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CONTAINS CONFIDENTIAL  
INFORMATION

March 16, 1993

To: Members of the Executive Board

From: The Secretary

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

The attached supplement to the staff report for the 1992 Article IV consultation with Azerbaijan (SM/93/33, 2/9/93) has been prepared on the basis of additional information.

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

Supplementary Information

Prepared by the staff representatives for the  
1992 consultation with Azerbaijan

(In consultation with other departments)

Approved by John Odling-Smee and A. Basu

March 16, 1993

A staff team visited Baku during February 12-19, 1993 to obtain information on the 1993 state budget and discuss the status of currency reform in Azerbaijan. 1/ The mission met with the State Advisor to the President on Economic Policy, the Minister of Finance, the Chairman and the First Deputy Chairman of Azerbaijan National Bank (ANB), the First Deputy Chairman of the State Committee of Statistics, and other senior officials. The mission partly overlapped with follow-up missions from the Monetary and Exchange Affairs and Statistics Departments of the Fund on central bank reform and monetary statistics, respectively. This supplement provides a brief update on recent economic developments in Azerbaijan, status of currency reform, and details of the draft 1993 state budget. 2/

1. Recent economic developments

Azerbaijan's economic situation appears to have deteriorated since the consultation discussions in November/December 1992. Output has continued to decline, with the drop in GDP in 1992 now estimated at closer to 30 percent, as against 26 percent previously. The monthly rate of consumer price inflation accelerated to 22 percent in November and reached 92 percent in December 1992, before receding to 33 percent in January 1993. The sharp jump in the price level in December reflected mainly the impact of the

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1/ The team consisted of Mrs. Gürgen (Head), Mr. Coelho (both EUR II), Mr. Craig (FAD), Mr. Durdag (World Bank), and Mr. Yablonsky (Interpreter, BLS). The mission also introduced to the authorities a candidate (presently a World Bank staff member) for the position of Fund resident representative in Baku. The authorities requested the stationing of a Fund resident representative, as well as the placement of resident advisors on budget preparation and monetary operations.

2/ Azerbaijan completed its quota subscription payment to the Fund on February 26, 1993.

sizable increases in bread prices, energy tariffs, and oil and oil product prices at the beginning of the month, which triggered increases in prices of a broad range of goods. Developments in the last two months of the year raised the average and the end-of-period inflation rates in 1992 to 607 percent and 1,367 percent, respectively. Following the sizable wage adjustments in December 1992, the minimum wage was raised to rub 3,000 on January 1, 1993, which led to a new round of increases in wages, salaries, and payments of social benefits.

These developments contributed to a deterioration in government and public enterprise finances. While the Government ended 1992 with only a slightly higher budget deficit, on a cash basis, than envisaged earlier (see Section 3), preliminary indications are that a large deficit was incurred in the republican budget in January 1993. Enterprise arrears to banks and other enterprises more than doubled in the last two months of 1992 to reach rub 37 billion at end-December, equivalent to 24 percent of total bank credit outstanding on the same date. Domestic credit grew tenfold during 1992, with most of the increase channeled to state-owned enterprises. The conflict in Nagorno-Karabakh, with recent heavy casualties and losses of territory by Azerbaijan, 1/ also continues to place growing demands on financial resources and detracts from the reform effort.

Balance of payments data for 1992 are incomplete at this stage, but data on non-FSU trade indicate a lower surplus for the year (US\$420 million) than projected (US\$820 million) at the time of the earlier staff discussions. End-1992 foreign exchange reserves were also lower than anticipated (US\$60 million compared to US\$150 million), although reserves exceeded US\$100 million if US\$55 million held in Azerbaijan by state-owned enterprises are included.

