FOR AGENDA

EBS/03/164

December 5, 2003

To: Members of the Executive Board

From: The Secretary

Subject: **Azerbaijan Republic—Third Review Under the Three-Year Arrangement Under the Poverty Reduction and Growth Facility**

Attached for consideration by the Executive Directors is a paper on the third review under the three-year arrangement under the Poverty Reduction and Growth Facility for the Azerbaijan Republic, which is tentatively scheduled for discussion on **Friday, December 19, 2003**. A draft decision appears on pages 16–19. At the time of circulation of this paper to the Board, the Secretary's Department has received a communication from the authorities of the Azerbaijan Republic indicating that they consent to the Fund's publication of this paper.

Questions may be referred to Mr. Wakeman-Linn (ext. 34145) and Mr. Hobdari (ext. 36276) in MCD.

Unless the Documents Section (ext. 36760) is otherwise notified, the document will be transmitted, in accordance with the procedures approved by the Executive Board and with the appropriate deletions, to the European Bank for Reconstruction and Development, the European Commission, the Islamic Development Bank, and the Organisation for Economic Cooperation and Development, following its consideration by the Executive Board.

This document will shortly be posted on the extranet, a secure website for Executive Directors and member country authorities.

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AZERBAIJAN REPUBLIC

Third Review Under the Three-Year Arrangement Under the Poverty Reduction and Growth Facility

Prepared by Middle East and Central Asia and Policy Development and Review Departments (in consultation with other departments)

Approved by Julian Berengaut and Juha Kähkönen

December 5, 2003

- Discussions on the third review under the PRGF arrangement were held in Baku August 27-September 17 and November 5-12, 2003. The staff team comprised Messrs. Wakeman-Linn (head), Hobdari and Gvenetadze, Ms. Ten Berge (all MCD), Ms. Aturupane (PDR), Mr. Le Borgne (FAD), and Mr. Surin (BLS). Mr. Zavoico, the resident representative, assisted the missions.

- The mission met with the Prime Minister, Ministers of Finance, Economic Development and Taxes, Governor of the National Bank, other officials, parliamentarians, and representatives of the business and diplomatic communities.

- Azerbaijan's three-year arrangement under the Poverty Reduction and Growth Facility (PRGF) for SDR 80.45 million (50 percent of the quota) was approved by the Executive Board on July 2, 2001 (EBS/01/91). As of September 30, 2003, total Fund credit and loans outstanding to Azerbaijan amounted to SDR 177.2 million (110 percent of quota).

- The last Executive Board discussion on Azerbaijan (May 14, 2003) completed the 2003 Article IV consultation with the Azerbaijan Republic, and approved completion of the second review and disbursement of the third tranche in the amount of SDR 12.87 million, or 7.99 percent of quota, under the PRGF arrangement. On that occasion, Directors commended the authorities for implementing prudent financial policies, and urged them to develop a long-term strategy for the use of oil revenues and continue aggressive implementation of structural reforms. Directors stressed completion of bank privatization and acceleration of energy sector restructuring.

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EXECUTIVE SUMMARY

A **three-year arrangement under the PRGF**, in an amount equivalent to SDR 80.45 million (50 percent of quota) was approved on July 6, 2001. The first semi-annual loan was disbursed in July 2001, the second in February 2002 and the third in May, 2003. The **2003 Article IV consultation** with Azerbaijan was concluded on May 14, 2003.

Macroeconomic developments continued to be favorable in the first ten months of 2003, with 10.8 percent real GDP growth compared to the same period a year earlier and low single-digit inflation. The central bank continued the policy of informal exchange rate targeting which has served Azerbaijan well. International reserves continued to grow and the real effective exchange rate depreciated slightly. Fiscal policy for the first three quarters of 2003 was slightly tighter than programmed, largely due to lower than programmed investment expenditures.

All quantitative and structural performance criteria for end-June were met. All but two indicative targets for end-March, end-June and end-September (ceilings on reserve money and unpaid government bills) and one end-June structural benchmark (adoption of the Banking System Law) were also met. The higher reserve money reflects a welcome recovery in money demand, the Banking System Law is expected to be adopted by end-2003 and the stock of unpaid government bills has been brought within program targets.

Implementation of the structural reforms under the program continued. There has been good progress in preparing International Bank of Azerbaijan (IBA) and BUS Bank for privatization, although the sale of 20 percent of IBA to EBRD will likely take place in early 2004 rather than by end-2003. Significant progress was made in converting quasi-fiscal subsidies to fiscal subsidies. However, further efforts will be necessary to continue progress in reducing these subsidies, which are now expected to increase modestly in 2003 (after declining sharply in 2001 and 2002) due to the lack of effective control of the enterprises benefiting from these subsidies. The authorities are determined to impose strict budget constraints on these enterprises.

The authorities acknowledge the importance of developing a long-run oil revenue management strategy, and intend to adopt such a strategy in the first quarter of 2004 and to base the 2005 budget on this strategy.

For 2004, **real GDP growth** is projected to be 8.1 percent, while CPI inflation is again targeted at 2.5 percent. Azerbaijan's **current account** deficit will remain high, but it will be fully financed by oil-sector FDI. The consolidated government **fiscal deficit** is expected to decline to 1.2 percent of GDP in 2004 from 2.0 percent in 2003.

The government will continue comprehensive structural reforms, including adoption of an automatic price adjustment mechanism for domestically sold oil and gas product prices, approval of annual expenditure plans and revenue projections for the four state owned enterprises receiving subsidies from the budget, and adoption of the banking system and central bank laws.

I. Introduction

1. In the attached supplemental letter of intent (SLOI, Attachment I), the Azerbaijan authorities request completion of the third review under the PRGF arrangement. In support of this request, the SLOI assesses economic progress under the PRGF since completion of the second review, sets out policy intentions for the rest of 2003 and for 2004, and proposes performance criteria and indicative targets through end-December 2004.[1]

2. A new government took office on October 31, 2003, following the October 15 presidential election in which Ilham Aliyev, the previous prime minister and son of the outgoing president, was elected president. The post-election period was marred by a brief period of violence and unrest, amid opposition claims that the balloting was fraudulent.

II. Recent Developments and Performance Under the Program

3. **Macroeconomic developments in the first ten months of 2003 were in line with program expectations** (Tables 1-6). Real GDP grew 10.8 percent compared to the same period a year earlier, led by oil-related foreign direct investments (FDI). The 12-month CPI was up 2.6 percent as of end-October, compared to 3.3 percent at end-2002. Following a gradual nominal depreciation of the manat vis-à-vis the US dollar in recent years—averaging 3-4 percent annually—the exchange rate of the manat to the dollar has remained virtually unchanged during 2003. The real effective exchange rate has continued to depreciate (Figure 1).

4. **The strong growth in monetary aggregates that started in 2002 has continued,** with annual manat broad money growth amounting to about 30 percent as of end-October 2003, contributing to a fast pace of credit growth. With low inflation, these developments in the monetary and credit aggregates reflect a welcome increase in money demand (Figure 2). The stock of money and credit to the economy nonetheless remain low (both less than 8 percent of GDP).

5. **Fiscal policy during the first three quarters of 2003 was slightly tighter than programmed,** largely due to lower-than-programmed investment expenditures. The consolidated government deficit is expected to be 2.0 percent of GDP in 2003, compared to 0.5 percent of GDP in 2002, due to increased infrastructure investments and strong wage and pension increases, with the treasury deposits built up during the first nine months of 2003 projected to be largely drawn down during the fourth quarter. The non-oil deficit is projected to be 12.1 percent of GDP, below the program target and well below the long-term sustainable non-oil deficit, as set out in SM/03/158.

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[1] Fund relations, IMF-World Bank relations, and statistical issues are detailed in Appendices I, II and III.

Figure 1. Exchange Rates
(January 1997-September 2003)

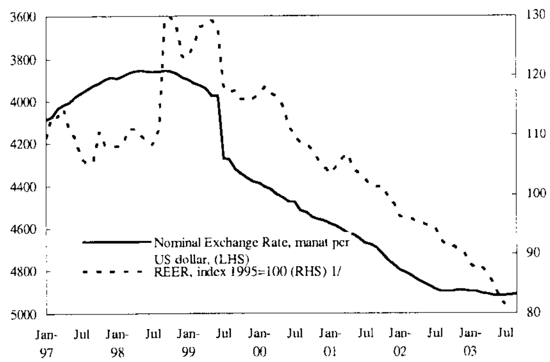
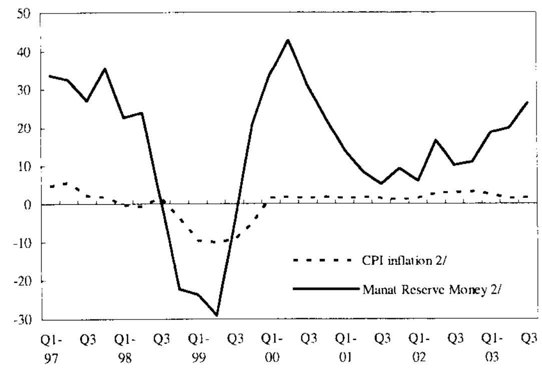


Figure 2. Money and Inflation
(1997Q1-2003Q3)



Source: Azerbaijan authorities and Fund staff estimates.
1/ Decrease means depreciation.
2/ 12-month growth rates.

6. **Azerbaijan's external sector developments in 2003 have been characterized by high oil-sector related FDI and strong export performance.** In the first nine months of 2003, non-oil goods exports grew almost 30 percent compared to the same period in 2002. Net FDI more than doubled in the first half of the year compared to the same period in 2002, and is expected to exceed US$2 billion in 2003. The construction of the Baku-Tbilisi-Ceyhan (BTC) oil pipeline remains on schedule, despite a delay in arranging credit lines.

7. **All quantitative and structural performance criteria for end-June were met** (Tables 7 and 8), as were all but two indicative targets for end-March, end-June and end-September (ceilings on reserve money and unpaid government bills) and one end-June structural benchmark (adoption of the Banking Systems Law). The stock of unpaid bills was within program targets at end-September, but slightly exceeded the end-March and end-June targets, due to spending delays in some budgetary institutions (SLOI, ¶ 4). While it took longer then expected to reach consensus within the government on the final version of the draft Banking System Law, one has now been submitted to Parliament and is expected to be adopted by end-2003.

8. As regards the banking system, progress continues in **rehabilitating BUS Bank and privatizing International Bank of Azerbaijan (IBA)**. Discussions continue on the sale of 20 percent of IBA to EBRD, which is now expected to take place in early 2004. In July, without prior consultation with staff, the National Bank of Azerbaijan (ANB) extended a 15-year, collateral-free, low interest manat 100 billion loan to a private bank, MOST Bank, so it could buy selected non-performing loans from IBA, and thus improve the latter's chances for privatization (SLOI, ¶ 14).

9. **Due to high oil prices, SOCAR paid higher taxes during the first nine months of 2003 than projected in the budget.** Consistent with the program, the treasury saved these higher tax payments (0.2 percent of GDP) in the first half of 2003, as a cushion against future

oil price declines. Savings for the third quarter have not yet been set aside, pending final calculations on the amount to be saved. On energy subsidies, despite increased transparency and some improvement in collections from end-users, combined fiscal and quasi-fiscal **subsidies to Azerenergy and Azerigas grew in nominal terms**, apparently due to lack of effective government control (SLOI, ¶ 37).

III. Policy Discussions

10. Discussions focused on banking sector reforms, development of a long-term strategy for the use of oil revenue that would serve as a guide for fiscal policy over the medium-term, the 2004 budget, and energy sector reforms.

A. Macroeconomic Framework in 2004

11. **Given the performance to date, the staff and authorities agreed that real GDP and inflation targets for 2003 and 2004 remain broadly appropriate.** Changes in the macroeconomic framework for 2004 relative to EBS/03/57 include lower real growth due to a modest contraction in the oil sector because of the ongoing gradual decline in SOCAR's own production, and temporary operational issues in other oil fields, a larger build up in ANB's international reserves due to the higher oil prices, and a more rapid projected increase in money demand.

12. **Azerbaijan's external position is expected to remain strong, with low debt and strong growth in non-oil exports**. While the current account deficit is projected to remain high in 2004 (about 38 percent of GDP), it will be fully financed by oil-related FDI. Net of oil sector imports, Azerbaijan is projected to run a current account surplus of about 3 percent of GDP in 2004.

B. Monetary and Exchange Rate Policies and Financial Sector Reform

13. The authorities remain committed to implementing financial policies consistent with low inflation and exchange rate stability. In line with recent developments, **the program projects a continued increase in real money demand**, leading to a 9 percent decline in velocity in 2004. In view of the fast pace of credit growth implied by this increase in monetary aggregates, as well as the significant wage increases awarded in 2003, the ANB will carefully monitor inflation and credit growth, to ensure that financial policies remain consistent with macroeconomic stability, and that the quality of banking sector's assets does not deteriorate.

14. Given the limited scope for open market operations, due to the low stock of treasury bills, interventions in the foreign exchange market will remain the main monetary policy instrument. **The ANB will continue to allow for movements of the manat vis-à-vis the US dollar within a narrow band**. This informal exchange rate targeting has served Azerbaijan well, contributing to low inflation and growth in international reserves. With the continued strong growth in non-oil exports, the exchange rate appears consistent with the goal of non-oil growth.

15. **The authorities acknowledged that the issuance of the MOST Bank loan was contrary to sound central bank practices.** Understandings were reached with the ANB to add a provision in the **draft Central Bank Law** to prohibit future loans of this type by limiting ANB credits to less than six months maturity and requiring proper collateral (SLOI, ¶14). Pending adoption of this law, these rules have been reflected in ANB regulations. The ANB has signed a memorandum of understanding with MOST Bank, to ensure its compliance with prudential standards, according to an ANB determined timetable. Finally, to offset the impact of the loan on its net domestic assets, the ANB will sell up to manat 100 billion in government securities from its portfolio by end-2003. This operation will have no direct fiscal cost, and little indirect fiscal cost via future ANB profit transfers.

16. The staff urged the authorities to also ensure that the **draft Central Bank Law** protects the ANB's independence, provides the ANB with sufficient authority to supervise banks, and requires full transparency of ANB operations. Consistent with recommendations from MFD, LEG and the World Bank, the authorities revised the **draft Banking Systems Law** to ensure compliance with Basle core principles, and intend to enact this law by end-2003 (SLOI, ¶15).

17. While progress continues on the preparations of IBA and BUS Bank for privatization, and both the authorities and the EBRD staff have assured the Fund staff that the sale of 20 percent of IBA to EBRD is going to happen in the near future, it now appears unlikely that this will take place by the end of 2003. As a result, **the issuance of a tender for all remaining government shares of IBA**—a step which is to take place following the sales agreement with EBRD—will not take place until sometime in the first half of 2004. The April 23, 2003 LOI had established this as an end-December 2003 structural performance criterion; the SLOI requests postponement to end-June 2004. Staff supports this request. The government share of IBA recapitalization is expected to be about manat 30 billion, which will be financed by the receipts from the sale to EBRD.

C. Oil Revenue Management Strategy

18. The mission had extensive and wide-ranging discussions on the importance of developing **a sustainable, rules-based long-term strategy for the use of oil revenue** that is consistent with the PRSP priorities. The staff urged the authorities to develop an economically and politically sustainable strategy that would insulate the budget from short-term swings in oil prices by targeting the size of the non-oil deficit.

19. The mission suggested that, given the pressing needs for infrastructure and social spending in Azerbaijan, a strong case can be made for a gradual increase in the non-oil deficit over the medium-term.[2] Significant investments in infrastructure and human capital will be necessary—particularly for reliable provision of energy and water, an efficient

[2] The proposed strategy was presented in SM/03/158.

transport and communication network, and improved education and health services—to support sustainable non-oil growth. In this context, the staff emphasized the urgent need to strengthen capacity for project evaluation, implementation and monitoring.

20. **The authorities acknowledged the importance of developing a long-run oil revenue management strategy, and generally agreed with the approach proposed by the staff.** An inter-ministerial commission, chaired by the Prime Minister, was formed to prepare such a strategy by early 2004, which will ensure that it will form the basis for preparation of the 2005 budget (SLOI, ¶ 21).

D. The 2004 Consolidated Budget

21. The original draft 2004 budget prepared by the authorities targeted a 0.7 percent of non-oil GDP reduction in the non-oil deficit, as lower domestically financed capital expenditures were only partially offset by increased foreign financed capital expenditures, and did not provide for increased use of oil fund assets.

22. The mission noted that, while caution in using oil revenue is essential, the implementation priorities of the PRSP should be given equal weight, so as to develop the infrastructure critical for non-oil growth. Moreover, sharp increases in Oil Fund assets—which would be the result of continued slow use of these funds—might eventually increase political pressures for large, inefficient expenditures.

23. Based on the above considerations, **the mission presented the merits of a modest increase in the non-oil deficit in 2004**, in the form of tax cuts and spending increases that would enhance the prospects for non-oil growth. In particular, the mission suggested a reduction in the non-oil enterprise profit tax (EPT) from 25 to 15 percent; a reduction by 2-3 percentage points in the social security contribution rate (currently at 29 percent) or a similar reduction in the personal income tax (PIT); and an increase in education, health and capital expenditures.

