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February 9, 1993

To: Members of the Executive Board

From: The Secretary

Subject: Azerbaijan Republic - Staff Report for the 1992 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1992 Article IV consultation with Azerbaijan, which is tentatively scheduled for discussion on Friday, March 12, 1993. A draft decision appears on page 23.

Mrs. Gürgen (ext. 37340) or Mr. Coelho (ext. 34883) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

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INTERNATIONAL MONETARY FUND

AZERBAIJAN REPUBLIC

Staff Report for the 1992 Article IV Consultation

Prepared by the staff representatives for the 1992 consultation with Azerbaijan

(In consultation with other departments)

Approved by Eduard Brau and A. Basu

February 5, 1992

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I. Introduction

Azerbaijan became a member of the International Monetary Fund on September 18, 1992. 1/ The first Article IV consultation discussions were held in Baku during November 24-December 11, 1992. The staff team 2/ met with Mr. Akhundov, the State Advisor to the President on Economic Policy; Mr. Masimov, First Deputy Prime Minister and Chairman of Goskomekonplan (presently the Prime Minister); Mr. Mamedov, the Minister of Finance; Mr. Garayev, the Minister of Foreign Economic Relations; Messrs. Abdullayev and Rustamov, Chairman and First Deputy Chairman of Azerbaijan National Bank; Mr. Ahmedov, President of the Azerbaijan International Bank; Mr. Bagirov, President of the State Oil Company; Mr. Gahramanov, First Deputy Chairman of the State Committee of Statistics; and with other senior government officials. The mission overlapped and closely coordinated with a Statistics Department (STA) multi-topic mission 3/ and, in its final week, with a Fiscal Affairs Department (FAD) follow-up technical assistance mission.

Azerbaijan's pre-membership economic review paper was discussed by the Executive Board on April 9, 1992. On that occasion, Executive Directors noted that Azerbaijan is well endowed with natural resources, and stressed the importance of establishing an appropriate macroeconomic environment and regulatory framework in which its growth potential could be realized. Directors observed that a reduction in the size and role of the Government and progress with privatization would be crucial for the successful transformation of Azerbaijan's economy. Directors also emphasized the need to reform the banking system and public enterprises.

Following the membership mission in February/March, there were two EUR II staff visits to Azerbaijan in May and October 1992 to assess economic developments and the Government's reform program. There were also four technical assistance missions from the Fund during 1992, which, in addition to those noted above, included an FAD mission in February and a mission from the Monetary and Exchange Affairs Department (MAE) in October. These

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1/ Azerbaijan's initial quota has been raised from SDR 78 million to SDR 117 million, and the subscription is expected to be paid shortly. Details of Azerbaijan's relations with the Fund are provided in Annex I.

2/ The team consisted of Mrs. Gürgen (Head), Mr. Coelho, Mr. Ucer (all EUR II), Mrs. Landell-Mills (PDR), Mr. Craig (FAD), Ms. Monnett (Staff Assistant, ADM), and Mr. Rishik (Interpreter, BLS).

3/ The STA mission made significant initial progress in reclassifying budgetary accounts in accordance with Government Finance Statistics (GFS), constructing a monetary survey, and compiling a preliminary balance of payments statement for Azerbaijan for the period 1991-92. These data form the basis of the discussions in this report. However, considerable data gaps and shortcomings remain, complicating the analysis and casting doubts in some areas. In particular, a great deal of uncertainty pertains to the breakdown of the monetary data into domestic and foreign accounts.

missions were aimed at assisting the authorities in establishing an institutional and statistical framework necessary for the conduct of effective stabilization and structural policies.

A series of missions from the World Bank visited Azerbaijan during 1992 to carry out work related to World Bank membership, conduct discussions for the first Country Economic Memorandum (CEM), and develop a lending program for technical assistance/institution-building, in particular, in the energy sector. 1/ The World Bank also organized and chaired a Pre-Consultative Group meeting for Azerbaijan held in Paris on December 16, 1992. The meeting provided a forum for discussion of the Government's reform program and Azerbaijan's technical assistance needs and priorities.

II. Background

In October 1992, Azerbaijan's Parliament rejected CIS membership with an overwhelming majority. The Government plans to maintain bilateral links with the republics of the former Soviet Union (FSU), while also strengthening the country's ties with the rest of the world. During 1992, Azerbaijan signed the Black Sea Cooperation Accord (February), became a member of the United Nations (March) and the European Bank for Reconstruction and Development (EBRD), and joined the Economic Cooperation Organization (November). The authorities have indicated their intention to approach the GATT for observer status for Azerbaijan.

The Nagorno-Karabakh Autonomous Region, which was placed under Azerbaijan's control in 1923 and is populated predominantly by Armenians, has been a growing source of friction between Azerbaijan and Armenia. The outbreak of violence in this region since 1988, culminating in a protracted war in the recent period, has triggered large movements of refugees in both countries, absorbed considerable human and financial resources, and led to a closure of important avenues of Armenian trade through Azerbaijan. In April/May 1992, the conflict resulted in the loss of Azeri control over the key cities of Lachin and Susha, and the opening of a corridor between Karabakh and Armenia. This had severe political repercussions in Azerbaijan, paving the way for a strong victory for the Popular Front in the June presidential elections. President Elchibey, while recognizing the cultural rights of national minorities, has ruled out political autonomy for Armenians and other minority groups in Azerbaijan and mounted a major counteroffensive in Karabakh. The fighting continues, with alternating military gains and heavy casualties on both sides.

Azerbaijan is endowed with fertile agricultural land and a variety of mineral resources, including oil and natural gas. After leading the FSU in economic growth during the 1970s and the early part of the 1980s, Azerbaijan's performance weakened considerably. Output declined

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1/ Azerbaijan's relations with the World Bank are outlined in Annex II.

cumulatively by close to 17 percent during 1988-91, although stabilizing in the latter year. Apart from the adverse factors that affected FSU republics in the recent period, this deterioration was attributable to a reduction in grape cultivation and yields following Moscow's anti-alcohol campaign in the mid-1980s; disruptions to supplies of raw materials and inputs associated with the intensification of the Nagorno-Karabakh conflict; and prolonged work stoppages in industry, following the march on Baku by Union troops in early 1990. Azerbaijan is highly dependent on trade, with exports and imports averaging 46 percent and 37 percent of GDP, respectively, in the second half of the 1980s. During 1987-91, a major proportion of Azerbaijan's trade was conducted with the FSU (mainly Russia and Ukraine) and a trade surplus, averaging 16 percent of GDP, was maintained. This was partly offset by a small deficit in non-FSU trade. Fiscal policy in the second half of the 1980s was generally conservative and the state budget was in approximate balance, after allowing for net transfers from the Union. Prices remained fairly stable until the Union-wide price adjustments in April 1991.

III. Recent Economic Developments

For Azerbaijan, 1992 was a year of transition to a market economy, with the attendant dislocations and disruptions to economic activity. Preoccupation with the war in Karabakh and its political ramifications slowed the economic decision-making process and detracted from the reform effort, particularly in the earlier part of the year. Nevertheless, Azerbaijan's economic performance in 1992--notably its budgetary outturn, inflation, and external position--compared favorably with other FSU republics (Table 1). Such comparisons can only be approximate and are subject to serious data qualifications so that caution has to be exercised in interpreting the data. Nevertheless, the contrast could partly be indicative of differences in resource endowments and economic policies.

1. Output, employment, prices, and wages

A striking adverse development in 1992 was the sharp drop in production, estimated at above 26 percent (Table 2 and Chart 1). The breakdown of the central command system, the dislocations in the ruble area, escalation of the conflict in Karabakh, and a cool summer combined with heavy rains that drastically curtailed the production of key cash crops were the major factors contributing to this outcome. Crude oil and refinery production declined for the third consecutive year, reflecting input shortages and growing inadequacies in production methods and infrastructure. The authorities also pointed to some instances of conversion from military to civilian lines of production, which disrupted output in the related industries, but the impact of this was negligible, given the limited size of Azerbaijan's past production for the Union military complex. There were some signs of stabilization in industrial output in the final months of the year, although the authorities are cautious in interpreting this as indicative of a possible recovery in the immediate future.

The decline in total recorded open employment during the first nine months of 1992 was far less pronounced (under 10 percent) than the overall drop in output. This reflected mostly the unwillingness of state-owned enterprises, which continued to face soft budget constraints, to lay off workers. Inflation 1/ accelerated sharply during 1992 in response to price liberalization early in the year, adjustments in controlled prices, the weakening of financial policies domestically and in the ruble area, as well as growing supply constraints. The twelve-month rate of inflation reached 735 percent in October 1992.

The authorities aimed to keep the growth in nominal wages roughly in line with the increase in the price level to protect living standards. The measured average economy-wide nominal wage rose by more than sixfold during the first nine months of 1992 compared to 1991. Wages declined sharply in real terms during the first half of 1992, but there was a catching up in the third quarter. Following an almost doubling to rub 130 per month in April 1991, the minimum wage was raised three times during 1992 to reach rub 2,500 in December. These adjustments triggered sharp increases in social benefit payments linked to the minimum wage.

