

Republic of Azerbaijan: Fifth Review Under the Poverty Reduction and Growth Facility and Request for Waiver of Performance Criteria—Staff Report; Press Release on the Executive Board Discussion; and Statement by the Executive Director for the Republic of Azerbaijan

In the context of the fifth review under the Poverty Reduction and Growth Facility and request for waiver of performance criteria with the Republic of Azerbaijan, the following documents have been released and are included in this package:

- the staff report for the Fifth Review Under the Poverty Reduction and Growth Facility and Request for Waiver of Performance Criteria, prepared by a staff team of the IMF, following discussions that ended on May 17, 2005, 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 June 13, 2005. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- a Press Release summarizing the views of the Executive Board as expressed during its June 24, 2005 discussion of the staff report that completed the request and review.
- a statement by the Executive Director for the Republic of Azerbaijan.

The documents listed below have been or will be separately released.

Letter of Intent sent to the IMF by the authorities of the Republic of Azerbaijan*
Ex Post Assessment of Longer-Term Program Engagement

*May also be included in Staff Report

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

Fifth Review Under the Poverty Reduction and Growth Facility Arrangement and Request for Waiver of Performance Criteria

Prepared by the Middle East and Central Asia Department
(In consultation with other departments)

Approved by Lorenzo Pérez (MCD) and Juha Kähkönen (PDR)

June 13, 2005

- A staff team visited Baku from May 4–17, 2005 for discussions on the fifth (last) review under the PRGF arrangement and on the staff's *ex post* assessment of longer-term program engagement with Azerbaijan.
- The team consisted of Mr. Kramarenko (head), Ms. Zermeño, Messrs. Gvenetadze, Fedorov (all MCD), and Chinoy (PDR). Mr. Zavoico, the resident representative, assisted the mission. Messrs. Zurbrügg and Mammadov (OED) participated in policy discussions.
- The mission met with President Ilham Aliyev, Prime Minister Rasi-zade, other senior government officials, and representatives of the business, banking, and diplomatic communities. The staff organized a seminar on energy subsidies with the academic community and attended a PRSC annual conference.
- Azerbaijan accepted the obligations of Article VIII, Sections 2, 3, and 4 effective November 30, 2004.
- An arrangement under the PRGF for an amount equivalent to SDR 80.45 million (50 percent of quota) was approved on July 6, 2001. At the request of the authorities, the arrangement has been extended through July 4, 2005, and access has been reduced to SDR 67.58 million, with the concomitant cancellation of the sixth review. The fourth review was completed by the Executive Board on December 22, 2004.
- On the occasion of the 2004 Article IV consultation discussions and fourth review completion, Directors commended the authorities for Azerbaijan's strong macroeconomic performance in recent years, but expressed concern that—despite the high real GDP growth—the incidence of poverty remains high. They also emphasized that inflation developments should be closely monitored and additional steps taken, if necessary, in order to achieve the authorities' inflation objective of 5 percent for 2005. Directors also called for gearing structural reforms toward improving the budget formulation process, containing the wage bill growth, enhancing competition in the banking sector, strengthening the performance of state-owned enterprises, improving the business climate, and tackling governance and corruption issues.
- The authorities indicated that they had decided to forego the last disbursement under the PRGF, owing to Azerbaijan's strong external position.

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EXECUTIVE SUMMARY

Buoyed by rapid domestic demand growth, the economy has continued to expand at double-digit rates, but inflation has recently risen. Domestic demand has been increasing much faster than GDP partly on account of large oil sector related and other investments. In addition, an expansionary policy mix and a loosening of wage policies have added to the domestic demand expansion. Strong domestic demand also contributed to an increase in the current account deficit in 2004, but the external position remains sustainable. While the headline 12-month CPI rate increased to 15.5 percent in April 2005, the recent monetary policy tightening led to a decline in the inflation rate to 13.4 percent in May 2005.

Performance under the program has been satisfactory. All but one end-March 2005 quantitative performance criteria (PCs) and indicative targets were met: the floor on net international reserves (NIR) was not observed by a small margin mainly on account of lower-than-expected tax payments by the State Oil Company of the Republic of Azerbaijan (SOCAR). All structural performance criteria have been met, albeit with delays; and structural benchmarks have been largely implemented. Inadvertently, the continuous PC on the non-accumulation of external payments arrears was not observed, but the issue has been fully resolved. The staff supports the authorities' request for waivers of performance criteria.

Short-term growth outlook is favorable, but there are important political risks. Real GDP is projected to grow by almost 19 percent and the external current account deficit is projected to decline significantly in 2005, on account of rapid growth of oil production and exports. However, political pressures for higher spending are rising in the run-up to the November 2005 parliamentary elections.

The Supplementary Letter of Intent (SLOI) explains the authorities' strategy to bring down core inflation to single digits by end-2005. The proposed package includes a commitment to increase refinancing rates, continue with exchange rate appreciation, limit the non-oil fiscal deficit to about 15½ percent of non-oil GDP, improve the monitoring of spending by public enterprises, and strictly enforce anti-monopoly legislation. Although the measures detailed in the SLOI will most likely contribute to a reduction in inflationary pressures, the staff projects core inflation to remain in double digits in 2005, given the high likelihood of further wage growth, increased spending by SOCAR, and continued large capital inflows. The authorities recognized the risks to their inflation forecast under the proposed policy package, and assured the staff that they intend to monitor macroeconomic developments closely and stand ready to tighten further their monetary policy stance, if needed.

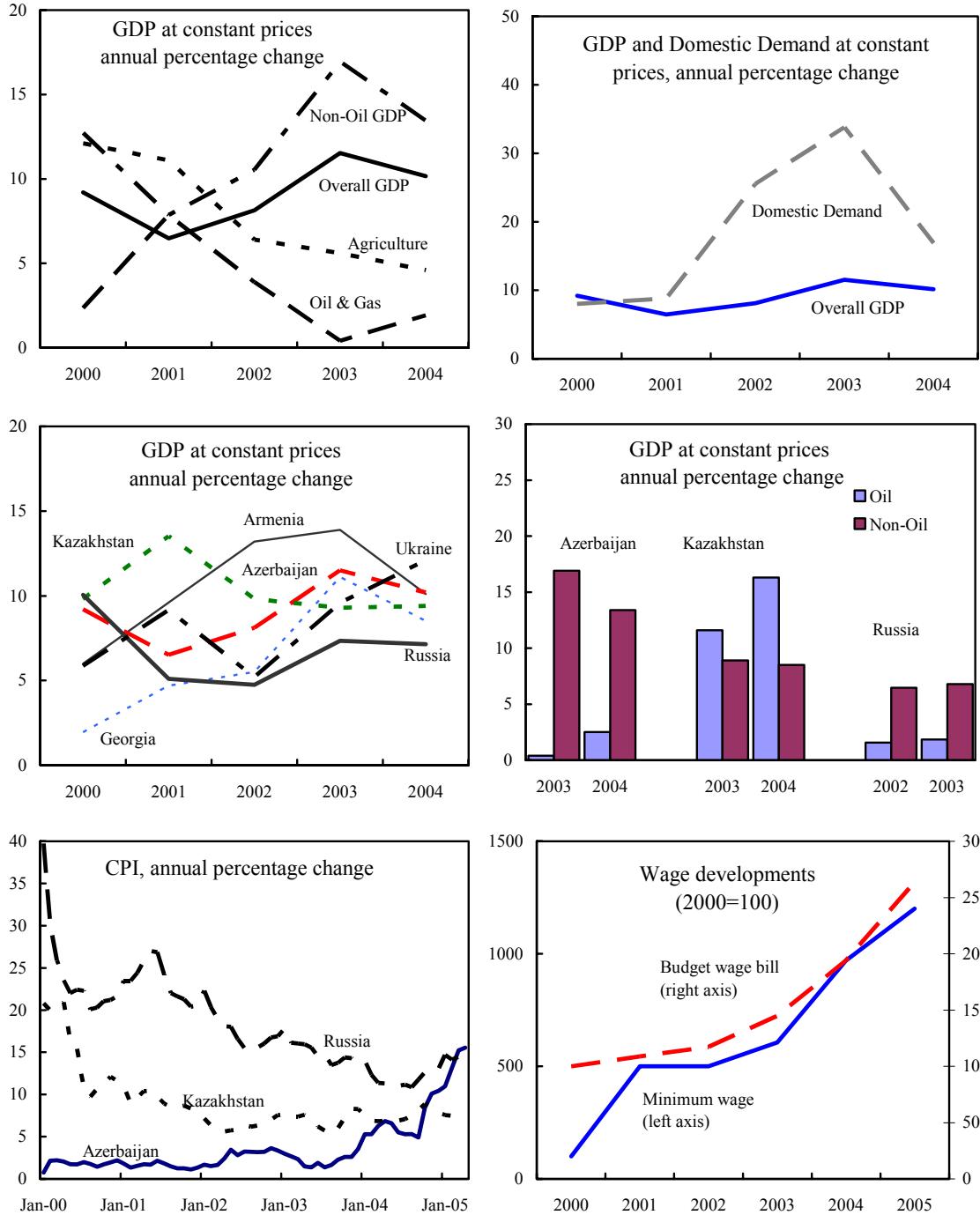
The authorities broadly agreed with conclusions and recommendations of the EPA and expressed interest in a successor arrangement. In this regard, a clear demonstration by the authorities of strong commitment to reduce inflation, activate indirect instruments of monetary policy, and improve taxation and corporate governance of state-owned enterprises, including SOCAR, would lay a good basis for initiating discussions on a possible successor Fund-supported program.

I. RECENT DEVELOPMENTS AND PERFORMANCE UNDER THE PROGRAM

- 1. Political tensions are rising in the run-up to the November 2005 parliamentary elections.** The current government, although committed in principle to market-oriented reforms, has faced difficulties advancing the reform agenda in a timely manner. While the authorities understand the risks of pursuing expansionary policies in the current environment of double-digit inflation, political pressures for increased spending and high credit growth, as a means of reducing social and political tensions ahead of the elections, remain high.
- 2. Buoyed by rapid domestic demand growth, the economy has continued to expand at double-digit rates since 2003 (Figure 1).** In 2004, real GDP grew by 10.2 percent, with non-oil GDP growing by 13.4 percent (Table 1). Preliminary estimates for the first quarter of 2005 suggest that year-on-year growth rates of oil and non-oil GDP were in double digits as well. Domestic demand increased much faster than GDP in 2004, mainly on account of investment. Foreign direct investment in the hydrocarbon sector has financed a significant share of gross domestic investment and has stimulated rapid growth in construction, transportation, and services since 2003. An expansionary policy mix and a loosening of wage policies have also added to the domestic demand expansion (Figure 1).
- 3. 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 poverty reduction conference, held in Baku on May 12, 2005, opened a dialogue on a new 10-year program of poverty reduction, which will succeed the current three-year State Program of Poverty Reduction and Economic Development (SPPRED) expiring in 2005.
- 4. Inflation has been rising since the beginning of 2004.** Demand pressures, exacerbated by expansionary macroeconomic policies, contributed to an increase in the headline 12-month CPI rate to 15.5 percent in April 2005 compared to 3.6 percent in December 2003.¹ The administered energy and utility price increases implemented in November 2004, and January and March 2005 only added about 1.5 percentage points to the headline inflation rate. Therefore, the 12-month core inflation rate reached about 14 percent in April 2005, well above the year-end program target of 5 percent.
- 5. Strong domestic demand contributed to an increase in the current account deficit in 2004, but the external position remains sustainable.** The positive impact of higher oil prices on exports was more than offset by rapid growth of imports, including those related to oil projects (Table 6). This, together with a significant increase in the repatriation of profits by foreign oil companies, led to an increase in the current account deficit to

¹ There are also reports that governance problems in the retail sector contributed to price increases for certain consumer goods.

Figure 1. Azerbaijan and Selected CIS Countries: Real Sector Developments, 2000–05



Sources: Azeri authorities; and Fund staff estimates.

30.3 percent of GDP in 2004 from 27.7 percent in 2003. Since the current account deficit was largely financed by FDI, external public and publicly guaranteed debt increased modestly to \$1.6 billion (18.6 percent of GDP) by end-2004. The external liquidity position remains comfortable: gross official reserves amounted to about \$1 billion (3½ months of non-oil imports) and the Oil Fund accumulated about \$1 billion in foreign assets by end-March 2005.

6. **Competitiveness of the non-oil sector remains adequate.** Non-oil exports grew by 36 percent in dollar terms in 2004, as the CPI-based real effective exchange rate index (REER) was virtually flat in 2004 after having depreciated by about 30 percent during 2001–03 (Figures 2 and 3). The recent REER appreciation might have contributed to the recorded slowdown in non-oil export growth to 5 percent year-on-year in the first quarter of 2005.

7. **All but one quantitative end-March 2005 performance criteria and indicative targets were met (Table 7).** The floor on NIR was missed by a small margin mainly on account of lower-than-expected tax payments by SOCAR. Given the small amount of the deviation (\$5 million) and the corrective actions aimed at enforcing compliance of SOCAR with tax obligations (SLOI, paragraph 20), the staff supports the authorities' request for a waiver for the nonobservance of this PC.

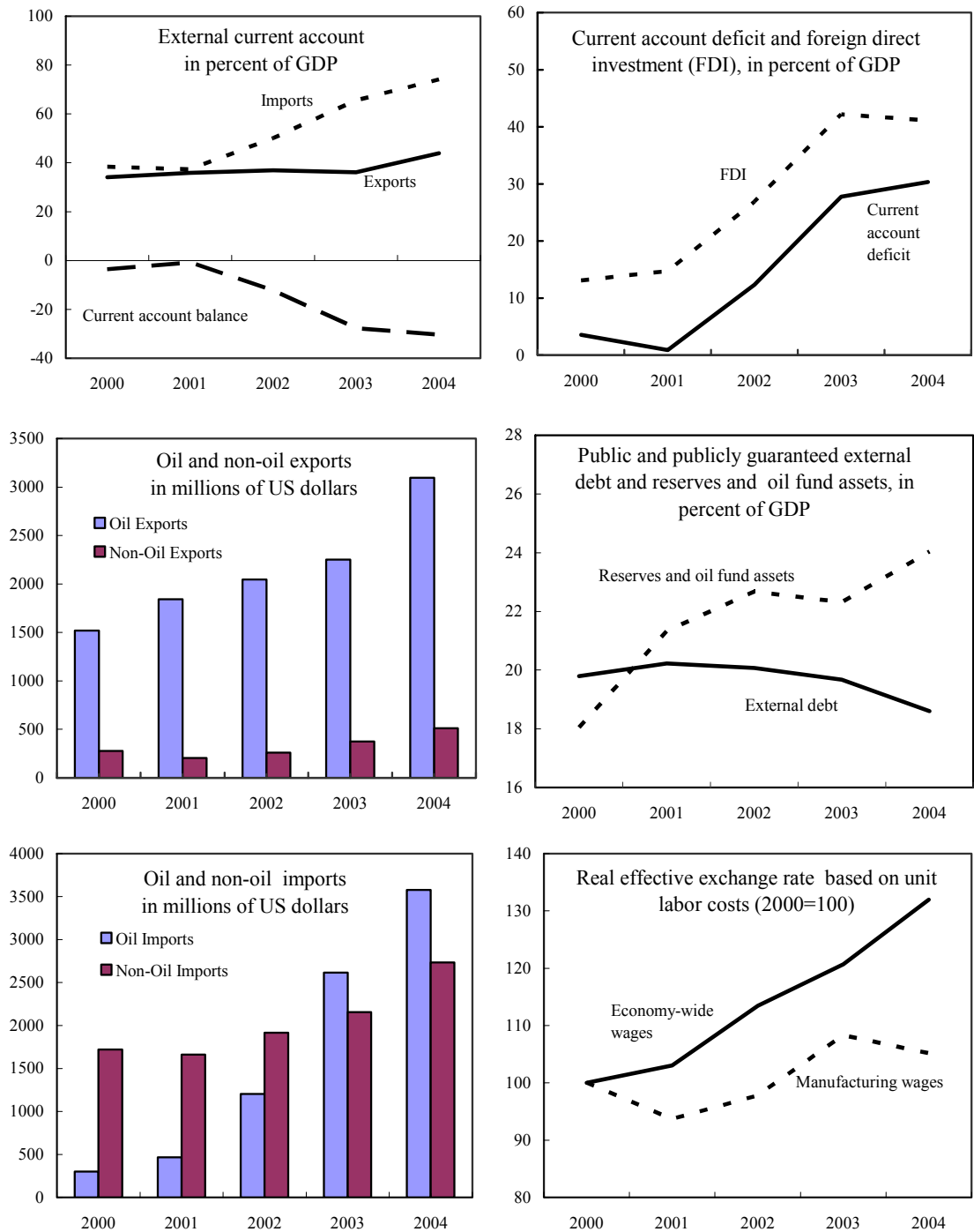
8. **The public sector added to domestic demand pressures.** While budget implementation has been consistent with program targets (Tables 4 and 5), spending by public enterprises has been on the rise. In 2004, the non-oil fiscal deficit declined to 12.6 percent of non-oil GDP compared to the program target of 14.4 percent of GDP (Figure 4), mainly on account of better-than-expected non-oil revenues (1.6 percent of non-oil GDP). In the first quarter of 2005, the non-oil fiscal deficit was within the program limit, but it doubled in nominal terms, and increased significantly as a share of quarterly non-oil GDP compared to the first quarter of 2004. Despite good non-oil revenue performance, problems with oil revenue collection persisted. SOCAR did not fully pay its current tax liabilities in cash in 2004 and the first quarter of 2005 and maintained tax arrears (Figure 4). This, together with relatively regressive taxation of oil revenues,² improved significantly the cash flow position of SOCAR,³ which was reportedly used to increase investment.

