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July 6, 2022

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From: The Secretary

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REPUBLIC OF AZERBAIJAN

STAFF REPORT FOR THE 2022 ARTICLE IV CONSULTATION

July 5, 2022

KEY ISSUES

Context. The economy has recovered rapidly from the pandemic, supported by progress with vaccinations and the easing of social restrictions. However, high inflation and the war in Ukraine present new challenges. While Azerbaijan has benefitted from higher oil and gas prices, the war and sanctions could have an adverse impact on the economy, introducing significant uncertainty to the outlook. For the medium-term, the main challenge remains to manage the expected decline in oil production and oil revenues and to support diversification.

Policy Recommendations

- In the near term, there is room to use the existing fiscal space to mitigate the impact of the high food prices on the most vulnerable. The large revenue windfall from high oil prices and prudent fiscal stance provide room for temporary and targeted income support and food subsidies.
- In the medium- and long-term, sustained fiscal consolidation is required to prepare for the decline in oil production and oil revenues, with the goal of sharing exhaustible oil wealth with future generations. Staff recommends an annual reduction of the non-oil primary deficit by at least 1½ percent of non-oil GDP. The reformed fiscal rule launched in 2022 should help support this adjustment.
- Following several rounds of monetary tightening, the CBA policy rate is now close to its pre-pandemic level, but the policy rate continues to be negative in real terms and lower than regional peers. With robust economic activity, global tightening on the horizon, and inflation becoming more broad-based, further monetary tightening will be needed.
- Financial soundness indicators point to a strong banking sector, but there are risks that need to be monitored. The CBA should move to risk-based supervision and supervise banks on a consolidated basis. The impact of the war in Ukraine and related sanctions need to be monitored closely.
- The projected decline in oil production necessitates the diversification of the economy away from oil dependence. The private sector will need to play a key role in this transition, supported by reforms to state-owned enterprises and efforts to strengthen governance and combat corruption.

Approved By
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and Maria Gonzalez
(SPR)

Discussions with the authorities were held in Baku during May 25–June 7, 2022. The staff team comprised of Chad Steinberg (head), Jiri Jonas, and Gustavo Ramirez (all MCD), with support from Tina Burjalani (LEG), Aghgun Gadirli (IMF's local office), Amine Yaaqoubi (MCD), and Yizhi Xu (APD). Piotr Trabinski and Amin Muradov (OED) participated in the discussions. Branden Laumann provided excellent production assistance. The mission met with Finance Minister Sharifov, Central Bank of Azerbaijan Chairman Kazimov, Minister of Labor and Social Protection Babayev, Deputy Minister of Economy Hasanova, other senior officials, and representatives of the private sector, civil society, academia, and the diplomatic community.

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CONTEXT: NEW CHALLENGES

1. The economy has recovered rapidly from the pandemic, but high inflation is a present concern. Growth accelerated briskly in 2021 and early 2022 on the back of high oil prices and progress with vaccinations that allowed for an easing of social restrictions. At the same time, though, global inflation has fed into a broad-based increase in the CPI basket.

2. The war in Ukraine and related sanctions increase uncertainty and generate new policy challenges. While Azerbaijan benefits from high oil and gas prices, the war poses new risks from rising food prices, food security, and spillovers from sanctions. In the long-term, the main challenges remain fiscal consolidation and the diversification of the economy.

3. Policy implementation was in line with past Fund advice. The authorities have saved the large oil revenue windfall, launched a revised fiscal rule, and have phased out the exceptional support to the financial sector. There was no need to consider further monetary easing (as advised), as the downside risks to growth did not materialize and inflation increased.

Azerbaijan: Implementation of IMF Recommendations	
2021 Article IV Recommendations	Policy Actions Taken
Fiscal Policy	
In 2021, automatic stabilizers should be allowed to operate in case of adverse shock and windfall revenues from higher-than-budgeted oil prices should be saved.	Oil price turned out to be significantly higher than budgeted but the spending was somewhat less than budgeted, with the windfall from higher oil price saved.
Fiscal consolidation should start in 2022 and be sustained over the medium-term.	While the 2022 budget projects a moderate fiscal easing, it is based on a very conservative oil price assumption of \$50 per barrel.
Medium-term fiscal adjustment should be supported by the revised fiscal rule.	In 2022, the authorities launched a revised fiscal rule, targeting non-oil primary balance and government debt/GDP.
Monetary and Exchange Rate Policy	
Further monetary easing could be considered, especially if downside risks materialize.	Downside risks did not materialize but inflation turned out to be higher than projected, prompting the central bank to increase interest rates.
A gradual move to a more flexible exchange rate should be considered in the medium-term.	The authorities continue to plan for a move to a more flexible exchange rate in the medium-term.
Financial Sector Policy	
Phase out exceptional prudential easing introduced in response to the pandemic.	All prudential and regulatory easing introduced during the pandemic has been phased out.
Strengthen financial oversight of lenders and borrowers in the medium-term.	MCM TA mission on risk-based supervision has concluded.
Enhance the effectiveness of the AML/CFT framework.	Coordinating Council was established in October 2020 to organize, coordinate, and formulate the methodology of national risk assessment of the AML/CFT system, prepare for the MONEWAL assessment. The Council prepared the draft of AML/CFT law.
Structural Policy	
Address impediments to private sector growth and job creation.	Azerbaijan 2030: National Priorities for Socio-Economic Development approved in February 2021 identified development on non-oil sector and favorable business environment as one of the priorities.
Strengthen the governance and anticorruption frameworks.	The authorities launched in 2022 the National Anticorruption Plan.

RECENT DEVELOPMENTS: FROM A ROBUST PANDEMIC RECOVERY TO THE WAR IN UKRAINE

4. Growth rebounded strongly from the pandemic. Real GDP increased by 5.6 percent in 2021. Oil GDP¹ increased by 1.8 percent owing to the relaxation of the OPEC+ restrictions and a boost in gas exports. Non-oil GDP rose by 7.2 percent, with activity accelerating in contact-intensive and transportation sectors. The war in Ukraine has so far had a limited impact on the real economy and growth continued to be strong in the first five months of 2022, driven by the non-oil sector and strong consumer demand.

5. But inflation also increased rapidly. Inflation increased sharply from 2.7 percent (yoy) in December 2020 to 12.0 percent in December 2021, and further to over 13 percent in May 2022. This primarily reflects external factors but also reflects an adjustment in regulated prices and strong domestic demand, as suggested by the strong rebound in the non-oil economy. The initially narrow increase in prices has had important second round effects, with prices rising across the CPI basket. This is having a disproportionate effect on the purchasing power of the most vulnerable.

6. High oil and gas prices resulted in a sizable improvement in the balance of payments. The current account balance improved to a surplus of 15.2 percent of GDP in 2021 (from a small deficit in 2020) and remained elevated in the first quarter of 2022. Strong FX earnings continue to support the de facto peg, with limited demand for FX in official auctions since April 2020. The improvement in the current account has also supported a change in our assessment of the external position to stronger than (from substantially weaker than) the level consistent with medium-term fundamentals and desirable policies (Annex I).

7. Oil revenue windfalls have thus far been saved. In 2021, SOFAZ oil revenues jumped by over 60 percent and non-oil revenues increased with stronger economic activity. Total budgetary expenditures increased only moderately even with higher-than-budgeted pandemic-related spending, as the authorities reallocated spending. As a result, the overall fiscal balance improved by 11 percent of GDP, reaching a surplus of 4 percent in 2021. The non-oil primary deficit also improved significantly (by 7 percent of non-oil GDP). Public and publicly guaranteed debt declined to 42 percent of GDP in 2021.

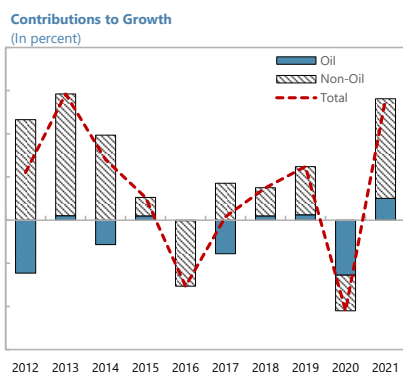
8. The CBA started to reverse its monetary easing stance. By end-March 2022, the CBA raised the interest rate by 150 basis points, in 5 consecutive meetings, to 7.75 percent, 25 basis points above the end-2019 level. The CBA then paused at both its April and June meetings citing a moderation in inflation expectations and an appreciation in the nominal effective exchange rate. The policy rate remains negative in real terms with inflation in double digits. Average lending rates on new loans in manat gradually increased in 2021, while average manat deposit rates remained broadly unchanged.

¹ Oil GDP includes the production and processing of oil and gas.

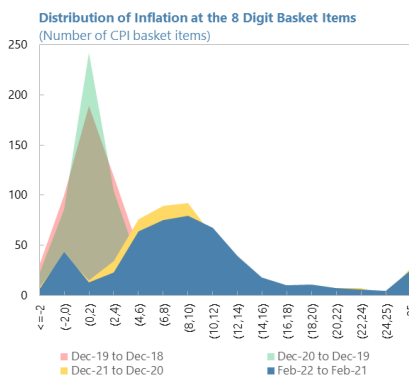
9. The banking sector is resilient, but there are pockets of vulnerability. According to the financial soundness indicators (FSIs), the banking sector appears to have adequate capital buffers, ample liquidity, and nonperforming loans continue to decline. However, the large number of restructured loans may mask a sizable amount of impaired business loans. Consumer lending is picking up rapidly in some banks, boosting profitability in the short term but potentially weighing down on credit quality in the medium term. The CBA has phased out all pandemic-related banking sector support measures. The only Russian bank subsidiary, Bank VTB (Azerbaijan), represents 0.5 percent of total banking assets.

Figure 1. Azerbaijan: Recent Developments

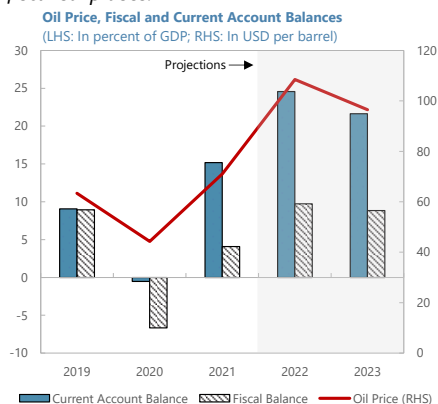
Growth rebounded sharply, led by the non-oil sector,...



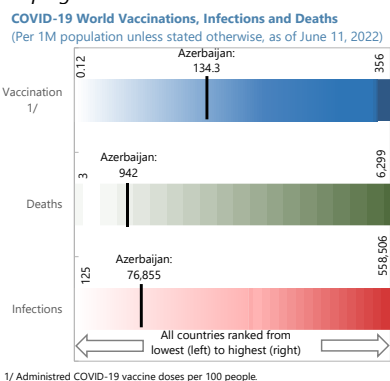
Inflation is broad based...



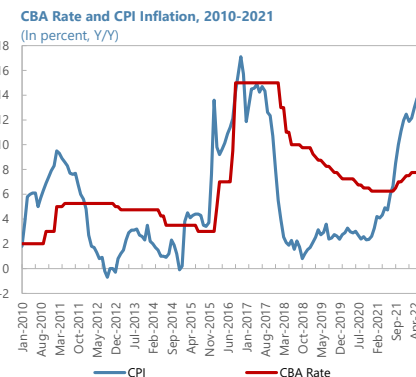
The high oil price is resulting in large current account and fiscal surpluses.



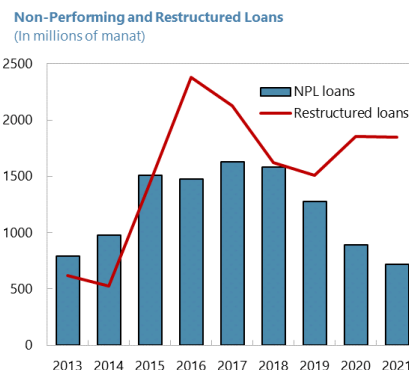
...as the authorities implemented a successful vaccination campaign.



...prompting the CBA to begin its tightening cycle.



NPLs have declined but restructured loans remain high.

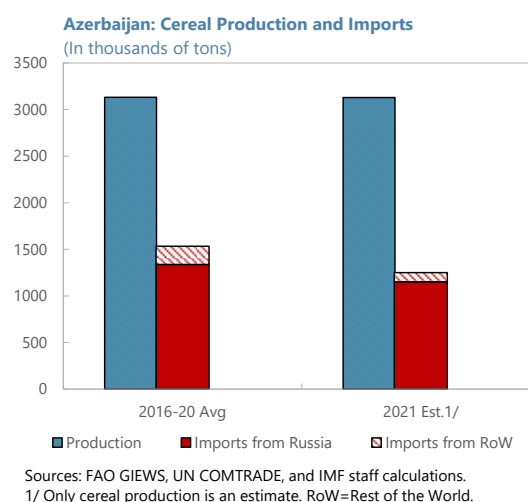


Sources: National authorities, Haver Analytics, and IMF staff calculations and estimates.

OUTLOOK AND RISKS: A POSITIVE OUTLOOK WITH LARGE RISKS ON THE HORIZON

10. Growth and inflation are projected to moderate in 2022 and further decline in the medium term. Staff projects a deceleration of growth to 3.8 percent in 2022 (with non-oil GDP growing at 5.5 percent based on strong growth through May), and further to around 2½ percent in the medium term, as the output gap closes in 2023 and oil and gas production gradually declines. Inflation is projected to remain elevated in 2022 reflecting adverse external factors, including high food and commodity prices and supply chain rigidities, and decline gradually thereafter. Additional monetary tightening would be needed to support inflation returning to the upper bound of the CBA target band (4 ± 2 percent) by end-2024 and remain around the mid-point thereafter.

11. The economic spillovers from the war in Ukraine create new challenges and inject new uncertainty to the outlook. The increase in energy prices and the potential increase in gas sales to Europe boost exports and fiscal revenues over the medium term, with SOFAZ assets approaching 100 percent of GDP in 2025. Still, food price inflation and food security are an immediate concern, as a significant share (17 percent) of Azerbaijan's imports come from Russia, most of it food. Trade spillovers are mainly related to agricultural products and the impact on the financial sector has been limited to date but needs to be monitored (Annex II).



12. Risks to the outlook have increased but remain broadly balanced. The negative impact of sanctions on Russia or a worsening of the situation in Turkey could weigh on the outlook. The war in Ukraine poses a risk for food security. A prolonged conflict would impede Azerbaijan's access to its main markets for wheat and other food staples; while limited access to fertilizers and other inputs could hinder agricultural production. There also remains uncertainty about the path of the virus post-Omicron. Domestic risks include fiscal risks from SOEs and a deterioration of banks assets' quality. There could also be pressure to increase government expenditure due to higher oil revenues. Higher oil and gas prices resulting from ongoing geopolitical tensions would benefit Azerbaijan; and while prospects for expanding gas exports to Europe in the short-term appear limited, this represents an upside risk (Annex III).

13. The authorities shared staff's view that the war in Ukraine has significantly increased uncertainty to the outlook. Even though the impact of the war has thus far been limited, the authorities noted that Russia and Ukraine are important trading partners to Azerbaijan and that the continuation of the conflict is bound to have an adverse impact. The authorities consider food security as the highest risk, particularly in the case of a prolonged war, but also pointed to the prospects of a good harvest in Russia and Kazakhstan this year as a mitigating factor. The authorities also stated that because of Azerbaijan's geographic location they could potentially benefit from alternative trade routes to the European market

POLICY DISCUSSIONS

Policy discussions focused on: (i) the near-term fiscal policy response to the food price shock and medium-term fiscal adjustment plans; (ii) the monetary policy response to higher inflation and continued efforts to modernize the monetary policy framework; (iii) the health of the banking sector following the phasing out of pandemic-related measures, and the possible risks from the war in Ukraine and the acceleration of consumer lending; and (iv) steps to promote growth diversification, improve the performance of state-owned enterprises, and strengthen governance.

A. Fiscal Policy: Protecting the Poor and Saving the Windfall

14. Sharply higher oil revenues are projected to result in a significant budget surplus in 2022. This is based on the WEO oil price of \$108.5 per barrel, which contrasts with the authorities' more conservative assumption of \$50 per barrel (see table), and stronger projected non-oil revenue growth (15.7 percent).² Staff's total spending projection—an increase by about 14 percent—is slightly higher than the authorities' approved budget, reflecting some provision for the planned supplementary budget. Staff considers the increase in the 2022 budget spending appropriate.

2022 Budget and Staff Projections (In millions of manat)			
	2021	2022	
	Actual	Budget	Staff
Revenues	33,895	27,685	47,542
Non-oil	15,725	12,955	17,638
Oil	18,172	14,690	29,904
Expenditures	30,102	32,914	35,588
Current	21,467	24,878	26,554
Capital	8,635	8,036	9,034
Balance	3,793	-5,229	11,953
Oil price (\$ per barrel)	71.1	50	108.5

Sources: National authorities, and IMF staff estimates.

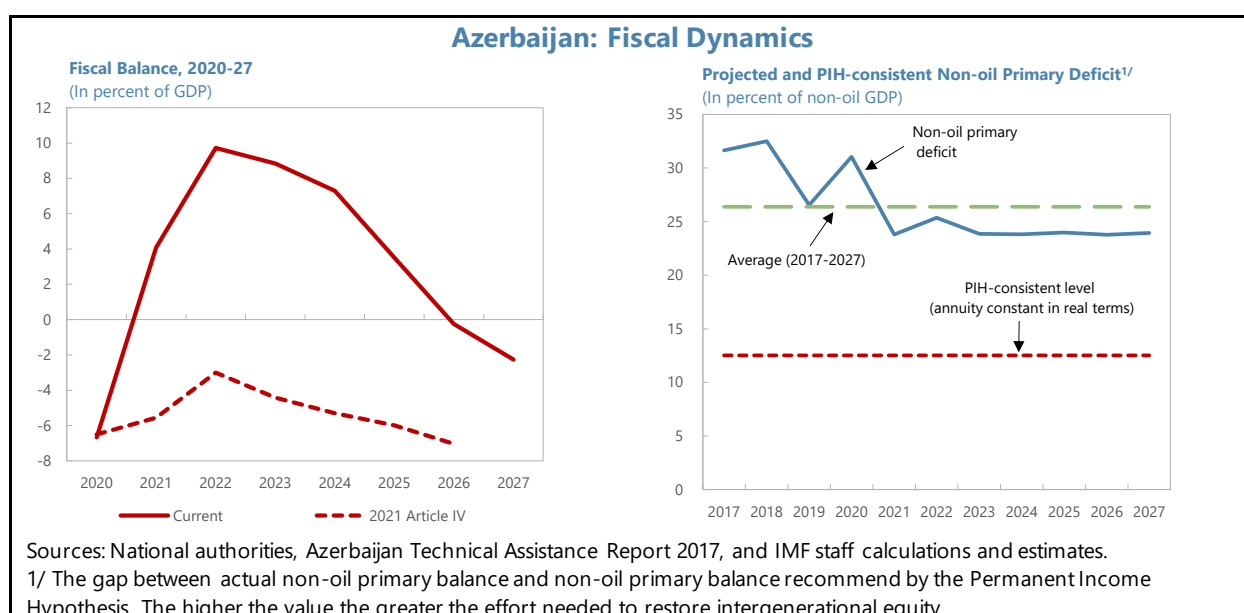
15. Staff considers it appropriate to use some of the existing fiscal space to mitigate the impact of higher food prices and welcomes plans to improve the targeting of social assistance. Given the robust performance of non-oil revenues and spending discipline, the authorities have fiscal space to mitigate the impact of the war in Ukraine and higher food prices on the population. The authorities implemented a package of budgetary measures to protect the vulnerable from high food prices, including an adjustment to pensions and measures to ensure food security.³ Staff understands that wheat imports and sales are already exempted from both VAT and custom tariffs. These exemptions are temporary and are set to expire by January 1, 2024. The increased social spending is supported by projected strong non-oil revenue growth and does not pose a risk to fiscal sustainability. Staff also welcomes the steps to clamp down on ghost pension and disability beneficiaries. Looking ahead, staff notes the authorities' plans to

² During January–April 2022, state budget revenues rose by 30 percent.

³ The measures, originally introduced in late 2021 as food prices started to increase, include a 20 percent increase in the minimum wage and the minimum pension, and a 35 percent increase in social allowances. Also, subsidies to flour producers were extended and will remain in place until further notice, and VAT exemptions for wheat, wheat flour, and bread were extended until January 1, 2024. The total social package approved in late 2021 amounts to AzN 2.1 bn (1.6 percent of GDP) for the remainder of 2021 and 2022 and covers 3.5 million people. The package is mostly included in the 2022 Budget, but some additional support would be included in the supplementary budget.

further improve the targeting of social assistance, by improving the digitalization of the information of socially vulnerable families.⁴

16. Given the high dependence on oil revenues and the projected decline in oil production, a credible long-term fiscal consolidation plan remains a necessity. With the oil price projected to remain high, the medium-term fiscal outlook has improved but remains highly dependent on the oil price. In the baseline scenario with no policy adjustment, large—though declining—fiscal surpluses are projected in the medium term, with the non-oil primary deficit remaining broadly constant, at around 24 percent of non-oil GDP. Compared to the long-term Permanent Income Hypothesis (PIH)-consistent NOPB benchmark of 12.5 percent of non-oil GDP, this implies a policy gap of about 11.5 percent of non-oil GDP,⁵ underscoring the need for fiscal adjustment as the oil production and oil-related revenues gradually decline. General government debt is projected to drop to 20 percent of GDP in 2022 and then to increase gradually to 30 percent of GDP by 2027. It remains sustainable under the alternative DSA scenarios (Annex IV).



17. Staff continues to view as appropriate a reduction in the non-oil primary deficit on average by at least 1.5 percent on non-oil GDP annually in the medium term. This would reduce the gap with the indicative PIH benchmark and create cushions in case of adverse shocks. Achieving this objective would require the implementation of measures not currently included in the baseline, which could include both revenue and spending measures:

⁴ Currently, there is insufficient information in the household registry. It allows assessment of the financial situation of individual members but not of the whole household. A pilot project is planned to start in several regions this year to close this gap.

⁵ This is significantly less than the gap of 21.5 percent of non-oil GDP estimated in the 2021 Article IV Report. The reduction reflects mainly the sharp increase in medium-term oil price and oil revenues.

- **Revenue measures.** To prepare for the decline in oil output in the medium term, the authorities will need to boost non-oil revenues. The 2021 FAD technical assistance report identified a number of options to boost revenues. Possible measures include steps to broaden the tax base by reducing numerous tax holidays, tax exemptions and reduced tax rates for selected sectors and activities, reform of the personal income tax system, and modernization of the property tax system.⁶

Potentail Yield on Fiscal Measures, 2027 (Difference from baseline, in percent of non-oil GDP)	
Total Revenue	3.5
Personal Income Tax	1.1
Corporate Tax	0.3
Value Added Tax - Domestic	0.6
Property Tax	0.2
Total Expenditure	-4.5
Wages and Salaries	-2
Purchases of Goods and Services	-2.5

Sources: IMF staff calculations and estimates.

- **Expenditure measures.** Currently, the baseline scenario assumes growth of the wage bill and spending on goods and services broadly in line with nominal non-oil GDP growth. However, following a large increase in public sector wages in 2019 and 2021, a more moderate increase in the wage bill, in line with inflation or less, is recommended. A similar recommendation applies to spending on goods and services. Also, as recommended previously, further rationalization of generalized subsidies should be implemented, by gradually raising domestic energy prices while at the same time protecting the poor.⁷ This would improve efficiency, encourage investment, help reduce the use of fossil fuels, and encourage the use of renewable energy.

18. Staff welcomes the re-introduction of a revised fiscal rule in 2022 and supports the announced targets. The design of the revised fiscal rule, targeting the non-oil primary balance (NOPB) and general government debt, represents an improvement over the previous rule suspended during the pandemic, and is broadly in line with FAD TA recommendations. The medium-term target of reducing the non-oil primary deficit to 20 percent of non-oil GDP by 2025, while keeping the public debt-to-GDP ratio below 20 percent of GDP, is appropriately ambitious. To serve as a credible fiscal anchor, the fiscal rule needs to be a transparent and binding tool guiding the formulation of government budgets. This requires clear accountability for the observation of the fiscal targets and correction of eventual slippages. Moreover, the executive authority appears to have significant discretion in determining the annual and medium-term deficits and debt limits in the current framework. The authorities should clearly formulate the supporting provisions and safeguards to ensure the observance of the fiscal rule over time, including correction mechanisms, escape clauses, and strong fiscal oversight. Finally, staff welcomes the development of a rolling expenditure framework for the pilot sectors—education, agriculture, and environmental protection—for 2022–25 and calls for a continuation of the work to strengthen the medium-term budget framework.