2. Financial developments

The authorities made a strong effort to maintain fiscal discipline during 1992. A cash surplus was recorded in the consolidated state budget during the first nine months of 1992 (Table 3), although the budget reverted to a small deficit in the third quarter. Tax reform was initiated early in the year and additional measures implemented subsequently. The decline in output and initial difficulties with administering new taxes, however, held collections below their potential levels. Nevertheless, the loss in Union grants was partly compensated for by higher tax revenue. The major boost to expenditure came from wage increases, subsidies, selective cash compensations in the final quarter (discontinued since), and defense and refugee-related spending. Cutbacks in other spending categories helped contain expenditure growth. At the time of the mission's visit, the primary state budget deficit on a cash basis was officially estimated at about rub 7 billion in 1992, equivalent to less than 4 percent of GDP. This outcome would imply a sharp turnaround in budgetary performance in the final quarter of the year, reflecting, for the most part, the cumulative impact of the September and December price and wage increases. The deficit was to be financed by bank credit, for which Parliamentary authorization was obtained.

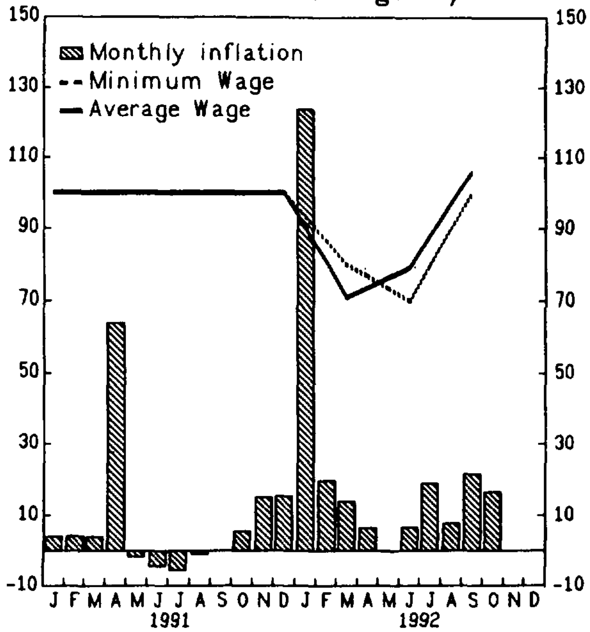
1/ Measured by the retail price index (RPI), compiled since early 1990. The wholesale price index shows a much stronger increase over the same period, owing mainly to differences in the coverage of the two indices, as well as certain statistical problems. For a more detailed discussion of price indices, see Chapter IV of the Azerbaijan Recent Economic Developments (RED) report (to be issued shortly).

CHART 1

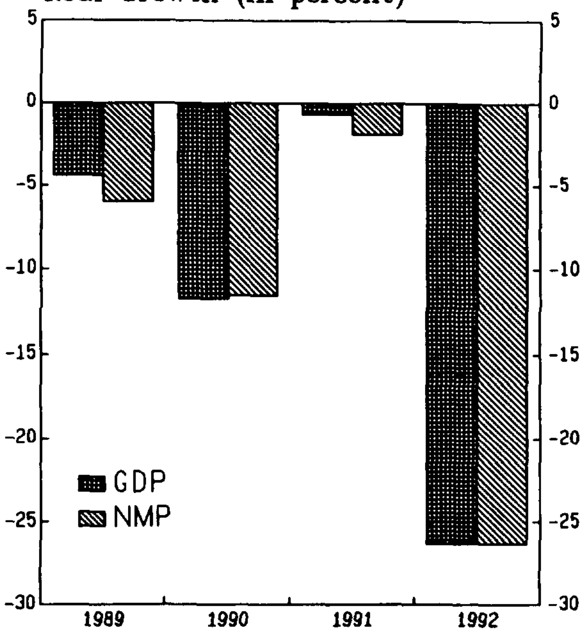
Azerbaijan

Selected Economic Indicators, 1989-92

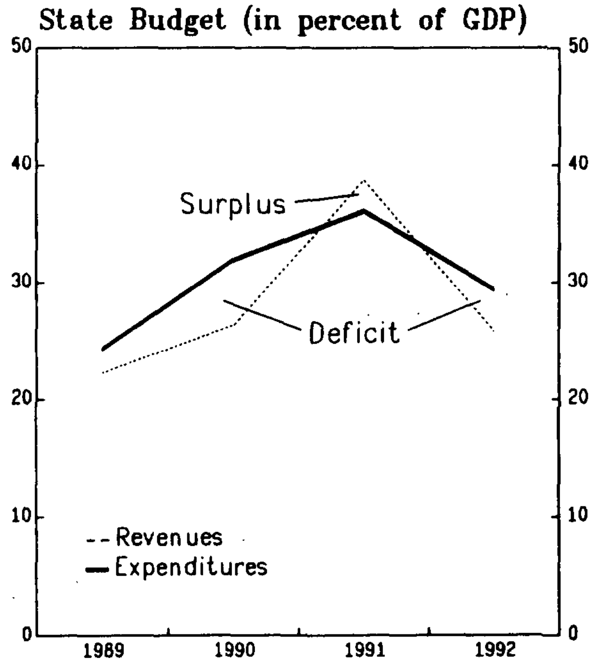
Inflation and Real Wages 1/



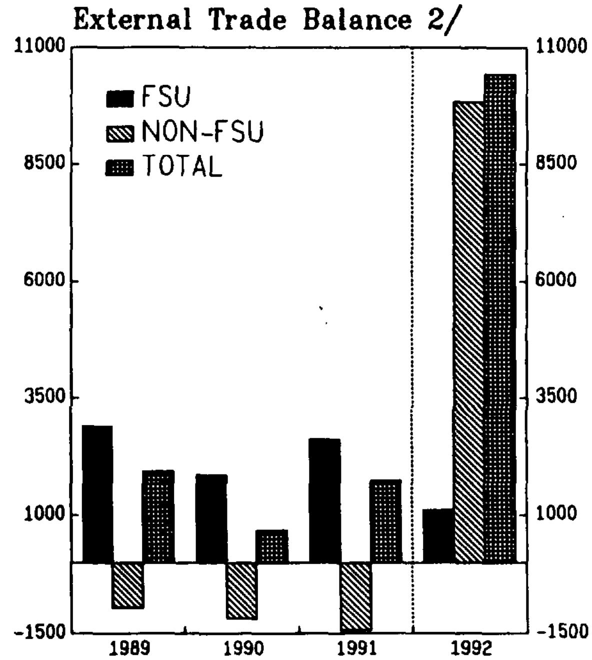
Real Growth (in percent)



State Budget (in percent of GDP)



External Trade Balance 2/



Source: Data provided by the authorities and staff estimates.

1/ Inflation refers to monthly percentage change in the Retail Price Index. Minimum and average real wage indices take 1991 as base.

2/ Excludes adjustments for border trade and freight. For 1989-91, trade balances are in millions of rubles. For 1992, trade balances are in tens of millions of rubles.

However, the budget cash accounts did not capture domestic payments arrears incurred by the Government, nor the operations of off-budget funds, particularly the so-called hard currency funds (see Section IV.2.b). Gross payments arrears of rub 1.8 billion, identified in the third quarter, were expected to be eliminated by the end of the year. Recorded defense-related spending (equivalent to about 3 percent of GDP) may also have been underestimated. These factors have to be viewed against the possibility that some of the extrabudgetary funds may have been in surplus at the end of 1992. Insufficient data rule out an accurate assessment of the public sector's overall position. The authorities are reviewing the options for introducing a more comprehensive coverage of the state budget in 1993. There will be need for further technical assistance, from the Fund and other sources, to develop adequate data on the financial operations of both the Government and public enterprises.

State-owned enterprises, which dominate economic activity, continued to face soft budget constraints in 1992 and were largely insulated from the need to adapt to market signals. The enterprise sector received support from the banking system, with the growth in bank credit to state-owned enterprises reaching undue proportions in an environment of declining productive activity. Total domestic credit grew ninefold during the first nine months of 1992, on the strength almost entirely of the increase in credit to nonfinancial public enterprises (Table 4). There was also a sizable accumulation of inter-enterprise arrears, estimated to total rub 12 billion during January-October 1992, equivalent to 9 percent of total domestic credit outstanding at end-October. 1/ Interest rates were adjusted during the year, but remained highly negative in real terms and out of line with rates in other FSU republics. Azerbaijan National Bank's (ANB) refinance rate was 12 percent in October 1992 (compared with 80 percent in the Russian Federation), while bank deposit and lending rates ranged from 6-25 percent and 6-70 percent, respectively. The upward rigidity of interest rates encouraged borrowing for speculative purposes.

The ruble bank note issue by Moscow to Azerbaijan was limited during the first seven months of 1992. To alleviate the shortage of cash and ease wage arrears, which peaked at rub 4 billion in early August, Azerbaijan introduced its national currency, the manat (at a rate of 10 rubles per manat), in mid-August 1992. The manats put into circulation during the year remained insignificant (rub 500 million, or about 2 percent of total currency issued); the ruble issue picked up in the latter part of the year, and rubles continued to circulate alongside the manat and be accepted for payments. The authorities are considering making the manat sole legal tender in Azerbaijan in the near future (see Section IV.3).

1/ The recorded outstanding inter-enterprise arrears consist of the total amount of payments orders presented to the banking system and not executed due to the insufficiency of funds in the client's account, and recorded in the so called "Account No. 2".