## 2. Currency reform

Increased uncertainty in the economic and political outlook has resulted in a postponement of the currency reform from an initial intention to act by early 1993. The authorities also appear reluctant to move until there is an understanding on the treatment of interrepublican claims and withdrawn rubles, and are concerned that Azerbaijan's payments with the other republics of the FSU may be disrupted if the manat becomes the sole legal tender. A draft law on the manat was submitted to Parliament at the beginning of February, but not approved pending further specification of details of the currency changeover. The authorities indicated their commitment to introducing the national currency in the near future, and noted that the technical preparations for this move, including securing an adequate supply of manat bank notes and minting coins, are at an advanced stage.

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1/ The loss by Azerbaijan of more than a dozen villages in Karabakh in February prompted the resignation of the Defense Minister.

A move to the manat is effectively taking place. The ruble issue by the Central Bank of Russia to Azerbaijan has virtually ceased in the past two months. The ensuing cash shortage, which the authorities point out was intensified by the outflow of rubles as cheaper goods from neighboring republics entered Azerbaijan's markets following the December price adjustments, is being compensated for by a very sharp increase in the manat issue. From January 1 through mid-February 1993, close to manat 1.5 billion (equivalent to rub 15 billion at the conversion rate of 10 rubles per manat) were issued. This amount corresponds to about half the stock of currency outstanding at end-1992. The authorities indicated, moreover, that there are plans to pay all wages and salaries in manats and to require that certain domestic purchases (e.g., gasoline) be made exclusively in manats. Hence, the manat is becoming more widely used in domestic payments, although at the time of the mission's visit the withdrawal of rubles from circulation had not been initiated.

In anticipation of a currency changeover, and to avoid disruptions in interrepublican trade flows, mechanisms for interrepublican payments are being worked out, and agreements involving reciprocal central bank credit lines (including the option of ANB credit lines in manats) are under negotiation. The staff noted that these credit lines should be short term and temporary, to be phased out once sufficient progress had been made in establishing an efficient, decentralized payments system at the level of commercial banks. The authorities' earlier inclination to peg the manat to a major currency appears to have weakened under the present uncertain circumstances. Although a decision has not been taken on this matter, they did not rule out a market-determined exchange rate for the manat, once it is fully adopted.

Reform of banking institutions and monetary policy instruments is proving to be a slow process, given the ongoing reorganization of the ANB and the need to hire qualified personnel. At the time of the discussions, the monetary and credit program for 1993 was being finalized for submission to Parliament, together with the 1993 draft state budget. The details of the program were not available, but the authorities noted that there would be an increase in interest rates. Preliminary indications are that the ANB refinance rate will be raised to 35 percent from its present level of 12 percent, with possibly a lower rate applying to two specialized (Agroprom and Prominvest) banks. The staff cautioned the authorities of the risks inherent in the prevailing credit policies and interest rate structure. The contemplated increase in the ANB refinance rate would not be adequate to curb strong credit expansion, sustained through currency issue. The staff urged the authorities to raise the cost of credit substantially and refrain from sectoral credit allocation at preferential interest rates.

3. The state budget

a. The 1992 state budget outcome

Revised data on the estimated outcome for the 1992 state budget 1/ indicate higher levels of both revenue and expenditure than anticipated, and a cash deficit of rub 8.2 billion (4.2 percent of GDP), compared with the previous estimate of rub 7 billion (3.6 percent of GDP). Given that the state budget was in surplus during the first three quarters of 1992, the estimated outcome for the year implies a large deficit (rub 9.6 billion) in the final quarter, reflecting mainly the cumulative impact of the price and wage increases in September and December 1992, and the elimination of the Government's domestic payments arrears. The deficit was fully financed by credit from the ANB. Data shortcomings rule out an assessment of the overall position of the government sector including extrabudgetary funds, although there are indications that the deficit in the state budget may have been partly offset by surpluses in some of the extrabudgetary funds. A surplus (rub 4 billion, or 2 percent of GDP) was incurred, for example, in the Social Protection Fund, due largely to the application of the 40 percent social security levy on rapidly growing payrolls in the final months of the year. However, this has to be interpreted with caution, since it is likely to be the outcome of timing differences between collections and payments of benefits, which would have been reversed at the beginning of 1993.

b. The 1993 draft state budget

At the time of the staff visit, the 1993 draft state budget was being finalized for submission to Parliament. The estimates indicate a deficit of rub 37 billion (Table 1), equivalent to 5 percent of officially projected GDP, 2/ which is to be financed by credit from the ANB and the issue of a modest amount of government securities. The budget is to be reviewed on a quarterly basis.