9. **In hindsight, it appears that the authorities and the staff were too late to acknowledge incipient inflationary pressures.** In 2004, high money and credit growth resulted from large unsterilized purchases of foreign exchange by the central bank in the face of increased domestic spending out of oil revenues and large capital inflows (Tables 2 and 3 and Figure 2). The rapid increase in the monetary aggregates was initially interpreted as a

² In 2005, SOCAR pays an export tax of 25 percent on the difference between the domestic price (\$8 per barrel) and the world market price for oil, and a royalty of about \$2 per barrel.

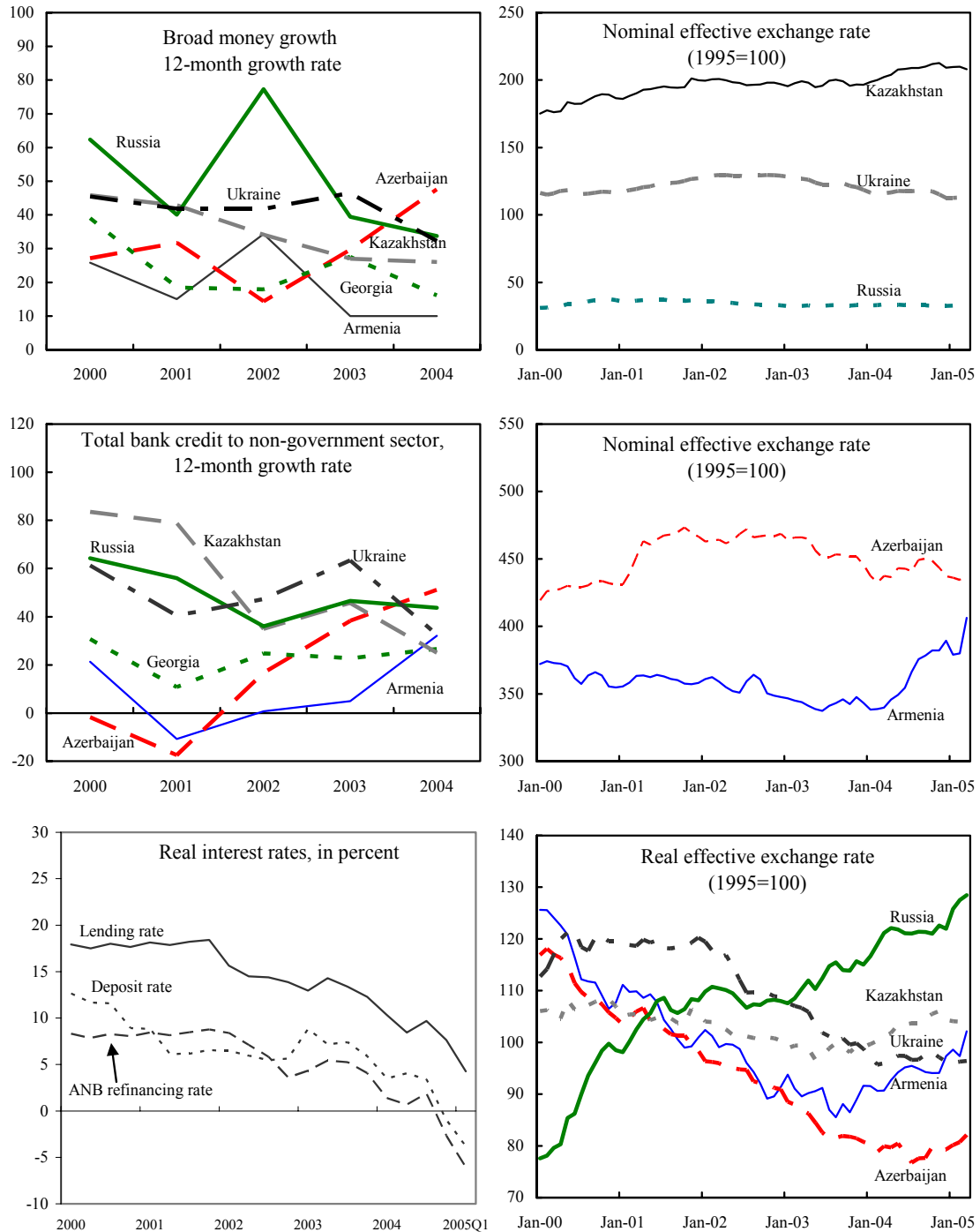
³ In 2004, SOCAR's tax payments fell short of tax liabilities by 1.7 percent of non-oil GDP and SOCAR's cash spending is estimated at 32 percent of non-oil GDP.

Figure 2. Azerbaijan: External Sector Developments, 2000–04



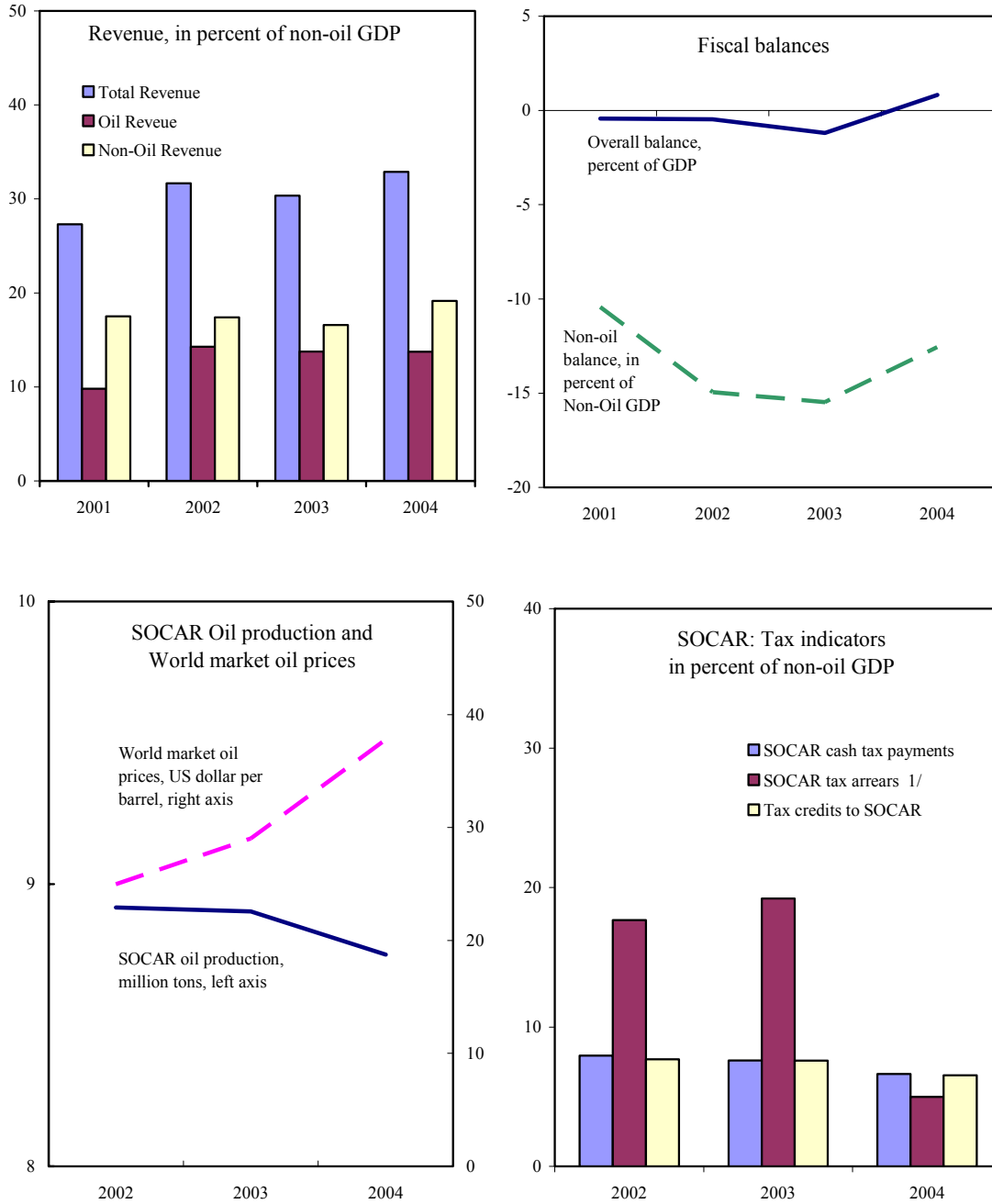
Sources: Azeri authorities, and Fund staff estimates.

Figure 3. Azerbaijan and Selected CIS Countries: Monetary and Exchange Rate Indicators, 2000–05



Sources: Azeri authorities; and Fund staff estimates.

Figure 4. Azerbaijan: Fiscal Developments, 2001–04



Sources: Azeri authorities; and Fund staff estimates.

1/ Includes principal and accumulated interest.

sign of deepening financial intermediation, while rising inflation was ascribed to one-off supply-side factors. By February 2005—less than two months before the program’s last test date—it became clear that the policy stance was too lax and that a nominal exchange rate appreciation was warranted. In response to these findings, the authorities immediately exited the de facto fixed exchange rate regime.

10. The exit from the de facto fixed peg to the dollar and some monetary policy tightening in the first half of 2005 led to a decline in headline inflation to 13.4 percent in May. While the Azerbaijan National Bank (ANB) abandoned the de facto fixed exchange rate regime in mid-February, the pace of nominal appreciation has accelerated only recently. The nominal effective exchange rate appreciation has reached 6.7 percent since January 1, 2005, most of which has occurred since May. This appreciation was achieved in part through reduced unsterilized purchases of foreign exchange by the ANB, which, in turn, contributed to a significant reduction in banks’ manat excess reserves. Moreover, refinancing rates were increased to 7.5 percent from 7 percent in late May. However, monetary conditions have remained loose, as evidenced by highly negative real interest rates on deposits and ANB’s refinancing facilities. Also, declining real lending interest rates contributed to an expansion in credit to the private sector by 72 percent from end-April 2004 to end-April 2005.

11. The recent significant increase in credit growth has not led to a deterioration in officially reported banking soundness indicators. The ratio of nonperforming loans is reported to have declined to 8.2 percent at end-March 2005 from 9.5 percent at end-December 2004. However, the International Bank of Azerbaijan (IBA)—the largest bank—has not complied with capital adequacy and large exposure limit requirements for some time (most other banks do comply). In addition, the IBA and a number of smaller banks do not comply with the limit on the net open position in foreign exchange.

12. Measures under all structural PCs have been implemented, albeit with delays in some cases (Table 8). The end-December 2004 PC on approval of revenue and expenditure plans of four state-owned enterprises (including SOCAR) was not observed, as its implementation was delayed until April 15. The end-March 2005 structural PC on tenders of all financial services to be provided to the government was observed. Structural measures under the end-April 2005 PC on the improvement of the budget preparation process have been implemented, but with some delays. The staff supports the authorities’ request for waivers for the nonobservance of the end-December 2004 and end-April 2005 PCs by the initial deadlines because deviations were temporary.

13. Structural benchmarks have been largely implemented, but with some delays. The financial discipline of the major state-owned enterprises (end-March 2005 structural benchmark) is expected to be improved through better budgeting and monitoring procedures, which have been approved by the cabinet of ministers (SLOI, paragraph 11). Also, the timetable for the public sector employment reform (end-March 2005 structural benchmark) has been submitted to the cabinet of ministers (SLOI, paragraph 11).

14. **There has been progress in other areas of structural reforms.** Beyond their commitments for the completion of this review, the authorities increased natural gas prices by about 200 percent to \$48 per thousand cubic meters on March 1, 2005, bringing them above the cost recovery level and closer to the marginal cost of \$62 per thousand cubic meters. Furthermore, Azerbaijan was the first oil-producing country in the world to publish a report in the context of the Extractive Industries Transparency Initiative (EITI), but corporate governance of SOCAR remains opaque. In addition, following a breakdown of negotiations with EBRD on IBA privatization, a new Presidential decree was issued in March 2005, calling for a revival of privatization of the IBA and Kapital Bank—the two remaining state-owned banks—through competitive tenders. The authorities are in the process of choosing a consultant for organizing these tenders. Finally, there has been substantial progress in preparing a legal framework and technical infrastructure for establishing a comprehensive mechanism of targeted social assistance from January 1, 2006.

II. POLICY DISCUSSIONS

15. **Discussions focused on the three main components of the authorities' package of disinflation measures:**

- The appropriate degree of exchange rate flexibility and monetary policy tightening.
- The extent to which the automatic fiscal stabilizers should be allowed to work.
- Key structural measures that need to be implemented to contribute to a reduction in inflationary pressures.

16. **The staff also discussed the *ex post* assessment of longer-term program engagement with Azerbaijan and sought the authorities' views on the future of Azerbaijan's relations with the Fund.**

A. Short-term Macroeconomic Outlook

17. **The growth outlook for 2005 remains favorable.** Growth of non-oil GDP is expected to decelerate to 10.3 percent in 2005 from 13.4 percent in 2004, mainly owing to the expected substantial REER appreciation, stemming from large capital inflows and a relatively expansionary policy stance. However, with the completion of the Baku-Tbilisi-Ceyhan oil pipeline scheduled for October 2005, oil production and exports are projected to increase significantly, boosting real GDP growth to almost 19 percent.

18. **The authorities have adopted a multi-pronged strategy to bring down core inflation to single digits by end-2005.** The proposed package includes a commitment to increase refinancing rates, continue with exchange rate appreciation, limit the non-oil fiscal deficit to about 15½ percent of non-oil GDP, improve the monitoring of spending by public enterprises, and strictly enforce anti-monopoly legislation (SLOI, paragraph 14). Although these measures will most likely contribute to a reduction in inflationary pressures, the staff projects core inflation to remain in double digits in 2005, given the high likelihood of further wage growth, increased spending by SOCAR, and continued large capital inflows. The authorities recognized the risks to their inflation forecast under the proposed policy package,

and intend to monitor macroeconomic developments closely and stand ready to tighten their monetary policy stance if needed.

19. **The external position is expected to strengthen in 2005.** The current account deficit would decline to 13.6 percent of GDP, mainly on account of rapid growth of oil export prices and volumes. Strong capital inflows, mainly FDI in the hydrocarbon sector, are projected to contribute to a further increase in gross official reserves to \$1.2 billion (3.7 months of non-oil imports) and a decline in external public and publicly guaranteed debt to 13.5 percent of GDP by year-end. Oil Fund assets are expected to increase to \$1.3 billion by year-end.

20. **The main downside risk to the growth outlook in 2005 is related to a greater-than-expected impact of real effective exchange rate appreciation on the non-oil sector.** The authorities recognize this risk. In this context, they expressed a commitment to step up the implementation of structural reforms, and to consider a tighter fiscal policy stance with more cautious wage policy over the medium term, should there be evidence that competitiveness pressures are hurting non-oil sector development.

B. Monetary and Exchange Rate Policies and Banking System Stability

21. **There was broad agreement that greater exchange rate flexibility is essential for reducing inflationary pressures.** The authorities broadly concurred with the staff assessment that the delayed exit from the de facto fixed peg to the dollar has contributed to inflationary pressures. Against this background, they agreed that greater exchange rate flexibility is needed, but indicated that moving to a float should be a future objective. The authorities underscored that a successful transition to a float could only be achieved once substantial progress has been made in developing money markets, deepening the liquidity of the foreign exchange market dominated by one large supplier, and further improving the forecasting capacity of the ANB (Box 1). In this context, the staff and the authorities agreed that the nominal effective exchange rate should be used as the operational target of monetary policy in the coming months and its appreciation is key for reducing inflation. The staff also called for shifting the focus of ANB's public communication strategy from the exchange rate to the explanation of inflation objectives and risks to the inflation outlook. The authorities broadly agreed with this proposal.

22. **While there is a commitment to tighten monetary policy more aggressively in the near future, the ANB felt that sustained nominal appreciation could pose some risks.** The authorities agreed to accelerate the pace of nominal effective exchange rate appreciation and increase refinancing rates during May–June. However, they felt that the results of these policies should be carefully reassessed in July to determine whether the pace of the tightening of monetary conditions should be changed, given concerns about the banking system's ability to cope with nominal appreciation. The ANB is also facing political constraints limiting its flexibility in exchange rate policy, as vested interest groups and large segments of the population holding U.S. dollar assets are opposed to exchange rate appreciation.

Box 1. How to Ensure a Smooth Transition to a Float

A number of structural reforms are needed over the medium term:

First, a transparent intervention strategy in the foreign exchange market is essential and needs to be devised, in particular given that SOCAR is by far the main supplier of foreign exchange to the market.

Second, the banking system needs to be strengthened by fostering competition and transparent corporate governance. Moreover, the ANB needs to improve its ability to monitor private sector exchange rate risks and use its authority to enforce commercial banks' compliance with foreign exchange exposure limits.

Third, giving priority to price stability, as the sole nominal anchor, requires a significant strengthening of the de facto independence of the ANB, which is de jure enshrined in the new central bank law. Also, determined efforts are needed to enhance ANB's capacity to forecast inflation.

Fourth, the ANB and the ministry of finance should foster the development of money markets by improving the functioning of debt securities markets. In this context, it is encouraging that following up on the recommendations of an MFD technical assistance report, a Protocol Agreement was signed in June 2005, establishing a new debt coordination committee. The main objective of this committee is to design and manage a coherent strategy of treasury and ANB bills of different maturities. Moreover, an interbank swap market became functional in late May 2005.