3. External sector developments

Azerbaijan's external position strengthened in 1992. This was attributable mainly to diversification of exports to hard currency markets and a resulting partial shift to trade at world market prices. The share of Azerbaijan's trade with non-FSU countries (in U.S. dollar terms) rose from 13 percent of total trade in 1991 to almost 50 percent in 1992. Estimates by the staff indicate that by contrast to other FSU republics, Azerbaijan experienced a considerable improvement in its terms of trade in 1992.

A preliminary balance of payments statement (Table 5) for Azerbaijan indicates a recorded current account surplus of about US$500 million during the first nine months of 1992. This was attributable mainly to the swing in hard currency trade to a large surplus. For the year as a whole, the current account surplus is estimated at US$650 million. This outcome reflects, for the most part, an improvement in Azerbaijan's oil trade balance, on account mainly of a rise in export prices for refined products. 1/ However, the strength of the current account, coupled with identified capital inflows, is not matched by an increase in official foreign exchange reserves. 2/ The latter is estimated at US$150 million for the year (with two thirds of this amount realized through November), implying an unexplained negative residual of close to US$800 million. Apart from the inevitable data shortcomings at this initial stage of balance of payments compilation, this development may be attributable to some underreporting of imports and to the accumulation of unrecorded foreign exchange balances. The latter is acknowledged by the authorities, and has triggered the recent centralization of export activities and their monitoring by the Ministry of Foreign Economic Relations. It is hoped that foreign exchange balances will be repatriated as the Government's program of economic stabilization and reform is implemented and confidence in the economy strengthens.

Azerbaijan's exchange and trade system underwent several changes during 1992, the latest of which was in early November. The system distinguishes between trade in strategic (oil, cotton, and other goods, constituting 70-80 percent of total exports) and nonstrategic goods, and remains complex and controlled. Although the export surrender rate (rub 50 per U.S. dollar) was abolished and the exchange rate unified at the market rate in November, the new system resulted in a wide array of implicit exchange rates for exporters of strategic goods (for details, see Section IV.5).

1/ For a detailed discussion of trade, see Chapter VII of the RED.
2/ Azerbaijan also holds an undisclosed amount of gold, acquired in 1992, which is not captured in reserve movements.

IV. Report on the Discussions

At the time of the discussions, there appeared to be a consensus within the Government that breaking away from the ruble area was a precondition for the successful implementation of Azerbaijan's economic stabilization and reform program. Remaining differences of opinion pertained more to the precise timing of such an action, rather than to its desirability. The prevalent view was to act quickly, putting in place the requisite changes for the full adoption of the national currency, and completing the move before the impact of these changes was diluted by occurrences beyond Azerbaijan's control. In preparation for the national currency, the authorities have initiated a number of legal and institutional changes, moved to further align domestic and foreign prices, and kept up a dialogue with the Russian Federation and the other FSU republics with a view to ensuring an orderly withdrawal from the ruble area.

1. Price liberalization and inflation

Azerbaijan liberalized prices of a large proportion of producer and consumer goods during 1992. Following the first major move in January, there was further liberalization in April, so that only the prices of oil, gas, electricity, public transportation, housing, and bread remained controlled. There was, in addition, some rationing of meat, butter, and sugar at controlled prices. Price-setting behavior for consumer goods under the liberalized category, moreover, continued to be monitored at the retail level through registration requirements and limits on retail markups. These procedures may have rendered price liberalization less effective than envisaged. For items whose prices are controlled, following the substantial adjustments in January 1992, the policy has generally been to increase prices when justified by cost developments, although the adjustment lags, in some instances, may have been longer than in neighboring republics. More recently, regional price disparities have carried increasing weight in the authorities' decision to adjust prices in order to prevent an outflow of goods. Following the sizable increases in September, there were further adjustments on December 4 in bread prices (a doubling, on top of the previous fourfold increase), energy tariffs (by 3 1/2 times), and oil and oil product prices (by 3 to 4 times). However, even after these increases, domestic prices of these items remain out of line with costs and well below international levels. 1/

In view of the expected full move to the national currency in the near future, further progress with price liberalization--with a view possibly to completing the process prior to making manat the sole legal tender--has received growing attention in recent months, although the authorities are of the view that certain controls will need to be retained for social

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1/ According to official estimates, domestic prices of gasoline, fuel oil, and diesel are 43 percent, 12 percent, and 28 percent of international prices, respectively.

considerations and until monopolistic conditions can be eased. The authorities are introducing anti-monopoly legislation, which is expected to be in place in early 1993. On energy pricing, as with several other goods, the authorities are concerned that the impact of price adjustments is quickly eroded by the depreciation of the ruble. Hence, they wish to coordinate action in this area with the full introduction of the national currency, bearing in mind the impact of large price adjustments on production costs and wages. The mission urged the authorities to make further progress with price liberalization, and more closely align domestic and international prices prior to the move to the national currency in order not to undermine confidence in the new currency with large price shocks in the aftermath of its introduction.

2. Fiscal policy 1/

The submission to Parliament of the 1993 state budget was delayed to take into account more fully the pending policy actions, and allow for the impact of the December price-wage adjustments. While the mission could not, therefore, be provided with the key parameters of the 1993 budget, it was given the broad elements of fiscal policy in the period ahead. The discussions indicated that the authorities are committed to containing the state budget deficit in 1993. At the same time, they intend to adopt measures to revitalize the economy. The mission emphasized the importance for the Government's stabilization effort and public confidence in the national currency of formulating the 1993 budget and policies pertaining to the rest of the public sector with a view to curtailing imbalances and substantially reducing inflation during the year. The sections below outline progress with fiscal reforms to date and the direction of policies for 1993. 2/

a. Tax reform

Azerbaijan's tax reform effort is aimed at broadening the tax base and putting in place an efficient tax system that meets the requirements of a market economy. The authorities introduced the value-added tax (VAT) and excise taxes with the 1992 budget and implemented further tax measures during the year, including the extension of excise taxes to petroleum products, in line with an earlier FAD recommendation. Separate VAT and excise duties were imposed on a limited number of exports as a temporary response to the perceived underpricing of Azerbaijan's goods in the FSU.

The authorities are considering a number of tax measures for 1993: expanding excise taxes to imports and tea, raising oil royalties and converting them to an ad valorem basis, extending VAT to imports,

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1/ This section draws, in part, on the discussions conducted by the follow-up FAD mission which visited Baku during December 3-17, 1992.

2/ Draft legislation covering many of these measures has been submitted by the Ministry of Finance to the President's Office.

introducing import duties under a new customs tariff, and implementing a number of changes in the enterprise profits tax. Legislation was passed reducing the standard rate for the VAT from its present level of 28 percent to 20 percent, effective January 1, 1993, with exemptions applying to basic foodstuffs. A separate proposal under consideration was the introduction of a differential VAT rate structure.

The mission welcomed the extension of excise taxes to oil products and the increase in oil royalties, and noted that import duties outside the FSU should apply at a low and uniform rate. On the changes related to the VAT, the authorities were cautioned that introduction of multiple rates would create severe administrative problems and reduce the effectiveness of the VAT as a broadly based consumption tax, and that there should be, at most, one additional reduced rate applying to a limited number of well-defined products. In this context, it would be preferable to replace the exemption on basic foodstuffs with the reduced tax rate. The mission also recommended a phasing out of export taxes, except on products with controlled domestic prices. Regarding enterprise taxation, a number of changes are contemplated: the fixed assets of enterprises are to be revalued from historical to current values; the progressive rate structure for small profits and most differential rates are to be eliminated; and an excess profit tax is to be applied (at a rate of 80 percent) to profits beyond a defined norm, with deductions allowed for investment. The mission noted that the latter move could curb private initiative and trigger spending on less productive investment. It pointed to the risks inherent in extending the scope of the contemplated excess profits tax to activities beyond a small number of well-defined monopolies.

More generally, tax exemptions continue to complicate and weaken the efficiency and yield of the tax system. The tax administration, moreover, will face growing strains as privatization and other forces change the nature of the tax collection task. Recommendations were made to reduce tax exemptions and strengthen tax administration.

b. Expenditure policies

The major objectives of expenditure policy are to limit government spending and increase its efficiency. The authorities implemented measures to this end during 1992 in line with FAD recommendations, including the elimination of budgetary subsidies on some basic commodities; merging of the Pension and Social Security Funds; and elimination of selected family allowances and the introduction of income testing on others. Social security spending, however, continues to absorb considerable resources. Certain categories of expenditure, moreover, remain outside the state budget, making their control difficult. A sizable proportion of producer and consumer subsidies (for bread, meat, butter, and sugar) are financed through extrabudgetary funds, in particular, the United Currency Fund and the Social Insurance Fund. 1/

The mission reiterated the high costs and distortionary effects of subsidies and urged the authorities to eliminate remaining price controls. Until this is accomplished, there would be merit in adjusting prices more promptly to reflect cost changes and increasing the transparency of subsidies. The authorities wish to remove subsidies in a way that would avoid a social backlash; they plan to reduce or eliminate subsidies on public transportation, irrigation and water, housing maintenance, medicine, and newsprint in the 1993 budget, and to include the bread subsidy explicitly in the budget.