19. The authorities emphasized the need for fiscal adjustment to prepare for the decline in oil production and oil revenues. The authorities shared staff's view that in the near term, there is fiscal space to provide help to the most vulnerable to mitigate the impact of the increased food prices. However, given the projected decline in oil revenues, they underscored the need to save a large part of oil revenue windfall, while reducing the non-oil primary deficit fast, bringing it to 20 percent of non-oil GDP by 2025. The authorities also agreed with staff that both revenue and spending measures will have

⁶ Experience suggests that a significant effort would be required to realize revenue yields from property tax.

⁷ The adjustment and liberalization of some regulated fuel prices and water tariffs in January 2021 is a step in the right direction.

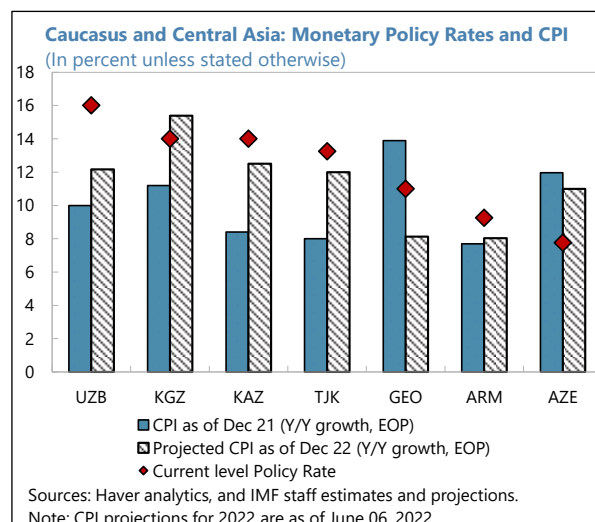
to contribute to the adjustment, and they considered staff's suggested measures and estimated yields as feasible. The authorities view the revised fiscal rule as an important step to ensure responsible fiscal policy and sustained fiscal consolidation.

B. Monetary Policy: Tackling Inflation and Strengthening Interbank Markets

20. In response to increasing inflation, the CBA has appropriately reversed monetary easing and increased interest rates in the second half of 2021 and in early 2022.

The increase in inflation reflects mainly external and non-monetary domestic factors, including the increase in imported food prices and the adjustment and liberalization of some regulated fuel and water tariffs in early 2021. Staff agrees with the CBA's assessment that imported inflation has been an important driver. However, inflation has now become more broad-based, and the risk exists that it will remain elevated in the future.⁸ Thus, further monetary tightening would be needed to reduce the risk that inflation and inflation expectations become more

entrenched and difficult to reverse. The increase in the CBA's discount rate has so far been relatively limited compared to the previous episode of higher inflation and also compared to regional peers (see chart). The CBA must also be ready to keep pace with expected increases in global interest rates. At this unique moment, where tradeoffs are particularly difficult, clear CBA communication becomes even more important.



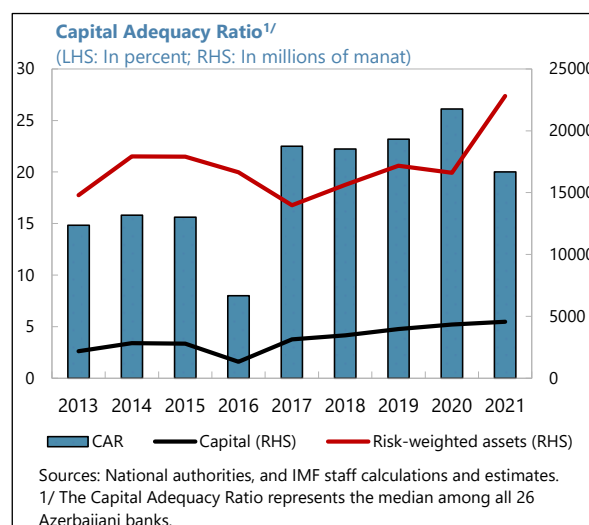
21. Because of the pandemic-related disruptions, modernization of the monetary policy framework has been delayed. The authorities continue to *de facto* peg the currency to the US dollar. The *de facto* peg has been effective in keeping inflation under control in Azerbaijan's undiversified economic setting where the ER is the main channel for the transmission of inflationary shocks. With Fund technical assistance, the authorities have been considering a strategy that puts more emphasis on interest rates rather than monetary aggregates as the intermediate target, and increased exchange rate flexibility in the long-run. While the pandemic has delayed implementation, work should continue to develop domestic markets to improve the transmission channels of monetary policy, including the expansion of the government securities market and developing active money markets, continued efforts to de-dollarize the economy, strengthening the CBA's analytical and forecasting capacity, and improving the effectiveness of communication. The Fund stands ready to continue providing technical assistance to the authorities in this effort. Staff also understands that the CBA is working on developing a new CBDC strategy and stands ready to support the CBA in this effort.

⁸ A period of high inflation could result in a wage-inflation spiral. Relying on targeted support, in case of a protracted food price shock, would help mitigate such risk.

22. The authorities shared staff's concern about the acceleration of inflation, but also pointed to the limited ability of monetary policy to counter supply shocks. The authorities argued that the main source of the pickup in inflation was an external supply shock, mainly the increase in commodity prices, as well as imported inflation from other countries. Thus far, they see the role of wage pressures and strong domestic demand as limited. Given the mainly external and supply-side sources of inflation thus far, weak monetary transmission, and limited financial integration mitigating the concern that the widening of the interest rate spread with advanced economies would trigger capital outflows, the CBA officials were more concerned than staff about the balance of costs and benefits of further monetary tightening. As for the modernization of the monetary policy framework, the authorities see the move to an interest rate targeting and a more flexible exchange rate as happening in the medium- to long-term. In the meantime, preparatory work will continue, and the authorities emphasized that the main priority is to develop an active interbank money market as a first step in strengthening monetary transmission.

C. Financial Sector Policy: Monitoring Risks

23. Financial soundness indicators are strong. The banking sector's capital adequacy ratio fell to 19.1 percent at end-2021, as risk-weights were reset to their pre-pandemic levels and risk-weighted assets expanded rapidly.⁹ The NPL ratio declined further, reflecting both improved credit quality and effective financial support measures. Credit flows have picked up, particularly in the consumer loans segment, as banks search for higher yields and seek to meet the demand deferred during the pandemic. De-dollarization trends have continued, with loan dollarization falling to 25.4 percent by March 2022, the lowest level in seven years. Net open FX positions have been generally declining, though there was some increase in Q1 2022 as banks' FX liabilities increased while FX loans continued to decline.



24. The official FSIs, however, could overstate the health of the banking system, as there are pockets of vulnerability. Uncollateralized business loans and restructured loans remain major credit risks. Restructured loans—mainly in the corporate sector—have increased and may not be adequately provisioned, as current regulations are not based on expected credit loss. Consumer lending is also increasing rapidly in a few banks (Annex VI). Recent stress tests indicate that the NPL ratio would increase by the same magnitude as during the 2015–16 crisis in an adverse scenario. The CBA is mindful of these risks and is closely monitoring risky exposures, in particular consumer loans with high DTI ratios.

25. Efforts to strengthen financial supervision and provisioning should continue.

Notwithstanding recent improvements in supervision, the CBA should renew the pandemic-delayed effort to move to a risk-based framework and supervise larger banks on a consolidated basis. The CBA should

⁹ The minimum CAR requirement is 12 percent for systemically important banks and 10 percent for other banks.

also continue to conduct stress tests and thematic inspections to assess banks' asset quality. In the medium term, provisioning rules could be modernized and aligned to the IFRS 9 framework to account for expected credit loss rather than actual incurred loan loss.¹⁰

26. The banking sector's exposure to Russia is limited but needs to be monitored. The sanctions on Russia have thus far had a limited impact on Azerbaijan's banking sector. However, as Azerbaijan's exposure to Russia is non-negligible given Russia's role as an important trading partner, Azerbaijani banks may turn to alternative payment systems; the authorities should closely monitor these developments. There also appear to be some challenges with correspondent banking. The authorities do not currently see any serious problems with correspondent banks in Russia and they are monitoring the situation closely. However, there appear to be some challenges with the correspondent banks in the United States and Europe, including delays in processing payments. While two thirds of Azerbaijan's banks have correspondent account in the U.S. and European banks, some banks continue to have problems with accessing correspondent banking services.

27. The authorities consider the banking sector as fundamentally healthy and not posing any risks to financial stability. They noted the high capitalization, solid profitability, strong liquidity, and declining NPLs. The authorities also do not view the restructured loans or increasing consumer lending as sources of vulnerabilities that would require an immediate regulatory response. In the same vein, the authorities also do not consider regulatory forbearance during the pandemic as a source of future asset impairment, as only loans of good quality qualified for forbearance, and only a small portion of the loan portfolio has been restructured because of the pandemic. Regarding the war in Ukraine and the sanctions on Russian banks, the CBA noted that the impact on Azerbaijan's banks has thus far been limited. Finally, the authorities agreed that further steps to strengthen banking supervision are needed, but before they move to IFRS9 reporting, they want to first address banks' limited modelling capacity and data constraints.

D. Structural Reforms: Diversify and De-Carbonize

28. Azerbaijan's long-term challenge is to diversify and de-carbonize the economy. The long-term development plan, Azerbaijan 2030, establishes a roadmap for the country to reduce dependency on oil exports and to promote a more sustainable and diversified economy. The ongoing decline in crude oil production has been offset by gas and there are significant ongoing investments in alternative sources of energy. Part of the additional windfall from oil revenues could be invested in productive investment, including green infrastructure that could also support intraregional trade.

29. An important impediment is the large footprint of SOEs in the economy. The number of SOEs is large, and there has been limited progress in implementing the government's strategy to reduce state participation. However, the recent establishment of Azerbaijan Investment Holding (AIH) provides an opportunity to reinvigorate reforms (Annex VII). The following steps could be considered: (i)

¹⁰ In addition to days past due (DPD) criteria, CBA's current provisioning regulation also includes qualitative criterion (unlikely to pay - UTP), which is a forward-looking method for banks to create provisions before credit loss occurs.

separate commercial from noncommercial activities, with the latter to be financed from the budget; (ii) increase SOE transparency and performance monitoring through AIH; (iii) facilitate privatization and financial restructuring where needed; and (iv) introduce measures to mitigate the social impact of SOE reforms. A successful SOE reform would support a transition to a private-sector led growth model and help reduce fiscal risks.

30. Moreover, efforts to strengthen governance and

combat corruption should continue.

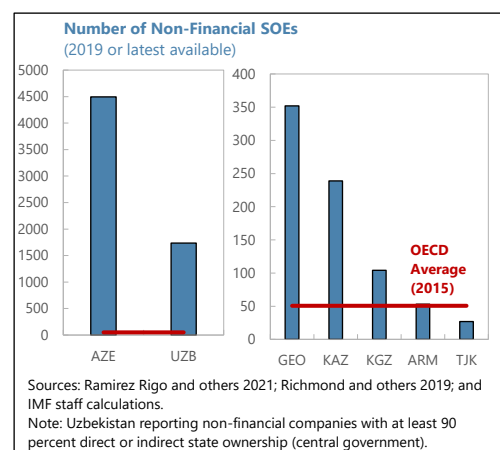
Governance weaknesses and corruption vulnerabilities are present in several state functions and economic areas, including in the judiciary, AML/CFT, public procurement, and transparency in the extractive industries (Annex VIII).¹¹ Some progress has been achieved in fiscal transparency, as evidenced by Azerbaijan's improved Open Budget Project score from 39 in 2019 to 57 in 2021.^{12, 13} Otherwise, progress has been limited and the National Anti-Corruption Action Plan (NACAP) falls short of addressing weaknesses in critical areas. To be more effective, the authorities should integrate critical policy measures into an updated anti-corruption strategy, address the remaining gaps in the AML/CFT legal framework, and focus on its effective implementation (also in view of the ongoing assessment by MONEYVAL), including with a view to avoid adding stresses to existing aforementioned correspondent banking pressures, continue to upgrade their anti-corruption framework in line with the international standards, and strengthen its implementation.

31. The authorities concurred with staff on the need to implement structural reforms with a view to raising non-oil growth and diversify the economy.

They understand that oil production and revenues will decline and that the development of a private sector-led dynamic non-oil sector needs to be nourished to ensure continued growth in living standards. The authorities also emphasized the importance of reducing the costs of bank financing and agreed with staff on the need to de-carbonize the economy and are actively pursuing efforts to increase the share of renewable energy resources.

32. Regarding governance, the authorities highlighted the progress in combating corruption.

They noted the improved rankings by a number of international organizations. The authorities consider the National Action Plan for Strengthening the Fight against Corruption for 2022–26 as an important further step to address governance issues. The authorities also stated that leaving the Extractive Industries Transparency Initiative (EITI) was motivated by reasons not related to their willingness to pursue open and accountable management of oil and gas resources, and that SOFAZ still discloses voluntarily all information.



¹¹ See paragraph 7 of Annex VIII for more details on the specific AML/CFT issues that need to be addressed.

¹² An assessment of fiscal governance was done during the 2019 Article IV consultation.

¹³ The Open Budget Survey (OBS) assesses the three components of a budget accountability system: public availability of budget information; opportunities for the public to participate in the budget process; and the role and effectiveness of formal oversight institutions, including the legislature and the national audit office. The majority of the survey questions assess what occurs in practice, rather than what is required by law.

STAFF APPRAISAL

33. Azerbaijan recovered strongly from the pandemic. The recovery was led by the non-oil sector as a successful vaccination campaign and the easing of social restrictions have created the conditions for the recovery in contact-intensive sectors. Higher oil prices have also supported the recovery.

34. However, inflation emerged as a new challenge. Inflation accelerated rapidly in 2021 to around 12 percent and remained at this level or above in 2022. Initially, the acceleration of inflation reflected imported food inflation and the liberalization of regulated prices in early 2021. Over time, though, inflation has become broad-based, affecting almost all items in the consumption basket. The purchasing power of the most vulnerable are particularly affected by the rise in food prices.

35. As an oil and gas exporter, Azerbaijan has benefitted from high oil and gas prices, but the war in Ukraine increases uncertainty over the outlook. The windfall oil and gas revenues led to a significant strengthening of the balance of payments and boosted government revenues and SOFAZ assets. If protracted, though, the war and related sanctions on Russia could pose risks to economic growth and food security and could further increase inflationary pressures.

36. Windfall oil revenues have been mostly saved, strengthening the fiscal position and creating fiscal space for measures to mitigate the impact of high food prices. Despite a large revenue windfall, the authorities have implemented a disciplined fiscal policy and saved most of the additional revenues. Given the strong fiscal position, staff supports the steps to provide temporary and targeted assistance to the most vulnerable to mitigate the impact of the high food prices.

37. With oil production and revenues projected to decline, fiscal adjustment is needed over the medium- and long-term. In staff's view, a sustained annual improvement in the non-oil primary balance by at least 1½ percent of non-oil GDP is required to ensure fiscal sustainability and to save enough oil revenues for future generations to ensure intergenerational equity. Fiscal adjustment should include both revenue and expenditure measures.

38. Staff welcomes the reintroduction of the fiscal rule suspended during the pandemic. The new fiscal rule targets the non-oil primary balance and the debt-to-GDP ratio. While the design of the fiscal rule reflects Azerbaijan's specific circumstances, staff calls on the authorities to continue working on supporting provisions and safeguards to ensure the observance of the fiscal rule over time to increase its credibility. Efforts to strengthen the medium-term budget framework should also be continued.

39. Staff welcomes the CBA's increase in interest rate in response to higher inflation but views further tightening as necessary to bring inflation down. Since mid-2021, the CBA has increased its policy rate by a cumulative 150 basis points. However, with inflation increasing, the policy rate remains negative in real terms, and among the lowest in the CCA region. If not addressed, inflation expectations could become more entrenched and inflation more difficult to bring down over the medium-term. Thus, staff sees further monetary tightening as necessary.

40. The work on modernizing the monetary policy framework should continue. Staff supports the authorities' plans to modernize the monetary policy framework, to rely more on interest rate rather than monetary aggregates as an intermediate target, and also to increase exchange rate flexibility in the long-run. This should improve monetary transmission and improve the CBA's capacity to control inflation and mitigate cyclical volatility.

41. Strong financial soundness indicators point to a resilient banking sector. Banks are mostly well capitalized and liquid, with solid profitability and declining nonperforming loans. Staff pointed out the relatively high amount of restructured loans and a rapid growth of consumer lending as potential sources of risk to banks that need to be monitored. Staff also encourages continued efforts to improve banking supervision, including a move to risk-based supervision, consolidated supervision of large banks, and the introduction of the IFRS9 reporting standard.

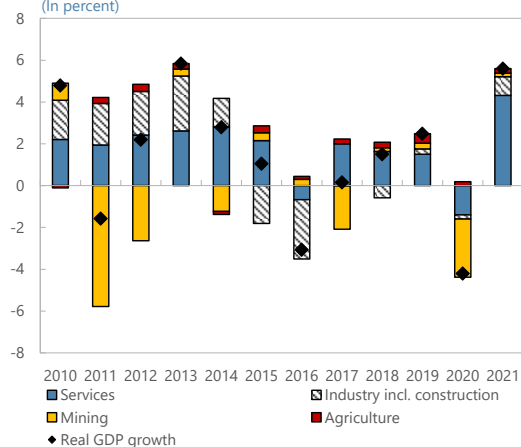
42. Addressing governance and structural impediments to private sector growth would support the diversification of the economy. Staff welcomes the long-term development plan, Azerbaijan 2030, which provides a roadmap to reduce dependency on oil exports and promote a more sustainable and diversified economy. The large number of SOEs distorts the playing field, hinders private sector development, and poses fiscal risks. The recently established Azerbaijan Investment Holding should play an important role in improving SOE performance and reducing their footprint in the economy. Finally, staff calls on the authorities to continue their efforts to strengthen governance and the rule of law in order to create a more favorable environment for private sector development.

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

Figure 2. Azerbaijan: Real Sector Indicators

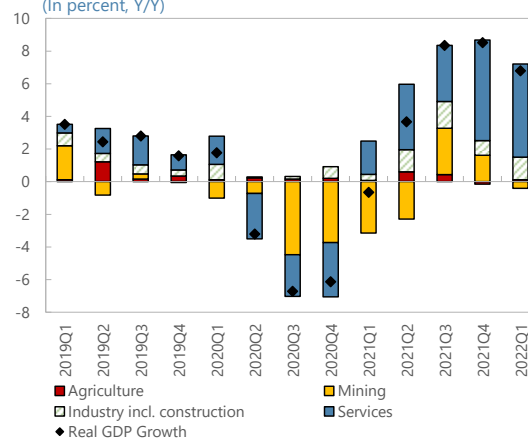
Growth recovered strongly in 2021 led by contact-intensive activities,...

Contribution to Real GDP Growth, 2010-2021
(In percent)



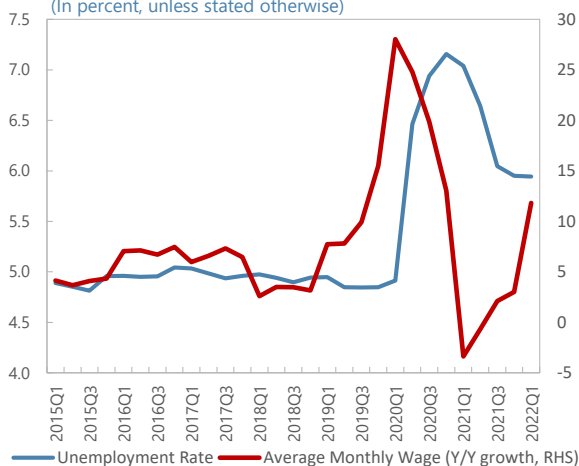
... and has remained strong in recent quarters...

Contributions to Quarterly Real GDP Growth, 2019-22
(In percent, Y/Y)



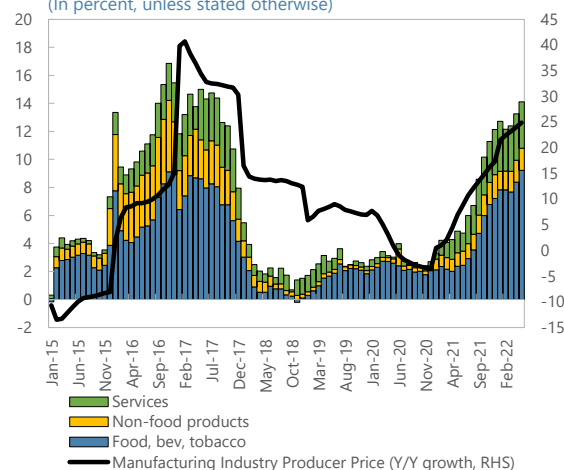
... with the labor market half way in the recovery path.

Unemployment Rate and Wages
(In percent, unless stated otherwise)



Inflationary pressures are building ...

Contributions to Headline Inflation, Y/Y EOP
(In percent, unless stated otherwise)



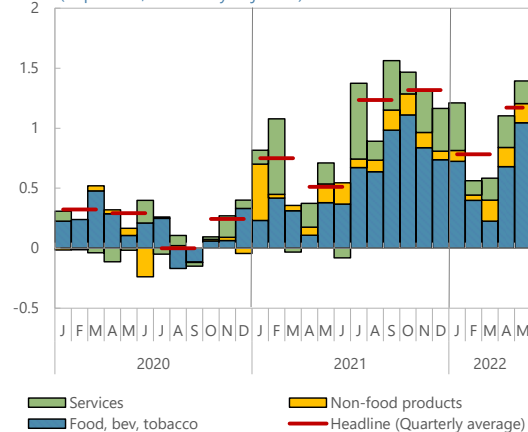
... with significant price increases in most items of the consumer basket,...

Azerbaijan: Consumer Price Index, EOP
(In percent change, Y/Y)



... and some evidence of additional momentum in early 2022.

Contributions to Headline Inflation, M/M
(In percent, seasonally adjusted)

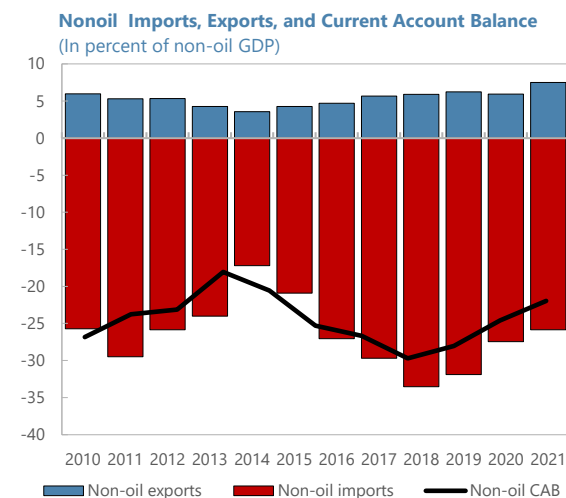
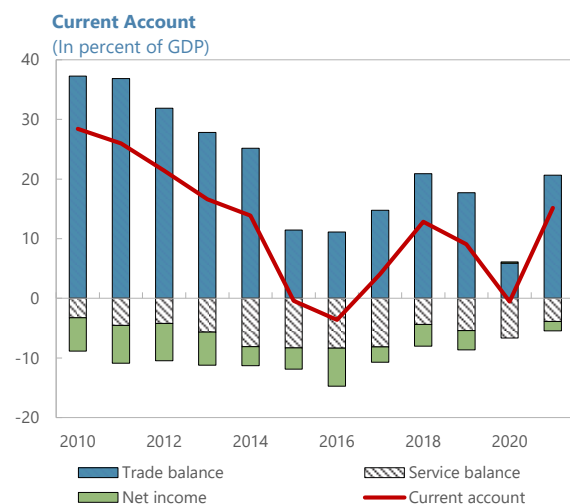


Sources: National authorities, Haver, and IMF staff calculations.

Figure 3. Azerbaijan: External Sector

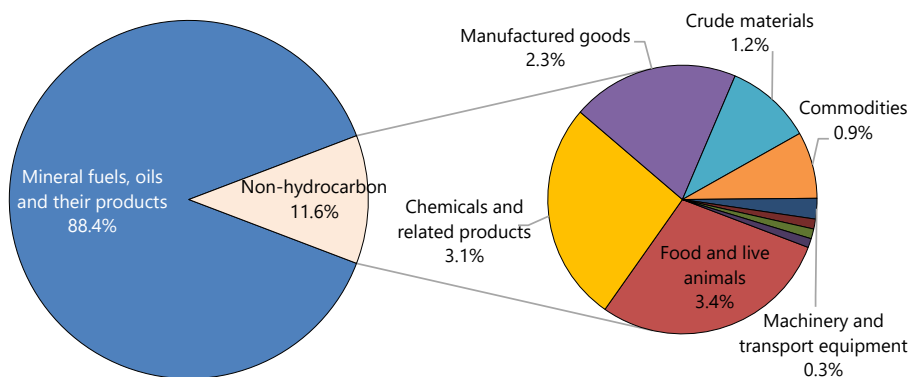
The external position improved substantially, driven by hydrocarbon prices,...