23. **The staff agreed that the ANB should not commit to any specific exchange rate target until the end of the year, as some flexibility is needed to avoid a conflict between the inflation objective and a precise exchange rate target.** However, it argued that policy interest rates will need to increase until they have become positive in real terms, and the exchange rate should continue to appreciate during the next six months. With respect to potential risks of nominal exchange rate appreciation for the banking system, the staff urged the authorities to establish strict schedules for banks, which did not comply with prudential limits on open positions in foreign exchange, to achieve compliance in the near future. This in turn will provide more flexibility for the ANB to conduct monetary policy.

24. **Credit risk has become the main source of vulnerability for the banking system.** In light of the findings of the FSAP (2004) on weaknesses in credit risk management by commercial banks, and drawbacks in corporate accounting and governance, the authorities share the staff's concern about the quality of the rapidly expanding loan portfolios and indicated that they would strengthen the supervision of credit risks.

C. Fiscal Policy

25. **The initial target for the non-oil fiscal deficit in 2005 was reduced to support disinflation, but there would still be some fiscal relaxation compared to 2004.** On current policies, the non-oil fiscal deficit for 2005 is projected by the staff at 15.4 percent of non-oil GDP, compared with the program target of 16.8 percent, on account of automatic fiscal stabilizers. This reflects the authorities' decision not to spend all additional non-oil revenues. The authorities argued that they expected a lower non-oil deficit than projected by the staff on account of even higher non-oil revenues, which they hoped to collect based on envisaged tax administration measures (SLOI, paragraph 12). The staff emphasized that it would be premature to count on a rapid impact of these measures in the short term.

26. **The staff strongly discouraged the authorities from increasing the minimum wage because of its inflationary impact, which would negatively affect competitiveness⁴ and the purchasing power of the poor.** The authorities were of the view that a 20 percent increase in the minimum wage from October 1, 2005 would only have a small impact on the budget (0.3 percent of non-oil GDP), as the average monthly wage of budgetary employees, which is linked to the minimum wage, will increase by 16.5 percent for the last quarter of 2005. They also disagreed with the staff concern about the potential demonstration impact of the minimum and public sector wage increases on private sector wage decisions and competitiveness. The authorities explained that most private sector employees have wages well above the minimum level, and the main objective of the proposed minimum wage increase was to accelerate poverty reduction in the absence of a comprehensive mechanism of targeted social assistance. However, they made a commitment to reassess their wage policy intentions by September, if core inflation were to remain in double digits.

27. **The authorities also decided to change the composition of financing of the non-oil fiscal deficit to reduce liquidity pressures emanating from the budget.** In particular, net withdrawals from the Oil Fund are projected to decrease because of the net improvement in the non-oil fiscal deficit and an increase in Treasury bill issues by 115 billion manats.

28. **There was agreement that SOCAR's operations have an important macroeconomic impact, given that the size of its budget is comparable to that of the state budget.** The authorities reassured the staff that SOCAR would pay in cash its current tax liabilities from the second quarter of 2005, as required by the 2005 budget law and the newly issued anti-inflation decree (SLOI, paragraph 20). Moreover, several steps targeting the improvement of quarterly monitoring of the recently approved 2005 budgets of state-owned enterprises, including SOCAR, have been implemented (SLOI, paragraph 11). Finally, the authorities are committed to take additional steps to increase taxation of higher-

⁴ If the intended increase is implemented, Azerbaijan's minimum wage would reach about \$30 per month and would exceed the current level of Russia's minimum wage.

than-budgeted oil revenues and improve corporate governance of SOCAR, in consultation with the World Bank, already in 2005 (SLOI, paragraphs 21 and 21).⁵

D. Structural Reforms

29. The authorities indicated that during the course of the year, they would follow through with the important structural measures initiated in the context of this review:

- Effectively implementing the decisions to improve the budget preparation process starting with the 2006 draft budget, and approving a medium-term program for further improvements, including a transition to program budgeting, in cooperation with the World Bank staff.
- Adhering to the timetable for the public sector employment reform to contain the increase of the wage bill in the medium term.
- Making further progress toward completing the establishment of a targeted social assistance mechanism by January 1, 2006.

30. The authorities also attach great importance to measures aimed at improving governance and the business climate, owing to their beneficial impact on the supply side of the economy and competitiveness. In particular, they will intensify their efforts in the fight against corruption through determined implementation of the recently enacted anti-corruption law. Moreover, legal steps will be taken against artificial monopolies, and the anti-monopoly agency will be strengthened (SLOI, paragraphs 23). Also, a new anti-monopoly code will be submitted to Parliament by July 2005. Finally, the authorities will submit a new draft investment law to Parliament in the near future, taking into account World Bank staff advice.

E. Medium-term Sustainability and Capacity to Repay the Fund

31. The medium-term fiscal and external outlooks are favorable and Azerbaijan's risk of debt servicing problems is very low. The fiscal position is projected to remain consistent with the authorities' long-term objective of maintaining constant real consumption out of oil wealth under current WEO oil price projections,⁶ provided there is continued progress in reducing energy subsidies in the medium term (Text Table and Figure 5). In this regard, the staff is encouraged by the authorities' indication that they would further reduce energy subsidies in 2006. The external outlook would improve substantially over the medium

⁵ The additional oil revenue, which SOCAR would retain owing to higher-than-budget prices, is estimated by the staff at 7.9 percent of non-oil GDP in 2005.

⁶ This approach to oil wealth management allows for front-loaded consumption out of oil wealth relative to the size of the non-oil economy (Figure 5).

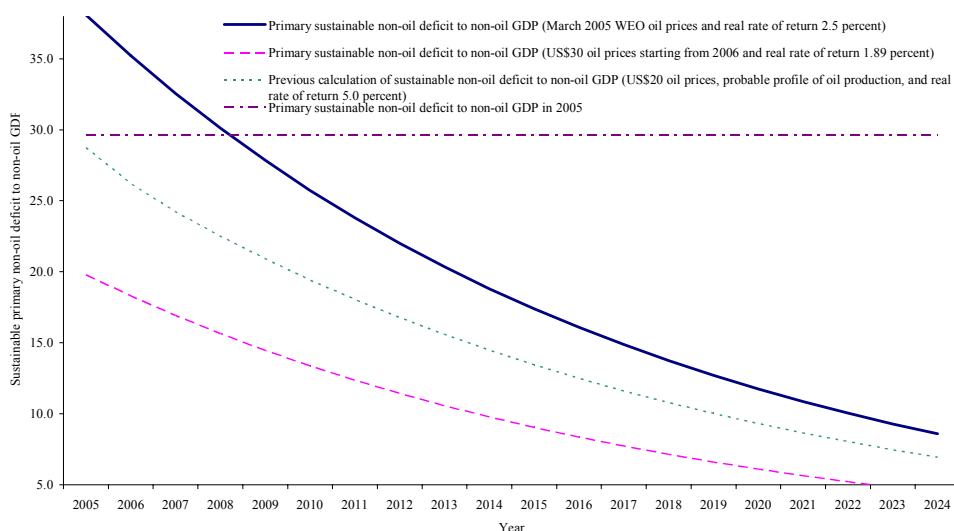
term, as the current account balance is projected to shift into surplus by 2006 and external public and publicly guaranteed debt is projected to decline to 9 percent of GDP by 2010, owing to an increase in oil exports. This said, Azerbaijan remains vulnerable to a large decline in oil prices, given the relatively fast pace of depletion of hydrocarbon wealth and slow progress in export diversification. In this regard, the authorities agreed that the acceleration in the pace of structural reforms is key to improved competitiveness and longer-term external sustainability.

Text Table. Azerbaijan: Non-oil Fiscal Deficit and Non-oil Primary Balance
(In percent of projected non-oil GDP)

	2005 proj.
Non-oil fiscal deficit (program definition)	15.4
Total adjustments:	14.2
Explicit subsidies	4.7
Implicit subsidies (estimates)	12.4
VAT and Excises on oil and gas	-2.5
Interest paid by the budget	-0.3
Non-oil primary balance	29.6

Source: Azeri authorities; and Fund staff estimates.

Figure 5. Azerbaijan: Program Fiscal Target and Primary Sustainable Non-Oil Deficit
(In percent of Non-Oil GDP)



Source: Azeri authorities; and Fund staff estimates.

32. Azerbaijan has had an excellent track record in servicing its external debt.

Azerbaijan has serviced its external debt to the Fund in a timely manner, and the staff expects this to continue. A minor technical problem in servicing a loan to a bilateral creditor in 2004 has been fully resolved, and the staff supports the authorities' request for the nonobservance of the continuous PC on non-accumulation of external payments arrears. The status of negotiations on Azerbaijan's disputed external obligations with Kazakhstan, Turkmenistan, and Uzbekistan has remained unchanged since 2003.

F. Future Fund Engagement

33. Since 1994, the Fund has provided almost continuous financial support to

Azerbaijan. The staff has prepared an *ex post* assessment (EPA) of Azerbaijan's longer-term program engagement with the Fund, which concludes that on balance, prolonged use of Fund resources by Azerbaijan was justified (Box 2). Although there is no balance of payments need in the medium term, the EPA recommends a successor Fund arrangement, given the macroeconomic nature of the risks and the need to continue with Fund core reforms that will help Azerbaijan avoid the resource revenue curse.

34. The authorities broadly agreed with the main conclusions and recommendations of the EPA. They expressed satisfaction with Azerbaijan's longer-term program engagement with the Fund and recognized that Fund support played an important role in the process of transition and nation building. With respect to macroeconomic policies, the authorities indicated that they did not fully agree with the EPA's assessment of monetary policy as passive, as they exercised some flexibility in the conduct of monetary and exchange rate policies, when warranted by macroeconomic conditions. Moreover, they disagreed with the EPA criticism of insufficient exchange rate flexibility in the wake of the Russian crisis (1998), which ultimately led to deflation. Finally, the authorities expressed a view that the report tends to overemphasize the macroeconomic risks going forward in light of their determination to address inflationary pressures. With respect to structural reforms, the authorities acknowledged that nominal implementation of certain measures was one of the reasons for shortcomings in program implementation, but they felt the EPA did not give them sufficient credit for their recent efforts in the fight against corruption. Looking forward, the authorities agreed that the country faces important macroeconomic risks, and reforms in the Fund core areas should continue. Against this background, they expressed interest in a successor arrangement.

Box 2. Ex Post Assessment: Main Lessons and Recommendations

On balance, prolonged use of Fund resources by Azerbaijan was justified. The outcomes of the ten-year engagement with the Fund are quite positive. Growth objectives were largely achieved, poverty declined to 40.2 percent in 2004 from about 60 percent in 1994, and Azerbaijan's current fiscal and external positions are sustainable. While most annual inflation targets were met, at times, deviations from program inflation targets were large, reflecting in part, the nonobservance by the authorities of their commitments under the program, and, in part, deficiencies in program design.

Key lessons and challenges ahead:

- **Longer-term program engagement made a substantial contribution to the process of nation building and progress in transition to a market economy in Azerbaijan.** However, the transition process turned out to be more complex and took longer than expected, and the reform agenda is by no means completed.
- **On the macroeconomic front,** the main lesson is that a combination of exchange rate pegs, underdeveloped monetary policy instruments, and a lack of effective control on the consolidated public sector position is not conducive to maintaining macroeconomic stability in the presence of frequent, large exogenous shocks. The program design, monitoring, and quantitative conditionality framework should have embedded appropriate incentives and mechanisms for timely adjustment to shocks.
- **On the structural front,** the Fund contributed to the strengthening of national institutions, such as the central bank, tax administration, and the ministry of finance. Jointly with the World Bank, Fund programs achieved significant progress in the privatization of small- and medium-size companies, and trade and price liberalization. However, progress in financial and energy sector reforms fell short of program expectations, and problems with the business environment and governance have persisted.
- **Looking forward,** Azerbaijan faces a medium-term challenge of ensuring sustainable growth of non-oil output, export diversification, and poverty reduction in a stable macroeconomic environment at a time when oil revenues are projected to increase substantially.
- **Key remaining reforms include** the development of a new operational framework for monetary and exchange rate policies; improvements to monitoring of revenues and expenditures of state-owned enterprises, including SOCAR; and steps to foster competition, innovation, and growth in the banking system.

III. STAFF APPRAISAL

35. **Azerbaijan's growth performance has been impressive, but double-digit inflation is an issue of concern.** While double-digit growth of non-oil output is commendable and was key to poverty reduction, the recent increase in inflation to double digits, if sustained for a prolonged period of time, could seriously undermine the authorities' anti-poverty strategy and reduce the medium-term growth potential of the economy.

36. **The staff is encouraged by the authorities' decision to allow for greater exchange rate flexibility and to tighten monetary conditions.** The de facto fixed exchange rate

regime helped maintain low inflation through end-2003. However, its inconsistency with low inflation, against the background of large capital inflows and increased spending out of oil wealth, was not recognized early enough. In early 2005, it became obvious that inflationary pressures reflected more underlying macroeconomic conditions rather than temporary one-off factors. The recent acceleration in the pace of exchange rate appreciation and the increase in policy interest rates are steps in the right direction, and the authorities should maintain the current pace of exchange rate appreciation in nominal effective terms until strong evidence of a sustained reduction in inflation has emerged. The staff also welcomes the authorities' recent decision to move toward greater exchange rate flexibility and strongly encourages them to implement their plans for supporting structural measures.

37. **Banking system risks should be carefully monitored and transparency should be ensured in the privatization of the two remaining state-owned banks.** The ANB should fully use its legal authority on banking supervision and intensify efforts at supervising credit risks. Moreover, the exposure of all banks to foreign exchange risks should be brought in compliance with prudential regulations without delay. In this regard, the ANB should abide by its commitment to a zero tolerance approach to non-compliance with prudential regulations and strictly monitor the approved schedules for non-compliant banks. Finally, the recent decision to speed up the privatization of the two remaining state-owned banks is welcome, but the authorities should ensure transparency in organizing privatization tenders, consistent with best international practice.

38. **Prudent fiscal policy is equally important for successful disinflation.** While a significant reduction in the non-oil fiscal deficit in 2004 is commendable, the main lesson from the implementation of economic policies in 2004 is that prudent management of the budgets of public enterprises is also important for achieving program macroeconomic objectives. The staff supports the authorities' decision to allow fiscal stabilizers to work and reduce the non-oil fiscal deficit in 2005, compared to the initial program target, by saving a portion of the significantly higher non-oil revenues. It also welcomes the political commitment to collect SOCAR's tax liabilities in cash from the second quarter of 2005 and improve monitoring of SOCAR's spending.

39. **The intention to increase the minimum wage, which would also result in an increase in public sector wages, has risks.** The staff believes that the short-term poverty alleviation impact of the proposed wage increase could be outweighed by risks to macroeconomic stability, competitiveness, and employment as well as by the potential negative impact on the purchasing power of the unemployed poor.

40. **Fiscal reforms should continue.** Recent decisions on the improvement of the budget formulation process, the revival of plans for civil service reform, and substantial steps toward establishing targeted social assistance are welcome, but would need to be fully implemented in the context of the preparation of the 2006 draft budget to ensure the achievement of poverty reduction goals and fiscal sustainability. The staff also welcomes the authorities' commitment to important measures related to the improvement of taxation and corporate governance of public enterprises, including SOCAR, and urges the authorities to implement

these measures in 2005, given their critical importance for macroeconomic stabilization and transparency.

41. **Further improvements to governance and the business environment are of paramount importance for medium-term growth sustainability in a low-inflation environment.** Strong political support on the part of the highest political authorities is needed to effectively implement the newly enacted anti-corruption law. Moreover, instances of monopolistic behavior should be fully investigated based on the existing anti-monopoly legislation. Finally, the authorities should speed up the passage of the new investment law.

42. **The medium-term external and fiscal position appears sustainable, provided implicit energy subsidies are further reduced and structural reforms are accelerated.** With respect to fiscal sustainability, energy subsidies should be reduced to leave more resources available for targeted social assistance and productive expenditure and ensure longer-run fiscal sustainability. External sustainability, in turn, crucially depends on the ability to diversify the economy under conditions of a significant real appreciation that is likely to occur on account of the political decision to adopt a permanent income approach to oil wealth management, which calls for upfront spending of oil revenues.

43. **Notwithstanding the policy understandings reached between the staff and the authorities for the completion of this review, the authorities' economic program for 2005 is subject to macroeconomic and political risks.** It will be difficult to achieve single-digit core inflation by end-2005, particularly if the authorities went ahead with their decision to increase wages and are insufficiently aggressive on the monetary policy and exchange rate fronts. Delays in enforcing SOCAR's compliance with its budget would also add to inflationary pressures. Despite these risks, the authorities have reassured the staff that they would take additional measures if necessary, to ensure that inflation does not get out of control and stressed that completion of this review would reinforce the political ability of key policy makers to maintain the reform momentum in a difficult political environment ahead of the upcoming November elections.

44. **Given the identified risks and conclusions of the EPA, the staff encourages the authorities to continue to implement staff recommendations after the expiration of this PRGF arrangement.** In this regard, a clear demonstration by the authorities of strong commitment to reduce inflation rates, activate indirect instruments of monetary policy, and improve taxation and corporate governance of state-owned enterprises, including SOCAR, would lay a good basis for initiating discussions on a possible successor Fund-supported program.

45. In light of satisfactory compliance with program conditionality and the authorities' expressed commitment to maintain exchange and interest rate policies under review so as to ensure a steady decline in core inflation by year-end, and to continue with their structural reform program, the staff supports the authorities' requests for waivers of nonobservance of performance criteria and completion of the fifth review. It also welcomes the authorities' decision to forego the last purchase under the PRGF arrangement.