The authorities are seeking ways to make certain public enterprises (state television, newspaper, etc.) self-supporting in 1993, and plan to restrict public investment spending to essential infrastructure. They also contemplate setting up a fund, financed partly from the budget, to provide initial capital to private entrepreneurs through interest-free loans and government guarantees on foreign borrowing. The mission cautioned against initiating large spending programs that could put undue pressure on the budget and prove difficult to reverse at a time when expenditure restraint would be needed. Should such a fund be established, it would be essential to limit and closely monitor its operations, select projects on the basis of profitability criteria at world market prices, avoid subsidized loans, and ensure the freedom of the fund from political interference. Finally, the authorities intend to initiate an ambitious civil service reform in 1993 and reorganize the central administration of the Government, reducing its size by about 40 percent.

c. Social safety net

Azerbaijan maintains a generous system of social benefits, aimed at ensuring that no one receives less than the subsistence income and that all have free access to health and education services. In addition, there are subsidies for bread and other essential foodstuffs, the latter coupled with a ration system. Several benefits and services are extended to the elderly, widowed, and disabled. Pension payments have become particularly generous, with the average pension reaching close to 70 percent of the average wage in the recent period. Child allowances are now income-tested, but most other benefits are provided universally. As unemployment is a recent development in Azerbaijan, there is no effectively operating scheme of unemployment benefits. The main focus of policy has been to develop vocational training programs for the unemployed.

1/ For details of the mechanism through which subsidies are administered, see Chapter V of the RED.

The annual cost of the social safety net is substantial; approximate estimates indicate that such costs (including the bread subsidy) were equivalent to almost one fourth of GDP in 1992. This is also reflected in the internationally high social security levies on enterprises (equivalent to 40 percent of payroll, which may be raised to 47 percent in 1993), and large transfers from the state budget to extrabudgetary funds that administer and finance social benefits. There is urgent need, therefore, to develop a program to streamline and more closely target the social safety net, with a view to bringing the scope of benefits in line with available resources and channeling benefits to the most vulnerable groups.

3. Currency reform and monetary policy

The adoption of the national currency (manat) as the sole legal tender in Azerbaijan remains high on the Government's policy agenda. 1/ This move is viewed by the authorities as a precondition for Azerbaijan to conduct an independent monetary policy, consistent with broad stability in prices. To this end, the authorities have stepped up technical preparations for currency issue; made progress in putting in place legal and institutional changes in the banking system, particularly in the Central Bank; and are reviewing measures to strengthen monetary policy instruments. The authorities attach importance to an orderly withdrawal from the ruble area and are negotiating mutually acceptable payments arrangements with the FSU republics through agreements specifying the mechanism of payment in the event that own currencies are introduced. There are also ongoing contacts with the Russian Federation on matters related to currency reform, including the treatment of withdrawn rubles. The authorities indicated their intention to retain the recalled rubles until appropriate arrangements are made that take into account all payments obligations.

The authorities have prepared a detailed plan of action, outlining the modalities of conversion to the manat, the timing of various measures, and the supporting policies. This plan is under revision and had not been finalized at the time of the discussions. An important consideration in the introduction of the national currency is the choice of an appropriate exchange regime. This matter is receiving considerable attention, and the authorities are reviewing the options of initially floating the currency versus pegging it to a major foreign currency. While a final decision has not yet been taken, they appear to be tending towards a peg, on the grounds that Azerbaijan's foreign exchange market is not yet sufficiently developed to allow for a market-determined exchange rate.

The staff's position on this has been to advocate a float, until such time as strong stabilization policies have taken hold and brought inflation

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1/ A EUR II staff visit in October 1992 and an overlapping MAE mission provided an initial opportunity for the Fund to advise the authorities on the technical aspects of introduction of the national currency, as well as on supporting macroeconomic policies.

under control, and an adequate stock of foreign exchange reserves has been accumulated to help provide backing for a fixed exchange rate. 1/ Hence, a peg would not be ruled out at a subsequent stage, particularly given Azerbaijan's relatively favorable balance of payments prospects. Should the authorities choose to peg the currency from the outset, the initial level of the peg would need to be given careful consideration. The mission stressed that whatever the choice of an exchange regime, there would need to be adequate policies to reduce inflation to a low level and sustain confidence in the currency. Hence, restraint in financial policies would be essential in either case. In addition, the foreign exchange market would need to be developed to provide ease of access to a broad range of participants and facilitate current account convertibility.

The Government's monetary and credit guidelines for 1993 were under preparation at the time of the discussions. While details were not available, the authorities indicated that there would be changes in policies regarding interest rates, reserve requirements of banks, the interbranch settlement system (MFO), and certain other aspects of monetary and credit arrangements with a view to correcting many of the present shortcomings. Measures to contain credit expansion would include the establishment of correspondent accounts at the ANB by the specialized banks, which would facilitate the settlement of interbank claims and phase out the MFO system. Interest rates would be raised substantially, with ANB's refinance rate moving up to possibly 60 percent from its prevailing level of 12 percent, although there could be lower rates for selected categories of lending. Reserve requirements would apply to all banks, including the specialized banks that have been exempted. The latter, together with other commercial banks, would be issued licenses by the ANB to transact in the foreign exchange market, which is currently dominated by the International Bank and needs to be deepened.

The mission welcomed these intentions and noted that until indirect instruments of monetary control could be developed more fully, it would be desirable to set credit ceilings and ensure compliance by banks in order to contain domestic credit growth. Provided that the present plans to move rapidly to the national currency hold, these limits would need to be consistent with the objective of significantly reducing inflation during the year. Monetary and fiscal policies should be closely coordinated to support the manat. It would be essential to strictly limit government recourse to bank credit in 1993, discontinue automatic credit extension to state-owned enterprises, and avoid preferential credit arrangements, which would be distortionary and difficult to discontinue. Interest rate policy should aim at achieving positive real rates regardless of whether or not the currency reform is fully in place. In the first instance, the ANB's refinance rate

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1/ To support the national currency, the authorities have set up a stabilization fund into which they are depositing a large part of the proceeds of earnings from strategic exports. In November 1992, the size of this fund had reached US$100 million.

will need to be raised close to that of the Central Bank of Russia (CBR). Once the currency reform is completed, interest rates should be set taking into account the anticipated inflation path and the need to provide clear signals on the Government's intention to restore price stability. The mission also noted the importance of strengthened bank supervision in preventing the recurrence of loan arrears.

4. Incomes policy

Although wage data are not complete and fully reliable, there appears to be some evidence that Azerbaijan did not experience a sharp decline in real wages and salaries witnessed in some of the other FSU republics. The decline in real wages in the first half of the year was largely reversed during the second half. Salaries in the government sector were doubled on January 1, 1992 as in the other FSU republics, and raised again substantially in June and September. Enterprises were free to set their own wages, with no safeguards against excessive wage awards other than a provision in the tax law that limits the tax deductible component of wage costs to four times the minimum wage. Data on average nominal wage developments in different sectors of the economy indicate fairly sizable increases in nominal wages during the year. In the second half of 1992, the minimum wage was raised three times, triggering adjustments in pensions and social benefits.

A wage indexation law was passed in June 1992, to be effective at the beginning of 1993; to date it has not been implemented. The law envisages graduated compensation, based on income levels, for quarterly changes beyond a predetermined amount in the value of a minimum consumption basket. The scheme applies to a range of benefits in addition to wages. 1/ The mission cautioned the authorities that it will be important to the success of the Government's stabilization effort not to perpetuate past inflationary pressures with a rigid indexation mechanism. Such a scheme could prove too costly to sustain--including in terms of loss of competitiveness--and should be reconsidered or substantially modified to cover only basic payments to the poorest groups. The mission indicated that there would not be much scope for further wage increases at a time when the prices of not only final goods but raw materials were being adjusted to world levels. The authorities acknowledged the need to contain wage costs. They indicated that the implementation of the indexation scheme was highly uncertain.

5. External policies

The authorities realize that the removal of exchange and trade restrictions is essential to the strategy of achieving a rational structure of relative prices and promoting export diversification and growth. For the

1/ For details, see Chapter IV of the RED.

time being, however, they maintain an exchange and payments system that is distortionary and increasingly geared toward controls. 1/

On November 3, 1992, a number of significant modifications were made to the export payments regime. The export surrender rate of rub 50 per U.S. dollar was abolished and a unified exchange rate (set by the ANB since December, and adjusted to reflect variations in the ruble/US$ Moscow rate) was made applicable to all transactions. In addition, the foreign exchange retention rates for exports were raised and a confiscatory element of the previous regime eliminated. Nevertheless, the system remains complex and contains features that are likely to discourage exports. Enterprises exporting strategic goods are remunerated for 70 percent of their sales at domestic prices, which results in a wide range of effective returns. The exchange system for strategic goods implicitly taxes exporters (and subsidizes public sector imports) without, however, any revenue accruing to the budget from this source. Trade in strategic goods has become more centralized and is now conducted by foreign trade organizations under the regulation of the Ministry of Foreign Economic Relations (MFER). Export licenses are required for exports of strategic goods, and are granted freely within global quotas set by the MFER. Export bans apply to a limited number of mainly defense-related items.