... with the structural non-oil imbalances broadly unchanged.

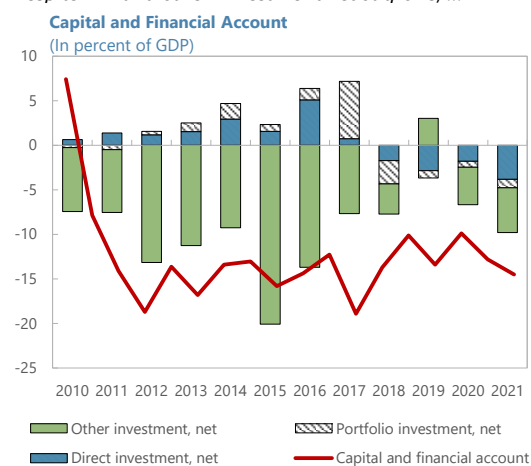


Exports are highly concentrated in hydrocarbon products.

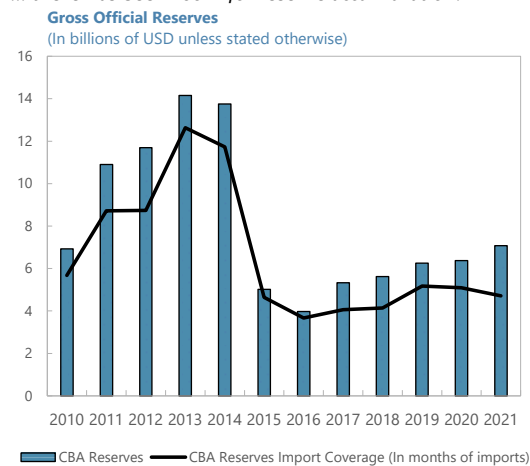
Export of Goods: Main Commodities
(In percent of total exports, 2021)



Despite FDI and other investment net outflows, ...



... there has been room for reserve accumulation.

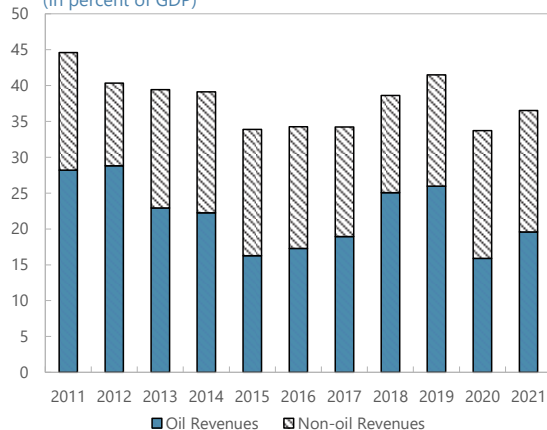


Sources: National authorities, WITS, Haver, and IMF staff calculations.

Figure 4. Azerbaijan: Fiscal Sector

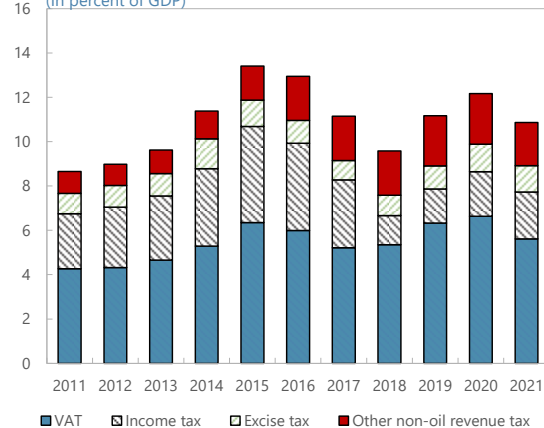
Oil Revenues are an important part of total government revenues ...

Consolidated Government Revenues
(In percent of GDP)



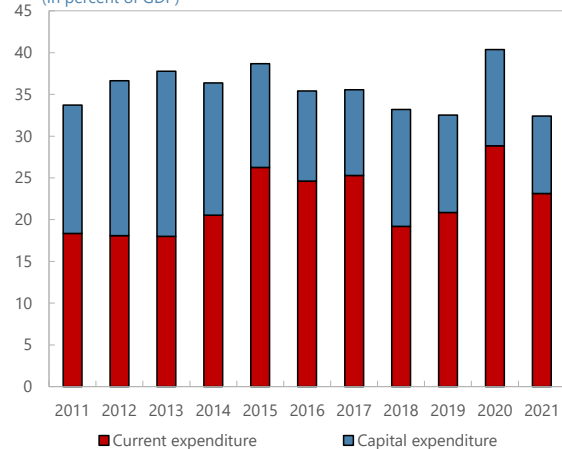
... with tax revenues relatively low, particularly direct tax revenues.

Tax Revenues
(In percent of GDP)



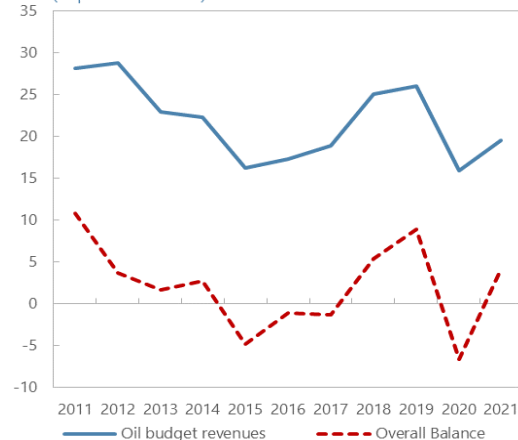
The share of capital expenditure has been gradually declining.

Total Expenditures
(In percent of GDP)



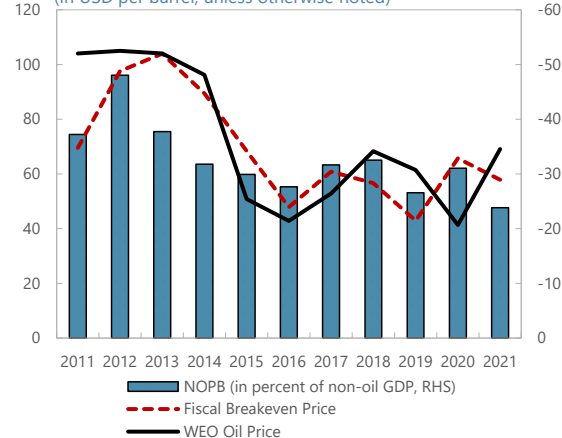
Overall budget balance moves in line with oil budget revenues.

Overall Balance and Oil Budget Revenues
(In percent of GDP)



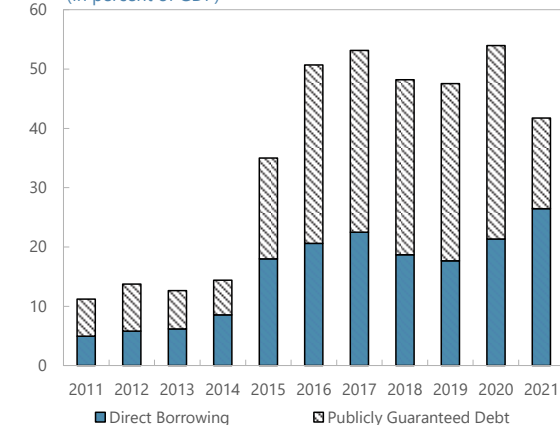
Non-oil primary deficit remains high and the breakeven oil price fell below the WEO oil price.

Oil Price, Fiscal Breakeven Oil Price, Nonoil Primary Balance
(In USD per barrel, unless otherwise noted)



After a jump in 2015–16, public debt/GDP has declined recently.

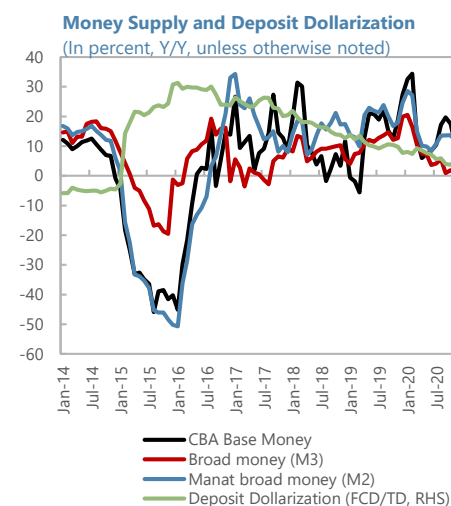
Total Public Debt
(In percent of GDP)



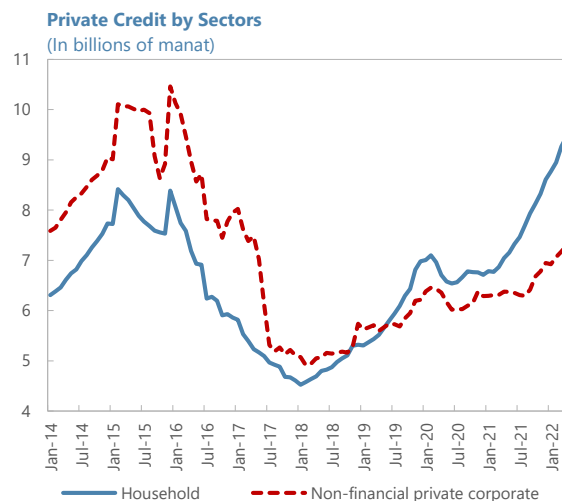
Sources: National authorities, Haver, IMF World Economic Outlook, and IMF staff calculations.

Figure 5. Azerbaijan: Monetary and Exchange Rate Developments

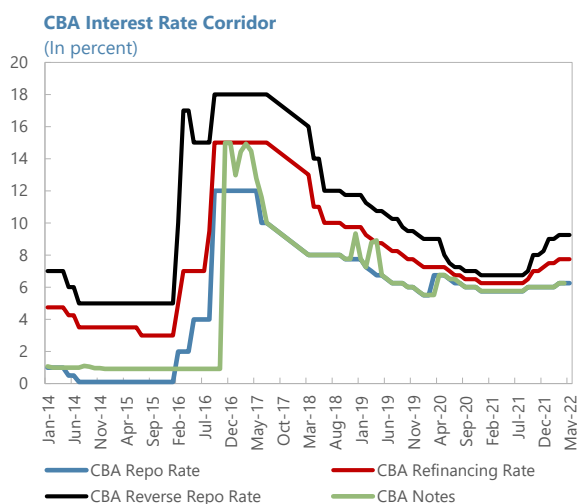
Money growth picked up in 2021...



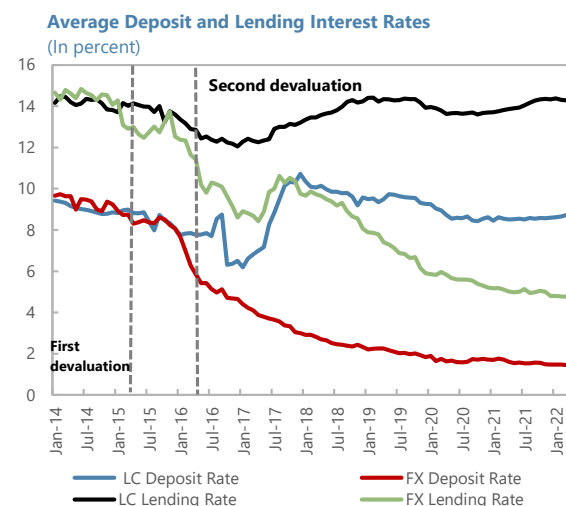
... and credit to households accelerated sharply.



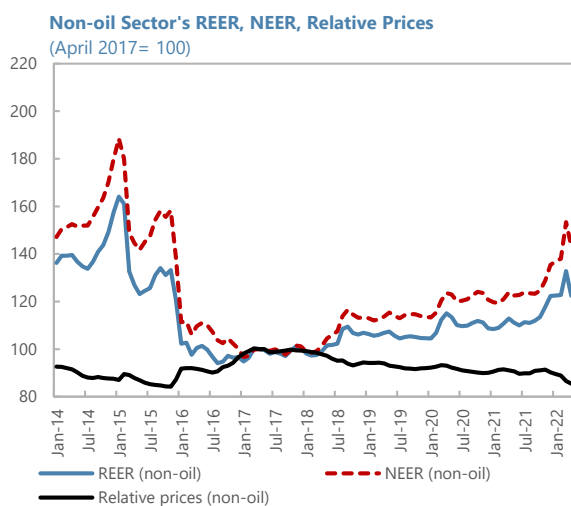
CBA reversed the rate cuts from the pandemic ...



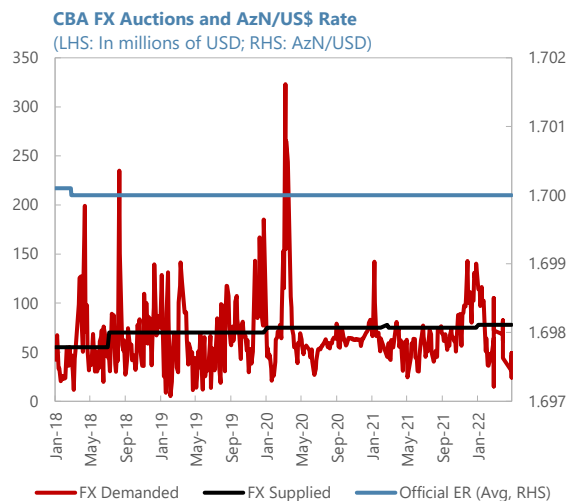
...but bank LC lending and deposit rates remain broadly stable.



The real effective ER appreciated since the start of 2020.



Since Q2 2021, FX demand was mostly below FX supply.



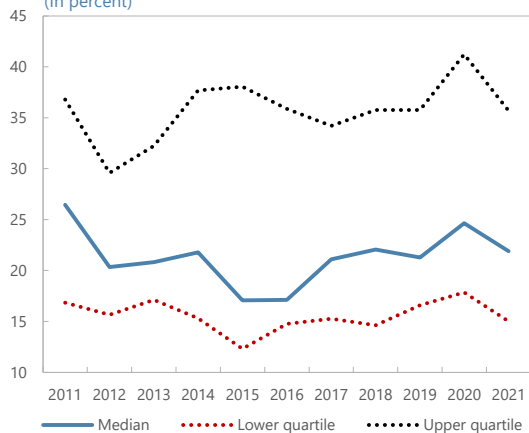
Sources: Haver, and IMF staff calculations.

Figure 6. Azerbaijan: Banking Sector

Reduced bank capital adequacy ratio reflects increased risk weights as regulatory easing unwinds.

Bank Capital Adequacy Ratio

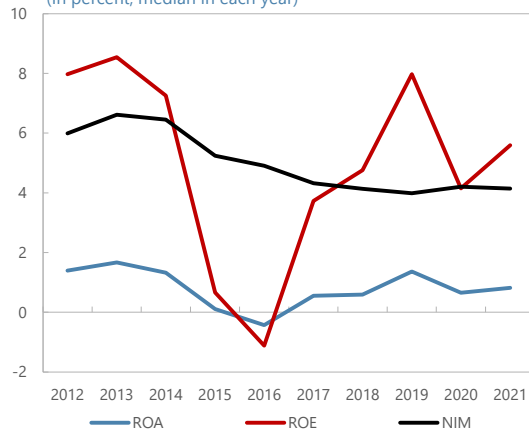
(In percent)



Bank profitability remains subdued and lower than the pre-pandemic level.

Bank Profitability Indicators

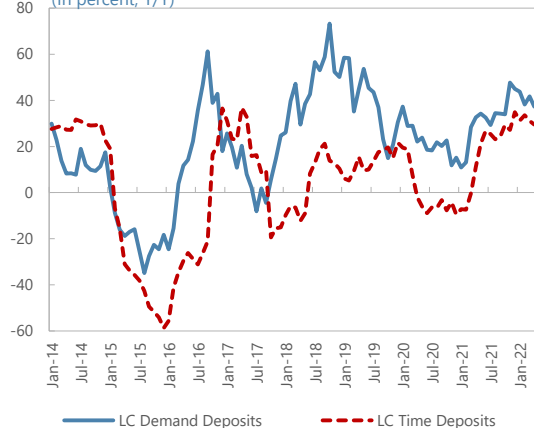
(In percent, median in each year)



...reflecting robust improvement in local currency deposits...

Growth of Deposits in Local Currency

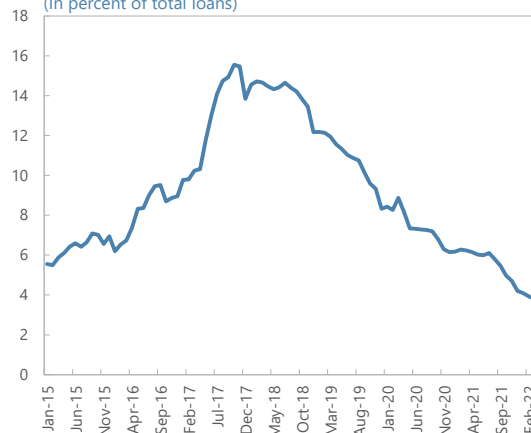
(In percent, Y/Y)



The nonperforming loan ratio has been declining.

Overdue Loans^{1/}

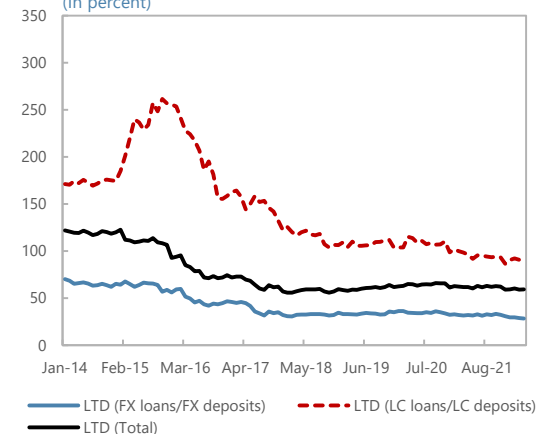
(In percent of total loans)



Banking sector liquidity in both local currency and foreign currency has improved...

Loan-to-Deposit Ratio

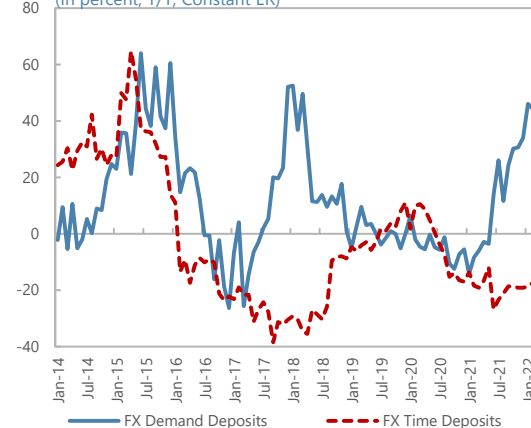
(In percent)



...and foreign currency demand deposits.

Growth of Deposits in Foreign Currency

(In percent, Y/Y, Constant ER)



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

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.

Table 1. Azerbaijan: Selected Economic and Financial Indicators, 2019–27

	2019	2020	2021	Projections					
				2022	2023	2024	2025	2026	2027
(Annual percentage change, unless otherwise specified)									
National income									
GDP at constant prices	2.5	-4.2	5.6	3.8	2.6	2.5	2.5	2.5	2.5
<i>Of which:</i> Oil sector 1/	0.7	-6.9	1.8	0.7	0.5	0.3	0.3	0.3	0.3
Non-oil sector	3.6	-2.6	7.2	5.5	3.7	3.5	3.5	3.5	3.5
Consumer price index (period average)	2.7	2.8	6.7	12.3	9.5	7.0	5.0	4.0	4.0
Consumer price index (end of period)	2.4	2.7	12.0	11.0	8.0	6.0	4.0	4.0	4.0
Money and credit									
Domestic credit, net	9.3	-2.4	26.9	7.7	9.2	11.0	11.2	10.9	10.7
<i>Of which:</i> Credit to private sector	15.2	-0.7	16.7	9.1	10.2	10.5	11.0	11.0	11.0
Manat base money	27.3	11.6	32.2	10.0	9.0	9.0	9.0	9.0	9.0
Manat broad money	24.4	11.3	17.6	15.0	13.9	13.0	11.5	10.4	10.4
Total broad money	19.9	1.1	18.7	14.9	12.2	11.4	10.0	8.9	8.9
External sector									
Exports f.o.b.	-4.5	-36.6	72.3	63.1	-3.8	0.2	-10.1	-13.3	-3.5
<i>Of which:</i> Oil sector	-6.0	-40.0	77.0	69.6	-4.7	-0.3	-11.8	-15.7	-4.8
Imports f.o.b.	3.5	-11.1	3.4	20.0	4.5	3.5	1.3	0.3	0.3
<i>Of which:</i> Oil sector	7.8	-0.3	-13.4	13.5	2.9	2.4	3.1	2.9	2.8
Real effective exchange rate	3.9	4.3	2.0	...	...	...	...	...	...
(In percent of GDP, unless otherwise specified)									
Gross investment	20.3	24.2	17.3	14.1	15.1	16.6	18.7	21.4	23.3
Consolidated government	11.7	11.5	9.3	7.4	7.1	7.0	6.9	6.8	6.8
Private sector	8.6	12.7	8.0	6.8	8.0	9.7	11.8	14.5	16.6
<i>Of which:</i> Oil sector	2.2	0.1	-4.0	-2.8	-2.6	-2.3	-2.1	-1.8	-1.6
Gross national savings	29.4	23.7	32.5	38.7	36.8	37.6	35.1	32.1	32.4
Consolidated general government finances 2/									
Total revenue and grants 3/	41.5	33.7	36.5	38.7	39.0	39.0	36.4	33.1	31.4
Total expenditure 4/	32.5	40.4	32.4	29.0	30.2	31.7	32.9	33.3	33.6
Current expenditure 4/	20.8	28.8	23.1	21.6	23.0	24.7	26.0	26.5	26.9
Net acquisition of non-financial assets	11.7	11.5	9.3	7.4	7.1	7.0	6.9	6.8	6.8
Overall fiscal balance 4/	8.9	-6.7	4.1	9.7	8.8	7.3	3.5	-0.2	-2.3
Non-oil primary balance, in percent of non-oil GDP	-26.6	-31.1	-23.8	-25.4	-23.9	-23.8	-24.0	-23.8	-23.9
General government debt 5/	17.7	21.3	26.4	20.0	21.2	23.5	25.5	27.7	30.0
General government and government-guaranteed debt	47.5	54.0	41.8	29.2	29.1	30.1	32.0	34.0	36.1
External sector									
Current account (- deficit)	9.1	-0.5	15.2	24.6	21.6	21.0	16.3	10.7	9.1
Foreign direct investment (net)	-2.9	-1.8	-3.8	-3.4	-3.1	-2.9	-2.7	-2.5	-2.2
Memorandum items:									
Gross official international reserves (in millions of U.S. dollars)	6,258	6,369	7,075	7,275	7,475	7,675	7,875	8,075	8,275
in months of next year's non-oil imports f.o.b.	5.4	6.8	6.5	6.0	6.0	6.0	6.1	6.2	6.4
Nominal GDP (in millions of manat)	81,896	72,578	92,858	122,901	126,319	129,278	133,279	138,358	145,008
Nominal non-oil GDP (in millions of manat)	50,392	50,793	57,786	68,463	77,741	86,127	93,626	100,779	108,479
Nominal GDP (in millions of U.S. dollars)	48,174	42,693	54,622	72,295	74,305	76,046	78,400	81,387	85,299
Oil Fund Assets (in millions of U.S. dollars)	43,323	43,564	45,025	53,429	62,168	70,742	76,580	79,840	82,076
Assumed oil price, WEO plus \$2-\$3 premium (in U.S. dollars per barrel)	63.4	44.3	71.1	108.5	96.5	85.7	78.7	74.4	72.2
Exchange rate (manat/dollar, end of period)	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.