Table 1. Azerbaijan: Selected Economic and Financial Indicators, 2001–05

	2001	2002	2003	Prog 2004	Act. 2005	Prog 2005	Proj.
(Annual percentage change, unless otherwise specified)							
GDP at current prices	12.7	14.1	17.9	20.5	17.2	27.7	40.6
GDP at constant prices	6.5	8.1	11.5	7.8	10.2	21.6	18.7
<i>Of which:</i> Oil sector	7.9	3.9	0.4	-1.1	2.5	39.7	40.3
Other sectors	7.9	10.5	16.9	12.1	13.4	10.3	10.3
Implicit GDP deflator	5.8	5.5	5.7	11.8	6.4	5.0	18.5
Consumer price index (end-period)	1.3	3.3	3.6	10.0	10.4	5.0	12.0
Core consumer price index 1/	1.6	4.0	4.3	...	10.8	...	11.0
Consolidated government finance 2/							
Total revenue	0.8	34.1	14.6	25.2	25.9	38.4	42.0
Total expenditure	0.9	36.8	21.1	12.1	11.9	30.5	36.0
<i>Of which:</i> Current expenditure	5.0	15.3	19.5	21.0	21.6	28.4	32.9
Investment expenditure	-23.2	210.3	26.1	-13.1	-15.5	38.6	49.0
Investment expenditure (net of BTC)	-23.2	163.2	8.7	18.2	9.9	33.6	44.8
Money and credit 3/							
Net foreign assets	31.0	4.7	16.4	21.9	29.9	19.9	9.3
Net domestic assets	-1.5	8.4	12.9	17.7	17.5	2.2	27.2
Domestic credit	0.1	11.7	17.6	22.4	28.3	4.8	25.1
<i>Of which:</i> Credit to the economy	-14.8	9.1	21.4	30.5	36.0	9.9	29.3
Manat broad money (average, annual changes)	9.7	18.8	36.6	44.8	45.6	44.3	46.1
Foreign currency deposits (level, as a ratio to broad money)	48.0	46.9	47.4	50.8	53.0	46.5	53.5
Income velocity of average manat broad money (M2) 4/	11.3	11.6	11.3	9.9	10.1	9.0	9.8
External sector (in US\$)							
Exports f.o.b.	13.7	12.7	13.9	41.7	42.6	36.6	48.3
<i>Of which:</i> Oil sector	21.1	11.1	10.0	34.7	37.6	47.4	61.1
Imports f.o.b.	-4.8	24.5	49.3	26.6	31.5	6.6	22.2
<i>Of which:</i> Oil sector	-5.5	142.7	230.1	43.6	46.5	-1.4	16.1
Export volumes	31.8	15.2	2.9	15.8	18.5	34.9	19.6
Import volumes	-2.4	20.7	42.2	20.1	19.1	6.6	15.3
Terms of trade	-12.1	-5.1	5.4	16.1	9.1	1.2	17.0
Real effective exchange rate (- deprec.)	-6.1	-7.5	-11.3	...	-2.0	...	...
(In percent of GDP, unless otherwise specified)							
Gross investment	20.7	34.6	50.2	54.5	48.5	39.9	38.6
Consolidated government 5/	2.1	4.8	4.4	4.4	4.1	4.8	4.2
Private sector	18.6	29.8	45.8	50.1	44.4	35.2	34.3
<i>Of which:</i> Oil sector	14.6	26.9	41.4	40.5	39.2	26.9	21.1
Gross domestic savings	24.3	27.3	26.7	33.1	24.2	41.1	34.0
Gross national savings	19.8	22.2	22.5	27.3	18.2	33.4	25.0
Consolidated government	1.6	5.1	4.8	5.3	5.1	6.9	6.4
Private sector	18.2	17.1	17.7	22.0	13.0	26.4	18.6
Consolidated government finance 2/							
Total revenue and grants	18.7	22.0	21.3	22.6	22.8	24.5	23.1
Total expenditure	18.7	22.4	23.0	21.8	22.0	22.3	21.3
Overall fiscal balance	-0.4	-0.5	-1.2	0.9	0.8	2.2	1.8
Overall fiscal balance (net of BTC, in percent of non-oil GDP)	-0.6	0.5	0.6	1.3	1.5	3.8	3.6
Statistical discrepancy	0.4	0.1	-0.5	...	...	...	...
Non-oil deficit 6/							
As a share of GDP	-7.1	-10.3	-10.8	-9.7	-8.7	-10.4	-9.4
As a share of GDP net of BTC	-7.1	-9.5	-9.2	-9.7	-8.5	-10.2	-9.1
As a share of non-oil GDP	-10.4	-14.9	-15.5	-14.4	-12.6	-16.8	-15.4
As a share of non-oil GDP net of BTC	-10.4	-13.7	-13.2	-14.4	-12.2	-16.5	-14.8
External sector							
Current account (- deficit)	-0.9	-12.3	-27.7	-27.1	-30.3	-6.6	-13.6
Foreign direct investment (net)	5.1	16.8	31.5	29.4	27.3	11.7	9.3
Public and publicly guaranteed external debt outstanding	20.2	20.1	19.7	17.5	18.6	14.6	13.5
External debt service ratio (including IMF) 7/	4.9	4.4	5.2	3.7	3.6	2.5	1.9
Memorandum items:							
Gross official external reserves (US\$ millions) 8/	725	721	803	923	1,075	1,181	1,165
Nominal GDP (in manat billion)	26,578	30,312	35,733	42,246	41,873	53,929	58,881
Nominal GDP (US\$ millions)	5,708	6,236	7,276	8,598	8,523	10,988	12,662
Nominal non-oil GDP (in manat billion)	18,072	20,901	24,975	28,415	29,022	33,217	36,069
Nominal GDP per capita (in US\$)	701	760	879	1,031	1,022	1,307	1,506
Oil Fund Assets (US\$million, end-period stock)	493	693	821	981	974	1,322	1,320
Population (midyear, in million)	8.1	8.2	8.3	8.3	8.3	8.4	8.4

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

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

2/ Excludes the increased revenues and expenditures from including SOCAR's quasi-fiscal activities in the budget.

3/ In percent of beginning of the year broad money (M3) stock, unless otherwise specified.

4/ In terms of non-oil GDP.

5/ For 2002 and 2003 includes investments of US\$50 million and US\$121.5 million, respectively, for the government's share in BTC, equivalent to 0.8 percent and 1.7 percent of GDP, respectively.

6/ Calculated by deducting Oil Fund, AIOC, and SOCAR revenues from the consolidated government budget balance.

7/ In percent of exports of goods and services.

8/ Excluding Oil Fund assets.

Table 2. Azerbaijan: Monetary Survey, 2001–05 1/
(In billions of manats, unless otherwise indicated)

	2001		2002		2003		2004		2005	
	December		December		December		December		March	
	Prog.	Act.	Prog.	Act.	Prog.	Act.	Prog.	Act.	Prog.	Act.
Net foreign assets	2,431	2,590	3,214	4,294	4,687	4,375	5,663	5,361	4,542	4,735
Net international reserves of the ANB (convertible)	1,969	2,130	2,681	3,396	4,169	3,723	4,707	4,501	3,735	4,707
Net foreign assets of commercial banks (convertible)	454	464	533	902	535	678	886	886	811	960
Other	8	-4	1	-4	-17	-26	-4	-26	-4	-4
Net domestic assets	943	1,224	1,718	2,590	2,580	2,625	2,738	4,559	2,286	2,625
Domestic credit	2,232	2,625	3,295	4,401	4,688	4,972	4,730	6,510	4,143	4,972
Net claims on general government	405	493	346	-54	-35	-280	-342	-342	-267	-280
Credit to the economy	1,826	2,132	2,949	4,455	4,724	5,251	6,852	6,852	4,410	5,251
Other items (net)	-1,289	-1,400	-1,577	-1,812	-2,109	-2,346	-1,951	-1,951	-1,857	-2,346
Broad money	3,373	3,814	4,933	6,884	7,267	7,000	8,401	9,920	6,828	7,000
Manat broad money	1,753	2,026	2,592	3,385	3,418	3,173	4,499	4,611	3,248	3,173
Currency outside banks	1,469	1,669	2,041	2,346	2,389	2,212	3,193	3,091	2,199	2,212
Manat deposits	284	357	551	1,039	1,029	961	1,306	1,519	1,049	961
Foreign currency deposits	1,620	1,789	2,341	3,499	3,849	3,827	3,902	5,309	3,580	3,827
Net foreign assets	31.0	4.7	16.4	21.9	29.9	-4.3	19.9	9.3	3.6	-4.3
Net domestic assets	-1.5	8.4	12.9	17.7	17.5	0.6	2.2	27.2	-4.4	0.6
Domestic credit	0.1	11.7	17.6	22.4	28.3	3.9	4.8	25.1	-3.8	3.9
Credit to the economy	-14.8	9.1	21.4	30.5	36.0	7.3	9.9	29.3	-0.7	7.3
Broad money (M3) (percentage change)	23.9	22.4	25.1	37.8	39.7	21.3	28.4	37.7	-0.8	22.0
Average broad money (M3) (percentage change)	9.7	18.8	36.6	44.8	45.6	14.2	44.3	46.1	15.2	14.2
Currency as a ratio to broad money	43.6	43.7	41.4	34.1	32.9	31.6	38.0	31.2	32.2	31.6
Foreign currency deposits as a ratio to broad money	48.0	46.9	47.4	50.8	53.0	54.7	46.5	53.5	52.4	54.7
Memorandum items:										
Gross international official reserves (US\$ millions)	725	721	803	923	1,075	983	1,181	1,165	985	983
Net international official reserves (US\$ millions)	427	462	582	737	905	808	1,022	1,020	811	808
Velocity of total broad money (M3) 3/	6.5	6.1	6.0	4.9	5.0	...	4.4	4.6	...	...
Reserve money 2/	1.7	13.7	23.4	37.8	63.3	-21.4	20.6	-0.8	-3.4	-21.4

(Changes in percent of beginning of year total broad money stock, unless otherwise specified 2/)

Sources: Azerbaijan National Bank, and Fund staff estimates.

1/ Accounts are valued at program exchange rates of 4,606 manat per U.S. dollar and 1.26 U.S. dollar per SDR through end-March 2005.

2/ Quarterly figures are cumulative changes year to date.

3/ Velocity is defined as nominal non-oil GDP divided by average broad money.

Table 3. Azerbaijan: Summary Accounts of the Azerbaijan National Bank, 2001–05 1/
(In billions of manats)

	December 2002		2003		2004		2005		
	2001	2002	2003	2004	December		March		
					Prog.	Act.	Prog.	Act.	Prog.	Proj.
Net foreign assets	1,967	2,124	2,677	3,391	4,166	3,730	3,719	4,703	4,497
Net domestic assets	-174	-85	-160	76	-56	-379	-491	-520	-422
Domestic credit	233	240	314	396	331	-60	-108	-293	-453
Net claims on general government	132	154	75	167	112	-279	-312	-484	-611
Net claims on central government	678	457	78	170	115	-276	-309	-481	-608
Pre-2000 oil bonus deposit	-546	-304	-3	-3	-3	-3	-3	-3	-3
World Bank counterpart funds	0	0	0	0	0	0	0	0	0
Claims on banks (excluding ANB bills)	101	86	237	327	315	342	339	389	355
ANB bills	0	0	0	-100	-99	-125	-138	-200	-200
Other items (net)	-407	-325	-474	-319	-387	-320	-383	-226	31
Reserve money	1,793	2,039	2,517	3,468	4,109	3,351	3,228	4,183	4,075
Manat reserve money	1,684	1,872	2,316	3,162	3,200	2,987	2,810	3,708	3,532
Currency in circulation	1,534	1,756	2,169	2,818	2,631	2,673	2,496	3,392	3,301
Bank reserves	145	110	147	343	569	314	313	315	230
Reserves in foreign currencies	109	167	201	306	909	364	419	475	543
Other deposits	5	6	0	0	0	0	0	0	0

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

1/ Accounts are valued at program exchange rates of 4,606 manat per U.S. dollar and 1.26 U.S. dollar per SDR through end-March 2005.

Table 4. Azerbaijan: Consolidated Government Operations, 2003–05

(In billions of manats)

	Q1		Q1		Q1		2005 1/	Rev. Budget	Proj.	
	2003	Prog	Act	Prog	Act	Prog				Prel. Act.
		2004								
Total revenue and grants	9,506	2,402	2,481	11,426	11,441	3,226	3,292	14,663	13,216	15,288
Total revenue	9,477	2,402	2,481	11,376	11,441	3,226	3,292	14,613	13,166	15,238
Tax revenue	5,494	1,367	1,454	6,663	6,587	1,948	2,054	9,146	9,149	9,715
Income tax	1,644	355	574	2,156	2,225	661	795	2,695	3,151	3,030
Individual income tax	752	156	189	1,075	1,108	257	330	1,200	1,300	1,347
Enterprise profits tax	891	200	385	1,080	1,117	404	465	1,495	1,851	1,683
Social security contributions	745	200	179	848	909	206	226	982	982	1,000
Value added tax (VAT)	2,049	480	522	2,386	2,263	596	608	2,831	2,904	2,877
Excise taxes	335	74	22	377	362	144	155	663	675	688
Taxes on international trade	463	197	86	581	507	250	152	1,583	1,050	1,720
Of which: SOCAR additional revenue	126	82	0	184	150	85	0	610	0	799
Other taxes	258	61	71	316	320	90	118	393	387	399
Nontax revenue 2/	2,088	535	334	2,830	2,957	868	768	3,997	2,331	3,837
Of which: Oil Fund revenues 3/	1,211	305	152	1,695	1,516	598	365	2,792	1,078	2,542
Tax credits for SOCAR energy subsidies 4/	1,895	500	693	1,882	1,897	410	471	1,470	1,686	1,686
Total grants (current)	28	0	0	50	0	0	0	50	50	50
Total expenditure	10,114	2,395	2,256	11,099	11,097	2,749	3,010	13,495	14,501	14,201
Current expenditure	7,972	2,009	2,073	9,238	9,287	2,320	2,360	10,917	...	11,504
Primary current expenditure	5,995	1,481	1,365	7,257	7,296	1,875	1,877	9,315	...	9,694
Wages and salaries	1,579	457	418	2,115	2,117	610	606	2,876	2,991	2,991
Goods and services	2,012	382	365	2,503	2,479	522	540	3,098	...	3,293
Transfers to households	2,192	609	548	2,438	2,516	706	699	3,166	...	3,226
Of which: social protection	1,855	493	438	1,971	2,020	551	551	2,479	...	2,538
Subsidies	162	28	21	139	136	27	17	110	120	120
Oil Fund (operating expenditures)	4	1	0	4	3	1	1	14	14	14
Other	46	4	12	58	44	8	13	50	...	50
SOCAR energy related subsidies 4/	1,895	500	693	1,882	1,897	410	471	1,470	1,686	1,686
Interest	82	28	15	98	93	34	12	130	130	123
Current balance (-, deficit)	1,534	393	407	2,188	2,154	906	932	3,747	...	3,784
Investment expenditure and net lending	2,142	386	183	1,861	1,810	429	650	2,578	2,838	2,697
Domestically-financed	1,522	262	130	1,267	1,218	256	577	1,834	2,094	2,005
without BTC loan	946	262	125	1,267	1,129	256	577	1,729	1,889	1,800
Foreign-financed	620	124	53	593	592	173	73	744	744	693
Statistical discrepancy 5/	-184	0	55	-36	1	0	0	0	0	0
Consolidated government balance, cash basis (-, deficit)	-425	8	170	363	344	476	283	1,168	-1,285	1,086
Excluding foreign project loans	195	131	223	956	935	650	356	1,912	-541	1,779
Non-oil balance	-3,865	-968	-387	-4,105	-3,643	-979	-784	-5,590	-5,718	-5,546
Financing	425	-8	-170	-363	-344	-476	-283	-1,168	1,285	-1,086
Domestic (net)	-611	-131	-231	-1,062	-1,020	-649	-356	-1,980	473	-1,842
Banking system	-73	-98	-269	-396	-379	-214	-244	-355	...	-307
Of which: Treasury bills	-34	14	-61	-60	-99	21	0	85	200	200
Oil Fund	-640	-61	-19	-833	-788	-459	-94	-1,721	...	-1,096
Nonbank sector	5	3	2	7	5	2	1	6	...	6
Privatizations and other sale of assets	98	25	53	160	157	23	32	90	190	90
Other	0	0	2	0	-17	0	-50	0	0	-534
External (net)	1,035	124	61	699	677	173	73	812	812	755
Loans	1,123	143	82	776	756	206	95	910	910	849
Project loans	666	143	74	650	650	206	95	812	812	759
Oil bonuses	288	0	8	27	106	0	0	0	0	0
World Bank PRSC	169	0	0	98	0	0	0	98	98	91
Amortization due	-88	-19	-21	-77	-80	-34	-22	-98	-98	-94
Financing gap	0	0	0	0	0	0	0	0	0	0
Memorandum items:										
Oil revenue 6/	3,440	...	557	4,467	3,986	1,456	1,066	6,758	4,433	6,632
Non-oil revenue 7/	4,170	...	1,231	5,077	5,558	1,360	1,756	6,435	7,097	6,970

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

1/ The program column reflects the initially approved 2005 budget on the basis of earlier WEO oil price projections (US\$42.75 per barrel), and staff's estimates of non-oil revenues. The revised budget column reflects the 2005 budget (based on a US\$25 per barrel oil price) with proposed amendments on which detailed data on the economic classification of expenditures are not available yet. Expenditure numbers in this column do not reflect the authorities' commitment to save about 300 bln. manats presented in the SLOI, paragraph 18. The projection column reflects the March 2005 WEO oil price projections (US\$49.5 per barrel), staff's estimates of non-oil revenues, and the authorities' commitment to save about 300 bln. manats presented in the SLOI, paragraph 18.