The authorities view these export arrangements--notably the centralization of foreign trade--to be temporary, but essential for the time being to guard against the diversion abroad of earnings from strategic exports. The mission urged the authorities to eliminate the disincentive to exporters by removing the distortions arising from the exchange system, and ensuring returns to all exporters at the unified market exchange rate. The elimination of differential domestic taxes was also recommended. A tightening of monetary policy would be a better way to prevent capital outflows, and a discontinuation of the centralized trade system would allow for the development of the foreign exchange market. The mission also noted that quantitative export controls should be replaced by taxes to be collected in local currency and sustained for a temporary period during which the domestic prices of the items are held below world levels.

Although there are no licensing requirements for imports, and foreign exchange is available at the unified rate for all imports, most trade continues to be effectively controlled through bilateral trade agreements (for 1993, agreements are in place for several FSU republics and Turkey), and a measure of central control is maintained through the system of compulsory contract registration. Since August 1992, new barter transactions are allowed only in exceptional circumstances. There are no import tariffs, although they are expected to be introduced once the

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1/ A detailed description of Azerbaijan's exchange and payments system, and a listing of exchange restrictions for which the authorities are invoking the transitional arrangements of Article XIV, are provided in the RED.

national currency is fully in place. As noted earlier, the mission suggested that the tariffs introduced should be low and uniform.

The authorities have recently centralized Azerbaijan's foreign exchange holdings (which are estimated at US$150 million at end-1992) at the ANB. Azerbaijan has not accumulated any foreign debt, apart from unsettled balances under bilateral clearing arrangements, and has not signed the G-7 accord on FSU external debt. The authorities indicated that they could consider discussing the "zero-option" solution (i.e., giving up both the responsibility for servicing FSU debt and claims on FSU assets). They are also seeking advice to develop a centralized system for recording, monitoring, and managing external debt.

6. Structural reforms

a. Legal framework

The authorities have initiated wide-ranging reforms in the legal framework, although progress has been slower in certain areas than anticipated. Considerable ground was covered during 1992 in preparing legislation to support the development of a market economy. While a number of laws and decrees were enacted during the year, important gaps remain in the legal framework. In late 1992, development of the private sector continued to be constrained by the absence of a privatization law, commercial law, property law, contract law, bankruptcy law, and customs law, although, at the time of the discussions, the authorities were confident that most of these laws would be in place by early 1993. In addition, a review by the World Bank of existing legislation indicated the need for significant revisions in the Land Code, Lease Law, Law on the Protection of Foreign Investment, and the Civil Code. A task force was formed in the Office of the President to address these matters and accelerate legal reforms. The authorities also wish to increase the role of foreign private investment in the economy, and are currently negotiating the participation of foreign firms in Azerbaijan's oil sector. 1/ The passage of the Petroleum Law currently under preparation is expected to facilitate this process.

b. Financial sector reforms

With the passage of the Law on Banks and Banking Activity and the Law on the National Bank in August 1992 (and, more recently, its Charter), Azerbaijan has made important inroads into putting in place the legal framework for the establishment of a two-tier banking system that meets the requirements of a market-oriented economy. In December 1992, the ANB

1/ Negotiations with oil companies (the Amoco Group, Pennzoil, Statoil, Ramco, and Apache) for exploration and production in the four major proven offshore oil fields have resulted in the signing of several agreements, and contracts are under discussion.

assumed the responsibilities of a central bank. At the same time, the specialized banks were transformed into joint-stock commercial banks. The mission noted that the next phase of financial reform should include (in line with the recommendations of the MAE mission) subjecting banks to a uniform regulatory framework that is enforced across banks. Steps should also be taken to restructure the organization of the ANB to meet the requirements of a modern central bank, streamline its accounting practices, and improve its advisory and research capabilities. There are indications that the authorities are beginning to move in some of these areas. The monetary and credit program for 1993 to be approved by Parliament shortly is expected to include changes along the above lines in regulations applicable to banks. A reorganization of the ANB was recently initiated and its management strengthened.

c. *Privatization and enterprise restructuring*

Azerbaijan's Privatization Law went through several changes, before the latest draft cleared its first reading in Parliament in November 1992. At the time of the discussions, the final draft law was not yet available, although the authorities indicated that this version would be a combination of the preceding three, allowing for both sales and distribution of property, with some preferential treatment of employees. Three stages were envisaged for privatization: small trade and services would be sold in the first year, followed by medium-sized enterprises in the second, and basic industry last. This process would be implemented flexibly to allow for earlier sales in the second and third categories if warranted. Upon completion of the first two stages (within about two years), close to 30 percent of state-owned enterprises are expected to be in private hands. Strategic sectors of the economy--including the oil sector, heavy industry, and defense--would remain under state control, although this would not rule out majority rather than full-state ownership and participation of foreign investors. The privatization of real estate and land were to be covered by separate legislation under preparation. Land reform would aim at achieving a far-reaching distribution of land among the population, while ensuring an efficient size of individual holdings.

The mission welcomed the plans for privatization, and urged the authorities to put in place the related implementing decrees. The Government's privatization program would need to be supplemented by a comprehensive reform of enterprises remaining under state control to significantly increase their efficiency and accountability. The authorities noted that this might be facilitated by selling minority shares or establishing joint ventures. The Government has targeted enterprises in the oil sector for the latter, since potential foreign partners were already identified. Turkey had recently extended a credit line of US$250 million (none disbursed so far) for enterprise restructuring. The authorities acknowledged that indiscriminate and excessive access to domestic credit has discouraged efficiency in the enterprise sector and are seeking ways to make enterprises self-financing; they do not rule out the closure of nonviable enterprises.

7. Technical assistance

The Government recognizes that the design of its structural reform program and developing the institutional capacity for its implementation requires a substantial amount of technical assistance. Such support could usefully focus on providing technical advice and training in key areas such as the legal framework, macroeconomic management, privatization, enterprise restructuring, banking reform, and the social safety net. The authorities disclosed Azerbaijan's technical assistance needs at the Pre-Consultative Group meeting referred to earlier, with the request that a substantial portion of it be funded on concessional terms. They indicated that arrangements are being put in place to coordinate the assistance that would be forthcoming.

The participants (ten governments, the Commission of the European Communities, and eight international and financial organizations) expressed interest in meeting Azerbaijan's technical assistance needs, and agreed to indicate, by mid-February, the extent and direction of such assistance. The European Community has already approved a substantial amount of grant assistance under its program for 1992, and would be considering a program for 1993. The World Bank has offered to help through an Institution-Building Technical Assistance Loan. It was agreed at the Paris meeting that a follow-up meeting would take place in Baku in March 1993 to coordinate efforts in this area. The World Bank has provided a grant of US$340,000 to support the Government in managing the coordination of technical assistance from bilateral and international sources.

The Fund has initiated technical assistance to Azerbaijan in the areas of public finance, monetary and banking operations, and statistics. There will be follow-up missions in the next six months, and training of government officials through IMF Institute courses. Discussions are also underway for the stationing of resident advisors (in the fiscal and monetary areas), as well as a Fund Resident Representative in Baku.

V. Medium-Term Prospects

Azerbaijan is rich in natural resources. With the right policies in place, it has promising prospects for resuming the high rates of growth achieved in the past. To this end, the Government has turned its attention to addressing immediate stabilization issues, while also initiating systemic and sectoral reforms. Rapid progress in these areas (including currency reform), coupled with resolution of the conflict over Karabakh and sustained political stability, will be essential elements of a growth scenario. Increased stability in the ruble area will also be important for maintaining traditional supply sources and markets.

Given the dominance of the oil sector in trade, and its capacity to substantially add to foreign exchange earnings, much will depend on how rapidly this sector is developed. Exploitation of Azerbaijan's rich oil resources will require passage of the relevant laws, opening up of an export route, and considerable restructuring of the industry. The authorities believe that ongoing negotiations with foreign oil companies, if brought to a successful conclusion, could attract foreign investment in this sector of US$100-US$300 million annually during 1993-94, and substantially higher amounts (up to US$1 billion annually) thereafter. Azerbaijan's oil equipment industry also holds considerable export promise, both to the FSU and new markets, once it is modernized. In addition, Azerbaijan would gain from the development of its largely underutilized natural gas resources. 1/ Outside the oil and gas sectors, the authorities believe that Azerbaijan has potential to expand its exports of semi-processed cotton goods and other light manufactures, and efforts are underway to elicit foreign investment to increase capacity in these sectors.

Preliminary balance of payments projections by the staff for 1993 suggest a continued current account surplus as non-FSU markets are further penetrated. In view of the serious data weaknesses and the uncertainties related to the transition period, there is little to be gained from engaging in detailed medium-term projections for Azerbaijan at this stage. However, an illustrative scenario for 1993-97 indicates that developments broadly along the lines described above can be expected to bring about a strong recovery, with real GDP growth resuming in 1994 and reaching 6-7 percent by the end of the period (Table 6). The investment-to-GDP ratio would rise sharply, as both domestic and foreign investment pick up. Reflecting strong import growth associated with the restructuring of export industries, the external current account could be expected to revert to a deficit that would be financed primarily by sizable direct foreign investment flows in the orders of magnitude referred to above. Fiscal adjustment and financial sector reforms would help generate domestic savings and sustain higher investment levels.

