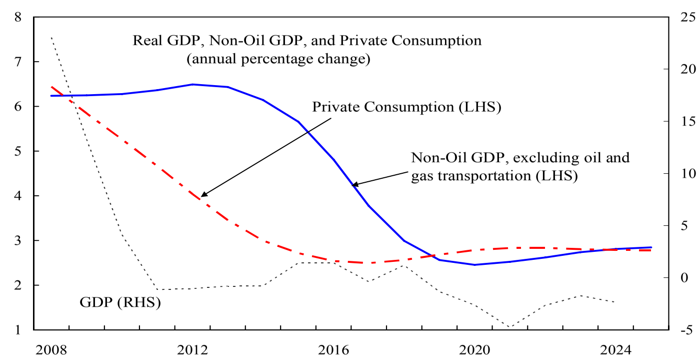


... the oil fund assets will be depleted and drastic expenditure cuts will be needed to avoid explosive debt dynamics by the mid-2010s.

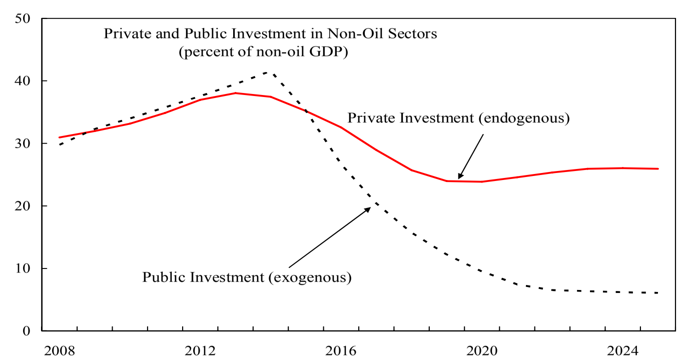


Growth Model Simulation Results

Under the baseline policy scenario, relatively high non-oil growth from 2007-12 would be followed by a period of low non-oil growth (2-3 percent) ...



... due to a reduction in private investment and the negative effects of reduced government capital expenditure.



Sources: Azeribaijan authorities; Fund staff estimates and projections.

starting in the early 2010s, which is compounded by the negative effects of reduced government capital expenditure from the mid-2010s.

Box A1. Neo-Classical Growth Model

The model assumes that there are three types of agents in the economy: government, households, and firms.

Government

Government revenue, expenditure, and financing are exogenously given with the government budget constraint as follows:

(1) $C_t^g + X_t^g - O_t^g - T_t = D_{t+1}^* - (1+i_t^*)D_t^*$,

where C^g is government consumption, X^g is government investment, O^g is oil revenue, D^* is government external debt, and i^* is the world interest rate. T is net lump-sum transfers, which are defined as the lump-sum taxes minus transfers to households plus domestic financing through the issuance of government bonds. The domestic real interest rate equals the marginal productivity of capital minus the depreciation rate by the firms' maximization.

Households

Households earn wages and rental rates of capital, allocate their income to consumption and investment, and also receive net lump-sum transfers. The households maximize their utility function (2) subject to their budget constraint (3) and the transition equation for private capital (4):

(2) $\max_{C_t, K_{t+1}} \sum_{t=1}^{\infty} \beta^t u(C_t)$,

where $u(C) = \ln(C)$ (the utility function)

(3) $w_t L_t + i_t K_t = C_t + X_t + T_t$ (the household's budget constraint),

(4) $K_{t+1} = X_t + (1-\delta)K_t$ (the private capital accumulation),

where C is private consumption, K is private capital, X is private investment, w is wage, i is the rental rate, and L is labor, β is the time preference factor.

Firms

Hydrocarbon production is exogenously given, and firms produce only non-oil goods. They maximize their profits with the following non-oil production function:

(5) $f(K_t, L_t) = A_t K_t^{\alpha} L_t^{1-\alpha}$, where $A_t = \left\{ z_t + \theta \frac{K_t^g}{L_t} \right\}^{1-\alpha}$

where A is total factor productivity, the growth rate of z is that of labor-augmented technological progress, K^g is public capital that follows the following transition equation:

(6) $K_{t+1}^g = X_t^g + (1-\delta^g)K_t^g$

θ is the coefficient that captures the impact of public capital on the TFP.

The model's parameters and initial conditions are calibrated for Azerbaijan as presented in Text Table A1. The model is solved numerically and the results are reported in Figure A1.

