IMF Country Reports 21/278

Republic of Azerbaijan: 2021 Article IV Consultation-Press Release; and Staff Report

INTERNATIONAL MONETARY FUND

IMF Country Report No. 21/278

REPUBLIC OF AZERBAIJAN

2021 ARTICLE IV CONSULTATION—PRESS RELEASE; AND STAFF REPORT

December 2021

In the context of the Staff Report for the 2021 Article IV Consultation, the following documents have been released and are included in this package:

- A **Press Release.**
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on a lapse of time basis, following discussions that ended on May 21, 2021, 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 July 1, 2021.
- An **Informational Annex** prepared by the IMF staff.

The IMF's transparency policy allows for the deletion of market-sensitive information and premature disclosure of the authorities' policy intentions in published staff reports and other documents.

Copies of this report are available to the public from

International Monetary Fund • Publication Services
PO Box 92780 • Washington, D.C. 20090
Telephone: (202) 623-7430 • Fax: (202) 623-7201
E-mail: publications@imf.org Web: http://www.imf.org
Price: $18.00 per printed copy

International Monetary Fund
Washington, D.C

© 2021 International Monetary Fund

©International Monetary Fund. Not for Redistribution

IMF Executive Board Concludes 2021 Article IV Consultation with the Republic of Azerbaijan

FOR IMMEDIATE RELEASE

Washington, DC – December 23, 2021: On July 21, 2021**, t**he Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with Azerbaijan on a lapse of time basis.

Azerbaijan was severely hit by the COVID-19 pandemic and the decline in oil prices, but a sizable relief package helped to cushion the economic impact of the shock. Real GDP declined by 4.3 percent in 2020, driven by a significant contraction in oil GDP, which fell by 7.2 percent, while nonoil GDP declined by 2.6 percent. With the *de jure* free floating exchange rate regime, the manat continued to be *de facto* pegged to the US dollar, and average consumer price inflation remained subdued, at below 3 percent. Oil export revenues fell by 40 percent and the current account balance moved from a 9 percent of GDP surplus in 2019 to a small deficit in 2020. The authorities responded to the crisis with a fiscal package of close to 5 percent of GDP, including emergency health spending, subsistence cash transfers to the unemployed, temporary public jobs, support to microentrepreneurs and deferral of some taxes. The fiscal package was complemented by financial sector measures, including loan guarantees and the temporary relaxation of capital and loan provisioning norms. As a result of increased spending and lower revenues, consolidated fiscal balance turned from a surplus of over 8 percent of GDP in 2019 to a deficit of 6.4 percent of GDP in 2020.

Economic activity is projected to rebound in 2021, as the nonoil economy recovers from the pandemic. Nonoil GDP growth is projected to rise to 3.5 percent in 2021, before settling at 2.5 percent in the medium term. Hydrocarbon output is expected to remain stable as increased natural gas production is expected to offset declining productivity of aging oil fields. Inflation is expected to rise to 4 percent in 2021, remaining at 3 percent on average in the medium term. The current account is projected to return to a surplus of around 2.5 percent of GDP in 2021 as oil prices recover and natural gas exports rise and remain in a small surplus in the medium term.

The outlook is subject to a high degree of uncertainty, with risks broadly balanced. A spread of more dangerous COVID-19 virus strains and/or a slowdown in the rollout of vaccines may delay the re-opening of the economy. Slower-than-expected recovery of global demand would also pose a risk to the oil sector. On the upside, a faster-than-expected global recovery could push oil and gas prices higher, boosting revenues and strengthening fiscal and external balances. With oil resources gradually being

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. Due to the COVID-19 pandemic, the 2021 discussions were carried out virtually.

©International Monetary Fund. Not for Redistribution

exhausted, accelerated structural reforms are needed to diversify the economy and improve productivity of the nonoil sector, strengthening Azerbaijan's economic prospects.

Executive Board Assessment[2]

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

Azerbaijan faced an unprecedented challenge in 2020, but timely and appropriate policy response mitigated the impact of the pandemic on the economy. A significant relief package helped cushion the impact of the pandemic and the decline in oil prices. With vaccination progressing and lockdown measures gradually eased, the economy has started to recover. The near-term challenge is to properly calibrate the phasing out of the COVID-19-related stimulus, balancing the need to avoid endangering the recovery while preparing the ground for addressing structural challenges. In the long term, Azerbaijan's running out of oil in the coming decades poses the fundamental challenge as the economy needs to wean off its dependence on oil revenues.

While fiscal policy has been appropriately eased during the pandemic, a growth-friendly fiscal consolidation needs to start in 2022. The accommodative fiscal stance in 2021 is appropriate and, in the case of adverse shocks, automatic stabilizers should be allowed to operate and additional, targeted on-budget fiscal support should be provided, as necessary, within the available fiscal space. Windfall revenue from higher-than-budgeted oil prices should be saved. Looking ahead, continued expansionary stance would not be compatible with preserving the *de facto* peg and fiscal sustainability and would also make it more difficult to attain intergenerational equity in the face of a projected exhaustion of oil resources. Thus, consolidation should start in 2022 and be sustained over the long term, to gradually achieve a significant reduction in the nonoil primary deficit. While the authorities see a key role for expenditure consolidation, measures to improve nonoil revenues will eventually have to contribute to adjustment. Consolidation needs to be accompanied by measures to protect the vulnerable and support education and health, with a view to enhancing inclusiveness and productivity. Stepped structural and financial sector reforms are also critical, to mitigate the adverse impact of consolidation on economic growth.

Planned fiscal adjustment should be supported by the revised fiscal rule. In response to the outbreak of the pandemic, the authorities have temporarily suspended the fiscal rule. They intend to revise and re-launch it in 2022, using the nonoil primary balance and debt-to-GDP targets to anchor fiscal policies. Public financial management reforms, including of the medium-term fiscal framework, fiscal risk management and transparency, are needed to support the implementation of the rule and its credibility. Establishing a solid track record of the rule implementation is particularly important given its suspension in 2020 during the pandemic, a year after its introduction.

Further monetary easing could be considered to support the nascent recovery, especially if downside risks were to materialize. Although CBA has reduced its policy rates since the outbreak of the pandemic, financial conditions remain tighter than when the pandemic started. Despite the de facto peg, low financial integration and a large spread over the Fed rates provide room for further rate cuts. In addition,

[2] At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.IMF.org/external/np/sec/misc/qualifiers.htm.

©International Monetary Fund. Not for Redistribution

following a recent temporary uptick, inflation is projected to remain close to the mid-point of the CBA target range.

A gradual move to a more flexible ER regime should be considered in the medium term. The *de facto* peg has been effective in keeping inflation under control, but as Azerbaijan's main trading partners have more flexible regimes, maintaining competitiveness is challenging under the peg. A more flexible exchange rate would facilitate adjustment to oil price shocks, reduce adjustment burden on fiscal policy, and support diversification of the economy and market development. The current difference between the *de jure* flexible exchange rate regime and the *de facto* pegged one and the framing of policy communication in inflation-targeting terms poses risks to policy credibility and needs to be addressed promptly. More broadly, the external position is deemed to be substantially weaker than the level consistent with medium-term fundamentals and desirable policies (Annex III).

Targeted and time-bound plan to phase out exceptional prudential easing introduced in response to the pandemic is needed. The authorities need to balance the risk to bank soundness arising from prematurely phasing out the forbearance measures and the risks from delaying the reversal to credit quality and market discipline. Staff welcomes the recent replacement of a blanket deposit insurance, in place since the previous banking crisis, with a limited guarantee program, a list of regulatory tightening measures that have been already implemented or on the schedule, and the efforts in improving financial stability analysis capacity. In the medium term, strengthening financial oversight of both lenders' risk-taking activities and borrowers' credit risk is an important complement that is needed to ensure financial stability and improve access to finance. The authorities should also continue making progress in enhancing the effectiveness of the AML/CFT framework.

Impediments to private sector growth and job creation need to be tackled to support private sector development and diversification of the economy. Weak institutions, limited SME access to credit; inefficient labor, product, and service markets; and sizeable skill gaps result in high informality, discourage nonoil FDI and slow productivity growth. Addressing these weaknesses, including by strengthening the governance and anti-corruption frameworks, attending the scarring impact from the pandemic, and pursuing the green agenda envisaged under the Azerbaijan 2030 Priorities, are needed to achieve inclusive and green growth. The recently released national priorities set ambitious goals for social and economic development and would need to be supported by well-designed and consistently implemented policy reforms.

©International Monetary Fund. Not for Redistribution

Azerbaijan: Selected Economic Indicators

Population (2020 est.): 10.06 million | Literacy/Poverty rates: 100.0 (2018)/5.4 (2018)
Quota (in SDR million): 391.7 | Per capita GDP (in US$, 2020): 4,232
Main products and exports: Oil, gas, and fruits. | Key export markets: Italy, Turkey, Israel

				Projections	
	2018	2019	2020	2021	2022
Output					
Real GDP growth (in percent)	1.5	2.2	-4.3	2.3	1.7
Real non-oil GDP growth (in percent)	2.1	3.3	-2.6	3.5	2.5
Real oil GDP growth (in percent)	0.5	0.4	-7.0	0.2	0.2
Employment					
Unemployment rate (in percent)	4.9	4.8	7.2	5.8	5.7
Prices					
Consumer price index (period average)	2.3	2.7	2.8	4.0	3.2
General government finances					
Revenue (including grants, in percent of GDP)	38.6	41.5	33.8	31.7	33.5
Expenditure (in percent of GDP)	33.1	33.3	40.4	37.2	36.5
Current expenditure	19.1	21.6	28.8	27.2	27.6
Capital spending and net lending	14.0	11.7	11.6	10.0	8.9
Fiscal balance (in percent of GDP)	5.5	8.2	-6.5	-5.6	-3.0
Non-oil primary fiscal balance (in percent of non-oil GDP)	-31.7	-27.2	-30.3	-32.1	-30.2
General government gross debt (direct borrowing) 1/	18.7	17.7	21.4	30.6	31.4
General government gross debt including guarantees	48.2	47.7	54.1	46.0	44.4
Money and credit					
Broad money (including foreign currency deposits, percentage change)	5.7	19.9	1.1	8.3	6.4
Bank credit to the private sector (percentage change)	14.9	15.2	-0.7	5.0	9.1
Balance of payments					
Current account balance (in percent of GDP)	12.8	9.1	-0.5	2.4	1.9
Foreign direct investment (in percent of GDP)	-1.7	-2.9	-1.8	0.8	1.0
Gross international reserves (in months of non-oil imports)	4.7	5.4	6.8	5.4	5.9
Exchange rate					
REER (average, percentage change)	3.1	3.9	4.5	…	…

Sources: Azerbaijani authorities; and IMF staff estimates and projections.
1/ Starting in 2021, includes guarantees issued to Aqracredit for its acquisition of distressed assets from the IBA.

©International Monetary Fund. Not for Redistribution

REPUBLIC OF AZERBAIJAN

STAFF REPORT FOR THE 2021 ARTICLE IV CONSULTATION

July 1, 2021

KEY ISSUES

Context. Azerbaijan faced unprecedented challenges in 2020. The combined COVID-19 and oil price shocks pushed the economy into recession. A sizeable relief package helped cushion the economic impact from this shock, and the economy has started to recover. Yet the medium-term outlook remains subdued. The long-term fiscal position is unsustainable as oil resources are expected to run out by mid-century. The authorities have laid out strategic goals of accelerated yet sustainable socio-economic development over the next decade and are developing policy plans to that end.

Policy recommendations.

- In the near term, an accommodative fiscal stance is appropriate to ensure public health, including vaccine rollout, and support the recovery. Scope for further interest rate cuts exists especially if downside risks materialize.

- Once the recovery is firmly underway, fiscal consolidation should resume with the goal of sharing exhaustible oil wealth with future generations and strengthening precautionary buffers. Consolidation should be gradual and its composition growth-friendly, to mitigate the adverse impact on the economy and the vulnerable. Redesigning and reintroducing a credible fiscal rule would help reduce fiscal policy procyclicality and improve long-term fiscal sustainability.

- To strengthen credibility and better anchor policies, the *de jure* (free floating) and *de facto* (soft peg) exchange rate regimes should be reconciled. A move to greater exchange rate flexibility would improve resilience and foster market development.

- Reversing the exceptional prudential easing should proceed carefully. Financial sector reforms should aim at improving competition, developing financial markets, and improving access to finance, and financial sector oversight and risk monitoring need to be strengthened.

- To diversify the economy away from oil dependence and limit scarring from the pandemic, investment for healthcare, education, and green and digital infrastructure should be prioritized, together with reducing administrative burden and barriers to entry for private business and strengthening governance and the anti-corruption framework.

©International Monetary Fund. Not for Redistribution

Approved By
Zeine Zeidane (MCD) and Maria Gonzalez (SPR)

Discussions with the authorities were held remotely during April 19–May 21, 2021. The staff team comprised Natalia Tamirisa (head), Jiri Jonas, Gustavo Ramirez, Issouf Samake (all MCD), Yizhi Xu (MCM), Jean-Francois Wen (FAD), with support from Amine Yaaqoubi and Aghgun Gadirli. Piotr Trabinski, Marcel Peter, and Amin Muradov (OED) participated in the discussions. Chady El Khoury and Kohei Noda (LEG) joined meetings on governance. Branden Laumann provided excellent production assistance.

CONTENTS

CONTEXT AND RECENT DEVELOPMENTS 4

OUTLOOK AND RISKS 7

POLICY DISCUSSIONS 8

A. Fiscal Policy 8

B. Monetary and Exchange Rate (ER) Policy 14

C. Financial Sector Policy 15

D. Structural Policy 17

STAFF APPRAISAL 18

FIGURES

1. Economic Impact of COVID-19 6
2. Real Sector Indicators 21
3. External Sector 22
4. Fiscal Sector 23
5. Monetary and Exchange Rate Developments 24
6. Banking Sector 25
7. Social Spending 26

TABLES

1. Selected Economic and Financial Indicators, 2018–26 27
2. Balance of Payments, 2018–26 (In millions of U.S. dollars) 28
3. Balance of Payments, 2018–26 (In percent of GDP) 29
4. Statement of Consolidated Government Operations, 2018–26 (In millions of manat) 30
5. Statement of Consolidated Government Operations, 2018–26 (In percent of non-oil GDP) 31
6. Summary Accounts of the Central Bank, 2018–26 32
7. Monetary Survey, 2018–26 33
8. Inclusive Growth Indicators 34

©International Monetary Fund. Not for Redistribution

ANNEXES

I. Response to the Pandemic 35
II. Debt Sustainability Analysis 37
III. External Sector Assessment 39
IV. Risk Assessment Matrix 43
V. Priorities for Tax Reforms 47
VI. Financial Development, Inclusion, and Stability 50

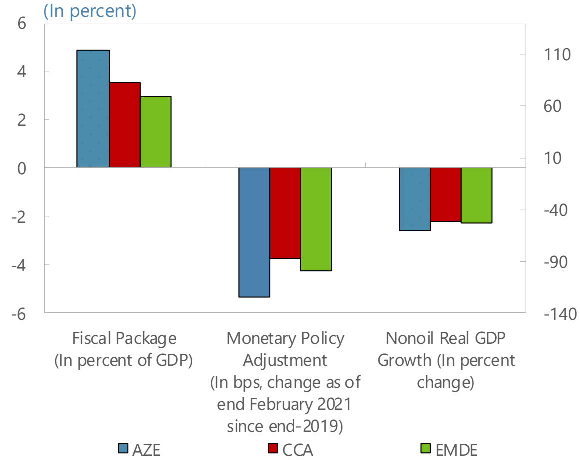
©International Monetary Fund. Not for Redistribution

CONTEXT AND RECENT DEVELOPMENTS

1. **A robust and swift policy response to the pandemic set the floor on the economic contraction and ignited a recovery**. Containment, health, and economic relief measures helped slow infections and protect the vulnerable. Defeating the pandemic and firming up the recovery—including through a broadening of the vaccine rollout—is the immediate priority. With oil reserves likely to be exhausted in the next few decades, multifarious reforms are needed to strengthen long-term fiscal sustainability and spur private sector-led, diversified and inclusive growth. Tackling these long-term challenges requires integrated policy frameworks and transparency, to support decision-making, foster credibility, and attract foreign investment.

2. **The confluence of the pandemic and oil shock pushed the economy into a recession**. Real GDP declined by 4.3 percent in 2020, driven by oil GDP, which fell by 7.0 percent, in part owing to the OPEC+ commitments (Figure 2).[1] Nonoil GDP dropped by 2.6 percent in 2020, with contact-intensive and transportation sectors (accounting for nearly half of the nonoil economy) affected the most.[2] Alongside strict containment measures aimed to slow the spread of infections, economic relief measures helped protect jobs and incomes (Annex I). Contraction in private credit was mild, owing to borrower support and interest rate cuts. Amid the recession, inflation remained below 3 percent, and the real effective exchange rate appreciated (by 5.5 percent).

Azerbaijan: Fiscal and Monetary Measures, 2020
(In percent)



Sources: IMF Covid Policy Tracker, National authorities and IMF staff calculations.

3. **The authorities suspended the fiscal rule and rolled out a sizeable relief package** (4.8 percent of GDP), to address public health needs and support individuals and firms affected by the pandemic (Annex I). The overall deficit turned from a surplus of 8.2 percent of GDP in 2019 to a deficit of 6.5 percent in 2020, owing to the decline in oil revenues and pandemic-related spending increases, amplified by the GDP decline (Table 5). Nonoil primary balance (NOPB) widened from -27 percent in 2019 to -30 percent of nonoil GDP in 2020. The fiscal package was financed by drawing down State Oil Fund of Azerbaijan (SOFAZ) assets and reallocating spending. Government debt remained below 35 percent of GDP, as of January 2021 (Annex II).[3]

[1] Oil GDP includes natural gas production which is becoming an important part of the sector.

[2] In Q1 2021, real GDP was flat compared to Q1 2020, with nonoil GDP increasing by about 2 percent. Inflation picked up to 4.2 percent in May, driven by increases in global food prices.

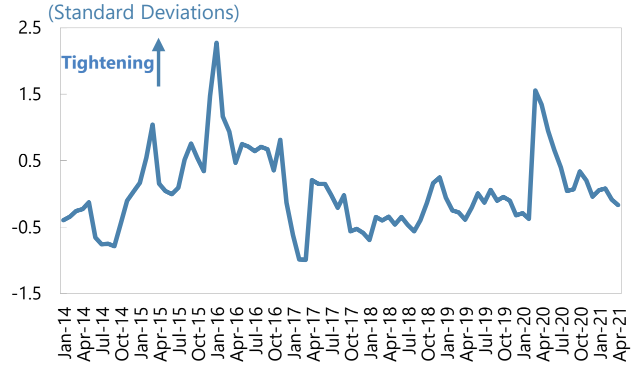
[3] This estimate includes the guarantee granted to Agrarkredit, a government-controlled credit agency, on the bond it issued to acquire bad assets from the IBA during the 2015-16 crisis. The government is highly likely to service the bond because Agrarkredit may not be able to recover the bad assets in full. The outstanding amount was AZN 9.48 billion (13.1 percent of the 2020 GDP), as of January 1, 2021. The debt service cost is limited, given 30-year maturity, 5-year grace period, and interest rate of 0.15 percent. Other guarantees account for additional 22 percent of GDP.

©International Monetary Fund. Not for Redistribution

4. A sharp reversal of the current account surplus in 2020 underscored high vulnerability to oil shocks. Oil export revenues declined by 40 percent, and import compression was smaller, given the undiversified structure of the economy (Figure 3, Tables 2–3). The 9.1 percent of GDP surplus of 2019 turned into a 0.5 percent deficit. FDI, mainly to the oil sector, contracted towards the end of the year. Central Bank of Azerbaijan's (CBA's) international reserves increased by 2.3 percent, to $6.4 billion, and valuation gains partially offset the drawdown of SOFAZ assets to finance the budget deficit.[4] Together with SOFAZ's assets of $43.6 billion, external buffers reached 117 percent of GDP at end-2020. Nonetheless, the external position deteriorated in 2020 and is deemed by staff to be substantially weaker than the level consistent with medium-term fundamentals and desirable policies (Annex III).

5. Monetary policy was eased, in the context of the *de facto* peg. With oil prices plummeting in March-April 2020, pressures on the manat intensified, and SOFAZ expanded foreign exchange (FX) sales (Figure 5). The subsequent rebound in oil prices allowed the authorities to gradually reduce the policy rate, starting in June, by 125 basis points to 6.25 percent by end-2020. In tandem, the CBA tightened reporting requirements for currency conversion in June 2020.[5] Although easing from the peaks of March–April 2020, financial conditions remain tighter than before the pandemic, mainly owing to manat real appreciation and sticky real lending rates.

Azerbaijan: Financial Condition Index
(Standard Deviations)



Source: IMF staff calculations.
Note: The financial condition index is constructed based on a list of financial variables in Azerbaijan (i.e., real short-term interest rates, sovereign spreads, manat lending rate term spreads, FX lending rate term spreads, VIX, change in NEER, and oil price) using principal component analysis.

6. Notwithstanding recent improvements in line with available data, vulnerabilities in the banking sector persist. By the start of the pandemic, bank buffers had recovered from the lows of the 2015–16 crisis. Moreover, in April 2020, CBA approved a package of measures aimed at supporting the banking sector and closed four medium-sized banks with long-standing solvency issues. As a result, the sectoral capital and liquidity ratios edged up in 2020, although improvements have not been uniform. Bank profitability worsened, likely owing to weak credit demand and loan impairment charges (Figure 6). Although FX exposures have declined since 2015–16, several large banks continue to run negative net open FX positions (NOFP). Deposit dollarization continued to decline in 2020 from the highs of the previous crisis but remains high, close to 50 percent, and concentrated in a few banks.

[4] SOFAZ's transfer of its 2020 asset valuation and profit gains to the CBA offset the $1.8 billion decline in the CBA reserves reported in the balance of payments.

[5] This measure is being assessed by staff using the Institutional View on Liberalization and Management of Capital Flows, as it might constitute a capital flow management measure.

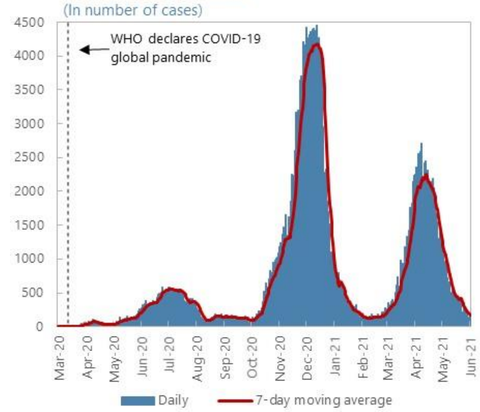
©International Monetary Fund. Not for Redistribution

Figure 1. Azerbaijan: Economic Impact of COVID-19

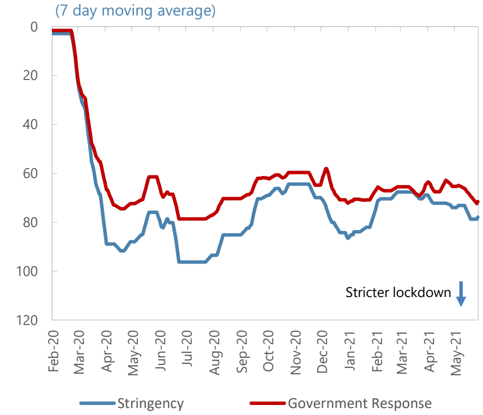
Azerbaijan experienced three waves of the COVID-19 pandemic…

Authorities responded with strong containment measures…

COVID-19 Daily Infections
(In number of cases)



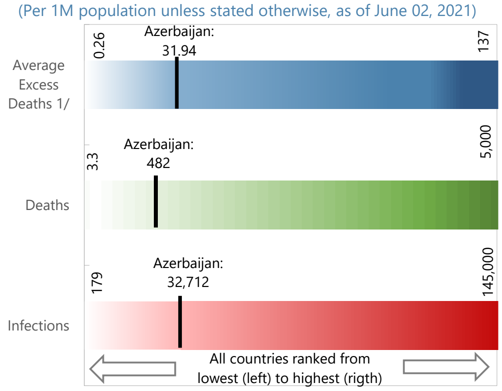
COVID Policy Indices
(7 day moving average)



…which, together with the public health response, helped reduce infections.

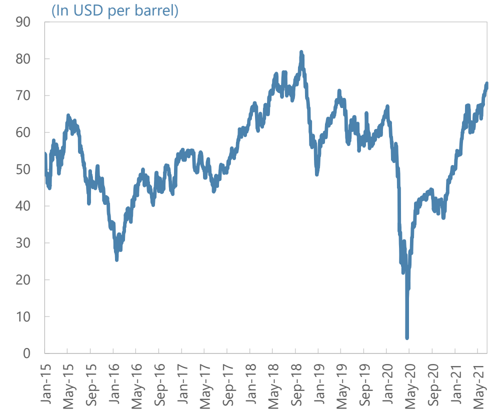
The collapse of oil prices in March 2020 exacerbated the economic impact from the pandemic.

COVID-19 World Average Excess Deaths, Infections and Deaths
(Per 1M population unless stated otherwise, as of June 02, 2021)



1/ Percentage difference between the number of deaths in 2020–2021 and the average number of deaths in the same period over the years 2015–2019.