State budget revenue is projected to increase to 40 percent of GDP in 1993, from 30 percent in 1992. The estimates take into account the lowering

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1/ The 1992 state budget did not include subsidies financed from off-budget funds and may not reflect all defense spending. These items are more fully captured in the draft 1993 state budget.

2/ The authorities based their budget estimates for 1993 on a projected 1993 GDP of rub 735 billion. This implies a nominal increase of about 270 percent over estimated 1992 GDP, or an inflation rate of approximately the same magnitude for the year, given that no more than a slight recovery (3 percent) in output is envisaged. Total revenue and expenditure, on the other hand, are each projected to grow by close to 400 percent over their 1992 levels. Hence, the impact of the GDP projection on the 1993 budget is not immediately apparent, although caution needs to be exercised in interpreting the data, given the coverage differences of the 1992 and 1993 budgets. More generally, the underlying inflation assumption appears optimistic in light of the recent thrust of policies.

of the VAT rate from 28 to 20 percent, effective January 1, 1993, 1/ (implying about rub 45 billion of foregone revenue), and the recent approval by Parliament of land and transportation taxes. The budget also incorporates the impact of the proposed new system of import duties (the details of which were not available), as well as a decision to shift the oil royalty from specific to ad valorem rates of 7.5 percent and 10 percent on onshore and offshore oil production, respectively. Allowance is not made for other tax measures presented to Parliament, including an excess profit tax on state enterprises, a tax on state enterprise fixed assets following their revaluation to current values by April 1993, a new gift and inheritance tax, and a proposed change in excise taxes. However, the net revenue impact of these measures is not expected to be significant. Possible proceeds from the sale of state property, which should result from the implementation of the Privatization Law passed on January 7, 1993, 2/ are also not included. The amount of revenue to be generated from this source in the current year will depend on how quickly a privatization program for 1993 is approved by Parliament.

The revenue projections, which rest mainly upon strong collections on VAT and excises, may prove too optimistic. While higher collections on oil products may materialize in light of the substantial price increases which took place in the latter part of 1992 and possible further adjustments in 1993, collections for other products may fall below budget forecasts. In this connection, the revenue impact of a recent cut in the excise tax rate on vodka (from 70 percent to 50 percent) to encourage the consumption of domestic goods could well be negative. Some doubt also attaches to whether the projected revenue from certain new taxes, such as customs duties, can be realized.

State budget expenditure are also projected to increase by 10 percentage points of GDP in 1993. This partly reflects a capturing in the state budget of certain expenditure items that were previously outside the budget, notably items financed from the hard currency funds. The two major expenditure items that are now fully included in the budget are the bread production subsidy (rub 34 billion) and defense spending (rub 92 billion). These items constitute 10 percent and 28 percent of total 1993 budget expenditure, or almost 5 percent and 13 percent of projected 1993 GDP, respectively. Defense expenditure includes allocations for reconstruction of damaged areas, resettlement of refugees, and the setting up of a military industrial complex. Another feature of the budget is an allocation for capital spending (rub 23 billion), mainly on agricultural, housing, water, and sewerage projects. Finally, the 1993 state budget incorporates a Private Entrepreneur Support Fund (rub 4.5 billion), which the authorities view as significant in promoting the transition to a market economy. The Fund is to be financed also from nonbudgetary sources, including a portion

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1/ Essential food items such as bread and grain products, dairy products, eggs, and baby food remain exempt from VAT.

2/ For details, see Appendix I of Azerbaijan: Recent Economic Developments (SM/93/51), March 5, 1993.

of privatization proceeds and foreign loans, and is to be used for interest-free loans and other forms of start-up assistance to private entrepreneurs, particularly in agriculture and export industries. The authorities expect this initiative to reinforce the privatization program to be initiated in 1993.