24. **The authorities were reluctant to eliminate the regional and sectoral variations in the EPT** that had been introduced in 2003, as they felt that is was important to ensure regional development. While acknowledging the importance of this goal, staff emphasized that variations in the EPT were an ineffective tool for encouraging such development, and were harmful for tax administration. The staff also noted that the PRSP contains a wide range of policy proposals that could more effectively encourage regional development. The authorities eventually decided to eliminate the regional and sectoral variations in the EPT, and to cut the profit tax rate for all companies a modest 1 percentage point to 24 percent (reducing revenue by 0.1 percent of GDP), and to develop, in close cooperation with the staffs of the Fund and the World Bank, a more effective regional development program.

25. Understandings were reached on a revision in the personal income tax rate (SLOI ¶ 24; this reform will cost 0.1 percent of GDP), but the authorities were not prepared at the present time to consider a cut in social security contributions. They were also reluctant

to increase spending on health and education because of concerns regarding effective expenditure management in these sectors.

26. **Staff and authorities reached understandings on one area where additional expenditures could usefully be undertaken**: increased capital expenditures to construct permanent housing for refugees and internally displaced persons (IDPs), to replace existing tent camps. Improving the living standards of refugees and IDPs is one of the six key objectives of Azerbaijan's PRSP. This construction would take place in Azerbaijan's regions, where economic growth has been modest and there remains substantial excess capacity.

27. The 2004 budget now targets a non-oil deficit of 15.7 percent of non-oil GDP, with investment expenditures (net of BTC) increasing as a share of GDP from the expected 2003 level of 4.6 percent to 5.2 percent in 2004. The budget also includes initiatives aimed at improving the efficiency of tax policy and administration, as well as broadening the tax base, including a significant reduction in the list of goods exempt from the VAT (SLOI, ¶ 23-26).

28. **The mission questioned the rationale for the wage increases in the 2004 budget,** in light of the significant increases already awarded in mid-2003. The majority of the increase reflects the full year effect of the mid-2003 wage increases (manat 393 billion, or about 1 percent of GDP). The authorities noted that the other targeted increases are part of a civil service reform effort (manat 90 billion in 2004, or 0.2 percent of GDP), as well as an alignment of wages across government institutions (manat 37 billion or 0.1 percent of GDP), consistent with the PRGF objective to reduce incentives for corruption. The authorities committed to no general wage increases during 2004 and, in the event that the civil service reforms are not as expensive as budgeted, to save any unspent funds (SLOI, ¶ 30).

29. The authorities will be continuing a comprehensive **reform of the Social Protection Fund (SPF)**, aimed at ultimately moving to a fully-funded pension system (SLOI, ¶ 32). In that context, they had considered removing all SPF revenues and expenditures, including pensions, from the treasury. Staff argued against such a move, which would undermine fiscal reforms and increase governance concerns. The authorities acknowledged these arguments, and decided to keep all SPF expenditures and revenues in the treasury.

E. External Sector Policies

30. Following the third step in the process of replacing specific with ad-valorem custom duties, which was taken on October 1, 2003, the authorities remain committed to taking in April 2004 the final step. This will reduce the weighted average tariff to 6.5 percent, with remaining specific duties applying only to excisable products. Negotiations on WTO membership are continuing, and the authorities are accelerating their efforts to resolve outstanding debt disputes with Kazakhstan, Turkmenistan, and Uzbekistan.

F. Energy Sector Reforms

31. The authorities have made important strides in improving the transparency of energy-related fiscal and quasi-fiscal subsidies, and have substantially reduced these subsidies, from

an estimated 22 percent of GDP in 2000 to around 9 percent of GDP in 2002. However, **the lack of effective control of the enterprises benefiting from these subsidies is inhibiting efforts at further reducing them**. Based on the results for the first three quarters of 2003, the fiscal subsidies are now expected to reach 6 percent of GDP, exceeding the budgeted level by 1.3 percent of GDP, largely due to a decline in the fuel efficiency of electricity production. Total fiscal and quasi-fiscal subsidies are projected to reach about 10 percent of GDP in 2003.

32. To control these energy subsidies, the authorities will approve, during January, the 2004 expenditure and revenue plans for the four state-owned companies that receive subsidies from the state, ensuring these plans are both reasonable and consistent with the subsidy allocation in the budget,[3] and will review their implementation quarterly (SLOI, ¶ 38).

33. The authorities remain committed to aligning domestic prices of kerosene and diesel fuel with world market prices. They had previously decided to take this step in early 2004, after designing an effective targeted safety net to protect the vulnerable groups. While the authorities are working on such a safety net in cooperation with the World Bank, it has proven more difficult than expected. The Bank staff concurs with the authorities' view that, as a result, reform of these prices will not be possible in 2004.

IV. Balance of Payments and Capacity to Repay the Fund

34. The medium-term outlook (Table 9) remains favorable, and is largely unchanged since EBS/03/57. The balance of payment projection assumes the development of BTC, Azeri-Chirag-Guneshli and Shah Deniz projects will proceed according to schedule. The current account deficit is expected to decline from 38 percent of GDP in 2004 to 20 percent in 2005, with these deficits continuing to be financed by oil sector FDI.

35. Azerbaijan's external financing needs in 2004 (Table 10) will be covered by the proposed disbursements from the Fund (US$36 million) and World Bank (US$20 million in balance of payment financing), as well as bilateral support. Azerbaijan is in the process of graduating from IDA and other concessional project financing, in light of the fast per capita income growth in recent years. **Therefore, the program allows for a somewhat larger increase in non-concessional borrowing in 2004 than in previous years,** to make room for infrastructure-related loans currently under discussion with EBRD and IBRD.

36. Azerbaijan has been able to repay the Fund, and the staff expects this to continue to be the case (Table 11). Its external debt ratio is moderate (21 percent of GDP at end-2003)

[3] The energy subsidies in the 2004 budget amount to manat 1,882 billion, based on a realistic assessment of energy consumption and utility payment capacity. This represents a 9 percent reduction from the expected 2003 level. While this reduction is modest, it is consistent with the authorities' medium-term program to gradually eliminate these subsidies.

and its debt service obligations are around 5.8 percent of exports of goods and services. Obligations to the Fund, after peaking in 2003 at about 2.8 percent of exports of goods and services, or 11 percent of gross reserves, are projected to gradually decline over the medium-term.

V. Safeguards Assessment

37. The authorities have made progress in implementing the recommendations of the 2002 safeguards assessment recommendations, but have yet to implement the recommendations regarding the ANB's profit distribution mechanism and the establishment of an audit committee under the ANB board. It is anticipated that the revised Central Bank Law (expected by end-March 2004) will address the first concern by requiring that profits available for distribution to the budget by ANB be calculated on the basis of actual operating results measured in accordance with International Accounting Standards. In addition, the ANB is considering alternative structures to alleviate the existing audit deficiencies, as it is concerned that the recommended audit committee could undermine its independence.[4]

VI. Program Monitoring

38. Measures to be implemented as structural performance criteria and benchmarks for end-December 2003, and end-March and end-June 2004 are listed in Table 12, and described in the April 23, 2003 LOI as well as the attached SLOI (¶ 40-41). Quantitative performance criteria for end-December 2003, end-June 2004 and end-December 2004 and quarterly indicative targets through end-December 2004 are specified in Table 7. These targets are based on WEO projections for oil prices at the time the program was discussed with the authorities (US$25.50 per barrel in 2004). All relevant quantitative performance criteria will be fully adjusted for changes in oil prices relative to programmed oil prices, as described in EBS/03/57 (Attachment I, Annex I). If prices fall well below the budget assumption of US$20 on average for 2004, there would be a need to reconsider program targets. The updated disbursement schedule is presented in Table 13.

39. The program contains a number of structural conditions, which the staff and authorities believe are critical to the program's success, as explained in Box 1. The structural conditionality for the coming reviews relates to the adoption of new laws on the Banking System and the Central Bank, measures to ensure the gradual reduction of energy related fiscal and quasi-fiscal subsidies, and measures to enhance the transparency of tax policy and customs administration. Successful implementation of banking and energy sector reforms, as well as improved governance, are critical for realizing the macroeconomic and poverty alleviation objectives under the program.

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[4] The ANB fears that the appointment of government officials, or even academics, to an audit committee could undermine their independence from the government. They are in the process of studying practices of other central banks to seek to identify an appropriate solution to this problem.

Box 1. Structural Conditionality Streamlining Assessment

1. Coverage of Structural Conditionality in the Program

Structural conditionality under the proposed program includes performance criteria and benchmarks for end-December 2003, and end-March and end-June 2004, as follows:

- ***fiscal policy**, through structural performance criteria on the Cabinet of Minister's approval of a long-term strategy for the use of oil revenue, the unification of the enterprise profit tax rate on the non-oil sector; and a reduction in VAT exemptions. This conditionality is critical for creating an enabling environment for non-oil growth, facilitating tax administration and improving governance, and expanding the tax base;*

- ***banking sector**, through performance criteria related to the adoption of new laws on the banking systems and the central bank; and to completing the privatization of IBA. The conditionality is critical to safeguarding the integrity of the banking system and to establishing a level playing field in the banking sector;*

- ***trade policy,** through a structural performance criterion. Further liberalization of the trade regime is essential for the balanced development of Azerbaijan's economy;*

- ***energy sector**, through structural performance criteria and a benchmark aimed at controlling energy subsidies and ensuring domestic energy prices remain in line with world market prices. Arrears, nonpayments, and waste of resources in the domestic energy sector pose a serious potential threat to medium-term macroeconomic stability;*

- ***governance issues,** through a structural benchmark on the Customs Committee. Reforming the Customs Committee is a central element of the effort to improve governance in Azerbaijan.*

2. Status of Structural Conditionality from Earlier Reviews

See Table 8.

3. Structural Areas Covered by Bank Lending and Conditionality

A Structural Adjustment Credit (SAC II) was approved in March 2002, and has been fully disbursed. SAC II includes conditionality on (i) public, social, and financial sectors; (ii) reduction of implicit subsidies, privatization, and regulatory reform in the utilities sectors; and (iii) private sector development. The EBRD plays an important role in banking sector reform. Discussions have begun on a successor credit.

4. Other Relevant Structural Conditions not included in the Current Program

The current program does not include conditionality on enterprise privatization. The World Bank takes the lead on this issue.

VII. Risks to the Program

40. With the major oil projects largely on schedule—oil exports from the BTC pipeline are expected to start in early 2005—the short-term risks to the program have reduced considerably. In addition, the level of international reserves is comfortable, and Oil Fund assets have reached US$788 million as of end-September 2003. However, given Azerbaijan's dependence on oil and oil product exports, the economy remains vulnerable to a sustained sharp drop in oil prices, as well as to security risks related to BTC. Over the medium-term, the main risks relate to the possible failure to develop and implement an economically and politically sustainable strategy for the use of oil revenue, as well as to sharply reduce the fiscal and quasi-fiscal subsidies—two critical objectives under the PRGF-supported arrangement. In addition, insufficient progress in improving governance could impede the creation of an enabling environment for private sector growth.

41. Over the long term, the major challenge facing Azerbaijan is the challenge of **managing the country's oil wealth in a way that allows for sustained, significant non-oil growth**. Few countries have successfully confronted this challenge.

VIII. Staff Appraisal

42. **Macroeconomic performance continues to be strong, with double digit real GDP growth and low inflation**, reflecting the authorities' prudent macroeconomic management and continued progress in structural reforms. A broad structural reform program is being implemented, focusing on improving transparency and strengthening financial discipline in the energy sector, developing a more competitive financial sector, and improving governance and the business environment. Poverty remains widespread, however, and further progress is required in infrastructure development, structural reforms and governance to boost non-oil investments.

43. **Sustained economic growth and poverty reduction will require careful management of Azerbaijan's oil wealth**. The staff welcomes the authorities' commitment to adopt a long-term strategy for the use of oil revenue in early 2004, and to base fiscal policy on that strategy. The staff urges the authorities to ensure this strategy is based on broad consultations with civil society. The use of the oil wealth will require that the authorities aggressively seek to expand their capacity for project evaluation, implementation and monitoring.

44. The political sustainability of reforms requires that the current generation be seen to benefit sufficiently from the country's oil wealth. In light of the pressing social, human capital and infrastructure needs, **the staff believes Azerbaijan could gradually increase the non-oil deficit over the medium-term toward the sustainable long-run level**, based on carefully targeted and monitored increases in spending and cuts in taxes that are aligned with the PRSP priorities. To that end, the staff supports the moderate fiscal easing in 2004 (compared to the 2003 deficit, net of the BTC expenditures in the budget), as well as the decision to target the increased spending on the most needy. In this context, the staff urges

the authorities to ensure efficient capital spending on housing for refugees and IDPs, including through proper planning and execution of these expenditures.

45. In view of Azerbaijan's dependence on oil revenue, **the authorities are to be commended for continuing to base their annual budgets on conservative oil price assumptions.** In addition, the commitment to save oil revenue from higher than budgeted oil prices in 2004, a continuation of their practice in 2003, is laudable.

46. **Monetary and exchange rate policies remain appropriate**. The staff believes the proposed mix of financial policies in 2004 is consistent with the program's objectives. In view of the projected strong growth in money and credit aggregates, however, the authorities are encouraged to closely review developments during 2004, to ensure that macroeconomic stability is maintained and the banking sector's credit portfolio remains healthy.

47. **The continuation of banking sector reforms is important.** The new laws on the Banking System and the Central Bank should lay the foundation for a further strengthening of the sector, while the privatization of IBA and BUS Bank will be vital to enhancing competition. While supporting the authorities' request for a postponement of the structural performance criterion on the issuance of a tender for all remaining government shares in IBA, staff nonetheless urges the authorities to ensure rapid progress in these areas.

48. **The extension by ANB of a long-term, below market rate loan to a private bank** runs counter to sound central banking practices and raises important governance issues. The staff encourages the authorities to ensure the new Central Bank Law limits ANB lending to short-term loans against proper collateral, and urges the ANB to ensure the bank meets all prudential standards.

49. While commending the ANB for implementing most recommendations of the **safeguards assessment**, the staff regrets the failure to implement the recommendation for an audit committee, and urges the authorities to resolve this matter quickly.

50. **The staff is concerned about growing pressures for energy subsidies**; failure to reduce these subsidies would threaten the program's long term objectives. It therefore fully supports the authorities' commitment to approve the 2004 spending plans of four state-owned enterprises and to take any corrective measures during the year to ensure actual subsidies remain within the 2004 budgetary appropriations. Staff also urges the authorities to accelerate the corporatization and eventual privatization of these companies, which will be critical if the pace or reduction in these subsidies is to increase.

51. The staff commends the authorities for their continued implementation of macroeconomic and structural policies targeted under the program. The staff believes the SLOI lays out policies that should help preserve macroeconomic stability and accelerate structural reforms, in support of sustainable economic growth and continued poverty alleviation, and that the risks to the program are manageable. Thus, **the staff supports the authorities' request for completion of the third review under the PRGF.**

PROPOSED DECISION

The following decision, which may be made by a majority of the votes cast, is proposed for adoption by the Executive Board:

1. The Azerbaijan Republic (Azerbaijan) has consulted with the Fund, as trustee for the Poverty Reduction and Growth Facility (PRGF) Trust, in accordance with paragraph 2(ee) of the three-year arrangement for Azerbaijan under the PRGF Trust (EBS/01/91, Supplement 3, 07/09/01, as amended) in order to review program implementation, reach revised understandings regarding the conditions for the disbursement of the fifth loan under the arrangement, and regarding the phasing of the sixth and seventh loans under the arrangement.

2. The letter dated December 4, 2003 from the Prime Minister, the Chairman of the National Bank of Azerbaijan, the Minister of Finance and the Minister of Economic Development shall be attached to the three-year PRGF arrangement for Azerbaijan, and the letters dated June 15, 2001, February 6, 2002 and April 23, 2003, together with their respective Memoranda of Economic and Financial Policies and Technical Memoranda of Understanding, shall be read as supplemented and modified by the letter dated December 4, 2003 and its attachments.

3. Accordingly, the following amendments shall be made to the three-year PRGF arrangement for Azerbaijan:

(a) A new paragraph 1(ccc) shall be added to the arrangement as follows:

"(ccc) the sixth loan under the arrangement, in an amount equivalent to SDR 12.87 million, will be made available on or after August 15, 2004, at the request of Azerbaijan and subject to paragraph 2 below, and the seventh loan under the arrangement, in an amount equivalent to SDR 12.87 million, will be made available on or after February 15, 2005, at the request of Azerbaijan and subject to paragraph 2 below."

(b) Paragraph 1(dd) shall be deleted and replaced as follows:

"The conditions for disbursement of the sixth and seventh loans shall be established in the context of the fourth review of Azerbaijan's program with the Trustee.";

(c) Paragraph 2(ccc)(ii)(V) of the arrangement shall be deleted.

(d) Paragraph 2(ccc)(ii) of the arrangement shall be amended by the addition of the following:

"(VI) the enactment of the Banking Systems Law as submitted to Parliament; or

(VII) the submission to Parliament of a new Central Bank Law which limits the maturity of any Central Bank of Azerbaijan loan to not more than six months, and requires acceptable collateral for all such loans."

