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Azerbaijan Republic: Letter of Intent

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Republic of Azerbaijan : Letter of Intent

June 11, 2005

Mr. Rodrigo de Rato
Managing Director
International Monetary Fund
700 19th Street
Washington, D.C. 20431

Dear Mr. de Rato,

1. On December 22, 2004, the Executive Board completed the fourth review under Azerbaijan's Poverty Reduction and Growth Facility (PRGF) arrangement, which is in support of our reform program. While requesting completion of the fifth review, we would like to take this opportunity to inform you about our continuing implementation of this program, as well as our policy intentions for the second half of 2005, and to request waivers for nonobservance of several performance criteria (PCs). This letter should be read as additional to our original Letter of Intent and Memorandum of Economic and Financial Policies, dated June 15, 2001, as well as our letters of February 6, 2002, April 23, 2003, December 4, 2003, and December 6, 2004.
2. Our performance relative to the quantitative PCs and indicative targets for end-December 2004 and end-March 2005 is presented in Table 1. Performance relative to these targets should be measured as detailed in Annex I of our April 23, 2003 letter.
3. Our program policies and objectives described below are fully consistent with our State Program for Poverty Reduction and Economic Development (SPPRED).
4. In light of Azerbaijan's strong economic position, the government made a decision not to draw the last tranche upon completion of the fifth review under the PRGF arrangement.

A. Recent Macroeconomic Developments

5. **The economy continues to grow rapidly, buoyed by high revenues from oil exports and a rapid increase in investment.** In 2004, real GDP grew by 10.2 percent with non-oil real GDP growth exceeding 12.6 percent. The non-oil fiscal deficit declined to 13 percent of non-oil GDP in 2004, owing to higher-than-expected non-oil revenues and our strict adherence to nominal expenditure targets. However, spending of public enterprises increased in 2004, providing a strong impetus to domestic demand growth. The external position has further strengthened, as gross international reserves of the Azerbaijan National Bank (ANB) increased to \$1 billion (equivalent to 3 ½ months of non-oil imports), Oil Fund assets almost reached \$1 billion, and public and publicly guaranteed external debt further declined to 13 percent of projected 2005 GDP by end-March 2005.

6. **Inflation has been rising since 2004.** Our initial assessment that the increase in inflation in the second half of 2004 was caused by one-off factors was not confirmed by recent developments. In hindsight, it appears that rapid growth of broad money and banking credit over the last 12 months, which was fueled by increased spending of oil revenues and capital inflows, has led to a significant pick-up in inflation. In addition, substantial wage increases in the public sector, ineffective control on the budgets of state-owned enterprises, large upward revisions to energy and utilities prices in November 2004, January 2005, and March 2005, as well as monopolies in certain consumer goods, contributed to higher inflation. In response to persistent inflationary pressures, the ANB stepped up its sterilization efforts and allowed the exchange rate to appreciate in the first half of 2005. Moreover, nominal state budgetary spending remained within the initial allocations for the first quarter of 2005, despite higher-than-expected non-oil revenues. Following these policy steps, inflation appears to have peaked in April 2005.

7. **We continue our efforts in poverty reduction.** As a result of rapid economic growth and increased social spending, poverty declined to 40.2 percent in 2004 from 49 percent in 2001. A SPPRED conference, held in Baku on May 12, 2005, opened a dialogue on a new 10-year program of poverty reduction, which will succeed to the current three-year SPPRED, expiring in 2005.

B. Performance Relative to Program Targets

8. **We experienced difficulties in meeting one end-March 2005 quantitative PC.** The ceilings on the non-oil fiscal deficit, net credit of the ANB to government, and net domestic assets of the ANB were observed. However, the floor on net international reserves was not observed, as SOCAR's cash tax payments fell short of its tax liabilities.

9. **Inadvertently, we did not observe the continuous PC on the non-accumulation of external debt arrears, due to a technical problem in calculating interest payments to an official bilateral creditor.** This issue has been fully resolved, which provides a basis for our request for a waiver for nonobservance of this continuous PC.