The Social Protection Fund is expected to move into a deficit of rub 24 billion (3 percent of GDP) in 1993, after allowing for rub 31 billion in transfers from the budget to finance payment of family allowances. This will result from two policy decisions: (i) the introduction of a more generous pension system in late 1992, which had the effect of raising the average pension from 30 percent to 75 percent of the average wage; and (ii) a reduction (effective January 1, 1993) in the social payroll contribution from 40 percent to 25 percent for agricultural enterprises, and to 35 percent for other enterprises. Although the position of this Fund is to be reviewed in April, indications are that any deficit incurred will be financed through bank credit.

Increasing the transparency of government expenditure in 1993 is a welcome move, although the introduction of a preferential scheme (interest-free loans) for private entrepreneurs can be expected to interfere with efficient credit allocation. The heavy burden placed on budgetary resources by the bread subsidy and defense spending, which are now more fully and explicitly identified in the budget, underscore the desirability of eliminating subsidies through price liberalization and exploring all options for the speedy resolution of the conflict in Karabakh. Budgetary support for the Social Protection Fund is also up sharply in 1993. The amounts projected for these three expenditure items, together with allocations for a catching up in capital expenditure and support for private sector activity, will require substantial real cuts in other expenditure categories.

#### 4. Staff appraisal

The recent significant deterioration in Azerbaijan's financial situation is of concern. The two main areas where expectations have taken a downturn since the staff appraisal of Azerbaijan's economic policies in the context of the Article IV consultation discussions relate to the outlook for public finances and the prospects for a successful introduction of the national currency. On the former, indications are that the draft state budget has not been formulated within an overall policy framework for 1993, aimed at achieving financial stability. The attempt to maintain real wages and to increase certain social benefits--notably pensions--in the face of rising inflation and sharp declines in output, and in the absence of compensating expenditure cuts, is clearly proving to be unsustainable, as evidenced by the recent sharp deterioration in public sector finances. The bread subsidy continues to grow, as price adjustments fail to keep pace with cost increases, and this is also likely to be valid for subsidies that are not captured in the budget. The greater transparency in defense spending and the size of allocations contemplated for 1993 starkly reveal the magnitude of the demands placed on financial resources by the intensified conflict in Karabakh. While information is insufficient to assess the

outlook for overall public sector finances in 1993, the large deficit projected for the Social Protection Fund, which follows from policies aimed at maintaining and, in certain cases, raising the purchasing power of social benefits, will further strain financial resources. The thrust of fiscal policy presently planned for 1993, therefore, provides little assurance that the public sector deficit can be contained to provide a basis for the introduction of the national currency in conditions of financial stability. The Government will need to monitor budgetary developments during the course of the year, with the objective of closely restricting expenditure to revenue generated and strictly containing recourse to bank credit.

An apparent consequence of the turnaround in Azerbaijan's economic situation is the delay in the adoption of the national currency from an initial intention to complete this move by early 1993. The staff would urge the authorities to introduce the national currency in a deliberate manner, with supporting financial policies and institutional reforms in place, rather than in a piecemeal fashion and in reaction to unanticipated events. In this regard, it will be essential for the ANB to assume an active role in monetary management, curtailing bank financing of the state budget and strictly curbing access by state-owned enterprises to bank credit. The ANB should restrain credit demand increasingly through appropriate economic incentives, including by means of a well-conceived interest rate policy, rather than through administrative regulation, and ANB's relationship with financial institutions should be based on principles of uniform treatment. So far, moves to translate the new functions attributed to the ANB by its charter into concrete policies and actions have been modest, partly because of the ongoing reorganization of the institution. The staff would urge the authorities to act more decisively and boldly in the above areas, and to formulate monetary policy targets with the objective of achieving a reduction in inflation.