(e) A new paragraph 2 (cccc) shall be inserted as follows:

"(cccc) If the Managing Director of the Trustee finds, with respect to the sixth loan referred to in paragraph 1(ccc) of the arrangement, that Azerbaijan has not carried out its intentions, with respect to:

(i) by January 31, 2004, approval by the Cabinet of Ministers of annual expenditure plans and revenue projections for 2004 for Azerchemia, Azerenergy and Azerigas, as specified in paragraph 41 of the letter dated December 4, 2003; or

(ii) by March 31, 2004, the enactment of the Central Bank Law limiting the maturity of any Central Bank of Azerbaijan loan to not more than six months, and requiring acceptable collateral for all such loans; or

(iii) by March 31, 2004, the approval by the Cabinet of Ministers of a long-term strategy for oil revenue management, based on published fiscal rules that reduce the exposure of the budget to volatility in oil revenues, as specified in paragraph 41 of the letter dated December 4, 2003; or

(iv) by June 30, 2004, the issuance of a tender for all remaining government shares of IBA as specified in paragraph 57 of the letter dated April 23, 2003 and paragraph 17 of the letter dated December 4, 2003."

4. The Fund decides that:

(a) the third review, as contemplated in paragraph 2(ee) of the three-year PRGF arrangement for Azerbaijan, is completed; and

(b) Azerbaijan may request disbursement of the fourth loan referred to in paragraph 1(cc)(i) of the three-year PRGF arrangement for Azerbaijan.

Table 1. Azerbaijan: Selected Economic and Financial Indicators, 2001-2005

	2001	2002	2003		2004		2005
	Act.	Act	Prog.	Proj	Prog.	Rev Prog	Rev Prog
	(Annual percentage change, unless otherwise specified)						
GDP at current prices	12.7	11.4	13.8	15.7	6.7	6.3	14.7
GDP at constant prices	9.9	10.6	9.2	9.3	8.8	8.1	14.0
Of which: oil sector	7.9	3.9	0.3	0.7	7.9	-2.1	53.4
other sectors	10.4	12.3	11.4	11.3	9.0	10.3	6.5
Implicit GDP deflator	2.5	0.7	4.1	5.9	-1.9	-1.7	0.6
Consumer price index (end-period)	1.3	3.3	2.5	2.5	2.5	2.5	2.5
Consolidated government finance 1/							
Total revenue	0.8	34.1	17.7	15.2	5.0	12.1	12.7
Total expenditure	0.9	36.8	25.2	24.7	-1.2	6.6	12.5
Of which: current expenditure	5.0	15.3	24.3	24.2	3.8	13.0	11.7
investment expenditure	-23.2	210.3	27.8	26.1	-16.0	-12.3	15.6
investment expenditure (net of BTC loan)	-23.2	163.2	9.4	8.8	15.8	20.0	15.6
Money and credit 2/							
Net foreign assets	31.0	4.7	6.2	6.6	...	9.8	...
Net domestic assets	-1.5	8.4	9.8	19.0	...	11.7	...
Domestic credit	0.1	11.7	8.0	18.1	...	9.3	...
Of which: credit to the economy	-14.8	9.1	8.5	16.0	...	14.9	...
Manat broad money (average, annual changes)	9.7	12.8	15.1	23.2	...	27.0	...
Foreign currency deposits (level, as a ratio to broad money)	48.0	46.9	46.9	46.0	...	44.7	...
Income velocity of average manat broad money (M2) 3/	11.3	11.6	11.9	10.8	...	9.7	...
External sector (in US dollars)							
Exports f.o.b.	13.7	12.7	16.5	8.9	-10.7	-6.9	29.4
Of which: oil sector	21.1	11.1	17.0	8.0	-13.3	-9.4	33.0
Imports f.o.b.	-4.8	24.5	70.0	40.7	10.2	34.7	-12.8
Of which: oil sector	-5.5	142.7	328.1	209.3	10.1	70.9	-32.9
Export volumes	31.8	15.2	-1.2	-4.0	9.9	5.4	47.3
Import volumes	-2.4	20.7	64.3	35.9	10.2	34.4	-12.7
Terms of trade	-12.1	-5.1	14.0	9.7	-18.8	-11.8	-12.1
Real effective exchange rate (- deprec.)	-6.1	-8.3	...	...	...	...	...
	(in percent of GDP)						
Gross fixed investment	22.9	34.8	55.3	53.0	54.9	58.3	46.1
Consolidated government 4/	2.1	4.9	6.4	4.6	5.1	5.2	5.2
Private sector	20.8	29.9	48.9	48.4	49.8	53.2	40.9
Of which: oil sector	14.6	27.5	41.1	39.5	41.0	45.0	32.4
Gross domestic savings	24.3	25.3	31.7	30.0	24.7	24.1	31.0
Gross national savings	19.8	20.1	25.6	25.6	20.2	20.5	25.8
Consolidated government	1.6	5.3	4.5	4.3	4.6	4.0	4.1
Private sector	18.2	14.9	21.1	21.3	15.6	16.5	21.7
Consolidated government finance 1/							
Total Revenue and grants	18.7	22.5	23.3	22.4	22.9	23.6	23.2
Total expenditure	18.7	22.9	25.2	24.7	23.3	24.8	24.3
Overall fiscal balance	-0.4	-0.5	-1.9	-2.0	-0.4	-1.2	-1.1
Overall fiscal balance (net of BTC, in percent of non-oil GDP)	-0.6	0.5	-0.2	-0.4	...	-1.6	-1.6
Statistical discrepancy	0.4	0.1	...	-0.3	...	...	...
Nonoil deficit 5/	-7.1	-10.6	-12.5	-12.1	-10.6	-11.8	-11.7
External sector							
Current account (- deficit)	-0.9	-12.6	-29.7	-27.4	-34.6	-37.8	-20.2
Foreign direct investment (net)	5.1	17.2	30.1	29.1	31.4	36.1	20.2
Public and Publicly Guaranteed external debt outstanding	22.2	22.7	21.1	20.8	21.0	20.9	19.4
External debt service ratio (including IMF) 6/	4.9	4.4	5.6	5.8	5.0	5.5	3.6
Memorandum items:							
Gross official external reserves (US$ millions)	725	721	735	732	788	815	890
Nominal GDP (in manat billion)	26,578	29,602	33,675	34,252	35,937	36,410	41,752
Nominal GDP (US$ millions)	5,708	6,090	6,882	6,977	7,345	7,415	8,504
Nominal GDP per capita (in US dollars)	701	742	832	843	880	889	1,011
Oil Fund Assets (US$million, end-period stock)	493	693	...	817	...	862	952

Sources: Azeri authorities and staff estimates and projections.

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

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

3/ In terms of nonoil GDP.

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

5/ Calculated by deducting Oil Fund, AIOC and SOCAR revenue, as well as government financed BTC investment from the consolidated government budget balance.

6/ In percent of exports of goods and services.

Table 2. Azerbaijan: Monetary Survey, 2001-2004 1/

(in billions of manats)

	2001	2002	2003								2004			
	Dec.	Dec.	Mar		Jun		Sept		Dec		Mar	Jun	Sep	Dec
	Act.	Act.	Prog	Act	Prog	Act	Prog	Prel Act	Prog	Proj	Prog	Prog	Prog	Prog
Net foreign assets	2,431	2,590	2,053	2,634	2,216	2,751	2,578	2,914	2,838	2,842	2,828	2,892	3,131	3,313
Net international reserves of the ANB (convertible)	1,969	2,130	1,758	2,003	1,875	2,285	2,162	2,431	2,369	2,347	2,361	2,458	2,669	2,813
Net foreign assets of commercial banks (convertible)	454	464	294	637	339	470	415	482	467	499	471	438	467	504
Other	8	-4	2	-6	2	-4	2	1	2	-4	-4	-4	-4	-4
Net domestic assets	163	1,203	1,434	1,203	1,517	1,322	1,452	1,470	1,603	1,947	2,018	2,251	2,316	2,508
Domestic credit	1,452	2,603	2,835	2,768	2,908	2,872	2,833	2,957	2,939	3,312	3,352	3,557	3,595	3,756
Net claims on general government	405	493	674	491	664	362	505	245	473	573	475	542	402	305
Net claims on central government	405	493	674	491	664	362	505	245	473	573	475	542	402	305
Pre-2000 oil bonus deposits	-546	-304	0	-182	0	-3	0	-3	0	0	0	0	0	0
Other claims (net)	0	0	0	-1	0	-1	0	-1	0	-1	-1	-1	-1	-1
Credit to the economy	1,826	2,132	2,160	2,295	2,244	2,510	2,328	2,715	2,466	2,741	2,879	3,017	3,195	3,453
Other items (net)	-1,289	-1,400	-1,401	-1,566	-1,391	-1,550	-1,382	-1,487	-1,337	-1,365	-1,334	-1,306	-1,278	-1,248
Broad money	3,373	3,814	3,487	3,855	3,733	4,073	4,030	4,387	4,440	4,787	4,843	5,140	5,446	5,819
Manat broad money	1,753	2,026	1,853	1,947	1,984	2,209	2,141	2,325	2,360	2,587	2,585	2,760	2,941	3,219
Currency outside banks	1,469	1,669	1,507	1,558	1,614	1,683	1,742	1,773	1,919	2,033	2,008	2,119	2,231	2,413
Manat deposits	284	357	346	388	370	526	399	552	440	554	577	641	710	806
Foreign currency deposits	1,620	1,789	1,634	1,908	1,749	1,864	1,889	2,061	2,081	2,200	2,258	2,380	2,504	2,599
			(changes in percent of beginning of year total broad money stock, unless otherwise specified; quarterly changes cummulative)											
Net foreign assets	31.0	4.7	-14.2	1.1	-10.0	4.1	-0.5	8.3	6.2	6.6	-0.3	1.0	5.9	9.5
Net domestic assets	-1.5	8.4	5.6	-0.1	7.8	2.5	6.1	6.3	9.8	19.0	1.4	6.1	7.5	11.4
Domestic credit	0.1	11.7	5.5	4.1	7.4	6.3	5.5	8.5	8.0	18.1	0.8	5.0	5.7	9.0
Credit to the economy	-14.8	9.1	0.8	4.2	3.0	9.6	5.1	14.9	8.5	16.0	2.8	5.6	9.2	14.4
Broad money (M3) (percentage change)	29.4	13.1	-8.6	1.1	-2.1	6.8	5.6	15.0	16.4	25.5	1.2	7.4	13.8	21.6
Average broad money (M3) (percentage change)	38.5	22.4	8.4	0.0	7.2	17.7	15.2	25.6	22.5	24.2	15.1	19.3	26.5	34.6
Average manat broad money (M2) (percentage change)	9.7	18.8	7.7	10.3	6.5	15.4	14.5	25.9	25.0	36.4	16.5	20.4	28.5	38.8
Currency as a ratio to broad money	43.6	43.7	43.2	40.4	43.2	41.3	43.2	40.4	43.2	42.5	41.5	41.2	41.0	41.5
Foreign currency deposits as a ratio to broad money	48.0	46.9	46.9	49.5	46.9	45.8	46.9	47.0	46.9	46.0	46.6	46.3	46.0	44.7
Memorandum Items:														
Gross international official reserves (US$ millions)	725	721	624	678	647	737	709	752	735	732	715	735	774	815
Net international official reserves (US$ millions)	427	462	380	434	406	496	468	527	513	509	512	533	579	610
Velocity of total broad money (M3) 2/	6.5	6.0	...	...	...	...	...	...	6.1	5.7	...	...	...	5.2
Reserve money (quarterly changes cumulative)	1.7	14.0	-8.9	-2.9	-2.9	5.7	4.4	12.5	14.5	18.9	-2.2	6.1	10.7	14.4

Sources: Azerbaijan National Bank; and Fund staff estimates.

1/ As of June 2001, accounts are valued at program exchange rates of 4,606 manat per US dollar and 1.26 US dollar per SDR.

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

Table 3. Azerbaijan: Summary Accounts of the Azerbaijan National Bank , 2001-2004 1/
(In billions of manats)

	2001	2002	2003										2004			
	Dec.	Dec	Mar		Jun		Sept			Dec			Mar	Jun	Sept	Dec
	Act.	Act.	Prog	Act	Prog	Act	Prog	Adj Prog 2/	Act	Prog	Adj Prog 2/	Proj	Prog	Prog	Prog	Prog
Net foreign assets	1,967	2,124	1,752	2,003	1,870	2,285	2,156	2,008	2,431	2,363	2,224	2,345	2,359	2,456	2,667	2,811
Net international reserves (convertible)	1,969	2,130	1,758	2,003	1,875	2,285	2,162	2,014	2,431	2,369	2,230	2,347	2,361	2,458	2,669	2,813
Gross international reserves (convertible)	3,339	3,320	2,874	3,124	2,978	3,393	3,265	3,117	3,463	3,383	3,244	3,366	3,292	3,386	3,563	3,756
Foreign liabilities (convertible)	-1,371	-1,190	-1,116	-1,121	-1,103	-1,108	-1,103	-1,103	-1,032	-1,014	-1,014	-1,019	-930	-928	-894	-943
Other	0	0	-6	0	-6	0	-6	-6	0	-6	-6	0	0	0	0	0
Net domestic assets	-174	-85	105	-20	111	-127	-27	120	-133	-28	111	80	9	114	17	-36
Domestic credit	233	240	426	275	421	207	274	421	221	229	367	349	261	338	213	130
Net claims on general government	132	154	326	163	311	91	148	296	-6	93	232	112	0	53	-95	-202
Net claims on central government	609	478	326	246	311	64	148	296	219	93	232	233	0	53	-95	-202
Pre -2000 oil bonus deposits	-546	-304	0	-182	0	-3	0	0	-3	0	0	0	0	0	0	0
World Bank counterpart funds	0	0	0	0	0	-152	0	0	-68	0	0	0	0	0	0	0
Claims on banks	101	86	100	110	110	114	125	125	225	135	135	235	259	283	306	330
Other items (net)	-407	-325	-321	-295	-310	-334	-301	-301	-354	-256	-256	-268	-252	-223	-196	-166
Reserve money	1,793	2,039	1,857	1,979	1,981	2,156	2,129	2,129	2,294	2,336	2,336	2,425	2,368	2,570	2,683	2,775
Manat reserve money	1,684	1,872	1,704	1,806	1,817	1,989	1,955	1,955	2,101	2,139	2,139	2,231	2,146	2,340	2,451	2,588
Currency in circulation	1,534	1,756	1,535	1,676	1,637	1,804	1,760	1,760	1,904	1,931	1,931	2,050	2,029	2,201	2,297	2,373
Bank reserves	145	110	168	122	180	185	195	195	197	208	208	181	117	139	153	214
Reserves in foreign currencies	109	167	144	173	153	166	165	165	193	187	187	194	222	230	232	188
Other deposits	5	6	10	8	10	0	10	10	0	10	10	0	0	0	0	0

Sources: Azeri authorities and staff estimates and projections.

1/ As of June 2001, accounts are valued at program exchange rates of 4,606 manat per US dollar and 1.26 US dollar per SDR.

2/ Original program is adjusted using the program's adjustors on excess SOCAR revenues and on amortization related to external financing to the budget.