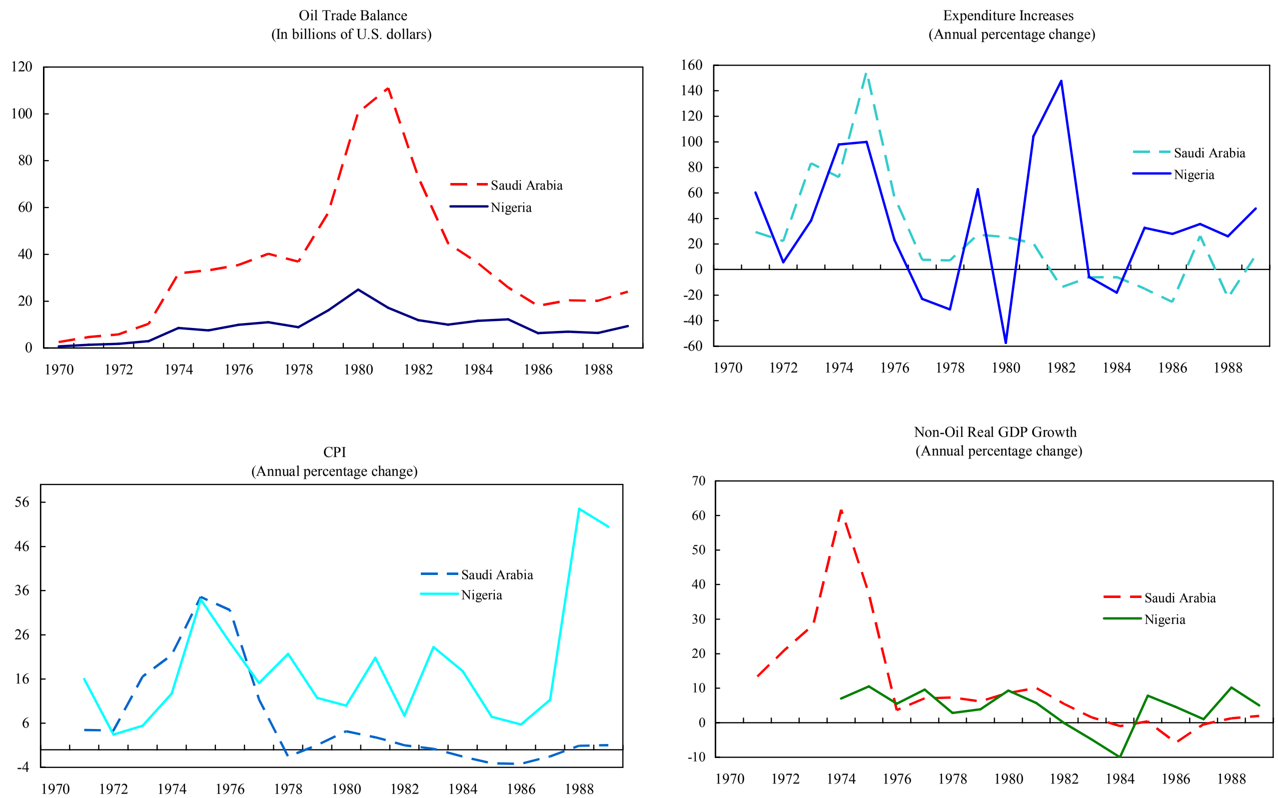
Text Table A1. Azerbaijan: Parameters and Initial Conditions of the Neo-Classical Growth Model

Parameter values			
Capital elasticity of output (α) 1/	0.30	Depreciation rate of public capital (δ^g)	0.10
Time preference (β)	0.98	Depreciation rate of private capital (δ)	0.10
Coefficient of K^g for the augmented TFP (θ)	0.05	Population growth (n)	0.005
Long-run rate of technological progress (g)	0.030		
Initial conditions			
Private capital-non-oil GDP ratio 2/	1.33		
Public capital-non-oil GDP ratio 2/ 3/	0.30		

Source: Fund staff estimates.
1/ Based on existing country studies. The number is in line with the share of labor income in non-oil GDP for Azerbaijan.
2/ Estimated using a perpetual inventory methodology.
3/ An estimate of the central government's capital stock in the non-oil sectors.