Azerbaijan is entering a period in which it will be critical to continue and deepen the policy initiatives started earlier to stabilize and reform the economy, and not to waiver in the face of unforeseen difficulties. This will be a challenge well worth meeting, given Azerbaijan's resource endowment and potential prospects for the resumption of growth. A concerted effort is needed, moreover, on the part of Azerbaijan and the Russian Federation to strengthen cooperation on the steps leading to the introduction of the national currency. The staff stands ready to support Azerbaijan's reform effort, including through continuing its technical assistance program and exploring all options to accommodate the authorities' requests for the stationing of resident experts in Baku.

Table 1. Azerbaijan: 1993 Draft State Budget

(In millions of rubles)

	1992 Revised Estimates			Draft 1993 Budget		
	State Estimate	Republican Actual	Local Estimate	State Projected	Republican Projected	Local Projected
Revenue	<u>59,983</u>	<u>39,133</u>	<u>29,262</u>	<u>297,026</u>	<u>233,596</u>	<u>86,577</u>
(In percent of GDP)	30.4			40.4		
Value-added tax (VAT)	20,124	15,624	4,500	106,999	75,468	31,531
Of which: oil	4,000	4,000	--	38,200	38,200	--
Excise tax	8,854	8,704	150	114,790	114,790	--
Of which: oil	4,000	4,000	--	48,900	48,900	--
Profit tax	13,532	1,532	12,000	45,410	27,441	17,969
Income tax	3,600	--	3,600	10,643	--	10,643
Oil royalties	1,362	1,362	--	6,030	6,030	--
Revaluation of stocks	6,538	6,538	--	4,989	4,989	--
Customs duties	94	94	--	4,852	4,852	--
Land tax	--	--	--	1,280	--	1,280
Transport tax	--	--	--	1,502	--	1,502
Other revenue	5,879	5,279	600	531	26	505
Transfer from republican budget	...	...	8,412	...	...	23,147
Expenditure	<u>68,244</u>	<u>48,406</u>	<u>28,250</u>	<u>333,833</u>	<u>258,004</u>	<u>98,977</u>
(In percent of GDP)	34.6			45.4		
National economy	14,112	10,912	3,200	53,884	43,334	10,550
Of which: Bread subsidy	2,050	2,050	--	34,000	34,000	--
Science	784	784	--	2,970	2,939	31
Social and cultural	34,612	13,062	21,550	129,038	44,168	84,870
Of which:						
Education	18,065	4,565	13,500	64,267	13,341	50,926
Culture and media	1,870	870	1,000	6,441	2,327	4,114
Health	7,520	1,520	6,000	26,003	4,730	21,273
Sport	80	30	50	127	50	77
Social security	382	132	250	1,500	695	805
Social Protection Fund	4,495	3,745	750	30,700	23,025	7,675
Bread price compensation	2,200	2,200	--	--	--	--
Law enforcement	4,291	4,291	--	15,592	15,442	150
Defense-related spending	9,081	9,081	--	91,432	91,432	--
Defense spending	8,081	8,081	--	70,502	70,502	--
Restoration of regions	...	...	...	3,000	3,000	--
Military facility conversions	--	--	--	942	942	--
Refugees	1,000	1,000	--	4,600	4,600	--
Military industrial complex	--	--	--	12,313	12,313	--
Karabakh compensation	--	--	--	75	75	--
State administration	1,857	857	1,000	7,504	4,128	3,376
Reserve fund	...	...	...	5,143	5,143	--
Capital expenditure	...	...	...	22,958	22,958	--
Private Entrepreneur Support Fund	--	--	--	4,500	4,500	--
Other expenditure	3,507	1,007	2,500	813	813	--
Transfers to local governments	...	8,412	...	...	23,148	...
Deficit (-)/Surplus (+)	<u>-8,261</u>	<u>-9,273</u>	<u>1,012</u>	<u>-36,807</u>	<u>-24,408</u>	<u>-12,400</u>
(In a percent of GDP)	-4.2			-5.0		

Source: Azerbaijan Ministry of Finance.