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**Statement by Mr. Trabinski and Mr. Muradov on Republic of Azerbaijan
Executive Board Meeting
July 20, 2022**

On behalf of our Azerbaijani authorities, we would like to thank staff for their candid report and the productive discussions during the Article IV mission in Baku. The authorities broadly concur with staff's analysis of the macroeconomic and financial stability outlook and their policy recommendations in these areas.

Azerbaijan remains committed to a close partnership with the IMF, as the economy moves forward and policy makers will have to grapple with new challenges, such as those stemming from the war in Ukraine or the need for a green and digital transition. Over the years, Azerbaijan has had a fruitful cooperation with the Fund, benefiting from financial assistance in the early years after independence and from various technical assistance more recently. The Fund's contributions to the improvement of macroeconomic policies and management are very much appreciated by our authorities.

Latest developments and outlook

Over the last few years, Azerbaijan faced the twin shocks of the pandemic and the ensuing decline in oil prices. In response to these shocks, the authorities implemented a comprehensive policy package to contain the pandemic and mitigate its impact on the economy. A sizeable relief package that included an increase in health expenditures, tax exemptions to affected businesses, and financial assistance to people who lost their jobs during the pandemic has been implemented. The Central Bank of Azerbaijan (CBA) also lowered the refinancing rates, extended a blanket deposit guarantee scheme, and introduced a moratorium for late fees and interest rate penalties. In addition, the authorities implemented a successful vaccination policy. As of July 13, 2022, more than 53 percent of the population has received the first shot, and more than 48 percent of the population are fully vaccinated. Over 33 percent of the population has also received at least one booster shot. The authorities are closely monitoring data on new infection cases as well as on the new variants of the virus

and they are responding accordingly. These measures helped Azerbaijan withstand the shocks and supported its solid recovery in 2021.

This year, the war in Ukraine and its repercussions represent another external shock for the economy of Azerbaijan. Increasing food prices, inflation, supply chain disruptions, as well as the sanctions imposed on Russia create new challenges. While higher oil prices can benefit the economy and ensure additional fiscal space, the abovementioned factors hinder growth prospects. Nevertheless, our authorities are committed to continuing their prudent macroeconomic policies and management, enhancing the scope of structural reforms, and supporting the most vulnerable during these difficult times. During the first half of 2022, the economy has demonstrated solid growth, pursuing its rapid recovery from the pandemic.

Fiscal policy

The authorities are committed to maintaining a prudent and sustainable fiscal stance. Ensuring fiscal sustainability and decreasing the dependence on oil revenues are important pillars of fiscal policy. Our authorities followed a conservative approach to the 2022 budget, assuming an oil price of \$50 per barrel and later \$70 per barrel for the 2022 supplementary budget. The main purpose of the supplementary budget is to promote the reconstruction efforts in the newly liberated territories after the war, finance food security measures, and support the most vulnerable. Most of the windfall from higher oil prices will be saved.

The authorities agree with staff and are committed to growth-friendly medium-term fiscal consolidation. The first-ever fiscal rule in Azerbaijan was introduced in 2019 but had then to be suspended during the pandemic. It was revised and reintroduced in 2022, taking into consideration previous experience and the potential shortcomings of the original fiscal rule. The reintroduced fiscal rule is simpler and easier to understand, prevents procyclicality, and focuses on two main objectives: decreasing the non-oil primary fiscal deficit and ensuring a sustainable debt-to-GDP ratio in the medium term. Our authorities would like to thank the Fund for its technical assistance in designing and, later, revising the fiscal rule.

The authorities are also working on various revenue and expenditure measures to decrease the non-oil primary fiscal balance. Here, the main areas of focus are improving tax policy and administration, enhancing digitalization, reducing tax exemptions and holidays, as well as modernizing the tax systems, in particular in the property and income tax areas. Expenditure side measures include increasing the efficiency and accountability of public investment spending, optimization of the social security benefits, and reducing subsidies.

One of the main cornerstones of the public financial management reforms has been increasing fiscal transparency. According to the latest assessment of the International Budget Partnership, Azerbaijan is one of the top performers, improving by 37 points compared to the previous assessment, and currently ranking as 44th among the 120 countries assessed within

the framework of the Open Budget Survey. Azerbaijan is also assessed as one of only 17 of the 120 surveyed countries that publishes all eight required budget documents to ensure fiscal transparency.