The major downside risks to this scenario would be slippages in moving forward with the reform program and failure to achieve peace in the region which, in addition to diverting domestic resources from productive investment, could discourage foreign investment. Under such an alternative, the prospects for achieving broadly based, sustainable growth in the medium term would be seriously jeopardized.

1/ Azerbaijan presently imports natural gas from Russia, Turkmenistan, and Iran. It also compensates for inadequate gas supplies by increased fuel oil consumption. Higher domestic natural gas production could substitute for both and eventually result in gas exports.

VI. Staff Appraisal

For Azerbaijan, 1992 marked a significant point of departure from the past. In addition to the heightened process of political transformation, the country experienced an almost overwhelming exposure to the requirements of putting in place a market-based economic system and the attendant legal and institutional changes. Uncertainties stemming from the transition were aggravated by the dislocations in the ruble area as a whole. These factors, combined with the intensification of the conflict over Nagorno-Karabakh and adverse weather that affected agriculture, triggered a very sharp drop in output. It is commendable that domestic macroeconomic imbalances were kept within bounds in the face of such shocks, and some progress was made in initiating measures to correct underlying structural weaknesses.

A major concern of the authorities is the general lack of financial discipline in the larger members of the ruble area, which complicates the pursuit of noninflationary financial policies in the smaller members. Hence, making the national currency (manat) the sole legal tender in Azerbaijan is foremost on the Government's policy agenda for 1993. The economic policy package for this year will need to be formulated to take into account this important move, with careful coordination of measures to ensure that they are mutually reinforcing and supportive of the new currency. The authorities are completing the preparations--both at the technical and policy levels--needed to effect a smooth transition to the national currency in the near future.

The latitude that this change will provide in exercising control over economic policies should be used to achieve a sharp reduction in inflation in 1993. In this context, it will be crucial to contain the state budget deficit and reduce the imbalances in the rest of the public sector, while implementing further structural measures to strengthen revenue and reorient expenditure. Fiscal policies under consideration for 1993 will go a part of the way toward achieving these objectives, although the present fragmentation in government revenue and expenditure complicates the control of these aggregates. It will be important to achieve greater transparency in fiscal operations by capturing implicit taxes and subsidies, as well as various extrabudgetary funds, in the state budget. This can be expected to increase awareness of costs associated with maintaining relative price distortions and speed up their elimination. In addition, tax measures will need to be carefully designed not to discourage private initiative, and restraint will need to be exercised in embarking upon expenditure programs that could be too costly and difficult to reverse.

A further key requirement for improving public finances will be to instill financial discipline in state enterprises by considerably hardening their budget constraints, while moving forward with measures to restructure and modernize this sector. Progress in this area should facilitate the elimination of enterprise arrears. To avoid re-emergence of the latter, banks and enterprises should be discouraged from financing nonviable enterprises. Strengthening enterprise management, and putting in place the legal and institutional framework to clarify ownership rights, contract arrangements, and bankruptcy and liquidation procedures should constitute crucial components of enterprise reform.

Following the liberalization of a sizable proportion of producer and consumer prices in early 1992, greater flexibility was introduced into the pricing of items remaining subject to control. The large increases in oil, energy, and bread prices effected in two stages during the final quarter of the year brought domestic prices of these items closer to their international levels, although the gap between the two continues to be sizable. Notwithstanding social considerations and concerns about monopolistic practices, full liberalization of prices would reduce allocative inefficiencies stemming from administered prices, and eliminate subsidies that absorb vast amounts of financial resources. In any event, there would be merit in closely aligning domestic and international prices prior to the move to the national currency in order not to undermine public confidence in the new currency with large price shocks in the period succeeding its introduction.

It will be important to the success of the Government's stabilization effort to strengthen incomes policy to complement sound fiscal and monetary policies. While Azerbaijan appears to have benefitted from a terms-of-trade gain in 1992, real wage increases cannot be sustained in the absence of a recovery in output. Moderation in wages will also be needed to cushion the impact on domestic industry of increases in energy prices as these are brought closer to world levels. This could be achieved by finding ways of containing excessive wage growth in the public enterprise sector, and by not strictly compensating the population for the impact of past price increases. The staff welcomes the decision not to implement the indexation law and, in view of the anticipated reduction in inflation, encourages the authorities to adopt a forward-looking wage policy. A carefully designed social protection program that takes into consideration resource constraints and targets the hardest-hit segments of the population should complement wage policy and strengthen the social acceptability of reforms.

Passage of the banking legislation has set the ground for the ANB to function as an independent central bank, actively engaging in monetary policy formulation. The staff emphasized to the authorities the importance of containing domestic credit expansion in 1993 if a reduction in inflation is to be achieved. This will require close monitoring of credit to public enterprises, the growth in which reached undue proportions over the past year. Highly negative real interest rates made it increasingly attractive for public enterprises to borrow from the banking system. It will be essential to tighten monetary policy through restraint in credit expansion and a more active interest rate policy aimed at achieving positive real rates and providing clear signals on the Government's intention to restore price stability. The ANB should also promote without delay the effective use of monetary instruments, including the uniform enforcement of reserve requirements across banks, and strengthen bank supervision.

An important consideration in the move to the national currency will be the choice of an appropriate exchange regime. The decision between an initial float or the pegging of the exchange rate for the manat to a major currency should carefully weigh the factors relevant to the two alternatives, in particular, which option could best ensure stability in the exchange rate without the need for artificial support through the imposition of exchange or trade restrictions. The staff would favor a floating of the exchange rate for an initial period, and stress that, under either alternative, it will be essential to put in place strong supporting stabilization policies in order to promote confidence in the national currency and strengthen competitiveness. In addition, measures will be needed to develop the foreign exchange market to provide ease of access to a broad range of participants and facilitate current account convertibility.

Significant modifications were made to Azerbaijan's exchange and trade system in November 1992. The staff welcomes the unification of the exchange system, but cautions the authorities on the intensification of controls on trade in strategic goods that constitute the bulk of exports. The repatriation of export earnings and strengthening of official reserves, which this move is intended to achieve, could best be realized through sound financial policies and the removal of distortions in the present system, which rule out market-related returns to exporters. The implicit export tax in foreign currency mobilized under the new procedures is partly used to finance the Government's foreign currency expenditures and fund large price subsidies. The staff would urge the authorities to reconsider these arrangements as they would give the wrong signals domestically and to the international community, are unlikely to curb the nonrepatriation of foreign exchange earnings on a sustained basis, and would interfere with the broadening of the foreign exchange market. An active interest rate policy, combined with a simplified and decentralized exchange and trade system, would be more effective in achieving the authorities' objectives underlying the adoption of the present system.

The staff welcomes the authorities' determination to ensure Azerbaijan's orderly withdrawal from the ruble area, in particular, the initiatives taken to put in place mutually acceptable payments arrangements. The staff shares the authorities' view that trade relations with the ruble area would need to be maintained, while expanding to new markets. Until an effective mechanism for interstate settlements develops, some barter arrangements between consenting enterprises on commercial terms might be unavoidable to mitigate the adverse effects of payments difficulties on trade and output. It will be important to remove at the earliest opportunity the remaining quantitative restrictions on exports. The authorities are also urged to conclude discussions with the Russian Federation on FSU debt, with a view to normalizing the situation vis-à-vis external creditors.

The staff welcomes the growing importance attached by the authorities to structural reforms, but notes that progress in implementing the contemplated changes continues to be slow. In view of the crucial role of systemic reforms in Azerbaijan's transition to a market economy, the authorities are urged to accelerate efforts in this area. In particular, it will be essential to clearly define privatization and foreign investment policies, stimulate market-oriented behavior and efficiency in public enterprises, and speed up the adoption of key legislation.

The staff believes that Azerbaijan will need considerable further technical assistance, policy advice, and training in the period ahead. In order to effectively monitor economic developments and formulate policies, it will be essential to establish a comprehensive economic data base in conformity with international standards, and ensure that mechanisms are put in place for the systematic compilation and dissemination of the data. There is, in particular, urgency in initiating a broader data coverage of public sector operations.

It will be difficult for Azerbaijan's economic stabilization and reform efforts to bear fruit unless the conflict over Nagorno-Karabakh can be resolved. The staff, therefore, hopes that the various avenues being pursued to achieve this can be successful, as this will be essential for Azerbaijan to realize its growth potential in the near future.

Azerbaijan has availed itself of the transitional arrangements under Article XIV, and maintains exchange restrictions in accordance with the provisions of this Article.

It is recommended that the next Article IV consultation with Azerbaijan be held on a standard 12-month cycle.

Proposed Decision

The following draft decision is proposed for adoption by the Executive Board:

1. The Fund takes this decision in concluding the 1992 Article XIV consultation with Azerbaijan, in the light of the 1992 Article IV consultation with Azerbaijan conducted under Decision No. 5392-(77/63), adopted April 29, 1977, as amended (Surveillance over Exchange Rate Policies).

2. Azerbaijan's restrictions on payments and transfers for current international transactions, described in SM/93/ , are maintained in accordance with Article XIV, Section 2. The Fund encourages Azerbaijan to remove these restrictions.