10. **Our performance relative to our structural commitments has been satisfactory, although some measures were implemented with delays.** We observed the end-March 2005 PC by announcing tenders for purchases of all government payment services in the regions, where there is more than one bank. The end-December 2004 PC on approval of revenues and expenditures plans of four state-owned enterprises was not observed. We only approved these plans by April 15, as it took longer than expected to finalize them in light of revisions to energy tariffs and uncertainty over prices for imported gas. Finally, the end-April 2005 PC on the improvement of the budget preparation process was not observed. While we completed the review of our experience of the 2005 budget preparation by end-February 2005 and established an expenditure commission in March 2005, we only approved a Cabinet of Ministers instruction on measures aiming to ensure stronger links among various government programs, and annual budget allocations in June 2005. Moreover, we will continue to improve the budget formulation process, including through a transition to program budgeting, in close

cooperation with the World Bank. Based on full implementation of the end-December 2004 and end-April 2005 PCs, we request waivers for their nonobservance by the initial program deadlines.

11. **Structural benchmarks under the program have been largely implemented, albeit with delays.** To fulfill the commitment under the end-March 2005 structural benchmark on the improvement of the financial discipline of Azerigas, Azerenergy, Azerichimia, and SOCAR, the cabinet of ministers has approved a schedule of budget submissions by these and six other state-owned enterprises in the context of the 2006 budget, and guidelines on monitoring of budget execution by these enterprises. The implementation of the end-March 2005 structural benchmark on the preparation of a timetable for public sector employment reform was delayed. However, we have undertaken a number of initiatives on several fronts with the aim of effecting material improvements in the functioning of the civil service and budgetary organizations: (i) in January 2005, the President signed a decree that established a commission in charge of the civil service reform; (ii) in May 2005, a timetable for sequencing specific measures in the area of public sector employment reform was submitted to the cabinet of ministers; and (iii) a draft proposal on how to rationalize the pay structure of budgetary organizations has been submitted to the cabinet of ministers.

12. **We have also implemented a number of other important structural measures in the first half of 2005.** In the area of banking privatization, a Presidential decree has been issued, authorizing the government to initiate tenders for privatizing the International Bank of Azerbaijan (IBA) and Kapital Bank, the two remaining state-owned banks. A tender for advisory services in the privatization of these banks will be announced soon, and we are committed to ensure transparent privatization of these two banks, consistent with best international practice. With respect to revenue administration, a number of measures will be submitted for parliamentary approval by October 2005 to improve VAT administration, including stricter procedures for voluntary registration of VAT tax payers and the amelioration of the process of collecting overdue tax obligations. In addition, we have submitted a new investment law to parliament. Finally, Azerbaijan was the first oil-producing country to publish a report in the context of the Extractive Industries Transparency Initiative.

C. Short-Term Outlook

13. **The macroeconomic outlook for 2005 remains favorable.** The preliminary estimates for the first quarter of 2005 indicate that non-oil real GDP continues to grow at double digit rates. An expected significant increase in oil production and exports, large FDI inflows, and the continued growth momentum in the non-oil sectors would boost real GDP growth to about 19 percent and contribute to a significant improvement in Azerbaijan's external position.

14. **We will strive to reduce core inflation¹ to single digits by end-2005, which is our key priority.** A combination of prudent fiscal policy, greater exchange rate flexibility, better monitoring of state-owned enterprises, and a determined implementation of structural reforms is essential for the success of our disinflation policy in 2005. To ensure the coordination of all government agencies in their efforts to bring down inflation, a special Decree of the President was issued on May 31, 2005, spelling out the disinflation program, whose main measures are presented in this letter.

D. Monetary and Exchange Rate Policies

15. **Greater exchange rate flexibility is essential for successful disinflation.** Since increased spending out of oil wealth in the medium term will inevitably lead to real appreciation of the manat, we will gradually move to greater exchange rate flexibility so as to ensure that this real appreciation does not exclusively occur through higher inflation but also through nominal appreciation. Since mid-February 2005, the ANB has continued the policy of exchange rate appreciation. Also, it has started to increase interest rates on its refinancing facilities since mid-May. Exchange and interest rate policies will be reviewed during the year so as to ensure a steady decline in core inflation to single digits by year-end.