Table 4. Azerbaijan : Consolidated Government Operations, 2003-2004
(In billions of manats)

	2003								2003		2004				2004 3/	
	Q1		Q2		Q3		Q4		Year		Q1	Q2	Q3	Q4	Year	Year
	Prog	Act	Prog	Act	Prog	Act	Prog	Proj	Prog.	Proj	Prog				Budget	Prog
Total revenue and grants	1,996	2,191	2,316	2,290	2,389	2,426	2,736	2,813	9,437	9,719	2,402	2,438	2,786	2,846	9,965	10,473
Total revenue	1,996	2,191	2,316	2,290	2,389	2,426	2,686	2,763	9,387	9,669	2,402	2,438	2,786	2,796	9,915	10,423
Tax revenue	1,174	1,164	1,327	1,343	1,345	1,389	1,540	1,561	5,386	5,457	1,367	1,537	1,610	1,730	5,987	6,244
Income tax	284	359	331	376	351	398	385	381	1,350	1,514	355	415	440	482	1,692	1,691
Individual income tax	122	147	142	173	151	204	165	160	580	685	156	182	193	211	742	742
Enterprise profits tax	162	212	189	203	200	193	219	221	770	829	200	233	247	270	950	950
Social security contributions	148	155	163	182	167	216	240	164	718	718	200	205	230	213	848	848
Value added tax (VAT)	419	413	487	511	476	513	538	505	1,919	1,942	480	560	543	615	2,199	2,199
Excise taxes	63	92	74	93	77	75	86	97	300	356	74	86	90	100	350	350
Taxes on international trade	216	94	220	113	191	121	203	331	830	659	197	201	196	202	537	795
SOCAR additional revenue	113	33	101	43	70	45	65	67	348	187	82	68	61	47	0	258
Other taxes	45	50	52	67	83	67	89	84	270	268	61	71	111	118	361	361
Nontax revenue	423	451	589	572	645	552	746	589	2,402	2,164	535	556	574	631	2,046	2,297
of which: Oil Fund revenues 1/	215	217	310	365	316	306	305	299	1,147	1,187	305	296	284	292	928	1,179
Tax credits for SOCAR energy subsidies	400	576	400	375	400	485	400	613	1,599	2,049	500	344	603	435	1,882	1,882
Total grants (current)	0	0	0	0	0	0	50	50	50	50	0	0	0	50	50	50
Total expenditure	2,311	2,124	2,578	2,714	2,474	2,453	2,723	3,215	10,087	10,508	2,395	2,638	2,925	2,944	10,901	10,901
Current expenditure	1,665	1,660	1,935	1,829	2,046	2,027	2,276	2,848	7,922	8,366	2,009	2,138	2,363	2,511	9,021	9,021
Primary current expenditure	1,224	1,059	1,498	1,437	1,595	1,524	1,784	2,081	6,101	6,101	1,481	1,764	1,735	2,032	7,012	7,012
Wages and salaries	316	297	407	351	399	390	481	566	1,604	1,604	457	556	482	630	2,125	2,125
Goods and services	386	274	512	492	592	540	619	804	2,110	2,110	382	539	608	741	2,270	2,270
Transfers to households	460	445	490	513	550	548	641	635	2,140	2,140	609	609	609	609	2,435	2,435
of which: social protection	377	369	407	432	467	465	558	542	1,808	1,808	493	493	493	493	1,971	1,971
Subsidies	49	38	49	61	39	30	26	34	163	163	28	45	22	25	120	120
Oil Fund (operating expenditures)	1	1	1	1	1	1	1	3	5	5	1	1	1	1	4	4
Other	12	4	39	19	14	16	16	40	80	80	4	15	14	25	58	58
Contingent expenditure	10	0	10	0	20	0	55	94	95	94	0	0	0	0	1	1
SOCAR energy related subsidies	400	576	400	375	400	485	400	613	1,599	2,049	500	344	603	435	1,882	1,882
Interest	32	25	27	18	31	17	37	60	127	122	28	29	24	44	126	126
Current balance (-, deficit)	331	530	381	460	343	399	460	-34	1,515	1,354	393	300	423	335	944	1,451
Investment expenditure and net lending	646	463	643	885	428	426	448	368	2,165	2,142	386	499	562	433	1,880	1,880
Domestically-financed	553	281	558	658	194	334	206	182	1,510	1,457	262	293	368	225	1,148	1,148
without BTC loan	227	156	290	300	194	334	206	182	916	881	262	293	368	225	1,148	1,148
Foreign-financed	93	182	85	227	235	92	242	185	655	686	124	206	194	208	732	732
Statistical discrepancy	0	101	0	-186	0	-28	0	1	0	-113	0	0	0	0	0	0
Consolidated government balance, cash basis (-, defic	-315	-34	-262	-239	-85	1	12	-403	-650	-675	8	-200	-139	-98	-936	-428
Excluding foreign project loans	-222	148	-177	-12	150	93	254	-218	5	10	131	7	56	110	1,668	304
Non-oil deficit 2/	-1041	-796	-1,138	-1,176	-964	-843	-899	-1,342	-4,224	-4,157	-968	-1,172	-1,051	-1,096	-4,287	-4,288
Financing	315	34	262	239	85	-1	-12	403	650	675	-8	200	139	98	936	428
Domestic (net)	233	-148	170	-389	-289	-93	-243	204	-129	-426	-131	1	-152	-99	125	-382
Banking system	203	2	-11	-138	-158	-108	-32	335	-1	90	-98	67	-140	-97	-12	-268
Of which:Treasury bills	10	23	5	-24	5	16	20	-3	40	12	14	14	9	9	46	46
Oil Fund	9	-192	143	-281	-168	-14	-255	-145	-268	-632	-61	-68	-65	-65	-8	-259
Nonbank sector	1	1	3	0	3	1	5	1	10	2	3	3	2	3	10	10
Privatizations and other sale of assets	20	30	35	23	35	35	40	26	130	115	25	25	50	60	160	160
Other	0	11	0	7	0	-5	0	-12	0	0	0	-25	0	0	0	-25
External (net)	82	182	93	628	374	92	231	199	780	1,101	124	199	291	197	811	810
Loans	111	201	110	637	404	113	252	246	878	1,196	143	214	314	215	887	886
Project loans	111	201	95	229	253	113	252	197	712	739	143	214	216	215	788	788
Oil bonuses	0	0	15	239	0	0	0	49	15	288	0	0	0	0	0	0
World Bank SAC	0	0	0	169	151	0	0	0	151	169	0	0	98	0	100	98
Amortization due	-29	-19	-18	-9	-31	-21	-21	-47	-98	-95	-19	-15	-24	-19	-76	-76
Financing gap	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0

Sources: Azeri authorities and staff estimates and projections.

1/ Includes profit oil, acreage fees, and income earned on Oil Fund assets. Oil bonuses also enter in the Oil Fund, but these are treated as a financing item.

2/ For the 2003 program target, the figure reported in EBS/03/57 was 4,042. However, this figure incorrectly did not exclude AIOC profit tax of 182 billion manat.

3/ The budget column reflects the draft budget submitted to Parliament, which assumes an oil price of US$20 per barrel in 2004, whereas the program is based on WEO oil prices (US$25.5 per barrel).

Table 5. Azerbaijan: Selected Fiscal Indicators, 2001-2004
(in percent of GDP, unless otherwise indicated)

	2001 Act.	2002 Act.	2003 Prog	2003 Proj	2004 Budget 5/	2004 Prog. 5/
Total revenue and grants	18.7	28.0	28.0	28.4	27.4	28.8
Total revenue	18.6	27.8	27.9	28.2	27.2	28.6
of which: tax revenue	14.6	15.5	16.0	15.9	16.4	17.1
nontax revenue	3.9	6.9	7.1	6.3	5.6	6.3
Tax credits for SOCAR energy subsidies	...	5.4	4.7	6.0	5.2	5.2
of which: oil revenue	6.7	15.5	15.4	16.1	14.4	15.8
nonoil revenue	11.9	12.3	12.5	12.1	12.9	12.9
nonoil revenue (percent of nonoil GDP) 1/	17.5	17.4	17.6	17.3	17.2	17.2
Total grants (current)	0.1	0.2	0.1	0.1	0.1	0.1
Total expenditure	18.7	28.3	30.0	30.7	29.9	29.9
Primary expenditure	18.4	22.6	24.5	24.1	24.4	24.4
Primary current expenditure	16.3	16.9	18.1	17.8	19.3	19.3
Of which: wage bill	4.5	4.3	4.8	4.7	5.8	5.8
goods and services	4.5	4.6	6.3	6.2	6.2	6.2
transfers	6.3	6.6	6.4	6.2	6.7	6.7
Domestically financed investment and net lending 2	1.1	3.0	4.5	4.3	3.2	3.2
Foreign-financed investment	1.0	2.7	1.9	2.0	2.0	2.0
SOCAR energy related subsidies	...	5.4	4.7	6.0	5.2	5.2
Interest on public debt	0.3	0.3	0.4	0.4	0.3	0.3
Wages/ primary current expenditure (in percentage)	27.3	25.5	26.3	26.3	30.3	30.3
Transfers / primary current expenditure (in percentage)	38.3	38.8	35.1	35.1	34.7	34.7
Wages/ non-oil revenue (in percentage)	37.5	35.2	38.0	38.7	45.4	45.4
Transfers / nonoil revenue (in percentage)	52.7	53.4	50.8	51.7	52.0	52.0
Expenditure in education and health	4.3	4.6	4.6	4.4	5.1	5.1
Education	3.5	3.7	3.6	3.6	4.1	4.1
Health	0.8	0.9	1.0	0.9	1.0	1.0
Military expenditure	1.8	2.1	2.1	2.0	2.1	2.1
Current expenditure	16.6	22.6	23.5	24.4	24.8	24.8
Investment expenditure (net of BTC)	2.1	4.9	4.7	4.6	5.2	5.2
Current balance (+ , surplus)	2.1	5.4	4.5	4.0	2.6	4.0
Primary balance (+, surplus)	-0.2	-0.2	-1.6	-1.6	-2.2	-0.8
Primary balance, excluding oil (+, surplus)	-6.8	-15.7	-16.9	-17.8	-16.6	-16.6
Primary balance (excl. externally financed investment)	0.8	2.5	0.4	0.4	-0.2	1.2
Consolidated government balance, cash basis (+, surplus)	-0.4	-0.5	-1.9	-2.0	-2.6	-1.2
Non-oil Balance 3/						
- In percent of total GDP	-7.1	-10.6	-12.5	-12.1	-11.8	-11.8
- In percent of non-oil GDP 1/ 4/	-10.4	-15.0	-17.6	-17.4	-15.7	-15.7
Memorandum items:						
Total external assistance, excluding IMF	1.1	3.4	2.6	3.5	2.4	2.4
Project financing	1.1	2.9	2.1	2.2	2.2	2.2
Program financing	0.0	0.5	0.5	1.3	0.3	0.3
Financing gap	0.0	0.0	0.0	0.0	0.0	0.0

Sources: Azeri authorities and IMF staff estimates and projections.

1/ Non-oil GDP has been reclassified to exclude GDP for oil and gas processing which is now included in oil GDP.

2/ Investment expenditure increases by 0.8 percent of GDP in 2002 and by 1.8 percent of GDP in 2003 due to an equity investment by the government in BTC Azerbaijan.

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

4/ Expenditure on BTC amounted to 2.4 percent of non-oil GDP in 2003, and 1.2 percent in 2002.

5/ The budget column reflects the draft budget submitted to Parliament, which assumes an oil price of US$20 per barrel in 2004, whereas the program is based on WEO oil prices (US$25.5 per barrel).

Table 6. Azerbaijan: Balance of Payments, 2002-2005

(In millions of U.S dollars)

	2002	2003						2004					2005
	2002	Q1	Q2	Q3	Q4	Year		Q1	Q2	Q3	Q4	Year	Year
	Act	Act	Prel. Est	Prel. Est	Proj.	Prog.	Proj	Rev Prog	Rev Prog	Rev Prog	Rev Prog	Rev Prog	Rev Prog
Exports, f.o.b.	2,305	657	593	650	612	2,685	2,511	618	593	568	560	2,338	3,025
Of which: oil and oil products	2,046	583	519	573	534	2,394	2,210	537	509	484	473	2,003	2,664
other	259	73	74	76	78	291	301	81	84	84	87	335	361
Imports, f.o.b.	-1,823	-487	-678	-666	-735	-3,100	-2,565	-798	-899	-904	-853	-3,454	-3,011
Of which: oil and gas sectors	-336	-127	-305	-282	-324	-1,438	-1,039	-391	-479	-479	-426	-1,775	-1,191
other	-1,487	-359	-372	-383	-411	-1,662	-1,526	-407	-419	-425	-427	-1,678	-1,820
Trade balance	482	170	-85	-16	-123	-415	-54	-180	-306	-336	-293	-1,115	15
Services (net)	-936	-379	-378	-366	-427	-1,215	-1,550	-344	-348	-356	-375	-1,422	-1,297
Credit	362	104	98	99	106	386	407	113	111	113	115	453	487
Debit	-1,298	-483	-476	-464	-533	-1,601	-1,956	-457	-459	-469	-490	-1,875	-1,783
Of which: oil and gas sectors	-868	-382	-353	-331	-392	-1,122	-1,458	-301	-307	-313	-331	-1,252	-1,122
Income	-386	-98	-96	-122	-120	-493	-437	-101	-111	-98	-105	-415	-600
Investment income (net)	-326	-83	-81	-106	-99	-416	-369	-84	-89	-78	-82	-333	-522
o/w profit of oil consortium	-344	-95	-94	-100	-99	-420	-389	-89	-85	-80	-84	-338	-555
Compensation of employees	-39	-11	-10	-12	-12	-45	-45	-12	-12	-12	-12	-47	-49
Interest on public debt (including Fund)	-20	-5	-5	-4	-9	-32	-24	-5	-11	-8	-11	-34	-30
Transfers (net)	70	13	49	32	35	77	129	35	38	36	37	146	162
Private	15	3	36	19	21	17	79	21	20	21	22	84	97
Public	55	10	13	13	14	60	50	14	18	14	15	61	65
Current account balance	-769	-294	-509	-471	-635	-2,046	-1,911	-589	-727	-754	-736	-2,807	-1,720
Net direct investment	1,048	428	556	580	525	2074	2,090	543	681	716	733	2,673	1,716
Oil companies	984	422	547	574	515	1974	2,060	528	666	700	715	2,609	1,637
contracted (net)	1,613	599	673	756	701	2727	2,728	703	834	862	877	3,276	2,672
capital repatriation	-629	-176	-174	-182	-195	-755	-727	-175	-168	-162	-162	-667	-1,036
bonus	0	0	49	0	10	3	59	0	0	0	0	0	0
Other	64	6	9	6	9	100	30	16	15	16	17	65	79
Public sector capital	167	37	63	7	17	126	126	24	25	58	24	131	127
Medium Long-term borrowing	216	47	81	23	43	190	195	32	47	67	47	193	180
Budget support	30	0	34	0	0	33	34	0	0	20	0	20	0
Other long-term loans	185	47	47	23	43	157	160	32	47	47	47	173	180
Scheduled amortization	-48	-10	-18	-15	-26	-64	-69	-8	-22	-10	-23	-62	-53
Other (including short term capital) 1/	-135	-135	17	38	101	-44	21	37	48	42	25	151	68
Capital account balance	1,080	330	636	626	644	2,156	2,236	604	753	816	782	2,955	1,912
Errors and omissions	-90	-29	-14	-122	0	0	-165	0	0	0	0	0	0
Overall balance	221	7	112	33	8	110	160	14	26	62	46	149	191
Financing	-221	-7	-112	-33	-8	-110	-160	-14	-26	-62	-46	-149	-192
Change in net foreign assets of NBA (-, increase)	-35	25	-61	-33	17	-55	-52	-4	-14	-51	-35	-104	-102
Net credit from the Fund	-39	-17	-3	-18	-3	-42	-41	-21	6	-12	6	-20	-27
Disbursements/purchases	10	0	18	0	18	36	36	0	18	0	18	36	18
Repayments/repurchases	-49	-17	-21	-18	-21	-77	-77	-21	-11	-12	-11	-56	-45
Change in gross official reserves (-, increase)	4	43	-58	-15	20	-14	-11	17	-20	-38	-42	-84	-75
Change in other foreign liabilities (+, increase)	0	0	0	0	0	0	0	0	0	0	0	0	0
Change in arrears (-, decrease) 2/	15	5	3	4	4	0	15	0	0	0	0	0	0
Change in oil fund assets (-, increase)	-201	-37	-55	-3	-29	-55	-124	-10	-12	-11	-11	-45	-90
Financing gap	0	0	0	0	0	0	0	0	0	0	0	0	0
Memorandum items:													
Current account balance (in percent of GDP)	-12.6	...	...	...	...	-29.7	-27.4	...	...	...	...	-37.8	-20.2
Excluding oil sector imports of goods and non-factor service	7.1	...	...	...	...	7.5	8.4	...	...	...	...	3.0	7.0
Gross official reserves (US$ millions)	721	678	737	752	732	735	732	715	735	774	815	815	890
Gross official reserves (in months of non-oil imports c.i.f.)	4.3	...	...	...	...	3.7	3.8	...	...	...	...	3.9	4.0
Oil fund assets	693	...	...	...	...	748	817	...	...	...	...	862	952
WEO oil price (US$ per barrel)	25.0	...	...	...	...	31	28.5	...	...	...	...	25.5	23.5

Sources: Azeri authorities and staff estimates and projections.

1/ For 2004-2005, includes debt financing of the Baku-Tbilisi-Ceyhan (BTC) pipeline project and the Shah Deniz project by SOCAR.

2/ Arrears are for the nonpayment of electricity imported from Turkey by Azerenergy (a state-owned company) for Nakchivan. The stock of arrears as of August 2003 is estimated at 578.6 billion manat, approximately US$ 118 million. These arrears are not an obligation of the government of Azerbaijan.

Table 7. Azerbaijan: Quantitative Performance Criteria and Benchmarks for the PRGF, 2003-2004 1/ 2/
(In billions of Manats, unless otherwise indicated)

	2002	2003												2004			
	Dec	Mar			Jun			Sep			Dec		Mar	Jun	Sept	Dec
	Act	Prog	Adj. Prog.	Act	Prog	Adj. Prog.	Act	Prog	Adj Prog 3/	Prel Act	Prog	Rev Prog	Prog	Prog	Prog	Prog
1. Quantitative performance criteria and benchmarks																
Floor on net international reserves of the ANB (end-of-period stock, in US$ million)	462	380	372	434	406	414	496	468	436	527	513	513	512	533	579	610
Ceiling on net domestic assets of the ANB (end-of-period stock)	-85	105	143	-20	111	72	-127	-27	121	-133	-28	-28	9	114	17	-36
Ceiling on net credit to the general government from the ANB (end-of-period stock)	154	326	364	163	311	271	91	148	296	-6	93	93	0	53	-95	-202
Ceiling on the overall consolidated non-oil deficit 4/ 5/	...	1,038	927	796	2,179	2,291	1,972	3,143	3,225	2,815	4,224	4,224	968	2,141	3,192	4,288
Ceiling on New Nonconcessional External Debt Contracted or Guaranteed by the Consolidated Government or the ANB (excluding the IMF) (flows, in US$ million) 4/																
Less than one year's maturity	0	0	0	0	0	0	0	0	0	...	0	0	0	0	0	0
Medium- and long-term debt, one to less than five years	...	0	0	0	0	0	0	0	0	...	0	0	0	0	0	0
Other long-term debt (maturity five and more years)	...	20	20	0	40	40	0	60	60	...	80	80	50	100	125	150
2. Continuous performance criterion																
Ceiling on Stock of Outstanding Nonreschedulable External Payments Arrears of the Consolidated Government and the ANB (end-of-peroid stock, in US$ million)	0	0	0	0	0	0	0	0	0	...	0	0	0	0	0	0
3. Indicative targets																
Ceiling on stock of ANB's manat reserve money (end-of-period stock)	1,866	1,704	1,704	1,806	1,817	1,817	1,989	1,955	1,955	2,101	2,139	2,231	2,146	2,340	2,451	2,588
Ceiling on stock of unpaid bills in excess of Manat 50 billion (end-of-period stock)	-36	0	0	22	0	0	3	0	0	-3	0	0	0	0	0	0

1/ The program targets are indicative targets for end-March 2003, end-September 2003, end-March 2004 and end-September 2004, and performance criteria and indicative targets for end-June 2003, end-December 2003, end-June 2004 and end-December 2004.
2/ Foreign exchange components are valued using program exchange rates of 4,606 manat/US$ and 1.26 US$/SDR.
3/ For September 2003 the adjusted program column is based on current projections for (i) oil prices; (ii) exports of crude oil and oil products; (iii) foreign financed investments; and (iv) amortization due on government-contracted external debt.
4/ Cumulative changes during the year.
5/ For the end-December 2003 program target, the figure reported in EBS/03/57 was 4,042. However, this figure incorrectly did not exclude AIOC profit tax of 182 billion manat.