9. **The simulation results of the neo-classical growth model are consistent with the experience of Nigeria and Saudi Arabia in managing a large spike and a subsequent decline in their oil revenues during the 1970s and 1980s (Figure A2).** In response to the large oil price increase of the mid-1970s, Nigeria and Saudi Arabia undertook exceptionally high expenditure increases. Saudi Arabia saw phenomenal real non-oil GDP growth rates because of an effective expenditure management and the opening-up of its economy to trade and immigration. Nigeria, on the other hand, saw more modest non-oil GDP growth—6.5 percent, compared with the size of expenditure increases, as poor management of its investment program and the ballooning wage bill intensified the negative impact of Dutch disease on agriculture, while no material improvement in productivity occurred. After oil prices had declined in the early 1980s, even Saudi Arabia experienced a prolonged period of low growth because public expenditure needed to be reduced. Moreover, large expenditure increases in Nigeria and Saudi Arabia fueled high inflation, which did not decline to the international levels until expenditure increases were trimmed.

Figure A2. Nigeria and Saudi Arabia : Selected Economic Indicators, 1970-89



Sources: IFS, WEO, and the Saudi Arabian Monetary Authority.

INTERNATIONAL MONETARY FUND

REPUBLIC OF AZERBAIJAN

2007 Article IV Consultation—Informational Annex

Prepared by Middle East and Central Asia Department

April 19, 2007

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ANNEX I: AZERBAIJAN: FUND RELATIONS

As of February 28, 2007

1. **Membership Status:** Joined: September 18, 1992; Article VIII

2. **General Resources Account:**

	SDR Million	Percent of Quota
Quota	160.90	100.00
Fund Holdings of Currency	172.46	107.18
Reserve position in Fund	0.01	0.01

3. **SDR Department:**

	SDR Million	Percent of Allocation
Holdings	0.97	N/A

4. **Outstanding Purchases and Loans:**

	SDR Million	Percent of Quota
Extended arrangements	11.56	7.18
PRGF arrangements	68.53	42.59

5. **Financial Arrangements:**

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

6. **Projected Obligations to Fund:**
(SDR million; based on existing use of resources and present holdings of SDRs)

	Forthcoming				
	2007	2008	2009	2010	2011
Principal	14.92	13.72	12.03	9.66	10.94
Charges/Interest	0.70	0.48	0.27	0.18	0.12
Total	15.62	14.20	12.30	9.83	11.06

7. **Safeguards Assessment**

Under the Fund's safeguards assessment policy, Azerbaijan National Bank (ANB) was subject to an assessment with respect to the PRGF arrangement, which was approved on July 6, 2001 and expired on July 4, 2005. A safeguards assessment of the ANB was completed on March 8, 2002. The assessment concluded that risks may exist in the legal structure and independence of the Central Bank, and in its internal audit and control systems.

The authorities have implemented all but one of the 2002 safeguards assessment recommendations. The National Bank Law adopted in 2004 clearly specifies the modalities for the ANB profit distribution, consistent with one of the last two outstanding recommendations, and requires that ANB's internal audit division be responsible only to the chairman of the ANB Board. The latter falls short of establishing an independent audit committee under the Board, as recommended by the safeguards assessment mission.

8. **Exchange Rate Arrangements**

The currency of Azerbaijan is the manat, which became sole legal tender on January 1, 1994. Currently de jure, the exchange rate is allowed to float against all currencies. Exchange rates for cash transactions are quoted by commercial banks licensed to deal in foreign exchange on the basis of market conditions. However, Azerbaijan has maintained a crawling peg exchange rate system since early 2006.

Azerbaijan accepted the obligations of Article VIII, Sections 2, 3, and 4 effective November 30, 2004.

9. **Article IV Consultation**

The 2005 Article IV consultation with Azerbaijan was concluded on March 27, 2006.

10. **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.

11. **Resident Representative**

Mr. Basil B. Zavoico, the Fund's fifth Resident Representative, took up his duties in Baku in July 2003.

12. **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 until 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 until April 1996. He was succeeded by Mr. Peter Barrand, who was stationed in Baku from January 2001 until December 2002. Mr. Isaac Svartsman was resident advisor in the ANB for bank supervision and restructuring from September 1998 to April 2001. Nataliya Ivanik took up the position of STA regional external sector statistics advisor in November 2006.