2/ Starting from 2004 includes contingent revenues accrued on the "deposit account" of budgetary organizations.

3/ 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.

4/ Tax credits for SOCAR energy subsidies for the third and fourth quarters of 2004 were allocated in the 2005 calendar year. Tax credits for the first quarter of 2005 have not been allocated yet.

5/ Statistical discrepancy of 189.2 bln. manat in the first quarter of 2005 is eliminated assuming that expenditures during the rest of the year will be less by the same amount.

6/ Excludes SOCAR tax credits for energy subsidies.

7/ Including grants.

Table 5. Azerbaijan: Selected Fiscal Indicators, 2001–05
(In percent of non-oil GDP, unless otherwise indicated)

	2001	2002	2003	Prog.	Act.	Prog.	Rev. budget	Proj.
				2004 1/		2005 2/	2005 2/	
Total revenue and grants	27.5	39.6	38.1	40.2	39.4	44.1	36.6	42.4
Total revenue	27.3	39.3	37.9	40.0	39.4	44.0	36.5	42.2
Of which : Tax revenue	21.5	21.9	22.0	23.5	22.7	27.5	25.4	26.9
Nontax revenue	5.8	9.8	8.4	10.0	10.2	12.0	6.5	10.6
Tax credits for SOCAR energy subsidies	...	7.7	7.6	6.6	6.5	4.4	4.7	4.7
Of which : Oil revenue 3/	9.8	21.9	21.4	22.3	20.3	24.8	17.0	23.1
Non-oil revenue	17.5	17.4	16.6	17.7	19.2	19.2	19.5	19.2
Total grants (current)	0.2	0.3	0.1	0.2	0.0	0.2	0.1	0.1
Total expenditure	27.4	40.1	40.5	39.1	38.2	40.6	40.2	39.4
Primary expenditure	27.1	32.1	32.6	32.1	31.4	35.8	...	34.4
Primary current expenditure	24.0	23.9	24.0	25.5	25.1	28.0	...	26.9
Of which : Wage bill	6.6	6.1	6.3	7.4	7.3	8.7	8.3	8.3
Goods and services	6.6	6.5	8.1	8.8	8.5	9.3	...	9.1
Transfers	9.2	9.3	8.8	8.6	8.7	9.5	...	8.9
Domestically financed investment and net lending 4/	1.6	4.2	6.1	4.5	4.2	5.5	5.8	5.6
Foreign-financed investment	1.5	3.9	2.5	2.1	2.0	2.2	2.1	1.9
SOCAR energy related subsidies	...	7.7	7.6	6.6	6.5	4.4	4.7	4.7
Interest on public debt	0.4	0.4	0.3	0.3	0.3	0.4	0.4	0.3
Wages/primary current expenditure (in percentage)	27.3	25.5	26.3	29.1	29.0	30.9	...	30.9
Transfers/primary current expenditure (in percentage)	38.3	38.8	36.6	33.6	34.5	34.0	...	33.3
Wages/non-oil revenue (in percentage)	37.5	35.2	38.1	41.7	38.1	45.0	...	43.2
Transfers/non-oil revenue (in percentage)	52.7	53.4	52.9	48.0	45.3	49.6	...	46.6
Expenditure in education and health	6.3	6.5	5.8	6.8	5.4	7.1	...	6.5
Education	5.1	5.2	4.7	5.4	4.4	5.4	...	4.9
Health	1.2	1.3	1.1	1.4	1.0	1.7	...	1.6
Military expenditure	2.7	2.9	2.7	3.2	2.4	3.6	4.1	4.0
Current expenditure	24.4	32.0	31.9	32.5	32.0	32.9	...	31.9
Investment expenditure (net of BTC)	3.0	6.9	6.3	6.5	5.9	7.4	...	6.9
Current balance (+, surplus)	3.0	7.6	6.1	7.7	7.4	11.3	...	10.5
Primary balance (+, surplus)	-0.3	-0.3	-1.4	1.6	1.5	3.9	...	3.4
Primary balance, excluding oil (+, surplus)	-10.1	-14.6	-15.1	-14.1	-12.2	-16.4	...	-15.0
Primary balance (excl. externally financed investment)	1.2	3.6	1.1	3.7	3.5	6.1	...	5.3
Consolidated government balance, cash basis (+, surplus)	-0.6	-0.7	-1.7	1.3	1.2	3.5	-3.6	3.0
Non-oil Balance 5/								
- In percent of total GDP	-7.1	-10.3	-10.8	-9.7	-8.7	-10.4	-9.7	-9.4
- In percent of total GDP (net of BTC)	-7.1	-9.5	-9.2	-9.7	-8.5	-10.2	-9.4	-9.1
- In percent of non-oil GDP	-10.4	-14.9	-15.5	-14.4	-12.6	-16.8	-15.9	-15.4
- In percent of non-oil GDP (net of BTC)	-10.4	-13.7	-13.2	-14.4	-12.2	-16.5	-15.3	-14.8
Memorandum items:								
Total external assistance, excluding IMF	1.6	4.8	3.3	2.6	2.2	2.7	2.5	2.4
Project financing	1.6	4.1	2.7	2.3	2.2	2.4	2.3	2.1
Program financing	0.0	0.7	0.7	0.3	0.0	0.3	0.3	0.3
Financing gap	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0

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

1/ Program column ratios for oil revenues, non-oil revenues, and primary non-oil balance have been corrected. Nominal values for these items remained unchanged.

2/ The program column reflects the initially approved 2005 budget on the basis of earlier WEO oil price projections (US\$42.75 per barrel), and staff's estimates of non-oil revenues. The revised budget column reflects the 2005 budget (based on a US\$25 per barrel oil price) with proposed amendments on which detailed data on the economic classification of expenditures are not available yet. Expenditure numbers in this column do not reflect the authorities' commitment to save about 300 bln. manats presented in the SLOI, paragraph 18. The projection column reflects the March 2005 WEO oil price projections (US\$49.5 per barrel), staff's estimates of non-oil revenues, and the authorities' commitment to save about 300 bln. manats presented in the SLOI, paragraph 18.

3/ Starting from 2002 includes SOCAR tax credits for energy subsidies.

4/ Investment expenditure increases by 1.2 percent of non-oil GDP (0.8 percent of GDP) in 2002 and by 2.4 percent of non-oil GDP (1.7 percent of GDP) in 2003 due to an equity investment by the government in BTC Azerbaijan.

5/ Calculated by deducting Oil Fund, AIOC and SOCAR revenues from the consolidated government budget balance.

Table 6. Azerbaijan: Balance of Payments, 2002–05

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

	Actual		Prog.	Act.	Q1		Annual	
	2002	2003			2004	2005	2005	2005
Exports, f.o.b.	2,305	2,625	3,718	3,743	1,206	931	5,079	5,552
<i>Of which:</i> Oil and oil products	2,046	2,250	3,031	3,097	1,067	803	4,468	4,989
Other	259	374	688	647	140	128	611	563
Imports, f.o.b.	-1,823	-2,723	-3,447	-3,581	-890	-1,130	-3,674	-4,375
<i>Of which:</i> Oil sector	-336	-1,109	-1,592	-1,624	-352	-694	-1,570	-1,885
Other	-1,487	-1,614	-1,855	-1,957	-538	-436	-2,104	-2,490
Trade balance	482	-98	272	162	316	-200	1,405	1,177
Services (net)	-936	-1,613	-2,114	-2,238	-366	-262	-1,280	-1,762
Credit	362	436	487	492	125	123	542	542
Debit	-1,298	-2,049	-2,601	-2,729	-491	-385	-1,822	-2,305
<i>Of which:</i> Oil and gas sectors	-868	-1,505	-1,939	-1,953	-301	-190	-1,119	-1,350
Income	-386	-442	-678	-703	-212	-210	-1,050	-1,402
Investment income (net)	-326	-374	-573	-570	-187	-185	-952	-1,282
<i>Of which:</i> Profit of oil consortium	-344	-386	-547	-521	-200	-168	-971	-1,179
Compensation of employees	-39	-50	-70	-98	-18	-22	-70	-98
Interest on public debt (including Fund)	-20	-19	-35	-34	-7	-4	-28	-22
Transfers (net)	70	134	191	192	50	48	204	267
Private	15	77	118	134	33	33	135	199
Public	55	57	74	57	17	15	68	68
Current account balance	-769	-2,019	-2,328	-2,587	-211	-624	-722	-1,720
Net direct investment	1,048	2,353	2,531	2,351	303	375	1,282	1,173
Oil companies	984	2,315	2,484	2,258	289	355	1,225	1,091
Contracted (net)	1,613	2,972	3,438	3,391	702	680	2,902	3,126
Capital repatriation	-629	-716	-960	-1,154	-412	-325	-1,676	-2,034
Bonus	0	60	6	22	0	0	0	0
Other	64	38	47	93	14	20	57	81
Public sector capital	167	115	103	17	28	6	131	131
Medium long-term borrowing	216	177	165	75	44	20	198	197
Budget support	30	34	20	0	0	0	20	20
Other long-term loans	185	142	145	75	44	20	178	177
Scheduled amortization	-48	-61	-63	-58	-17	-14	-66	-66
Other (including short-term capital)	-135	-115	-7	718	38	158	-93	863
<i>of which:</i>								
BTC-related borrowing	...	...	...	1,095	...	...	...	500
SOCAR borrowing	...	...	...	0	...	...	...	170
Capital account balance	1,080	2,353	2,627	3,086	369	539	1,320	2,166
Errors and omissions	-90	-98	0	-16	0	0	0	0
Overall balance	221	237	298	484	159	-85	599	447
Financing	-221	-237	-298	-484	-159	85	-599	-447
Change in net foreign assets of ANB (-, increase)	-35	-124	-160	-331	-75	98	-287	-101
Net credit from the Fund	-39	-42	-40	-59	-13	6	-29	-11
Disbursements/purchases	10	37	19	0	0	20	19	20
Repayments/repurchases	-49	-79	-59	-59	-13	-14	-48	-31
Change in gross official reserves (-, increase)	4	-82	-120	-272	-62	92	-258	-90
Change in other foreign liabilities (+, increase)	0	0	0	0	0	0	0	0
Change in arrears (-, decrease)	15	15	22	0	7	0	29	0
Change in oil fund assets (-, increase)	-201	-128	-160	-153	-91	-13	-340	-345
Financing gap	0	0	0	0	0	0	0	0
Memorandum items:								
Current account balance (in percent of GDP)	-12.3	-27.7	-27.1	-30.3	...	...	-6.6	-13.6
Excluding oil sector imports of goods and services	7.0	8.2	14.0	11.6	...	...	17.9	12.0
Gross official reserves (US\$ millions)	721	803	923	1,075	985	983	1,181	1,165
Gross official reserves (in months of non-oil imports, c.i.f.)	4.0	3.5	3.9	3.7	...	...	4.5	3.7
Oil fund assets (US\$ millions)	693	821	981	974	...	...	1,322	1,320
WEO oil price (US\$ per barrel)	25.0	29.0	38.5	37.8	...	...	42.8	49.5

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

Table 7. Azerbaijan: Quantitative Performance Criteria and Indicative Targets for the PRGF, 2002-05
(in billions of manats, unless otherwise indicated)

	2002		2003		2004		2004		2004		2004		2005		
	Dec	Act.	Dec	Act.	Mar	Act.	Jun	Act.	Sep	Act.	Dec	Act.	Mar	Prel Act.	
1. 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	612	533	537	668	579	588	772	737	745	905	811	808
Ceiling on net domestic assets of the ANB (end-of-period stock)	-85	-160	9	-129	114	95	-99	17	-25	-165	76	38	-56	-379	-491
Ceiling on net credit to the general government from the ANB (end-of-period stock)	154	75	0	-12	53	34	-26	-95	-137	-117	167	129	112	-279	-312
Ceiling on the overall consolidated non-oil deficit 5/ 6/	...	3,865	968	899	387	2,141	1,959	1,023	3,041	2,132	4,105	4,141	3,642	979	868
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
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
Other long-term debt (maturity five and more years)	...	0	50	10	100	100	32	125	125	32	150	150	32	50	7
2. Continuous performance criterion															
Ceiling on Stock of Outstanding Nontreschulable 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	0.004	0	0
3. Indicative targets															
Ceiling on stock of ANB's manat reserve money (end-of-period stock)	1,872	2,316	2,146	2,456	2,340	2,340	2,761	2,451	2,451	2,905	3,162	3,162	3,200	2,987	2,810
Ceiling on stock of unpaid bills in excess of Manat 50 billion (end-of-period stock)	-36	-41	0	10	0	0	20	0	0	9	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 1 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.

Table 8. Structural Performance Criteria and Benchmarks for End-December 2003, End-March 2004, End-June 2004, End December 2004, End-March 2005 and End-April 2005		
End-December 2003		
<i>Structural Performance Criteria</i>		
Establish a single uniform enterprise profit tax for all non-oil companies.	Observed.	Profits tax unified at 24 percent on November 28, 2003.
Adoption of a procedure for future automatic adjustments of domestic energy prices.	Not Observed.	Decree adjusting most domestic energy product prices took effect in November, 2004.
Replacement of specific with ad-valorem customs duties in continued adherence to timetable adopted in compliance with end-March 2002 structural performance criteria.	Observed.	Consistent with the timetable under the program, on October 1, 2003 the authorities replaced a number of specific with ad-valorem custom duties.
Adoption of a Cabinet of Ministers decision reducing list of VAT exemptions and requiring that all future changes be done in the context of annual budget preparation process.	Observed.	Adopted by Cabinet of Minister's Decision No. 155 dated December 4, 2003.
Adoption by Parliament of a new Banking Systems Law.	Not observed.	Adopted in January 2004, but the implementing Presidential decree restricted Central Bank's independence. This issue was resolved with the passage of the Central bank Law.
Submission to Parliament of the new Central Bank Law.	Not observed.	The revised draft satisfactory to the Fund staff was submitted to Parliament in Nov. 2004.
<i>Structural Benchmarks</i>		
Continued adherence of the SCC reform program.	Observed.	
Allocation of tax credits to SOCAR and subsidies to Azerenergy and Azerigas related to unpaid fuel consumed by the utilities.	Observed.	Subsidies calculated and allocated to SOCAR quarterly.
End-March 2004		
<i>Structural Performance Criteria</i>		
Approval by Cabinet of Ministers of a long-term strategy for oil revenue management.	Not observed.	Strategy endorsed by the President on Sept. 27, 2004.
Adoption of the Central Bank Law.	Not observed.	Adopted in Dec.04.
Approval by Cabinet of Ministers of annual expenditure plans and revenue projections for Azerchemia, Azerenergy, and Azerigas for 2004.	Not observed.	Plans for Azerchemia approved in January, but plans for Azerenergy and Azerigas were approved only in April.

Table 8. Structural Performance Criteria and Benchmarks for End-December 2003, End-March 2004, End-June 2004, End December 2004, End-March 2005 and End-April 2005

<p>End-June 2004 Structural Performance Criterion Issuance of a tender for all remaining government shares in IBA.</p>			Not observed.	Progress on the sale of 20 percent of IBA to EBRD has stalled, and thus the tender for selling all remaining shares in IBA could not be issued.
<p>Structural Benchmark Review by Cabinet of Ministers of first quarter 2004 implementation by Azerchemia, Azerenergy, Azerigas and Baku metro of their expenditure plans and revenue projections, and taking any measures to ensure these budgets are adhered to.</p>			Not observed.	
<p><i>Prior Actions for the Fourth Review</i></p>				
<p>Adoption of National Bank Law.</p>			Observed.	
<p>Announcement that all banks have the right to serve as collection points for gas and water bills, and that the respective utilities will cooperate with all participating banks.</p>			Observed.	
<p>Inclusion in the draft implementing Presidential decree on the 2005 budget of non-oil fiscal deficit path of 2.4 percent of non-oil GDP increase in 2005, and a one percent increase in subsequent years.</p>			Observed.	
<p>Announcement that pensioners are free to choose the payment outlet (including private commercial bank) they wish to receive their pensions through, and that the ATM cards issued to pension recipients can be used at any ATM in the country.</p>			Observed.	
<p>End-December 2004 Structural Performance Criterion Approval by the Cabinet of Ministers of revenue and expenditure plans for Azerchemia, Azerenergy, Azerigas, and SOCAR, consistent with the subsidy allocations in the 2005 budget.</p>			Not observed.	All plans were approved by the Cabinet of Ministers in April 2005.
<p>End-March 2005 Structural Performance Criterion Issuance of tenders for all financial services to be purchased by the Ministry of Finance.</p>			Observed.	Tenders were issued in all regions with more than one bank.
<p>Structural Benchmarks Submission to Cabinet of Ministers of a timetable for the design of a comprehensive medium-term civil service reform program.</p>			Not observed.	Submitted in May 2005.
<p>Based on a review by the Cabinet of Ministers adoption of decisions to strengthen the financial discipline and oversight of Azerchemia, Azerenergy, Azerigas, and SOCAR.</p>			Not observed.	A government resolution on improved monitoring of state owned enterprises was approved in June 2005.
<p>End-April 2005 Structural Performance Criterion Adoption by the Cabinet of Ministers of a plan to improve the annual budget process, and strengthen connections between the SPPRED, MTEF, PIP and annual budget with this plan to be the preparation of the 2006 budget.</p>			Not observed.	The review of the experience with the 2005 budget preparation was completed in February 2005, and a government instruction on the improvement of the budget process was approved in June 2005.