Table 8. Structural Performance Criteria and Benchmarks for End-June 2003

Reform Measure	Status	Comments
Structural Performance Criteria		
Adoption by Parliament of amendments to the Budget System Law (BSL) submitted as prior actions (as specified in paragraph 55 and 56 of LOI)	Observed	The Parliament of Azerbaijan passed amendments to the BSL on May 13.
Adoption by the Cabinet of Ministers of improved regulations on VAT refunds (as specified in paragraph 56 of LOI)	Observed	Improved regulations were adopted by the Cabinet of Ministers decree on June 12, 2003
Structural Benchmarks		
Establishment of a revenue forecasting commission (as described in paragraph 25 of LOI)	Observed	Forecasting commission was established by the Cabinet of Ministers resolution on June 27, 2003
Adoption by Parliament of a new Banking Systems Law (as described in paragraph 42 of LOI)	Not observed	Draft law was submitted to parliament before end-June, but Parliament started deliberations in September. The draft is expected to be adopted by end-2003 (see Table 12)

Table 9. Azerbaijan: Macroeconomic Framework, 2000-2008

	2000	2001	2002	2003	2004	2005	2006	2007	2008
	Act	Act	Act			Projections			
GDP and prices (annual percentage changes)									
Real GDP	11.1	9.9	10.6	9.3	8.1	14.0	18.4	21.7	16.6
Oil sector	2.4	7.9	3.9	0.7	-2.1	53.4	65.8	59.3	34.5
Other sectors	13.7	10.4	12.3	11.3	10.3	6.5	5.5	5.5	5.0
GDP deflator	12.5	2.5	0.7	5.9	-1.7	0.6	1.3	1.9	2.3
Consumer price index (end-period)	2.2	1.3	3.3	2.5	2.5	2.5	2.5	2.5	2.5
Monetary aggregates (annual percentage changes)									
Broad Money (M3)	27.1	29.4	13.1	25.5	21.6	11.2	10.1	10.2	9.6
Credit to non-government 1/	-1.7	-17.5	16.7	28.6	26.0	11.2	10.1	10.2	9.6
Savings and investments (in percent of GDP)									
Gross fixed investment	23.1	22.9	34.8	53.0	58.3	46.1	41.8	25.6	19.1
Consolidated government	3.0	2.1	4.9	4.6	5.2	5.2	5.4	4.6	4.5
Private sector	20.1	20.8	29.9	48.4	53.2	40.9	36.4	21.0	14.7
Of which: oil sector	11.2	14.6	27.5	39.5	45.0	32.4	27.9	14.5	8.3
Gross domestic savings	21.3	24.3	25.3	30.0	24.1	31.0	37.8	48.2	55.2
Gross national savings	17.1	19.8	20.1	25.6	20.5	25.8	31.0	37.3	42.4
Consolidated government	2.4	1.6	5.3	4.3	4.0	4.1	4.6	9.0	12.6
Private sector	14.7	18.2	14.9	21.3	16.5	21.7	26.4	28.3	29.7
Consolidated government (in percent of GDP)									
Revenue 2/	21.2	18.7	28.0	28.4	28.8	27.3	25.6	27.2	27.0
Expenditures 2/	20.8	18.7	28.3	30.7	29.9	28.4	26.4	22.8	18.8
Current	18.6	16.6	17.2	18.2	19.6	19.1	17.8	15.5	14.3
of which: interest payments	0.4	0.3	0.3	0.4	0.3	0.4	0.4	0.3	0.3
Investments	3.0	2.1	5.7	6.3	5.2	5.2	5.4	4.6	4.5
Overall balance	-0.6	-0.4	-0.5	-2.0	-1.2	-1.1	-0.8	4.4	8.2
Non-oil balance 3/	-8.1	-7.1	-10.6	-12.1	-11.8	-11.7	-11.2	-10.4	-9.6
Balance of payments (in millions of US dollars)									
Trade balance	260	581	482	-54	-1,115	15	837	3,618	5,903
Exports	1,799	2,046	2,305	2,511	2,338	3,025	4,016	6,350	8,463
Of which: Oil and gas sector	1,519	1,841	2,046	2,210	2,003	2,664	3,631	5,941	8,028
Imports	1,539	1,465	1,823	2,565	3,454	3,011	3,179	2,732	2,560
Of which: Oil and gas sector	147	138	336	1,039	1,775	1,191	1,179	685	442
Services, net	-225	-375	-936	-1,550	-1,422	-1,297	-1,248	-761	-466
Receipts	260	290	362	407	453	487	518	552	585
Payments	-485	-665	-1,298	-1,956	-1,875	-1,783	-1,767	-1,313	-1,051
Of which: Oil and gas sector	-154	-329	-868	-1,458	-1,252	-1,122	-1,114	-672	-401
Income, net	-295	-332	-386	-436	-415	-600	-879	-1,580	-2,159
Current account balance	-187	-50	-769	-1,910	-2,807	-1,720	-1,103	1,483	3,502
Capital and financial account balance	496	420	1,080	2,235	2,955	1,912	1,393	-845	-2,523
Of which: net FDI	149	299	1,048	2,090	2,673	1,716	1,369	-1,013	-2,740
Memorandum items:									
Gross official reserves									
- in millions of US dollars	680	725	721	732	815	890	928	946	964
- in months of prospective nonoil sector imports of GNF!	4.9	4.5	4.3	3.8	3.9	4.0	4.1	4.1	4.1
External debt/GDP (in percent)	22.1	22.2	22.7	20.8	20.9	19.4	17.1	14.5	13.0
External debt service/exports of GNFS (in percent)	4.6	4.9	4.4	5.8	5.5	3.6	2.4	1.6	1.1
Oil Fund Assets									
- in millions of US dollars	272	493	693	817	862	951	1185	1754	2701
- in percent of non-oil GDP	7.3	12.7	16.2	16.8	15.5	15.7	18.1	24.8	35.4
Nominal GDP									
- in billions of Manats	23,591	26,578	29,602	34,252	36,410	41,752	50,077	62,108	74,038
- in millions of US dollars	5,273	5,708	6,090	6,977	7,415	8,504	10,199	12,649	15,079

Sources: Azeri authorities; and Fund staff projections.

1/ Negative credit growth reflects the impact of closure of nonviable banks, including the closure of Agrobank in 2001.

2/ Revenue and expenditure prior to 2002 do not include quasi-fiscal activities in the energy sector.

3/ Calculated by deducting Oil Fund, AIOC and SOCAR revenue, as well as government financed BTC investment from the consolidated government budget balance.

Table 10. Azerbaijan: External Financing Needs and Sources, 2000-2005
(In millions of US dollars)

	2000	2001	2002	2003	2004	2005
Gross financing needs	511.7	400.6	1,063.3	2,192.1	3,053.3	1,982.7
Current account deficit (incl. official transfers)	173.3	39.6	763.9	1,906.2	2,804.4	1,718.6
Debt amortization	18.1	45.4	48.4	69.9	62.3	53.2
Medium and long-term debt	18.1	45.4	48.4	69.9	62.3	53.2
Short term debt	0.0	0.0	0.0	0.0	0.0	0.0
Gross reserve accumulation (+ increase)	7.0	45.4	-4.2	11.0	83.6	74.6
Oil Fund accumulation (+ increase)	247.5	220.5	200.7	123.8	44.9	89.6
IMF repurchases and repayments, and charges	65.8	49.7	54.5	81.3	58.2	46.6
Gross financing sources	496.5	400.6	1,063.3	2,176.9	3,053.3	1,982.7
Foreign direct investment (net)	148.5	298.7	1,047.8	2,089.7	2,673.3	1,716.0
Debt financing	262.8	185.1	215.5	194.8	192.8	180.4
IMF purchases	0.0	10.2	10.1	36.3	35.7	17.8
Other flows	85.2	-93.4	-210.1	-144.0	151.5	68.4
Financing gap	0	0	0	0	0	0

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

Table 11: Azerbaijan : Capacity to Repay the Fund, 2000-2005

(In millions of SDR's)

	2000	2001	2002	2003	2004	2005
				Projections		
Outstanding use of Fund credit	257.7	234.8	204.9	175.0	160.4	140.7
IMF obligations	49.6	39.0	42.1	58.5	41.9	33.7
Purchases and Disbursements	0.0	8.1	8.1	25.7	25.7	12.9
Repurchases and Repayments	39.0	30.9	38.0	55.6	40.3	32.6
Charges	10.6	8.1	4.1	2.9	1.6	1.1
Outstanding use of Fund credit as a ratio of						
Exports of goods and services	16.6	12.8	9.9	8.3	8.0	5.5
External public debt	29.3	23.6	19.2	16.7	14.3	11.8
Gross official reserves	50.3	41.2	36.8	33.2	27.3	21.9
GDP	6.5	5.2	4.4	3.5	3.0	2.3
Quota	160.1	145.9	127.3	108.8	99.7	87.5
Debt service obligations to IMF as a ratio of						
Exports of goods and services	3.2	2.1	2.0	2.8	2.1	1.3
External public debt	5.6	3.9	3.9	5.6	3.7	2.8
Gross official reserves	9.7	6.9	7.6	11.1	7.1	5.2
GDP	1.3	1.0	1.0	1.2	0.8	0.6
Quota	30.8	24.3	26.2	36.4	26.1	20.9
Memorandum item:						
Quota (million SDR)	160.9	160.9	160.9	160.9	160.9	160.9

Source: Staff estimates and projections.

Table 12. Azerbaijan: Structural Performance Criteria and Benchmarks for end-December 2003, end-March 2004 and end-June 2004

Reform Measure
End-December 2003
Structural Performance Criteria
Determine a single uniform enterprise profit tax rate for all non-oil companies (¶ 23 and 57 of LOI)
Adoption of a procedure for future automatic adjustments of domestic energy prices (¶ 52 and 57 of LOI)
Replacement of specific with ad-valorem customs duties in continued adherence to timetables adopted in compliance with end-March 2002 structural performance criteria (¶ 26 and 57 of LOI, see also EBS/02/21) 1/
Adoption of a Cabinet of Ministers decision reducing list of VAT exemptions and requiring that all future changes be done in the context of annual budget preparation process (¶ 24 and 57 of LOI)
Adoption by Parliament of a new Banking Systems Law (¶ 42 of LOI, and ¶ 15 and 40 of SLOI) 2/
Submission to Parliament of the new Central Bank Law (¶ 14 and 40 of SLOI) 2/
Structural Benchmark
Continued adherence to the SCC reform program (¶ 26 of LOI)
Allocation of tax credits to SOCAR and subsidies to Azerenergy and Azerigas related to unpaid fuel consumed by the utilities
End-March 2004
Structural Performance Criteria
Approval by Cabinet of Ministers of a long-term strategy for oil revenue management (¶ 21 and 41 of SLOI) 2/
Adoption of the Central Bank Law (¶ 14 and 41 of SLOI) 2/
Approval by Cabinet of Ministers of annual expenditure plans and revenue projections for Azerchemia, Azerenergy, Azerigas and Baku metro for 2004 (¶ 38 and 41 of SLOI) 2/
End-June 2004
Structural Performance Criterion
Issuance of a tender for all remaining government shares in IBA (¶ 40 SLOI) 2/ 3/
Structural Benchmark
Review by Cabinet of Ministers of first quarter 2004 implementation by Azerchemia, Azerenergy, Azerigas and Baku metro of their expenditure plans and revenue projections, and taking any necessary measures to ensure these annual budgets are adhered to (¶ 38 and 41 of SLOI) 2/

1/ Consistent with the timetable under the program, on October 1, 2003 the authorities replaced a number of specific with ad-valorem custom duties

2/ New proposed performance criteria to be established at the time of the third review in connection with the disbursement of the fifth loan.

3/ In EBS/03/ 57 (¶ 37 and 57 of LOI), this was scheduled to be a structural performance criterion for end-2003.

Table 13: Azerbaijan: Disbursements
Under the PRGF Arrangement

(In millions of SDRs)

Date of Disbursement	Conditions	Disbursement
July 13, 2001	Disbursed upon Board approval of the PRGF arrangement	8.05
February 28, 2002	Disbursed upon completion of the first review under the PRGF arrangement	8.05
May 29, 2003	Disbursed upon completion of the second review under the PRGF arrangement	12.87
On or after December 19, 2003	Completion of the third review; end-June 2003 performance criteria	12.87
On or after February 15, 2004	Completion of the fourth review; end-December 2003 performance criteria	12.87
On or after August 15, 2004	Completion of the fifth review; end-June 2004 performance criteria	12.87
On or after February 15, 2005	Completion of the final review; end-December 2004 performance criteria	12.87

Azerbaijan: Fund Relations
As of September 30, 2003

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

2. **General Resources Account:**

	SDR Million	Percent of Quota
Quota	160.90	100.00
Fund Holdings of Currency	238.95	148.51
Reserve position in Fund	0.01	0.01

3. **SDR Department:**

	SDR Million	Percent of Allocation
Holdings	1.39	N/A

4. **Outstanding Purchases and Loans:**

	SDR Million	Percent of Quota
Extended arrangements	42.03	26.12
Contingency and Compensatory	14.08	8.75
Systemic Transformation Facility	21.94	13.63
PRGF arrangements	99.17	61.63

5. **Financial Arrangements:**

Type	Approval Date	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
PRGF	07/06/2001	03/31/2005	80.45	28.97
EFF	12/20/1996	03/19/2000	58.50	53.24
ESAF/PRGF	12/20/1996	03/19/2000	93.60	81.90

6. **Projected Obligations to Fund:**
(SDR million; based on existing use of resources and present holdings of SDRs)

	Forthcoming				
	2003	2004	2005	2006	2007
Principal	15.62	40.29	32.57	24.86	24.45
Charges/Interest	0.66	1.57	1.06	0.69	0.42
Total	16.28	41.86	33.62	25.55	24.87

7. **Safeguards Assessment**

Under the Fund's safeguards assessment policy, National Bank of Azerbaijan (NBA) is subject to an assessment with respect to the PRGF arrangement, which was approved on July 6, 2001 and is scheduled to expire on July 5, 2004 (in view of the delay in completing the second review under the program, the authorities are requesting that the PRGF arrangement be extended to March 31, 2005). A safeguards assessment of the NBA was completed on March 8, 2002. The assessment concluded that risks may exist in the legal structure and independence of the Central Bank, and in its internal audit and control systems.

The authorities have made progress in implementing the recommendations of the 2002 safeguards assessment, but have yet to implement the recommendations regarding the bank's profit distribution mechanism and the establishment of an audit committee. It is anticipated, however, that the revised Central Bank Law (expected by end-March 2004) will address the first concern by requiring that profits available for distribution be calculated on the basis of actual operating results measured in accordance with International Accounting Standards. In addition, the bank is considering alternative structures to alleviate the existing audit oversight deficiencies.

8. **Exchange Rate Arrangements**

The currency of Azerbaijan is the manat, which became sole legal tender on January 1, 1994. Currently, the exchange rate is allowed to float against all currencies. Noncash exchange rates are determined five times a week at the foreign exchange auctions conducted by the Baku Interbank Currency Exchange (BICEX). Exchange rates for cash transactions are quoted by commercial banks licensed to deal in foreign exchange on the basis of market conditions. The Azerbaijan National Bank (ANB) conducts the policy of informal exchange rate targeting and determines an official exchange rate against the U.S. dollar every day, equal to a weighted average of all foreign exchange markets, including the off-auction interbank market, the retail intra-bank market, and the bank note market located in foreign exchange bureaus.

Azerbaijan has been classified by the staff with the group of countries whose exchange rate regimes are managed floats.

9. **Article IV Consultation**

The 2003 Article IV consultation with Azerbaijan was concluded on May 14, 2003.

10. **ROSCs**

A fiscal transparency ROSC module was prepared by FAD (SM/00/278, 12/12/01 and updated in April 2003 (SM/03/159, 04/30/03). A data dissemination ROSC module was completed by STA in March, 2003 (IMF Country Report No. 03/86). The authorities have agreed to publish the ROSC and it has now been put on the IMF web site.