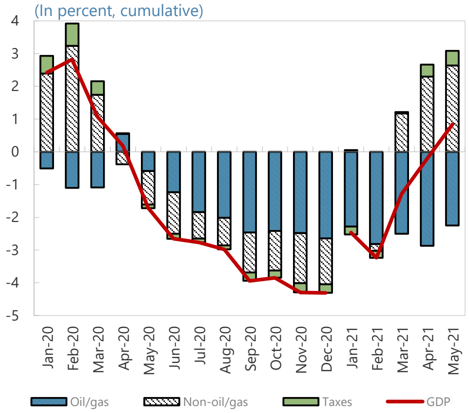
Oil Price
(In USD per barrel)



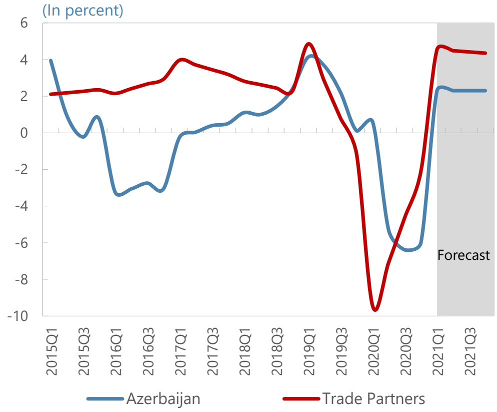
Economic contraction was broad-based in 2020…

…and the business cycle is correlated with that of the trading partners.

Contributions to Real GDP Growth
(In percent, cumulative)



Quarter-over-Quarter Real GDP Growth
(In percent)



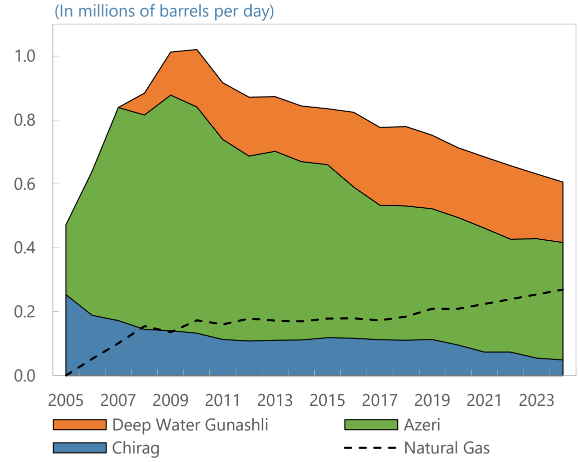
Sources: COVID-19 Government Response Tracker, John Hopkins University, National authorities, Our World in Data, WEO, and IMF staff calculations.

©International Monetary Fund. Not for Redistribution

OUTLOOK AND RISKS

7. **Economic growth is expected to recover in 2021**. Staff projects a 2.3 percent increase in real GDP this year, driven by the nonoil sector. The economy is reopening following the start of vaccination in mid-January (with almost 10 percent of population fully vaccinated as of early June). Fiscal policy remains supportive. Increased gas production, owing to the opening of the Southern Gas Corridor (SGC) to Europe, is projected to offset the decline in oil output.

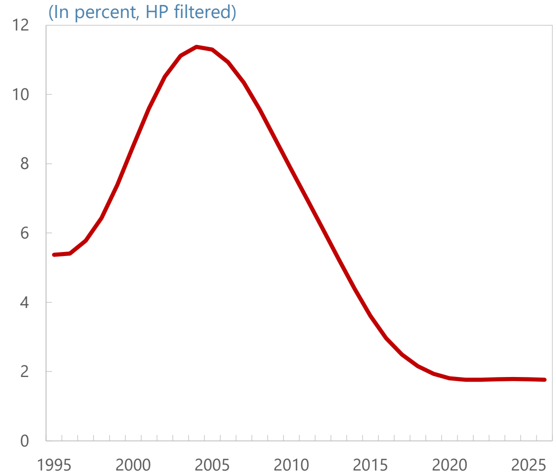
Azerbaijan: Azeri-Chirag-Gunashli Oil and Gas Production
(In millions of barrels per day)



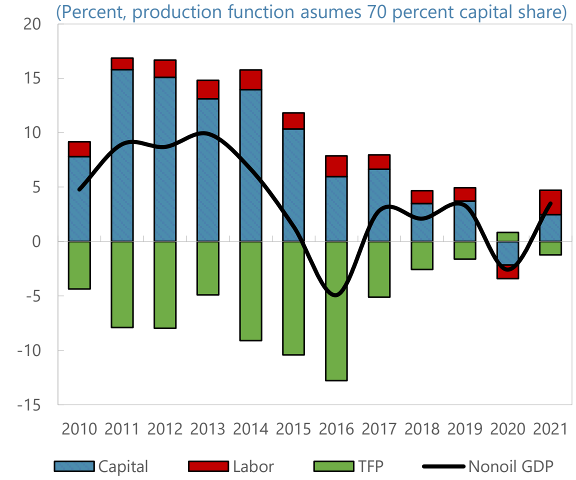
Sources: British Petroleum and IMF staff calculations.

8. **Medium-term prospects remain subdued**. Weak nonoil productivity growth compounds the impact of slowing capital accumulation. Scarring from the pandemic—including a prolonged decline in demand in contact-intensive sectors such as tourism and transportation, increased unemployment, disruptions in learning, long-term health effects of COVID, and slowdown in investment—weighs on the outlook (Table 1). Hydrocarbon output is projected to remain stable as higher gas production compensates for the declining productivity of the aging oil fields.

Azerbaijan: Potential Nonoil Output Growth
(In percent, HP filtered)



Azerbaijan: Contribution to Nonoil Real GDP Growth
(Percent, production function asumes 70 percent capital share)



Sources: National authorities, and IMF staff calculations.

9. **Risks are broadly balanced** (Annex IV). The emergence of more dangerous virus strains, and problems in the global rollout of vaccines could delay the global reduction in infections and the recovery, while putting pressure on oil demand and prices. Domestically, the third wave of infections in the spring of 2021 and challenges in vaccination could slow the re-opening of the economy, while faster-than-expected structural decline in productivity could weaken growth. Besides oil price volatility, higher-than-expected Karabakh reconstruction needs and weaknesses in SOE and bank

©International Monetary Fund. Not for Redistribution

balance sheets present fiscal risks. Policy fragmentation and weaknesses in policy frameworks, if allowed to persist, are another source of downside risks. On the upside, a faster global recovery and higher oil prices could boost growth and improve fiscal and external balances. Over the medium term, a significant boost in structural reform efforts could improve economic prospects.

10. The authorities broadly shared staff's assessment of risks but were more optimistic about economic growth prospects. While recognizing uncertainty about the future course of the pandemic, the authorities noted that the vaccination is already showing positive results and expressed hope that it would lead to a reopening of the economy and pick-up in activity. The authorities expected that reforms to be designed and initiated in line with the recently launched National Priorities for Socio-Economic Development over the next decade would improve SOE's performance and boost productivity in the nonoil sector in the coming years.

POLICY DISCUSSIONS

Staff recommended: (i) continuing to support the economy in the near term and phase out the exceptional support gradually, to avoid jeopardizing the recovery; (ii) recalibrating fiscal plans and anchors to ensure long-term sustainability; (iii) aligning the de jure and de facto exchange rate regimes; (iv) fostering sustainable, inclusive, diversified and private sector-led growth; and (v) improving resilience and management of fiscal and financial risks, including contingency planning, to evaluate available policy space.

A. Fiscal Policy

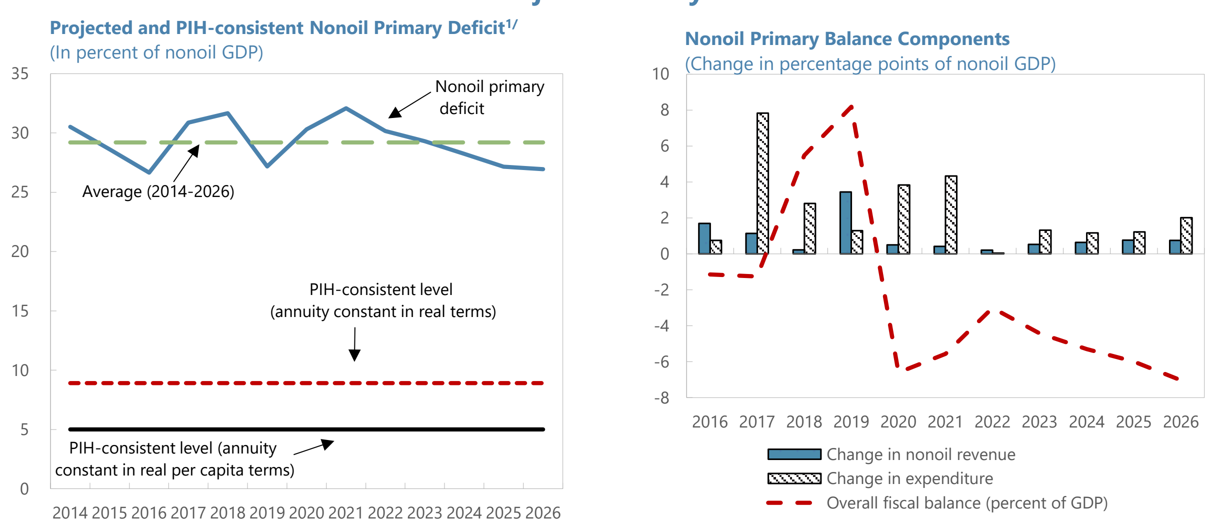
11. The authorities and staff agreed that an accommodative fiscal stance is appropriate for 2021. The 2021 budget implies a significant widening of the deficit, based on a conservative oil price assumption of $40 per barrel. Staff projects a smaller deficit, reflecting a higher assumed oil price. Still, this implies a moderate additional stimulus, with NOPB deteriorating by 1.8 percentage point (pp) of nonoil GDP. This stance is reasonable, given the continued need to fight COVID-19 and support the recovery as well as some fiscal space available in the near term. Support should remain in place until the recovery is firmly underway and after that it should be phased out gradually, to avoid cliff effects. Health spending needs to be sufficient to ensure a successful vaccine rollout and defeat the pandemic.

12. All recognized that fiscal policy should remain flexible. The authorities and staff agreed that if downside risks were to materialize, automatic stabilizers should be allowed to operate and additional, targeted on-budget fiscal support should be provided, as necessary, within the available fiscal space (Annex IV). Staff recommended saving the windfall gains from the oil price exceeding the 2021 budget assumptions and reallocating instead spending to cover additional needs, to limit a further deterioration in the long-term fiscal position and buffers. However, the authorities signaled their intention to revise spending up in the near term to cover additional reconstruction and vaccination needs, as well as subsidies to agriculture in response to the increase in diesel tariffs in early 2021.

©International Monetary Fund. Not for Redistribution

13. Staff emphasized that weakening long-term fiscal sustainability requires formulating credible reform plans. Deficits are expected to persist (Tables 4–5), as oil prices are projected to remain below fiscal breakeven levels and the reconstruction needs of the Karabakh region – not yet costed but potentially high – will be largely met from public sources (the 2021 budget allocated 2.5 percent of GDP to reconstruction). Moreover, oil revenues as a share of oil GDP have been historically well above nonoil revenues as a share of nonoil GDP, and under the current tax structure, the projected decline in the share of oil GDP in total GDP will also lead to a decline in total revenue as a share of GDP (Table 5). Thus, declining oil revenues would require increasing effective taxation of the nonoil sector in the coming years. High oil dependence (oil revenues account for half of total government revenues) and sizeable contingent liabilities underscore the need for adequate precautionary buffers. A large gap of 21 pp of nonoil GDP from the long-term Permanent Income Hypothesis (PIH)-consistent NOPB benchmark of 9 percent of nonoil GDP implies that, on current policies, the fiscal position is not sustainable in the long run.

Azerbaijan: Fiscal Dynamics



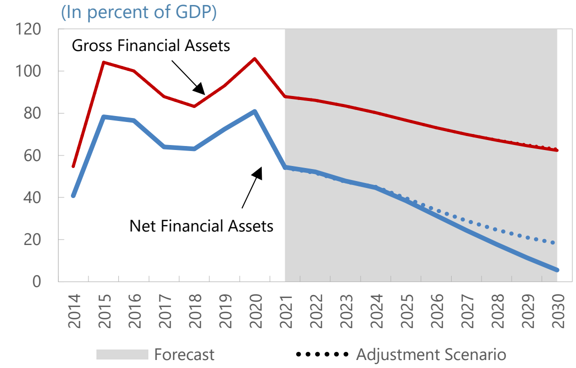
Sources: National authorities, and IMF staff calculations.

1/ The gap between actual nonoil primary balance and non-oil primary balance recommend by the Permanent Income Hypothesis. The higher the value the greater the effort needed to restore intergenerational equity.

14. There was consensus that significant, multi-year fiscal adjustment would be needed to improve intergenerational equity and reduce external misalignment. The authorities considered that such consolidation would also support the *de facto* currency peg. Staff projected in the baseline that consolidated government's net financial assets (NFA) would decline to 7.1 percent of GDP by 2030 and the PIH gap would reach 14 pp of non-oil GDP in 2030. The baseline assumed, in line with the authorities' previously announced plans, that NOPB would improve by 1 pp of nonoil GDP per year.

©International Monetary Fund. Not for Redistribution

Azerbaijan: Financial Assets
(In percent of GDP)



Sources: National authorities and IMF staff calculations and estimates.
Notes: Baseline scenario assumes the nonoil primary balance increases on average by about 1 pp per year during 2022–30. Adjustment scenario assumes the nonoil primary balance increases on average by about 1.5 pp per year during 2022–30.

15. The authorities and staff agreed that, given the continued weakening of the fiscal position, a sustained consolidation would be needed after the recovery from the pandemic takes hold. Based on domestic and international experiences,[6] staff recommended a steady NOPB improvement of 1.5 pp of nonoil GDP per year on average during 2022–30. Such an adjustment would strike an appropriate balance among improving long-term fiscal sustainability, addressing development needs, and mitigating the adverse impact on the economy.[7] The authorities generally agreed. They explained that, although their preliminary plans assumed medium-term consolidation (especially in 2022 as the pandemic spending was expected to unwind), they were considering the possibility of spending a (still to be identified) portion of windfall gains on reconstruction. Staff emphasized the importance of developing credible medium-term fiscal plans, including identifying consolidation measures, and evaluating their impact on the economy.

Azerbaijan: Fiscal Scenarios, 2021-26
(In percent of nonoil GDP, unless stated otherwise)

	2021	2022	2023	2024	2025	2026	Adjustment in 2022	Average annual change 2023-26
Staff's Proposed Adjustment Scenario								
Revenue	48.2	49.1	45.7	43.1	40.8	39.0	0.9	-2.2
Expenditure	57.2	53.8	51.8	49.6	47.9	46.4	-3.4	-1.8
Overall balance	-9.0	-4.7	-6.0	-6.5	-7.2	-7.4	4.3	-0.5
Nonoil Primary Balance	-32.6	-30.4	-29.0	-27.3	-26.1	-24.9	2.2	1.4
Debt (In percent of GDP) 1/	31.1	30.8	30.4	29.9	29.4	28.9	-0.3	-0.5
SOFAZ Assets (In millions of USD)	42,643	42,065	40,857	40,719	39,033	37,145	-578	-1238
Oil Prices ($ per barrel)	60.5	56.8	54.5	53.3	52.7	53.7		
Real Nonoil GDP Growth (In percent)	3.5	2.5	2.5	2.5	2.5	2.5		
Inflation (In percent)	4.0	3.2	3.2	3.2	3.2	3.2		
Authorities' Preliminary Adjustment Scenario								
Revenue	44.6	41.4	41.6	40.1	38.9	36.6	-3.2	-1.6
Expenditure	58.4	51.2	48.1	45.8	43.4	41.6	-7.2	-2.2
Overall Balance	-13.7	-9.8	-6.6	-5.7	-4.5	-4.9	4.0	0.5
Nonoil Primary Balance	-30.5	-25.7	-23.1	-21.4	-19.3	-18.0	4.8	1.7
Debt (In percent of GDP) 1/	24.4	22.5	21.1	19.8	19.3	18.4	-1.9	-0.9
SOFAZ Assets (In millions of USD)	41,066	38,738	37,169	35,822	34,586	33,051	-2328	-1373
Oil Prices ($ per barrel)	40	40	40	40	40	40		
Real Nonoil GDP Growth (In percent)	3.1	4.8	4.1	4.3	2.8	2.6		
Inflation (In percent)	3.0	3.0	3.0	3.0	3.0	3.0		

Sources: National authorities and IMF staff calculations and estimates.
1/ Starting in 2021, includes guarantees issued to Aqracredit for its acquisition of distressed assets from the IBA.

[6] Azerbaijan consolidated by 1.6 pp of GDP per year on average during 2016-19. In three-to-four year-long adjustment episodes, half of countries reduced their primary balance by 5 percent of GDP, and a quarter by 7 percent of GDP. Escolano, J. and others, 2018, How Much Is A Lot? The Maximum Size of Fiscal Adjustments, *Journal of Applied Economics*, 21(1), 137-59.

[7] However, even under this adjustment scenario, NFA decline to 18 percent of GDP by 2030. The debt ratio in the authorities' scenario is lower than that in the staff's scenario because of different debt coverage (see Footnote 3), lower deficits, higher nominal GDP, and larger drawdown of SOFAZ assets.

©International Monetary Fund. Not for Redistribution

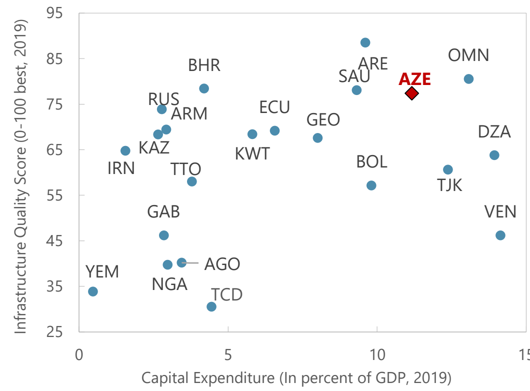
16. The composition of fiscal consolidation should be designed with a view to alleviating its likely adverse impact on economic growth while mobilizing nonoil revenues. In line with the authorities' policy plans, staff's baseline assumed that consolidation would be achieved mainly through current expenditure restraint and rationalization, resulting in slower growth of spending on wage bill, goods and services, and transfers, while pandemic- and reconstruction-related spending declines gradually. In the adjustment scenario, staff recommended the following fiscal reforms to achieve larger consolidation in a growth-friendly manner:

- Broad-based improvements in ***spending efficiency*** (especially for infrastructure where high quality was achieved at a relatively high cost in the past) through expenditure reviews, performance budgeting and enhancements in the public investment management framework and governance. Improvements in investment efficiency would also improve productivity.

- A gradual reduction of the ***wage bill*** as a share of GDP (following the 40 percent rise in public sector wages in 2019, the public wage bill increased by 3 pp of GDP in the last two years to 9 percent of GDP, the second highest in the region). Anchoring wage increases on labor productivity is essential to prevent the loss of competitiveness. Public employment is among the highest in EMDCs and some gradual downsizing (for example, through attrition and the reduction of "ghost" employees[8]) could be another source of savings.

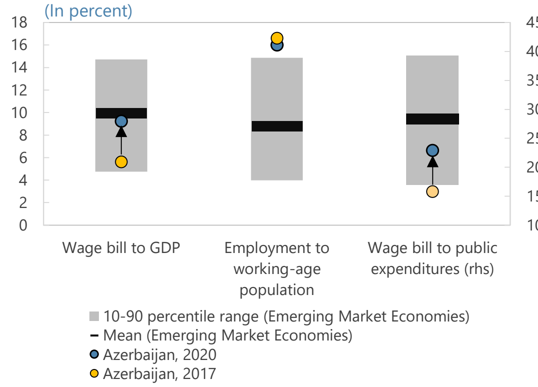
- Phasing out ***generalized subsidies*** (which account for 15 percent of GDP, mostly owing to below-cost recovery domestic prices for energy products) would reduce the need for fiscal

Azerbaijan: Quality of Infrastructure and Capital Expenditure



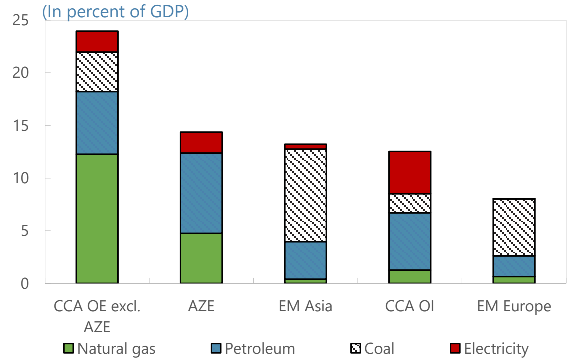
Sources: World Economic Forum Global Competitiveness Report 2019, World Economic Outlook, and IMF staff calculations.

Azerbaijan: Wage Bill and Public Employment
(In percent)



Sources: National authorities, IMF Expenditures Assessment Tool, and IMF staff calculations.
Note: Comparison of public wage bill faces challenges due to differences in definitions, coverage, and data availability across countries.

Azerbaijan: Post-tax Subsidies, 2017 [1/]
(In percent of GDP)



Sources: IMF FAD Energy Subsidies, and IMF staff calculations.
1/ Post-tax energy consumer subsidies exist if the consumer prices are below the supply costs plus the efficient levels of taxation.

---

[8] OECD, 2016, Fourth Round of Monitoring of the Istanbul Anti-Corruption Action Plan.

©International Monetary Fund. Not for Redistribution

support to the SOEs,[9] improve fairness, and help "green" the economy by containing energy consumption and green-house-gas (GHGs) emissions. In January 2021, the authorities already raised prices for lower-octane gasoline (by 11 percent), diesel (33 percent), and water and sewage fees (100 percent) and deregulated prices of some oil products. The timeline and scope of future subsidy reforms would need to be identified, in the context of broader SOE reforms and with adequate social protection to the vulnerable groups of population (see below).

- Revenue mobilization measures and ***tax reforms***, focusing on personal income taxes (no new exemptions, progressive taxation), modernizing property taxes (market value assessments), and reducing tax expenditures from extensive exemptions (appending tax expenditure estimates to the budget) would also support fiscal consolidation (Annex V). While pointing to room for revenue mobilization using the latter two measures over the medium term, staff recognized that any personal income tax reforms would need to be delayed until after the seven-year sunset clauses of the 2019 reforms expire.[10]

- The above reforms should create space for ensuring appropriate ***social spending*** (on health, education, and support of the vulnerable).[11] This is critical for promoting inclusive growth and raising productivity, against the backdrop of the pandemic-induced increases in unemployment (Figure 2), poverty and scarring. Another benefit is facilitating subsidy and SOE reforms, and transformations caused by diversification, digitalization and climate change.[12] Staff recommended reform priorities centered on improving the adequacy of social assistance in the poorest quintiles by increasing the size of benefits paid to the poor (Figure 7, Table 8). Extending social insurance programs to include self-employed and informal workers is also important, as the COVID-19 experience demonstrated. Efforts to improve the efficiency and effectiveness of social spending need to continue, through better targeting and monitoring. Recent improvements in the e-government systems (including e-transfers of cash to the unemployed during the pandemic and the "ASAN" one-stop shop for public e-services) and the centralization of social contributions for benefit programs are welcome in this regard.

17. The authorities expected consolidation to be largely expenditure-driven and concurred it should be growth-friendly. They have not yet identified specific policy measures to support their consolidation plans but indicated their intention to focus on improving spending efficiency while enhancing cost recovery of SOEs and slowing public wage bill growth. While broadly agreeing with staff's recommendations concerning revenue mobilization, the authorities noted that

[9] The government has been supporting SOEs through transfers and capital injections, "bridge financing" for debt service, and budget co-financing of investment projects. In 2020, such on-budget support amounted to over 2 percent of GDP. The authorities expect it to fall to 0.5 percent of GDP in 2021.

[10] The PIT tax holiday was legislated to take effect on January 1, 2019 and expire at end-2025, as part of the government's strategy to encourage informal operators to register formal labor contracts. The authorities attributed an increase in registered labor contracts in 2019-20 to the announcement of the holiday.

[11] The IMF's 2019 Strategy on Social Spending and Annex V of the 2019 Article IV Consultation Report, available at www.imf.org.

[12] By reducing the need for precautionary saving, higher social spending would also help close the external gaps (Annex III).

©International Monetary Fund. Not for Redistribution

they were proceeding with estimation of tax expenditures and planned to review specific tax reform options proposed by the IMF's technical experts. The authorities did not see social spending reforms as an immediate priority, pointing out that social spending per capita was higher in Azerbaijan than in most regional peers while poverty levels were lower than in global peers.[13] Moreover, social spending increased significantly in recent years on the heels of increases in wages and other payments (introduced in part to offset the impact of past devaluations). Like staff, the authorities considered it important that any future wage increases are aligned with productivity growth.

18. A well-designed fiscal anchor would enhance policy credibility and long-term fiscal sustainability while reducing procyclicality. Following the temporary suspension of the fiscal rule during the pandemic, the authorities have been working to address the design issues and plan to reintroduce the rule in 2022, while updating the medium-term expenditure framework (MTEF) and Debt Management Strategy.[14] They emphasized their intention to limit future general government debt issuance and keep the debt ratio (excluding Aqrakredit guarantees) below 20 percent of GDP. As the authorities are considering new parameters for their fiscal rule, staff recommended setting the floor for the average annual NOPB improvement at 1.5 pp in 2022–26 and the general government debt target at 40 percent of GDP (including Agrarkredit guarantees), with the ceiling at 45 percent, to provide buffers for adverse shocks and contingent liability risks. Staff did not recommend setting an operational target for the stabilization portion of SOFAZ assets, although estimating the value (of SOFAZ assets)-at-risk would be useful. To complement the fiscal rule, consideration could be given over the medium term to developing an asset-liability management framework, which would help evaluate risk-return trade-offs of public financial assets and liabilities in an integrated manner. The authorities and staff agreed that deeper public financial management reforms, including of the MTEF, monitoring, and reporting of fiscal performance, are important to support the implementation and credibility of the rule. Further building of the Ministry of Finance's macro-fiscal capacity would ensure quality forecasts and timely data and support reporting and compliance with the rule.

