

**EXECUTIVE
BOARD
MEETING**

SM/22/167
Correction 1

July 18, 2022

To: Members of the Executive Board

From: The Acting Secretary

Subject: **Republic of Azerbaijan—Staff Report for the 2022 Article IV Consultation**

Board Action: The attached corrections to SM/22/167 (7/6/22) have been provided by the staff:

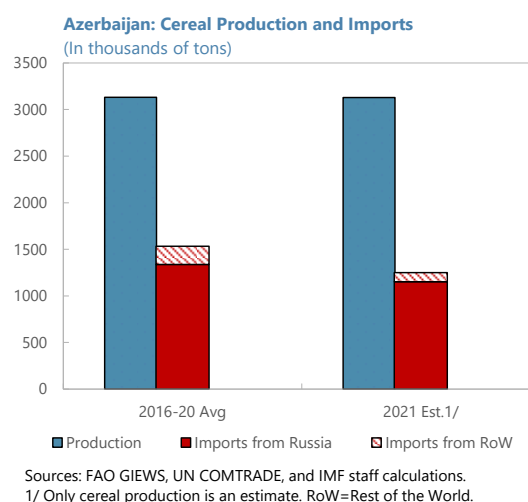
Typographical Errors **Pages 7 and 32**

Questions: Mr. Steinberg, MCD (ext. 34808)
Mr. Jonas, MCD (ext. 38674)
Mr. Ramirez, MCD (ext. 38616)

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~~Türkiye 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

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~~Türkiye). 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.