Table 2. Azerbaijan: Balance of Payments, 2019–27
(In millions of U.S. dollars, unless otherwise specified)

	2019	2020	2021	2022	2023	Projections			
						2024	2025	2026	2027
Exports, f.o.b.	19,868	12,588	21,692	35,375	34,025	34,094	30,657	26,579	25,657
Oil and gas sector	18,017	10,817	19,145	32,463	30,943	30,841	27,206	22,940	21,830
Other	1,851	1,771	2,547	2,912	3,082	3,253	3,451	3,639	3,826
Imports, f.o.b.	-11,335	-10,077	-10,419	-12,502	-13,065	-13,522	-13,702	-13,739	-13,775
Oil and gas sector	-1,882	-1,876	-1,625	-1,845	-1,899	-1,944	-2,004	-2,062	-2,119
Others	-9,454	-8,200	-8,794	-10,658	-11,166	-11,578	-11,698	-11,677	-11,656
Trade balance	8,533	2,512	11,274	22,873	20,960	20,572	16,955	12,840	11,882
Services, net	-2,616	-2,841	-2,123	-2,408	-2,208	-1,970	-1,927	-1,942	-1,959
Oil and gas sector	-1,839	-2,417	-1,645	-1,840	-1,623	-1,368	-1,302	-1,293	-1,282
Others	-777	-424	-478	-568	-585	-602	-625	-649	-677
Factor income, net	-2,061	-456	-1,319	-3,430	-3,375	-3,364	-2,945	-2,913	-2,905
Oil and gas	-2,805	-1,438	-1,857	-4,093	-4,107	-4,093	-3,611	-3,611	-3,611
Others	744	982	539	664	732	729	666	698	706
Transfers, net	509	558	459	720	704	714	722	727	732
Current account balance	4,365	-228	8,292	17,755	16,081	15,952	12,805	8,712	7,751
Non-oil current account balance	-7,126	-5,314	-5,726	-6,929	-7,233	-7,483	-7,484	-7,262	-7,067
Capital account, net	-19	-7	-4	-4	-4	-4	-4	-4	-4
Direct investment, net	-1,379	-770	-2,088	-2,440	-2,336	-2,232	-2,122	-2,010	-1,896
Oil and gas	-815	-486	-2,866	-2,767	-2,667	-2,568	-2,469	-2,370	-2,270
Others	-563	-284	778	327	331	336	347	360	375
Portfolio investment, net	-389	-282	-519	105	153	123	77	77	77
Other investment, net	1,456	-1,801	-2,749	-7,262	-5,405	-5,514	-5,168	-3,768	-3,945
Oil and gas	-117	-270	-111	302	148	233	64	36	57
Others	1,572	-1,531	-2,638	-7,564	-5,553	-5,747	-5,232	-3,804	-4,003
Oil bonus	451	452	457	450	450	450	451	452	453
Financial derivatives	-4	0	0	0	0	0	0	0	0
Financial account, net	135	-2,401	-4,898	-9,147	-7,138	-7,174	-6,762	-5,249	-5,310
Capital and financial account balance	116	-2,408	-4,903	-9,151	-7,143	-7,178	-6,766	-5,253	-5,315
General government and government-guaranteed debt	661.8	648.0	-153.6	0.0	0.0	0.0	0.0	0.0	0.0
Overall balance	5,143	-1,988	3,235	8,604	8,939	8,774	6,038	3,459	2,436
Financing	-5,143	1,848	-3,235	-8,604	-8,939	-8,774	-6,038	-3,459	-2,436
Change in net foreign assets of CBA (increase -)	-632	-111	-706	-200	-200	-200	-200	-200	-200
Change in Oil Fund assets (increase -)	-4,808	-241	-1,461	-8,404	-8,739	-8,574	-5,838	-3,259	-2,236
Change in other government FX assets (increase -)	297	2200	-1068	0	0	0	0	0	0
Memorandum items:									
Current account balance (in percent of GDP)	9.1	-0.5	15.2	24.6	21.6	21.0	16.3	10.7	9.1
Gross official international reserves	6,258	6,369	7,075	7,275	7,475	7,675	7,875	8,075	8,275
in months of next year's non-oil imports f.o.b.	5.4	6.8	6.5	6.0	6.0	6.0	6.1	6.2	6.4
Oil Fund assets	43,323	43,564	45,025	53,429	62,168	70,742	76,580	79,840	82,076
Public and publicly guaranteed external debt (in percent of GDP)	47.2	55.7	43.7	34.3	36.2	38.8	41.0	43.3	45.5
Oil price (US\$ per barrel)	63.4	44.3	71.1	108.5	96.5	85.7	78.7	74.4	72.2
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)	48,174	42,693	54,622	72,295	74,305	76,046	78,400	81,387	85,299

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

Table 3. Azerbaijan: Balance of Payments, 2019–27
(In percent of GDP, unless otherwise specified)

	2019	2020	2021	Projections					
				2022	2023	2024	2025	2026	2027
Exports, f.o.b.	41.2	29.5	39.7	48.9	45.8	44.8	39.1	32.7	30.1
Oil and gas sector	37.4	25.3	35.0	44.9	41.6	40.6	34.7	28.2	25.6
Other	3.8	4.1	4.7	4.0	4.1	4.3	4.4	4.5	4.5
Imports, f.o.b.	-23.5	-23.6	-19.1	-17.3	-17.6	-17.8	-17.5	-16.9	-16.1
Oil and gas sector	-3.9	-4.4	-3.0	-2.6	-2.6	-2.6	-2.6	-2.5	-2.5
Others	-19.6	-19.2	-16.1	-14.7	-15.0	-15.2	-14.9	-14.3	-13.7
Trade balance	17.7	5.9	20.6	31.6	28.2	27.1	21.6	15.8	13.9
Services, net	-5.4	-6.7	-3.9	-3.3	-3.0	-2.6	-2.5	-2.4	-2.3
Oil and gas sector	-3.8	-5.7	-3.0	-2.5	-2.2	-1.8	-1.7	-1.6	-1.5
Others	-1.6	-1.0	-0.9	-0.8	-0.8	-0.8	-0.8	-0.8	-0.8
Factor income, net	-4.3	-1.1	-2.4	-4.7	-4.5	-4.4	-3.8	-3.6	-3.4
Oil and gas	-5.8	-3.4	-3.4	-5.7	-5.5	-5.4	-4.6	-4.4	-4.2
Others	1.5	2.3	1.0	0.9	1.0	1.0	0.8	0.9	0.8
Transfers, net	1.1	1.3	0.8	1.0	0.9	0.9	0.9	0.9	0.9
Current account balance	9.1	-0.5	15.2	24.6	21.6	21.0	16.3	10.7	9.1
Non-oil current account balance	-14.8	-12.4	-10.5	-9.6	-9.7	-9.8	-9.5	-8.9	-8.3
Capital account, net	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Direct investment, net	-2.9	-1.8	-3.8	-3.4	-3.1	-2.9	-2.7	-2.5	-2.2
Oil and gas	-1.7	-1.1	-5.2	-3.8	-3.6	-3.4	-3.1	-2.9	-2.7
Others	-1.2	-0.7	1.4	0.5	0.4	0.4	0.4	0.4	0.4
Portfolio investment, net	-0.8	-0.7	-1.0	0.1	0.2	0.2	0.1	0.1	0.1
Other investment	3.0	-4.2	-5.0	-10.0	-7.3	-7.3	-6.6	-4.6	-4.6
Oil and gas	-0.2	-0.6	-0.2	0.4	0.2	0.3	0.1	--	0.1
Others	3.3	-3.6	-4.8	-10.5	-7.5	-7.6	-6.7	-4.7	-4.7
Oil bonus	0.9	1.1	0.8	0.6	0.6	0.6	0.6	0.6	0.5
Financial derivatives	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financial account, net	0.3	-5.6	-9.0	-12.7	-9.6	-9.4	-8.6	-6.4	-6.2
Capital and financial account balance	0.2	-5.6	-9.0	-12.7	-9.6	-9.4	-8.6	-6.5	-6.2
General government and government-guaranteed debt	1.4	1.5	-0.3	0.0	0.0	0.0	0.0	0.0	0.0
Overall balance	10.7	-4.7	5.9	11.9	12.0	11.5	7.7	4.3	2.9
Financing	-10.7	4.3	-5.9	-11.9	-12.0	-11.5	-7.7	-4.3	-2.9
Change in net foreign assets of CBA (increase -)	-1.3	-0.3	-1.3	-0.3	-0.3	-0.3	-0.3	-0.2	-0.2
Change in Oil Fund assets (increase -)	-10.0	-0.6	-2.7	-11.6	-11.8	-11.3	-7.4	-4.0	-2.6
Change in other government FX assets (increase -)	0.6	5.2	-2.0	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:									
Current account balance	9.1	-0.5	15.2	24.6	21.6	21.0	16.3	10.7	9.1
Gross official international reserves	13.0	14.9	13.0	10.1	10.1	10.1	10.0	9.9	9.7
in months of next year's non-oil imports f.o.b.	5.4	6.8	6.5	6.0	6.0	6.0	6.1	6.2	6.4
Oil Fund assets	89.9	102.0	82.4	73.9	83.7	93.0	97.7	98.1	96.2
Public and publicly guaranteed external debt	47.2	55.7	43.7	34.3	36.2	38.8	41.0	43.3	45.5
Oil price (US\$ per barrel)	63.4	44.3	71.1	108.5	96.5	85.7	78.7	74.4	72.2
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\$)	48,174	42,693	54,622	72,295	74,305	76,046	78,400	81,387	85,299

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

Table 4. Azerbaijan: Statement of Consolidated Government Operations, 2019–27
(In millions of manat)

	2019	2020	2021	Projections					
				2022	2023	2024	2025	2026	2027
Revenue									
Total revenue	33,966	24,467	33,895	47,542	49,273	50,381	48,489	45,772	45,503
Tax revenue	13,916	13,786	16,724	19,892	21,379	22,415	23,456	24,253	24,847
Income taxes	3,499	3,503	4,152	5,200	5,620	6,036	6,350	6,599	6,764
Individual income tax	952	1,151	1,195	1,415	1,607	1,781	1,936	2,084	2,243
Enterprise profits tax	2,547	2,352	2,957	3,785	4,013	4,255	4,415	4,515	4,521
Value added tax (VAT)	5,185	4,818	5,214	5,857	6,374	6,828	7,229	7,506	7,804
Excise taxes	855	898	1,106	1,275	1,433	1,576	1,710	1,827	1,952
Taxes on international trade	1,714	1,561	2,626	2,844	3,028	2,868	2,851	2,767	2,476
Other taxes	741	641	600	711	808	895	973	1,047	1,127
Social security contributions	1,923	2,365	3,025	4,004	4,115	4,212	4,342	4,508	4,724
Nontax revenue	20,030	10,661	17,151	27,630	27,874	27,947	25,013	21,499	20,634
Of which: Oil Fund revenues	19,031	9,361	15,986	27,032	27,264	27,326	24,377	20,843	19,954
Grants	20	20	20	20	20	20	20	20	20
Expenditure									
Total Expenditure	26,647	29,303	30,102	35,588	38,103	40,944	43,822	46,106	48,785
Current Expense	17,075	20,934	21,467	26,554	29,109	31,910	34,588	36,642	38,969
Compensation of employees	5,270	6,197	6,050	7,168	8,140	9,018	9,803	10,552	11,358
Use of goods and services	3,929	6,027	7,257	8,561	9,921	10,991	12,048	13,118	14,270
Social benefits	4,806	5,644	6,001	7,960	8,184	9,040	9,840	10,101	10,453
Of which: Social protection fund	1,735	1,180	1,762	1,888	1,944	2,154	2,341	2,520	2,712
Subsidies	2,467	2,419	1,485	2,232	2,286	2,332	2,414	2,428	2,483
Grants	20	20	20	20	20	20	20	20	20
Interest	568	605	628	585	527	474	426	384	345
Other expense 1/	16	22	27	28	32	35	38	40	40
Net Acquisition of Nonfinancial Assets	9,572	8,368	8,635	9,034	8,994	9,034	9,234	9,464	9,815
Overall balance 1/	7,319	-4,836	3,793	11,953	11,169	9,437	4,667	-335	-3,282
Overall balance excluding one off items 2/	7,319	-4,836	3,793	11,953	11,169	9,437	4,667	-335	-3,282
Non-oil primary balance 3/	-13,385	-15,771	-13,752	-17,366	-18,543	-20,520	-22,449	-23,965	-25,965
Net financial transactions	7,319	-4,836	3,793	11,953	11,169	9,437	4,667	-335	-3,283
Net acquisition of financial assets	8,680	-4,124	4,491	13,021	14,349	13,969	9,261	4,807	2,985
Oil Fund	8,174	-3,065	4,603	14,287	14,856	14,576	9,925	5,541	3,802
Privatization and other sale of assets	-118	-61	-112	-200	-240	-288	-346	-415	-498
Banking System 4/	887	-843	0	-400	-300	-300	-300	-300	-300
Others	-263	-155	0	-666	33	-19	-19	-19	-19
Net incurrence of liabilities	1,361	712	947	1,068	3,179	4,531	4,594	5,142	6,268
Domestic debt issuance	137	750	600	0	200	600	600	600	600
Of which: Domestic banking sector	134	1,135	394	0	200	600	600	600	600
External Loans	1,224	952	347	993	600	543	565	350	350
Other	0	-990	0	75	2,379	3,388	3,429	4,192	5,318
Memorandum items:									
Oil revenue	21,271	11,540	18,172	29,904	30,239	30,432	27,542	24,014	23,028
Non-oil revenue	12,695	12,927	15,723	17,638	19,033	19,950	20,947	21,757	22,474
Non-oil tax revenue 5/	9,753	9,242	11,512	13,016	14,288	15,097	15,948	16,574	17,049
Non-oil GDP (in million of manats)	50,392	50,793	57,786	68,463	77,741	86,127	93,626	100,779	108,479

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

1/ Includes the extraordinary SOFAZ transfer (\$1.4 billion) to the CBA in 2017

2/ Excludes the impact of the 2017 extraordinary SOFAZ transfer (\$1.4 billion) to the CBA.

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

4/ Comprises government deposits in CBA and commercial banks.

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

Table 5. Azerbaijan: Statement of Consolidated Government Operations, 2019–27
(In percent of non-oil GDP)

	2019	2020	2021	Projections					
	2019	2020	2021	2022	2023	2024	2025	2026	2027
Revenue									
Total revenue	67.4	48.2	58.7	69.4	63.4	58.5	51.8	45.4	41.9
Tax revenue	27.6	27.1	28.9	29.1	27.5	26.0	25.1	24.1	22.9
Income taxes	6.9	6.9	7.2	7.6	7.2	7.0	6.8	6.5	6.2
Individual income tax	1.9	2.3	2.1	2.1	2.1	2.1	2.1	2.1	2.1
Enterprise profits tax	5.1	4.6	5.1	5.5	5.2	4.9	4.7	4.5	4.2
Value added tax (VAT)	10.3	9.5	9.0	8.6	8.2	7.9	7.7	7.4	7.2
Excise taxes	1.7	1.8	1.9	1.9	1.8	1.8	1.8	1.8	1.8
Taxes on international trade	3.4	3.1	4.5	4.2	3.9	3.3	3.0	2.7	2.3
Other taxes	1.5	1.3	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Social security contributions	3.8	4.7	5.2	5.8	5.3	4.9	4.6	4.5	4.4
Nontax revenue	39.7	21.0	29.7	40.4	35.9	32.4	26.7	21.3	19.0
Of which: Oil Fund revenues	37.8	18.4	27.7	39.5	35.1	31.7	26.0	20.7	18.4
Grants	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Expenditure									
Total Expenditure	52.9	57.7	52.1	52.0	49.0	47.5	46.8	45.8	45.0
Current Expense	33.9	41.2	37.1	38.8	37.4	37.0	36.9	36.4	35.9
Compensation of employees	10.5	12.2	10.5	10.5	10.5	10.5	10.5	10.5	10.5
Use of goods and services	7.8	11.9	12.6	12.5	12.8	12.8	12.9	13.0	13.2
Social benefits	9.5	11.1	10.4	11.6	10.5	10.5	10.5	10.0	9.6
Of which: Social protection fund	3.4	2.3	3.0	2.8	2.5	2.5	2.5	2.5	2.5
Subsidies	4.9	4.8	2.6	3.3	2.9	2.7	2.6	2.4	2.3
Grants	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Interest	1.1	1.2	1.1	0.9	0.7	0.6	0.5	0.4	0.3
Other expense 1/	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net Acquisition of Nonfinancial Assets	19.0	16.5	14.9	13.2	11.6	10.5	9.9	9.4	9.0
Overall balance 1/	14.5	-9.5	6.6	17.5	14.4	11.0	5.0	-0.3	-3.0
Overall balance excluding one off items 2/	14.5	-9.5	6.6	17.5	14.4	11.0	5.0	-0.3	-3.0
Non-oil primary balance 3/	-26.6	-31.1	-23.8	-25.4	-23.9	-23.8	-24.0	-23.8	-23.9
Net financial transactions	14.5	-9.5	6.6	17.5	14.4	11.0	5.0	-0.3	-3.0
Net acquisition of financial assets	17.2	-8.1	7.8	19.0	18.5	16.2	9.9	4.8	2.8
Oil Fund	16.2	-6.0	8.0	20.9	19.1	16.9	10.6	5.5	3.5
Privatization and other sale of assets	-0.2	-0.1	-0.2	-0.3	-0.3	-0.3	-0.4	-0.4	-0.5
Banking System 4/	1.8	-1.7	0.0	-0.6	-0.4	-0.3	-0.3	-0.3	-0.3
Others	-0.5	-0.3	0.0	-1.0	0.0	0.0	0.0	0.0	0.0
Net incurrence of liabilities	2.7	1.4	1.6	1.6	4.1	5.3	4.9	5.1	5.8
Debt securities	0.3	1.5	1.0	0.0	0.3	0.7	0.6	0.6	0.6
Of which: Domestic banking sector	0.3	2.2	0.7	0.0	0.3	0.7	0.6	0.6	0.6
External Loans	2.4	1.9	0.6	1.5	0.8	0.6	0.6	0.3	0.3
Other	0.0	-1.9	0.0	0.1	3.1	3.9	3.7	4.2	4.9
Memorandum items:									
Oil revenue	42.2	22.7	31.4	43.7	38.9	35.3	29.4	23.8	21.2
Non-oil revenue	25.2	25.5	27.2	25.8	24.5	23.2	22.4	21.6	20.7
Non-oil tax revenue 5/	19.4	18.2	19.9	19.0	18.4	17.5	17.0	16.4	15.7
Non-oil GDP (in billion of manats)	50.4	50.8	57.8	68.5	77.7	86.1	93.6	100.8	108.5

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

1/ Includes the extraordinary SOFAZ transfer (\$1.4 billion) to the CBA in 2017)

2/ Excludes the impact of the 2017 extraordinary SOFAZ transfer (\$1.4 billion) to the CBA.

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

4/ Comprises government deposits in CBA and commercial banks.

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

Table 6. Azerbaijan: Summary Accounts of the Central Bank, 2019–27
(In millions of manat, unless otherwise specified)

	2019	2020	2021	Projections					
	2019	2020	2021	2022	2023	2024	2025	2026	2027
Net foreign assets	11,692	14,371	15,570	15,910	16,250	16,590	16,930	17,270	17,610
Net international reserves of the CBA	11,692	14,372	14,366	15,911	16,251	16,591	16,931	17,271	17,611
Gross international reserves	12,055	14,750	15,627	17,172	17,512	17,852	18,192	18,532	18,872
Foreign liabilities	-363	-379	-1,261	-1,261	-1,261	-1,261	-1,261	-1,261	-369
Other items, net	0	-1	-1	-1	-1	-1	-1	-1	-1
Net domestic assets	1,432	681	2,985	5,602	7,261	9,607	11,881	14,110	16,571
Domestic credit	4,354	2,622	4,287	6,923	8,602	10,969	13,263	15,512	17,995
Net claims on consolidated central government	-2,710	-4,626	-3,679	-420	-320	-219	-119	-19	80
<i>Of which:</i> claims on central government	27	297	326	326	326	326	326	326	326
manat deposits of central government	-2,338	-2,662	-2,304	-2,104	-2,004	-1,904	-1,804	-1,704	-1,604
Net claims on banks 1/	7,064	7,247	7,966	7,343	8,921	11,188	13,383	15,531	17,914
Credit to the economy	0	0	0	0	0	0	0	0	0
Net claims on other financial corporations 1/									
Other items, net	-2,921	-1,940	-1,302	-1,321	-1,341	-1,361	-1,382	-1,402	-1,423
Reserve money	13,125	15,053	19,761	21,512	23,511	26,198	28,812	31,380	34,182
Manat reserve money	12,153	13,564	17,938	19,731	21,507	23,443	25,553	27,852	30,359
Currency outside CBA	10,406	11,840	12,310	14,138	15,626	17,266	18,820	20,514	22,361
Bank reserves and other deposits	1,747	1,725	5,628	5,593	5,881	6,176	6,732	7,338	7,998
Reserves in foreign currency	973	1,489	1,824	1,780	2,004	2,755	3,259	3,527	3,823

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.

Table 7. Azerbaijan: Monetary Survey, 2018–27
(In millions of manat, unless otherwise specified)

	2018	2019	2020	2021	Projections					
	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027
Net foreign assets	14,951	16,924	18,436	20,171	21,797	22,218	22,640	23,063	23,487	23,912
Net international reserves of the CBA	11,038	11,692	14,372	14,366	15,911	16,251	16,591	16,931	17,271	17,611
Net foreign assets of commercial banks	4,078	5,511	4,290	6,293	6,393	6,493	6,593	6,693	6,793	6,893
Other	-165	-280	-226	-488	-508	-527	-545	-562	-578	-593
Net domestic assets	9,126	11,943	10,750	14,475	18,000	22,453	27,136	31,679	36,135	41,033
Domestic credit, net	15,973	17,460	17,042	21,624	23,281	25,421	28,222	31,369	34,797	38,536
Net claims on consolidated central government	-3,550	-4,590	-4,982	-3,225	-2,854	-2,354	-1,454	-554	346	1,246
Credit to the economy	13,058	15,036	14,934	17,433	19,019	20,959	23,160	25,708	28,535	31,674
<i>Of which: private sector</i>	13,058	15,036	14,934	17,433	19,019	20,959	23,160	25,708	28,535	31,674
Credit to other financial public sector	6,465	7,014	7,090	7,416	7,116	6,816	6,516	6,216	5,916	5,616
Other items, net	-6,847	-5,518	-6,293	-7,148	-5,281	-2,968	-1,086	310	1,338	2,497
Broad money	24,078	28,866	29,186	34,647	39,797	44,671	49,776	54,742	59,621	64,945
Manat broad money	14,656	18,239	20,303	23,870	27,460	31,269	35,341	39,414	43,524	48,059
Cash outside banks	7,601	9,501	10,773	10,941	12,017	12,812	13,639	14,302	14,974	15,651
Manat deposits	7,054	8,738	9,530	12,930	15,443	18,457	21,701	25,112	28,549	32,408
Foreign currency deposits	9,422	10,628	8,883	10,776	12,337	13,401	14,435	15,328	16,098	16,886
(Annual percentage change)										
Net foreign assets	-0.7	13.2	8.9	9.4	8.1	1.9	1.9	1.9	1.8	1.8
Net domestic assets	18.2	30.9	-10.0	34.7	24.3	24.7	20.9	16.7	14.1	13.6
Credit to the economy	14.9	15.2	-0.7	16.7	9.1	10.2	10.5	11.0	11.0	11.0
<i>Of which: private sector</i>	14.9	15.2	-0.7	16.7	9.1	10.2	10.5	11.0	11.0	11.0
Broad money (M3)	5.7	19.9	1.1	18.7	14.9	12.2	11.4	10.0	8.9	8.9
Manat broad money (M2)	17.6	24.4	11.3	17.6	15.0	13.9	13.0	11.5	10.4	10.4
Reserve money	7.8	23.3	14.7	31.3	8.9	9.3	11.4	10.0	8.9	8.9
Manat reserve money	11.7	27.3	11.6	32.2	10.0	9.0	9.0	9.0	9.0	9.0
Memorandum items:										
Gross official international reserves (US\$ millions)	5,626	6,258	6,369	7,075	7,275	7,475	7,675	7,875	8,075	8,275
Velocity of total broad money (M3)	1.9	1.7	1.7	1.7	1.7	1.7	1.7	1.7	1.7	1.7
Credit to private sector in percent of non-oil GDP	28.0	29.8	29.4	30.2	27.8	27.0	26.9	27.5	28.3	29.2
Share of foreign currency credits in total credit portfolio	38.0	34.2	30.8	27.7	24.9	22.4	20.2	18.2	16.4	14.7
Current to broad money ratio	31.6	32.9	36.9	31.6	30.2	28.7	27.4	26.1	25.1	24.1
Share of foreign currency deposits in total deposits	57.2	54.9	48.2	45.5	44.4	42.1	39.9	37.9	36.1	34.3
Foreign currency deposits to broad money ratio	39.1	36.8	30.4	31.1	31.0	30.0	29.0	28.0	27.0	26.0

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

Table 8. Azerbaijan: Banking Sector Financial Soundness Indicators, 2017–21
(In percent, unless otherwise specified)

	2017	2018	2019	2020	2021
Regulatory Capital to Risk-Weighted Assets (Median)	22.5	22.2	23.2	26.1	20.0
Capital to Assets	13.3	13.8	14.0	14.7	12.9
Liquid Assets to Total Assets 1/	46.7	41.1	39.5	38.2	40.3
Nonperforming Loans (NPLs) to Total Loans 2/	13.8	12.2	8.3	6.1	4.2
Loan-loss provisioning to nonperforming loans ratio 2/	90.8	93.3	113.9	127.3	159.3
Bank Return on Assets (Median)	0.6	0.6	1.4	0.7	0.8
Bank Return on Equity (Median)	3.7	4.8	8.0	4.1	5.6

Sources: National authorities; and IMF staff estimates.