Azerbaijan: Technical Assistance, 2002–2006

Fund Dept.	Area of Assistance	Mission Dates
TRE	Safeguards assessments	January 2002
LEG/MAE	Banking legislation	January 2002
MAE	Central Bank accounting	January 2002
MAE	Payments system	February 2002
STA	National Accounts	Oct./Nov. 2002
FAD	Tax administration reform	December 2002
MAE	Bank restructuring and monetary operations	December 2002
STA	National Accounts	Jan./Feb. 2003
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
MFD	Monetary Operations	August 2006
FAD	Public Financial Management	September 2006
STA	Government Finance Statistics	Oct./Nov. 2006

ANNEX II: AZERBAIJAN: IMF-WORLD BANK RELATIONS

- The World Bank has been actively involved in structural reforms, poverty reduction measures, public expenditure management, agricultural policies, private sector development, institution building, and governance. A range of instruments is used to conduct the dialogue. SAC-II, which was fully disbursed in June 2003, supported a wide-ranging structural reform agenda and its accompanying second institution building and technical assistance credit (IBTA II) assisted institutional capacity building, especially of the Treasury Information management System (TIMS), public investment program preparation, and utility reforms. The Bank's Board approved a Poverty Reduction Support Credit (PRSC) in May 2005. By supporting the authorities' State Program of Poverty Reduction and Economic Development (SPRED), the PRSC aimed to improve the business environment, the efficiency and effectiveness of allocations in the social sectors, support anti-corruption efforts and increased transparency and accountability of public finances.

- The Bank's new Country Partnership Strategy (CPS) was discussed at the World Bank's Board on December 7, 2006. The CPS is based on a broad policy reform approach combined with sector investment projects in agriculture, transport, water, refugees/IDPs, environment, education, health, and energy. Analytical and advisory assistance for the next four years includes Programmatic Poverty Assessments, Programmatic Public Expenditure Reviews (PER), an update on the CFAA (financial accountability) and CPAR (procurement), and ongoing work on trade facilitation and mitigation of the social costs of utility price increases. The Bank is also continuing its advisory services in the energy sector, the health sector, and the water sector.

- After the PRGF arrangement expired in July 2005, close collaboration between the IMF and the World Bank has continued. In a number of areas—social sectors and safety nets, investment policy and expenditure management, environment, governance, infrastructure, and agriculture—the Bank takes the lead in the dialogue. The Bank is also leading the dialogue in private sector development and public enterprise reform and Bank analysis serves as an input into Fund policy advice. In other areas—energy, financial sector, and trade—both institutions work together. Finally, in areas such as monetary and exchange rate policy, fiscal policy and customs reforms, the IMF takes the lead with more limited Bank involvement.

- The IFC's strategy emphasizes support to the non-oil sector to help economic diversification. To this end, the IFC will help catalyze FDI in non-oil sector projects, which focus on exports, help generate foreign exchange earnings and contribute to the modernization of the country's manufacturing base and basic infrastructure. The IFC's strategy for the non-oil sectors involves (i) promoting competition in the banking sector, establishing joint ventures in the non-bank financial sector, technical assistance to private local banks for institutional capacity building; (ii) improving access to finance through credit lines to local private banks for on-lending to small and medium size enterprises (SMEs); (iii) enhancing the business climate and reducing impediments to foreign investments; (iv) supporting agri-business and agro-processing; and (v) creating conditions for private provision of public services.

World Bank contacts:

Christos Kostopoulos (CKostopoulos@worldbank.org), Senior Country Economist for Azerbaijan. Phone (202) 473-8143.

Christian Petersen (CPetersen@worldbank.org), Lead Economist for the South Caucus. Phone (202) 473-3965.

ANNEX III. AZERBAIJAN: 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, and an SDDS assessment mission is planned for April 17-25, 2007 to provide focused technical assistance on the outstanding issues required for SDDS subscription.

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 uses population-based weights in the aggregation of elementary price indices. However, this treatment raises 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.

B. Fiscal Sector

5. 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.

6. 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

7. Following two STA technical assistance missions in 2000 and 2002, the Azerbaijan National Bank (ANB) compiles monetary statistics according to the methodology of the *Monetary and Financial Statistics Manual.* The ANB 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 December 2006 issue of the *International Financial Statistics(IFS) Supplement.*

D. External Sector

8. Starting in November 2006, a Regional Advisor in External Sector Statistics to Azerbaijan and Georgia has been 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 (4) assist the authorities in coordinating with other international institutions and bilateral agencies involved in technical assistance in statistics in Azerbaijan and Georgia.

9. While the overall structure of the balance of payments (BOP) statistics is broadly consistent with the fifth edition of the *Balance of Payments Manual,* several compilation weaknesses remain. These include (i) insufficient data on FDI stocks and flows that prompt inadequate estimates for FDI income and impede the proper treatment of profit taxes of the oil sector; (ii) undercoverage of nonguaranteed external debt and growing inconsistencies with the relevant creditor source data; (iii) incorrect treatment of operational leases of mobile equipment; and (iv) an inadequate breakdown between FDI equity and other capital, which is necessary to properly record transactions associated with the Baku-Tbilisi-Ceyhan Pipeline, Shah-Denis gas field, and South Caucasus Pipeline.