Table 9. Azerbaijan: Medium-Term Balance of Payments Projection, 2004–10

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

	2004	2005	2006	2007	2008	2009	2010
Exports, f.o.b.	3,743.0	5,552.3	8,549.4	12,719.8	16,613.1	18,290.0	18,700.7
Of which: oil, gas and oil products	3,096.5	4,988.9	7,931.3	12,053.0	15,890.3	17,509.2	17,857.1
of which: AIOC	1,779.2	3,432.7	6,438.0	10,485.5	14,303.7	15,932.4	16,417.8
other	646.5	563.4	618.1	666.8	722.7	780.8	843.6
Imports, f.o.b.	-3,581.0	-4,375.0	-4,176.1	-3,965.2	-3,878.0	-4,162.8	-4,474.7
Of which: oil sector	-1,624.0	-1,885.3	-1,421.5	-929.0	-548.5	-510.7	-606.9
other	-1,957.0	-2,489.7	-2,754.6	-3,036.2	-3,329.6	-3,652.1	-3,867.8
Trade balance	162.0	1,177.3	4,373.3	8,754.6	12,735.0	14,127.2	14,226.0
Services (net)	-2,237.6	-1,762.5	-1,413.1	-997.4	-715.5	-707.1	-836.4
Credit	491.6	542.2	609.9	765.0	879.8	976.7	1,029.6
Debit	-2,729.2	-2,304.6	-2,022.9	-1,762.4	-1,595.2	-1,683.8	-1,866.0
Of which: oil sector	-1,952.6	-1,350.3	-985.9	-647.5	-395.2	-367.0	-419.5
Income	-702.5	-1,402.0	-2,181.5	-1,126.2	-2,281.0	-2,261.1	-1,832.5
Investment income (net)	-569.8	-1,282.0	-2,048.0	-986.0	-2,135.1	-2,113.3	-1,680.5
of which: profit of oil consortium	-521.0	-1,178.7	-1,968.0	-998.8	-2,431.4	-2,869.9	-2,961.7
Compensation of employees	-98.3	-98.3	-107.5	-107.5	-107.5	-107.5	-107.5
Interest on public debt (including Fund)	-34.4	-21.7	-26.0	-32.7	-38.5	-40.3	-44.5
Transfers (net)	191.5	267.3	343.1	441.7	536.1	592.7	628.3
Private	134.1	199.2	256.8	332.1	404.8	448.9	477.8
Public	57.4	68.1	86.3	109.6	131.3	143.8	150.5
Current account balance	-2,586.6	-1,719.8	1,121.9	7,072.7	10,274.6	11,751.7	12,185.4
Net direct investment	2,351.4	1,172.7	-157.4	-3,358.3	-390.1	159.4	476.2
Oil companies	2,258.3	1,091.5	-245.1	-3,451.3	-488.6	54.9	365.5
contracted (net)	3,391.0	3,125.7	3,131.3	2,143.9	1,319.7	1,285.4	1,583.4
capital repatriation	-1,154.3	-2,034.2	-3,376.4	-5,595.2	-1,808.3	-1,230.5	-1,217.9
bonus	21.6	0	0	0	0	0	0
Other	93.1	81.2	87.7	93.0	98.5	104.4	110.7
Public sector capital	17.0	130.6	225.8	222.8	216.0	221.2	240.8
Medium and long-term borrowing	75.0	196.7	275.2	275.0	275.0	270.0	270.0
Budget support	0	20.0	0	0	0	0	0
Other long-term loans	75.0	176.7	275.2	275.0	275.0	270.0	270.0
Scheduled amortization	-58.0	-66.1	-49.4	-52.2	-59.0	-48.8	-29.2
Other (including short term capital)	718.0	863.1	-197	243.4	480.4	631.1	625.0
of which:							
BTC-related borrowing	1,094.6	500.0	0	0	0	0	0
SOCAR borrowing	0	170.0	0	0	0	0	0
Capital account balance	3,086.4	2,166.5	-128.1	-2,892.2	306.3	1,011.6	1,342.0
Errors and omissions	-15.6	0	0	0	0	0	0
Overall balance	484.2	446.7	993.7	4,180.5	10,580.9	12,763.3	13,527.4
Financing	-484.1	-446.5	-993.7	-4,180.5	-10,580.9	-12,763.3	-13,527.5
Change in net foreign assets of ANB (increase -)	-331.0	-101.3	-147.8	-163.7	-166.3	-175.4	-194.8
Net credit from the Fund	-58.7	-10.9	-37.8	-37.2	-20.9	-8.1	-2.4
Disbursements/purchases	0	19.6	0	0	0	0	0
Repayments/repurchases	-58.7	-30.5	-37.8	-37.2	-20.9	-8.1	-2.4
Change in gross official reserves (increase -)	-272.3	-90.4	-110.0	-126.5	-145.5	-167.3	-192.4
Change in oil fund assets (- increase)	-153.2	-345.2	-845.9	-4,016.8	-10,414.6	-12,587.9	-13,332.7
Memorandum items:							
Current account balance (in percent of GDP)	-30.3	-13.6	6.9	33.5	39.9	41.2	40.1
Excluding oil sector imports	11.6	12.0	21.6	41.0	43.6	44.3	43.5
Gross official reserves	1,075.0	1,165.5	1,275.5	1,402.0	1,547.4	1,714.7	1,907.1
Gross official reserves (in months of next year's imports c.i.f.)	1.9	2.3	2.7	3.1	3.2	3.2	3.4
Oil fund assets	974.3	1,319.5	2,165.4	6,182.2	16,596.8	29,184.7	42,517.4
Public and publicly guaranteed external debt stock (in percent of GDP)	18.6	13.5	11.6	9.8	8.8	8.7	9.0
Total external debt (in percent of GDP)	33.2	28.5	23.3	19.9	18.8	19.8	21.2
Scheduled public debt service excl. IMF (in percent of exports of goods and nonfactor services)	2.2	1.4	0.8	0.6	0.6	0.5	0.4
WEO oil price (US\$ per barrel)	37.8	49.5	48.8	46.5	45.3	44.5	44.0

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

Table 10: Azerbaijan: Capacity to Repay the Fund, 2005–10

	2005	2006	2007	2008	2009	2010
(In millions of SDRs)						
Outstanding use of Fund credit	127.4	102.6	78.1	64.4	52.4	42.7
IMF obligations	21.4	26.0	25.2	14.1	12.3	9.8
Purchases and Disbursements	12.9	0.0	0.0	0.0	0.0	0.0
Repurchases and Repayments	20.0	24.9	24.5	13.7	12.0	9.7
Charges	1.3	1.1	0.7	0.4	0.3	0.2
(In percent)						
Outstanding use of Fund credit as a ratio of:						
Exports of goods and services	3.2	1.7	0.9	0.6	0.4	0.3
External public debt	11.4	8.2	5.7	4.3	3.2	2.4
Gross official reserves	16.6	12.2	8.5	6.3	4.6	3.4
GDP	1.5	1.0	0.6	0.4	0.3	0.2
Quota	79.2	63.7	48.5	40.0	32.5	26.5
Debt service obligations to IMF as a ratio of:						
Exports of goods and services	0.5	0.4	0.3	0.1	0.1	0.1
External public debt	1.9	2.1	1.8	0.9	0.7	0.5
Gross official reserves	2.8	3.1	2.7	1.4	1.1	0.8
GDP	0.2	0.2	0.2	0.1	0.1	0.0
Quota	13.3	16.1	15.6	8.8	7.6	6.1
Memorandum item:						
Quota (million SDRs)	160.9	160.9	160.9	160.9	160.9	160.9

Source: Fund staff estimates and projections.

Table 11: Azerbaijan: Review and Phasing of Disbursements
Under the PRGF Arrangement

(In millions of SDRs)

Date of Disbursement	Conditions	Disbursement
July 13, 2001	Disbursed upon Board approval of the PRGF arrangement	8.05
February 28, 2002	Disbursed upon completion of the first review under the PRGF arrangement	8.05
May 29, 2003	Disbursed upon completion of the second review under the PRGF arrangement	12.87
December 29, 2003	Disbursed upon completion of the third review under the PRGF arrangement	12.87
January 11, 2005	Disbursed upon completion of the fourth review under the PRGF arrangement	12.87
On or after June 24, 2005	Completion of the fifth (last) review; end-December 2004, end-March 2005, and end-April 2005 performance criteria	12.87

Table 12. Azerbaijan: Millennium Development Goals, 1990–2002
Country Profile

	1990	1995	2001	2002
1. Eradicate extreme poverty and hunger	2015 target = halve 1990 \$1 a day poverty and malnutrition rates			
Population below \$1 a day (percent)	...	...	3.7	...
Poverty gap at \$1 a day (percent)	...	...	1.0	...
Percentage share of income or consumption held by poorest 20percent	...	...	7.4	...
Prevalence of child malnutrition (percent of children under 5)	...	10.1	16.8	...
Population below minimum level of dietary energy consumption (percent)	...	37.0	21.0	...
2. Achieve universal primary education	2015 target = net enrollment to 100			
Net primary enrollment ratio (percent of relevant age group)	...	...	79.8	...
Percentage of cohort reaching grade 5 (percent)	...	...	...	...
Youth literacy rate (percent ages 15-24)	...	...	...	...
3. Promote gender equality	2005 target = education ratio to 100			
Ratio of girls to boys in primary and secondary education (percent)	99.8	107.5	97.5	...
Ratio of young literate females to males (percent ages 15-24)	...	...	...	...
Share of women employed in the nonagricultural sector (percent)	35.0	39.5	45.4	...
Proportion of seats held by women in national parliament (percent)	...	2.0	...	...
4. Reduce child mortality	2015 target = reduce 1990 under 5 mortality by two-thirds			
Under 5 mortality rate (per 1,000)	106.0	102.0	97.0	96.0
Infant mortality rate (per 1,000 live births)	84.0	81.0	78.0	76.0
Immunization, measles (percent of children under 12 months)	66.0	97.0	99.0	97.0
5. Improve maternal health	2015 target = reduce 1990 maternal mortality by three-fourths			
Maternal mortality ratio (modeled estimate, per 100,000 live births)	...	...	94.0	...
Births attended by skilled health staff (percent of total)	...	...	84.1	...
6. Combat HIV/AIDS, malaria and other diseases	2015 target = halt, and begin to reverse, AIDS, etc.			
Prevalence of HIV, female (percent ages 15-24)	...	...	0.0	...
Contraceptive prevalence rate (percent of women ages 15-49)	...	...	55.4	...
Number of children orphaned by HIV/AIDS	...	...	...	...
Incidence of tuberculosis (per 100,000 people)	...	...	...	...
Tuberculosis cases detected under DOTS (percent)	...	...	82.0	82.0
	...	4.0	6.0	42.8
7. Ensure environmental sustainability	2015 target = various (see notes)			
Forest area (percent of total land area)	11.1	...	12.6	...
Nationally protected areas (percent of total land area)	...	5.5	5.5	5.5
GDP per unit of energy use (PPP \$ per kg oil equivalent)	1.3	1.0	2.0	...
CO2 emissions (metric tons per capita)	6.4	4.2	3.6	...
Access to an improved water source (percent of population)	...	...	78.0	...
Access to improved sanitation (percent of population)	...	...	81.0	...
Access to secure tenure (percent of population)	...	...	...	...
8. Develop a Global Partnership for Development	2015 target = various (see notes)			
Youth unemployment rate (percent of total labor force ages 15-24)	...	...	...	...
Fixed line and mobile telephones (per 1,000 people)	86.3	85.7	199.6	220.3
Personal computers (per 1,000 people)	...	...	...	...

Table 12. Azerbaijan: Millenium Development Goals, 1990–2002 (concluded)
Country Profile

	1990	1995	2001	2002
General indicators				
Population (in millions)	7.2	7.7	8.1	8.2
Gross national income (US\$ billions)	...	3.0	5.3	5.8
GNI per capita (US\$)	...	390.0	660.0	710.0
Adult literacy rate (percent of people ages 15 and over)	...	...	...	...
Total fertility rate (births per woman)	2.7	2.3	2.1	2.1
Life expectancy at birth (years)	70.8	69.0	65.2	65.2
Aid (percent of GNI)	0.7	3.9	4.3	6.1
External debt (percent of GNI)	...	10.6	23.4	24.5
Investment (percent of GDP)	26.5	23.8	20.7	32.8
Trade (percent of GDP)	83.1	87.7	78.2	95.0

Azerbaijan: Fund Relations

As of April 30, 2005

1. **Membership Status:** Joined: 09/18/1992; Article VIII

2. General Resources Account:	SDR Million	Percent of Quota
Quota	160.90	100.00
Fund Holdings of Currency	193.32	120.15
Reserve position in Fund	0.01	0.01

3. SDR Department:	SDR Million	Percent of Allocation
Holdings	9.43	N/A

4. Outstanding Purchases and Loans:	SDR Million	Percent of Quota
Extended arrangements	27.55	17.12
Systemic Transformation Facility	4.88	3.03
PRGF arrangements	102.09	63.45

5. **Financial Arrangements:**

Type	Approval Date	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
PRGF	07/06/2001	07/04/2005	67.58	54.71
EFF	12/20/1996	03/19/2000	58.50	53.24
ESAF/PRGF	12/20/1996	03/19/2000	93.60	81.90

6. **Projected Obligations to Fund:**

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

	Forthcoming				
	<u>2005</u>	<u>2006</u>	<u>2007</u>	<u>2008</u>	<u>2009</u>
Principal	20.04	24.86	24.45	13.72	12.03
Charges/Interest	<u>1.32</u>	<u>1.12</u>	<u>0.71</u>	<u>0.41</u>	<u>0.26</u>
Total	21.35	25.98	25.16	14.13	12.28

7. **Safeguards Assessment**

Under the Fund's safeguards assessment policy, Azerbaijan National Bank (ANB) is subject to an assessment with respect to the PRGF arrangement, which was approved on July 6, 2001 and is scheduled to expire 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 newly adopted National Bank Law 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, 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. The ANB conducts the policy of informal exchange rate targeting and determines an official exchange rate against the U.S. dollar every day, equal to a weighted average of all foreign exchange markets, including the off-auction interbank market, the retail intra-bank market, and the bank note market located in foreign exchange bureaus.

Azerbaijan has been classified by the staff with the group of countries whose exchange rate regimes are de facto managed floating with no pre-determined path for the exchange rate.

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

9. Article IV Consultation

The 2004 Article IV consultation with Azerbaijan was concluded on December 22, 2004.

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.

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 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.

Azerbaijan: Technical Assistance, 2001–2005

Fund Dept.	Area of Assistance	Mission Dates
STA	National accounts and GDPS	February 2001
STA	Price statistics	February 2001
STA	Balance of Payments Statistics	April 2001
MAE	Banking supervision	May 2001
MAE	Payments system	May 2001
MAE	Central Bank Internal Audit	June 2001
FAD	Customs Administration	June 2001
FAD	Budget systems law	August 2001
MAE	Bank restructuring and monetary operations	June 2001
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	Sep. 2003
FAD	Revenue Administration	August 2003
FAD	Tax Policy	August 2003
MFD	Payment and Settlement Systems	Jan. 2004
STA	Balance of Payments Statistics	May 2004
MFD	Payment and Settlement Systems	May 2004
MFD	Regional Public Debt management	April 2004
FAD	Customs Administration	Sep. 2004
STA	National Accounts	Sep./Oct. 2004
FAD	Tax administration	Dec. 2004
MFD	Public Debt Management	Dec. 2004
STA	National Accounts	Mar./Apr. 2005

Azerbaijan: IMF-World Bank Relations

A. Partnership in Azerbaijan's Development Strategy

- The government's poverty reduction strategy, embodied in its first full State Program for Poverty Reduction and Economic Growth (SPPRED) was discussed by the IDA and IMF Boards in May 2003. The strategy comprises six key strategic aims identified as follows: (i) the facilitation of an enabling environment; (ii) the maintenance of macroeconomic stability; (iii) the improvement in the quality of and equity in access to basic health and education services; (iv) the improvement of infrastructure (including roads, delivery of utility services, communications, irrigation); (v) the reform of the current system of social protection to give a more targeted, but effective protection to the vulnerable; and (vi) the improvement of the living conditions and opportunities for the one million refugees and Internally Displaced People (IDP) of the Nagorno-Karabakh conflict. While the PRSP's overall direction is considered appropriate, weaknesses were identified related to costing, prioritizing, and sequencing measures as well as their monitoring and evaluation.
- Macroeconomic management aims at maintaining a stable economic environment through appropriate fiscal, monetary, exchange rate, and sustainable debt policies. In support of these policies, the authorities are tightening payment discipline, especially in the energy sector, hardening budget constraints for state-owned enterprises, and pursuing enterprise and banking privatization and restructuring. Consistent macroeconomic management has supported the economic recovery since 1995. Nonetheless, maintaining strong growth will depend importantly on accelerating structural reforms to enhance private sector development and to encourage foreign and domestic investment, particularly in the non-oil sectors of the economy.
- The IMF has taken the lead in assisting Azerbaijan in enhancing macroeconomic stability and related structural reform measures. In this regard, the Fund has encouraged the authorities to continue with fiscal reforms and to maintain a prudent monetary policy stance. The government has also been encouraged to enhance governance and strengthen financial discipline in the energy sector, to strengthen the banking sector, and to improve the legal and regulatory environment for private sector development. The Fund has supported Azerbaijan's economic reform program since 1995. The authorities were successful in achieving macroeconomic stabilization under the economic reform program supported by the early IDA and IMF structural adjustment arrangements, which formed the foundation for an ongoing Fund-supported program under the Poverty Reduction and Growth Facility (PRGF), approved by the Executive Board in July 2001, with the first review endorsed by the Board on February 20, 2002, the second review completed on May 14, 2003, the third review completed on December 19, 2003, the fourth review completed on December 22, 2004, and the fifth (last) review scheduled for late June 2005.