Note: This is based on prudential reporting methodology.

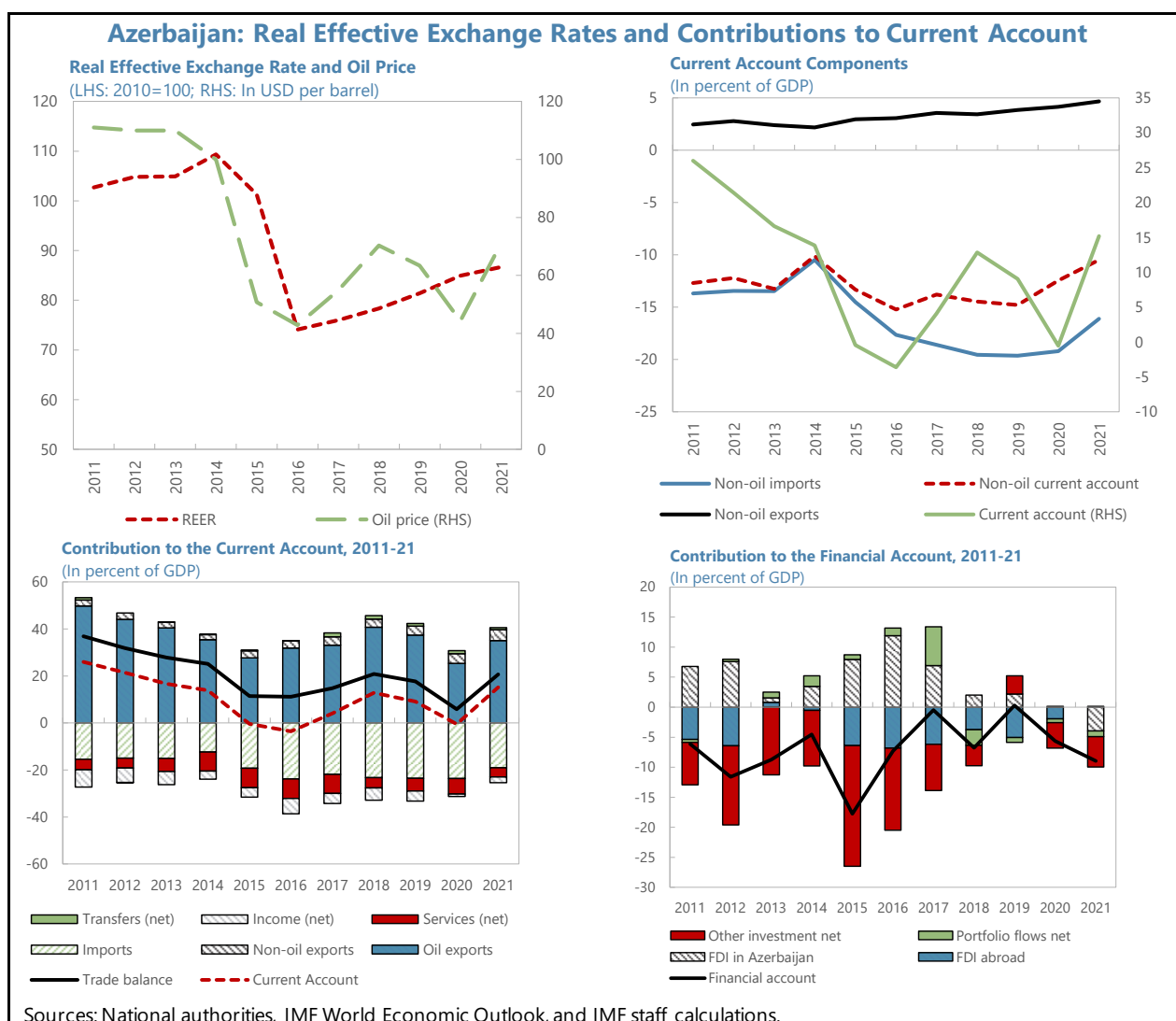
1/ Liquid assets include cash and cash equivalents, claims on the CBA, Nostro accounts, and deposits with financial institutions.

2/ In percent of real sector loans. Disclosed NPLs are underestimated, as only the overdue portion of principal and interest is disclosed as NPL.

Annex I. External Sector Assessment

Staff assesses the external position to be stronger than the level consistent with medium-term fundamentals and desirable policies. Amid the rapid recovery of oil and gas prices, a large increase in oil export revenues caused a significant improvement in the external position in 2021. With the unfolding of the war in Ukraine, global energy prices are expected to remain high in the medium term, providing significant external buffers, despite the higher international food prices. If external conditions persist, the current account (CA) balance will be stronger than the level needed to ensure sufficient savings for future generations. This assessment is subject to a high degree of uncertainty related to the future path of oil and gas prices.

1. A small deficit turned into a large CA surplus in 2021. Following a CA deficit of 0.5 percent of GDP in 2020, the CA balance improved substantially to a surplus of 15.2 percent of GDP in 2021 owing to a sharp increase in global oil and gas prices and the commission of a new gas project that offset the stagnant crude oil production. The non-oil CA deficit improved in 2021 but remains high, at 10.5 percent of GDP, driven by large non-oil imports. Non-oil exports are low at 4.7 percent of GDP.



The CA surplus is projected to further increase to 24.6 percent of GDP in 2022 due to the sharp increase in oil and gas prices and then to gradually decline in tandem with the reduction of oil prices and the expected decline in oil export volumes. High demand for gas in Europe could generate additional windfalls, but this will require significant capital investments.

2. External reserve coverage remains more than adequate. With the large CA surplus, CBA's gross international reserves increased significantly, reaching \$7 billion (13 percent of GDP, 6.0 months of next year's imports of goods) by end-2021. 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 \$45 billion in assets (82 percent of GDP) at end-2021. Together, CBA and SOFAZ liquid assets are equivalent to 35 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 (Figure AI.1). 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 2027, given expected CA surpluses, rising reserves, and limited increases in external debt (red diamonds).

3. The external position has strengthened in 2021 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 per capita terms, the CA norm is estimated at 10.9 percent of GDP in 2021, implying a favorable CA gap of 3.5 percent of GDP.² The gap is expected to remain positive over the medium term at 3.5 percent of GDP and will provide substantial buffers if associated windfalls are well capitalized over time.
- 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 stronger than fundamentals in 2021. The CA norm is estimated at 5.0 percent of GDP, implying a favorable gap of 10.3 percent of GDP, after adjusting for the remaining effects of the pandemic. Policy changes that would help maintain

Azerbaijan: EBA-lite Model Results, 2021			
	CA model 1/	REER model 1/	Consumption model
	(in percent of GDP)		
CA-Actual	15.2		15.2
Cyclical contributions (from model) (-) 2/	-0.6		0.2
COVID-19 adjustor (-) 3/	0.1		0.1
Additional temporary/statistical factors (-)	0.0		0.0
Natural disasters and conflicts (-)	0.5		0.5
Adjusted CA	15.3		14.4
CA Norm (from model) 3/	5.0		10.9
Adjustments to the norm (-)	0.0		0.0
Adjusted CA Norm	5.0		10.9
CA Gap	10.3	0.8	3.5
o/w Relative policy gap	3.1		
Elasticity	-0.29		-0.29
REER Gap (in percent)	-34.9	-2.7	-11.9

1/ Based on the EBA-lite 3.0 methodology

2/ Cyclical adjustment for the consumption module is based only on the output gap

3/ Additional cyclical adjustment to account for the temporary impact of the pandemic on tourism and remittances.

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

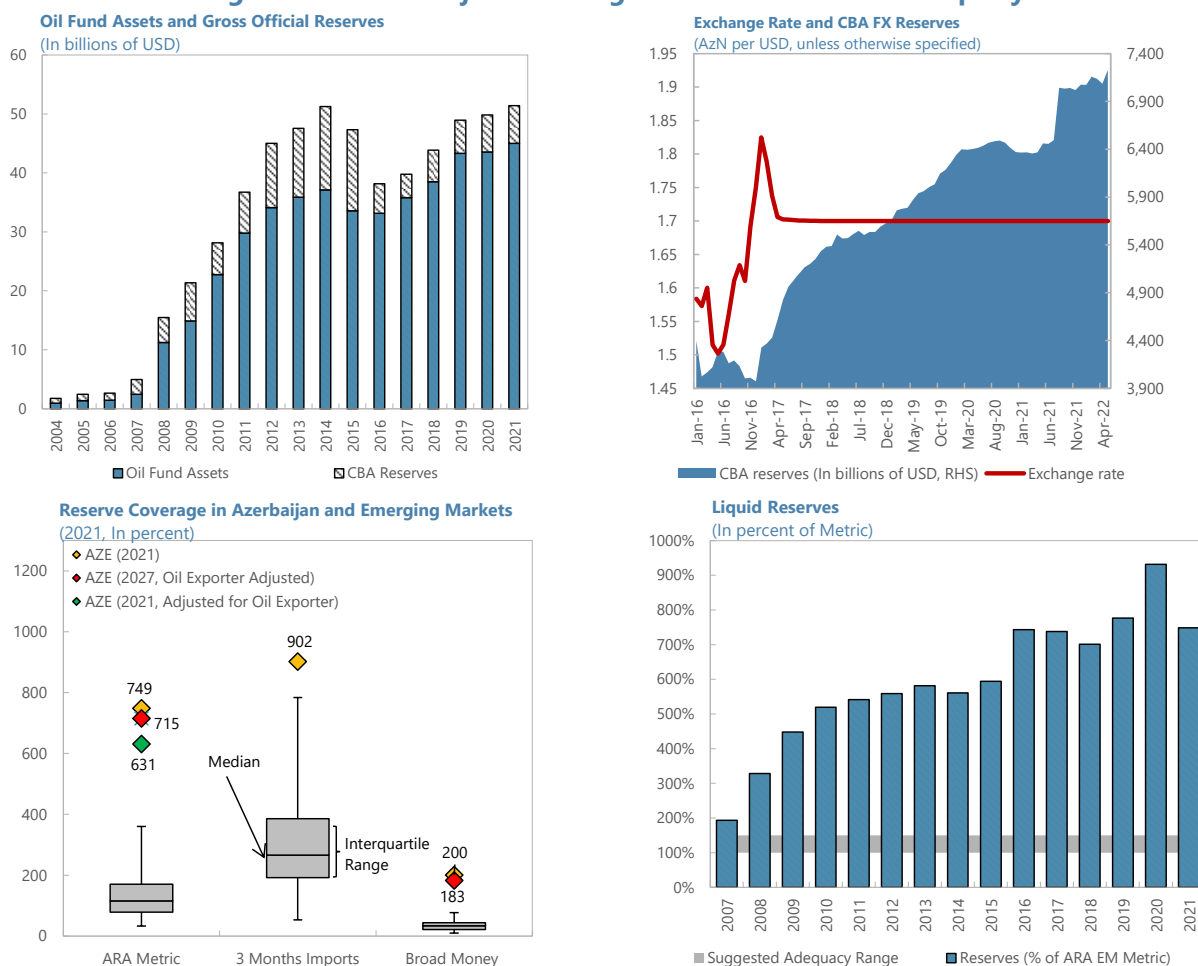
² The estimated norm is sensitive to the choice of model parameters, such as the GDP growth rate, interest rate, and population growth rate, as well as the underlying oil prices.

the CA over the medium term include: (i) fiscal consolidation; and (ii) investments in gas to increase export capacity to Europe, which would increase the saving-investment balance; balanced by (iii) financial deepening, for bank credit to the private sector to rise closer to the EM average; and (iv) structural reforms to promote private investment, which would reduce the saving-investment balance.

4. The manat continued to appreciate in 2021. 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 13.6 percent stronger than 2017 at the end of 2021. 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 not overvalued, with a REER gap in a range of -35 to -3 percent, consistent with the large favorable CA gap over the medium term. The permanent income model points to similar conclusions, indicating a large REER positive gap, in line with the positive CA gap implied by a constant real per capita annuity.

5. Overall, staff assesses the external position to be stronger than the level consistent with medium-term fundamentals and desirable policies. This assessment is based on the EBA-lite commodity module's consumption model, based on the PIH, given its relevance. Specifically, staff assesses the CA gap to be positive and around 3.5 percent of GDP, based on the constant real per capita annuity estimated by the EBA-Lite commodity approach, and the medium-term REER gap to be largely negative (-12 percent) and favorable when considering the current account model and balanced when the REER approach is used. The results are highly sensitive to the assumed oil price.

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.

Figure AI.1. Azerbaijan: Exchange Rates and Reserve Adequacy

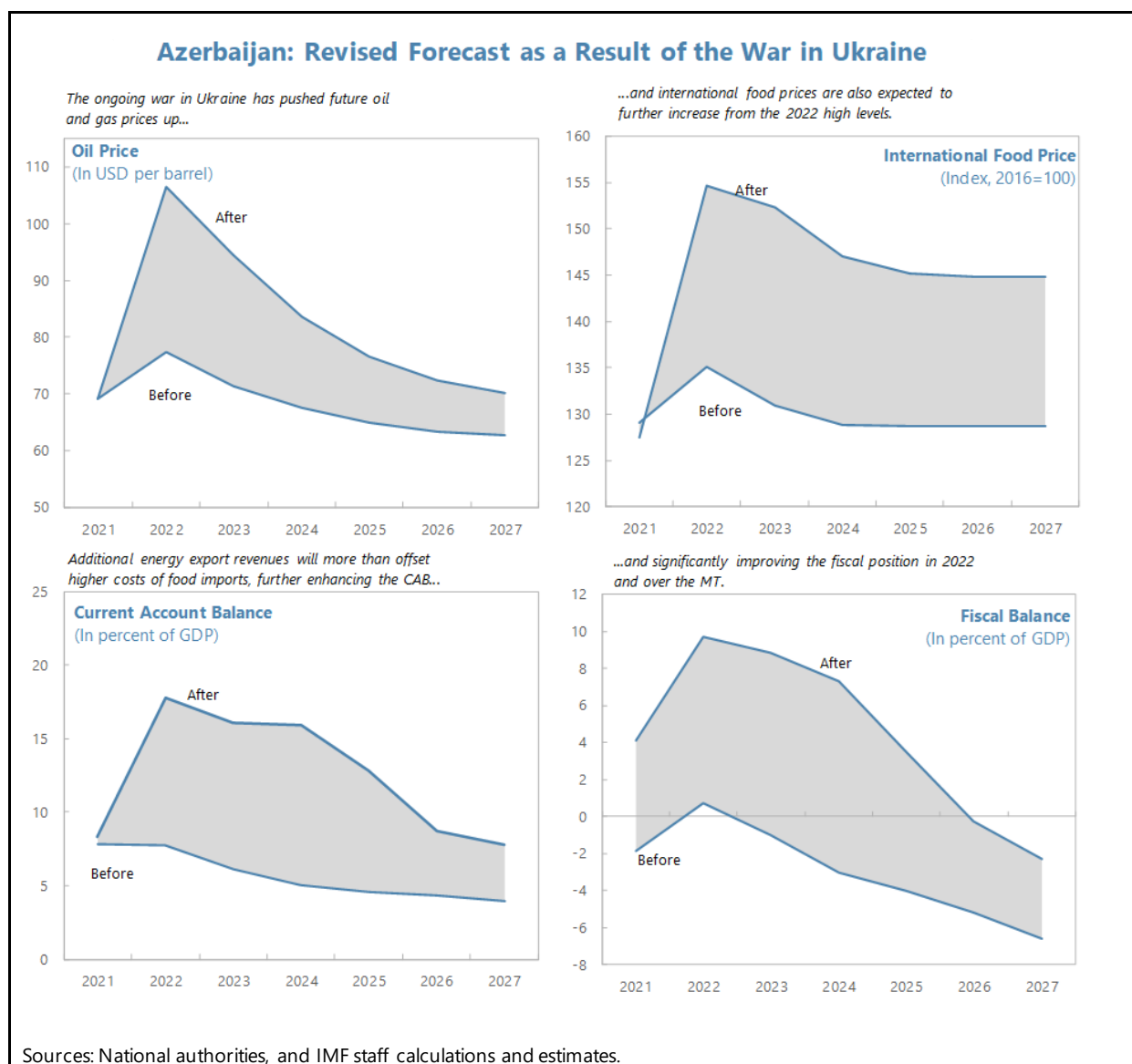
Sources: National authorities, Haver, IMF FAD Reserve Adequacy Tool, and IMF staff calculations.

Note: The data for EM refer to a sample of 47 emerging markets.

Annex II. Impact of the War in Ukraine

Azerbaijan's economy benefits from higher energy prices from the war in Ukraine and related sanctions, but the war presents new policy challenges. The increase in energy prices and the potential increase in gas exports to Europe boost exports and fiscal revenues. Still, food price inflation and food security are an immediate concern. Trade spillovers are limited to agricultural products, and the impact on the financial sector has been limited to date.

1. Azerbaijan's benefits from the higher oil and gas prices. Energy prices are expected to increase in 2022 and remain high in the medium-term, reflecting geopolitical tensions, large market disruptions, and the implicit understanding of the permanent nature of the shocks. This will translate into substantially higher export and fiscal revenues.

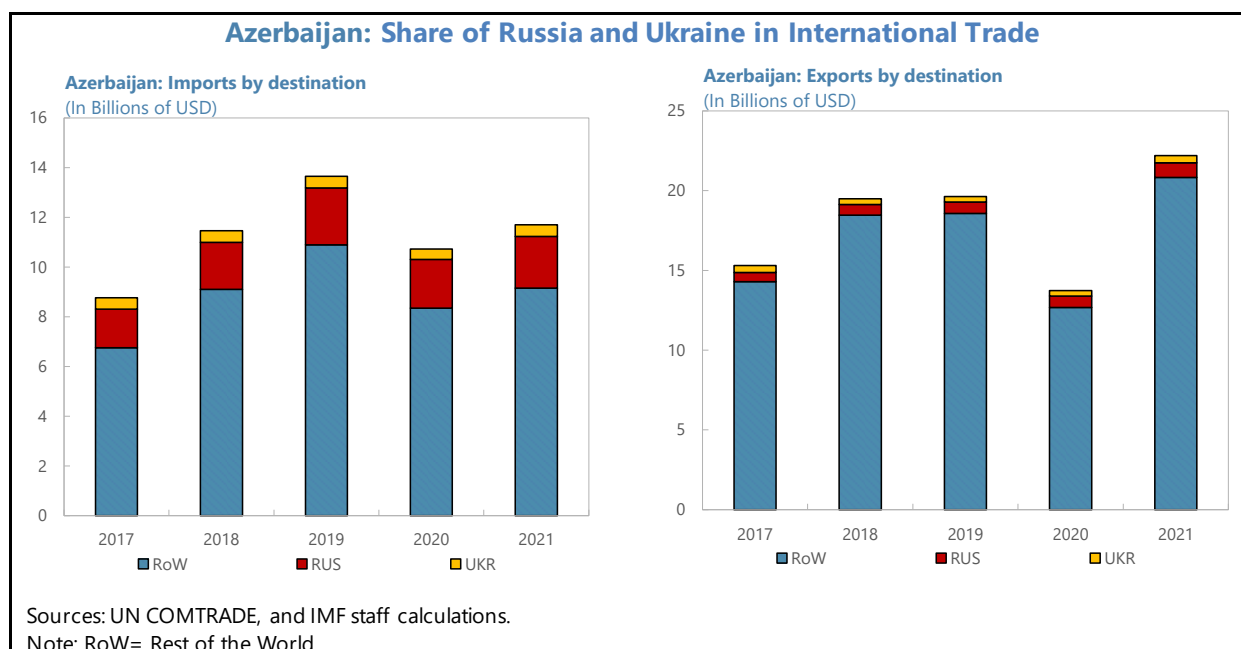


2. There is also the potential for Azerbaijan to benefit from a structural shift in global gas markets. Demand for Azerbaijan's gas has increased as Europe seeks alternative sources. Increasing existing capacity will require long-term investments in new pipelines and gas fields. In the short-run, the impact is more limited, as pipelines currently run at full capacity.

3. Global food price inflation will have an important effect on domestic inflation. Due to the large food import component in the consumption basket, international food prices are expected to passthrough to domestic food inflation, with a disproportionate impact on the most vulnerable. There are also concerns about the future availability of food staples and fertilizer, with wheat and other food stuff mainly brought from either Russia or Ukraine.

4. Direct trade with Russia and Ukraine is concentrated in agricultural products. Russia is Azerbaijan's largest import partner (17 percent of total imports), with concerns about food supplies. Exports are more limited, with Russia representing 3.7 percent of total exports and Ukraine 1.7 percent, which is also primarily trade in agricultural products.

5. Sanctions have created some disruptions but are expected to be contained. The initial imposition of sanctions triggered a small-scale bank run on the Azerbaijan subsidiary of Bank VTB (0.5 percent of total banking sector assets). However, as the bank's liquidity ratio is 74.5 percent (2.5 times the regulatory requirement), the run is unlikely to lead to a solvency issue. Some complications could arise with correspondent banking relations, as international banks are likely required to comply with strict sanctions. There are also concerns about payment systems.



Annex III. Risk Assessment Matrix¹

Risk Assessment Matrix			
Risk	Likelihood	Possible Impact	Policy Advice
External Risks and Spillovers			
Russia's invasion of Ukraine leads to escalation of sanctions and other disruptions. Sanctions on Russia are broadened to include oil, gas, and food sectors. Russia is disconnected almost completely from the global financial system and large parts of the trading system. This, combined with Russian countersanctions and secondary sanctions on countries and companies that continue business with Russia, leads to even higher commodity prices, refugee migration, tighter financial conditions, and other adverse spillovers, which particularly affect LICs and commodity-importing EMs.	High	High. As a large oil and gas exporter, Azerbaijan would benefit from higher oil and gas prices, increased government revenue and stronger balance of payments. Oil fund (SOFAZ) assets would increase significantly. However, the food import bill would rise. Tightening financial conditions and spiking risk premia would have a limited impact given the low dependence on external financing and limited presence of nonresident investors.	Maintain prudent fiscal policy and avoid a procyclical increase in budget spending. Save most of the oil revenue windfall. Continue prudent borrowing policy to avoid a high dependence on external financing. Use part of the additional budget revenues to provide temporary support to the most vulnerable.
Rising and volatile food and energy prices. Commodity prices are volatile and trend up amid supply constraints, war in Ukraine, export restrictions, and currency depreciations. This leads to short-run disruptions in the green transition, bouts of price and real sector volatility, food insecurity, social unrest, and acute food and energy crises (especially in EMDEs with lack of fiscal space).	High	Medium. Rising food prices could have an important impact, but the increase in food import costs would be relatively minor compared to increased oil and gas export revenues. Thus, rather than increased cost of food imports, the main concern is the availability of food given significant imports of cereals from Russia and Ukraine.	Undertake proactively measures to ensure sufficient imports of food from alternative markets, while encouraging domestic production. Provide support to the vulnerable who would be most affected by rising food prices. Support maximum use of the existing transport infrastructure to export natural gas.

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.