19. Better risk management, transparency and reporting need to accompany fiscal reforms. Some large SOEs have been operating at a loss, owing to operational inefficiencies,

Azerbaijan: Financial Indicators for Utility and Railway SOEs, Latest Available

	Sector	Net Earnings	Debt	Return on Assets
		(In Millions of manats)		(In percent)
Azerenerji	Power generation and transmission	-232	1,500	-6
Azersu	Water supply and sanitation	-592	247	-65
Azerbaijan Railways	Railway transport	-556	2,549	-14.8

Source: Staff estimates based on financial statements of the companies.
Notes: For Azerenerji and Azersu the figures are for 2019, while for Azerbaijan Railways the figures are for 2017 (the latest year for which information is publicly available).

[13] See Figure 7 for cross-country comparisons of social spending in per capita terms, as a share of GDP and government spending, and the social protection coverage of the vulnerable groups.

[14] The authorities also intend to strengthen their macroeconomic forecasting and policy analysis systems to ensure consistency of fiscal policies, monetary and structural policies and increase policy formulation transparency.

©International Monetary Fund. Not for Redistribution

outdated equipment, and low regulated prices. Improving SOE profitability would reduce the drain on public resources and increase room for productive spending. This requires reforms to enhance SOE operational efficiency as well as financial control and reporting, alongside gradually eliminating generalized subsidies. Better monitoring and management of risks from SOE guaranteed debt is also crucial.[15,16] In this context, the authorities emphasized progress in recent SOE reforms, including the establishment of the Azerbaijan Investment Holding, and performance indicators and corporate governance guidelines for SOEs. Welcoming these important reforms, staff recommended also putting in place a comprehensive framework for fiscal risk management,[17] accompanied by increased transparency and timely publication of data and statements on fiscal risks and SOE performance. In addition, continued efforts to ensure transparency of government spending, especially for COVID-19 and reconstruction, are important, including through publication of the ex post budget execution reports and audits (as outlined in the Law on Budget Systems of Republic of Azerbaijan). SOEs reforms and increased transparency of public spending will also help lessen vulnerabilities to corruption.

B. Monetary and Exchange Rate (ER) Policy

20. Although monetary policy is subordinated to the *de facto* peg, staff saw room for further easing. Despite recent interest rate cuts, financial conditions were tighter than prior to the pandemic, real interest rates for manat loans remained in double digits, and the spread between CBA and Fed rates was sizeable. Low financial integration limited short-term capital flows. Inflation was projected to increase in 2021 to close to the mid-point of CBA's band, mainly owing to one-off increases in administered prices and higher global food prices; core inflation remains below 3 percent on a cumulative y/y basis in 2021. With the output gap still negative, slow money growth, and nominal effective ER appreciating, this increase was expected to be short-lived. Inflation expectations were well anchored, and risks to inflation were balanced. Against this backdrop, consideration could be given to further easing, in staff's view, to support the nascent recovery, especially if downside risks were to materialize. While recognizing that room for easing might exist to support the recovery, CBA considered the current monetary stance appropriate, since its mandate focused on price stability and the outlook for inflation was uncertain. CBA intended to continue to reassess the outlook regularly by reviewing monetary and nonmonetary factors in a forward-looking manner.

[15] Government-guaranteed SOE debt stood at 35 percent of the 2020 GDP in January 2021, including Agrarkredit debt to the CBA, i.e., local currency debt related to the past banking crisis (13.1 percent of GDP); and foreign currency debt related to the Southern Gas Corridor commercial enterprise (9 percent of GDP), SOEs in energy, oil, airline, railroad and other sectors (5 percent of GDP), and the unclassified (1 percent of GDP). The government has been budgeting annually for payments on guaranteed debt and has set up an off-budget contingency fund to make payments on guaranteed debt while providing a line of credit to SOEs facing payment difficulties.

[16] Another source of risk stems from bank weaknesses, as evidenced by the IBA restructuring, the recent closure of four banks and the need to provide support to the Azerbaijan Deposit Insurance Fund.

[17] Specific measures include establishing an ownership monitoring framework based on the OECD's Guidelines on Corporate Governance of SOEs, conducting an SOE sectorization into public corporations and general government units according to GFSM 2014, and creating a risk management unit in the Ministry of Finance.

©International Monetary Fund. Not for Redistribution

21. Looking ahead, staff advocated a gradual move to a more flexible ER regime, to facilitate adjustment to oil price shocks and foster market development. The *de facto* peg has been effective in keeping inflation under control in Azerbaijan's undiversified economic setting where the ER is the main channel for the transmission of inflationary shocks. However, the peg limits CBA's ability to provide monetary support to the economy in times of stress and puts a higher burden on fiscal policy. Maintaining competitiveness is challenging under the peg since Azerbaijan's main trading partners have more flexible regimes. Greater ER flexibility would support diversification and encourage the development of financial markets, and better management of currency risks. It is preferable to introduce increased ER flexibility from the position of strength, while external buffers are projected to remain sufficient in the coming years. Although currency mismatches in the banking and corporate sectors have declined since the 2015–16 crisis and appear manageable, continued efforts to de-dollarize the economy are still needed, including by improving policy credibility and possibly widening the differential in reserve requirements for FX and manat deposits. In this context, staff underscored risks to policy credibility stemming from the difference in Azerbaijan's *de jure* and *de facto* ER regimes and from framing policy communication in inflation-targeting (IT) terms, urging the authorities to address these inconsistencies.

22. While reaffirming IT as their long-term goal, the authorities believed the *de facto* peg to be optimal for the foreseeable future. They believed that the manat was at a fair value but recognized that their empirical analysis was backward-looking and country-specific, in contrast to staff's forward-looking, PIH-based, and multilaterally consistent EBA-Lite framework (Annex III). In any event, CBA saw fiscal and structural policies as the main policy levers for addressing any potential competitiveness issues. Regarding the difference between the *de facto* and *de jure* ER regimes, CBA did not see the need for an official change in the ER regime on the grounds that market participants and the public understood well CBA's policy of keeping the ER pegged to the dollar. Staff advised periodically reviewing the appropriateness of the peg, to assess the evolving balance between its costs and benefits, and developing contingency plans, in the event the country is hit by a large and prolonged adverse shock, for example, to oil prices. All agreed that ongoing efforts to improve policy coordination (particularly, the recent establishment of an Economic Council), CBA liquidity forecasting and research capacity, and communication[18] as well as initiatives to strengthen CBA independence in monetary policy making could help CBA enhance its role and lay the ground for an eventual transition to IT. Alongside, stepped up efforts to improve the functioning of interbank, money and FX markets, and monetary transmission are needed to support financial market development and transition to the new economic growth model.

C. Financial Sector Policy

23. The authorities and staff agreed that prudential policies need to pivot carefully from incentivizing banks to use their buffers to rebuilding these buffers and reducing problem assets over time. While reversing the exceptional prudential easing prematurely may adversely affect bank soundness indicators, there are also important risks to delaying the reversal of such

[18] In recent years, CBA started producing press releases after each monetary policy decision, quarterly monetary policy reviews, and annual monetary policy guidelines. It also publishes information on FX auctions.

©International Monetary Fund. Not for Redistribution

forbearance. In particular, this could mask the growing vulnerabilities in the banking sector, ultimately undermining credit quality and market discipline, putting future stability at risk. Given the still outstanding restructured loans portfolio in the banking sector, staff recommended that CBA uses the available breathing space to ascertain implications of the support measures and the likely impact of their reversal on the recovery and bank balance sheets strength. Such evidence-based analysis, in tandem with data reporting transparency and close communication with financial market participants, would ensure a more targeted and time-bound plan to phase out financial sector support measures.

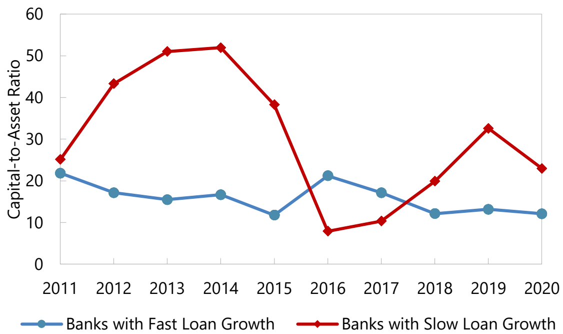
24. In this context, the authorities indicated their intention to start with measures that are less binding for the banking sector and phase out other measures as the recovery solidifies. Staff welcomed the recent replacement of a blanket deposit insurance, in place since the previous banking crisis, with a limited guarantee program, and a list of tightening measures that have been implemented or on the schedule. Rolling back exemptions on borrowers' credit histories soon would help mitigate the adverse impact on lending standards. The risk weight on mortgage loans, reduced to 50 percent last year, should be complemented by stronger prudential measures (i.e., LTV requirement in line with Basel III standards) to prevent deterioration in the quality of the mortgage portfolio.

25. Staff saw strengthening financial oversight as an important complement to medium-term reforms aimed to improve access to finance (Annex VI). The latter is essential for transition to the new growth model, as financial development and access to finance have been declining since the 2015–16 crisis and lag peers. However, past credit expansions were driven largely by weaker banks, which may cause bank distress and output loss. Stronger supervision and regulation are needed to prevent the repeat, including strengthening financial oversight of both lenders' risk-taking activities and borrowers' credit risk.

26. Staff's and the authorities' stress-testing exercise confirmed that systemic banks are resilient against credit risks yet vulnerable to direct and indirect FX risks. The authorities agreed that some vulnerabilities in the banking sector exist: the restructured loan portfolio quality was deteriorating, with some systemic and mid-sized banks remaining exposed to the FX risks mostly due to their outstanding net open FX positions, and bank profitability being still subdued as a consequence of weak credit demand and increased loan impairment charges. However, the authorities reckoned that these vulnerabilities were unlikely to pose a serious threat to banking stability. The IMF staff expressed its readiness to continue supporting CBA in their important efforts to enhance risk-based supervision and stress-testing.

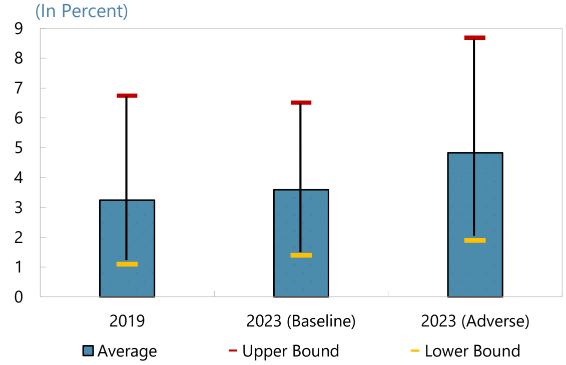
©International Monetary Fund. Not for Redistribution

Azerbaijan: Capital-to-Asset Ratio and Loan Growth
(Average, In Percent)



Sources: National authorities and IMF staff calculations.
Note: Banks with fast (slow) loan growth are the five banks with the highest (lowest) annual changes in gross loans.

Azerbaijan: NPL Ratios for Business Loans in Systemic Banks
(In Percent)



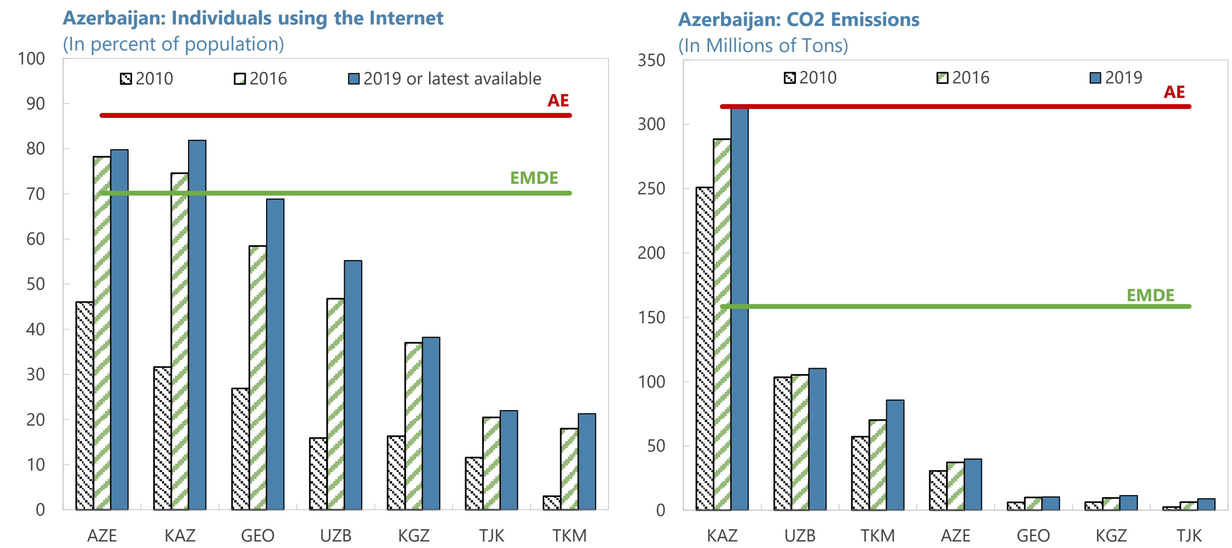
Sources: National authorities, and IMF staff calculations.
Note: The chart presents estimates of NPL ratios for business loans in four systemic banks. The baseline stress scenario uses staff's baseline macroeconomic forecast. The adverse scenario assumes that the nonoil real GDP growth rate is 2 percentage points below the baseline forecast during 2021-23.

27. Staff also emphasized that greater CBA independence and transparency are also essential for its ability to fulfill its mandate. Amendments to the CBA Law are needed to increase its independence not only in monetary policymaking but also financial supervision. Staff welcomed the authorities' plans to publish the Financial Stability Report this year, including financial soundness indicators and stress tests results. Staff urged CBA to encourage banks to share more details on the ultimate beneficiary ownership and enhance fit and proper tests for those who own and control banks, to better assess shareholders' financial strength and sources of funding. Staff also recommended that the authorities continue making progress in enhancing the effectiveness of the AML/CFT framework, including in preparation for the upcoming MONEYVAL assessment and to mitigate potential pressure to correspondent banking relationships. Preventive measures are important in this context, including in relation to domestic politically exposed persons and risk-based supervision for banks, as well as bolstering entity transparency through the swift adoption and operationalization of the national registry for beneficial ownership, and enhancing prosecution, conviction, and confiscation of ill-gotten proceeds.

D. Structural Policy

28. Deep-rooted impediments hinder private sector growth and job creation. They include weak governance and institutions, limited SME access to credit; inefficient labor, product, and service markets; and sizeable skill gaps. The combined result is high informality, limited nonoil FDI, weak entrepreneurship and SME development, and slow productivity growth. Scarring from the pandemic (including increased insolvency, unemployment, learning losses, etc.) needs to be addressed. Improving inclusiveness requires expanding economic opportunities for women and the young. Continued digitalization of the economy, building on broad access to internet and expanded e-government services, is important for raising productivity growth. Policies also need to address climate change, increase green investment, and improve energy efficiency.

©International Monetary Fund. Not for Redistribution



Sources: The Global Carbon Project (2020), The World Bank World Development Indicators, and IMF staff calculations.

29. Designing and implementing comprehensive reforms in line with the recently released national priorities would go a long way towards promoting sustainable, inclusive, and green growth over the longer term. Among other things, the recently created Azerbaijan Holding Company is expected to play a key role in improving corporate governance and efficiency of SOEs. Applying the Anti-Monopoly law would lower entry barriers and improve market efficiency. Identifying ways to improve competition in the financial sector, where net interest margins appear high by comparison to peers, could help improve access to finance. The WTO accession would expose domestic producers to international competition, encouraging improvements in productivity and diversification. Developing the green growth agenda, as envisaged under the National Priorities, is an important task, alongside reforming generalized energy subsidies. Applying the OECD's Investment Guidelines could help attract FDI and know-how, while minimizing tax expenditures. Following up on the most macro-critical aspects of the governance recommendations outlined the 2019 Article IV report remains critical and would augment the impact of other structural reform efforts.

30. The authorities concurred with staff on the need to accelerate structural reforms with a view to raising nonoil growth and fostering economic diversification. The authorities noted that the recently developed broad-ranging reform agenda, embedded in their ten-year development plan, focuses on improving corporate governance of SOEs, and later their productivity and efficiency, through the creation of Azerbaijan Investment Holding. They saw recent deregulation of prices for utilities and oil products as a step towards greater market price determination and reduction of government subsidies. At the same time, the authorities believed that tax incentives would boost private sector investment in the nonoil sector, employment, and export diversification.

STAFF APPRAISAL

31. Azerbaijan faced an unprecedented challenge in 2020, but timely and appropriate policy response mitigated the impact of the pandemic on the economy. A significant relief package helped cushion the impact of the pandemic and the decline in oil prices. With vaccination

©International Monetary Fund. Not for Redistribution

progressing and lockdown measures gradually eased, the economy has started to recover. The near-term challenge is to properly calibrate the phasing out of the COVID-19-related stimulus, balancing the need to avoid endangering the recovery while preparing the ground for addressing structural challenges. In the long term, Azerbaijan's running out of oil in the coming decades poses the fundamental challenge as the economy needs to wean off its dependence on oil revenues.

32. **While fiscal policy has been appropriately eased during the pandemic, a growth-friendly fiscal consolidation needs to start in 2022**. The accommodative fiscal stance in 2021 is appropriate and, in the case of adverse shocks, automatic stabilizers should be allowed to operate and additional, targeted on-budget fiscal support should be provided, as necessary, within the available fiscal space. Windfall revenue from higher-than-budgeted oil prices should be saved. Looking ahead, continued expansionary stance would not be compatible with preserving the *de facto* peg and fiscal sustainability and would also make it more difficult to attain intergenerational equity in the face of a projected exhaustion of oil resources. Thus, consolidation should start in 2022 and be sustained over the long term, to gradually achieve a significant reduction in the nonoil primary deficit. While the authorities see a key role for expenditure consolidation, measures to improve nonoil revenues will eventually have to contribute to adjustment. Consolidation needs to be accompanied by measures to protect the vulnerable and support education and health, with a view to enhancing inclusiveness and productivity. Stepped structural and financial sector reforms are also critical, to mitigate the adverse impact of consolidation on economic growth.

33. **Planned fiscal adjustment should be supported by the revised fiscal rule**. In response to the outbreak of the pandemic, the authorities have temporarily suspended the fiscal rule. They intend to revise and re-launch it in 2022, using the nonoil primary balance and debt-to-GDP targets to anchor fiscal policies. Public financial management reforms, including of the medium-term fiscal framework, fiscal risk management and transparency, are needed to support the implementation of the rule and its credibility. Establishing a solid track record of the rule implementation is particularly important given its suspension in 2020 during the pandemic, a year after its introduction.

34. **Further monetary easing could be considered to support the nascent recovery, especially if downside risks were to materialize**. Although CBA has reduced its policy rates since the outbreak of the pandemic, financial conditions remain tighter than when the pandemic started. Despite the de facto peg, low financial integration and a large spread over the Fed rates provide room for further rate cuts. In addition, following a recent temporary uptick, inflation is projected to remain close to the mid-point of the CBA target range.

35. **A gradual move to a more flexible ER regime should be considered in the medium term**. The *de facto* peg has been effective in keeping inflation under control, but as Azerbaijan's main trading partners have more flexible regimes, maintaining competitiveness is challenging under the peg. A more flexible exchange rate would facilitate adjustment to oil price shocks, reduce adjustment burden on fiscal policy, and support diversification of the economy and market development. The current difference between the *de jure* flexible exchange rate regime and the *de facto* pegged one and the framing of policy communication in inflation-targeting terms poses risks to policy credibility and needs to be addressed promptly. More broadly, the external position is

©International Monetary Fund. Not for Redistribution

deemed to be substantially weaker than the level consistent with medium-term fundamentals and desirable policies (Annex III).

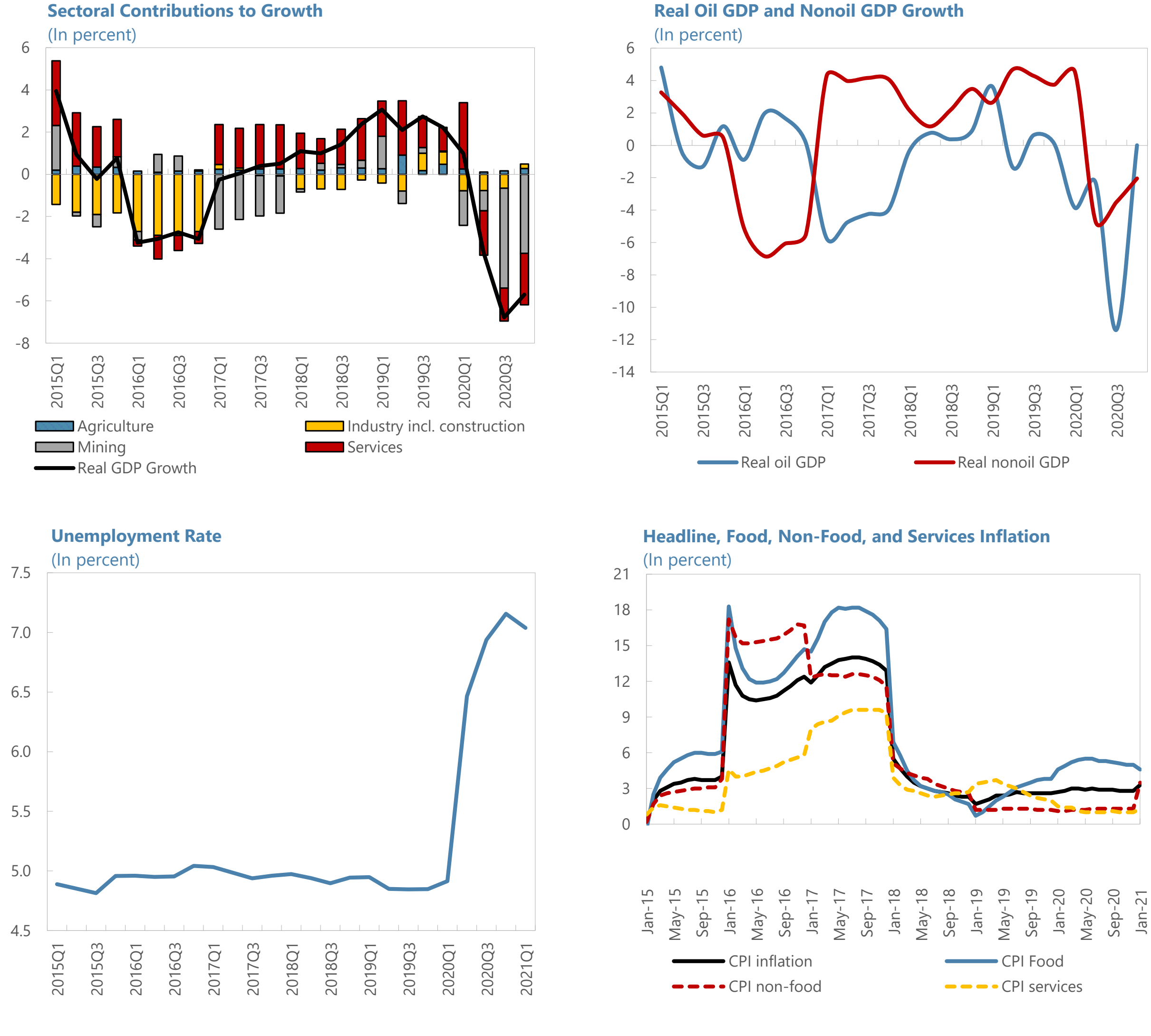
36. Targeted and time-bound plan to phase out exceptional prudential easing introduced in response to the pandemic is needed. The authorities need to balance the risk to bank soundness arising from prematurely phasing out the forbearance measures and the risks from delaying the reversal to credit quality and market discipline. Staff welcomes the recent replacement of a blanket deposit insurance, in place since the previous banking crisis, with a limited guarantee program, a list of regulatory tightening measures that have been already implemented or on the schedule, and the efforts in improving financial stability analysis capacity. In the medium term, strengthening financial oversight of both lenders' risk-taking activities and borrowers' credit risk is an important complement that is needed to ensure financial stability and improve access to finance. The authorities should also continue making progress in enhancing the effectiveness of the AML/CFT framework.

37. Impediments to private sector growth and job creation need to be tackled to support private sector development and diversification of the economy. Weak institutions, limited SME access to credit; inefficient labor, product, and service markets; and sizeable skill gaps result in high informality, discourage nonoil FDI and slow productivity growth. Addressing these weaknesses, including by strengthening the governance and anti-corruption frameworks, attending the scarring impact from the pandemic, and pursuing the green agenda envisaged under the Azerbaijan 2030 Priorities, are needed to achieve inclusive and green growth. The recently released national priorities set ambitious goals for social and economic development and would need to be supported by well-designed and consistently implemented policy reforms.