11. **Resident Representative**

Mr. Basil B. Zavoico, the Fund's fifth Resident Representative took up his duties in Baku in July 2003.

12. **Resident Advisers**

An adviser on the establishment of the Treasury in the Ministry of Finance, Mr. Nurcan Aktürk, was stationed in Baku from December 1994 until September 1996. He was succeeded by Mr. B.K. Chaturvedi, whose assignment was extended twice, first through August 2000, and then through May 2001. Mr. B.K. Chaturvedi has been replaced by

Mr. A. Khan whose assignment started May 2001 and ended in August 2002. A technical long-term adviser for tax administration, Mr. Mark Zariski, was stationed in Baku from April 1995 until April 1996. He was succeeded by Mr. Peter Barrand, who was stationed in Baku from January 2001 until December 2002. Mr. Isaac Svartsman was resident advisor in the ANB for bank supervision and restructuring from September 1998 to April 2001.

Azerbaijan: Technical Assistance 1998-2003

Fund Dept.	Area of Assistance	Mission Dates
FAD	Treasury project inspection	April/May 1998
MAE	Bank restructuring	May 1998
BCS	Book entry system	October 1998
LEG	Tax code legislation	November 1998
FAD	Tax administration	December 1998
LEG	Tax code	Jan./Feb. 1999
STA	Balance of payments statistics	Mar./April 1999
LEG	Tax code	Mar./April 1999
MAE	Bank restructuring	April/May 1999
FAD	Tax administration	Sept./Oct. 1999
MAE	Bank restructuring	Oct./Nov. 1999
STA	Price statistics	November 1999
STA	National accounts statistics	November 1999
FAD	Tax administration	Jan./Feb. 2000
FAD	Customs administration	Mar./April 2000
FAD	Expenditure policy	April/May 2000
LEG	Tax code	September 2000
MAE	Bank restructuring	October 2000
FAD	Treasury computerization	Oct./Nov. 2000
STA	Price statistics	November 2000
STA	National accounts and GDDS	November 2000
STA	Money and banking statistics	Nov./Dec. 2000
STA	National accounts and GDDS	February 2001
STA	Price statistics	February 2001
STA	Balance of Payments Statistics	April 2001
MAE	Banking supervision	May 2001
MAE	Payments system	May 2001
MAE	Central Bank Internal Audit	June 2001
FAD	Customs Administration	June 2001
FAD	Budget systems law	August 2001
MAE	Bank restructuring and monetary operations	June 2001
TRE	Safeguards assessments	January 2002
LEG/MAE	Banking legislation	January 2002
MAE	Central Bank accounting	January 2002
MAE	Payments system	February 2002
STA	National Accounts	Oct./Nov. 2002
FAD	Tax administration reform	December 2002
MAE	Bank restructuring and monetary operations	December 2002
STA	National Accounts	Jan./Feb. 2003
FAD	Budget systems law	Feb/March 2003
STA	Consumer Price Statistics	June 2003
STA	National Accounts	Jul./Aug. 2003
MFD	Regional Technical Assistance in Public Debt Management	Jul./Sep. 2003
FAD	Revenue Administration	August 2003
FAD	Tax Policy	August 2003

Source: International Monetary Fund

Azerbaijan: IMF-World Bank Relations

Partnership in Azerbaijan's Development Strategy

- The Government's poverty reduction strategy, embodied in its first full State Program for Poverty Reduction and Economic Growth (SPPRED) was discussed by the IDA and IMF Boards in May 2003. The strategy comprises six key strategic aims identified as follows: (i) the facilitation of an enabling environment; (ii) the maintenance of macroeconomic stability; (iii) the improvement in the quality of and equity in access to basic health and education services; (iv) the improvement of infrastructure (including roads, delivery of utility services, communications, irrigation); (v) the reform of the current system of social protection to give a more targeted, but effective protection to the vulnerable; and (vi) the improvement of the living conditions and opportunities for the one million refugees and Internally Displaced People (IDP) of the Nagorno-Karabakh conflict. While the PRSP's overall direction is considered appropriate, weaknesses were identified related to costing, prioritizing, and sequencing measures as well as their monitoring and evaluation.

- Macroeconomic management aims at maintaining a stable economic environment through appropriate fiscal, monetary, exchange rate, and sustainable debt policies. In support of these policies, the authorities are tightening payment discipline, especially in the energy sector, hardening budget constraints for state-owned enterprises, and pursuing enterprise and banking privatization and restructuring. Consistent macroeconomic management has supported the economic recovery since 1995. Nonetheless, maintaining strong growth will depend importantly on accelerating structural reforms to enhance private sector development and to encourage foreign and domestic investment, particularly in the non-oil sectors of the economy.

- The IMF has taken the lead in assisting Azerbaijan in enhancing macroeconomic stability and related structural reform measures. In this regard, the Fund has encouraged the authorities to continue with fiscal reforms and to maintain a prudent monetary policy stance. The Government has also been encouraged to enhance governance and strengthen financial discipline in the energy sector, to strengthen the banking sector, and to improve the legal and regulatory environment for private sector development. The Fund has supported Azerbaijan's economic reform program since 1995. The authorities were successful in achieving macroeconomic stabilization under the economic reform program supported by the early IDA and IMF structural adjustment arrangements, which formed the foundation for an ongoing Fund-supported program under the Poverty Reduction and Growth Facility (PRGF), approved by the Executive Board in July 2001, with the first review endorsed by the Board on February 20, 2002, second review completed on May 15, 2003, and the third review scheduled for December 19, 2003.

- The World Bank has taken the lead in the policy dialogue on structural reforms, including poverty reduction measures, public expenditures, agricultural policies, private sector development, institution building and governance. A range of instruments is used to conduct the dialogue. SAC-II, which has been fully disbursed in June 2003 was supporting a wide-ranging structural reform agenda and its accompanying second institution building and technical assistance credit (IBTA II) is assisting institutional capacity building, especially of government budget preparation and execution, privatization and utility reforms. The Bank has initiated discussions with the authorities on the design of a proposed sequence of Poverty Reduction Support Credits based on the reform agenda of the SPPRED and the CAS. The objectives of the proposed PRSCs are to support proper management of public resources, strengthen corporate governance, encourage non-oil trade and investments and enable adequate regulation of utility services, while increasing the efficiency and sustainability of social services. The proposed PRSCs ensure continuity of the progress made with the support of SAC II.

- This broad-based policy reform approach is combined with sector investment projects in agriculture, roads, water, refugees/IDPs, environment, education, health and domestic gas. Recent analytical and advisory assistance has included a Poverty Assessment, a PER, a CPAR (procurement assessment), a CFAA (financial accountability), pension reforms paper and ongoing work on trade facilitation and mitigation of the social costs of utility price increases.

- The next section describes the Bank program and the division of responsibility between the two institutions. In a number of areas – social sectors and safety nets, environment, governance, infrastructure, and agriculture – the Bank takes the lead in the dialogue and there is no cross conditionality with the IMF-supported program. The Bank is also leading the dialogue in private sector development and public enterprise reform and Bank analysis serves as an input into the Fund program. In other areas—energy, financial sector, public expenditure management, public sector, trade and investment policy—both institutions work together and share cross conditionality. Finally, in areas like monetary policy, tax policy and customs, the IMF takes the lead with limited Bank involvement. (See Table 1).

Table 1. Bank-Fund Collaboration on Azerbaijan

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

Energy Sector Reform	Strengthening financial discipline in energy sector by unification of domestic and international prices for natural gas and oil products, allocation of subsidies to Azerenergy and Azerigas, and offsetting tax credits to SOCAR, full payment by budgetary organizations for their utility consumption.	Strengthening financial discipline in energy sector by elimination of implicit subsidies and improved collections and tariff policies, privatization of distribution companies, introduction of regulatory framework and agency, and specialized advice on oil and gas sector development.	*IMF:* PRGF performance criteria and benchmarks related to domestic energy prices, as well as the incorporation of previously quasi-fiscal subsidies into the state budget *Bank*: Policy conditionality on utility reforms, especially aimed at improving financial viability within the proposed PRSCs (previously SAC-II). PPIAF/ESMAP TA on sector restructuring and regulations. IBTA-I and –II supported assistance for privatization and in analyzing the environmental and social impact of such reforms and designing measures to protect the poor.
Financial Sector Reform	Strengthening the competitiveness and health of the banking system, privatization of state-owned banks, revision and introduction of a new legal framework for the banking sector (banking law, bankruptcy law, central bank law), development of manat financial markets, including the market for T-bills, safeguards assessment of the financial sector, FSAP	Restructuring and privatization of large State banks, strengthening of ANB's supervisory capacity, introduction of electronic payment systems, credit rating agencies and registries, SME credit, FSAP.	*IMF:* PRGF performance criteria and benchmarks on bank privatization, banking system law and central bank law. *Bank*: SAC-II Policy conditions on the financial sector within the proposed PRSC (previously SAC-II) and the financial sector TA credit.
Social/Poverty		Public expenditure reforms, strengthening of monitoring and evaluation systems, reform strategies for education, health, social assistance and protection as well as pension reform and direct assistance to IDPs.	*Bank*: Policy conditionality in SAC-II the proposed PRSC (previously in SAC-II). Poverty Assessment and TA for Household and other surveys, assistance with design of pension reforms and better targeting of social expenditures. Project to assist IDPs and refugees. Education and Health LILs aimed at improving service delivery to

			the poor.
Private Sector Development	Trade and investment policy	Integrated framework for trade and business development, improving and monitoring of the business and investment environment, streamlining procedures for entry and exit, enhancing high-level public/private sector dialogue, trade and transport facilitation, SME support, and privatization of SOEs.	*Bank*: enhanced public-private partnership supported via the proposed PRSC (previously by SAC II) and IBTA II; analytical assistance on the nexus of business environment and governance in cooperation with FIAS; integrated trade and business development framework report; trade and transport facilitation report; SAC II and IBTA II supported TA on privatization and labor redeployment.
Other sectors		Strengthening rural and agricultural infrastructure, transport policy and infrastructure, environmental clean-up and preservation.	*Bank*: investment projects in environment, agriculture and highways.

IMF-World Bank Collaboration in Specific Areas

Areas in which the World Bank leads and there is no direct IMF involvement

- These areas are the social sectors, agriculture, infrastructure and environment. In the social sphere, the Bank has been involved in both improving the data and analyzing poverty as well as in helping design pension reforms, and measures to mitigate the social impact of utility reforms aimed at raising collections and tariffs. In education a LIL is to be followed by an APL to improve quality. There is also an ongoing LIL in the health sector (in partnership with UNICEF) which aims at building capacity of the Ministry to carry out health care reforms and pilot them in selected districts.

- In infrastructure, Bank lending to date has comprised projects for Gas Rehabilitation, water supply and highways. An environment project is being followed by assistance to build the capacity of the new Ministry of Environment and mainstreaming environmental concerns across-the board, especially in the energy sector. In Agriculture the Bank has provided credits for farm privatization, irrigation rehabilitation and credit, extension and other agricultural services.

Areas in which the World Bank leads and its analysis serves as input into the IMF program

- The Bank leads the dialogue on structural reforms through the **proposed PRSCs**. The PRSCs will initially focus on any follow-up reforms to SAC-II and will extend to new reform initiatives. Bank leads in the areas of:

- **Privatization and Private Sector Development.** The Bank is taking the lead in the formulation of an integrated strategy and action plan for trade and private sector development.[5] An important element of the strategy is in providing a framework to better integrate the efforts of key stakeholders—i.e., the Government, multilateral and bilateral donors, the private sector, and others—in promoting non-oil trade and investment. The four broad policy components include: (i) Improving the Trade Policy Regime and Market Access—creating a more export-friendly tariff structure, accelerating Azerbaijan's accession to the WTO, increasing access to regional markets and the European Union; improving access to finance; streamlining administrative procedures; (ii) Enhancing Trade Facilitation—streamlining and strengthening customs procedures and improving the quality and capacity of Azerbaijan's transportation infrastructure; (iii) Improving the Macro Business Environment - the macro business environment cover a wide range of issues impacting on private sector development, including improving business registration

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

and licensing; land acquisition and site development; labor market policies; taxation; access to credit; support for SMEs; contract enforcement and dispute settlement; and public sector governance; and (iv) Developing Competitive Industry Clusters—industry-specific strategies for improving inter-firm cooperation, promoting innovation and quality, encouraging specialization and strengthening supply chains.

- The Foreign Investment Advisory Service (FIAS) has recently conducted a diagnostic study of the investment environment to determine the most important impediments to private sector investments, and this was followed up by the CIS Business Environment Enterprise Performance Survey 2002 (BEEPS) conducted by the Bank and EBRD together.

- **IFC's strategy** emphasizes support to the non-oil sector to help economic diversification. To this end, IFC will help catalyze FDI in non-oil sector projects which focus on exports, help generate foreign exchange earnings and contribute to the modernization of the country's manufacturing base and basic infrastructure. IFC's strategy for the non-oil sectors involves: (i) promotion of competition in the banking sector, establishment of joint ventures in the non-bank financial sector, technical assistance to private local banks for institutional capacity building; (ii) improving access to finance through credit lines to local private banks for on-lending to SMEs; (iii) efforts to improve the business climate and reduce impediments to foreign investments; (iv) support of agri-business and agro-processing; and (v) support for private provision of public services.

- As for **privatization**, the Bank provides support for hiring of financial technical and legal advisors, advises on the transaction processes, and ensures that proper social and environmental mitigation is taken into account. The Bank is also supporting the development of a strategy for further industrial privatization as well as for labor redeployment. Together with the EBRD, and in the context of the new proposed PRSCs, the Bank is also planning to support **financial and corporate restructuring of SOCAR**.

- **Regulatory Reforms,** including approval of draft regulations for electricity, gas, and water sectors, separation of regulatory and commercial functions in utilities, transport and communications sectors, establishing an independent regulator agency assigned with regulatory functions. In particular, all regulatory functions currently exercised by Azal, Azeri Rail, Azeri Road Company and Caspian Shipping Company will be transferred to the Ministry of Transport, the commercial and regulatory functions of the Ministry of Communications will be separated, and remaining regulatory functions of SOCAR will be transferred to the appropriate government institution.

- While the Bank has taken the lead in privatization and in structural reforms in the private sector as described above, the IMF has also a strong interest in these areas since many of these reforms are critical to achieving macroeconomic stabilization and enhancing growth prospects. Accordingly, there is a high degree of consultation and coordination between the two institutions on these matters.

Areas of shared responsibility

- The Bank and the Fund are working jointly in the following three main areas, supported by the Bank's SAC-II, the joint Bank/Fund Financial Sector Assessment Program (FSAP), several investment and technical assistance operations and the Fund's PRGF.

- **Public Expenditure Management.** This area includes public expenditure management reforms aimed at introduction of a medium-term expenditure framework and public investment program a long-term oil revenue management strategy, implementation of a new Budget Systems Law, consolidation of all extrabudgetary resources including the Oil Fund with the state budget, modernization of the Treasury, strengthening the Chamber of Accounts and supporting tax and customs administration. Both institutions are involved in supporting treasury modernization, while the Fund is providing technical assistance in support of tax and customs operations. The governance framework for the Oil Fund is another area in which there is very close cooperation, as well as the elimination of all quasi-fiscal subsidies.

- **Financial sector reforms.** This area includes strengthening the competitiveness and health of the banking system, privatization of state-owned banks, revision and introduction of a new legal framework for the banking sector (banking law, bankruptcy law, central bank law), development of manat financial markets, including the market for T-bills and implementing IMF's safeguards assessment's recommendations. Both institutions have conducted the first joint FSAP mission during September, 2003, while the second and last joint mission is scheduled to take place in December 2003. In terms of banking supervision, the IMF is monitoring the closure and merger of banks that do not satisfy prudential requirements.

- **Utilities reform,** including measures to reduce implicit subsidies in the electricity, gas, and water sectors, to ensure full payment by budgetary institutions their utility bills, to improve overall utility collections, revision of electricity and gas tariffs to cover the true costs of providing these services. The Fund takes the lead in seeking to ensure that budget organizations and state-owned enterprises pay their utility bills in full and the budget fully funds remaining energy-related subsidies, while the Bank is taking the lead in utility and state-owned enterprise reform, tariff revision and collections from households, regulatory reform and privatization.

Areas in which the IMF leads and its analysis serves as input into the World Bank program

- The Fund leads the dialogue on fiscal matters, setting the overall ceiling on the consolidated budget. In addition to the achievement of overall fiscal targets the Fund-supported PRGF includes performance criteria and structural benchmarks requiring: (i) issuance of a tender for all remaining shares in IBA; (ii) adoption by parliament of a new Banking System Law, and (iii) adoption of a procedure for future automatic adjustment of domestic energy prices.

- In the budgetary area the Fund is taking the lead on reforms of budgetary revenues and expenditures to (i) complete the process of subjecting all taxpayers to the tax legislation; (ii) improve procedures for revenue forecasting; (iii) improve tax and customs administration; (iv) eliminate the earmarking of revenues for some extra-budgetary operations of budget organizations. In these areas, as well as monetary policy, the Bank takes into account the policy recommendations of the IMF and ensures that its own policy advice is consistent.