10. The ANB has made steady progress toward implementing the short-term measures recommended by the 2002 data ROSC mission. Almost all short-term measures have now

been completed: the methodology for compiling reserve assets has been revised to exclude the Oil Fund assets, and they are now classified as other investment assets of the government; a new survey form for oil sector enterprises (IOCs) has been designed and distributed to international oil consortia; and the scope and classification of BOP statistics have been improved. However, the data provision from IOCs remain insufficient, which hampers the compilation of foreign direct investment estimates due to inconsistencies in timing, coverage, and valuation of the source data.

11. To date, significant progress has also been made in implementing the data ROSC medium-term recommendations. Starting with data for the third quarter of 2005, the classification of services has been expanded, and data on reinvested earnings have been included in the BOP. Moreover, the compilation system appears to be facing some operational problems due to the lack of collaboration with other data-producing agencies, such as the Oil Fund. Problems also remain with the sources and methods, particularly with regard to short-term liabilities. No data are available on intercompany lending to direct investment enterprises, and trade credit transactions are estimated on the basis of trade statistics and the International Transactions Reporting System (ITRS) data with no clear distinction between asset and liability transactions.

12. The ANB has initiated compilation of the International Investment Position (IIP) statistics, but the IIP statement is still at an evolving stage. The IIP data have been published in the *IFS* since 2002.

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. The law on external debt, which includes the assignment of responsibility for external debt compilation, has been drafted and provided to the Parliament. 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 ANB 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 ANB 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.

AZERBAIJAN: TABLE OF COMMON INDICATORS REQUIRED FOR SURVEILLANCE

AS OF APRIL 5, 2007

	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	4/04/07	4/05/07	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	2/28/07	3/09/07	D	D	M		
Reserve/Base Money	2/28/07	3/28/07	D	D	M	O, O, O, O	O, O, O, O, LO
Broad Money	2/28/07	3/28/07	M	M	M		
Central Bank Balance Sheet	2/28/07	3/28/07	D	D	M		
Consolidated Balance Sheet of the Banking System	2/28/07	3/28/07	M	M	M		
Interest Rates[2]	2/28/07	3/28/07	M	M	M		
Consumer Price Index	3/07	4/5/07	M	M	M	O, O, O, O	O, LO, O, O, O
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	12/06	2/14/07	M	Q	Q	LO, LNO, LNO, LO	LO, LO, O, O, LO
Revenue, Expenditure, Balance and Composition of Financing[3] – Central Government	12/06	2/14/07	M	Q	Q		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	12/06	2/14/07	Q	Q	Q		
External Current Account Balance	9/06	2/1/07	Q	Q	Q	LO, LO, LO, LO	O, LO, LO, O,LO
Exports and Imports of Goods and Services	9/06	2/1/07	Q	Q	Q		
GDP/GNP	12/06	1/30/07	Q	Q	Q	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, extra budgetary 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.

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

IMF Executive Board Concludes the 2007 Article IV Consultation with the Republic of Azerbaijan

On May 9, 2007, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Republic of Azerbaijan.[1]

Background

Azerbaijan's real GDP growth accelerated to 31 percent in 2006, driven by rapidly increasing oil production and transportation. Non-oil real GDP, excluding oil and gas transportation, grew by about 8 percent, as nontradable sectors benefited from ramped up government spending and rapidly growing banking credit. The tradable non-oil sector only grew by about 4 percent in 2006 compared with 10.4 percent in 2005, as labor costs increased and the real effective exchange rate appreciated. The officially reported poverty level continued to decline during 2005–06.

Inflation rose into the double digits by August 2006, and reached 16.4 percent in March 2007. The recent rise in the inflation rate was fueled by a significant relaxation of macroeconomic policies in the context of capacity constraints, as well as by the immediate effect of a large adjustment to utilities and energy prices.

The oil production boom and rising international oil prices have strengthened Azerbaijan's external position. In 2006, the external current account surplus is estimated to have increased to 16 percent of GDP from about 1 percent in 2005. The large current account surplus

[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.

contributed to a significant increase in gross official reserves (US$2.5 billion, or 5 months of non-oil imports) and government foreign assets (US$1.9 billion), whose sum has considerably exceeded public and publicly guaranteed external debt (US$2.0 billion, or 10 percent of GDP) at end-2006.