38. It is recommended that the next Article IV consultation takes place on the standard 12-month cycle.

©International Monetary Fund. Not for Redistribution

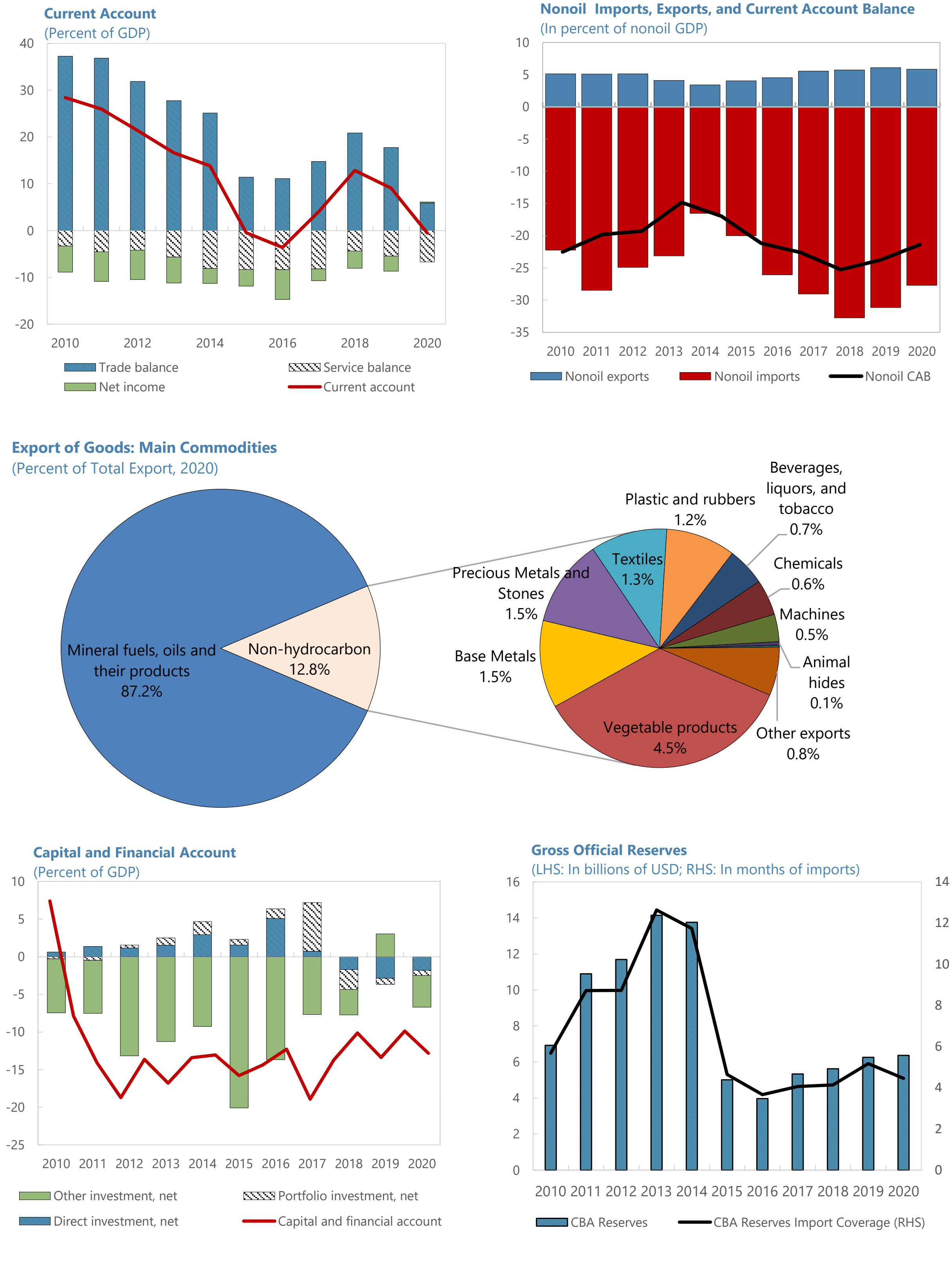
Figure 2. Azerbaijan: Real Sector Indicators



Sources: National authorities, Haver, and IMF staff calculations.

©International Monetary Fund. Not for Redistribution

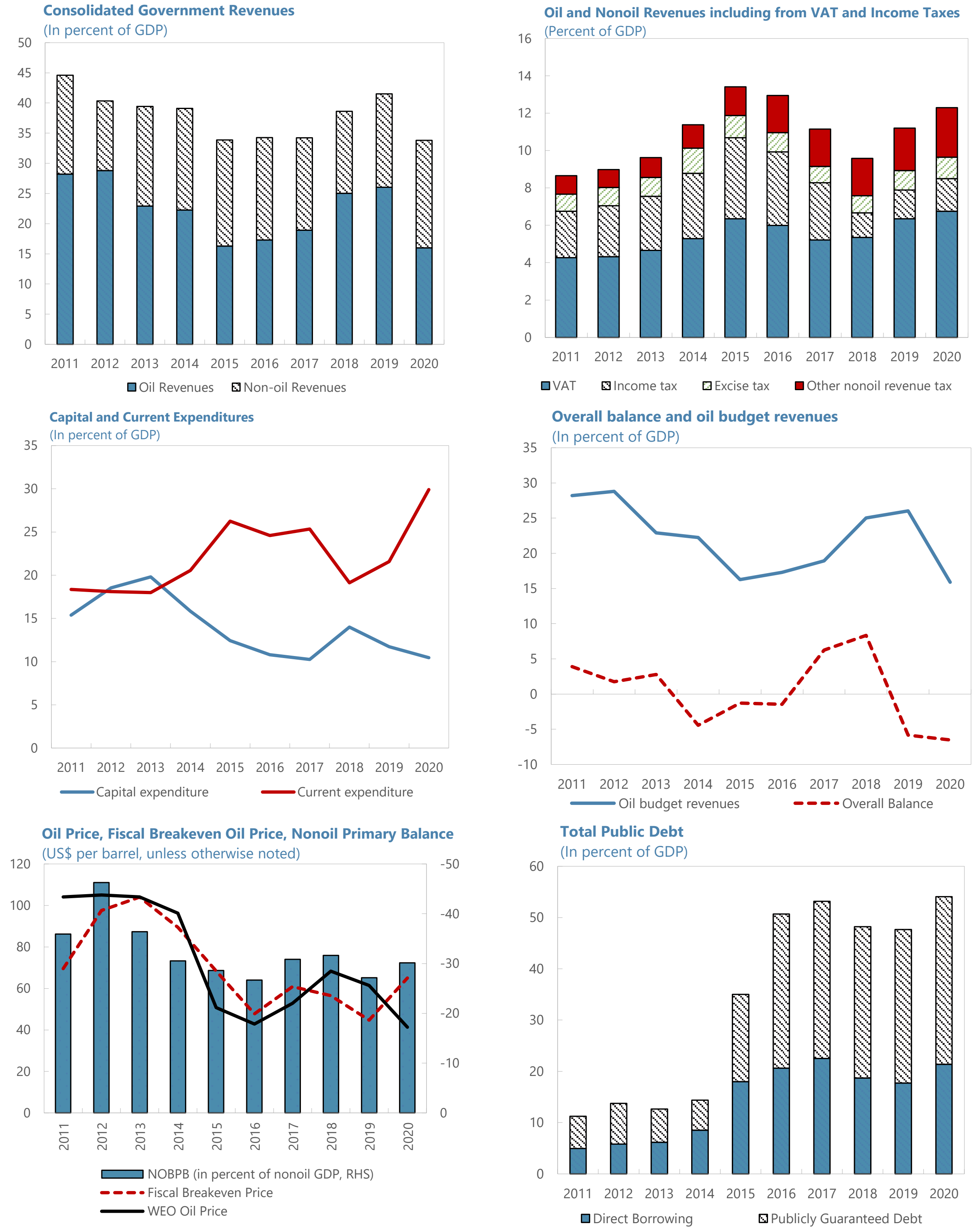
Figure 3. Azerbaijan: External Sector



Sources: WITS, Haver, and IMF staff calculations.

©International Monetary Fund. Not for Redistribution

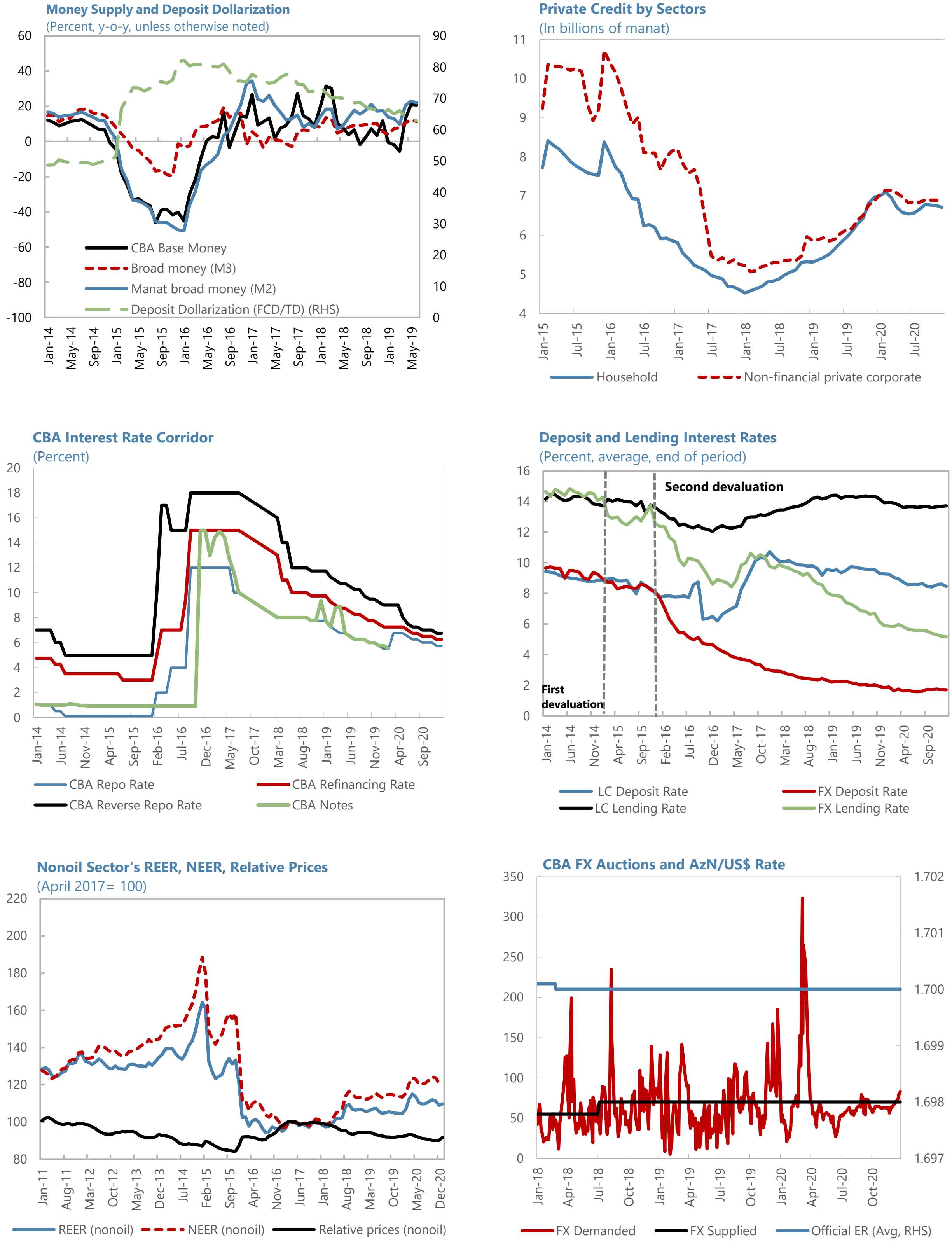
Figure 4. Azerbaijan: Fiscal Sector



Sources: National authorities, Haver, IMF World Economic Outlook, IMF Public Investment Management Assessment, and IMF staff calculations.

©International Monetary Fund. Not for Redistribution

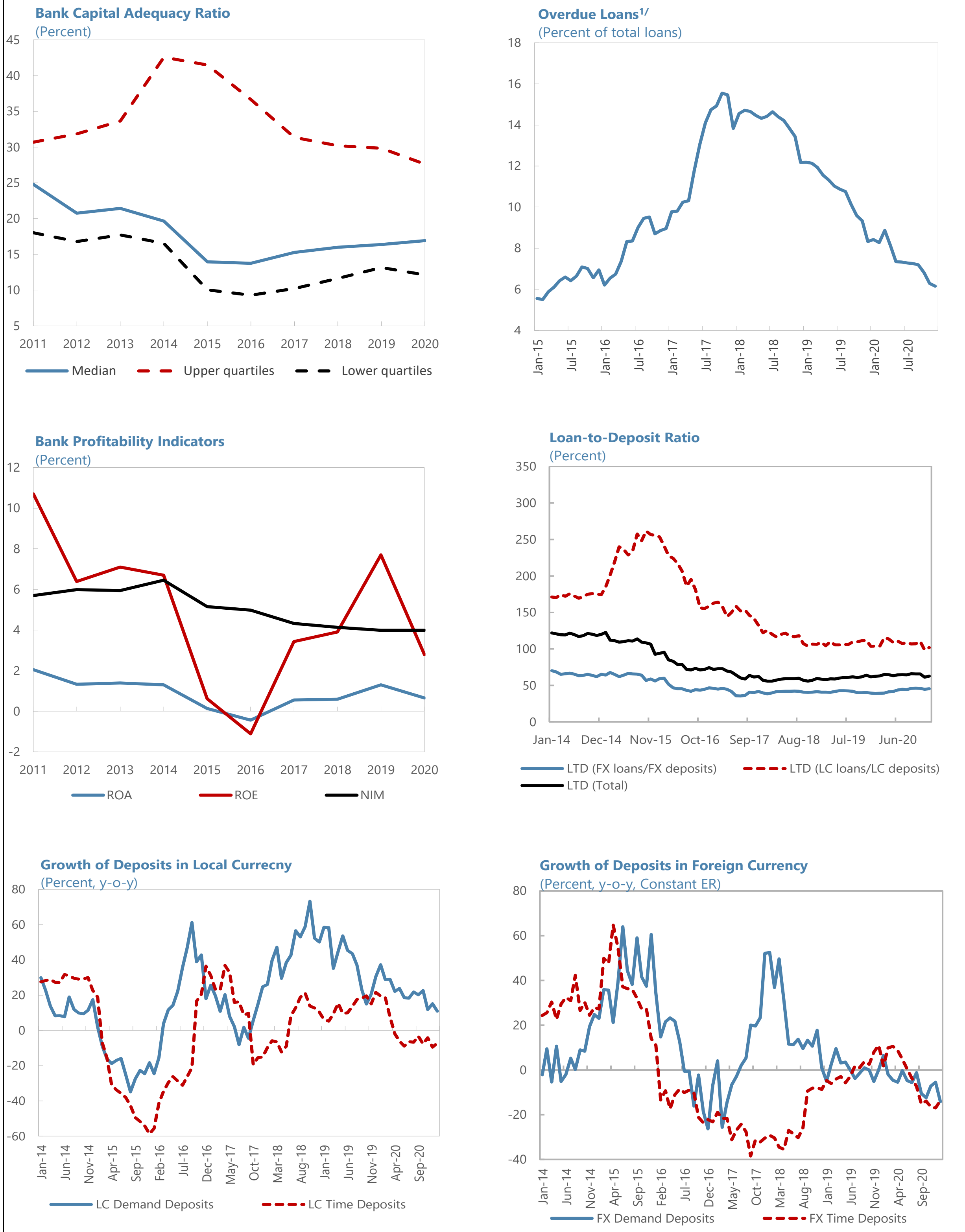
Figure 5. Azerbaijan: Monetary and Exchange Rate Developments



Sources: National authorities, Haver, and IMF staff calculations.

©International Monetary Fund. Not for Redistribution

Figure 6. Azerbaijan: Banking Sector



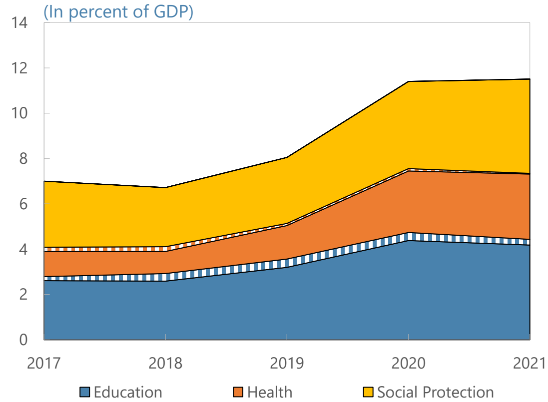
Sources: National authorities, Haver, and IMF staff calculations.

1/ According to the 2015 FSAP report, for statistical purposes only overdue payments are classified as non-performing loans (NPLs). The reported time series of NPLs does not fully reflect actual NPLs.

©International Monetary Fund. Not for Redistribution

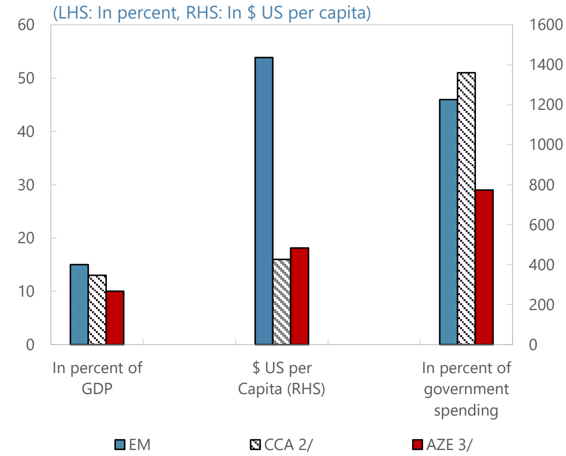
Figure 7. Azerbaijan: Social Spending

Social Spending
(In percent of GDP)

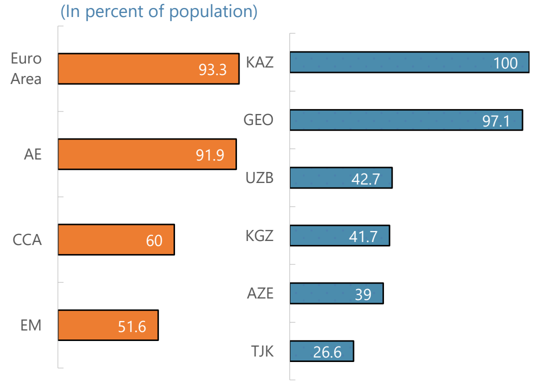


Note: Shaded fill refers to the capital expenditures component of social spending categories.

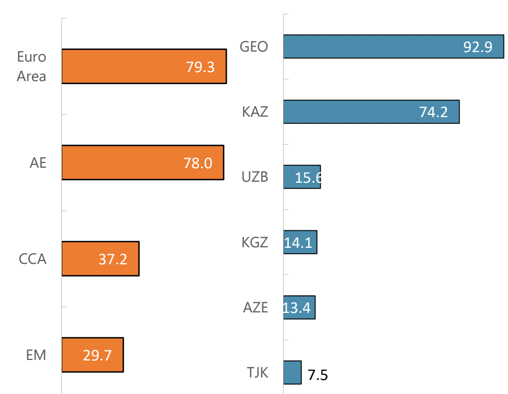
Social Spending1/
(LHS: In percent, RHS: In $ US per capita)



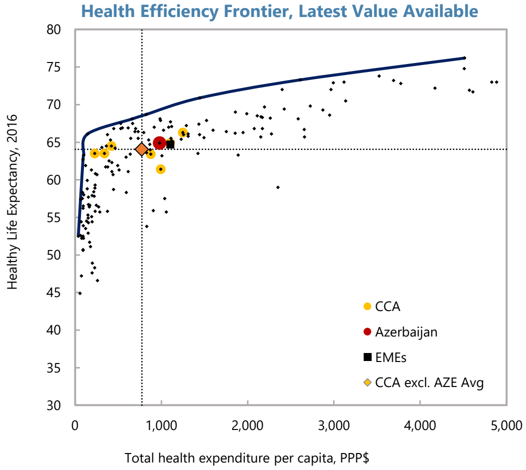
Population Covered By at least One Social Benefit
(In percent of population)



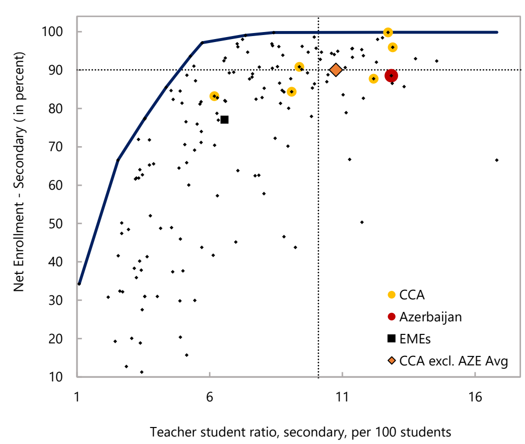
Vulnerable Persons Covered By Social Assistance
(In percent of population)



Health Efficiency Frontier, Latest Value Available



Teachers and Outcome, Secondary, Latest Value Available



Sources: ASPIRE, National authorities, IMF (2019), IMF EAT, UNWHO, World Development Indicators, World Economic Outlook, and IMF staff calculations.
1/ Education spending (from the WB and UNESCO) includes current and capital spending as well as transfers. Health spending (from the WHO) includes internal transfers and grants, transfers, subsidies to voluntary health insurance beneficiaries, NPISH or enterprise financing schemes as well as compulsory prepayment and social health insurance contributions, only on current expenditures. For more details on the definition of social spending, see the IMF's 2019 Strategy on Social Spending, available at www.imf.org. Social Protection and Security data is sourced from the April 2021 World Economic Outlook. Data for EM and CCA are the latest pre-pandemic data available (mostly 2018).
2/ The CCA average excludes Azerbaijan.
3/ Data for Azerbaijan refer to the 2021 approved budget.

©International Monetary Fund. Not for Redistribution

Table 1. Azerbaijan: Selected Economic and Financial Indicators, 2018–26

	2018	2019	2020	2021	2022	2023	2024	2025	2026
				Projections					
	(Annual percentage change, unless otherwise specified)								
National income									
GDP at constant prices	1.5	2.2	-4.3	2.3	1.7	1.7	1.7	1.7	1.7
Of which: Oil sector 1/	0.5	0.4	7.0	0.2	0.2	0.2	0.2	0.2	0.2
Non-oil sector	2.1	3.3	-2.6	3.5	2.5	2.5	2.5	2.5	2.5
Consumer price index (period average)	2.3	2.7	2.8	4.0	3.2	3.2	3.2	3.2	3.2
Money and credit									
Domestic credit, net	8.5	9.3	6.7	4.2	8.1	9.4	9.3	9.6	9.7
Of which: Credit to private sector	14.9	15.2	-0.7	5.0	9.1	10.2	10.5	11.0	11.0
Manat base money	11.7	27.3	11.6	10.5	9.0	9.1	9.2	9.3	9.4
Manat broad money	17.6	24.4	11.3	5.9	7.9	7.9	7.9	7.9	7.9
Total broad money	5.7	19.9	1.1	8.3	6.4	6.4	6.4	6.4	6.4
External sector									
Exports f.o.b.	37.2	-4.5	-36.6	32.1	-5.6	-3.7	-2.1	-2.1	-0.2
Of which: Oil sector	40.2	-6.0	-40.0	35.3	-7.4	-5.4	-3.7	-3.9	-2.0
Imports f.o.b.	21.2	3.5	-11.1	18.3	-5.8	-2.5	-1.5	-2.0	0.4
Of which: Oil sector	30.0	7.8	-0.3	12.0	3.9	3.4	3.5	3.9	4.2
Real effective exchange rate	3.1	3.9	4.5	--	--	--	--	--	--
	(In percent of GDP, unless otherwise specified)								
Gross investment	20.0	20.1	19.3	17.6	17.2	17.8	18.3	18.3	18.6
Consolidated government	14.0	11.2	11.6	10.0	8.9	8.4	7.7	6.8	5.9
Private sector	6.0	9.0	7.7	7.5	8.3	9.5	10.6	11.5	12.6
Of which: Oil sector	2.0	2.2	0.1	2.2	2.4	2.5	2.7	2.7	2.8
Gross national savings	32.8	29.2	18.7	20.0	19.1	19.7	20.0	19.9	20.0
Consolidated general government finances 2/									
Total revenue and grants 3/	38.6	41.4	33.8	31.7	33.5	32.1	30.9	29.7	28.8
Total expenditure 4/	33.1	33.3	40.4	37.2	36.5	36.5	36.2	35.7	35.8
Current expenditure 4/	19.1	21.6	28.8	27.2	27.6	28.1	28.5	28.9	29.4
Net acquisition of non-financial assets	14.0	11.7	11.6	10.0	8.9	8.4	7.7	6.8	6.4
Overall fiscal balance 4/	5.5	8.2	-6.5	-5.6	-3.0	-4.4	-5.3	-6.0	-7.0
Non-oil primary balance, in percent of non-oil GDP	-31.7	-27.2	-30.3	-32.1	-30.2	-29.3	-28.2	-27.2	-26.9
General government debt 5/	18.7	17.7	21.4	30.6	31.4	33.3	33.3	36.1	39.8
General government and government-guaranteed debt	48.2	47.7	54.1	46.0	44.4	43.5	40.4	40.4	40.8
External sector									
Current account (- deficit)	12.8	9.1	-0.5	2.4	1.9	1.9	1.7	1.5	1.4
Foreign direct investment (net)	-1.7	-2.9	-1.8	0.8	1.0	1.1	1.2	1.4	1.5
Memorandum items:									
Gross official international reserves (in millions of U.S. dollars)	5,626	6,258	6,369	6,369	6,569	6,769	6,969	7,169	7,369
in months of next year's non-oil imports f.o.b.	4.7	5.4	6.8	5.4	5.9	6.4	6.7	7.0	7.2
Nominal GDP (in millions of manat)	80,092	81,896	72,432	85,122	86,748	89,235	92,441	96,181	100,348
Nominal non-oil GDP (in millions of manat)	47,787	51,600	51,980	55,952	59,186	62,607	66,225	70,053	74,102
Nominal GDP (in millions of U.S. dollars)	47,113	48,174	42,607	50,072	51,028	52,491	54,377	56,577	59,028
Oil Fund Assets (in millions of U.S. dollars)	38,515	43,323	43,564	42,554	42,642	42,550	42,403	42,193	42,042
Assumed oil price, WEO plus $2-$3 premium (in U.S. dollars per barrel)	70.3	63.4	44.3	60.5	56.8	54.5	53.3	52.7	53.7
Exchange rate (manat/dollar, end of period)	1.7	1.7	1.7	1.7	1.7	1.7	1.7	1.7	1.7

Sources: National authorities, and IMF staff estimates and projections.