16. **The ANB will continue to enhance its capacity to conduct monetary policy.** It will increase the outstanding stock of its bills by 100 billion manats in 2005. Moreover, a series of measures have been implemented to improve coordination between the ANB and the Treasury in domestic debt management and to develop domestic securities markets. In particular, a Joint Coordination Committee on Public Debt Management was established and terms of references on information exchange between the ANB bills and the ministry of finance were approved in June 2005. An increasing stock of ANB and government securities and better domestic debt management practices will help the ANB use more actively indirect instruments of monetary policy.

17. **In light of rapid credit growth and greater exchange rate flexibility, the ANB will continue to strengthen banking supervision.** It has adopted a zero-tolerance approach to nonobservance of prudential regulations, and any non-compliant banks will be subjected to penalties for violations. The ANB will also strictly monitor the adherence of non-compliant banks to approved timetables of bringing their prudential ratios to compliance with regulations.

E. Fiscal Policy

18. **The fiscal policy stance for the remainder of 2005 will support our disinflation efforts.** To this end, in the context of the budget revision, which is expected in June 2005, we will reduce the non-oil fiscal deficit for 2005 to about 15 ½ percent of non-oil GDP (by about 1 ½ percent compared to the program target) mainly by allowing the automatic stabilizers to

¹ Excludes fuel, energy, transportation, water, and communications from the consumer price index.

work. According to our current projections, non-oil revenues will be about 665 billion manats higher than programmed, mainly reflecting higher inflation, strong growth performance of the non-oil sectors, and the effects of the recent increases in utilities prices. At the same time, the increase in nominal expenditure will represent 790 billion manats, accommodating higher spending on the BTC pipeline, imports of strategic and health equipment, investment projects, the opening of new embassies, an increase in certain categories of pensions and targeted social assistance, as well as a wage increase from October 1, 2005. At the same time, about 300 billion manats in expenditure savings on a cash basis are expected on account of under filled vacancies, lower business travel expenses, lower prices in tendering procedures, and a more appreciated exchange rate. We will not undertake any further budget revisions that could jeopardize the achievement of our inflation objectives for 2005. Moreover, we will reassess our intention to increase minimum and public sector wages from October 1, 2005 if inflation were to remain in double digits.

19. **The composition of financing will also be changed in the context of the June 2005 budget revision to reduce the liquidity impact of spending out of oil revenues.** The government will reduce its withdrawal from the Oil Fund, given the availability of additional non-oil revenues, and the issuance of treasury bills will be increased to 200 billion manats in 2005, of which 85 billion manats will be issued by end-July 2005.

20. **Monitoring of oil revenues will be improved.** In accordance with the 2005 budget law, we will ensure that SOCAR pays all current year tax liabilities in cash, and the IMF staff will receive quarterly statements of SOCAR's tax payments and obligations no later than the 25th of the last month of each quarter, as well as the final statements from the ministry of taxes as soon as they become available. Finally, the tax credits allocated to compensate SOCAR for subsidies to Azerenergy will be increased by 216 billion manats and will only be used to clear SOCAR's tax arrears, which amounted to 1,641 billion manats at end-March 2005. Based on the implementation of these corrective actions related to SOCAR, we request a waiver for the nonobservance of the relevant end-March 2005 quantitative PC.

21. **SOCAR's tax regime will be modified, to ensure that the budget captures an increasing share of revenues arising from higher-than-budgeted oil prices in the coming months.** We have requested technical assistance from the Fund and the World Bank in designing such a regime and we will also take into account the experience of neighboring countries.

F. Structural Measures

22. **A comprehensive program of improving monitoring and corporate governance of state-owned enterprises will be developed in 2005.** In particular, by end-September 2005, we will work out, together with the World Bank, a timetable and detailed program to improve the corporate governance of key state-owned enterprises, including SOCAR, through their corporatization and the designation of supervisory Boards.