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

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Azerbaijan: Statistical Issues

Although the authorities have made significant progress towards improving the quality and timeliness of their macroeconomic statistics, a number of weaknesses need to be addressed, particularly in the areas of national accounts and producer prices. In these areas, extensive technical assistance has been provided by the Fund. It is important for the authorities to persevere with the implementation of the recommendations derived from this assistance.

A data ROSC mission, which took place in May 2002, carried out a review of Azerbaijan's data dissemination practices against the GDDS, as well as an in-depth assessment of the quality of national accounts, CPI, PPI, government finance, monetary, and balance of payments statistics. The Data ROSC module is published on the IMF external website.

I. Real Sector

National Accounts Statistics

Peripatetic missions took place in Baku under the STA two-year period technical assistance on national accounts to the State Statistics Committee (SSC) of Azerbaijan. Progress was made in number of areas: (i) the methods for compiling the gross national income were improved and the revised estimates disseminated; (ii) input-output tables for 2001 and quarterly national account estimates at constant prices for 1998-2001 were compiled; (iii) the data on capital investments were revised. The mission identified several significant problems related to calculation of real growth in the construction sector. Due to the absence of a Producer Price Index (PPI) for construction, the SSC uses data on capital investment, which are considered to be more reliable than data collected directly from companies, to calculate real growth in the sector. Fund staff agree with the staff of SSC that the current approach used is a temporary solution. The PPI for construction is planned to be developed during 2004-2005.

Price Statistics

The price department of the SSC intended to update the consumer basket of goods and services and respective weights used for the compilation of the Consumer Price Index (CPI). Statistics mission visited Baku in the middle of June, 2003 to assess the progress with the pilot CPI based on the new weights prepared by the SSC. The mission assisted the staff of SSC with the specification for data processing for the new CPI and developed a preliminary list of approximately 550 market basket items. Procedures for estimating the market basket weights based on the results of the 2002 household budget survey have been developed and the SSC is to complete estimations of these weights by the end of 2003. The number of cities covered in the updated CPI will increase from 6 to 11. The new index is now planned to be published beginning with the July 2004 CPI index.

II. Fiscal Sector

The treasury system was overhauled with the assistance of an FAD resident advisor in 1998. Steady improvements were made since then, and the adoption of new budget classification system in 2002 paved the way for a computerization project currently underway. Since 2001 the government reports on quasi-fiscal activities in the energy sector and an estimate of these operations was included in the 2003 budget. In 2002, for the first time, a consolidated budget balance was produced. In 2003, the government amended its Budget System Law and, as a result, the state budget is now submitted to Parliament at the paragraph level. The recently published data ROSC recommends to expand the coverage of government finance statistics by including all operations recorded by the treasury and to publish details on financing and debt outstanding. Over the medium term the government should strive to publish all fiscal data in a single publication showing budget and GFS presentations. Over the medium term the government should develop a plan for adopting the framework and classification system recommended on the GFSM 2001 and strive to publish all fiscal data in a single publication showing budget and GFS presentations.

III. Monetary Sector

An STA technical assistance mission visited Baku in May 2002 and found the monetary statistics to be in full compliance with the GDDS and SDDS standards in terms of quality, coverage and timeliness, with the following two exceptions. First, the mission recommended that the chart of accounts for commercial banks be revised so as to allow a distinction between commercial banks' holdings of securities issued by residents and nonresidents. Second, some changes were needed to record properly thc accounts of the IMF and other international financial organizations in the balance sheet of the Azerbaijan National Bank (ANB). The mission also developed new report forms, to reflect the adoption of new charts of accounts for the ANB and the commercial banks that became effective in January 2003 and September 2002, respectively. These forms are now used to generate automatically the analytical tables required for monitoring the PRGF-supported program.

IV. External Sector

Balance of Payments (BOP): The overall structure of the balance of payments statistics is in broad conformity with the guidelines presented in the *Balance of Payments Manual, fifth edition*. Remaining weaknesses in the balance of payments compilation include (i) poor information on foreign direct investments (FDI) in the non-oil sector (ii) undercoverage of nonguaranteed external debt; (iii) poor data on migrants' transfers; and (iv) misclassification of current transfers and other liabilities transactions. An STA mission provided assistance on balance of payments and external debt statistics in March-April 2001, while the May 2002 data ROSC mission identified measures for further improving the balance of payments statistics.

The ANB has made steady progress toward implementing the recommended short-term measures in the Data ROSC module for strengthening the balance of payments statistics. Almost all short-term measures have been completed; the methodology for compiling reserve assets has been revised to exclude the Oil Fund assets and reclassify them into other investment assets of the government; a new survey form for oil sector enterprises has been designed and distributed to international oil consortia for their input; and the scope and classification of BOP statistics have been improved by separately identifying errors and omissions, goods for processing, transportation services by modes of transport, insurance services, and subcomponents of reserve assets. The separate identification of reinvested earnings still needs to be implemented, while the assigning of responsibilities for compilation of nonguaranteed external debt of the private and banking sectors will need legislation in order to move forward.

Substantial progress has also being made in implementing the Data ROSC module's medium-term recommendations on balance of payments statistics; the development of documentation on BOP sources and methods has been completed, but publication of this documentation is scheduled for 2004 due to budgetary constraints; a project to introduce advanced computing technology for data compilation and processing has been implemented; the ANB is working on strengthening the methodology on travel with respect to the estimation of shuttle trade and per capita expenditures of travelers; and the SSC plans to evaluate the statistical techniques used for the surveys on services and FDI transactions that it conducts, with a view to improving them.

International Investment Position (IIP): The ANB has initiated compilation of the IIP statistics, but the IIP statement is still at a preliminary stage. Starting from 1999, partial IIP data are published in the IMF's *International Financial Statistics*.

Reserves and Foreign Currency Liquidity: Monthly data on total official reserve assets and daily ANB net interventions in the foreign exchange market are provided within 15 days of the end of each month. Data on official reserves during the month are provided on request from Fund staff. Azerbaijan does not disseminate the reserves template, but the ANB and the government of Azerbaijan do not engage in any forward or futures transactions that could give rise to contingent short-term net drains on foreign currency assets.

External Debt: External debt statistics for public and publicly guaranteed external debt are reported on a quarterly basis with a lag of one to two months. A debt service schedule for public and publicly guaranteed external debt separately identifying the principal and interest components, is also provided with monthly periodicity and with a one quarter lag. However, systematic information on nonguaranteed external debt, including a sectoral breakdown of such debt, is lacking. The authorities are committed to strengthening the debt management system, including maintaining a database on debt comprising not only public and publicly guaranteed external and domestic debt, but also external and domestic debt of state-owned enterprises. The IMF plans to provide technical assistance, including on the monitoring of private non-guaranteed external debt, as part of the Regional TA Project for Public Debt Management initiated in September 2002.

Statistical Appendix: Core Statistical Indicators
(As of November 20, 2003)

	Exchange Rates	International Reserves 1/	Central Bank Balance Sheet	Reserve/ Base Money	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Overall Government Balance 2/	GDP	External Debt 3/	Debt Service 3/
Date of latest observation	9/30/03	9/30/03	9/30/03	9/30/03	9/30/03	9/30/03	03/03	Q2 2003	Q2 2003	End-Sep.	End-Dec.	Q2 2003	Q2 2003
Date received	10/11/03	10/11/03	10/11/03	10/11/03	10/11/03	10/11/03	April	Aug 14.	Aug 14	Oct 25	Jan. 8	Aug 27	Aug 27
Frequency of Data	D	D	D	D	M	M	M	Q	Q	M	M	M	M
Frequency of reporting	D	D	D	D	M	M	M	Q	Q	M	M	Q	Q
Source of data	A	A	A	A	A	A	A	A	A	A	A	A	A
Mode of reporting	C	C	C	C	C	C	C	C	C	C	C	C	C
Confidentiality	U	U	U	U	U	U	U	U	U	U	U	B	B
Frequency of publication	D	M	M	M	M	M	M	Q	Q	M	M	Q	Q

1/ Monthly data on total official reserve assets and daily ANB net interventions in the foreign exchange market are provided within 15 days from the end of each month. Data on official reserves during the month are provided on request from Fund staff. Azerbaijan does not disseminate the reserves template, but the ANB and the government of Azerbaijan do not engage in any forward or futures transactions that could give rise to contingent short-term net drains on foreign currency assets.

2/ The general government balance is calculated from financing items.

3/ External debt is reported for public and publicly guaranteed external debt with monthly periodicity and quarterly timeliness. A debt service schedule for public and publicly guaranteed external debt, separately identifying the principal and interest components, is reported also with monthly periodicity and with a one quarter lag.

December 4, 2003

Mr. Horst Köhler
Managing Director
International Monetary Fund
700 19th Street, N.W.
Washington, D.C. 20431

Dear Mr. Köhler:

1. On May 14, 2003, the IMF Executive Board endorsed the completion of the second review under Azerbaijan's Poverty Reduction and Growth Facility (PRGF) arrangement, which is in support of our economic reform program. We would like to take this opportunity to inform you about our continuing implementation of this program, as well as our policy intentions for the rest of 2003 and 2004, and to propose revised performance criteria, indicative targets and structural benchmarks for end-December 2003, as well as for 2004. This letter should be read as additional to our original letter of intent and Memorandum of Economic and Financial Policies, dated June 15, 2001, as well as our letters of February 6, 2002 and April 23, 2003.

2. Our performance relative to the quantitative performance criteria and indicative targets for end-March, end-June and end-September 2003, as well as the proposed quantitative performance criteria and indicative targets for December 2003 and 2004 are presented in Table 1. Performance relative to these targets and criteria will be measured as detailed in Annex I of our April 23, 2003 letter. The fourth and fifth reviews under our PRGF arrangement are scheduled for completion by February 15, 2004 and August 15, 2004, respectively.

3. The proposed performance criteria and indicative targets, as well as our program policies and objectives described below, are fully consistent with our State Program for Poverty Reduction and Economic Development (SPPRED).

Macroeconomic Developments

4. Macroeconomic developments continue to be consistent with our program targets, with real GDP growth in the first nine months of 2003 of 10.4 percent compared to the same period a year earlier, and 12 month consumer price inflation through October of 2.6 percent. All quantitative and structural performance criteria for end-June 2003 were met, as were all but two indicative targets for end-March, end-June and end-September 2003. While the reserve money target was exceeded modestly on all three dates, in light of the continuing low inflation it is clear this higher reserve money reflects more rapid than anticipated recovery in manat money demand. In addition, the target on unpaid budgetary expenses was exceeded by about 0.2 percent of GDP at end-March, with these excess unpaid bills almost eliminated by

end-June. As of end-September, the stock of unpaid bills was within program targets. The temporary increase in unpaid bills was the result of selected ministries that had received allocations to pay their bills, but had not yet done so. To address this issue, the Ministry of Finance will issue instructions to all ministries that, when they receive an allocation to pay a bill, that bill must be paid within 10 days. If the bills are not paid in that time period, future allocations to that ministry will be reduced.

5. The key energy sector investments—the Baku-Tbilisi Ceyhan oil export pipeline (BTC), the first phase of development of the Azeri-Chirag-Guneshli oil field (ACG), and the Shah-Deniz gas field and associated export pipeline—are proceeding according to plan. BTC should be operational in early 2005, in time for the oil from the first phase of ACG, while Shah Deniz gas should start flowing sometime in 2006.

6. We continue to believe the program targets for consumer price inflation and real GDP growth for 2003 remain appropriate. For 2004, we envision a slight decline in the real GDP growth rate due to a temporary slowdown in oil sector production, and will continue to target 2.5 percent annual inflation.

Progress on Structural Reforms

7. Structural reforms have been in line with our program commitments and objectives. **The two end-June structural performance criteria, which focused on fiscal reforms, were met**. First, the important amendments to the Budget Systems Law—which were drafted in close cooperation with Fund and Bank staff, and were designed to enhance the legislative foundation of the Oil Fund and ensure the full integration of its expenditures into a parliamentary-approved consolidated budget—were enacted in May 2003. In June we issued improved regulations on VAT refunds—the second structural performance criterion—which were designed in consultation with Fund staff. We have also met the end-June **structural benchmark** calling for the creation of a revenue forecasting commission; this commission has proven extremely valuable in improving the process of preparing revenue projections for the 2004 budget.

8. Other important fiscal reforms have also been implemented in 2003. First, the state oil company, SOCAR has worked closely with the Ministry of Taxes on a monthly basis to determine its legal tax liability, and has each quarter ensured that it fully met its tax obligations as determined by the Ministry of Taxes. As oil prices through September were higher than assumed in the budget, SOCAR's tax payments have exceeded the levels projected in the budget. Consistent with our program commitments, the Ministry of Finance has saved the additional revenues in the first two quarters of 2003 (73 billion manat, or 0.2 percent of GDP) as a cushion against possible future declines in oil prices and thus tax payments by SOCAR. The amount to be saved in the third quarter is being determined. Finally, we have continued to implement the reform program for the State Customs Committee, and our efforts to improve tax administration, including through increased reliance on performance indicators for the Ministry of Taxes; these performance indicators were designed in consultation with the former FAD resident advisor.

9. In one area our structural reform efforts have not met with as much success as we had hoped. While we have fully reflected the **subsidies to Azerenergy and Azerigas** in the state budget (a structural benchmark), and provided loans to Azerchemia to replace the previous quasi-fiscal subsidies from SOCAR, we have not yet had success in improving financial discipline in these enterprises and thereby reducing these subsidies—the ultimate objective of these reforms. Our efforts to reduce the subsidies have been made more difficult by the increase in oil product prices in early 2003. As a result, we will be taking a number of steps, discussed below, to strengthen our efforts to reduce these subsidies.

10. We have also continued to make significant progress in **reforming the banking sector**. While difficulties in finalizing the details of the draft new Banking Sector Law prevented us from adopting that law by end-June (the final structural benchmark for end June), we have now submitted that law to parliament.

11. The process of privatizing International Bank of Azerbaijan (IBA) has moved forward. Consistent with our intention to sell 20 percent of IBA to EBRD, thereby reducing government ownership of the bank to 30.2 percent, we signed a Memorandum of Understanding on this issue with EBRD in May 2003, and have hired a consultant to conduct an evaluation of the bank, in line with our goal of proposing to the EBRD the sale of a 20 percent share by end-2003. We are also well advanced in our restructuring of BUS Bank, to prepare it for privatization.

12. To facilitate the privatization of IBA, the ANB in July extended a 100 billion manat, 15-year loan to MOST Bank, at 2 percent interest and without collateral, which MOST Bank then used to purchase certain non-performing loans from IBA. MOST Bank purchased these assets, as it felt it had better opportunities to collect.

Monetary Policy and Financial Sector Reforms

13. We remain committed to adhering to the **monetary program and targets previously established for 2003,** except that, as money demand is recovering in 2003 more rapidly than had been expected when our monetary program for 2003 was first designed, we propose to accommodate this growing money demand by revising upward our reserve money indicative target for the year, as indicated in Table 1.

14. We will not, however, adjust the monetary program to accommodate the **monetary implications of the MOST Bank loan**. To offset the monetary impact of this transaction, and ensure that we are still able to adhere to the program performance targets on Net Domestic Assets of the ANB, the ANB is selling to banks government securities currently held by the ANB. In addition, ANB regulations have been revised to prohibit any loans with maturity greater than 6 months, and loans without proper collateral. These regulations will also be reflected in the new Central Bank Law, which we will submit to parliament in 2003, seeking its adoption in the first quarter of 2004. The ANB has entered into an agreement with MOST Bank, specifying steps the bank will take to ensure that it is in compliance with all prudential requirements, including an agreed timetable for increasing its capital base as

needed. Finally, notwithstanding the maximum 15 year maturity, MOST Bank will be repaying this loan as it collects on the underlying credits; indeed, they have begun modest repayments already.

15. We have reviewed the draft Banking System Law, in cooperation with the staffs of the Fund and World Bank, to ensure that it is consistent with Basle Core Principles, and we will seek its passage by parliament by the end of 2003.

16. For 2004, we anticipate a continuation of the recovery of money demand, with velocity of manat broad money declining by roughly 10 percent. Our proposed 2004 monetary program is consistent with this growing money demand, as well as with the continuation of low inflation. We will continue our informal **exchange rate targeting**, which has served Azerbaijan well, allowing for modest nominal depreciation in 2004.

17. We will take all steps necessary to ensure the **signing of a sales agreement on the sale of 20 percent of IBA** to the EBRD before the end of 2003, and immediately after completing this sale we will announce a tender for the sale of all remaining government shares in IBA. As the discussions with EBRD have been complex, the process is not moving as quickly as we had hoped at the time of our April 23, 2003 letter to the IMF Managing Director. As a result, we will not be able to meet our previous objective of issuing a tender for all remaining shares of IBA by end-December 2003, and request that this performance criterion be revised, with a new target date of end-June 2004. We will also recapitalize IBA during 2004, to ensure that it is in compliance with capital adequacy requirements.

18. With regard to BUS Bank, we have issued a tender for consulting services, with the aim of privatizing this bank by end-2004, including by offering at least 25 percent of the bank to a strategic investor in the second half of 2004. We have decided, in consultation with Fund and World Bank staffs, to now allow BUS Bank to begin making loans for the first time—an important step in making this bank attractive to potential investors. However, to limit the risks to the government and to the financial system, the amount of such loans will initially be limited to not more than 5 percent of the bank's statutory capital.