1/ Includes the production and processing of oil and gas.

2/ Consolidates State Budget, State Oil Fund of Azerbaijan (SOFAZ), Nakhchevan Autonomous Region (NAK) and State Social Protection Fund.

3/ Includes a transfer of CBA profits (AzN 650 million) in 2019.

4/ Includes the impact of an extraordinary SOFAZ transfer ($1.4 bn to the CBA in 2017) and expenditures for the NPL program in 2019 (AzN 650 mil).

5/ Starting in 2021, includes guarantees issued to Aqracredit for its acquisition of distressed assets from the IBA.

©International Monetary Fund. Not for Redistribution

Table 2. Azerbaijan: Balance of Payments, 2018–26
(In millions of U.S. dollars, unless otherwise specified)

				Projections					
	2018	2019	2020	2021	2022	2023	2024	2025	2026
Exports, f.o.b.	20,794	19,868	12,588	16,629	15,701	15,119	14,801	14,494	14,463
Oil and gas sector	19,176	18,017	10,817	14,631	13,543	12,814	12,337	11,850	11,613
Other	1,618	1,851	1,771	1,998	2,158	2,305	2,464	2,644	2,850
Imports, f.o.b.	-10,952	-11,335	-10,077	-11,916	-11,223	-10,938	-10,778	-10,568	-10,607
Oil and gas sector	-1,745	-1,882	-1,876	-2,101	-2,184	-2,257	-2,336	-2,427	-2,530
Others	-9,207	-9,454	-8,200	-9,815	-9,040	-8,681	-8,442	-8,141	-8,077
Trade balance	9,841	8,533	2,512	4,713	4,478	4,181	4,023	3,926	3,856
Services, net	-2,062	-2,616	-2,841	-2,759	-2,885	-2,806	-2,781	-2,777	-2,774
Oil and gas sector	-1,712	-1,839	-2,417	-2,286	-2,401	-2,307	-2,261	-2,233	-2,203
Others	-350	-777	-424	-472	-484	-500	-520	-544	-571
Factor income, net	-2,460	-2,061	-456	-1,321	-1,499	-1,313	-1,239	-1,223	-1,193
Oil and gas	-2,850	-2,805	-1,438	-1,872	-2,165	-2,049	-1,973	-1,895	-1,895
Others	390	744	982	551	667	736	734	672	702
Transfers, net	731	509	558	575	897	916	932	949	966
Current account balance	6,051	4,365	-228	1,208	991	977	935	875	855
Non-oil current account balance	-6,818	-7,126	-5,314	-7,164	-5,801	-5,224	-4,833	-4,420	-4,130
Capital account, net	1	-19	-7	-7	-7	-7	-7	-7	-7
Direct investment, net	-808	-1,379	-770	412	502	591	679	773	868
Oil and gas	-345	-815	-486	557	662	767	872	976	1,081
Others	-463	-563	-284	-145	-160	-176	-192	-203	-213
Portfolio investment, net	-1,241	-389	-282	160	190	248	230	198	198
Other investment, net	-1,591	1,456	-1,801	-3,232	-1,837	-2,150	-2,235	-2,300	-2,316
Oil and gas	261	-117	-270	372	371	227	323	167	153
Others	-1,852	1,572	-1,531	-3,604	-2,209	-2,377	-2,557	-2,467	-2,469
Oil bonus	450	451	452	450	450	450	450	451	452
Financial derviatives	-1	-4	0	0	0	0	0	0	0
Financial account, net	-3,191	135	-2,401	-2,211	-696	-861	-875	-878	-798
Capital and financial account balance	-3,189	116	-2,408	-2,218	-703	-868	-882	-885	-805
General government and government-guaranteed debt	646	661.8	648.0	0.0	0.0	0.0	0.0	0.0	0.0
Overall balance	3,508	5,143	-1,988	-1,011	288	109	53	-10	50
Financing	-3,508	-5,143	1,848	1,011	-288	-109	-53	10	-50
Change in net foreign assets of CBA (increase -)	-291	-632	-111	--	-200	-200	-200	-200	-200
Change in Oil Fund assets (increase -)	-2,709	-4,808	-241	1,011	-88	91	147	210	150
Change in other government FX assets (increase -)	-508	297	2200	0	0	0	0	0	0
Memorandum items:									
Current account balance (in percent of GDP)	12.8	9.1	-0.5	2.4	1.9	1.9	1.7	1.5	1.4
Gross official international reserves	5,626	6,258	6,369	6,369	6,569	6,769	6,969	7,169	7,369
in months of next year's non-oil imports f.o.b.	4.7	5.4	6.8	5.4	5.9	6.4	6.7	7.0	7.2
Oil Fund assets	38,515	43,323	43,564	42,554	42,642	42,550	42,403	42,193	42,042
Public and publicly guaranteed external debt (in percent of GDP)	47.1	47.3	55.8	50.2	52.2	54.9	55.7	58.7	62.4
Oil price (US$ per barrel)	70.3	63.4	44.3	60.5	56.8	54.5	53.3	52.7	53.7
Exchange rate (average, AZN/$)	1.7	1.7	1.7	1.7	1.7	1.7	1.7	1.7	1.7
Nominal GDP (in millions of U.S. dollars)	47,113	48,174	42,607	50,072	51,028	52,491	54,377	56,577	59,028

Sources: National authorities, and IMF staff estimates and projections.

©International Monetary Fund. Not for Redistribution

Table 3. Azerbaijan: Balance of Payments, 2018–26

(In percent of GDP, unless otherwise specified)

				Projections					
	2018	2019	2020	2021	2022	2023	2024	2025	2026
Exports, f.o.b.	44.1	41.2	29.5	33.2	30.8	28.8	27.2	25.6	24.5
Oil and gas sector	40.7	37.4	25.4	29.2	26.5	24.4	22.7	20.9	19.7
Other	3.4	3.8	4.2	4.0	4.2	4.4	4.5	4.7	4.8
Imports, f.o.b.	-23.2	-23.5	-23.6	-23.8	-22.0	-20.8	-19.8	-18.7	-18.0
Oil and gas sector	-3.7	-3.9	-4.4	-4.2	-4.3	-4.3	-4.3	-4.3	-4.3
Others	-19.5	-19.6	-19.2	-19.6	-17.7	-16.5	-15.5	-14.4	-13.7
Trade balance	20.9	17.7	5.9	9.4	8.8	8.0	7.4	6.9	6.5
Services, net	-4.4	-5.4	-6.7	-5.5	-5.7	-5.3	-5.1	-4.9	-4.7
Oil and gas sector	-3.6	-3.8	-5.7	-4.6	-4.7	-4.4	-4.2	-3.9	-3.7
Others	-0.7	-1.6	-1.0	-0.9	-0.9	-1.0	-1.0	-1.0	-1.0
Factor income, net	-5.2	-4.3	-1.1	-2.6	-2.9	-2.5	-2.3	-2.2	-2.0
Oil and gas	-6.0	-5.8	-3.4	-3.7	-4.2	-3.9	-3.6	-3.3	-3.2
Others	0.8	1.5	2.3	1.1	1.3	1.4	1.3	1.2	1.2
Transfers, net	1.6	1.1	1.3	1.1	1.8	1.7	1.7	1.7	1.6
Current account balance	12.8	9.1	-0.5	2.4	1.9	1.9	1.7	1.5	1.4
Non-oil current account balance	-14.5	-14.8	-12.5	-14.3	-11.4	-10.0	-8.9	-7.8	-7.0
Capital account, net	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Direct investment, net	-1.7	-2.9	-1.8	0.8	1.0	1.1	1.2	1.4	1.5
Oil and gas	-0.7	-1.7	-1.1	1.1	1.3	1.5	1.6	1.7	1.8
Others	-1.0	-1.2	-0.7	-0.3	-0.3	-0.3	-0.4	-0.4	-0.4
Portfolio investment, net	-2.6	-0.8	-0.7	0.3	0.4	0.5	0.4	0.4	0.3
Other investment	-3.4	3.0	-4.2	-6.5	-3.6	-4.1	-4.1	-4.1	-3.9
Oil and gas	0.6	-0.2	-0.6	0.7	0.7	0.4	0.6	0.3	0.3
Others	-3.9	3.3	-3.6	-7.2	-4.3	-4.5	-4.7	-4.4	-4.2
Oil bonus	1.0	0.9	1.1	0.9	0.9	0.9	0.8	0.8	0.8
Financial derviatives	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financial account, net	-6.8	0.3	-5.6	-4.4	-1.4	-1.6	-1.6	-1.6	-1.4
Capital and financial account balance	-6.8	0.2	-5.7	-4.4	-1.4	-1.7	-1.6	-1.6	-1.4
General government and government-guaranteed debt	1.4	1.4	1.5	0.0	0.0	0.0	0.0	0.0	0.0
Overall balance	7.4	10.7	-4.7	-2.0	0.6	0.2	0.1	--	0.1
Financing	-7.4	-10.7	4.3	2.0	-0.6	-0.2	-0.1	--	-0.1
Change in net foreign assets of CBA (increase -)	-0.6	-1.3	-0.3	--	-0.4	-0.4	-0.4	-0.4	-0.3
Change in Oil Fund assets (increase -)	-5.7	-10.0	-0.6	2.0	-0.2	0.2	0.3	0.4	0.3
Change in other government FX assets (increase -)	-1.1	0.6	5.2	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:									
Current account balance	12.8	9.1	-0.5	2.4	1.9	1.9	1.7	1.5	1.4
Gross official international reserves	11.9	13.0	14.9	12.7	12.9	12.9	12.8	12.7	12.5
in months of next year's non-oil imports f.o.b.	4.7	5.4	6.8	5.4	5.9	6.4	6.7	7.0	7.2
Oil Fund assets	81.8	89.9	102.2	85.0	83.6	81.1	78.0	74.6	71.2
Public and publicly guaranteed external debt	47.1	47.3	55.8	50.2	52.2	54.9	55.7	58.7	62.4
Oil price (US$ per barrel)	70.3	63.4	44.3	60.5	56.8	54.5	53.3	52.7	53.7
Exchange rate (average, AZN/$)	1.7	1.7	1.7	1.7	1.7	1.7	1.7	1.7	1.7
Nominal GDP (in Millions of US$)	47,113	48,174	42,607	50,072	51,028	52,491	54,377	56,577	59,028

Sources: National authorities, and IMF staff estimates and projections.

©International Monetary Fund. Not for Redistribution

Table 4. Azerbaijan: Statement of Consolidated Government Operations, 2018–26

(In millions of manat)

	2018	2019	2020	2021	2022	2023	2024	2025	2026
				Projections					
Revenue									
Total revenue	30,925	33,915	24,481	26,975	29,083	28,621	28,532	28,559	28,895
Tax revenue	11,255	13,870	13,804	15,527	16,073	16,214	16,511	16,930	17,444
Income taxes	3,496	3,499	3,503	4,685	5,214	5,140	5,137	5,156	5,262
Individual income tax	996	952	1,151	1,239	1,311	1,386	1,466	1,551	1,641
Enterprise profits tax	2,500	2,547	2,352	3,446	3,903	3,753	3,670	3,605	3,621
Value added tax (VAT)	4,288	5,185	4,818	4,816	4,741	4,784	4,865	5,009	5,154
Excise taxes	729	855	898	1,034	1,070	1,116	1,168	1,231	1,293
Taxes on international trade	1,283	1,668	1,580	1,523	1,485	1,489	1,506	1,529	1,546
Other taxes	721	741	641	690	730	773	817	864	914
Social security contributions	739	1,923	2,365	2,779	2,832	2,913	3,018	3,140	3,276
Nontax revenue	19,650	20,025	10,657	11,429	12,990	12,387	12,001	11,608	11,431
Of which: Oil Fund revenues	17,614	19,031	9,361	10,728	12,278	11,658	11,251	10,834	10,628
Grants	20	20	20	20	20	20	20	20	20
Expenditure									
Total Expenditure	26,543	27,232	29,261	31,707	31,691	32,565	33,429	34,326	35,961
Current Expense	15,329	17,660	20,893	23,191	23,931	25,087	26,314	27,803	29,494
Compensation of employees	4,414	5,270	6,197	6,570	6,950	7,352	7,777	8,226	8,702
Use of goods and services	3,153	3,884	5,980	6,837	7,220	7,838	8,291	8,870	9,533
Social benefits	4,593	5,438	5,656	6,096	5,971	5,980	6,117	6,383	6,675
Of which: Social protection fund	1,337	1,735	1,180	1,640	1,535	1,424	1,506	1,593	1,685
Subsidies	2,591	2,469	2,421	3,026	3,166	3,247	3,367	3,516	3,634
Grants	20	20	20	20	20	20	20	20	20
Interest	542	568	605	628	588	635	726	770	912
Other expense	16	11	14	14	15	16	17	18	19
Net Acquisition of Nonfinancial Assets	11,214	9,572	8,368	8,516	7,760	7,478	7,114	6,523	6,467
Overall balance	4,382	6,683	-4,780	-4,731	-2,608	-3,945	-4,897	-5,767	-7,066
Non-oil primary balance 1/	-15,131	-14,020	-15,755	-17,946	-17,851	-18,350	-18,700	-19,021	-19,964
Net financial transactions	4,382	6,683	-4,780	-4,731	-2,608	-3,945	-4,897	-5,767	-7,066
Net acquisition of financial assets	4,901	8,044	-4,068	-2,318	-370	-499	-623	-765	-705
Privatization and other sale of assets	-112	-118	-61	-100	-120	-144	-173	-207	-249
General government debt 2/	241	887	-843	-500	-400	-200	-200	-200	-200
General government and government-guaranteed debt	168	-898	-99	0	0	0	0	0	0
Net incurrence of liabilities	519	1,361	712	2,413	2,238	3,445	4,274	5,002	6,361
Domestic debt issuance	-1,086	137	750	1,404	213	214	215	216	217
Of which: Domestic banking sector	-1,088	134	1,135	1,299	205	206	207	208	209
External Loans	1,605	1,224	952	600	500	500	500	500	500
Other	0	0	-990	410	1,525	2,732	3,559	4,286	5,644
Memorandum items:									
Oil revenue	20,056	21,271	11,580	13,842	15,831	15,040	14,529	14,023	13,810
Non-oil revenue	10,869	12,644	12,901	13,133	13,252	13,580	14,003	14,535	15,085
Non-oil tax revenue 3/	8,074	9,707	9,220	9,634	9,689	9,919	10,215	10,601	10,987
Non-oil GDP (in million of manats)	47,787	51,600	51,980	55,952	59,186	62,607	66,225	70,053	74,102

Sources: National authorities, and IMF staff estimates and projections.

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

2/ Starting in 2021, includes guarantees issued to Aqracredit for its acquisition of distressed assets from the IBA.

3/ Tax revenue excluding AIOC and SOCAR profit tax, and social contributions.

©International Monetary Fund. Not for Redistribution

Table 5. Azerbaijan: Statement of Consolidated Government Operations, 2018–26

(In percent of non-oil GDP)

	2018	2019	2020	2021	2022	2023	2024	2025	2026
				Projections					
Revenue									
Total revenue	64.7	65.7	47.1	48.2	49.1	45.7	43.1	40.8	39.0
Tax revenue	23.6	26.9	26.6	27.8	27.2	25.9	24.9	24.2	23.5
Income taxes	7.3	6.8	6.7	8.4	8.8	8.2	7.8	7.4	7.1
Individual income tax	2.1	1.8	2.2	2.2	2.2	2.2	2.2	2.2	2.2
Enterprise profits tax	5.2	4.9	4.5	6.2	6.6	6.0	5.5	5.1	4.9
Value added tax (VAT)	9.0	10.0	9.3	8.6	8.0	7.6	7.3	7.2	7.0
Excise taxes	1.5	1.7	1.7	1.8	1.8	1.8	1.8	1.8	1.7
Taxes on international trade	2.7	3.2	3.0	2.7	2.5	2.4	2.3	2.2	2.1
Other taxes	1.5	1.4	1.2	1.2	1.2	1.2	1.2	1.2	1.2
Social security contributions	1.5	3.7	4.5	5.0	4.8	4.7	4.6	4.5	4.4
Nontax revenue	41.1	38.8	20.5	20.4	21.9	19.8	18.1	16.6	15.4
Of which: Oil Fund revenues	36.9	36.9	18.0	19.2	20.7	18.6	17.0	15.5	14.3
Grants	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Expenditure									
Total Expenditure	55.5	52.8	56.3	56.7	53.5	52.0	50.5	49.0	48.5
Current Expense	32.1	34.2	40.2	41.4	40.4	40.1	39.7	39.7	39.8
Compensation of employees	9.2	10.2	11.9	11.7	11.7	11.7	11.7	11.7	11.7
Use of goods and services	6.6	7.5	11.5	12.2	12.2	12.5	12.5	12.7	12.9
Social benefits	9.6	10.5	10.9	10.9	10.1	9.6	9.2	9.1	9.0
Of which: Social protection fund	2.8	3.4	2.3	2.9	2.6	2.3	2.3	2.3	2.3
Subsidies	5.4	4.8	4.7	5.4	5.3	5.2	5.1	5.0	4.9
Grants	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Interest	1.1	1.1	1.2	1.1	1.0	1.0	1.1	1.1	1.2
Other expense	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net Acquisition of Nonfinancial Assets	23.5	18.6	16.1	15.2	13.1	11.9	10.7	9.3	8.7
Overall balance	9.2	13.0	-9.2	-8.5	-4.4	-6.3	-7.4	-8.2	-9.5
Non-oil primary balance 1/	-31.7	-27.2	-30.3	-32.1	-30.2	-29.3	-28.2	-27.2	-26.9
Net financial transactions	9.2	13.0	-9.2	-8.5	-4.4	-6.3	-7.4	-8.2	-9.5
Net acquisition of financial assets	10.3	15.6	-7.8	-4.1	-0.6	-0.8	-0.9	-1.1	-1.0
Privatizations and other sale of assets	-0.2	-0.2	-0.1	-0.2	-0.2	-0.2	-0.3	-0.3	-0.3
General government debt 2/	0.5	1.7	-1.6	-0.9	-0.7	-0.3	-0.3	-0.3	-0.3
General government and government-guaranteed debt	0.4	-1.7	-0.2	0.0	0.0	0.0	0.0	0.0	0.0
Net incurrence of liabilities	1.1	2.6	1.4	4.3	3.8	5.5	6.5	7.1	8.6
Debt securities	-2.3	0.3	1.4	2.5	0.4	0.3	0.3	0.3	0.3
Of which: Domestic banking sector	-2.3	0.3	2.2	2.3	0.3	0.3	0.3	0.3	0.3
External Loans	3.4	2.4	1.8	1.1	0.8	0.8	0.8	0.7	0.7
Other	0.0	0.0	-1.9	0.7	2.6	4.4	5.4	6.1	7.6
Memorandum items:									
Oil revenue	42.0	41.2	22.3	24.7	26.7	24.0	21.9	20.0	18.6
Non-oil revenue	22.7	24.5	24.8	23.5	22.4	21.7	21.1	20.7	20.4
Non-oil tax revenue 3/	16.9	18.8	17.7	17.2	16.4	15.8	15.4	15.1	14.8
Non-oil GDP (in billion of manats)	47.8	51.6	52.0	56.0	59.2	62.6	66.2	70.1	74.1

Sources: National authorities, and IMF staff estimates and projections.

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

2/ Starting in 2021, includes guarantees issued to Aqracredit for its acquisition of distressed assets from the IBA.

3/ Tax revenue excluding AIOC and SOCAR profit tax, and social contributions.

©International Monetary Fund. Not for Redistribution

Table 6. Azerbaijan: Summary Accounts of the Central Bank, 2018–26

(In millions of manat, unless otherwise specified)

	2018	2019	2020	2021	2022	2023	2024	2025	2026
				Projections					
Net foreign assets	11,400	12,052	14,747	14,747	15,087	15,427	15,767	16,107	16,447
Net international reserves of the CBA	11,400	12,052	14,748	14,748	15,088	15,428	15,768	16,108	16,448
Gross international reserves	11,403	12,055	14,750	14,750	15,090	15,430	15,770	16,110	16,450
Foreign liabilities	-2	-2	-2	-2	-2	-2	-2	-2	-2
Other items, net	0	0	-1	-1	-1	-1	-1	-1	-1
Net domestic assets	-756	1,073	306	1,464	2,158	2,733	3,359	4,039	4,776
Domestic credit	4,666	4,355	2,623	3,815	4,545	5,156	5,818	6,535	7,309
Net claims on consolidated central government	-1,580	-2,709	-4,625	-2,892	-2,686	-2,580	-2,472	-2,364	-2,255
Of which: claims on central government	40	27	297	302	307	313	320	328	338
manat deposits of central government	-1,142	-2,338	-2,662	-2,462	-2,262	-2,162	-2,062	-1,962	-1,862
Net claims on banks 1/	6,246	7,064	7,247	6,707	7,231	7,735	8,290	8,899	9,564
Credit to the economy	0	0	0	0	0	0	0	0	0
Other items, net	-5,422	-3,282	-2,317	-2,351	-2,387	-2,422	-2,459	-2,496	-2,533
Reserve money	10,644	13,125	15,053	16,211	17,245	18,160	19,126	20,146	21,223
Manat reserve money	9,546	12,153	13,564	14,988	16,337	17,824	19,464	21,274	23,274
Currency outside CBA	8,364	10,406	11,840	11,489	13,070	14,616	15,960	17,445	19,084
Bank reserves and other deposits	1,182	1,747	1,725	3,499	3,267	3,208	3,503	3,829	4,189
Reserves in foreign currency	1,098	973	1,489	1,222	908	336	-338	-1,128	-2,051

Sources: National authorities, and IMF staff estimates and projections.

1/ Includes CBA holdings of Aqrarcredit's bonds as a part of the SPV, and IBA deposits.

©International Monetary Fund. Not for Redistribution

Table 7. Azerbaijan: Monetary Survey, 2018–26

(In millions of manat, unless otherwise specified)

				Projections					
	2018	2019	2020	2021	2022	2023	2024	2025	2026
Net foreign assets	15,314	17,284	18,812	20,892	21,312	21,733	22,155	22,578	23,002
Net international reserves of the CBA	11,400	12,052	14,748	14,748	15,088	15,428	15,768	16,108	16,448
Net foreign assets of commercial banks	4,078	5,511	4,290	6,390	6,490	6,590	6,690	6,790	6,890
Other	-165	-280	-226	-246	-266	-285	-303	-320	-336
Net domestic assets	8,764	11,582	10,374	10,719	12,316	14,042	15,905	17,915	20,080
Domestic credit, net	15,974	17,461	18,627	19,418	20,990	22,961	25,088	27,489	30,143
Net claims on consolidated central government	-3,549	-4,589	-3,397	-1,763	-1,317	-791	-344	65	476
Credit to the economy	13,058	15,036	14,934	15,681	17,107	18,852	20,832	23,123	25,667
Of which: private sector	13,058	15,036	14,934	15,681	17,107	18,852	20,832	23,123	25,667
Credit to other financial public sector	6,465	7,014	7,090	5,500	5,200	4,900	4,600	4,300	4,000
Other items, net	-7,210	-5,879	-8,254	-8,699	-8,674	-8,919	-9,183	-9,574	-10,062
Broad money	24,078	28,866	29,186	31,611	33,628	35,775	38,060	40,493	43,083
Manat broad money	14,656	18,239	20,303	21,496	23,203	25,043	27,023	29,155	31,450
Cash outside banks	7,601	9,501	10,773	10,110	11,109	11,984	12,608	13,257	13,931
Manat deposits	7,054	8,738	9,530	11,386	12,095	13,059	14,415	15,898	17,520
Foreign currency deposits	9,422	10,628	8,883	10,116	10,425	10,733	11,038	11,338	11,632
	(Annual percentage change)								
Net foreign assets	-0.7	12.9	8.8	11.1	2.0	2.0	1.9	1.9	1.9
Net domestic assets	19.2	32.2	-10.4	3.3	14.9	14.0	13.3	12.6	12.1
Credit to the economy	14.9	15.2	-0.7	5.0	9.1	10.2	10.5	11.0	11.0
Of which: private sector	14.9	15.2	-0.7	5.0	9.1	10.2	10.5	11.0	11.0
Broad money (M3)	5.7	19.9	1.1	8.3	6.4	6.4	6.4	6.4	6.4
Manat broad money (M2)	17.6	24.4	11.3	5.9	7.9	7.9	7.9	7.9	7.9
Reserve money	7.8	23.3	14.7	7.7	6.4	5.3	5.3	5.3	5.3
Manat reserve money	11.7	27.3	11.6	10.5	9.0	9.1	9.2	9.3	9.4
Memorandum items:									
Gross official international reserves (US$ millions)	5,626	6,258	6,369	6,369	6,569	6,769	6,969	7,169	7,369
Velocity of total broad money (M3)	2.0	1.8	1.8	1.8	1.8	1.8	1.7	1.7	1.7
Credit to private sector in percent of non-oil GDP	27.3	29.1	28.7	28.0	28.9	30.1	31.5	33.0	34.6
General government debt	38.0	34.2	30.8	27.7	24.9	22.4	20.2	18.2	16.4
General government and government-guaranteed debt	31.6	32.9	36.9	32.0	33.0	33.5	33.1	32.7	32.3
Share of foreign currency deposits in total deposits	57.2	54.9	48.2	47.0	46.3	45.1	43.4	41.6	39.9
Foreign currency deposits to broad money ratio	39.1	36.8	30.4	32.0	31.0	30.0	29.0	28.0	27.0

Sources: National authorities, and IMF staff estimates and projections.