Risk Assessment Matrix			
Outbreaks of lethal and highly contagious Covid-19 variants. Rapidly increasing hospitalizations and deaths due to low vaccine protection or vaccine-resistant variants force more social distancing and/or new lockdowns. This results in extended supply chain disruptions and a reassessment of growth prospects, triggering capital outflows, financial tightening, currency depreciations, and debt distress in some EMDEs.	Medium	Medium. New more dangerous virus strain could lead to lockdowns and abort the ongoing recovery. Renewed containment leads to higher budget spending and lower revenues, weakening the fiscal balance. Tightening financial conditions and spiking risk premia would have a limited impact given the low dependence on external financing and limited presence of nonresident investors.	Fiscal consolidation could be temporarily slowed down, with additional spending provided as needed to health and other sectors to fight the pandemic.
Domestic Risks			
Loss of spending discipline in response to higher oil and gas revenues. Higher oil and gas prices boost budget revenues, and budget spending will increase significantly.	Medium /Low	Medium. Failure to save oil windfall revenues would imply procyclical fiscal policy, higher inflationary pressures and weakening long-term fiscal position.	Gradually but steadily reduce the non-oil primary deficit by maintaining spending discipline, saving most of the oil windfall revenues, and increasing non-oil budget revenues.
Financial sector risks. Following the pandemic and regulatory forbearance, the risk exists that asset quality would deteriorate, and restructured loans turn out to be nonperforming. Pickup in bank consumer lending could also lead to increased risk.	Medium	Low. 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.	Following the reversal of prudential regulation easing in response to the pandemic, strengthen financial supervision and regulation, and closely follow the consumer lending development.
Weak SOE performance. Failure to improve weak SOEs financial performance will result in continued losses, with a negative impact on economic growth and growing contingent liabilities to the budget.	Medium	Low. Government guarantees pose a fiscal risk. Failure to strengthen SOE's performance would increase the risk that more guarantees will be issued, and existing guarantees called, increasing government debt.	Implement comprehensive reforms to improve corporate governance and efficiency of SOEs.

Annex IV. Debt Sustainability Analysis

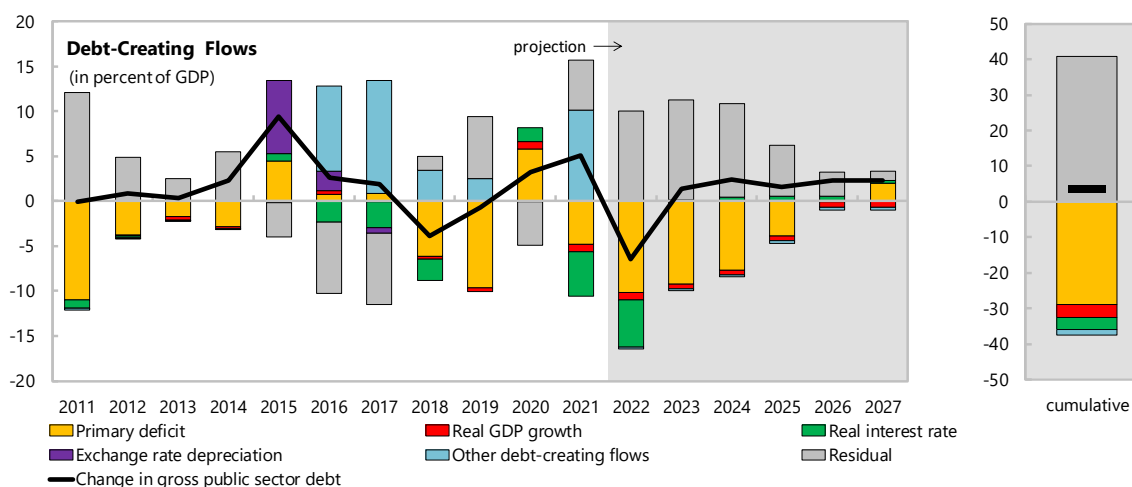
Figure AIV.1. Azerbaijan: Public Sector Debt Sustainability Analysis
(In percent of GDP unless otherwise indicated)

Debt, Economic and Market Indicators ^{1/}

	Actual		2021	2022	Projections					As of June 10, 2022	
	2011-2019 ^{2/}	2020			2023	2024	2025	2026	2027		
Nominal gross public debt	13.7	21.3	26.4	20.0	21.4	23.8	25.4	27.7	30.0	Sovereign Spreads	
										EMBIG (bp) ^{3/}	400
Public gross financing needs	-1.3	9.5	-1.9	-8.3	-7.6	-3.8	2.7	8.2	13.2	5Y CDS (bp)	
										241	
Real GDP growth (in percent)	1.3	-4.2	5.6	3.8	2.6	2.5	2.5	2.5	2.5	Ratings	Foreign Local
Inflation (GDP deflator, in percent)	6.7	-7.5	30.2	28.0	1.7	0.1	0.0	0.4	1.3		
Nominal GDP growth (in percent)	7.9	-11.4	27.9	32.4	2.8	2.3	3.1	3.8	4.8		
Effective interest rate (in percent) ^{4/}	2.8	4.1	4.1	2.4	2.5	2.5	2.5	2.5	2.5		
										Moody's	Ba2 Ba2
										S&P's	BB+ BB+
										Fitch	BB+ BB+

Contribution to Changes in Public Debt

	Actual		2021	2022	Projections					cumulative	debt-stabilizing
	2011-2019	2020			2023	2024	2025	2026	2027		
Change in gross public sector debt	1.5	3.3	5.1	-6.4	1.4	2.4	1.5	2.3	2.3	3.5	primary
Identified debt-creating flows	-0.1	8.1	-0.5	-16.4	-9.8	-7.9	-4.1	-0.4	1.3	-37.4	balance ^{9/}
Primary deficit	-3.2	5.8	-4.8	-10.2	-9.3	-7.7	-3.8	0.0	2.0	-29.0	-0.7
Primary (noninterest) revenue and grants	38.4	33.7	36.5	38.7	39.0	39.0	36.4	33.1	31.4	217.5	
Primary (noninterest) expenditure	35.2	39.5	31.7	28.5	29.7	31.3	32.6	33.0	33.4	188.5	
Automatic debt dynamics ^{5/}	0.1	2.3	-5.8	-6.1	-0.4	0.0	0.0	-0.1	-0.4	-6.9	
Interest rate/growth differential ^{6/}	-1.0	2.3	-5.8	-6.1	-0.4	0.0	0.0	-0.1	-0.4	-6.9	
Of which: real interest rate	-0.9	1.5	-4.9	-5.3	0.1	0.5	0.6	0.5	0.3	-3.3	
Of which: real GDP growth	-0.1	0.9	-0.9	-0.8	-0.5	-0.5	-0.6	-0.6	-0.7	-3.6	
Exchange rate depreciation ^{7/}	1.1	0.0	0.0	...	...	...	...	...	...	...	
Other identified debt-creating flows	3.1	-0.1	10.1	-0.2	-0.2	-0.2	-0.3	-0.3	-0.3	-1.5	
Privatization (negative)	-0.1	-0.1	-0.1	-0.2	-0.2	-0.2	-0.3	-0.3	-0.3	-1.5	
Contingent liabilities	3.2	0.0	10.2	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/}	1.5	-4.8	5.6	10.0	11.2	10.3	5.6	2.7	1.0	40.9	



Source: IMF staff calculations and estimates.

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 $\frac{r - \pi(1+g) - g + ae(1+r)}{(1+g+\pi+gr)}$ 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 $r - \pi(1+g)$ and the real growth contribution as $-g$.

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

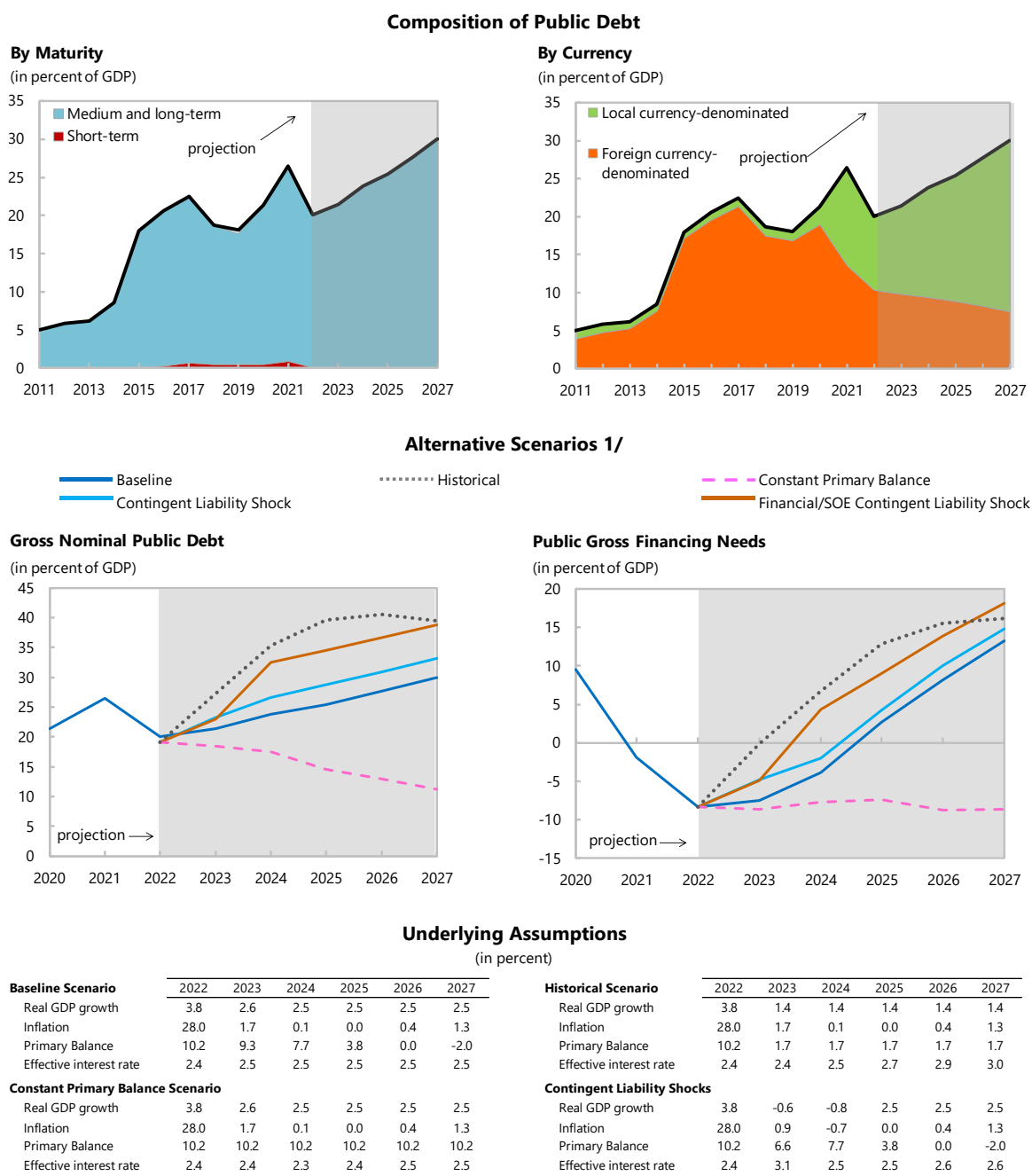
8/ Includes asset changes and interest revenues (if any). For projections, includes exchange rate changes during the projection period.

In 2021, reflects inclusion to debt of Aqracredit guarantee, and accumulation 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.

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

(In percent of GDP unless otherwise indicated)



Source: IMF staff calculations and estimates.

1/ Contingent liability shock refers to standard financial sector liability shock with one-off increase in non-interest 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.

Table 1. Azerbaijan: External Debt Sustainability Framework, 2017–27
(In percent of GDP unless otherwise indicated)

	Actual					Projections						Debt-stabilizing non-interest current account 6/ -3.6
	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027	
Baseline: External debt	53.3	47.1	47.2	55.7	43.7	34.2	35.5	37.9	40.4	43.0	45.6	
Change in external debt	3.3	-6.2	0.1	8.5	-11.9	-9.6	1.3	2.5	2.5	2.6	2.6	
Identified external debt-creating flows (4+8+9)	-14.1	-18.4	-12.2	5.4	-33.3	-29.2	-25.4	-24.4	-19.8	-14.2	-12.5	
Current account deficit, excluding interest payments	-4.8	-14.0	-10.2	-0.9	-16.3	-25.3	-21.9	-21.1	-16.6	-11.1	-9.5	
Deficit in balance of goods and services	-6.6	-16.5	-12.3	0.8	-16.8	-28.2	-24.7	-23.9	-18.9	-13.3	-11.7	
Exports	48.0	54.1	49.1	35.6	46.7	53.1	49.1	48.0	42.5	36.4	33.9	
Imports	41.3	37.6	36.8	36.4	29.9	25.0	24.4	24.1	23.7	23.1	22.3	
Net non-debt creating capital inflows (negative)	-5.7	0.9	-2.1	-1.1	-2.9	-3.5	-3.3	-3.0	-2.8	-2.5	-2.3	
Automatic debt dynamics 1/	-3.5	-5.3	0.1	7.5	-14.1	-0.5	-0.2	-0.2	-0.4	-0.5	-0.6	
Contribution from nominal interest rate	0.7	1.2	1.2	1.4	1.1	0.8	0.7	0.6	0.5	0.5	0.4	
Contribution from real GDP growth	-0.1	-0.7	-1.1	2.2	-2.3	-1.3	-0.9	-0.9	-0.9	-1.0	-1.0	
Contribution from price and exchange rate changes 2/	-4.2	-5.8	0.1	3.8	-12.9	...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	17.4	12.2	12.2	3.0	21.4	19.7	26.7	26.9	22.2	16.7	15.1	
External debt-to-exports ratio (in percent)	111.2	87.1	96.2	156.3	93.7	64.3	72.2	79.0	95.0	118.2	134.4	
Gross external financing need (in billions of US dollars) 4/	-0.7	-4.3	-3.3	1.4	-7.1	-16.7	-15.2	-15.0	-11.9	-7.8	-6.7	
in percent of GDP	-1.7	-9.0	-6.8	3.2	-13.0	-23.1	-20.1	-19.3	-14.9	-9.6	-7.9	
Scenario with key variables at their historical averages 5/						34.2	53.0	72.3	87.3	97.1	106.3	0.9
Key Macroeconomic Assumptions Underlying Baseline												
						Historical Average	Standard Deviation					
Real GDP growth (in percent)	0.2	1.5	2.5	-4.2	5.6	1.4	3.2	3.8	2.6	2.5	2.5	2.5
GDP deflator in US dollars (change in percent)	9.2	12.2	-0.2	-7.5	30.2	-1.0	17.8	28.0	1.7	0.1	0.0	0.4
Nominal external interest rate (in percent)	1.6	2.5	2.6	2.7	2.6	1.7	0.9	2.4	2.1	1.8	1.4	1.2
Growth of exports (US dollar terms, in percent)	12.9	28.4	-7.3	-35.6	67.6	0.2	30.9	51.4	-3.5	0.2	-9.2	-12.0
Growth of imports (US dollar terms, in percent)	3.5	3.5	0.0	-12.3	5.1	0.6	8.0	10.9	2.0	1.2	0.7	0.3
Current account balance, excluding interest payments	4.8	14.0	10.2	0.9	16.3	9.5	8.3	25.3	21.9	21.1	16.6	11.1
Net non-debt creating capital inflows	5.7	-0.9	2.1	1.1	2.9	0.4	2.7	3.5	3.3	3.0	2.8	2.5

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

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

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

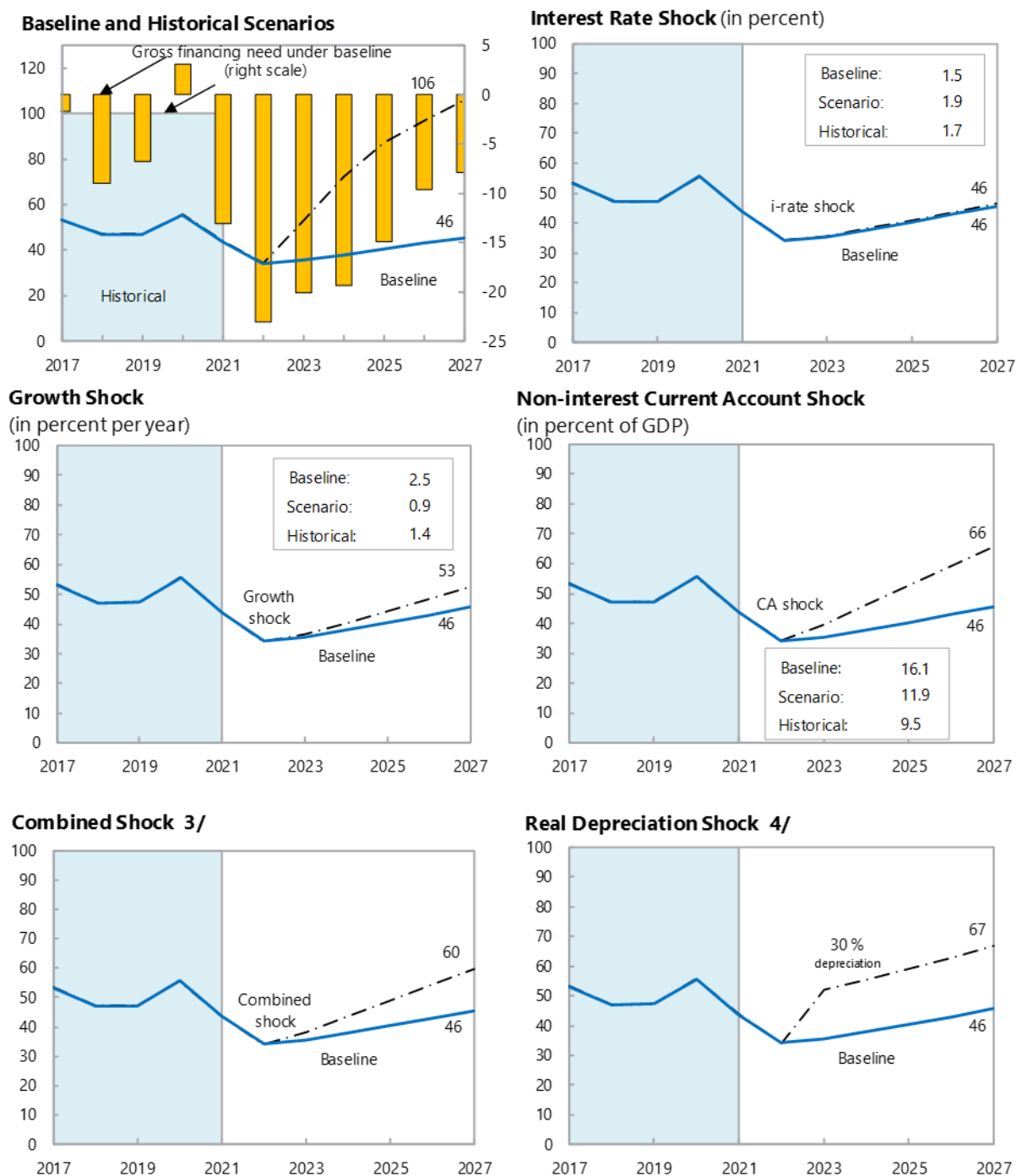
4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

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

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

Figure AIV.3. Azerbaijan: External Debt Sustainability: Bound Tests 1/ 2/

(In percent of GDP unless otherwise indicated)



Sources: IMF staff calculations and estimates.

1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.

2/ For historical scenarios, the historical averages are calculated over the ten-year period, and the information is used to project debt dynamics five years ahead.

3/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.

4/ One-time real depreciation of 30 percent occurs in 2010.

Annex V. Inflation: Sources and Outlook¹

In conjunction with inflationary pressures in the rest of the world, Azerbaijan is experiencing an episode of high inflation. The high share of imports in the consumption basket resulted in a rapid translation of global inflation to domestic inflation. The impact is now broad based and is disproportionately affecting the poor. Econometric analysis points to the strong passthrough of international food prices and the persistence of inflation.

1. Headline inflation increased rapidly in 2021. Inflation started to pick up in January with the liberalization of key regulated prices, including combustibles and utilities. By the second half of 2021, though, there were clear signs of the impact of global inflation, as international food and most commodity prices started to grow rapidly (WEO, Oct 21). This quickly fed into domestic inflation, reflecting in part the large import share, with headline inflation reaching 12 percent (y/y) in December.

2. The increase is now broad based. What started out as an increase in prices in a narrow base quickly spilled over into the rest of the consumption basket (Figure AV.1). By May 2022, about 44 percent of the items in the consumer basket reported a y/y price change of 10 percent or more, and 18 percent of the items recorded inflation above 15 percent (y/y).

3. The poor are disproportionately impacted. Food products represent more than 50 percent of the consumption basket of the bottom income deciles, resulting in higher perceived inflation rates for the poor (Figure AV.2). There is, for example, a 23 percent difference between the perceived inflation rate of the top and bottom decile. Higher informality also makes it more difficult to support vulnerable households with targeted social assistance policies.

4. Azerbaijan experienced high inflation in two recent episodes: the increase in global food prices in 2008 and the large devaluation in 2015–16. A key difference with these episodes is the aggressive use of policy rates in the past.

- In 2008, following a spike in international food prices, Azerbaijan also experienced a sharp increase in inflation. As with the current episode, the high share of food products in the CPI basket was an important factor. The second-round impact to other items in the basket was also large. The authorities responded with saving the windfall from high oil prices at the time, similar to the current episode, and sharply tightening monetary policy.
- In 2015–16, following two consecutive devaluations and rising food prices in 2016, inflation rose sharply. Notwithstanding slower service inflation due to a sizeable portion (about 13 percent) being administratively controlled. As in the earlier episode, interest rates were raised sharply to 15 percent.

5. Econometric analysis was conducted to help determine the drivers of inflation. Using monthly time series, a VAR was estimated for core inflation and the three components of headline inflation: food, nonfood, and services. The VAR includes y-o-y inflation, the y-o-y change in the

¹ Prepared by Gustavo Ramirez and Amine Yaaqoubi (MCD).

nominal non-oil effective exchange rate, the output gap (in percent of potential output) and credit to households in percent of GDP. In addition to the listed endogenous variables, international food prices, oil prices, and trade partners' CPI were added as exogenous variables.

6. Results confirm the strong passthrough of international food prices and the persistence of inflation. Food price inflation is significantly affected by international food price developments. In addition, there is important inertia in the formation of prices, with lagged inflation being significant and its coefficient in the range of 0.81 to 0.97 for the three components of the basket (food, nonfood, and services). These results point to the difficulties in curbing inflation, with international food prices high over the near term and the persistence of the inflation process.

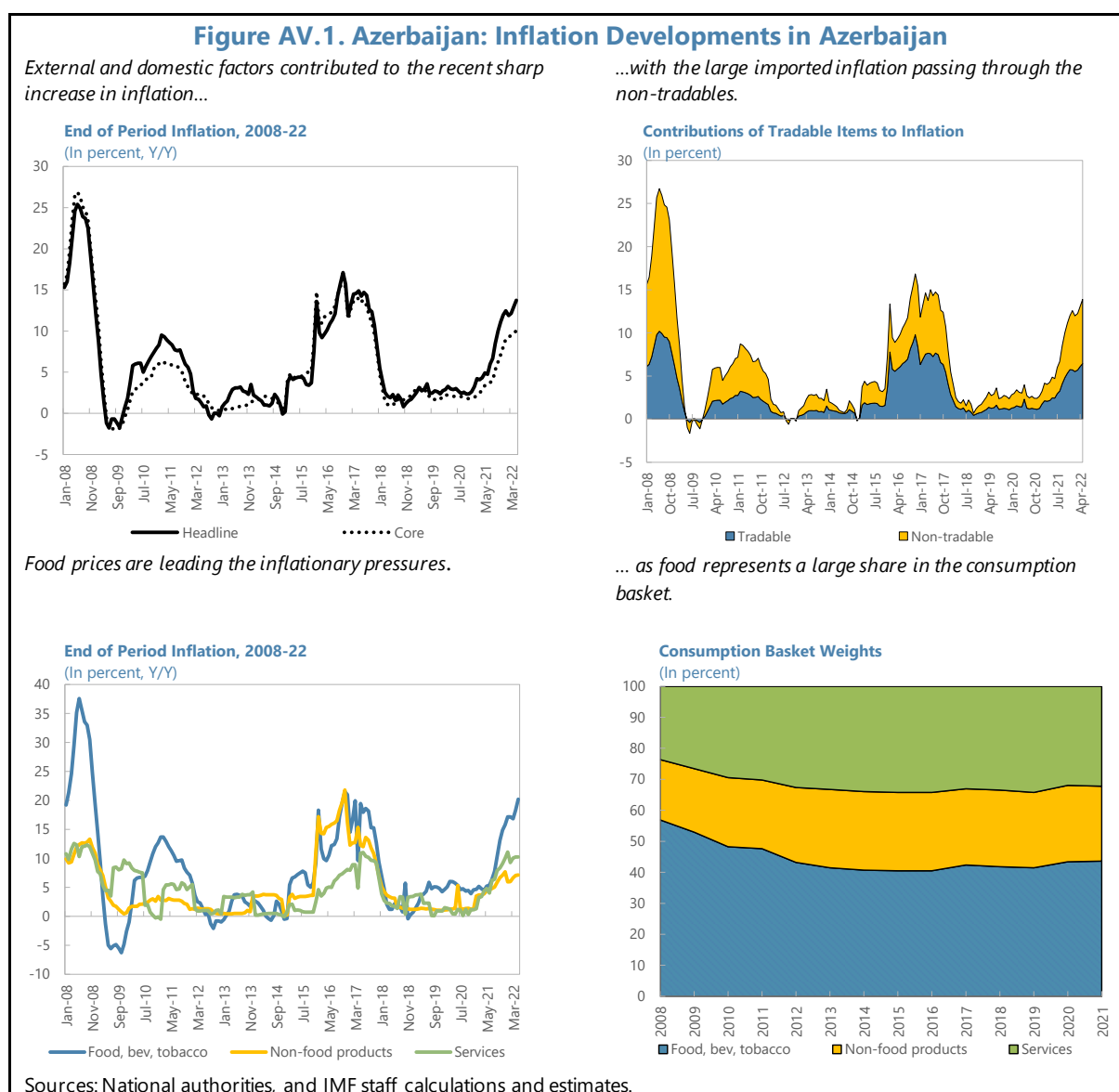
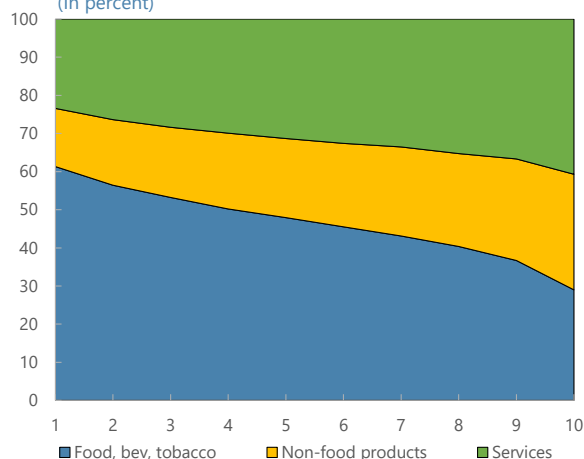


Figure AV.2. Azerbaijan: Inflation Perception by Decile

Food has a large share in poor households,...