The authorities undertook an exceptionally large fiscal relaxation in 2006. Oil revenue increased by 118 percent; and non-oil revenues increased by 4 percent of non-oil GDP owing to the buoyancy of tax bases. Wages, pensions, and other current expenditure increased by about 50 percent and capital expenditure more than tripled, bringing the total expenditure increase to 81 percent in 2006 compared with 2005. As a result, the non-oil primary deficit reached 33 percent of non-oil GDP in 2006 compared with only 13 percent in 2005.

In early 2006, the Azerbaijan National Bank (ANB) shifted from a fixed exchange rate to a de facto crawling peg to the U.S. dollar. With limited instrument independence, it undertook large unsterilized purchases of foreign exchange, in order to limit the annual exchange rate appreciation against the dollar to the targeted 5 percent. These policies led to a 133 percent increase in manat base money in 2006. Broad money increased by 86 percent and credit by 64 percent in 2006, fueling inflation.

The banking system continues to face important challenges. In response to rising credit and foreign exchange risks, the ANB tightened the prudential rules pertaining to these areas and increased the minimum capital requirement. However, at end-December 2006, many banks, including the two state-owned banks, failed to comply with one or more prudential regulations. The banking system remains relatively small (21 percent of GDP in 2006), highly concentrated (one bank controlled 46 percent of assets in 2006), and dominated by the two public banks (accounting for 51 percent of the banking system's assets in 2006).

Progress in other structural reforms has been mixed. The authorities put in place a new system of targeted social assistance in mid-2006, brought utilities tariffs closer to cost-recovery and selected petroleum product prices to world market levels in early 2007, and continued active participation in the Extractive Industry Transparency Initiative. However, some key state-owned enterprises operated without approved budgets in 2006, and there has been limited progress in improving budgetary expenditure management and controls, raising concerns about the quality of the rapidly increasing expenditures. In addition, several international surveys have reported on Azerbaijan's persistent problems with transparency, corruption, and the business climate.

The short-term growth and external outlooks remain exceptionally favorable, but keeping inflation from increasing further represents a major challenge. Driven by further rapid oil production growth, real GDP is projected to expand by about 30 percent, and the current account surplus is expected to increase to 27 percent of GDP in 2007. While rapidly growing capital expenditure would support non-tradable output growth, rising competitiveness pressures would negatively affect the tradable non-oil sector. As a result, non-oil GDP growth (excluding oil and gas transportation) is projected to decelerate to 7 percent in 2007. The continuation of the fiscal expansion would fuel domestic demand and liquidity growth. If monetary policy is not tightened, inflation is expected to increase further in 2007.

Executive Board Assessment

Executive Directors welcomed the strong real GDP growth driven by the temporary oil production boom, which resulted in a strengthening of Azerbaijan's external position, and enabled the authorities to initiate urgently needed investments in infrastructure and the social sectors, with encouraging progress in reducing poverty. Directors agreed that the oil boom presents an opportunity to lay a solid foundation for sustainable non-oil output growth and poverty reduction in the long term. To seize that opportunity, Directors encouraged the authorities to address the acceleration of inflation, the unsustainable pace of expenditure increases, and weaknesses in the business climate and governance, with the objective of further diversifying the economy.

Directors called on the authorities to moderate expenditure increases in the medium term to reduce inflation and ensure fiscal sustainability. Against that background, they welcomed the authorities' intention to start reducing the non-oil primary fiscal deficit to more sustainable levels in the medium term, while recognizing the pressing infrastructure and development needs. They were encouraged by the plans to implement a wide range of supporting fiscal measures, and emphasized the need to move expeditiously in these areas so as to firmly secure long-term fiscal sustainability. They also underscored the importance of improving expenditure management and developing a medium-term fiscal framework consistent with Azerbaijan's long-term oil revenue management strategy. Directors commended the authorities for participating in the Extractive Industries Transparency Initiative.

In the short run, Directors saw room for reining in the fiscal expansion in 2007 in order to contain domestic demand growth. In this respect, they recommended that the non-oil primary fiscal deficit be reduced to below its 2006 level, by curtailing energy subsidies, cutting low-priority current expenditure, and introducing greater selectivity into the choice of, and strengthened control over, investment projects.