©International Monetary Fund. Not for Redistribution

Table 8. Azerbaijan: Inclusive Growth Indicators

	Indicator	EMDE Average
Growth		
GDP per capita growth (percent; 2018-20 average)	-1.2	1.8
Gross Fixed Capital Formation (percent of GDP; 2018-20 average)	19.1	24.4
Poverty and Inequality		
Poverty headcount ratio at $3.20/day (percent of population; 2005)	0.0	31.9
Multidimensional poverty (percent of population)	2.4	31.2
Prevalence of stunting (% of children under 5, 2013)	17.8	21.7
GINI Index (2005)	26.6	39.8
Child mortality (per 1,000, 2019)	20.4	29.2
Growth in mean consumption (growth, %, bottom 40th percentile)	n.a.	2.4
Human Development and Access to Services		
Human Development Index (2019)	0.8	0.7
Life expectancy at birth (years, 2018)	72.9	72.3
Access to electricity (% of population, 2018)	100.0	81.1
Net school enrollment, secondary, total (% population, 2018)	88.5	68.3
Individuals using internet (% population, 2019)	79.8	46.9
Literacy rate (% population, 2017)	99.8	82.1
Government		
Commitment to reducing inequality index (2017)	0.52	0.46
Government spending on social safety net programs (percent of GDP, 2018)	0.8	1.6
Coverage of social safety net programs in poorest quintile (% population, 2015)	33.4	43.3
Government expenditure on education, total (% GDP, 2018)	2.5	4.4
Health expenditure, domestic general government (% of GDP, 2018)	0.9	2.8
Access to Finance		
Account at a financial institution (% age 15+, 2017)	28.6	48.9
Domestic credit to private sector (% GDP, 2019)	22.2	43.4
Loans to SMEs (% of GDP, N.A.)	n.a.	8.6

	Indicator	EMDE Average
Labor Markets (ILO estimates)		
Unemployment rate (% of total labor force, 2020)	6.0	6.9
Female unemployment rate (% of female labor force, 2020)	6.8	8.3
Youth unemployment rate (% of total labor force ages 15-24, 2020)	15.7	15.9
Labor force participation (% of total population ages 15+, 2020)	66.1	62.0
Female labor force participation (% of female population ages 15+, 2020)	63.1	50.8
Youth labor force participation (% of population ages 15-24, 2020)	41.8	42.3
Governance[1]		
Global Competitiveness Index - Institutions Index (2019)	58.5	50.0
Government Effectiveness (WGI, 2019)	-0.1	-0.4
Regulatory Quality (WGI, 2019)	-0.2	-0.4
Rule of Law (WGI, 2019)	-0.6	-0.4
Control of Corruption (WGI, 2019)	-0.9	-0.4
Corruption Perceptions Index (2020)	30.0	36.6
Gender Equity and Inclusion		
Account at a financial institution (female vs male, %, 2017)	94.2	81.0
Female employment to population ratio (%, 2020)	58.9	47.3
Literacy rate (female vs male, %, 2017)	99.9	87.1
Net school enrollment, secondary (female vs male, %, 2018)	99.2	100.7
Gender Gap Index (2018)	0.7	0.7
Female seats in Parliament (share of total seats, 2020)	17.4	22.3

Better than EMDE Average (green) **Worse than EMDE Average** (pink)

Sources: IMF World Economic Outlook, World Bank, World Economic Forum, International Labour Organization, Transparency International, UNDP, Oxfam International.
1 / Indicators use official sources and surveys to summarize perceptions of the quality of governance and business environments.

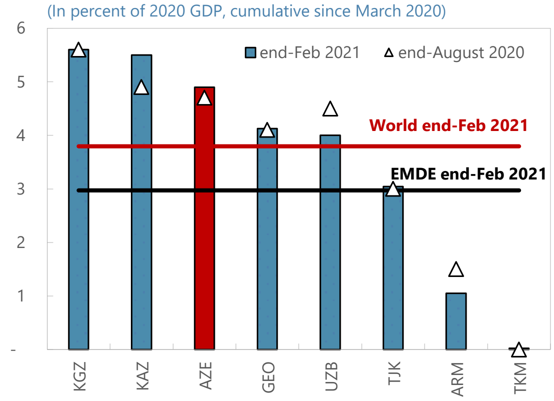
©International Monetary Fund. Not for Redistribution

Annex I. Response to the Pandemic

1. **The 2020 recession was driven by the oil sector, which contracted by 6.4 percent owing to OPEC+ cuts on top of a gradual structural decline in oil production**. The impact of the pandemic on the nonoil output was smaller (3 percent decline), broadly in line with that in global and regional peers. The pandemic mostly affected contact-intensive sectors, especially hospitality, which contracted by 59 percent but accounts for a small share of the economy. Construction and trade activity also declined (by 8.8 percent and 1.3 percent respectively). Given high labor intensity of contact-intensive sectors, unemployment rose from 4.8 percent in 2019 to 7.2 percent in 2020, and so did poverty. The large informal sector was also severely affected. However, manufacturing, transportation, and agriculture proved to be resilient, expanding by 10.4 percent, 4.6 percent, and 2 percent, respectively.

2. **A sizeable fiscal relief package, amounting to 4.8 percent of the 2020 GDP, cushioned the impact of the pandemic**. Measures were targeted to the affected sectors, firms, and individuals. Main instruments included loan guarantees, subsistence cash transfers to the unemployed and temporary public jobs, salary payments and support to microentrepreneurs, and support to passenger transportation (mostly the national airline). Spending and tax relief measures terminated at the end of 2020. The package was financed mainly through the budget, by reallocating spending and increasing transfers from SOFAZ. Some additional financing came from the Solidarity Fund, which included private donations.

Azerbaijan: Fiscal Support in Response to COVID-19
(In percent of 2020 GDP, cumulative since March 2020)



Sources: IMF COVID-19 Tracker and IMF staff calculations.
Notes: Includes announced discretionary fiscal packages including both above and below the lines support.

3. **The coverage of the package, at one fifth of the population, was broadly adequate.** This is reflected, among other things, in its substantial uptake by end-2020. (The duration of some measures (especially social support) was extended when the pandemic turned out to be more prolonged than originally expected.)

4. **Cash transfer programs helped people to cope with the crisis**. The largest cash transfer program to address the pandemic consisted of lump-sum subsistence payments to unemployed workers, including from the informal sector, who registered with the State Employment Service. The distribution of support benefitted from the recently introduced

COVID-19 Relief Measures
(In percent of GDP)

Fiscal Measures	**4.8**
Loan guarantees and subsidized loans to certain borrowers.	2.2
Expansion of unemployment insurance and temporary public jobs.	0.7
Partial payment of salaries and support to micro entrepreneurs.	0.4
Financial support passenger transportation.	0.4
Scaling up medical facilities and building of new hospitals.	0.3
Reduced or deferred taxes to qualified taxpayers.	0.2
Purchase of medical supplies, payment of allowances to medical workers.	0.1
Other COVID-19 relief programs. [1/]	0.5
CBA Measures	
Reduction of aggregate capital requirements by 1 percentage point.	
Delay in the planned countercyclical buffers increase from 0 to 0.5%.	
Reduction of risk weights for certain loans (mortgage loans, medical equipment).	
Loan loss provision deterioration and onsite inspections suspended.	

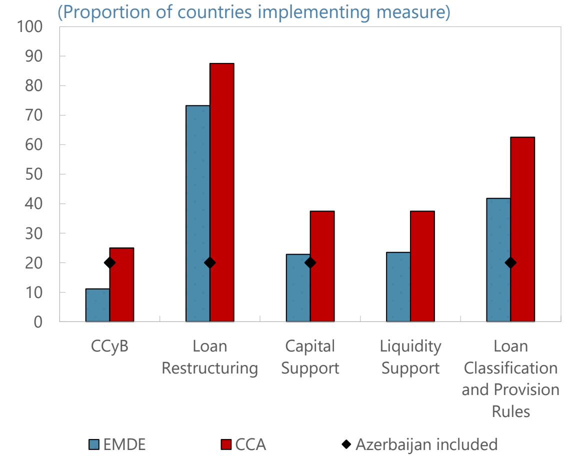
Sources: National authorities and IMF staff calculations.
1/ Mainly the use of the reserves of the State Social Protection Fund to sustain social payments (pensions and benefits) to the population in the face of reduced insurance contributions.

©International Monetary Fund. Not for Redistribution

digital social systems, which were expanded during the pandemic. Although the amount of the cash transfer per individual appeared reasonable by historical standards, the principal cash assistance to the unemployed replaced only 27 percent of average monthly income, which is somewhat low by international comparison. Additional social assistance for the most vulnerable persons during the pandemic was meagre (less than 0.1 percent of GDP). Even prior to the pandemic, Azerbaijan's social assistance expenditure and its coverage of the poorest quintile were well below the average for EM economies. Unemployment insurance remains a small program with tight eligibility criteria.

5. **Financial sector policies also helped cope with the crisis**. The impact on the financial sector was mitigated by a gradual reduction of the CBA policy rate, easing requirements on bank capital buffers and loan loss provisions, loan forbearance on interest payment and credit histories, and a temporary suspension of on-site inspections. Borrower support programs accounted for a significant portion of loan portfolios in the affected sectors. The scope for using liquidity support was limited by the *de facto* peg.

Azerbaijan: Financial Measures
(Proportion of countries implementing measure)



Sources: IMF Covid Policy Tracker, National authorities and IMF staff calculations.

©International Monetary Fund. Not for Redistribution

Annex II. Debt Sustainability Analysis (DSA)

Figure A.II.1. Azerbaijan: Public Sector Debt Sustainability Analysis (DSA)

(In percent of GDP unless otherwise indicated)

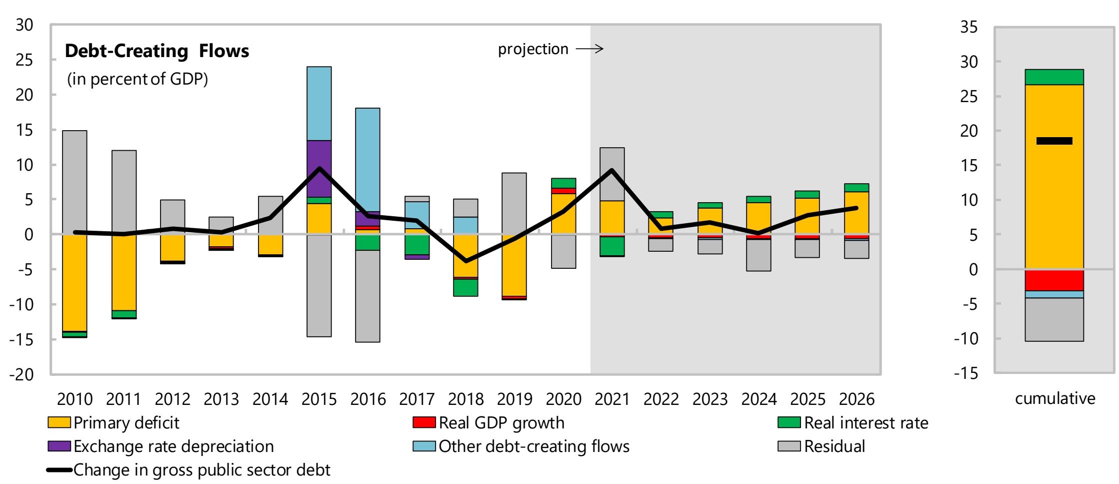
Debt, Economic and Market Indicators [1/]

	Actual			Projections					
	2010-2018 [2/]	2019	2020	2021	2022	2023	2024	2025	2026
Nominal gross public debt	12.3	18.1	21.4	30.6	31.4	33.2	33.3	36.1	39.9
Public gross financing needs	-2.1	-5.7	9.4	7.9	4.7	5.6	9.3	9.1	11.9
Net public debt	-54.0	-72.1	-80.9	-54.4	-52.1	-47.9	-44.7	-38.5	-31.3
Real GDP growth (in percent)	1.5	2.2	-4.3	2.3	1.7	1.7	1.7	1.7	1.7
Inflation (GDP deflator, in percent)	8.3	-0.2	-7.3	18.6	-0.2	0.6	1.3	1.8	2.1
Nominal GDP growth (in percent)	9.8	2.0	-11.3	17.5	1.9	2.9	3.6	4.0	4.3
Effective interest rate (in percent) [4/]	2.3	3.8	4.1	4.1	2.8	3.5	4.2	4.8	5.4

As of February 22, 2021		
Sovereign Spreads		
EMBIG (bp) 3/		366
5Y CDS (bp)		283
Ratings	Foreign	Local
Moody's	Ba2	Ba2
S&Ps	BB+	BB+
Fitch	BB+	BB+

Contribution to Changes in Public Debt

	Actual			Projections							
	2010-2018	2019	2020	2021	2022	2023	2024	2025	2026	cumulative	debt-stabilizing
Change in gross public sector debt	1.6	-0.6	3.3	9.2	0.8	1.8	0.1	2.8	3.8	18.5	primary
Identified debt-creating flows	-0.2	-9.4	8.0	1.7	2.6	3.9	4.7	5.4	6.4	24.7	balance [9/]
Primary deficit	-3.7	-8.9	5.8	4.8	2.3	3.7	4.5	5.2	6.1	26.7	0.3
Primary (noninterest) revenue and grants	38.9	41.5	33.8	31.7	33.5	32.1	30.9	29.7	28.8	186.6	
Primary (noninterest) expenditure	35.2	32.6	39.6	36.5	35.9	35.8	35.4	34.9	34.9	213.3	
Automatic debt dynamics [5/]	0.0	-0.4	2.3	-3.0	0.4	0.4	0.4	0.4	0.5	-1.0	
Interest rate/growth differential [6/]	-1.0	-0.4	2.3	-3.0	0.4	0.4	0.4	0.4	0.5	-1.0	
Of which: real interest rate	-0.9	0.0	1.4	-2.6	0.9	0.9	0.9	1.0	1.1	2.2	
Of which: real GDP growth	-0.1	-0.4	0.9	-0.4	-0.5	-0.5	-0.6	-0.6	-0.6	-3.2	
Exchange rate depreciation [7/]	1.1	0.0	0.0	…	…	…	…	…	…	…	
Other identified debt-creating flows	3.5	-0.1	-0.1	-0.1	-0.1	-0.2	-0.2	-0.2	-0.2	-1.1	
Privatization (negative)	-0.1	-0.1	-0.1	-0.1	-0.1	-0.2	-0.2	-0.2	-0.2	-1.1	
Contingent liabilities	3.6	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Accumulation/Drawdown of Deposits	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes [8/]	1.7	8.8	-4.7	7.6	-1.8	-2.1	-4.6	-2.6	-2.6	-6.1	



Source: IMF staff projection.

1/ Public sector is defined as general government.

2/ Based on available data.

3/ EMBIG.

4/ Defined as interest payments divided by debt stock (excluding guarantees) at the end of previous year.

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

6/ The real interest rate contribution is derived from the numerator in footnote 5 as r - π (1+g) and the real growth contribution as -g.

7/ The exchange rate contribution is derived from the numerator in footnote 5 as ae(1+r).

8/ Includes asset changes and interest revenues (if any). For projections, includes exchange rate changes during the projection period. In 2021, reflects inclusion to debt of Aqracredit guarantee, and drawdown of SOFAZ assets in 2022-26.

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

©International Monetary Fund. Not for Redistribution

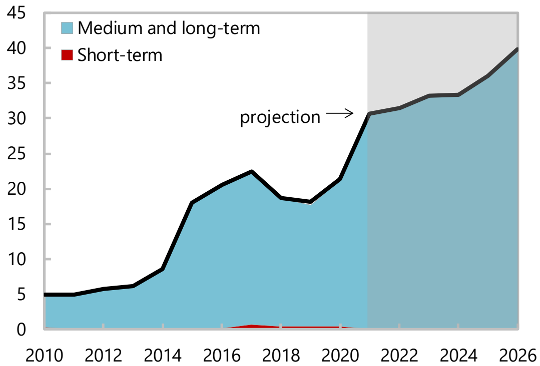
Figure A.II.2. Azerbaijan: Public DSA - Composition of Public Debt and Alternative Scenarios

(In percent of GDP unless otherwise indicated)

Composition of Public Debt

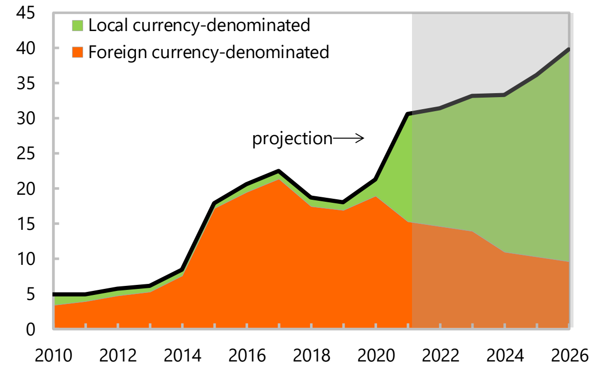
By Maturity

(in percent of GDP)



By Currency

(in percent of GDP)

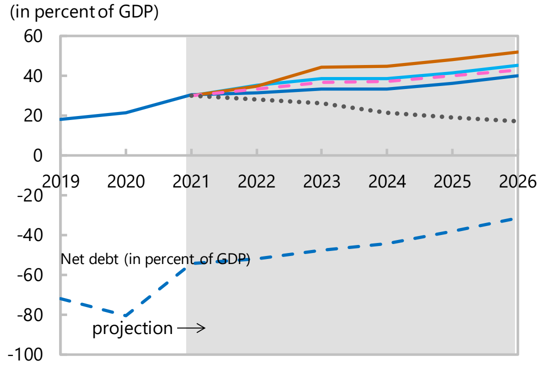


Alternative Scenarios 1/

Baseline
Contingent Liability Shock
Historical
Constant Primary Balance
Financial/SOE Contingent Liability Shock

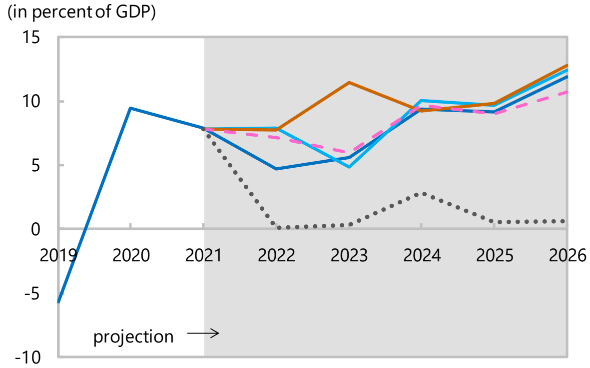
Gross Nominal Public Debt

(in percent of GDP)



Public Gross Financing Needs

(in percent of GDP)



Underlying Assumptions

(in percent)

	2021	2022	2023	2024	2025	2026
Baseline Scenario						
Real GDP growth	2.3	1.7	1.7	1.7	1.7	1.7
Inflation	18.6	-0.2	0.6	1.3	1.8	2.1
Primary Balance	-4.8	-2.3	-3.7	-4.5	-5.2	-6.1
Effective interest rate	4.1	2.8	3.5	4.2	4.8	5.4
Constant Primary Balance Scenario						
Real GDP growth	2.3	1.7	1.7	1.7	1.7	1.7
Inflation	18.6	-0.2	0.6	1.3	1.8	2.1
Primary Balance	-4.8	-4.8	-4.8	-4.8	-4.8	-4.8
Effective interest rate	4.1	2.9	3.7	4.3	4.9	5.3

	2021	2022	2023	2024	2025	2026
Historical Scenario						
Real GDP growth	2.3	0.7	0.7	0.7	0.7	0.7
Inflation	18.6	-0.2	0.6	1.3	1.8	2.1
Primary Balance	-4.8	2.3	2.3	2.3	2.3	2.3
Effective interest rate	4.1	2.9	3.2	3.8	4.8	6.0
Contingent Liability Shocks						
Real GDP growth	2.3	-1.3	-1.3	1.7	1.7	1.7
Inflation	18.6	-0.9	-0.1	1.3	1.8	2.1
Primary Balance	-4.8	-5.4	-3.7	-4.5	-5.2	-6.1
Effective interest rate	4.1	3.3	3.9	4.4	5.0	5.5

Source: IMF staff projection.

1/ Contingent liability shock refers to standard financial sector liability shock with one-off increase in non-interesat expenditures equal to 10 percent of banking sector assets; SOE/Financial sector shock combines financial sector and SOE contingent liability shocks, with non-interest expenditures increased by 20 percent of SOE guarantees excluding Aqracredit guarantees.

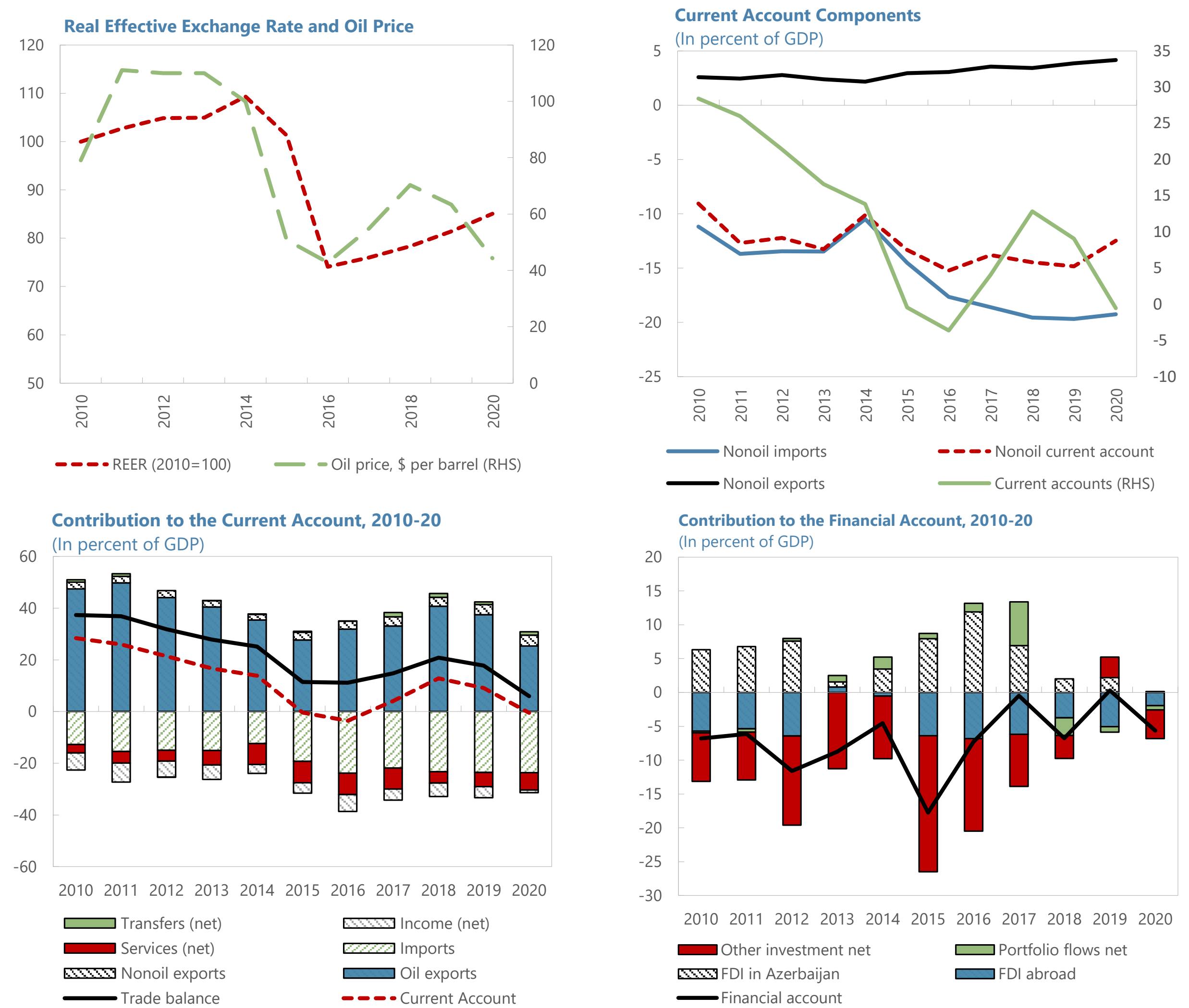
©International Monetary Fund. Not for Redistribution

Annex III. External Sector Assessment

Staff assesses the external position to be substantially weaker than the level consistent with medium-term fundamentals and desirable policies. Amid the pandemic, a decline in oil export revenues caused a sharp deterioration in the external position in 2020. While overall external buffers remain high, the current account (CA) balance is significantly weaker than the level needed to ensure sufficient savings for future generations.