- The World Bank has taken the lead in the policy dialogue on structural reforms, including poverty reduction measures, public expenditures, agricultural policies, private sector development, institution building, and governance. A range of instruments is used to conduct the dialogue. SAC-II, which has been fully disbursed in June 2003, was supporting a wide-ranging structural reform agenda and its accompanying second institution building and technical assistance credit (IBTA II) is assisting institutional capacity building, especially of government budget preparation and execution, privatization, and utility reforms. The Bank has initiated discussions with the authorities on the design of a proposed sequence of Poverty Reduction Support Credits (PRSCs) based on the reform agenda of the SPPRED and the CAS. The objectives of the proposed PRSCs are to support proper management of public resources, strengthen corporate governance, encourage non-oil trade and investments, and enable adequate regulation of utility services, while increasing the efficiency and sustainability of social services. The proposed PRSCs ensure continuity of the progress made with the support of SAC II. The first PRSC was approved by the Board in May 2005.
- This broad-based policy reform approach is combined with sector investment projects in agriculture, roads, water, refugees/IDPs, environment, education, health, and domestic gas. Recent analytical and advisory assistance has included a Poverty Assessment, a PER, a CPAR (procurement assessment), a CFAA (financial accountability), pension reforms paper, and ongoing work on trade facilitation and mitigation of the social costs of utility price increases. The Bank is continuing its advisory services for expenditure management under a Programmatic Public Expenditure Review, a Programmatic Poverty Assessment, and analytical work on the energy sector.
- The next section describes the Bank program and the division of responsibility between the two institutions. In a number of areas—social sectors and safety nets, environment, governance, infrastructure, and agriculture—the Bank takes the lead in the dialogue and there is no cross conditionality with the IMF-supported program. The Bank is also leading the dialogue in private sector development and public enterprise reform and Bank analysis serves as an input into the Fund program. In other areas—energy, financial sector, public expenditure management, public sector, trade, and investment policy—both institutions work together and share cross conditionality. Finally, in areas like monetary and exchange rate policy, tax policy and customs reforms, the IMF takes the lead with limited Bank involvement (see Table 1).

Table 1. Bank-Fund Collaboration on Azerbaijan

Area	Specialized Advice from Fund	Specialized Advice from Bank	Key Instruments
Macroeconomic Framework/ Management	Monetary policy, exchange rate, fiscal and trade policies, economic statistics.	Medium- to long-term public expenditure management of oil windfall, trade reform.	<p><i>IMF:</i> PRGF quantitative performance criteria and indicative targets on monetary and fiscal indicators.</p> <p><i>Bank:</i> Structural adjustment operations within the PRSC 1 (approved in May 2005), 2 and 3 (previously SAC-II) and IBTA II support of reforms in budget preparation and execution, Programmatic PER, integrated non-oil trade and investment strategy.</p>
Budget	Consolidated medium-term budget framework, including the Oil Fund's operations, budget systems law, treasury modernization, tax policy and administration, customs, debt management, extra budgetary funds, long-term oil revenue management strategy.	Budget systems law, consolidated medium-term budget framework, integration of the Oil Fund's governance framework, PIP capacity building, assistance with coordination of public expenditure management reforms.	<p><i>IMF:</i> PRGF performance criteria on overall consolidated fiscal deficit, excluding Oil Fund revenues and overall consolidated non-oil deficit including quasi-fiscal activities; performance criteria related to rules and legislation related to ensuring coherent fiscal policy, implementation of oil revenue management strategy and improvement of the annual budget process.</p> <p><i>Bank:</i> Policy conditionality on governance of the Oil Fund, budget systems law, MTEF and PIP within the proposed PRSCs (previously SAC-II), Programmatic PER, and IBTA-II support of activities for capacity building.</p>
Public Sector Reform	Support to State Customs Committee, Ministry of Taxes, Ministry of Finance.	Support to Ministry of Finance, Ministry of Economic Development, Ministry of Environment, and consolidation of Agencies and Departments, State Procurement Agency,	<p><i>IMF:</i> PRGF performance criteria and benchmarks related to ongoing administrative reforms in customs, taxes and finance.</p> <p><i>Bank:</i> Programmatic PER and technical assistance supported by IBTA-II.</p>

Table 1. Bank-Fund Collaboration on Azerbaijan

Area	Specialized Advice from Fund	Specialized Advice from Bank	Key Instruments
Energy Sector Reform	Strengthening financial discipline in energy sector by unification of domestic and international prices for natural gas and oil products, allocation of subsidies to Azerenergy and Azerigas, and offsetting tax credits to SOCAR, full payment by budgetary organizations for their utility consumption.	<p data-bbox="761 415 1003 441">Chamber of Accounts.</p> <p data-bbox="761 478 1032 898">Strengthening financial discipline in energy sector by elimination of implicit subsidies and improved collections and tariff policies, privatization of distribution companies, introduction of regulatory framework and agency, and specialized advice on oil and gas sector development.</p>	<p data-bbox="1062 478 1430 747"><i>IMF</i>: PRGF performance criteria and benchmarks related to domestic energy prices, the incorporation of previously quasi-fiscal subsidies into the state budget, as well as approval of revenue and expenditure plans for Azerenergy, Azerigas, Azerchemia, and SOCAR.</p> <p data-bbox="1062 768 1430 1251"><i>Bank</i>: Policy conditionality on utility reforms, especially aimed at improving financial viability within the proposed PRSCs (previously SAC-II). PPIAF/ESMAP TA on sector restructuring and regulations. IBTA-I and –II supported assistance for privatization and in analyzing the environmental and social impact of such reforms and designing measures to protect the poor. Energy Sector Report Lending operation includes management TA for Azerenergy (approved in May 2005).</p>
Financial Sector Reform	Strengthening the competitiveness and health of the banking system, privatization of state-owned banks, revision and introduction of a new legal framework for the banking sector (banking law, bankruptcy law, and central bank law), and development of manat financial markets, including the market for T-bills.	Restructuring and privatization of large State banks, strengthening of ANB's supervisory capacity, introduction of electronic payment systems, credit rating agencies and registries, SME credit, FSAP.	<p data-bbox="1062 1272 1430 1482"><i>IMF</i>: PRGF structural performance criteria and benchmarks on bank privatization, banking system law, central bank law and issuance of tenders for all financial services to be purchased by the Ministry of Finance.</p> <p data-bbox="1062 1503 1430 1650"><i>Bank</i>: SAC-II Policy conditions on the financial sector within the proposed PRSC (previously SAC-II) and the financial sector TA credit.</p>

Table 1. Bank-Fund Collaboration on Azerbaijan

Area	Specialized Advice from Fund	Specialized Advice from Bank	Key Instruments
Social/Poverty	Civil service reform.	Public expenditure reforms, strengthening of monitoring and evaluation systems, reform strategies for education, health, social assistance and protection, as well as pension reform and direct assistance to IDPs.	<p><i>IMF:</i> PRGF structural benchmark on submission to Cabinet of Ministers of a timetable for the design of a comprehensive medium-term civil service reform program.</p> <p><i>Bank:</i> Policy conditionality in SAC-II the proposed PRSC (previously in SAC-II). Programmatic Poverty Assessment and TA for Household and other surveys, assistance with design of pension reforms and better targeting of social expenditures. Project to assist IDPs and refugees. Education and Health LILs aimed at improving service delivery to the poor.</p>
Private Sector Development	Trade and investment policy.	Integrated framework for trade and business development, improving and monitoring of the business and investment environment, streamlining procedures for entry and exit, enhancing high-level public/private sector dialogue, trade and transport facilitation, SME support, and privatization of SOEs.	<p><i>Bank:</i> enhanced public-private partnership supported via the proposed PRSC (previously by SAC II) and IBTA II; analytical assistance on the nexus of business environment and governance in cooperation with FIAS; integrated trade and business development framework report. Trade and transport facilitation report; SAC II and IBTA II supported TA on privatization, and labor redeployment.</p>
Other sectors		Strengthening rural and agricultural infrastructure, transport policy and infrastructure, environmental clean-up, and preservation.	<p><i>Bank:</i> investment projects in environment, agriculture, water, and highways.</p>

B. IMF-World Bank Collaboration in Specific Areas

Areas in which the World Bank Leads and There is No Direct IMF Involvement

- These areas are the social sectors, agriculture, infrastructure and environment. In the social sphere, the Bank has been involved in both improving the data and analyzing poverty as well as in helping design pension reforms, and measures to mitigate the social impact of utility reforms aimed at raising collections and tariffs. In education, a LIL is to be followed by an APL to improve quality. There is also an ongoing LIL in the health sector (in partnership with UNICEF) which aims at building capacity of the Ministry to carry out health care reforms and pilot them in selected districts.
- In infrastructure, Bank lending to date has comprised projects for gas rehabilitation, water supply, and highways. An environment project is being followed by assistance to build the capacity of the new Ministry of Environment and mainstreaming environmental concerns across-the board, especially in the energy sector. In Agriculture, the Bank has provided credits for farm privatization, irrigation rehabilitation and credit, extension, and other agricultural services.

Areas in Which the World Bank Leads and Its Analysis Serves as Input Into the IMF Program

- The Bank leads the dialogue on structural reforms through the **proposed PRSCs**. The PRSCs will initially focus on any follow-up reforms to SAC-II and will extend to new reform initiatives. The first PRSC was approved in May 2005.
- **Privatization and Private Sector Development.** The Bank is taking the lead in the formulation of an integrated strategy and action plan for trade and private sector development.⁷ An important element of the strategy is in providing a framework to better integrate the efforts of key stakeholders—i.e., the government, multilateral and bilateral donors, the private sector, and others—in promoting non-oil trade and investment. The four policy components include: (i) Improving the Trade Policy Regime and Market Access—creating a more export-friendly tariff structure, accelerating Azerbaijan’s accession to the WTO, increasing access to regional markets and the European Union; improving access to finance; streamlining administrative procedures; (ii) Enhancing Trade Facilitation—streamlining and strengthening customs procedures and improving the quality and capacity of Azerbaijan’s transportation infrastructure; (iii) Improving the Macro Business Environment—the macro business environment covers a wide range of issues

⁷ See: *Azerbaijan: Building Competitiveness for Increased Non-Oil Trade and Investment—An Integrated Strategy and Action Plan*, World Bank, forthcoming.

- impacting on private sector development, including improving business registration and licensing; land acquisition and site development; labor market policies; taxation; access to credit; support for SMEs; contract enforcement and dispute settlement; and public sector governance; and (iv) Developing Competitive Industry Clusters— industry-specific strategies for improving inter-firm cooperation, promoting innovation and quality, encouraging specialization, and strengthening supply chains.
- The Foreign Investment Advisory Service (FIAS) has recently conducted a diagnostic study of the investment environment to determine the most important impediments to private sector investments, and this was followed up by the CIS Business Environment Enterprise Performance Survey 2002 (BEEPS) conducted by the Bank and EBRD together.
 - **IFC's strategy** emphasizes support to the non-oil sector to help economic diversification. To this end, 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. IFC's strategy for the non-oil sectors involves: (i) promotion of competition in the banking sector, establishment of 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 SMEs; (iii) efforts to improve the business climate and reduce impediments to foreign investments; (iv) support of agri-business and agro-processing; and (v) support for private provision of public services.
 - As for **privatization**, the Bank provides support for hiring of financial technical and legal advisors, advises on the transaction processes, and ensures that proper social and environmental mitigation is taken into account. The Bank is also supporting the development of a strategy for further industrial privatization as well as for labor redeployment. Together with the EBRD, and in the context of the new proposed PRSCs, the Bank is also planning to support **financial and corporate restructuring of SOCAR**.
 - **Regulatory reforms**, including approval of draft regulations for electricity, gas, and water sectors, separation of regulatory and commercial functions in utilities, transport and communications sectors, establishing an independent regulator agency assigned with regulatory functions. In particular, all regulatory functions currently exercised by Azal, Azeri Rail, Azeri Road Company, and Caspian Shipping Company will be transferred to the Ministry of Transport, the commercial and regulatory functions of the Ministry of Communications will be separated, and remaining regulatory functions of SOCAR will be transferred to the appropriate government institution.
 - While the Bank has taken the lead in privatization and in structural reforms in the private sector as described above, the IMF has also a strong interest in these areas since many of these reforms are critical to achieving macroeconomic stabilization and

enhancing growth prospects. Accordingly, there is a high degree of consultation and coordination between the two institutions on these matters.

- The Bank plays a central role in advising on development of a Medium-Term Expenditure Framework and Public Investment Program.

Areas of Shared Responsibility

- The Bank and the Fund are working jointly in the following three main areas, supported by the Bank's PRSCs and Programmatic PERs, the joint Bank/Fund Financial Sector Assessment Program (FSAP), several investment and technical assistance operations, and the Fund's PRGF.
- **Public Expenditure Management.** This area includes public expenditure management reforms aimed at the introduction of a medium-term expenditure framework and public investment program, a long-term oil revenue management strategy, implementation of a new Budget Systems Law, consolidation of all extrabudgetary resources including the Oil Fund with the state budget, modernization of the Treasury, strengthening the Chamber of Accounts, and supporting tax and customs administration. Both institutions are involved in supporting treasury modernization, while the Fund is providing technical assistance in support of tax and customs operations. The governance framework for the Oil Fund is another area in which there is very close cooperation, as well as the elimination of all quasi-fiscal subsidies.
- **Financial sector reforms.** This area includes strengthening the competitiveness and health of the banking system, privatization of state-owned banks, revision and introduction of a new legal framework for the banking sector (commercial bank law, bankruptcy law, and central bank law), and development of manat financial markets, including the market for treasury bills. Both institutions have conducted the joint FSAP missions during September and December 2003. FSAP report was finalized in February 2004. In terms of banking supervision, the Fund is monitoring the closure and merger of banks that do not satisfy prudential requirements.
- **Utilities reform,** including measures to reduce implicit subsidies in the electricity, gas, and water sectors, to ensure full payment by budgetary institutions their utility bills, to improve overall utility collections, revision of electricity, and gas tariffs to cover the true costs of providing these services. The Fund takes the lead in seeking to ensure that budget organizations and state-owned enterprises pay their utility bills in full and the budget fully funds remaining energy-related subsidies, while the Bank is taking the lead in utility and state-owned enterprise reform, tariff revision and collections from households, regulatory reform, and privatization.

Areas in Which the IMF Leads and Its Analysis Serves as Input Into the World Bank Program

- The Fund leads the dialogue on fiscal matters, setting the overall ceiling on the consolidated budget. In addition to the achievement of overall fiscal targets the Fund-supported PRGF includes performance criteria and structural benchmarks requiring: (i) approval by the Cabinet of Ministers of revenue and expenditure plans for four energy sector SOEs; (ii) adoption of decisions to strengthen the financial discipline and oversight of four energy sector SOEs, (iii) issuance of tenders for all financial services to be purchased by the Ministry of Finance; (iv) submission to the Cabinet of Ministers of a timetable for the design of a comprehensive medium-term civil service reform program; and (iv) improvement on the annual budget process.
- In the budgetary area the Fund is taking the lead on reforms of budgetary revenues to: (i) complete the process of subjecting all taxpayers to the tax legislation; (ii) improve procedures for revenue forecasting; (iii) improve tax and customs administration; and (iv) eliminate the earmarking of revenues for some extra-budgetary operations of budget organizations. In these areas, as well as monetary and exchange rate policy, the Bank takes into account the policy recommendations of the Fund and ensures that its own policy advice is consistent.

World Bank's contacts:

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Azerbaijan: Statistical Issues

1. Although the authorities have made significant progress towards improving the quality and timeliness of their macroeconomic statistics, a number of weaknesses need to be addressed, particularly in the areas of national accounts and producer prices. In these areas, extensive technical assistance has been provided by STA and it is important that the authorities address its recommendations.
2. A ROSC mission that took place in May 2002, carried out a review of Azerbaijan's data dissemination practices against the GDDS, as well as an in-depth 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 ROSC module is published on the IMF external website. Azerbaijan nominated a national GDDS Coordinator in early May, and the authorities intend to participate in the GDDS in 2005.

A. Real Sector

National Accounts Statistics

3. Peripatetic missions to Baku under STA's technical assistance project on national accounts provide assistance to the State Statistics Committee (SSC). Progress was made in a number of areas: (i) the methods for compiling the gross national income were improved and the revised estimates disseminated; (ii) quarterly national account estimates at constant prices for 1998–2003 were compiled; (iii) the data on capital investments were revised; (iv) estimates of undeclared wages were obtained; and (v) a new methodology for calculating price indices in construction and transportation is well underway and preliminary results are expected this year. The March/April 2005 mission identified the following problems: (i) the State 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 obtain reliable estimates of remittances from Azerbaijan citizens working abroad; and (iii) there are no estimates on the contribution of shadow economic activity in total GDP.

Price Statistics

4. The price department of the SSC intends to update the consumer basket of goods and services and weights used for the compilation of the CPI. A STA mission visited Baku in the middle of June 2003 to assess the progress with the pilot CPI based on new weights. The mission assisted the staff of the SSC with the specification for data processing for the new CPI and developed a preliminary list of approximately 550 market basket items. Procedures for estimating the market basket weights based on the results of the 2002 household budget survey have been developed and the SSC will shortly publish an updated CPI based on these weights.