Directors called on the ANB to pursue a more pro-active monetary policy, supported by greater exchange rate flexibility and further development of indirect instruments of monetary policy. Directors recommended that monetary conditions be tightened by reducing the ANB's unsterilized foreign exchange purchases, thus facilitating a real exchange rate adjustment via nominal exchange rate appreciation in response to the large increase in budgetary expenditure from oil revenues. In pursuing this strategy, some Directors recommended monitoring closely the impact of manat appreciation on the competitiveness of the non-oil sector and on the banking system. Directors generally recognized the authorities' efforts on the structural side to reduce real appreciation pressures, but believed that such efforts would be effective only in the medium term.

Directors supported the authorities' interest in moving to inflation targeting as part of their efforts to reduce inflation to single digits in the medium term. Key prerequisites for a transition to inflation targeting include enhancing the ANB's independence, eliminating fiscal dominance of monetary policy, developing securities markets, strengthening the banking system, and further improving the Consumer Price Index compilation methodology.

Regarding the financial sector, Directors considered that effective enforcement of prudential regulations would reduce the banking system's vulnerability to exchange rate appreciation, higher interest rates, and credit risks intensified by accelerating credit expansion. Noting the authorities' efforts to revive the privatization of the two state-owned banks, Directors recommended that the privatization terms be such as to attract strategic investors, and that only fit-and-proper investors be allowed to participate in the privatization.

Directors underscored that revitalizing productivity-enhancing structural reforms will be essential for maintaining non-oil sector competitiveness in the face of real exchange rate appreciation. They supported the authorities' plans to improve the business climate by simplifying licensing and registration procedures, and adopting and implementing the new anti-monopoly code, investment law, and anti-money laundering law. They called for steadfast implementation of the anti-corruption program and determined efforts to strengthen governance at the customs and tax administration agencies.

Directors welcomed the authorities' efforts to improve the statistical data base, which are aimed at subscribing to the IMF's Special Data Dissemination Standard.

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.

Azerbaijan: Selected Economic Indicators, 2003–07

	2003	2004	2005	2006 Prel.	2007 Proj.
		(Annual percentage change)			
Real economy					
GDP at constant prices	10.5	10.4	24.3	31.0	29.1
Oil sector, excluding oil and gas transportation	0.6	2.5	65.4	61.9	52.9
Non-oil sector, including oil and gas transportation	15.3	13.8	8.4	12.8	8.9
Non-oil sector, excluding oil and gas transportation	15.3	13.3	7.9	8.2	7.0
CPI (end-of-period)	3.6	10.4	5.5	11.4	20.0
	(In percent of GDP, unless otherwise specified)				
Consolidated government					
Total revenue and grants 1/	26.8	26.8	25.1	29.6	33.3
Total expenditure 1/	28.5	25.9	22.7	29.0	31.0
Fiscal balance 2/	-0.8	1.0	2.6	0.1	2.4
Non-oil primary fiscal balance (in percent of non-oil GDP)	-17.0	-12.9	-12.6	-32.6	-40.1
		(Annual percentage change)			
Money and credit					
Manat reserve money	23.7	38.2	7.5	132.6	80.5
Manat broad money	28.0	31.9	15.8	168.3	83.3
Banking sector credit to the economy	38.3	60.2	53.0	63.6	61.1
Velocity of total broad money (M3) 3/	7.7	6.3	5.2	4.4	3.6
	(In percent of GDP, unless otherwise specified)				
Balance of payments					
Current account balance (-, deficit)	-27.8	-29.8	1.3	15.7	27.4
External public debt 4/	19.7	18.5	12.5	10.0	10.3
Gross official international reserves					
In millions of US$, end of period	803	1,075	1,178	2,500	4,712
In months of non-oil imports c.i.f.	3.5	3.8	3.0	4.7	6.9
Exchange rate					
End-of-period (Manat/US$)	0.98	0.98	0.92	0.87	…
Real effective exchange rate (percentage change, “-“=depreciation)	-10.7	-3.5	6.6	8.9	…

Sources: Azerbaijan authorities; and IMF staff estimates.
1/ Includes tax credits allocated to SOCAR.
2/ Includes statistical discrepancy.
3/ Defined as gross domestic demand (excluding hydrocarbon imports) divided by average broad money.
4/ Includes government and government guaranteed external debt only.

Statement by Thomas Moser, Executive Director for the Republic of Azerbaijan
May 9, 2007

1. On behalf of my Azerbaijan authorities, I would like to thank the staff for the constructive discussions and the comprehensive staff report. Both provide valuable input to the authorities' policy formulation and implementation. Although Azerbaijan's short term growth and external outlooks are very favorable, the authorities are – not least thanks to the staff's hard work – fully aware of the medium term challenge that the substantial increase in oil revenues entails.