1. A large CA surplus turned into a small deficit in 2020. Following three years of surpluses, the CA reversed from 9.1 percent of GDP in 2019 to -0.5 percent of GDP in 2020 owing to a sharp decline in global oil prices and oil production cuts under the OPEC+ agreements in the midst of the pandemic. A recovery in oil prices in 2017–19, coupled with a reduction in oil-related construction and business services (as many projects were completed), led to a rebound of the CA to a surplus averaging 8.7 percent of GDP in the 2017–19 period. The nonoil CA deficit remains stubbornly high, at

Azerbaijan: Real Effective Exchange Rates and Contributions to Current Account



Sources: National authorities, IMF World Economic Outlook, and IMF staff calculations.

©International Monetary Fund. Not for Redistribution

12.5 percent of GDP, driven by large nonoil imports. Nonoil exports are low at 4 percent of GDP in 2019 and 2020. The CA is expected to swing back to a surplus of 2.4 percent of GDP in 2021 and then to gradually decline in tandem with oil export volumes.

2. **External reserve coverage remains more than adequate**. Despite the CA deterioration, CBA's gross international reserves increased moderately, reaching $6.4 billion (15 percent of GDP, 4.5 months of next year's imports of goods) by end-2020. CBA's reserves are complemented by the liquid part of foreign assets held by the Oil Fund (SOFAZ). This liquid part, mostly fixed income instruments, equities and gold, represents about 75 percent of the $43.5 billion in assets (102 percent of GDP) at end-2020. Together, CBA and SOFAZ liquid assets are equivalent to 25 months of next year's imports. Azerbaijan scores much better than most EMs on all criteria of the IMF's Assessing Reserve Adequacy (ARA) metric, which combines information on exports, broad money, short-term debt and other investment liabilities (yellow diamonds lower left chart). This is the case even after adjusting the ARA metric for the country's heavy reliance on oil exports (green diamond in same chart). Reserve coverage scores are projected to remain strong into 2026, given expected CA surpluses, rising reserves, and limited increases in external debt (red diamonds).

3. **The external position has substantially weakened in 2020 compared to the level implied by medium-term fundamentals and desirable policy settings**.

- The ***EBA-Lite commodity approach***[1] is preferable for assessing the CA position in Azerbaijan because it is based on the permanent income hypothesis (PIH) and reflects the fundamental goal of achieving intergenerational equity in this country with nonrenewable resources. Assuming the annuity is constant in real terms, the CA norm is estimated at 18.5 percent of GDP in 2020, implying a negative CA gap of 16.1 percent of GDP.[2] The gap is expected to remain negative over the medium term at 11.2 percent of GDP and will require sustained fiscal consolidation to narrow it further over time.

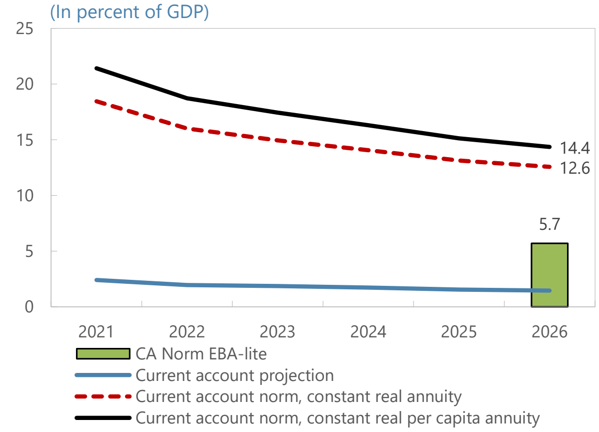
[1] Bems, R., and I. de Carvalho Filho, 2009, "Exchange Rate Assessments: Methodologies for Oil-Exporting Countries," IMF Working Paper 09/281.

[2] The estimated norm is sensitive to the choice of model parameters, such as the GDP growth rate, interest rate, and population growth rate, as well as the underlying oil prices.

©International Monetary Fund. Not for Redistribution

- The ***current account model***, which estimates an equilibrium level of the CA consistent with the gamut of structural and policy factors in the IMF's multilaterally consistent External Balance Assessment-Lite framework, also suggests that the CA was weaker than fundamentals in 2020. The CA norm is estimated at 5.7 percent of GDP, implying a negative gap of 1.8 percent of GDP, after adjusting for the temporary impact of COVID-19. Policy changes that would reduce the CA gap over the medium term include: (i) deeper and sustained fiscal consolidation than assumed in the baseline; (ii) financial deepening, for bank credit to the private sector to rise closer to the EM average; (iii) an increase in public health expenditures from current 2 percent of GDP by 0.5 percent of GDP in the medium term, closer to the EM average while improving spending efficiency.

Azerbaijan: Forecasted CA and CA Norm under Bems-Carvalho (Oil Resource) Adjustment
(In percent of GDP)



Source: IMF staff calculations.

4. **The manat continued to appreciate in 2020**. It has been *de facto* pegged to the dollar at a rate of 1.7 since April 2017. The real effective exchange rate (REER) was 12 percent stronger than 2017. The recent appreciation has been driven mostly by the U.S. dollar nominal appreciation vis-à-vis trading partners' exchange rates (particularly Russia and Turkey). The current account and REER models suggest that the exchange rate is significantly overvalued, with the REER gap in a range of 6.0 to 6.8 percent, consistent with the negative CA gap over the medium term. The permanent income model could indicate a much larger REER gap, in line with the larger CA gap implied by a constant real annuity.

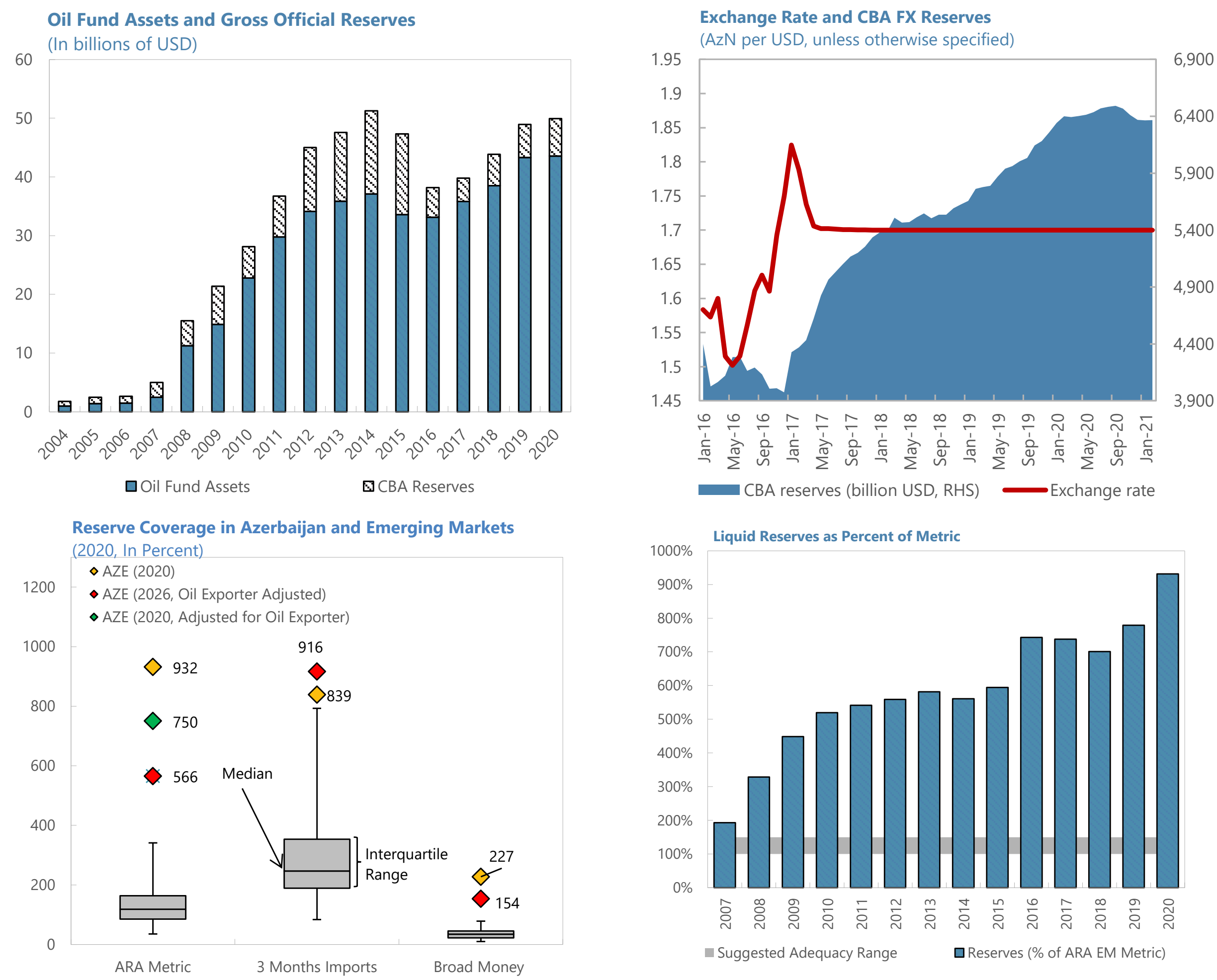
5. **Overall, staff assesses the external position to be substantially weaker than the level consistent with medium-term fundamentals and desirable policies**. This assessment is based on the results above, giving the relevance of the external sustainability approach based on the PIH. Specifically, staff assesses the CA gap to be -11.2 percent of GDP, based on the constant real annuity estimated by the EBA-Lite commodity approach, and the medium-term REER gap to be at least 6.0 to 6.8 percent, also considering the current account and REER models.

6. **Azerbaijan has been a net supplier of capital**. Capital and financial accounts are generally open but domestic financial markets are underdeveloped compared to those in regional and global peers. Capital inflows are dominated by FDI, mostly to the oil sector, and portfolio inflows, while outflows include trade credits, bank outflows, and outward FDI, mainly by the national oil company. Risks of increased bank outflows are mitigated through administrative and reporting requirements that were introduced in response to the 2015–16 crisis and largely remain in effect.[3]

[3] The administrative and reporting requirement measures are being assessed by staff using the Institutional View on Liberalization and Management of Capital Flows, as they might constitute capital flow management measures.

©International Monetary Fund. Not for Redistribution

Figure A.III.1. Azerbaijan: Exchange Rates and Reserve Adequacy



Sources: National authorities, Haver, IMF FAD Reserve Adequacy Tool, and IMF staff calculations.
Note: The data for EM refer to a sample of 47 emerging markets.

©International Monetary Fund. Not for Redistribution

Annex IV. Risk Assessment Matrix

Risk[1]	Description	Likelihood	Possible Impact	Policy Advice
	External Risks and Spillovers			
Unexpected shifts in the COVID-19 pandemic	Prolonged pandemic. The disease proves hard to eradicate, requiring more costly containment efforts and impacting economic activity. Delays in availability of vaccine and continued weakness in trading partners prompts a reassessment of growth prospects.	**Medium**	New more dangerous virus strains, and problems in the rollout of vaccines could delay the reduction in Covid cases and the phase-out of lockdown measures and resumption of economic activity. Continued containment necessitates higher budget spending and lower revenues, weakening fiscal balance. Slower global growth would reduce oil and natural gas exports.	Fiscal consolidation could be slowed down, with additional well-targeted spending provided as needed to health and other sectors to fight the pandemic. Monetary policy should remain accommodative.
Widespread social discontent and political instability	Social tensions erupt as the pandemic and inadequate policy response cause socio-economic hardship, or due to unequal access to vaccines. Growing political polarization and instability weaken policymaking and confidence.	**High**	Social discontent and political instability due inadequate response to the pandemic are likely to have a low impact on Azerbaijan. The risk of domestic political instability has been reduced following the end of the conflict with Armenia.	Ensure adequate, temporary, and targeted support to the population most adversely affected and vulnerable to the pandemic.

[1] The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 and 30 percent, and "high" a probability between 30 and 50 percent). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities. Non-mutually exclusive risks may interact and materialize jointly.

©International Monetary Fund. Not for Redistribution

Risk	Description	Likelihood	Possible Impact	Policy Advice
Oversupply and volatility in the oil market	Higher supply and lower demand lead to renewed weakness in energy prices. Uncertainty about production cuts, prospects for the shale gas industry, and the pace of demand recovery lead to bouts of volatility.	**Medium**	Given Azerbaijan's high oil dependence, the economy could go into recession in case of a large oil decline. The oil fund savings could help cushion the shock A prolonged oil price increase could generate a large windfall.	A prolonged oil price decline would necessitate a large fiscal adjustment. Windfall revenue from higher-than-budgeted oil prices should be saved. Over the medium/long term, implement structural reforms to foster greater diversification in production and exports, boosting competitiveness, and reducing dependency on oil.
Intensified geopolitical tensions and security risks	(Geo)political tensions in selected countries/regions cause economic/political disruption, disorderly migration, higher volatility in commodity prices, and lower confidence.	**High**	Greater security risks would raise oil prices helping to increase growth. However, FDI in the region could be negatively affected.	Avoid pro-cyclical fiscal policy and spending of revenue windfalls resulting from temporary oil price increase.

©International Monetary Fund. Not for Redistribution

Risk	Description	Likelihood	Possible Impact	Policy Advice
Accelerating de-globalization	Despite renewed efforts to reach multilateral solutions to existing tensions, geopolitical competition leads to further fragmentation. Reshoring and less trade reduce potential growth.	**Medium**	Disruptions in the global trading system and in regional integration would adversely affect Azerbaijan's plans to expand nonoil exports and oil processing industry, as well as attempts to enter global value chains.	Maintain sufficient fiscal buffers that would provide space to respond to adverse impact of global trading disruptions.
Domestic Risks				
Failure to reverse fiscal easing	Fiscal balance has weakened significantly in 2020 as a result of lower oil price, declining output, policy measures to mitigate the COVID-19 impact and the full-year impact of the 2019 public wage increase.	**Medium**	Failure to reverse fiscal easing would lead to an increase in public debt and/or reduction of SOFAZ assets. While not threatening fiscal sustainability, it would undermine the effort to achieve intragenerational equity.	Gradually phase out the exceptional budgetary support in response to the pandemic, followed by a reduction in subsidies and tight spending control. In the medium-term, implement revenues measures to boost non-oil budget revenues.
Financial sector risks	Risks could increase after the pandemic. The relaxation of prudential measures provided some relief to banks, but asset quality could deteriorate, and restructured loans could turn out to be nonperforming, weakening banking sector soundness.	**Medium**	A renewed deterioration of the banking system asset quality would reduce their capacity to extend new loans and support growth. The government may need to provide financial support which would entail additional fiscal costs.	Reverse gradually the easing of prudential regulation in response to the pandemic, followed by strengthening of financial supervision and regulation.

©International Monetary Fund. Not for Redistribution

Risk	Description	Likelihood	Possible Impact	Policy Advice
Weak SOE performance	Failure to improve weak SOEs financial performance will result in continued losses, with negative impact on economic growth and growing contingent liabilities to the budget.	**Medium**	High government guarantees are a source of large fiscal risk. Failure to strengthen SOE's performance would increase the risk that additional guarantees will be issued, and existing guarantees called, increasing government debt.	Implement comprehensive reforms to improve corporate governance and efficiency of SOEs.
Higher oil price	Stronger global growth leads to higher oil price.	**Medium**	Higher oil price strengthens export revenues and fiscal balance.	Avoid a pro-cyclical increase in budget expenditures.

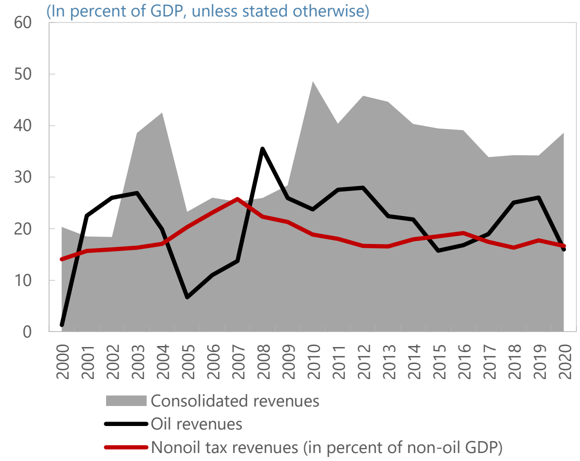
©International Monetary Fund. Not for Redistribution

Annex V. Priorities for Tax Reforms

As Azerbaijan strives to reduce the dependence of its economy on oil production and informal activity, a greater tax effort will be required to sustain its public finances. The groundwork for formulating and administrating future tax reforms must be laid as soon as possible.

1. **With oil production on a declining trend, mobilization of nonoil tax revenue is critical for strengthening long-term fiscal sustainability**. Nonoil tax revenue as a share of nonoil GDP has not increased to compensate for the gradually declining importance of oil revenues. To maintain consolidated revenues at 30 percent of GDP beyond 2026, nonoil tax effort will need to increase by 1.3 percent of nonoil GDP in 2027, and gradually rise by 10.8 percent of nonoil GDP in 2040. Clearly, as Azerbaijan transitions to a more diversified economy, additional revenues will need to be mobilized from the nonoil sector.

Azerbaijan: Oil Revenues and Non-Oil Tax Revenues
(In percent of GDP, unless stated otherwise)



Sources: National authorities and IMF staff calculations.

2. **Compared to its peers, Azerbaijan has higher rates for VAT, comparable for CIT, and lower for PIT**. The VAT rate is 18 percent with registration obligatory for taxpayers with annual turnovers exceeding AZN 200,000 ($120,000). The CIT rate is 20 percent, while the PIT structure depends on the sector of employment. The marginal PIT rates are 14 percent on monthly taxable incomes up to AZN 2,500 and 25 percent on the portion of income exceeding AZN 2,500, but the top rate applies only to the public and petroleum sectors. A key tax reform that took effect on January 1, 2019 exempted from PIT for a period of seven years employees working in the nonoil & gas and non-state sectors and earning up to AZN 8,000 per month (equivalent to $56,000 annual income). The tax rate applicable on the portion of income above AZN 8,000 is 14 percent. The top PIT rate for the non-public and nonoil sectors (14 percent) is lower than the average of the group of comparator countries and the CIT rate is slightly below the average rate of the comparators.[1] Azerbaijan also derives less revenues from property taxes.

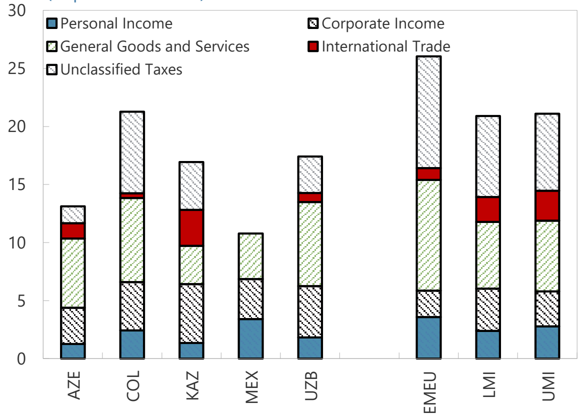
3. **Azerbaijan has recently adopted several tax policy and administration measures, with the goal of reducing the sizeable informal economy and expanding the tax base**. The administrative measures included expanding electronic information exchange with government agencies for tax control purposes; offering «Cash-back» incentives for consumers to promote "whitening" of turnovers in retail trade and service, while tightening financial sanctions for illegal employment and undeclared income. Recent tax policy measures included the PIT tax holiday in the nonoil, non-public sector (to encourage formal employment contracts), tighter eligibility restrictions for the simplified tax regime (to move microenterprises from the simplified regime to profit tax),

[1] The comparator countries are the oil producers Colombia, Kazakhstan, Mexico, Turkmenistan, and Uzbekistan.

©International Monetary Fund. Not for Redistribution

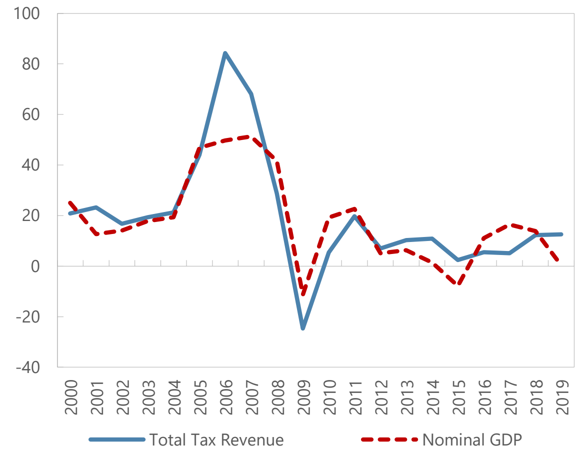
reducing the turnover tax rate of the simplified tax regime (to induce the self-employed to register their activities), cutting the income tax rate for micro-businesses (to promote growth), and expanding the use of tax incentives to attract investment and create positive agglomeration effects.

Azerbaijan: General Government Revenues, 2018
(In percent of GDP)



Notes: EMEU= Emerging Market Europe; LMI= Lower Middle Income countries; UMI= Upper Middle Income countries.

Azerbaijan: Growth of Total Tax Revenues and Nominal GDP
(In percent)



Sources: National authorities, and IMF staff calculations.

4. **Tax revenue as a share of GDP is lower than in most peers**. In 2019, tax revenues were 14.6 percent of GDP, an improvement of 1.5 pp over 2018, stemming mainly from increased VAT collection. VAT C-efficiency in Azerbaijan (0.52) in 2018 was comparable to the average for lower-middle income countries (0.50), while below the average for upper-middle income countries (0.62). PIT revenues have been on a downward trend, falling by 0.7 pp of GDP during 2016–19.

5. **The buoyancy of non-oil tax revenues is weak**.[2] In the few years preceding the global financial crisis, total tax revenue growth exceeded GDP growth, while the sharp GDP contraction in 2009 brought an even steeper fall in revenues, suggesting that overall tax buoyancy has been larger than one during this period, while the pattern is less clear in the subsequent years. A simple linear regression indicates that over the period 2000–19, on average a 1 pp change in GDP led to a 1.1 pp change in total tax revenues in the same year. The buoyancy stems entirely from oil sector CIT, underscoring revenue risks from the long-term slowdown in oil GDP growth. VAT buoyancy equals 1, while PIT exhibits weak buoyancy (with a coefficient of 0.85) and non-oil CIT shows buoyancy of 0.94 with respect to non-oil GDP. These findings further underscore the dependence of tax revenues on the oil sector and the weak response of other tax instruments to GDP growth.

6. **Tax reforms will be needed to reorient revenue mobilization to nonoil sector development**. Several directions are possible over the longer term, but the groundwork for these reforms, including strengthening the capacity of the tax administration, must be laid sooner.

[2] A buoyancy rate of 1 would imply that an extra percent of GDP would increase tax revenue by 1 percent, leaving the tax-to-GDP ratio unchanged. A tax buoyancy exceeding 1, however, would increase tax revenue by more than GDP and lead to improvements in the fiscal balance, as well as providing automatic stabilization against income shocks.

©International Monetary Fund. Not for Redistribution

i. *PIT* is the primary tax instrument for achieving fairness in taxation across income groups. The progressivity of PIT helps to offset the regressive aspect of the VAT, whereby the non-rich bear a disproportionate amount of tax compared to their income levels, either directly in tax payments or indirectly by a pass-through of the tax to consumers. Hence, PIT is both an important source of revenue mobilization and a key instrument for reducing inequality. Following the scheduled end of the PIT holiday for non-public, nonoil wage earners in 2026, a progressive PIT system based on end-of-year declaration of all sources of income should be put into place, with taxes withheld credited against the end-of-year tax liability. A PIT schedule with a small exemption level and at least one additional (non-zero) marginal tax rate, with the top rate designed to increase the tax paid by the richest individuals in the country, would help reduce the regressivity of taxation and increase revenues.

ii. *Property tax* is levied on the net book value of the fixed assets of legal entities, while for physical persons the tax is based on an amount per square meter of the area of the residential building, which depends on its location. A gradual replacement of the existing property tax with the one based on the market values of residential and nonresidential properties would improve revenue buoyancy and fairness. A modern residential property tax is less distortive than income tax and proxies wealth tax on owner-occupied dwellings.

iii. *Tax exemptions* are numerous[3] and may cause unnecessary revenue leakages via abusive transfer pricing practices and disruptions to the VAT chain, or because domestic investment and employment relocate to the tax-exempt areas without generating net increases in amounts. Moreover, studies show that infrastructure and the ease of doing business are more important than tax holidays for attracting FDI. The nature of exemptions from profit tax is that the size of the benefit is not directly related to the size of the investment and some of these investments would have occurred even without the tax break. The cost of the tax exemptions, in terms of forgone revenues, should be calculated and assessed in relation to their measured benefits. A recommended practice is to append an annual tax expenditure report to the budget. Reducing tax exemptions would broaden the tax base and likely improve revenue performance.

[3] Exemptions from profit tax include a 50 percent exemption for legal entities holding an investment promotion certificate and a ten-year exemption for entities resident in industrial and technology parks. VAT exemptions have been applied for all types of goods imported by the residents of industrial parks for the purposes of their activities for the period of five years until 1 May 2021. The first Free Economic Zone (FEZ) became operational in May 2020, to promote the emerging trade and logistics hub in the Alat settlement on the Caspian Sea coast. Goods and services imported into the FEZ are exempted from duties and VAT, and legal entities operating in the zone and their employees, as well as Free Zone residents, are exempt from all taxes related to their activities. The profits of SME clusters are exempted from tax for 7 years and 75 percent of the profit of micro entrepreneurs are exempt from profit tax and property tax. Startups are also exempt from income and profit tax for three years, while agricultural producers are exempted from profit tax, property tax, and VAT for 10 years.