Consumption Expenditure by Decile, 2021

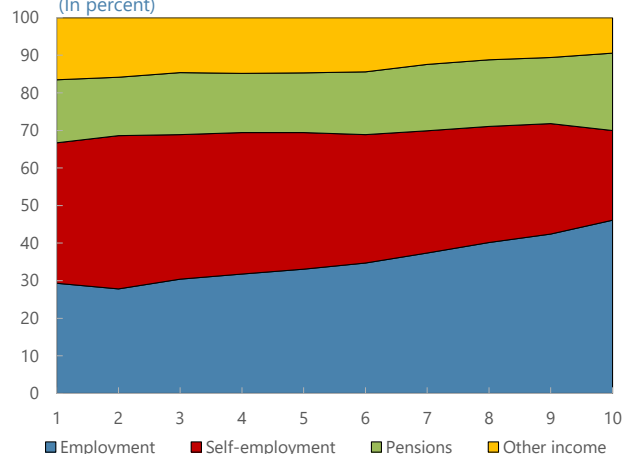
(In percent)



... which are also confronted with higher informality.

Structure of Household Income by Decile, 2021

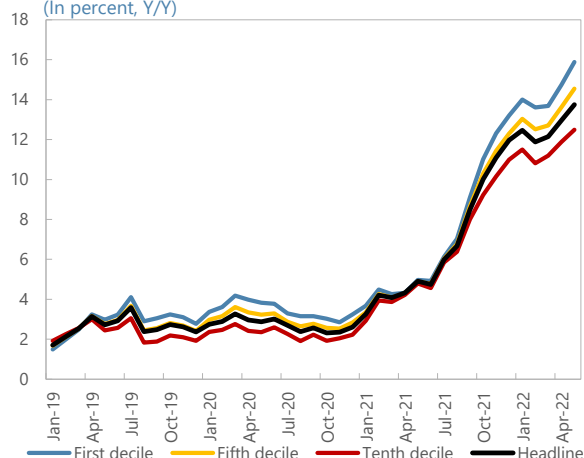
(In percent)



Recent spike in inflation has affected all households,...

Perceived Inflation by Decile

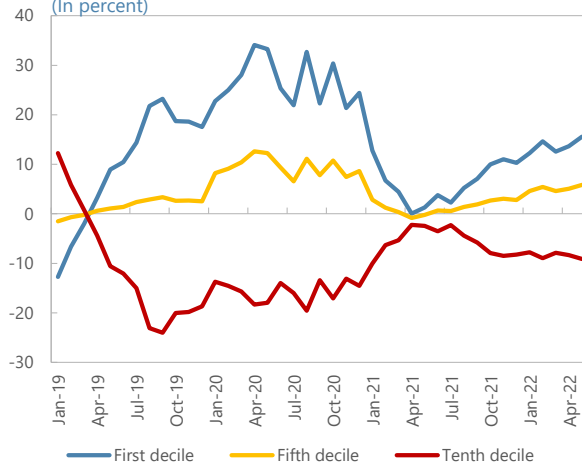
(In percent, Y/Y)



...but disproportionately the most vulnerable.

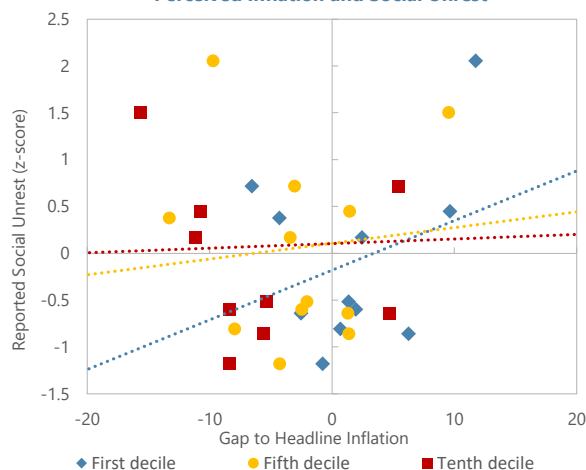
Deviation of Perceived Inflation from Headline CPI

(In percent)



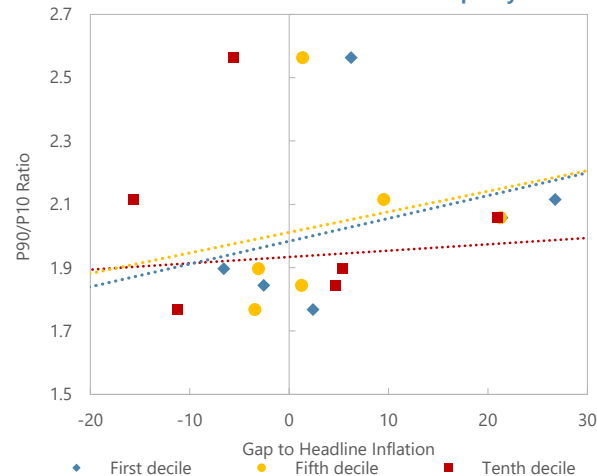
... which highlights the need for social policies,...

Perceived Inflation and Social Unrest



...to tackle potentially lasting impact on inequality.

Perceived Inflation and Income Inequality



Sources: Barret et al. (2020), National authorities, and IMF staff calculations and estimates.

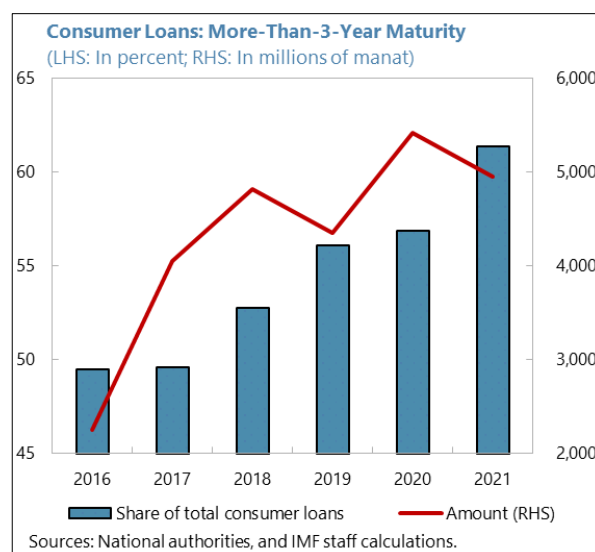
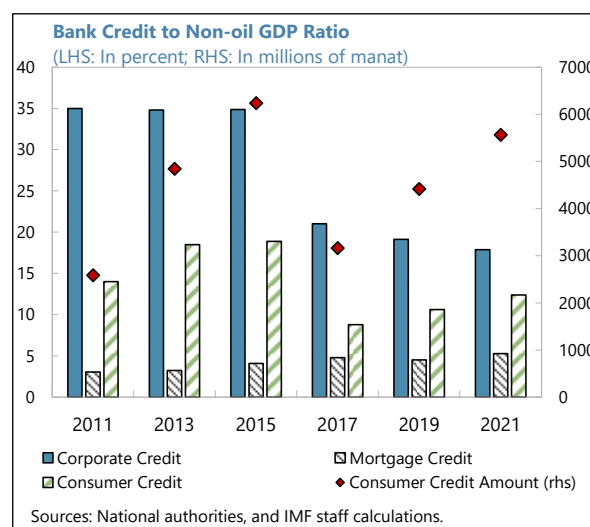
Annex VI. Consumer Loans¹

Consumer loans in Azerbaijan have been growing rapidly. The current low NPL ratio may not accurately reflect developing risks. Econometric analysis points to the risks of a sharp increase in household debt, as banks “lean into the wind”. Measures could be adopted to help mitigate risks, including updating provisioning standards and risk weights.

1. Azerbaijan is experiencing a consumer credit boom. This follows the pre-pandemic growth trajectory. The boom is concentrated in a few banks where bank profitability has also risen. International experience shows that this type of rapid growth in household leverage, in conjunction with deteriorating lending standards, is often associated with a higher likelihood of a future economic downturn or crisis; thus, it is important to monitor.

2. The low NPL ratio may not accurately reflect developing risks. There are several reasons to be cautious:

- NPLs have not yet been recognized following a period of financial sector support and the return of strong growth. As the recent Azerbaijan banking sector stress test TA mission highlighted, the consumer loan portfolio in the system is still vulnerable to shocks in the adverse scenario, in which the spike in NPL ratio is as sharp as that in the 2015–16 crisis.²
- The maturity of consumer loans is increasing. The share of loans with a maturity greater than 3 years is on the rise (text chart). Banks are stretching loan maturity in search of yields affecting medium-term solvency risks.
- Select supervision rules are outdated, including provisioning standards and the asset risk weight matrix. This could result in an underestimation of impaired loans, required provisions, and bank capital adequacy.



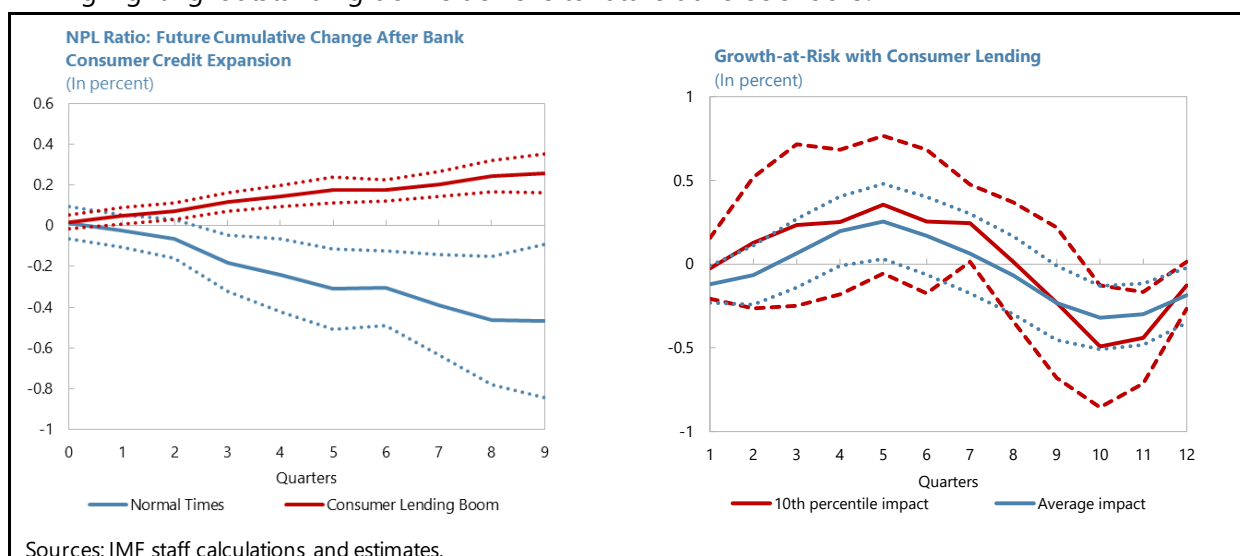
¹ Prepared by Yizhi Xu (APD).

² In the adverse scenario, we assume one standard deviation reduction in non-oil real GDP growth (5.7 percentage points), 30 percent manat depreciation, and worsening in a list of financial indicators. Note that Figure 2 panel 2 only presents the NPL ratio of local currency consumer loans. FX consumer loans have represented a much smaller share of the credit market in recent years as an effort of de-dollarization.

3. The boom likely reflects a search for yields in a few banks. Manat-denominated consumer loans are issued with higher lending rates, reflecting a higher risk premium. As banks continue to suffer from subdued profitability, there has been a strong incentive for banks to stretch profit margins by extending consumer loan business to households that have had relatively stable income. Regulatory forbearance may also have contributed.

4. Econometric analysis confirms the potential risks to macro-financial stability. Two exercises were conducted:

- An estimation of the impact of household debt on the NPL ratio shows that a one-percentage-point increase in bank-level consumer lending growth is associated with a 0.25 percentage point cumulative increase in the NPL ratio 9 quarters afterwards.³ This is consistent with findings in the academic literature.⁴
- A growth-at-risk (GaR) analysis also reveals that a one-percentage-point increase in aggregate consumer loan growth predicts an adverse impact on future medium-term real GDP growth both at the left-tail and the mean of the distribution.⁵ The impact is stronger at the left tail, highlighting outstanding downside risks to future adverse shocks.



³ The econometric specification takes the form of $\Delta NPL_Ratio_{i,t,t+h} = \beta_1 \Delta Consumer_Loan_{i,t} + \beta_2 \Delta Consumer_Loan_{i,t} \times Cons_Boom_t + \Gamma X_{i,t} + \gamma_i + \gamma_t + \varepsilon_{i,t}$ where $\Delta NPL_Ratio_{i,t,t+h}$ is bank i 's h -quarter ahead cumulative change in NPL ratio, $\Delta Consumer_Loan_{i,t}$ is bank i 's quarterly consumer loan growth rate, $Cons_Boom_t$ is a dummy if Azerbaijan's aggregate consumer loan growth rate belongs to the top quartile in full sample period. In addition, $X_{i,t}$ is a vector of bank-level controls, and (γ_i, γ_t) are respectively bank fixed-effects and quarter fixed-effects.

⁴ Mian, Sufi, and Verner (2017) study a global sample and find increase in the household debt to GDP ratio predicts lower GDP growth and higher unemployment in the medium-term. Jorda, Schularick and Taylor (2016) use a century-long data based on 17 advanced economies to find financial stability risks have been increasingly linked to household real estate lending boom. In addition, the financial stability risk associated with household debt is also studied in the October 2017 Global Financial Stability Report.

⁵ The growth-at-risk model is based on the following quantile regression $\Delta \log(RGDP)_{t,t+h}^\tau = \alpha_h^\tau + \beta_{1,h}^\tau FCI_t + \beta_{2,h}^\tau \Delta Credit_to_GDP_t^{Cons} + \beta_{3,h}^\tau \Delta Credit_to_GDP_t^{Mort} + \beta_{4,h}^\tau \Delta Credit_to_GDP_t^{Corp} + \gamma_h^\tau X_t + \varepsilon_{t,h}^\tau$, where $\Delta \log(RGDP)_{t,t+h}^\tau$ is cumulative growth in real GDP from quarter t to $t+h$, $\Delta Credit_to_GDP_t^{Cons}$, $\Delta Credit_to_GDP_t^{Mort}$, $\Delta Credit_to_GDP_t^{Corp}$ are respectively year-on-year change in consumer, mortgage, and corporate credit-to-GDP ratio, and $X_{i,t}$ are controls including year-on-year real GDP growth, year-on-year change in CPI, and quarterly change in policy rate.

5. Measures to help mitigate potential risks could be considered. These include:

- Continue to conduct stress tests and thematic inspections, emphasizing the banking sector risk-amplification channel through consumer lending and allowing the supervisor to closely monitor systemic risks to financial stability.
- The CBA could consider assigning a higher risk weight on nonperforming loans. The current risk weight matrix does not distinguish between performing and nonperforming loans. Using a higher risk weight on nonperforming loans could improve the early warning mechanism and discipline banks' risk-taking activities.
- In the medium term, provisioning rules could be modernized and aligned to the IFRS 9 framework, which accounts for expected credit loss rather than actual incurred loan loss. Operationally, since banks increase consumer lending in search of yields, the increased profit margin can be utilized to support the provisioning requirement.

Box 1. Bank Stress Testing Technical Assistance

At the request of the Central Bank of Azerbaijan, MCM provided technical assistance from October 25, 2021 to March 25, 2022 to enhance the central bank's stress testing framework and models for the banking sector. The mission focused on data issues, banks' solvency, credit risk modeling, and integration of indirect foreign exchange rate risk.

The mission identified credit risks by currency of denomination and foreign exchange rate risk as the main risks. The solvency stress testing tool developed by the IMF was populated with information on 24 Azerbaijani banks and shared with the authorities. The team used two scenarios (baseline and stressed)¹ agreed with the authorities, estimated new satellite models, and shared results with the authorities both at the level of the system and at the level of individual banks. New satellite models were estimated for credit risk by currency, lending rates, funding risks, and fee and commission income and expenses. Credit risks models were also estimated for households and corporates separately, in addition to differentiation in currency denomination. The results of the stress test reveal that, on aggregate, the impact on the banking system due to credit risk and FX risk shocks can be significant, with larger losses led by less-profitable banks.

The TA mission concluded with several technical assistance and policy recommendations. In the short-term, to improve the stress-test analysis, the authorities (CBA) were encouraged to collect data on the quality of collateral held by banks for credit risk analysis and improve the projection of interest rate risk by implementing a maturity ladder approach by time of repricing of assets and liabilities. In the medium-term, the authorities were encouraged to enhance the scenario design by enriching macro projection capacity and implementing the Growth-at-Risk framework, start banks' balance sheet and income statement data collection on a consolidated basis, and improve the quality of the supervisory data for accurate bank default rates calculation. On modernizing banking sector supervision rules, the mission suggested introducing a distinction of risk weights between banks' performing and non-performing loan exposure and switching to a more forward-looking provision model based on expected credit losses under the IFRS 9 accounting standard.

¹ The baseline scenario was based on the projections conducted by the IMF staff and included in the October 2021 World Economic Outlook. The adverse scenario was developed jointly by the IMF team and the CBA staff, which reflects downside external risks calibrated to magnitudes close to those observed during the 2015/16 banking crisis. The scenario assumes a cumulative 5.8 percent reduction in non-oil real GDP and a 30 percent depreciation of manat against USD during 2022–23.

Annex VII. SOE Reforms¹

Following the 2014–15 economic shock, the financial situation of many state-owned enterprises (SOEs) worsened, necessitating significant budgetary support. In response, the authorities identified the reduction of state participation in the existing SOEs as a priority in their strategic roadmap in 2016. However, there has been limited progress with achieving these objectives. The recent establishment of the Azerbaijan Investment Holding (AIH) in August 2020 provides an opportunity to reinvigorate the structural reforms initiated and improve the management system of state-owned enterprises.

1. Since the early 1990s, the role of state in Azerbaijan's economy has declined significantly.

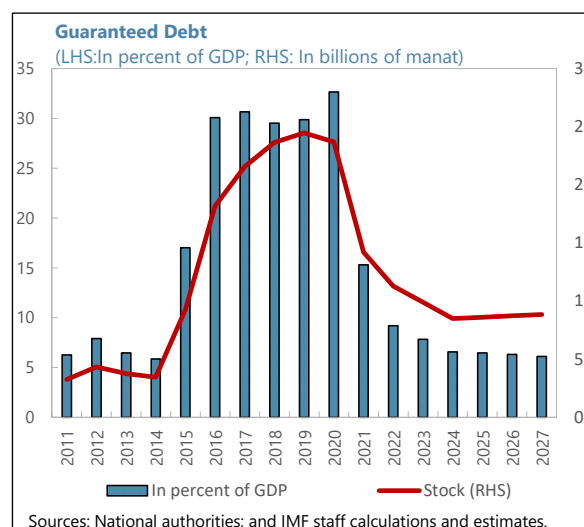
The share of the state in GDP output fell from about 70 percent in 1995 to around 16 percent by 2016 when the reform program started. During the same period, the share of state in employment fell from 56 percent to 24.6 percent.² The most prominent decline in state's share in output took place in industry (from 95 percent to 15 percent) and was relatively moderate in construction and transport. More recent data on the number of registered statistical units indicates a continued decline in the share of state-owned units. However, even with this decline, SOEs continue to play an important role in the economy, including in oil and gas production, power, water, and transport.

Distribution of Registered Statistical Unit by Type of Ownership						
	Number			Share in Total		
	2015	2019	2021	2015	2019	2021
State	10,540	10,498	10,729	11.1	8.1	6.9
Private	75,187	107,359	127,652	79.5	82.4	82.1
Municipal	1,653	1,706	1,729	1.7	1.3	1.1
Foreign	5,429	8,310	12,309	5.7	6.4	7.9
Mixed	1,754	2,450	3,016	1.9	1.9	1.9
Total	94,563	130,323	155,435	100.0	100.0	100.0

Sources: Statistical Yearbook of Azerbaijan 2021; and IMF staff calculations.

2. The oil price shock and currency devaluation in 2014–15 highlighted weaknesses in the SOEs.

While a number of SOEs were making losses even during the oil price boom, the collapse of the oil price in 2014, the devaluation of the manat in February 2015 and the subsequent floating and depreciation by another 50 percent in late 2015 and early 2016 exacerbated the situation. SOEs financial problems were also adversely impacted by two government policies: (i) keeping tariffs below cost recovery, in order to protect consumers; and (ii) keeping surplus labor in SOEs, to avoid a sharp increase in unemployment. The profits of oil company, SOCAR, previously used to support loss-making SOEs, turned into a loss in 2015. Thus, SOE's losses increased at the same time when the budget capacity to provide financial support had declined as a



¹ Prepared by Jiri Jonas (MCD).

² M. Schur and A. Haydarov, State-Owned Enterprise Reforms in Azerbaijan. In Reform, Opportunities and Challenges for State-Owned Enterprises, E. Ginting and K. Naqvi, eds. Asian Development Bank, July 2020.

result of lower oil revenues. In addition, the amount of guarantees on SOEs borrowing increased sharply at that time, creating additional fiscal risk (see chart). Outstanding guarantees jumped from about 5 percent of GDP in 2014 to 30 percent in 2016.

3. The authorities launched an effort to improve performance in 2016. Under the Strategic Roadmap on the National Economy Perspective from 2016, the authorities formulated a set of measures to improve SOEs efficiency, attract foreign investment and prepare for the privatization of selected nonstrategic SOEs. To improve SOEs performance, sectors were to be identified that would be expected to function more efficiently under private ownership, while the rest would remain in government hands, though also subject to reforms to improve governance and efficiency. The ultimate objective of the Roadmap was to diversify the economy, increase private sector participation and move to a model based on private sector-led growth.

4. With the support of IFIs, some steps were subsequently taken towards SOE reform. The World Bank, Asian Development Bank (ADB) and the European bank for Reconstruction and Development (EBRD) were all involved in assisting the government with the SOEs reforms. The assistance included improving SOE corporate governance, legal and institutional arrangements to support SOEs restructuring, promoting transparency and efficiency of SOEs, and assistance with the Improving Governance and Public-Sector Efficiency Program that contains a number of specific policy actions. The Cabinet of Ministers approved performance-based remuneration for SOEs management, and regulation of procedures for assessment of SOE efficiency (with key performance indicators – KPI – to serve as detectors of serious weaknesses). The implementation of SOE reforms was temporarily slowed due to the pandemic.