Azerbaijan: Basic Data

Social and demographic indicators (1991)

Area	86,600 sq. km.
Population	7.22 million
Urban	3.89 million
Rural	3.33 million
Population density	83 per sq. km.
Life expectancy at birth	71 years
Infant mortality rate	23 per thousand
Annual population growth rate	1.2 percent
Gross domestic product (GDP), 1991	26.7 billion rubles
GDP per capita, 1991	3,695 rubles

	1989	1990	1991	1992 (Act.) 1/	1992 (Est.)
Output, Prices, and Wages					
			(In millions of rubles; current prices)		
Gross domestic product (GDP)	15,484	14,697	26,676	127,655	197,031
Net material product (NMP)	10,919	10,712	20,370	98,196	151,562
			(Annual percentage change; constant prices)		
Gross domestic product	-4.4	-11.7	-0.7	...	...
Net material product	-6.0	-11.5	-1.9	-28.1	-26.0
Of which:					
Agriculture	-8.9	2.2	-2.9	-24.0	-22.0
Industry	-3.3	-17.1	-7.8	-28.2	-27.0
			(In percent of NMP in current prices)		
Agriculture	30.7	37.5	41.1	...	33.5
Industry	43.2	34.8	37.1	...	48.3
Construction	11.7	11.7	8.4	...	9.8
Transportation & communication	3.0	5.2	3.3	...	2.6
Other sectors	11.3	10.8	10.1	...	5.8
			(Percentage change)		
Retail prices					
Average	...	7.8	105.6	470.2	533.0
End of period	...	...	128.4	734.6	782.0
			(Rubles per month)		
Minimum wage	...	70	130 2/	2,500 3/	...
Average monthly wages	179	195	318	1,676	...
Of which: Agriculture	140	164	261	956	...
Industry	209	219	400	2,266	...
State Budget			(In millions of rubles)		
Revenue and grants	3,907	4,514	10,336	32,430	50,950
Expenditure	3,771	4,686	9,630	31,163	57,950
Overall balance 4/	136	-172	706	1,367	-7,000
In percent of GDP	0.9	-1.2	2.6	...	-3.6
Money and Credit			(In millions of rubles)		
Money supply	...	...	25,741	61,554	...
Of which: Currency issue	7,687	8,462	10,771	16,219 5/	...
Total domestic credit	...	...	14,295	118,239	...
Of which: Credit to nonfincial state enterprises	...	...	13,468	112,281	...

Azerbaijan: Basic Data (concluded)

	1989	1990	1991	1992 (Act.) 1/	1992 (Est.)
Trade and Current Account 6/					
	(In millions of rubles)		(In millions of dollars)		
Exports	7,123	6,430	392	1,072	1,429
FSU	6,675	6,105	367	456	608
Non-FSU	448	325	24	616	821
Imports	5,190	5,752	336	577	769
FSU	3,794	4,247	283	404	538
Non-FSU	1,396	1,505	70	149	199
Trade balance	1,933	678	56	495	660
FSU	2,881	1,858	84	52	70
Non-FSU	-948	-1,180	-46	467	622
Current account	...	...	149	498	647

Sources: Data provided by the Azeri authorities, and Fund staff estimates.

1/ Actual data on output and prices are from January through October; data on wages, trade, the current account, and the state budget are from January through September; and money and credit data are as of end-September.

2/ As of April 1, 1991.

3/ As of December 1, 1992.

4/ After net transfers from the former U.S.S.R. budget; primary balance on a cash basis.

5/ Includes a small amount of manat issue.

6/ There is a break in trade data after 1991. The breakdown of the trade data into FSU and non-FSU excludes adjustments for border trade and freight, while totals include such adjustments. FSU stands for former Soviet Union.

Table 1. Azerbaijan: Comparison of Key Economic Indicators with Selected FSU States, 1991-92 1/

	Azerbaijan	Russian Federation	Ukraine	Kazakhstan	Armenia	Georgia	Estonia
1991							
Real GDP (percentage change)	-0.7	-9.0	-11.2	-10.0	-10.8	-25.0	-12.6
Inflation (average, percent)	105.6	92.6	...	91.0	100.3	160.5	210.0
Interest rate (percent) 2/	12.0	...	12.0	...	20.0	15.0	...
Budget deficit (in percent of GDP)	2.6	-19.9	-13.9	-7.4	-2.0	-3.1	4.9
Trade balance (billions of rubles)	1.7	...	...	-9.1	-1.8	...	-0.9 3/
FSU	2.6	...	...	-2.0	-1.2	...	...
Non-FSU	-1.4	11.5	...	-7.1	-0.6	...	...
1992							
Real GDP (percentage change)	-26.0	-18.0	-15.0	-14.0	-37.4	-35.0	-26.0
Inflation (average, percent)	533.0	1,314.0	1,213.2	749.0	900.0	1,005.3	1,055.0
Interest rate (percent) 2/	12.0	80.0	80.0	65.0	30.0	40.0	67.0
Budget deficit (in percent of GDP)	-3.6	-7.5 4/	-31.5	-7.2	-22.0	-20.0	1.5
Trade balance (billions of rubles)	83.0	...	-0.7	-212.9	-12.8	...	-116.0 3/
FSU	8.8	...	-0.5	-10.7	-4.4	...	...
Non-FSU	79.2	-528.0 5/	-0.2	-202.2	-8.4	...	...

Sources: European II Department Staff Reports and centralized data base.

1/ Tentative estimates as of December 1992.
2/ Central Bank refinance rate; end of period.
3/ Current account in millions of U.S. dollars.
4/ Program target on a commitment basis as compared to a preliminary actual deficit of 14 percent of GDP during January-September, 1992.
5/ US$2.4 billion deficit, converted at an average exchange rate of rub 220 per U.S. dollar.

Table 2. Azerbaijan: Output, Price, and Wage Developments, 1989-92

	1989	1990	1991	1992 Q1	1992 Q2	1992 Q3	1992 Full year (Proj.)
Output 1/		(Annual real rates of change)					
Gross domestic product	-4.4	-11.7	-0.7	...	...	...	...
Net material product	-6.0	-11.5	-1.9	-31.7	-30.1	-30.2	-26.3
Of which:							
Agriculture	8.9	2.2	-2.9	-23.0	-28.3	-32.0	-22.0
Industry	-3.3	-17.1	-7.8	-35.4	-33.2	-32.9	-27.0
		(In percent of NMP at current prices)					
Agriculture	30.7	37.5	41.1	...	...	...	33.5
Industry	43.2	34.8	37.1	...	...	...	48.3
Retail prices 1/		(Percentage change)					
Average	...	7.8	105.6	459.7	372.7	436.7	533.3
End of period	...	...	128.4	518.2	354.1	655.7	781.5
Wages 2/		(Rubles per month)					
Minimum wage (end-period)	...	70	130	317	317	700	2,500
Average monthly wage	179	195	318	839	1,058	1,676	...
Of which:							
Agriculture	140	164	261	412	443	956	...
Industry	209	219	400	1,122	1,470	2,266	...
		(Index 1991=100)					
Real minimum wage (end-period)	...	...	100	80	70	100	...
Real average monthly wage	...	...	100	71	79	106	...

Sources: Data provided by the Azeri authorities, and Fund staff estimates.

1/ Quarterly growth rates for 1992 are cumulative from the beginning of the year, compared with the corresponding period of the previous year.

2/ Quarterly average wages for 1992 are cumulative averages from the beginning of the year. The real average wage index indicates the cumulative levels through the quarter in question relative to 1991 average. Price deflators were made consistent with these definitions.

Table 3. Azerbaijan: State Budget Summary, 1991-92

	1991 Actual	1992 Cumulative Totals Actual (3 months)	Actual (6 months)	Actual (9 months)	Estimate (yearly)
		(In millions of rubles)			
Total revenue and grants	10,336.2	5,120.7	14,635.2	32,430.6	50,950.0
Total revenue	6,696.2	5,120.7	14,635.2	32,189.6	50,709.0
Current revenue	6,690.5	5,076.2	14,371.4	31,815.1	50,307.0
Tax revenue	5,969.3	4,673.1	13,755.3	30,864.0	49,148.7
Nontax revenue	721.2	403.1	616.1	951.2	1,158.3
Capital revenue	5.6	44.5	263.9	374.5	402.0
Grants	3,640.0	--	--	--	--
Unclassified revenue	--	--	--	241.0	241.0
Total expenditure and net lending	9,630.5	3,645.8	11,767.0	31,163.3	57,950.0
Expenditure	8,091.4	3,646.0	11,769.3	31,069.8	58,000.0
Net lending	1,539.1	-0.2	-2.3	-6.5	-50.0
Overall deficit/surplus (cash basis)	705.7	1,474.9	2,868.2	1,367.3	-7,000.0
Plus net change in expenditure arrears, increase (+)	200.0	...	...	1,600.0 1/	-1,600.0
Overall deficit/surplus (accruals)	505.7	...	...	-232.7	-5,400.0
Financing of accruals balance	-505.7	...	...	232.7	5,400.0
Foreign	--	--	--	--	--
Domestic	505.6	-1,474.9	-2,868.2	232.7	5,400.0
Monetary authorities	-705.6	-1,474.9	-2,868.2	-1,367.3	7,000.0
Net change in arrears	200.0	...	...	1,600.0	-1,600.0
		(As percent of GDP)			
Total revenue & grants	38.7	...	...	...	25.9
Total revenue	25.1	...	...	...	25.7
Tax revenue	22.4	...	...	...	24.9
Nontax revenue	2.7	...	...	...	0.6
Total expenditure and net lending	36.1	...	...	...	29.4
Expenditures	30.3	...	...	...	29.4
Net lending	5.8	...	...	...	--
Overall deficit/surplus (cash basis)	2.6	...	...	...	-3.6

Sources: Ministry of Finance, and Fund staff (STA and EUR II) estimates. The estimates for 1992 were prepared by EUR II staff on the basis of discussions with the authorities.