©International Monetary Fund. Not for Redistribution

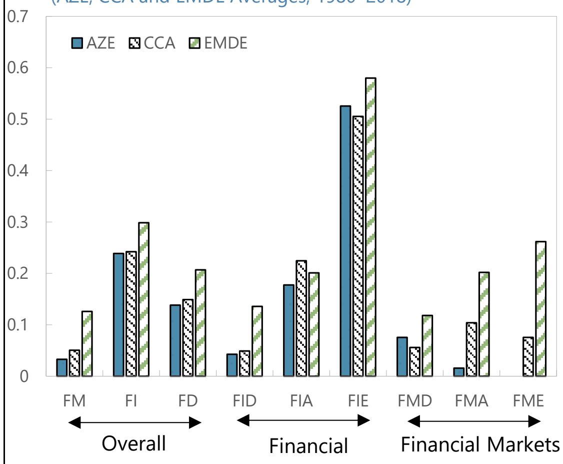
Annex VI. Financial Development, Inclusion, and Stability

Finance is an engine of growth and needs to play a key part in Azerbaijan's transition the new growth model. Yet if credit expansion is supply-driven, it raises risks to financial stability. Strengthening prudential oversight, stress-testing and transparency can help mitigate these risks.

1. **Azerbaijan lags its peers in financial development and inclusion**. Accessibility and depth are low, financial markets are underdeveloped, and weaknesses in bank balance sheets persist. High collateral requirements and low use of bank credit for business finance are among key obstacles.

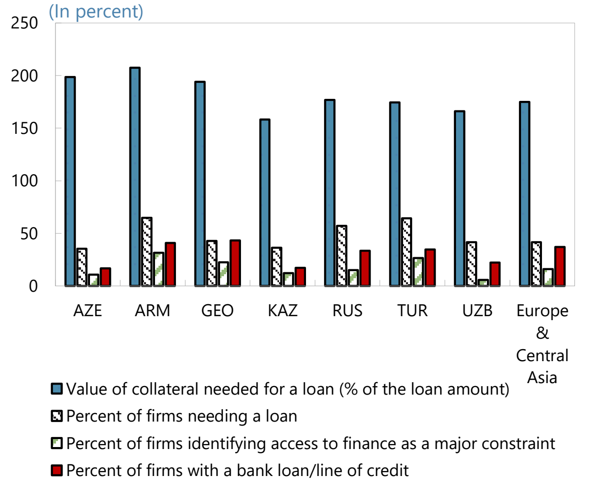
Azerbaijan:Financial Development Index

(AZE, CCA and EMDE Averages, 1980–2018)



Azerbaijan: Firm Credit Access Measures

(In percent)



Sources: World Bank Enterprise Survey, IMF staff calculations.

2. **Past credit expansions were driven by vulnerable banks and accompanied by a weakening of lending standards**. When credit booms are propelled by banks' increased lending capacity, weaker banks tend to take advantage of less binding constraints and expand risky lending aggressively. Without strong prudential oversight, rapid credit expansions tend to be accompanied by excessive risk-taking, exacerbating bank distress in an economic downturn.[1] An analysis using the future loan loss provision ratio to gauge current lending standards[2] shows that the 2013–15 credit boom in Azerbaijan was driven by banks with low capital ratios and weak lending standards.[3]

---

[1] Jiménez, G. and others, 2014. "Hazardous Times for Monetary Policy: What Do Twenty-Three Million Bank Loans Say About the Effects of Monetary Policy on Credit Risk-Taking?" *Econometrica*. 82(2), 463-505. Igan, D., and M. Pinheiro. 2011. "Credit Growth and Bank Soundness: Fast and Furious?" IMF paper. Igan, D., and N. Tamirisa. 2008. "Are Weak Banks Leading Credit Booms? Evidence from Emerging Europe." *Comparative Economic Studies*. 50(4), 599-619.

[2] Fahlenbrach, R., and others, 2017. "Why Does Fast Loan Growth Predict Poor Performance for Banks?" *The Review of Financial Studies*. 31(3), 1014-63.

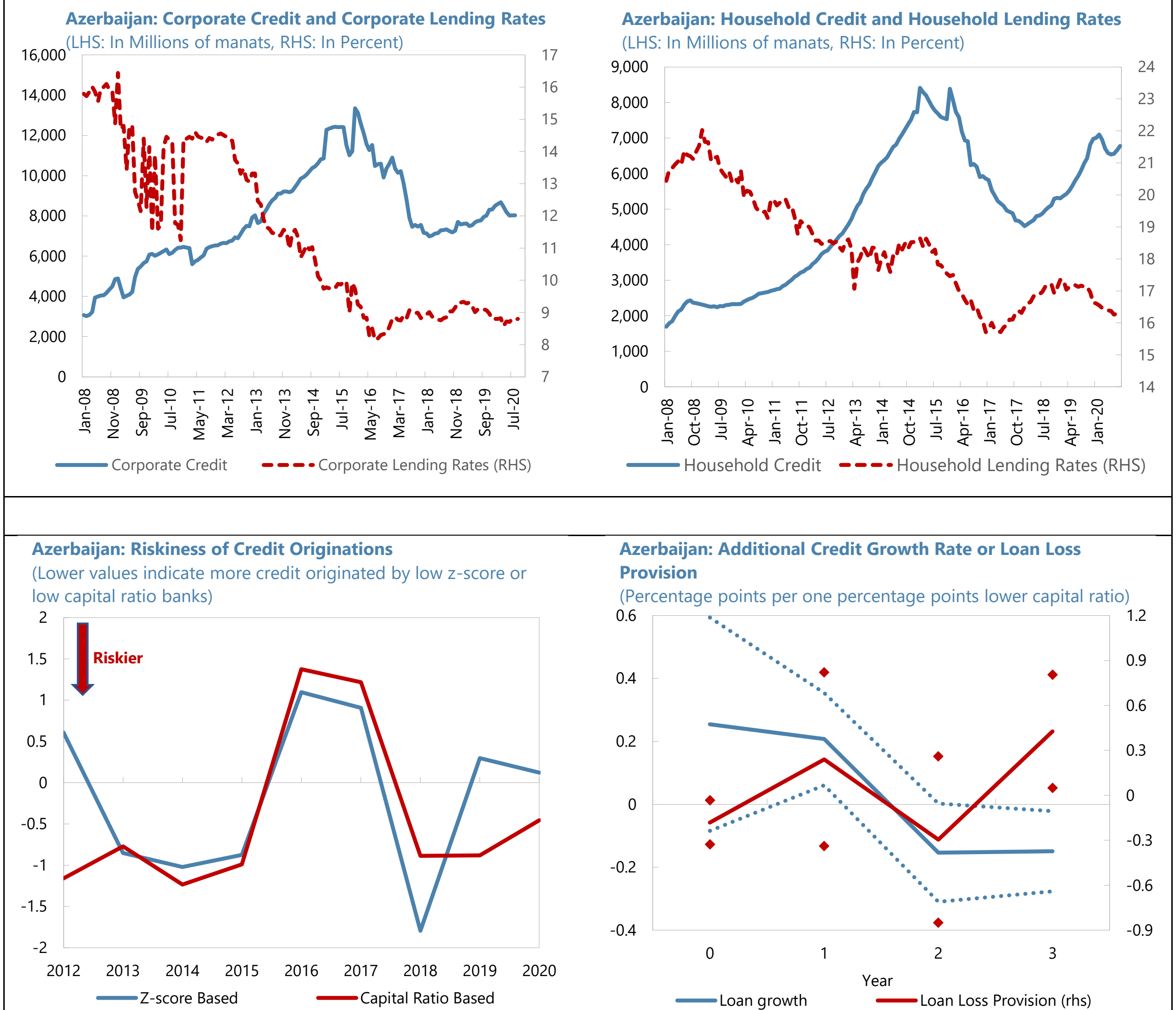
[3] The riskiness of credit originations is measured as:

$$RCO_t^X = \frac{\sum_{i \in High\ Growth} X_{i,t}}{N_{t,High\ Growth}} - \frac{\sum_{i \in Low\ Growth} X_{i,t}}{N_{t,Low\ Growth}}$$

where $High\ Growth$ refers to banks with credit increases in the top quartile, $Low\ Growth$ in the bottom quartile, $X_{i,t}$ is bank riskiness (the capital ratio or z-score), and $(N_{t,High\ Growth}, N_{t,Low\ Growth})$ are the numbers of banks in each group. Lower $X_{i,t}$ means greater risk, and negative RCO_t^X indicates credit expansion driven by weaker banks. Greenwood, R., and S. Hanson. 2013. "Issuer Quality and Corporate Bond Returns." *The Review of Financial Studies*. 26(6), 1483-1525.

©International Monetary Fund. Not for Redistribution

Azerbaijan: Selected Financial Indicators



Sources: National authorities, and IMF staff calculations.

Note: In panel 1, the RCOs are normalized by standard deviations in 2012–20. In panel 2, the estimates are $-\boldsymbol{\beta_2}$ in $\boldsymbol{Y_{i,t+h}} = \boldsymbol{\beta_0} + \boldsymbol{\beta_1 X_{i,t}} + \boldsymbol{\beta_2 X_{i,t}} \times \boldsymbol{S\_Boom_t} + \boldsymbol{\Gamma' Ctrls_{i,t}} + \boldsymbol{\gamma_i} + \boldsymbol{\gamma_t} + \boldsymbol{\varepsilon_{i,t}}$ where $\boldsymbol{Y_{i,t+h}}$ is h-year ahead credit growth or LLP ratio, $\boldsymbol{S\_Boom_t}$ is a time dummy for supply-driven credit booms, $\boldsymbol{X_{i,t}}$ is bank capital ratio. Dashed lines or dots indicate 90 percent confidence intervals.

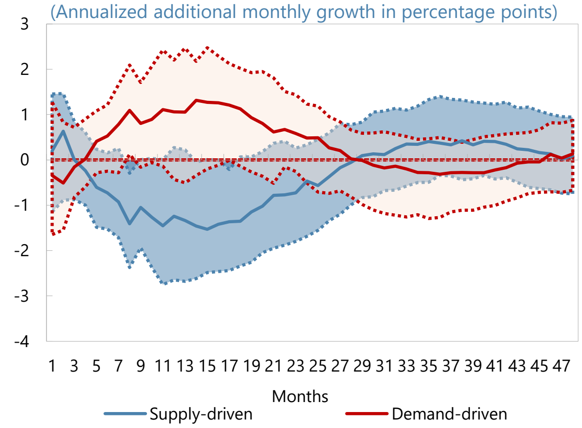
3. **Busts in supply-driven credit booms amplify economic downturns while demand-driven credit booms have lasting economic benefits**. In a vector autocorrelation,[4] increased credit supply boosts GDP in the first 4 months but the impact turns negative after 9 months, lasting for 2.5 years. An increase in credit demand, however, is followed by a 2.5-year boost to GDP.

[4] Uhlig, H., 2005. "What are the effects of monetary policy on output? Results from an agnostic identification procedure." *Journal of Monetary Economics*. 52, 381-419.

©International Monetary Fund. Not for Redistribution

4. To ensure sustainable financial deepening where increases in credit supply and demand go hand in hand, reforms need to include measures to strengthen bank supervision and regulation, promote SME financial literacy and improve financial sector transparency.

Azerbaijan: Impulse Response of Real GDP Growth After Credit Shock
(Annualized additional monthly growth in percentage points)



Source: IMF staff calculations.

©International Monetary Fund. Not for Redistribution

INTERNATIONAL MONETARY FUND

REPUBLIC OF AZERBAIJAN

STAFF REPORT FOR THE 2021 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

July 1, 2021

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

CONTENTS

RELATIONS WITH THE FUND ____ 2

STATISTICAL ISSUES ____ 5

RELATIONS WITH OTHER INTERNATIONAL INSTITUTIONS ____ 8

TECHNICAL ASSISTANCE PROVIDED BY THE FUND ____ 9

©International Monetary Fund. Not for Redistribution

RELATIONS WITH THE FUND

(As of May 31, 2021)

Membership Status

Date of membership: September 18, 1992

General Resources Account

	SDR Million	Percent Quota
Quota	391.70	100.00
Fund Holdings of Currency	333.90	85.24
Reserve position in Fund	57.83	14.76

SDR Department

	SDR Million	Percent Allocation
Net Cumulative Allocation	153.58	100.00
Holdings	95.67	62.29

Outstanding Purchases and Loans

	SDR Million	Percent of Quota
None	0.00	0.00

Latest Financial Arrangements

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

Projected Payments to the Fund

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

	Forthcoming				
	2021	2022	2023	2024	2025
Principal					
Charges/Interest	0.02	0.03	0.03	0.03	0.03
Total	**0.02**	**0.03**	**0.03**	**0.03**	**0.03**

©International Monetary Fund. Not for Redistribution

Safeguards Assessment

Under the Fund's safeguards assessment policy, the Central Bank of Azerbaijan (CBA) was subject to an assessment with respect to the PRGF arrangement that was approved on July 06, 2001 and expired on July 5, 2004. The assessment was completed on March 11, 2002, and it was concluded that the external audit and financial reporting were adequate. The assessment proposed a set of measures to strengthen internal control, data reporting to the Fund, and the legal framework. The majority of the recommendations were implemented, except for the recommendation to establish an Audit Committee. The external audit of 2011 CBA financial statements was completed by April 2012, and the audited financial statements along with the audit opinion has been published on the bank's website as an integral part of 2011 annual report.

Exchange Rate Arrangements

The currency of Azerbaijan is the manat, which became sole legal tender on January 1, 1994. The *de jure* exchange rate arrangement is free-floating, but the *de facto* regime remains a "stabilized arrangement" under the Fund's AREAER methodology.

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

Article IV Consultation

Azerbaijan is on a 12-month Article IV consultation cycle. The 2021 Article IV Board date is set for July 19, 2021 expected on a lapse of time basis. The previous Article IV consultation was finalized on September 6, 2019.

ROSCs

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

Resident Representative

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

©International Monetary Fund. Not for Redistribution

Resident Advisers

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

©International Monetary Fund. Not for Redistribution

STATISTICAL ISSUES

I. Assessment of Data Adequacy for Surveillance

General: Data provision to the Fund has some shortcomings but is broadly adequate for surveillance.

National Accounts: The State Statistical Committee (SSC) currently compiles annual and quarterly GDP by production at current and constant 2005 prices. The 2005 base year is outdated and there is scope to improve the input data and methodology used in producing the GDP estimates (these broadly conform to the System of National Accounts 1993). There is also a need for benchmarking and seasonal adjustment for quarterly GDP and for reexamining the classification of consumption and investment into public and private sectors. The last mission, (September 2018) assisted the SSC's National Accounts and Macroeconomic Statistics Department in enhancing the expenditure-side GDP estimates, consistency between the quarterly and annual GDP estimates, and measurement of taxes and subsidies on products. The authorities requested a CCAMTAC TA mission on national accounts to develop GDP by expenditure components at constant prices. The mission is scheduled for November 2021.

Price Statistics: In 2010, the CPI was revised to update the consumption basket (520 items). Expenditure weights are updated every year to reflect recent consumption patterns. Prices are collected from 58 geographic areas and disseminated at the national and regional level (nine regional indexes). CPI metadata lack sufficient detail and should be augmented. There is need to expand CPI coverage to include owner occupied housing and to develop a residential property price index. Producer price indices (PPI) cover all major sectors. Finally, export and import price indices (XMPI) are also compiled and released, but related metadata lack detail and should be augmented.

Fiscal Sector: The authorities report annual general government data according to the methodology of the Government Finance Statistics Manual 2014 (GFSM 2014) for inclusion in the IMF's annual GFS database. However, the stock positions in assets and liabilities have yet to be reported. The compilation of longer time series, including sub-annual series, to support surveillance and fiscal analysis and policy making, is also needed. While further work is required to improve the source data for the compilation of these statistics, the budgetary accounting and reporting system is adequate for a compilation and dissemination of the GFS on a quarterly basis.

To address the fiscal reporting issues, Azerbaijan participated in a three-year STA regional project to build capacity and improve GFS reporting to be used for fiscal policy making and Fund surveillance. STA assisted the authorities to move to the updated GFSM 2014 methodology, strengthen reporting of financial transactions and begin reporting balance sheet positions in assets and liabilities. Further TA in improving fiscal transparency will be provided in the framework of the new Regional Technical Assistance Centre.

Monetary statistics: Following two technical assistance missions in 2017 and 2018, Azerbaijan's monetary and financial statistics improved substantially and are now in full compliance with the methodology of the *Monetary and Financial Statistics Manual and Compilation Guide* (*MFSMCG*). The Central Bank regularly reports to STA monetary data using the standardized report forms (SRFs), with a monthly frequency for the central bank and other depository corporations (ODCs), and a quarterly frequency for other financial corporations.

©International Monetary Fund. Not for Redistribution

Azerbaijan reports data on some series and indicators of the Financial Access Survey (FAS), including the two indicators (commercial bank branches per 100,000 adults and ATMs per 100,000 adults) adopted by the UN to monitor Target 8.10 of the Sustainable Development Goals (SDGs).
Financial sector surveillance: The Financial Market Supervisory Authority (FIMSA) received in 2018 technical assistance on financial soundness indicators (FSIs). Available source data would allow the compilation and dissemination of monthly core and encouraged FSIs for deposit takers broadly in compliance with the methodology of the *FSI Compilation Guide*. The Central Bank is in contact with STA, aiming to start reporting the set of core and encouraged FSIs for posting on the IMF's website.
External Sector: Azerbaijan's balance of payments (BOP) statistics are compiled and disseminated by the CBA and are broadly in accordance with the sixth edition of the *Balance of Payments Manual (BPM6).* The CBA has also re-initiated compilation of International Investment Position (IIP) statistics in 2015, after a hiatus of 6 years. However, important challenges remain, and require high-level officials' support to be addressed, since the adoption of new data sources and estimation techniques may result in revised external sector statistics indicators that portray trends less favorable than the previous data vintage. This includes also the dissemination of IIP and external debt statistics. Despite the progress achieved with Swiss-funded TA, deficiencies remain in compiling BOP statistics. Significant under-coverage has been identified in balance of payments components such as trade in goods and services, investment income, and some financial account components. A number of methodological inconsistencies have also been identified in estimating assets in investment income (cash vs accrual), trade credit and advances; currency and deposits for other sectors; and reserve assets (net basis vs gross basis). These shortcomings affect a number of indicators used for assessing the country's performance such as debt sustainability and reserve assets adequacy. There is need to take measures for compiling and disseminating the IIP and external debt statistics. Previous TA missions assisted in compiling the draft IIP and external debt statements but the methodological inconsistencies mentioned above in estimating some financial account components led to the accumulation of unrealistic stocks for those components in the IIP. To address the inconsistencies between balance of payments and the IIP, revising the estimation techniques and addressing classification issues is required. Statistics for public and publicly guaranteed external debt are reported quarterly on a due-for-payment basis with a lag of one to two months. A debt service schedule for public and publicly guaranteed external debt, separately identifying the principal and interest components, is also provided with a one quarter lag. However, systematic information on nonguaranteed external debt, including a sectoral breakdown, is lacking. Data on official reserve assets is provided within 15 days of the end of each month. Azerbaijan does not disseminate International Reserves and Foreign Currency Liquidity Template data. TA missions stressed the importance of using the definition of gross official reserve assets that follows the *BPM6.*

II. Data Standards and Quality	
Azerbaijan participates in the Enhanced General Dissemination System and its National Summary Data Page was launched in February 2019.	A data ROSC was published on the IMF's website in March 2003.

©International Monetary Fund. Not for Redistribution

Azerbaijan: Table of Common Indicators Required for Surveillance

(As of June, 2021)

	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	06/2021	06/02/2021	D	D	M		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	04/2021	05/27/2021	M	M	M		
Reserve/Base Money	04/2021	05/27/2021	M	M	M		
Broad Money	04/2021	05/27/2021	M	M	M	O, O, O, O	O, O, O, O, LO
Central Bank Balance Sheet	04/2021	05/27/2021	M	M	M		
Consolidated Balance Sheet of the Banking System	04/2021	05/27/2021	M	M	M		
Interest Rates[2]	04/2021	05/27/2021	M	M	M		
Consumer Price Index	04/2021	05/27/2021	M	M	M	O, O, O, O	O, LO, O, O, O
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	Q1/2021	05/03/2021	Q	Q	Q		
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	04/2021	05/27/2021	M	M	M		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	Q1/2021	05/03/2021	Q	Q	Q		
External Current Account Balance	Q1/2021	06/14/2021	Q	Q	Q		
Exports and Imports of Goods and Services	Q1/2021	06/14/2021	Q	Q	Q		
GDP/GNP	04/2021	05/27/2021	M	M	M	O, LO, O, LO	LO, LNO, O, O, O
Gross External Debt	Q4/2020	05/27/2021	Q	Q	Q		
International Investment Position	N/A	N/A					

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] The general government consists of the central government (budgetary funds, extrabudgetary funds, and social security funds) and state and local governments.
[5] Including currency and maturity composition.
[6] Daily (D); Weekly (W); Monthly (M); Quarterly (Q); Annually (A); Irregular (I); Not Available (NA).
[7] Reflects the assessment provided in the data ROSC published on March 20, 2003 and based on the findings of the mission that took place during April 8–23, 2002 for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning (respectively) concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O), largely observed (LO), largely not observed (LNO), or not observed (NO).
[8] Same as footnote 7, except referring to international standards concerning (respectively) source data, statistical techniques, assessment and validation of source data, assessment and validation of intermediate data and statistical outputs, and revision studies.

©International Monetary Fund. Not for Redistribution

RELATIONS WITH OTHER INTERNATIONAL INSTITUTIONS

(As of May 25, 2021)

Asian Development Bank:

• Country page: https://www.adb.org/countries/azerbaijan/main

• ADB projects and results: https://www.adb.org/countries/azerbaijan/results-adb-supported-operations

European Bank for Reconstruction and Development:

• Country page: https://www.ebrd.com/azerbaijan.html

• EBRD projects: https://www.ebrd.com/work-with-us/project-finance/project-summary-documents.html?1=1&filterCountry=Azerbaijan

World Bank Group:

• Country page: https://www.worldbank.org/en/country/azerbaijan

• Overview of Word Bank Group lending: https://financesapp.worldbank.org/countries/Azerbaijan/

• IBRD-IDA project operations: https://projects.worldbank.org/en/projects-operations/projects-summary?lang=en&countrycode_exact=AZ

©International Monetary Fund. Not for Redistribution

TECHNICAL ASSISTANCE PROVIDED BY THE FUND

Azerbaijan: Technical Assistance, 2011–21

Fund Dept.	Delivered Assistance	Mission Dates
LEG	AML/CFT Diagnostic	Feb/Mar 2011
LEG	AML/CFT Structures and tools	Feb/Mar/Oct/Dec 2011
LEG	AML/CFT Legislation	Jul/Dec 2011
STA	Government Finance Statistics	Sep 2011
STA	Balance of Payments Statistics	Mar 2012
MCM	Moving Towards Exchange Rate Flexibility	Mar 2012
LEG	AML/CFT Structures and tools	Jun/May/Sep/Dec 2012
FAD	Pension Reform	Jul 2012
STA	National Accounts	Feb 2013
LEG	AML/CFT Structures and tools	Mar 2013
FAD	Debt and Cash Management and Budget Classification	Jun 2013
FAD	Pension Reform Follow Up	Jul/Nov 2013
STA	Quarterly National Accounts Statistics	Sep 2013
MCM	Follow-up Mission-Bank Restructuring (with MCD staff visit)	Mar 2014
STA	Quarterly National Accounts Statistics	May 2014
STA	External Sector Statistics	May 2015
MCM	Bank Restructuring (with MCD staff visit)	Sep 2015
STA	External Sector Statistics	Nov 2015
STA	External Sector Statistics	Apr 2016
MCM	Multi-Topic: Monetary, FX Operations and Bank Supervision	Apr 2016
FAD	TADAT Workshops, Research and Training Consultations	Apr 2016
LEG	Review of the Draft Law on Supervision of Financial Markets	May 2016
LEG	Ongoing review of the Draft Law on Deposit Insurance	Jun 2016
MCM	Bank Supervision	June 2016
MCM	Liquidity Forecasting	Sep 2016
STA	National Accounts	Oct 2016
MCM	Bank Restructuring and Bank Supervision	Oct 2016
MCM	Monetary Policy and Central Bank Operations	Mar 2017
FAD	PFM-Fiscal Rules	Apr 2017
STA	Government Finance Statistics	May 2017
STA	Financial Soundness Indicators	Q1 2018
MCM	Monetary Policy and Central Bank Operations (follow-up)	Q1 2018
MCM	Regulatory and Prudential Framework	Q1 2018
STA	Monetary and Financial Statistics	Q1 2018
STA	Government Finance Statistics (follow-up)	Q1 2018
STA	Balance of Payments Statistics	Q1 2018

©International Monetary Fund. Not for Redistribution

Azerbaijan: Technical Assistance, 2011–21 (concluded)		
STA	Government Finance Statistics (follow-up)	Q2 2018
STA	National Accounts	Q3 2018
MCM	Transition to Inflation Targeting, Monetary and Foreign Exchange Operations	Q3 2018
STA	Government Finance Statistics (follow-up)	Q4 2018
STA	National Accounts	Q4 2019
MCM	Banking Sector	Q1 2020
MCM	Financial Sector Supervision	Q2 2020
MCM	Risk-Based Supervision	Q4 2020
FAD	Fiscal Rules and PFM	Q4 2020
ICD	Macroeconomic Forecasting	Q1 2021
FAD	Nonoil Tax Policy	Q2 2021
STA	Consumer Price Index	Q2 2021
FAD	Macro-Fiscal Framework	Q2 2021
STA	Government Financial Statistics	Q2 2021

©International Monetary Fund. Not for Redistribution