5. To further push forward the SOE reform agenda, Azerbaijan Investment Holding was launched in 2020. A number of the largest state-owned companies and enterprises, as well as business entities with a share of state capital, were transferred to the management of the AIH (see table). The objectives of the AIH include: (i) to improve SOE performance and financial soundness; (ii) to strengthen their management system and increase the efficiency and transparency of their activities; (iii) develop and monitor performance indicators to conduct SOE performance review; (iv) and to encourage private investment in markets where SOEs operate.³

Budget Support to SOEs (In millions of manat)			
	2020	2021	Proj. 2022
Subsidies	403	14	464
Capital Investment	1,264	457	0
Debt Guarantees	195	233	174
Total	1,862	704	174
Total in % of GDP	2.6	0.8	0.4

Sources: Ministry of Finance; and IMF staff calculations.

6. Since its launch, AIH took initial steps to assess SOE performance, strengthen SOE monitoring, and develop a new SOE governance system. International consultancies were hired to assess the performance of some SOEs in AIH's portfolio. These assessments are to inform action plans to address the identified problems. An Integrated Information System was

³ International experience shows that the MoF will need to institutionalize its role in ownership monitoring framework outside the executive and supervisory boards of AIH, as it would have only a minority vote.

established to ensure a centralized reporting of SOEs in AIH portfolio starting with 2021 data. Furthermore, a supporting legal framework including new draft charts for AIH's SOEs is being developed. Finally, the process of developing corporate strategies, defining KPIs and developing annual performance targets and key medium-term business plan indicators has started.

7. It is too early to assess the impact of the steps taken thus far on SOE performance. Whether the AIH creation will represent the start of genuine SOE reforms remains to be seen, though the steps described above go in the right direction and there are encouraging signs that the budgetary support to SOEs has been declining. However, there has yet to be a tangible progress in the divestiture of state ownership in large SOEs (see chart). Kazakhstan experience with the SOE holding company (see Box) offers some useful lessons and directions for AIH to move ahead with its SOE reform agenda.



Box 1. Kazakhstan Investment Holding Samruk Kazyna

Kazakh Investment Holding (KIH) holds a significant amount of nonfinancial SOE's assets (almost 40 percent of GDP by end-2019). Like Azerbaijan, the KIH's portfolio includes major oil and gas company, national airline, electricity system operator and others. KIH enjoys operational independence from government, It provides centralized monitoring and published annual reports containing a range of information about SOEs under management, including key performance and financial indicators, ongoing and planned investment projects, and corporate management. Government sets an overall borrowing envelope and the KIH then allocates it among the SOEs. KIH also actively participates in preparing SOEs assets for privatization.

8. The effort to improve SOE performance need to start with the understanding of reasons behind the underperformance. The causes of underperformance could be both internal and external. External reasons are often related to less than full reimbursement by the government of the public service obligations (PSO), which could include provision of services for social reasons, or tariff policies that don't allow SOEs to recover fully its financial and operational costs. In turn, mixing public policy and commercial objectives makes it more difficult to evaluate SOE performance, which could in turn weaken SOE management incentives to operate in an effective way, and could also give rise to conflict of interest.

9. The next steps include defining clearly and formally the SOEs to remain under state ownership and their role. The authorities could update the 2016 list of SOEs to remain under state ownership. There should be a clear separation of non-commercial and commercial activities, and non-commercial functions, such as the provision of social services, should be either vested with separate entities supported by budget transfers. Alternatively, if such activities are to be conducted by SOEs, they should be transparently recorded and fully financed by budgetary subsidies or capital injections. SOEs should then be able to operate mainly on commercial basis, with full cost-recovery of its activities.

10. Clear definition of SOEs role should be accompanied by increased transparency and performance monitoring framework. The separation of noncommercial and commercial activities, and avoidance of potentially conflicting commercial and public policy objectives, should in turn allow better monitoring of SOEs performance. Making financial performance less affected by PSO and more dependent on internal factors should also strengthen management incentive to improve operational efficiency, as would performance-based remuneration. At the same time, an effective monitoring framework would further support SOEs financial discipline, but it would also serve as a detector of lingering or new problems and provide a better understanding of fiscal risks to the state as SOEs owner.

11. An alternative to SOE restructuring is the divestiture of state assets to private sector. Under the right conditions, attracting private sector participation could be a good option to improve SOE performance – either through sale of part of or all SOE assets, or through public private partnership (PPP), with appropriate fiscal risk management. For the effort to attract private participation to be successful, steps needs to be taken to ensure: (i) financial attractiveness of the offered SOE (debt restructuring, shedding of excess labor); and (ii) commercial attractiveness of the environment in which private sector is to operate. This concerns mainly legal and regulatory framework, but also ensuring competitive neutrality – equal treatment of SOEs and private companies.⁴ Azerbaijan’s failure to attract private investors in some of the large SOEs suggests that there is room for improvement in these areas.

12. Assessing and mitigating social impact should be part of SOE restructuring or divestiture. Often, as part of their social role, SOEs have been employing a larger workforce than would be required for efficient operations. Thus, successful SOEs reform or divestiture could require shedding of excess labor, and measures to mitigate social impact would be required. A number of approached have been followed in such circumstances, including offering employees the incentives to other job opportunities via severance payments and retraining programs, provision of temporary financial assistance (including extension of medical benefits) and provision of subsidies to new employers. Current and projected high windfall oil revenues provide Azerbaijan with ample fiscal space to finance such mitigating measures.

13. The experience of other countries suggests that successful SOEs privatization or reform could bring significant benefits.⁵ Serious SOEs reform or privatization could carry short-term costs, including the need to undertake financial restructuring to make the SOEs attractive to private investors, and to provide financial support to employees affected by labor shedding. However, the long-term benefits of improved efficiency and less need of budgetary support (plus increased tax or dividends payments to budget) are likely to exceed the short-term costs. This front-loading of costs and back-loading of benefits should make SOE reforms particularly attractive from current Azerbaijan’s perspective. High oil revenues allow to cover such costs without threatening fiscal

⁴ Often, SOEs benefit from a more favorable regulatory and tax treatment, preferential access to finance, free land, or preferential access to inputs and government procurement.

⁵ However, it is also recognized that privatization alone does not automatically produce these benefits, and that pre-conditions for successful privatization, including the regulatory framework and well-managed privatization process, are required. See Saul Estrin and Adeline Pelletier, Privatization in Developing Countries: What Are Lessons of Recent Experience? *The World Bank Research Observer*, vol. 33, no. 1 (February 2018).

sustainability. At the same time, the long-term projected decline in oil production and oil-related revenues underscores the importance of developing productive non-oil sector capable of taking over the baton of growth driver from the oil sector. Successful SOEs reform should be a key part of this handover.

Table A.VII.1. Azerbaijan: SOEs Under Azerbaijan Investment Holding (Energy and Natural Resources)	
SOCAR	The largest SOE involved in exploring and developing, producing, processing, and exporting oil and gas
AzerEnerji	Provides and operates national electric system
Azerishiq	Purchases and sells electricity to consumers
AzerGold	Exploration, production, processing, and marketing of ferrous and non-ferrous metals
Transport	
Azerbaijan Railways	Railway transportation and infrastructure
Azerbaijan Airlines	Largest state-owned passenger air carrier
Baku International Sea Trade Port	Provides marine port services
Azerbaijan Caspian Shipping	National and international maritime shipping
Baku Metropolitan	Provision of underground transportation and development and maintenance of infrastructure
Baku Bus	Passenger transportation within Baku
Utilities	
Azerbaijan Amelioration and Water	Water management in Azerbaijan
Azeristiliktechizat	Provision of heat and hot water supply to residential and nonresidential buildings
Azersu	Water extraction, treatment, and transportation. Sewerage and central drinking water supply.
Tamiz Shahr	Waste management in Baku
Finance	
ABB	Largest state-owned bank. Key role in social payment.
Azersigorta	State insurance company
Azer Turk Bank	Open joint-stock company with 75 percent state share
Source: Companies of Azerbaijan Investment Holding - Finance - AIH (aih.gov.az) .	

Annex VIII. Anti-Corruption and Rule of Law Issues¹

The authorities are taking welcome steps to improve governance. An ambitious judicial reform started in 2019 and the 2022–26 National Anti-Corruption Action Plan (NACAP) has been recently approved. However, the implementation of the anti-corruption legislation has thus far been uneven. Critical governance weaknesses, including the limited transparency in the extractive industries and other SOEs, judicial independence, and an ineffective institutional framework to combat corruption, remain to be effectively addressed. The failure to strengthen governance would significantly hamper Azerbaijan's ability to establish a more diversified economy and private sector-led growth.

- 1. In recent years, the authorities have been taking steps to address governance issues and strengthen the rule of law, but corruption vulnerabilities remain persistent in various sectors of the economy.** In 2019, an ambitious judicial reform to improve judicial efficiency was announced by the President. A review of the legislative framework related to protection of property rights is also ongoing. Fundamental risks are present in procurement, business licensing, and extractive industries.² The recently approved National Anti-Corruption Action Plan for 2022–26 (“NACAP”) addresses some of these critical areas by requiring relevant state agencies to take measures to strengthen procurement procedures and conduct corruption risk assessments in public investment projects.
- 2. Corruption and governance weaknesses could undermine efforts to promote private sector led growth.** Progress has been made in addressing administrative corruption in public service delivery by establishing and operating the Azerbaijan Service Assessment Network, an agency dedicated to streamlining and improving access to public services by citizens, and small and medium-size enterprises. Still, people's perception of corruption in the public sector remains high, with Azerbaijan's score of 30/100 in the Transparency International's Corruption Perception Index, and no change in the score for the last three years.³ The Council of Europe's Group of States Against Corruption (GRECO) and the OECD Anti-Corruption Network also highlighted the need to address systemic corruption.⁴
- 3. Implementation of the anti-corruption legislation has been uneven, and the framework requires strengthening.** Legal standards on transparency and accountability of top officials, in particular the rules related to conflict of interest, asset disclosure, and public access to

¹ This annex was prepared by Tina Burjaliani and Heena Gupta (LEG) and covers efficiency of legislative and institutional frameworks against corruption as well as frameworks pertinent to protection of property rights and contract enforcement.

² OECD-ACN-Azerbaijan-Round-4-Monitoring-Report-ENG.pdf, p. 25. Concerning transparency in SOEs, *see also* OECD (2022), *Anti-Corruption Reforms in Azerbaijan: Pilot 5th Round of Monitoring Under the Istanbul Anti-Corruption Action Plan*, OECD Publishing, Paris, <https://doi.org/10.1787/3ae2406b-en>, pp. 91-97. On procurement *see* *Id.* at 81-83.

³ The CPI measures perception of corruption in public sector by experts and businesspeople. The score shows the perceived level of corruption on an ascending scale of 0–100. The country's score is a combination of at least 3 data sources drawn from 13 different corruption surveys and assessments. *See* [2021 Corruption Perceptions Index - Explore the... - Transparency.org](https://www.transparency.org/en/cpi).

⁴ *See for instance* [OECD-ACN-Azerbaijan-Round-4-Monitoring-Report-ENG.pdf](#) and [FOURTH EVALUATION ROUND \(coe.int\)](#).

information fall short of international standards and best practices.⁵ The reforms to address these challenges are slow. NACAP envisages the development of conflicts of interest legislation by 2024 and proposals on identification of beneficial owners of legal entities participating in public procurement by 2026.

4. The current asset disclosure regime for top officials is inadequate and rarely enforced. The Anti-Corruption Act requires asset disclosure but top officials in the executive branch, MPs, judges and prosecutors are either excluded or inadequately covered.⁶ In practice, the asset declarations are not submitted, verified or made public.⁷ While the NACAP envisages the introduction of electronic submission of asset disclosure declarations by 2024, inadequate coverage of obligated subjects, scope of disclosure, and public accessibility of declarations remain unaddressed.

5. The institutional framework designed to counter corruption has been largely ineffective in addressing allegations of grand corruption. The lack of autonomy has been identified as a key impediment to the efficiency of anti-corruption institutions. Investigations of publicly exposed large scale corruption allegations do not take place citing legislative restriction to use media articles and journalist investigations as a source of information in criminal investigations even though art. 46.2 of the Criminal Procedural Code includes “information from media” as a ground for starting an investigation.⁸

6. Transparency in the extractive industry remains limited. Lack of legal requirement to collect information on beneficial owners of companies and to publicly disclose it through easily accessible registries, weak conflict of interest system and inability to monitor participation of Politically Exposed Persons contribute to opacity and corruption vulnerabilities in the sector. The State Statistical Commission, agency responsible for ensuring transparency in the extractive industry since Azerbaijan left EITI,⁹ publishes some financial data. The NACAP does not cover the extractives and envisages development of a concept on BO transparency for limited category of companies by 2026 even though extensive analytical and preparatory work has been done since 2017 with the assistance of international partners.¹⁰

⁵ OECD (2022), *Anti-Corruption Reforms in Azerbaijan: Pilot 5th Round of Monitoring Under the Istanbul Anti-Corruption Action Plan*, OECD Publishing, Paris, <https://doi.org/10.1787/3ae2406b-en>, in particular pp. 31-33, 39, 91-92.

⁶ *FOURTH EVALUATION ROUND* (coe.int) pp. 6–9.

⁷ *OECD Anti-Corruption Network for Eastern Europe and Central Asia (ACN)*, p. 58; See also *OECD-ACN-Azerbaijan-Round-4-Monitoring-Report-ENG.pdf*, p. 38.

⁸ OECD (2022), *Anti-Corruption Reforms in Azerbaijan: Pilot 5th Round of Monitoring Under the Istanbul Anti-Corruption Action Plan*, OECD Publishing, Paris, <https://doi.org/10.1787/3ae2406b-en>, pp. 132-133. *OECD-ACN-Azerbaijan-Round-4-Monitoring-Report-ENG.pdf* p. 76.

⁹ Presidential Decree of July 28, 2020. In 2017, Azerbaijan withdrew from the Extractive Industries Transparency Initiative (EITI) in response to the EITI Board decision to suspend it because of the lack of an enabling environment for civil society, a violation of the organization’s requirements on multi-stakeholder engagement and its civil society protocol. See at [Azerbaijan withdraws from the EITI | Extractive Industries Transparency Initiative; Azerbaijan: Assessment of progress with corrective actions 1\(i-iii\) | Extractive Industries Transparency Initiative \(eiti.org\)](#).

¹⁰ For detailed information on projects related to introduction of BO transparency in Azerbaijan, see [Beneficial ownership \(oilfund.az\)](#).

7. Prioritizing the implementation of AML/CFT measures is key to mitigate corruption and the laundering of related proceeds. The NACAP prioritizes AML/CFT measures to prevent and combat corruption. The current gaps in monitoring requirements pertaining to politically exposed persons, transparency of beneficial ownership of companies, AML/CFT supervision, money laundering convictions, international cooperation are among the measures that should be accelerated to address corruption risks and facilitate a positive outcome for the currently ongoing AML/CFT assessment by the Council of Europe's MONEYVAL Committee.

8. The state of the rule of law and the judicial independence has been a concern, despite the Constitutional guarantees in place. The practice of undue interference of the executive branch over the Judicial Legal Council (JLC), which has extensive powers in matters related to the appointment, promotion and disciplining of judges, and allegations of corruption within the judiciary, have been reported.¹¹ Transparent and merit-based appointment of judges, full institutional and functional independence of the JLC,¹² development and implementation of clear, objective and transparent criteria for appointment of senior prosecutors, introduction and implementation of transparency and accountability standards for judges and prosecutors are few among necessary measures to address the key challenges.¹³ The authorities plan to improve regulations related to JLC, including its composition, by 2026, as provided by the NACAP.

9. The government has been undertaking measures to improve judicial efficiency by introducing technology and streamlining the procedures. An ambitious judicial reform was announced by the President in 2019. Presidential Decree of April 3, 2019, established the specialized courts for commercial dispute resolution to ensure high quality of judicial process. Commercial courts were opened in Baku and five other cities by January 1, 2020. Contract enforcement process has been simplified by introducing electronic filing system of initial complains in commercial cases. While use of technology increases judicial efficiency, it is not sufficient to address the fundamental concerns on independence and impartiality of judges. Measures are being undertaken to promote alternative dispute resolution. The law on mediation was adopted and a Mediation Council established with trained and certified mediators available. Legislative framework on arbitration is being prepared.

10. Review of legislative framework on property rights, especially those related to registration, tenure and management of land is ongoing. Digitalization of cadastral plans made property registration system more transparent and the process easier. Legal procedures related to management and disposal of municipal lands are cumbersome and vulnerable to abuse and manipulation. The NACAP envisages the pertinent legislative reform to be completed by 2024. The

¹¹ UN Human Rights Committee, Concluding Observations on Azerbaijan, UN Doc. CCPR/C/AZE/CO/4, 16 November 2016; [PACE - Doc. 13084 \(2012\) - The honoring of obligations and commitments by Azerbaijan \(coe.int\)](#); [PACE - Doc. 14403 \(2017\) - The functioning of democratic institutions in Azerbaijan \(coe.int\)](#); [OECD-ACN-Azerbaijan-Round-4-Monitoring-Report-ENG.pdf](#), pp. 41–49.

¹² The structure of the Judicial Legal Council see [STRUCTURE OF THE JUDICIAL-LEGAL COUNCIL \(judicialcouncil.gov.az\)](#).

¹³ OECD (2022), *Anti-Corruption Reforms in Azerbaijan: Pilot 5th Round of Monitoring Under the Istanbul Anti-Corruption Action Plan*, OECD Publishing, Paris, <https://doi.org/10.1787/3ae2406b-en>, pp. 79-86; see also [FOURTH EVALUATION ROUND \(coe.int\)](#); [OECD-ACN-Azerbaijan-Round-4-Monitoring-Report-ENG.pdf](#).

Constitution requires due process and adequate compensation for confiscation of private property for public good (art. 29 § 4). Property related disputes are decided by the judiciary in accordance with the Civil Code and there are no separate mechanisms for complaining against or challenging decision of property registries and mapping or cadastral agencies.

Prioritized Actions

11. Effective anti-corruption strategies require comprehensive legislation for the prevention and punishment of corruption offences, an effective institutional framework that enforces law rigorously, and broad stakeholder participation in policy-making and monitoring.

To accelerate anti-corruption and rule of law reforms, the authorities should take the following measures:

- The anti-corruption legal and institutional framework needs to be upgraded and the implementation enhanced in line with international standards and best practices, including the recommendations made by the Council of Europe's GRECO and MONEYVAL, and OECD Anti-Corruption Network.
- Anti-corruption strategies, including the NACAP, should provide concrete measures to ensure transparency in the extractive industry, *inter alia*, by preparing a comprehensive corruption risk assessment of the sector, introduction of transparency standards for SOEs such as the disclosure of beneficial ownership information, and the introduction of safeguards against undue influence.
- The current asset disclosure system for top officials should be brought in line with international best practice (especially the G20 High Level Principles on Asset Disclosure by Public officials), cover MPs, executive branch officials, judges and prosecutors and should be enforced vigorously. The asset disclosure declarations of top officials should be made public and should cover *inter alia* assets beneficially owned abroad.
- The composition of the Judicial Legal Council should be amended in line with international best practices (especially considering the Council of Europe CCJE Opinion no. 10 on Council for Judiciary in the Service of Society and Opinion no.24 on Evolution of Councils for Judiciary and Their Roles in Independent and Impartial Judicial Systems) and political influence over appointment and dismissal of judges and prosecutors should be eliminated to address the key challenges of rule of law and effective enforcement of anti-corruption frameworks.
- Revision and upgrading of legislative framework on property rights, especially streamlining the rules on real estate transactions, should be completed. Recognition and enforcement of property rights, especially in rural areas and places where large government-backed development projects are implemented should be enhanced.



Appendix I. Draft Press Release

IMF Executive Board Concludes 2022 Article IV Consultation with the Republic of Azerbaijan

FOR IMMEDIATE RELEASE

Washington, DC – June [XX], 2022: The Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation¹ with Azerbaijan.

The Azerbaijan economy has recovered rapidly from the pandemic, but inflation and the war in Ukraine present new challenges. Real GDP increased by 5.6 percent in 2021, led by non-oil GDP which rose by 7.2 percent, while oil GDP increased by 1.8 percent. The war in Ukraine has so far had a limited impact on the real economy and growth continued to be strong in the first half of 2022, driven by the non-oil sector and strong consumer demand. Global inflation has fed into a broad-based increase in the CPI basket, with inflation reaching 12.0 percent in December 2021, and 13.7 percent in May 2022.

On the back of high oil prices, external and fiscal balances have improved significantly. Compared to a small deficit in 2020, the current account balance recorded a surplus of 15.2 percent of GDP in 2021, as SOFAZ oil revenues increased by 60 percent. The overall fiscal balance improved by 11 percent of GDP, reaching a surplus of 4 percent in 2021, and the non-oil primary deficit improved by about 7 percent of non-oil GDP (to 23.7 percent) in 2021. In 2022, the authorities have re-introduced a revised fiscal rule targeting the non-oil primary balance and debt-to-GDP ratio.

Economic activity is projected to moderate in 2022 and decelerate further in the medium term. Real GDP is projected to grow by 3.8 percent in 2022, with non-oil GDP growing at 5.5 percent. In the medium term, GDP growth will slow to 2.5 percent, mostly supported by the non-oil economy. Inflation is projected to remain elevated in 2022 and then return to the upper bound of the CBA target band (4±2 percent) by end-2024 and remain around the mid-point thereafter. High global energy prices are projected to boost exports and fiscal revenues over the medium term.

Risks to the outlook have increased due to the war in Ukraine but remain broadly balanced. The negative impact of sanctions on Russia or a worsening of the situation in Turkey could weigh on the outlook. The war in Ukraine poses a risk for food security. A prolonged war in Ukraine could impede Azerbaijan's access to its main markets for wheat and other food staples, while limited access to fertilizers and other inputs could hinder agricultural production. Domestic risks include fiscal risks from SOEs and a

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.

deterioration of banks assets' quality. High oil revenues could also lead to pressures to further increase budgetary spending. Higher oil and gas prices resulting from ongoing geopolitical tensions would benefit Azerbaijan.

Executive Board Assessment²

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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>.

Azerbaijan: Selected Economic Indicators

Population (2021 est.): 10.12 million		Literacy/Poverty rates: 100.0 (2018)/5.4 (2018)				
Quota (in SDR million): 391.7		Per capita GDP (in US\$, 2021): 5,398				
Main products and exports: Oil, gas, and fruits.		Key export markets: Italy, Turkey, Israel				
		2019	2020	2021	Projections	
					2022	2023
Output						
Real GDP growth (in percent)		2.5	-4.2	5.6	3.8	2.6
Real non-oil GDP growth (in percent)		3.6	-2.6	7.2	5.5	3.7
Real oil GDP growth (in percent)		0.7	-6.9	1.8	0.7	0.5
Employment						
Unemployment rate (in percent)		4.8	7.2	6.0	5.9	5.8
Prices						
Consumer price index (period average)		2.7	2.8	6.7	12.3	9.5
General government finances						
Revenue (including grants, in percent of GDP)		41.5	33.7	36.5	38.7	39.0
Expenditure (in percent of GDP)		32.5	40.4	32.4	29.0	30.2
Current expenditure		20.8	28.8	23.1	21.6	23.0
Capital spending and net lending		11.7	11.5	9.3	7.4	7.1
Fiscal balance (in percent of GDP)		8.9	-6.7	4.1	9.7	8.8
Non-oil primary fiscal balance (in percent of non-oil GDP)		-26.6	-31.1	-23.8	-25.4	-23.9
General government gross debt (direct borrowing) 1/		17.7	21.3	26.4	20.0	21.2
General government gross debt including guarantees		47.5	54.0	41.8	29.2	29.1
Money and credit						
Broad money (including foreign currency deposits, percentage change)		19.9	1.1	18.7	14.9	12.2
Bank credit to the private sector (percentage change)		15.2	-0.7	16.7	9.1	10.2
Balance of payments						
Current account balance (in percent of GDP)		9.1	-0.5	15.2	24.6	21.6
Foreign direct investment (in percent of GDP)		-2.9	-1.8	-3.8	-3.4	-3.1
Gross international reserves (in months of non-oil imports)		5.4	6.8	6.5	6.0	6.0
Exchange rate						
REER (average, percentage change)		3.9	4.3	2.0	...	...
Sources: National authorities; and IMF staff estimates and projections.						
1/ Starting in 2021, includes guarantees issued to Agracredit for its acquisition of distressed assets from the IBA.						