23. **We will continue to implement structural measures, which will help reduce inflationary pressures.** The anti-corruption committee will continue its efforts to enforce the newly enacted anti-corruption law. Also, legal steps will be taken against monopolies by strictly enforcing the current anti-monopoly legislation. Finally, a draft of the new anti-monopoly code will be submitted to Parliament by July 2005.

24. **We will continue our efforts in other areas of structural reforms.** We will participate in the third meeting of Azerbaijan's WTO accession working party in late June 2005. In addition, we have appointed a national SDDS coordinator and plan to subscribe to SDDS in the near future.

Sincerely,

/s/

Artur Rasi-zade
Prime Minister
Republic of Azerbaijan

/s/

Avaz Alekberov
Minister of Finance
Republic of Azerbaijan

/s/

Farhad Aliyev
Minister of Economic Development
Republic of Azerbaijan

/s/

Elman Rustamov
Chairman, National Bank
Republic of Azerbaijan

Attachment

Table 1. Azerbaijan: Quantitative Performance Criteria and Indicative Targets for the PRGF, 2002–05

(In billions of manats, unless otherwise indicated)

	December		Prog.	Adj. Prog. 3/4/	Act.	Prog.	Adj. Prog. 3/4/	Act.	Prog.	Adj. Prog. 3/4/	Act.	Prog.	Adj. Prog. 3/	Act.	Prog.	Adj. Prog. 3/	Prel. Act.	
			March			June			September			December			March			
	2002	2003	2004			2004			2004			2004			2005			
I. Quantitative performance criteria and indicative targets 1/ 2/																		
Floor on net international reserves of the ANB (end-of-period stock, in US\$ million)	462	582	512	510	612	533	537	668	579	588	772	737	745	905	811	813	808	
Ceiling on net domestic assets of the ANB (end-of-period stock)	-85	-160	9	18	-129	114	95	-99	17	-25	-165	76	38	-56	-379	-386	-491	
Ceiling on net credit to the general government from the ANB (end-of-period stock)	154	75	0	9	-12	53	34	-26	-95	-137	-117	167	129	112	-279	-286	-312	
Ceiling on the overall consolidated non-oil deficit 5/ 6/	...	3,865	968	899	387	2,141	1,959	1,023	3,192	3,041	2,132	4,105	4,141	3,642	979	868	784	
Ceiling on New Nonconcessional External Debt Contracted or Guaranteed by the Consolidated Government or the ANB (excluding the IMF) (flows, in US\$ million) 5/																		
Less than one year's maturity	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	
Medium- and long-term debt, one to less than five years	...	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	
Other long-term debt (maturity five and more years)	...	0	50	50	10	100	100	32	125	125	32	150	150	32	50	50	7	
2. Continuous performance criterion																		
Ceiling on Stock of Outstanding Nonschedulable External Payments Arrears of the Consolidated Government and the ANB (end-of-period stock, in US\$ million)	0	0	0	0	0	0	0	0	0	0	0	0	0	0.004	0	0	0	
3. Indicative targets																		
Ceiling on stock of ANB's manat reserve money (end-of-period stock)	1,872	2,316	2,146	2,146	2,456	2,340	2,340	2,761	2,451	2,451	2,905	3,162	3,162	3,200	2,987	2,987	2,810	
Ceiling on stock of unpaid bills in excess of Manat 50 billion (end-of-period stock)	-36	-41	0	0	10	0	0	20	0	9	0	0	0	-37	

1/ These are performance criteria for end-December 2003, end-June 2004, and end-March 2005, and indicative targets for end-March 2004, end-September 2004, and end-December 2004.

2/ Foreign exchange components are valued using program exchange rates of 4,606 manat/US\$ and 1.26 US\$/SDR through end-March 2005.

3/ Program targets are adjusted on the basis of program adjustors as specified in Attachment I, Annex I of IMF Country Report No. 03/154.

4/ Reported end-March 2004 indicative targets and end-June 2004 performance criteria have been revised compared to IMF Country Report No. 05/19, page 32, table 7; all of them have been observed.

5/ Cumulative changes during the year.

6/ For 2003, the figure reported in IMF Country Report No. 03/154 was 4,042. However, this figure incorrectly did not exclude AIOC profit tax of 182 billion manat.