1/ Consists of a buildup in arrears of rub 1,800 million in the first three quarters of 1992 less repayment of rub 200 million of arrears accumulated in 1991.

Table 4. Azerbaijan: Monetary Survey, 1991-92

(In billions of rubles; end-of-period)

	1991 December	1992 March	1992 June	1992 September
Assets	24.0	34.8	41.4	69.1
Net foreign assets	9.8	10.3	-24.4	-49.2
Assets	87.6	94.4	128.4	236.6
Convertible	0.9	9.0	--	6.5
Nonconvertible (claims in rubles)	86.7	85.5	128.4	230.1
Liabilities	-77.8	-84.1	-152.8	285.8
Convertible	--	-0.4	--	-1.3
Nonconvertible (claims in rubles)	-77.8	-83.7	-152.8	-284.4
Domestic credit	14.3	24.5	65.8	118.2
Net claims on Government	-0.5	-2.5	-4.5	-9.2
Claims on the rest of the economy	14.8	27.0	70.3	127.4
State enterprises (nonfinancial)	13.5	24.7	62.5	112.3
Private sector	1.4	2.3	7.8	15.2
Liabilities	24.0	34.8	41.4	69.1
Money	25.7	31.4	42.0	61.6
Currency issue	10.8	11.3	13.0	16.2
Rubles	10.8	11.3	13.0	15.9
Manats	--	--	--	0.3
Demand and time deposits	14.8	18.5	24.4	36.2
Long-term deposits and funds	0.2	1.6	4.7	9.1
Interbank settlements	0.7	-1.5	2.5	-5.1
Liabilities	25.9	30.1	64.4	135.1
Assets	-25.3	-31.6	-61.9	-140.2
Capital accounts	1.3	1.7	2.5	4.7
Other items, net	-3.6	3.2	-5.7	7.9

Sources: Azeri authorities, and Statistics and European II Departments of the IMF.

Table 5. Azerbaijan: Summary Balance of Payments, 1991-92

(In millions of U.S. dollars)

	1991	1992 Jan.-Sept.	1992 Proj.
Current account balance	149.2	497.8	647.0
Exports, f.o.b.	391.5	1,071.7	1,429.0
FSU	367.1	455.7	607.5
Non-FSU	23.9	615.6	821.0
Adjustment 1/	0.5	0.4	0.5
Imports, f.o.b.	-335.6	-576.5	-769.0
FSU	-283.2	-403.6	-538.0
Non-FSU	-69.6	-149.1	-199.0
Adjustment 1/	17.2	-23.8	-32.0
Trade balance	55.9	495.2	660.0
FSU 2/	83.9	52.1	69.5
Non-FSU 2/	-45.7	466.5	622.0
Services, net	-12.3	-48.5	-64.1
Transportation	-12.5	-23.3	-31.1
Travel	-0.4	-26.5	-35.0
Other	0.6	1.3	2.0
Current transfers, net	105.6	51.1	51.1
General government	105.6	51.0	51.0
Other	...	0.1	0.1
Capital account balance	...	333.6	300.0
Bank assets (rubles)	...	-257.5	...
Bank liabilities	...	591.1	...
Rubles	...	585.1	...
Foreign exchange	...	6.0	...
Net errors and omissions	...	-810.0	-797.0
Overall balance	...	21.4	150.0
Foreign exchange reserves (- increase)	...	-21.4 3/	-150.0

Sources: Compiled by the Statistics Department of the IMF, in collaboration with the Azeri authorities. Full-year projections for 1992 were prepared by the European II Department mission.

1/ For border trade, grant-financed imports, and freight.
2/ Excluding adjustments. Hence, these components do not add up to the trade balance adjusted as described in footnote 1.
3/ Reflects the increase in convertible foreign exchange assets derived from the monetary survey.

Table 6. Azerbaijan: Medium-Term Scenario, 1992-97

	1992 (Est.)	1993	1994-97 (Average)
		(In percent)	
GDP growth	-26	0	7
		(In percent of GDP)	
Investment	2	16	23
Total savings	2	16	23
Domestic	66 1/	32	10
Foreign	-64 1/	-16	13
Current account			
In millions US$	647	387	-410
In percent of GDP	64	16	-13

Sources: Azeri authorities, and Fund staff projections.

1/ These ratios have to be interpreted with extreme caution, since GDP figures are likely to be considerably understated in 1992 and the balance of payments estimates indicate large negative errors and omissions.

Azerbaijan: Relations with the Fund

(As of January 31, 1993)

I. Membership Status

(a) Date of membership:	September 18, 1992
(b) Status:	Article XIV

II. General Resources Account	SDR Million	% Quota
Quota (including Ninth Review)	117 1/	100.0
Fund holdings of Azerbaijan's currency	--	--
Reserve tranche position in the Fund	--	--
Operational budget transfers (net)	--	--

III. SDR Department	SDR Million	% Quota
Net cumulative allocation	--	--
Holdings	--	--
Designation plan amount	--	--

IV. Outstanding Purchases and Loans	SDR Million	% Quota
Stand-by arrangements	--	--
Extended arrangements	--	--
CCFF	--	--
SAF arrangements	--	--
ESAF arrangements	--	--

V. Financial Arrangements

None

VI. Projected Obligations to the Fund

None

VII. Exchange Rate Arrangements

The national currency is the manat, which bears a fixed relationship to the Russian ruble at a rate of 10 rubles to the manat. The exchange rate for the ruble is set by the Azerbaijan National Bank (ANB), and adjusted to reflect variations in the ruble/U.S. dollar rate in the Moscow Interbank Foreign Currency Exchange. The exchange rate (set by the ANB) applies to all payments transactions. On December 4, 1992, the buying rate for the ruble equaled rub 440 per U.S. dollar and the selling rate equaled rub 520

1/ Subscription payment is expected to be made shortly.

per U.S. dollar. Exchange rates for other currencies are determined by using international cross-rates for the U.S. dollar.

Azerbaijan has been classified by the staff with the group of countries whose currencies are pegged to another currency.

Azerbaijan maintains exchange restrictions in accordance with Article XIV. 1/

VIII. Article IV Consultations

The first Article IV consultation discussions with Azerbaijan were held in Baku during the period November 24-December 11, 1992.

It will be proposed that Azerbaijan be placed on a standard 12-month consultation cycle.

IX. Technical Assistance

FAD - Budget management, tax reform, and social security system	Feb. 17-March 9, 1992
MAE - Central banking operations and accounting, currency issue, and foreign exchange operations	October 19-30, 1992
STA - Monetary, balance of payment, and government finance statistics	Nov. 24-Dec. 10, 1992
FAD - Tax and expenditure reform	December 3-17, 1992

X. Resident Representative

None

XI. Resident Advisors

None.

1/ Azerbaijan has notified the Fund of the exchange rate arrangements that it intends to apply in fulfillment of its obligations under Article IV, Section 1, of the Articles of Agreement.

Azerbaijan: Relations with the World Bank

Azerbaijan became a member of the IBRD in September 1992. Even prior to formal membership, a Bank economic mission in July 1992 carried out an assessment of the economic situation and prospects, and progress in reforms. A second mission took place in September/October 1992, and a Country Economic Memorandum is under preparation. Simultaneously, in view of the importance of the energy sector for Azerbaijan's future growth and viability of balance of payments, in July 1992, the Bank initiated an energy sector review. The report for this review is also under preparation.

The Bank has discussed with the authorities ways in which it could support the reform process, especially through a possible policy-based quick-disbursing loan. The latter could help finance critical imports to arrest the decline in production, as a result of both the breakdown in interrepublican relations and the initiation of reforms toward a market-oriented system, and provide technical assistance in helping to design and implement the reform program. The Government's agreement with the IMF on a satisfactory stabilization program would be a prerequisite for such a loan. Pending the Government's approach to the Fund for support, the Bank has taken steps to prepare an Institution-Building Technical Assistance Loan to help in the design, sequencing, and implementation of economic reforms. It has also initiated the preparation of a technical assistance loan for the development of the energy sector, especially focussing on creating the necessary legal and economic environment for attracting foreign capital in the development of the petroleum sector. The Bank has approved an advance disbursement of US$500,000 from its Project Preparation Facility for the preparation of this energy sector TA loan.

At the request of the Government, and pending the assessment of its balance of payments needs, the Bank organized and chaired a Pre-Consultative Group meeting in Paris, held in December 1992, to mobilize support from multilateral and bilateral donors for meeting Azerbaijan's technical assistance needs. The Fund participated in this meeting and contributed its assessment of the macroeconomic situation, and the technical assistance it expects to provide in areas relevant to the Fund.

The Bank has also provided a grant of US$340,000 from its Institutional Development Fund to help the Government manage the coordination of external financial and technical assistance.