B. Fiscal Sector

5. Recent treasury modernization efforts are expected to improve the compilation of fiscal data. With the help of a peripatetic advisor from the Fund, the ministry of finance developed the treasury chart of accounts (COA), which is an essential input to the new treasury system being implemented. Currently the treasury is working on a more detailed version of the COA with the help of USAID and U.S. Treasury experts. This work is proceeding in parallel with the computerization of Treasury operations that is being done by SAP, a German company.

6. The 2002 data ROSC recommended expanding the coverage of government finance statistics by including all operations recorded by the treasury and publishing details on financing and debt outstanding. Over the medium term, the government should strive to publish all fiscal data in a single publication showing national and GFS presentations. It should also develop a plan for adopting the framework and classification system as recommended in GFSM 2001.

C. Monetary Sector

7. Following two STA technical assistance missions in 2000 and 2002, the Azerbaijan National Bank (ANB) now compiles monetary statistics according to the methodology of the *Monetary and Financial Statistics Manual*, and in full compliance with the GDDS and SDDS standards in terms of quality, coverage, and timeliness. ANB reports monetary data to STA within three weeks after the end of the reference month, and these data are used to generate automatically the analytical tables required for monitoring the PRGF-supported program.

D. External Sector

8. *Balance of Payments (BOP)*: While the overall structure of the BOP statistics was in broad conformity with the guidelines presented in the *Balance of Payments Manual, fifth edition*, the Data ROSC mission in May 2002 found that there were several weaknesses in the methodology of compilation, including: (i) an inadequate breakdown between FDI equity and other capital which is necessary to properly record transactions associated with the Baku-Tbilisi-Ceyhan Pipeline; (ii) undercoverage of nonguaranteed external debt; (iii) poor data on FDI income in the oil sector; and (iv) misclassification of current transfers and other liabilities transactions. A follow-up BOP mission in May 2004 provided further assistance in implementing the recommendations of the Data ROSC mission, developing the ITRS reporting system, and improving the methodological soundness of the public external debt data.

9. The ANB has made steady progress toward implementing the short-term measures recommended by the 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 reclassified them into other investment assets of the government; a new survey form for oil sector enterprises (IOCs) has been designed and distributed to

international oil consortia for their input; and the scope and classification of BOP statistics have been improved. However, the provision of data from reporters, specifically from the IOCs, is inadequate to compile the data on foreign direct investments. Estimates based on different assumptions result in inconsistencies from differences in timing, coverage, and valuation of the source data.

10. To date, significant progress has been made in implementing the Data ROSC module's medium-term recommendations on balance of payments statistics. However, while documentation on BOP sources and methods has been completed, its publication may be delayed until later this year due to budgetary constraints. It is STA's understanding that the compilation system is facing some operational problems due to the lack of collaboration with other data-producing government agencies, such as the State Oil Fund of the Azerbaijan Republic (SOFAZ).

11. *International Investment Position (IIP)*: The ANB has initiated compilation of the IIP statistics, but the IIP statement is still at an evolving stage. Data on the IIP published in the IMF's *International Financial Statistics* start in 2002 provides a comprehensive statement on international reserves, FDI, portfolio investment, and other investment assets and liabilities by sectors, including the foreign assets of SOFAZ.

12. *Reserves and Foreign Currency Liquidity*: 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 the reserves template, but the ANB and the government of Azerbaijan do not engage in any forward or futures transactions that could give rise to contingent short-term net drains on foreign currency assets.

13. *External Debt*: External debt statistics for public and publicly guaranteed external debt are reported on a quarterly 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 of such debt, is lacking. The 2004 mission emphasized that the responsibility for compiling external debt statistics be clearly assigned to a specific government agency. The authorities are committed to strengthening the debt management system, including maintaining a database on debt comprising not only public and publicly guaranteed external and domestic debt, but also external and domestic debt of state-owned enterprises. A Presidential Decree, dated December 29, 2004, stated that the ANB should prepare a proposal on the compilation of the external debt statistics including nonguaranteed external debt.

AZERBAIJAN: TABLE OF COMMON INDICATORS REQUIRED FOR SURVEILLANCE
AS OF APRIL 27, 2005

	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	3/31/05	3/31/05	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities ¹	3/31/05	4/11/05	D	D	M		
Reserve/Base Money	4/30/05	5/20/05	D	D	M	O, O, O, O	O, O, O, O, LO
Broad Money	4/30/05	5/20/05	M	M	M		
Central Bank Balance Sheet	4/30/05	5/20/05	D	D	M		
Consolidated Balance Sheet of the Banking System	4/30/05	5/20/05	M	M	M		
Interest Rates ²	4/30/05	5/20/05	M	M	M		
Consumer Price Index	3/31/05	4/11/05	M	M	M	O, O, O, O	O, LO, O, O, O
Revenue, Expenditure, Balance and Composition of Financing ³ – General Government ⁴	3/31/05	5/15/05	M	M	M	LO, LNO, LNO, LO	LO, LO, O, O, LO
Revenue, Expenditure, Balance and Composition of Financing ³ – Central Government	3/31/05	5/15/05	M	M	M	LO, LNO, LNO, LO	LO, LO, O, O, LO
Stocks of Central Government and Central Government-Guaranteed Debt ⁵	3/31/05	5/15/05	Q	Q	Q		
External Current Account Balance	3/31/05	5/15/05	Q	Q	Q	LO, LO, LO, LO	O, LO, LO, O, LO
Exports and Imports of Goods and Services	3/31/05	5/15/05	Q	Q	Q	LO, LO, LO, LO	O, LO, LO, O, LO
GDP/GNP	3/31/05	4/11/05	M	M	M	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), 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.

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 inflation⁸ 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

⁸ Excludes fuel, energy, transportation, water, and communications from the consumer price index.

1 ½ percent compared to the program target) mainly by allowing the automatic stabilizers to 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 2002		2003		2004		2004		2004		2004		2005				
	Prog.	Adj.	Prog.	Adj.	Prog.	Adj.	Prog.	Adj.	Prog.	Adj.	Prog.	Adj.	Prog.	Adj.			
1. 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 Nonrecourse External Debt Contracted or Guaranteed by the Consolidated Government or the ANB (excluding the IMF) (flows, in US\$ million) 5/	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Less than one year's maturity	...	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 Nonreschedulable 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	2,761	2,451	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	20	0	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 1,216 US\$/SDR through end-March 2005.

3/ Program targets are adjusted on the basis of program adjustments as specified in Attachment I, Annex 1 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 AOC profit tax of 182 billion manat.



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International Monetary Fund
Washington, D.C. 20431 USA

IMF Executive Board Completes Fifth Review Under Azerbaijan's PRGF Arrangement

The Executive Board of the International Monetary Fund (IMF) has completed the fifth and last review of the Azerbaijan Republic's performance under the three-year Poverty Reduction and Growth Facility (PRGF) arrangement. In doing so, the Board approved a request for waivers of performance criteria on net international reserves, the non-accumulation of external payment arrears, the approval of revenue and expenditure plans and the adoption of a plan to improve the annual budget process. While completion of the fifth review enables the release of the equivalent of SDR 12.87 million (about US\$ 18.8 million), the Azeri authorities have already stated that they will not draw the final tranche available under the arrangement.

The Executive Board approved the three-year arrangement on July 6, 2001 ([see News Brief No. 01/53](#)) for an amount equivalent to SDR 80.45 million (about US\$117.7 million), which was subsequently reduced to SDR 67.58 million on December 22, 2004 ([see Press Release No. 04/276](#)). Disbursements under the arrangement amount to SDR 54.71 million (about US\$80 million).

Following the Executive Board's discussion on Azerbaijan, Mr. Águstin Carstens, Deputy Managing Director and Acting Chair, said:

“Buoyed by strong domestic demand, Azerbaijan’s economy has continued to grow at double-digit rates since 2003. Growth has been broad-based and poverty has declined. The short-term growth outlook is favorable. However, inflation has accelerated to double-digit rates, in part reflecting an expansionary policy mix; and there have been some delays in the implementation of structural reforms. Against this background, the authorities have taken important measures to bring down inflation in the last few months, and are committed to continue with their disinflation policy and structural reform agenda after the PRGF arrangement ends on July 4, 2005.

“On the monetary and exchange rate front, the Azerbaijan National Bank has allowed the manat to appreciate and has increased interest rates. It will continue with its policy of exchange rate appreciation and interest rates increases to ensure a steady decline in inflation by year-end. In addition, the authorities have decided to increase exchange rate flexibility over the medium term, and have started to implement supporting structural reforms.

“Fiscal policy will support the authorities’ disinflation efforts. Although fiscal policy in 2005 will be relatively expansionary, the authorities have decided to reduce the targeted fiscal deficit.

Moreover, the authorities have taken steps to improve monitoring of budget execution by state-owned enterprises and to ensure timely payment of taxes by the State Oil Company of the Republic of Azerbaijan.

“The authorities intend to continue to implement structural reforms that are critical for diversifying the economy, maintaining Azerbaijan’s competitiveness, and achieving macroeconomic stability. Of particular importance will be fiscal and financial sector reforms, further improvements to corporate governance and taxation of state-owned enterprises, and efforts to further improve the business climate and governance,” Mr. Carstens said.

The PRGF is the IMF's concessional facility for low-income countries. PRGF-supported programs are based on country-owned poverty reduction strategies adopted in a participatory process involving civil society and development partners, and articulated in a Poverty Reduction Strategy Paper, or PRSP. This is intended to ensure that each PRGF-supported program is consistent with a comprehensive framework for macroeconomic, structural, and social policies, to foster growth and reduce poverty. PRGF loans carry an annual interest rate of 0.5 percent, and are repayable over 10 years with a 5 ½-year grace period on principal payments.

**Statement by Fritz Zurbrügg, Executive Director for Azerbaijan Republic
and Faig Mammadov, Advisor to Executive Director
June 24, 2005**

On behalf of our Azerbaijani authorities, we would like to thank the staff for the constructive policy discussions and the well-written staff documents. The report on the fifth review presents a concise picture of the overall positive economic developments since the discussion last December. The Ex-Post Assessment is a valuable complement, since it highlights the long way Azerbaijan has come in the ten years of cooperation with the Fund.

The Azerbaijani authorities would like to take this opportunity to thank the members of the Board for their longstanding support and the constructive comments expressed during the last program review. They particularly took note of the suggestion to consider foregoing the last purchase under the PRGF. Based on the strong performance of most macroeconomic indicators, the authorities have decided not to draw the last tranche.

As in the past, our Azerbaijani authorities consent to the publication of all the staff reports. Azerbaijan also remains committed to transparency in the area of extractive industries. As an early participant of the Extractive Industries Transparency Initiative (EITI), it is now finalizing the second cycle of reporting and sharing its experience with other oil-producing countries.

Recent Developments

Since 1996, the Azerbaijan economy continues its path of double digit growth, which is expected to reach a record level of 19-20 percent by the end of 2005. Such a growth path, driven by favorable oil market conditions, rising foreign direct investment and domestic demand, as well as the authorities' specific policy aimed at the development of the non-oil sector, has allowed GDP to double in less than a decade. This has led to a marked improvement of living standards. The external position has further strengthened, with public external debt at 18.6 percent of GDP and gross official reserves together with the assets of the State Oil Fund amounting to US\$2 billion at end-2004. Despite the challenges of supporting a large number of refugees and internally displaced people (12 percent of the population), the poverty level has declined to 40 percent in 2004 from 49 percent in 2001.

The main macroeconomic policy challenge for our authorities stems from the recent rise in inflation. Following a long period of single digit inflation, the upward pressure since October 2004 is of concern. With 12-month inflation peaking at 15.5 percent in April 2005, the authorities are fully aware of the risks that rates at such levels entail for poverty reduction efforts and medium-term growth. There has been a vigorous policy debate on how to rapidly get headline inflation under control. The Presidential decree, signed on May 31, 2005, sets the stage for a coordinated effort to bring down inflation through measures in the monetary, fiscal, and structural areas. The latest inflation figures are encouraging, with very low or even negative monthly rates for April, May and the first half of June. The authorities expect that the cumulative six-month consumer price inflation rate would be by 5 percent in the first half

of 2005. The aim of the comprehensive package is to reduce core inflation to single digits by end-2005.

Fiscal Policy

In 2004, fiscal policy has been in line with the program, with strong non-oil revenue performance leading to a lower non-oil deficit than targeted. The authorities are fully aware that the fiscal stance in 2005 will play a key role in the disinflation program. A budget revision this month will tighten expenditures as a ratio to GDP compared to the program, and weaknesses in the tax payments by the State Oil Company (SOCAR) as well as its taxation are being tackled. In line with the commitments in the Letter of Intent, SOCAR has paid its tax liabilities for the second quarter in cash. The authorities are also preparing proposals on the use of excess export oil revenues accumulated in the special account of the Treasury and have requested technical assistance from the World Bank and the Fund to help improve the taxation of SOCAR. As part of the authorities' prudent approach in using the oil revenues and in light of increased non-oil revenue collection, the use of the oil fund resources will be constrained to financing the targeted projects only. This also supports the authorities' disinflation program.

Within the agreed expenditure envelope, the authorities will continue to address both the development and poverty challenges by directing additional financing to infrastructure, as well as to increase minimum wages. Developing productive infrastructure, supporting local entrepreneurship, achieving more balanced growth across the sectors and the regions, and improving provision of basic services is one of the key priorities of the public expenditure policy.

As noted in the report, the authorities did not agree with staff's recommendation not to increase the minimum wages. They feel strongly that this is a key element of the social strategy aimed at improving the living standards of the population. The authorities are confident that the inflationary impact will be minor, particularly in view of the strong disinflation program. However, the authorities will assess the inflationary outlook in September, before implementing the wage increase. Another element of the strategy is targeted social assistance to protect the most vulnerable groups of population. The World Bank is providing valuable assistance in formulating an appropriate mechanism.

Monetary and Exchange Rate Policies

The policy of the Azerbaijan National Bank (ANB) aims at keeping the inflation rate at the single digit level, thereby encouraging the remonetization of the economy and preserving competitiveness of the non-oil sector. In light of rising inflation and increased foreign exchange inflows, the ANB has allowed the manat to appreciate in recent months. The nominal effective exchange rate has appreciated by more than 7 percent from the beginning of the year, putting downward pressure on inflation. According to ANB estimates, a 1 percent manat appreciation causes a 0.6 - 0.7 percent decline in the inflation, following a lag of a few months. This points to even greater downward pressures on inflation in the coming months.

During 2005, the ANB has restricted its manat interventions in the currency market. The authorities agree with staff that greater exchange rate flexibility is an important element of the disinflation policy. The ANB has also increased the refinancing rate by 0.5 percentage point and is ready to consider further increases, if necessary. The ANB and the relevant government agencies are intensifying their efforts to expand domestic money markets, so as to increase the mix of appropriate monetary policy instruments.

Financial Sector

Over the last 12 months, growth in credit to the private sector has been strong, resulting in a 72 percent increase (April 2005). The growth rates have been particularly high in loans extended to the trade and services sectors. At the same time, the share of non-performing loans has declined to 8.2 percent in March 2005. The ANB is monitoring the developments closely and has adopted a policy of zero-tolerance to enforce prudential regulations.

In terms of market structure, the share of credit from privately-owned banks has increased and currently stands at 47.1 percent. The registration of seven new non-banking financial institutions and the presence of 15 banks (out of 43) with foreign capital participation are important elements for a further deepening of financial markets and increased competition.

Structural Policies

Structural reforms are ongoing in a wide range of areas. Reforming the public administration, state enterprises, and the utilities sector, as well as improving the business environment continue to be at the top of the authorities' agenda. The business climate in Azerbaijan has continued to improve, as evidenced by the improved results of the joint World Bank/EBRD survey. Furthermore, foreign direct investment is still increasing and domestic investment is taking place in a wide range of economic areas.

The legal framework is being further improved by the preparation of the new Investment Law, the Competition Law, and various decrees, including those on strengthening the corporate governance and financial discipline of state owned enterprises. Although the progress was uneven, the process of separating commercial and regulatory functions of the state owned entities is underway. Furthermore, a comprehensive civil service reform is currently being discussed in the government with the aim of optimizing the cost and organizational structures of the budgetary organizations.

Ex-Post Assessment

The authorities broadly agree with the analysis of the Fund engagement in Azerbaijan and have highly valued, the Fund's financial support, policy advice, and technical assistance. Azerbaijan has come a long way from the period of economic chaos, hyperinflation, large fiscal deficits, high external debt obligations, and territorial conflict. The country has moved towards a situation characterized by stable macroeconomic policies, sustainable development, principles of market economy, and strengthened institutions and legal

foundations. These are all important elements for improving the living conditions of its citizens. The Fund has been an important partner in making these achievements possible.

The authorities note that the initial conditions were significantly aggravated by the territorial dispute over the Upper Karabagh region of Azerbaijan and the resulting flood of refugees and internally displaced people. This put tremendous pressure on the country in its first years of independence, stretching its scarce resources and constraining the peaceful development.

Our authorities would like to reiterate two main points of disagreement with the ex-post assessment. First, the overall characterization of monetary and exchange rate policy as passive is inappropriate, since the monetary policy tools had continuously developed, including through the adjustment of the reserve requirements and the rates of refinancing in the early years, as well as implementation of the preventive measures using both exchange rate and monetary policy instruments of during the inflation/deflation cycles, and the Russian crisis of 1998.

Second, as macroeconomic stabilization is one of the main achievements during the program periods, the authorities feel that the report gives recent developments too much weight. While not underestimating the risks of these events, in the authorities' view, they do not undermine their ability to maintain macroeconomic stability.

Looking forward, the staff makes a strong case for a successor arrangement. The Azerbaijani authorities highly value the Fund's support. They are currently reflecting on which form of cooperation would best suit the country's current needs.