19. In line with our efforts to **improve competition in the banking system**, in addition to privatizing these banks, the ANB has announced the elimination of the remaining ceiling on foreign bank participation. In 2004, the Ministry of Finance will, as a pilot project, tender for the provision of government banking services in at least three regions, as a first step toward full tendering for such services starting in 2005. We will ensure that the final version of the new Law on Accounting, a draft of which has already been submitted to Parliament, is fully satisfactory to the Fund and the World Bank, and that it is consistent with International Accounting Standards (IAS). To improve access to credit for our farmers, in consultation with Fund and World Bank staff, we have decided to merge our Rural Investment Fund and Agrocredit, creating a larger and more effective non-bank credit institution on the basis of a detailed business plan. Finally, once the FSAP report has been completed, we intend to move aggressively in implementing reforms recommended in that report.

Fiscal Policy and the 2004 Consolidated Budget

20. Azerbaijan is at an important juncture, as we prepare for the inflow of the growing oil revenue beginning in 2005. We are aware of the challenge this revenue confronts us with: the need to ensure that it is used to benefit our population, and that it does not become the resource curse that such revenue has been in many countries. We are also aware that this challenge is made even greater by the temporary nature of this oil revenue; according to current projections, our oil revenues will return to current levels within the foreseeable future.

21. As a result, we attach the highest priority to the development of a long term, coherent strategy for the use of oil revenue. We have created a commission, chaired by the Prime Minister and including the Ministers of Finance, Economic Development and Taxes, the chairman of the ANB, and the directors of SOCAR and the State Oil Fund (SOFAR). This commission is charged with preparing a **long term oil revenue management strategy** for consideration and approval by the Cabinet of Ministers and submission to the President no later than end-March 2004. This timing will ensure that this strategy forms the basis of the preparations of the 2005 budget. We will work in close cooperation with the Fund and World Bank staffs to develop this strategy, seeking to ensure that it is consistent with short run and long-term economic stability, and with our SPPRED. We will also ensure that this strategy is based on sound and transparent fiscal rules that limit the exposure of the budget to volatility in oil revenues. At the same time, we will work to further strengthen our Medium Term Expenditure Framework and Public Investment Program.

22. Our initial work on such a strategy has led us to conclude that we should gradually increase our use of oil revenue, but we are not yet ready to do that in 2004, as we are not sufficiently advanced in our preparation of this strategy. As a result, in our 2004 consolidated budget, the non-oil deficit, excluding BTC financing, is only modestly higher as a share of GDP than in 2003.

Revenues

23. We will introduce several tax policy reforms with the 2004 budget; these reforms are intended to improve the efficiency of tax policy, facilitate tax administration, reduce the tax burden on the non-oil sectors of the economy, and encourage firms currently operating in the shadow economy to join the formal economy. First, we will reunify the **enterprise profit tax** for all non-oil enterprises, replacing the current tax rates, which vary from 10 to 25 percent, with a uniform rate of 24 percent. The only exception to this unified tax regime will be for the agriculture sector, where we will renew, on an unchanged basis, our long-standing tax exemption. We will also impose on selected highly profitable non-oil state owned enterprises a mandatory dividend payment, yielding 45 billion manat for the 2004 budget. The variations in the enterprise profit tax rates that have been in place in 2003 were an initial attempt to encourage economic development of Azerbaijan's regions. In lieu of these tax preferences, we will work with the staffs of the IMF and the World Bank to design and adopt a comprehensive program for regional development that is consistent with our broader policies.

24. Second, in an effort to ease the tax burden on the lowest income workers, and to simplify the **personal income tax** (PIT) system, we will increase the income exempt from the PIT from 100,000 manat to 150,000 manat per month. We will also replace the current three rate system (12, 25 and 35 percent), with a two rate system: 14 percent for virtually all incomes, and 35 percent for high income workers (above 3 million manat per month).

25. Third, we have reduced the list of **VAT exemptions** by 20 percent (based on 2002 import values). Partially offsetting these reductions, in light of the rising cost of grain in the region, we have temporarily extended VAT exemptions to grain imports from October 1, 2003; this exemption will be eliminated no later than October 1, 2004 and will not be renewed. We have also adopted a Cabinet of Ministers decree stating that, in the future, the VAT exemption list will only be revised by the Cabinet of Ministers once a year, in the context of the annual budget preparation.

26. Fourth, we are continuing the process of gradually reducing the number of imported goods subject to specific import duties, and reducing the weighted average import tariff. Following the changes that took effect on October 1, 2003, there is only one more step remaining. As a result, by April 1, 2004, specific import duties will only apply to excisable goods, and the weighted average tariff will have been reduced to 6.5 percent.

27. Finally with regard to revenues, we intend to build on our success in collecting taxes from **SOCAR**. In the 2004 budget, we will include in the budget our commitment to save any revenues resulting from oil prices higher than envisioned in the budget (US$20 per barrel), as a cushion against future price declines.

Expenditures

28. The main innovation in expenditures in 2004 will come from our increased **use of Oil Fund money to finance high priority expenditures identified in our SPPRED**. First, we have identified key infrastructure projects—including school construction, and the building of critical roads and sewerage systems—and will finance them through the budget. However, while there are great infrastructure needs in Azerbaijan, as a result of the massive energy sector investment projects underway the construction industry is growing rapidly. To avoid overheating in this sector, we are reluctant to increase total capital expenditures too rapidly. Therefore, we are targeting an increase in domestic and foreign financed capital expenditures in the consolidated budget of about 8 percent. In 2005, as BTC and other big investment projects wind down, we will increase capital expenditures in the budget more aggressively.

29. Second, we will continue our efforts to resettle refugees and internally displaced persons who have spent over 12 years living in tent camps and other similar housing.

30. There will be no substantial changes in current expenditures. In particular, there will be no wage or pension increases in 2004, except for targeted increases designed to align salaries for selected positions across ministries. These increases are primarily related to our attempts to improve governance and fight corruption. We will also begin to implement a civil service reform program, aimed at improving and simplifying the civil service salary grid; for

2004, the expected cost of this reform is manat 90 billion. If the civil service reform costs less than currently anticipated, the excess budgeted funds will not be spent.

31. Finally with regard to expenditures, we have reviewed the operations of the Baku Metro, and have included an increased allocation for that enterprise which should enable it to avoid arrears, and thereby eliminate what has been a quasi-fiscal subsidy of the metro. We will review the Baku Metro tariff during 2004, with the aim of reducing the fiscal subsidy. There will also be some increase in the allocation for subsidies to Azerenergy, Azerigas and Azerchemia, due to difficulties in controlling those subsidies, as discussed below. Indeed, it is now clear that the amount allocated for those subsidies in 2003 is inadequate. We have thus included in the 2004 budget a provision of manat 450 billion, for the remaining 2003 subsidies and offsetting tax credit for SOCAR.

Pension Reform

32. The government of Azerbaijan has embarked on an aggressive program of reform in the pension system, in consultation with the staffs of the World Bank and the Fund. First, we have transferred responsibility for calculating pensions to the Social Protection Fund (SPF), the organization responsible for paying them, from the Ministry of Labor, and have transferred the responsibility for paying family allowances to the Ministry of Labor from the SPF. The aim of this is to have full responsibility for pensions in the SPF, but to remove responsibility for family allowances from the SPF. All SPF receipts and payments will continue to be made through the treasury. To enhance the SPF's ability to monitor its financial flows, the appropriate offices of the Ministry of Finance will provide the SPF with reports every 10 days on all SPF payments made, by taxpayer. The SPF will then be able to reconcile, on a timely basis, the inflows into the SPF subaccount of the treasury single account with the reports made to it by taxpayers.

33. Second, we are in the process of creating individual accounts in banks or post offices for all pension recipients, into which future pension payments will be deposited. We are also preparing to issue electronic cards to pension recipients, so that they can withdraw their pensions from their accounts without need for interacting with bank officers. We will begin this in Baku, and by the end of 2004 hope to have equipped 45 percent of all pension recipients with such cards. Finally, we are in the process of reviewing international experience, with the aim of finding improved methods for paying pensions to rural pensioners.

External and Domestic Debt

34. Our public and publicly guaranteed external debt remains at very modest levels. We are continuing to work with Kazakhstan, Turkmenistan and Uzbekistan to resolve modest disagreements with them regarding external debts. The government of Azerbaijan has no overdue external debt obligations to other creditors. In addition, we have recently reached agreement on the rescheduling of Georgia's obligations to us, in line with that country's Paris Club agreement.

35. We are continuing our efforts to strengthen our debt management system and have requested technical and financial assistance for domestic debt management, as well as for upgrading of hardware and debt management software. We are also in the process of revising the Law on Public Debt and are seeking technical assistance in this regard.

Energy Sector Financial Discipline

36. We are continuing our aggressive efforts to strengthen financial discipline in the energy sector. In 2003, we have transferred what were **previously quasi-fiscal subsidies**—with SOCAR providing fuel without payment to Azerenergy, Azerigas and Azerchemia—into explicit budget subsidies or loans. This has increased the transparency of these subsidies, making it clearer both to policy makers and to the public how much the government is paying to subsidize these sectors, and it has ensured that the burden of these subsidies is borne by the government, not by SOCAR. Unfortunately, as noted above, these subsidies have continued to grow in 2003, rather than declining as we had intended.

37. There has been modest progress in improving collections from end-users, with gas and electricity collections rates of roughly 49 and 33 percent, respectively, in the first half of 2003. This has enabled Azerenergy and Azerigas to pay SOCAR for roughly 20 percent and 2 percent, respectively, of the fuel they have consumed so far in 2003, up from virtually zero in the past. However, energy consumption by these companies—particularly Azerenergy and Azerchemia—has grown substantially in 2003, greatly exceeding our expectations.

38. To begin the process of reducing these subsidies, and ensuring improved financial discipline in state owned enterprises (SOEs), the government has taken the following steps. First, we will seek for the first time to impose hard budget constraints on four of the largest SOEs—Azerchemia, Azerenergy, Azerigas, Baku Metro. These enterprises have all been required to produce detailed revenue forecast and expenditure plans for 2004, which are consistent with the 2004 state budget allowance for subsidies, and these plans will be reviewed and approved by the Cabinet of Ministers by end-January 2004. Second, the government will require these companies to report on the implementation of these plans, on at least a quarterly basis, to the Ministries of Finance, Taxes and Economic Development. These ministries will, in turn, report to the Cabinet of Ministers, who will take whatever decisions are necessary to ensure that the budgets are adhered to—including, if warranted, financial penalties and changes in management. These reports will be shared with the staffs of the Fund and World Bank, and will be the basis for ensuring strict government control of, and reduction in, subsidies. Starting with the 2005 budget, it is our intention that any remaining subsidies will be provided in cash from the state budget. Third, we will initiate IAS financial and energy audits of these companies during 2004, which will provide important information for our efforts to introduce structural reforms in these companies. Finally, the process of corporatizing these enterprises has begun, with the aim of establishing corporate boards and public reporting requirements for each of them by the end of 2004. Corporatization will be an important step toward our goal of privatizing these enterprises.

39. We have also begun considering, in consultation with the staffs of the Fund and World Bank, the design of a mechanism for the future automatic adjustment of domestic oil product and natural gas prices, to keep them in line with world market prices. In consultation with Fund and World Bank staff, we will design and adopt such a mechanism before the end of 2003. During the first quarter of 2004, we will consult with Fund and World Bank staff and reach a decision on the timing for the implementation of this mechanism. In addition, we are working with the staff of the World Bank to develop a mechanism for cushioning the vulnerable against the necessary adjustment in kerosene and diesel fuel prices—the two remaining oil products whose price remains below world market levels. Unfortunately, designing an effective, targeted safety net has proven more difficult than we had hoped, and we will not be able to implement this reform in 2004.

Program Monitoring

40. Our letter of April 23, 2003, paragraph 57, spelled out structural performance criteria and benchmarks for end-December 2003. As noted above, we request that the performance criterion on the issuance of a tender for all remaining government shares of IBA by end-December 2003 be revised, with the new deadline for this performance criterion now being end-June 2004. In addition to the commitments described there, we propose two additional end-December performance criteria: 1) the adoption of the new Banking System Law, as described in paragraph 15; and 2) the submission to parliament of the new Central Bank Law, with the Law clearly limiting the maturity of any central bank loans to not more than six months, and requiring acceptable collateral for all such loans.

41. We also propose the following structural performance criteria for end-March 2004: 1) the approval by the Cabinet of Ministers of a long-term strategy for oil revenue management, based on published fiscal rules that reduce the exposure of the budget to volatility in oil revenues; 2) the adoption of the Central Bank Law incorporating the provisions identified in paragraph 40; and 3) the approval, no later than end-January 2004, by the Cabinet of Ministers of annual expenditure plans and revenue projections for Azerchemia, Azerenergy and Azerigas for 2004. Finally, we propose that a Cabinet of Ministers review of the ministerial report on the implementation in the first quarter of 2004 of the expenditure plans and revenue projections of Azerchemia, Azerenergy and Azerigas, including the taking of any decisions that may be necessary to ensure these annual budgets are adhered to, be an end-June structural benchmark under this program.

42. The fourth review of our PRGF Arrangement will focus on continued progress in energy sector reforms—particularly on the process of controlling the subsidies to Azerenergy, Azerigas and Azerchemia, and the timetable for the full operation of the automatic adjustment mechanism for oil product and natural gas prices—banking sector reforms, and the development of a comprehensive long-term strategy for the use of oil revenue.

43. The government and the ANB believe that the policies discussed above, combined with the policies described in our previous letters and MEFP, are adequate to achieve the objectives of the program, but we will take any further measures that may become appropriate for thc purpose. Azerbaijan will consult with the Fund on the adoption of these measures, and in advance of revisions to the policies discussed above, in accordance with Fund policies on such consultation.

Sincerely,

/s/
Artur Rasi-zade
Prime Minister
Azerbaijan Republic

/s/
Avaz Alekberov
Minister of Finance
Azerbaijan Republic

/s/
Farhad Aliyev
Minister of Economic Development
Azerbaijan Republic

/s/
Elman Rustamov
Chairman, National Bank
Azerbaijan Republic

Attachment

Table 1. Azerbaijan: Quantitative Performance Criteria and Benchmarks for the PRGF, 2003-2004 1/ 2/
(In billions of Manats, unless otherwise indicated)

	2002	2003											2004			
	Dec	Mar			Jun			Sep			Dec		Mar	Jun	Sept	Dec
	Act	Prog	Adj. Prog.	Act	Prog	Adj. Prog.	Act	Prog	Adj Prog 3/	Prel Act	Prog	Rev Prog	Prog	Prog	Prog	Prog
1. Quantitative performance criteria and benchmarks																
Floor on net international reserves of the ANB (end-of-period stock, in US$ million)	462	380	372	434	406	414	496	468	436	527	513	513	512	533	579	610
Ceiling on net domestic assets of the ANB (end-of-period stock)	-85	105	143	-20	111	72	-127	-27	121	-133	-28	-28	9	114	17	-36
Ceiling on net credit to the general government from the ANB (end-of-period stock)	154	326	364	163	311	271	91	148	296	-6	93	93	0	53	-95	-202
Ceiling on the overall consolidated non-oil deficit 4/ 5/	...	1,038	927	796	2,179	2,291	1,972	3,143	3,225	2,815	4,224	4,224	968	2,141	3,192	4,288
Ceiling on New Nonconcessional External Debt Contracted or Guaranteed by the Consolidated Government or the ANB (excluding the IMF) (flows, in US$ million) 4/																
Less than one year's maturity	0	0	0	0	0	0	0	0	0	...	0	0	0	0	0	0
Medium- and long-term debt, one to less than five years	...	0	0	0	0	0	0	0	0	...	0	0	0	0	0	0
Other long-term debt (maturity five and more years)	...	20	20	0	40	40	0	60	60	...	80	80	50	100	125	150
2. Continuous performance criterion																
Ceiling on Stock of Outstanding Nonreschedulable External Payments Arrears of the Consolidated Government and the ANB (end-of-peroid stock, in US$ million)	0	0	0	0	0	0	0	0	0	...	0	0	0	0	0	0
3. Indicative targets																
Ceiling on stock of ANB's manat reserve money (end-of-period stock)	1,866	1,704	1,704	1,806	1,817	1,817	1,989	1,955	1,955	2,101	2,139	2,231	2,146	2,340	2,451	2,588
Ceiling on stock of unpaid bills in excess of Manat 50 billion (end-of-period stock)	-36	0	0	22	0	0	3	0	0	-3	0	0	0	0	0	0

1/ The program targets are indicative targets for end-March 2003, end-September 2003, end-March 2004 and end-September 2004, and performance criteria and indicative targets for end-June 2003, end-December 2003, end-June 2004 and end-December 2004.
2/ Foreign exchange components are valued using program exchange rates of 4,606 manat/US$ and 1.26 US$/SDR.
3/ For September 2003 the adjusted program column is based on current projections for (i) oil prices; (ii) exports of crude oil and oil products; (iii) foreign financed investments; and (iv) amortization due on government-contracted external debt.
4/ Cumulative changes during the year.
5/ For the end-December 2003 program target, the figure reported in EBS/03/57 was 4,042. However, this figure incorrectly did not exclude AIOC profit tax of 182 billion manat.