2. Azerbaijan is at the beginning of a large oil production boom, accompanied by rapid economic growth and sizeable current account surpluses. Real GDP grew at about 30 percent (non-oil real GDP, excluding oil and gas transportation, at about 8 percent) in 2006 and is set to continue to grow at this pace in 2007. The authorities are determined to use the substantial oil revenues to modernize the country and reduce poverty.

Fiscal Policy

3. The population of Azerbaijan clearly expects the growing oil revenues to alleviate their most pressing economic problems; particularly, they expect a significant reduction in poverty and noticeable improvements in education and in the provision of stable energy and water supply. The authorities therefore consider it imperative that they use the financial opportunity presented by the oil boom to address the most pressing infrastructure and development needs without delay. Capital expenditure has thus been substantially increased to finance critical projects in the social sector (schools, hospitals, housing for the large number of refugees) and to improve basic infrastructure (electricity supply, roads, irrigation). In addition, pensions and public sector wages, which are at a modest level, are being increased, while at the same time staffing reductions are being considered.

4. However, the authorities understand the concerns raised by the staff with regard to fiscal sustainability and macroeconomic stability, and they agree that the pace of expenditure increases needs to be moderated in the medium term. With the most important infrastructure needs being currently addressed, the increase in the public investment program will be substantially scaled down in the coming years, and the authorities intend to implement a number of fiscal reforms to reduce the non-oil primary fiscal deficit. They will continue to further increase non-oil revenues by expanding the tax base and improving revenue administration. As announced at the last Article IV discussion, the authorities have implemented a new system of targeted social assistance and subsequently increased energy and utilities prices significantly, which will contribute to a substantial reduction in energy subsidies. Over the medium term, these subsidies will be fully eliminated. The government

also intends to improve collection on utility payments and to strengthen budgetary discipline of state-owned enterprises.

5. It should also be recalled that many crucial reforms were implemented early on in a forward-looking manner to prepare the country for the management of increasing oil revenues. In 1999, the Oil Fund was established to preserve oil wealth for future generations, and Azerbaijan was the first oil-producing country to issue an Extractive Industry Transparency Initiative (EITI) report. In January, the government released its fifth EITI report.

Monetary Policy and Financial Sector

6. Large oil-related foreign capital inflows and the significant increase in public spending poses significant challenges for monetary and exchange rate policies. The main objective of the monetary policy of the National Bank of Azerbaijan (ANB) is to bring inflation back to single digits in the medium term, and to this end the ANB intends to use all monetary instruments at its disposal, including nominal exchange rate appreciation. The ANB has no specific exchange rate target. As pointed out in the staff report, however, the authorities consider it essential that the benefits of an increase in interest rates and faster nominal exchange rate appreciation are properly weighed against financial stability risks and competitiveness considerations.

7. The ANB will continue to further improve its monetary policy framework and instruments. In line with IMF technical assistance recommendations, the ANB has introduced an interest rate corridor and other recommendations to improve open market operations. In addition, a number of additional improvements, including institutional reforms, are currently being discussed between the ANB and the government. These improvements aim at enhancing the ANB's capacity to conduct more proactive monetary and exchange rate policy.

8. As pointed out in the staff report, the ANB has tightened prudential regulation and increased the minimum capital requirement in response to vulnerabilities in the banking sector. Since the beginning of the year, substantial progress has been achieved in several of the problem areas identified by the staff. Moreover, the two banks that were listed as not having met the minimum capital adequacy ratio are in the process of resolving the problem. The authorities are also determined to privatize the two state-owned banks.

Structural Reforms

9. While the substantial increase in oil revenues will help the authorities to address many of the country's pressing development needs, the authorities are fully aware of the fact that oil revenues are not a panacea and that they cannot afford to slow down implementation of structural reforms. On the contrary, in order to address the rising competitiveness pressures in the non-oil sector, the authorities intend to advance their structural reform agenda.

10. Apart from the above mentioned fiscal, monetary and banking sector reforms, the authorities plan to implement further capital account and trade liberalization, improvements to customs administration, and to address the concerns relating to the business and investment climate. On April 30, 2007, the President of Azerbaijan issued a decree that calls for measures to promote entrepreneurship, such as the simplification of licensing and registration requirements. The authorities will also continue their work on a number of legislative initiatives, including their work on anti-corruption legislation.