Monetary policy and the financial sector

Amid mounting inflationary pressures, the CBA has reversed monetary easing and raised the policy rate in a series of meetings in the second half of 2021 and beginning of 2022. Inflationary pressures are mostly due to external factors and, to some extent, domestic measures such as adjustments to the regulated fuel and water tariffs. The authorities agree with staff that further monetary tightening may be needed considering that inflation is becoming broad based.

In this context, the authorities are also working on improving the monetary policy framework to improve the effectiveness of the monetary transmission mechanisms. While the de facto peg is effective in containing inflation, the authorities have set the goal of increasing exchange rate flexibility and transitioning to inflation targeting. The new governor of the CBA has announced the improvement of the monetary transmission mechanism as one of the short-term objectives to ensure the effectiveness of the monetary policy. Developing an active money market, de-dollarizing the economy, and strengthening the analytical capacity of the CBA are further short-term objectives pursued by the CBA to ensure a swift transition to a more effective monetary policy framework. In achieving these objectives, the CBA will closely work with Fund staff and benefit from IMF capacity development (CD). In this context, the CBA has already implemented several preparatory projects.

Financial sector indicators are solid and, overall, the financial sector has demonstrated strong resilience to the pandemic. The authorities have successfully phased out the pandemic-related support to the financial sector. The CBA is closely monitoring trends in consumer lending, which shows some indications of picking up in a few banks, and it stands ready to take the necessary measures based also on the lessons drawn from the crisis in 2015-2016.

The banking system's exposure to the consequences of the sanctions imposed on Russia so far is very limited, and the size of the only Russian bank subsidiary in Azerbaijan is negligible. In this context but unrelated to the sanctions imposed on Russia, many Azerbaijani banks are experiencing challenges with correspondent banks in the United States and Europe, including delayed processing of payments that disrupt cross-border trade. In several instances, banks were forced to choose settlements in currencies other than the US dollar and the euro for cross-border trades. Our authorities would like to request the support and cooperation of the relevant actors in the United States and Europe to solve this longstanding challenge.

Structural policies

Our authorities are committed to diversifying the economy away from oil and ensuring inclusive and sustainable private-sector-led growth. In recent years, Azerbaijan has implemented a series of reforms to strengthen governance, increase transparency, reduce red tape, and improve the business environment. Our authorities declared their commitment to continue judicial reforms. Commercial courts have been established in major cities. A randomized and automatic electronic assignment system of cases to judges has been introduced to improve contract enforcement.

In 2021, President Aliyev signed a decree to approve the National Priorities for Socio-Economic Development: Azerbaijan 2030. This framework document sets out an ambitious roadmap for long-term development with the following key priorities: building a competitive economy, supporting the development of an inclusive society, developing human capital, sustainably reintegrating liberated territories, and achieving a cleaner environment and greener growth. Based on this document, the Socio-Economic Strategy for 2022-2026 has been developed by the cabinet of ministers. The National Priorities for Socio-Economic Development are aligned with the goals of the United Nations 2030 Agenda for Sustainable Development.

Reducing the footprint of state-owned enterprises (SOEs) in the economy and improving their performance remains another key priority. The newly established Azerbaijan Investment Holding (AIH) focuses on improving the governance, financial soundness, accountability, efficiency and transparency of SOEs.

Our authorities wish to express their unease with the methodology used to assess governance issues during the Article IV consultation process. While the New Framework for Enhanced Engagement on Governance, approved by the IMF Executive Board in 2018, envisages the use of third-party indicators as part of the assessment, our authorities consider that the transparency of the process for selecting and aggregating third-party indicators can and should be improved. They believe that a transparent methodology that also considers the inputs from the country authorities on the selection and aggregation of third-party indicators would contribute to a constructive dialogue on governance issues.

Conclusion

Our authorities are committed to continuing sound macroeconomic policies, taking the necessary measures to overcome the current challenges induced by the war, and pursuing structural reforms to ensure sustainable and inclusive growth. They highly value Fund policy advice and CD and look forward to continuing the fruitful cooperation.