

**FOR  
INFORMATION**

FO/DIS/16/135

August 31, 2016

To: Members of the Executive Board

From: The Acting Secretary

Subject: **Republic of Azerbaijan—Assessment Letter for the Asian Development Bank**

Board Action:	Executive Directors' <b>information</b>
Publication:	Yes*
Questions:	Mr. Ross, MCD (ext. 35672) Mr. El Qorchi, MCD (ext. 38751) Ms. Castellanos, MCD (ext. 35988)



## REPUBLIC OF AZERBAIJAN—ASSESSMENT LETTER

August 31, 2016

### Recent Economic Developments

- 1. A number of negative shocks have impaired economic performance in Azerbaijan.** Lower oil prices, weak regional growth, currency devaluations in its main trading partners, and a contraction in hydrocarbon production have erased the large 2014 current account surplus. The Central Bank of Azerbaijan (CBA) undertook a 25 percent devaluation in February 2015 and a second 32 percent devaluation in December 2015, and shifted to a managed floating exchange rate regime. The devaluations led to a rise in dollarization, weakened bank balance sheets, and raised financial stability concerns. Growth fell to 1.1 percent in 2015 and contracted by 3.4 percent in first half of 2016, given cuts in public investment, stagnant credit activity and flat oil production. Inflation averaged 4.1 percent in 2015 and rose to about 10 percent in early 2016 given exchange rate pass-through effects.
- 2. While the CBA foreign exchange (FX) interventions have reduced official reserves, buffers remain substantial given the assets of the State Oil Fund of Azerbaijan (SOFAZ).** By end-2015, CBA net international reserves had declined by some 60 percent from end-2014 and stood at \$5.0 billion. CBA FX sales have lowered reserves to \$4.3 billion by end-June (3.5 months of projected 2016 imports of goods and services). SOFAZ assets, which can be used to support the exchange rate, amounted to some \$35 billion (close to 100 percent of 2016 projected GDP). Based on the IMF's composite reserve adequacy metric, Azerbaijan should hold about 8.4 months of current imports. Official CBA reserves coupled with SOFAZ assets amounts to about 28 months of current imports.
- 3. A counter-cyclical stimulus tailored to promote growth and protect vulnerable populations is being implemented.** Public sector wages, pensions, and social protection expenditures have been increased by 10 percent (3 percent of non-oil GDP) in 2016. With the issuance of an external Southern Gas Corridor (SGC) bond in March for \$1 billion, space was freed up in the state budget for an additional 3½ percent of non-oil GDP in capital spending to complete ongoing projects. To ease social tensions, state-owned enterprises and local authorities have hired 35,000 minimum wage workers on temporary contracts.<sup>1</sup> Moreover, new non-oil tax measures are expected to marginally reduce revenues by 0.25 percent of GDP. Overall, current and capital expenditures rise by about 2 percent of GDP, while the consolidated government non-oil primary deficit as a percent of non-oil GDP rises by about 4 pps, from 35 percent to 39 percent.<sup>2</sup>
- 4. The CBA tightened the monetary policy stance in 2016.** In three separate moves (in February, March, and August), the CBA increased its refinancing rate by 650 basis points (to 9.5 percent) and adjusted the interest rate corridor. Since mid-2016, the CBA has held manat deposit auctions to withdraw liquidity. The CBA is informally targeting base money growth in

---

<sup>1</sup> Some 90 percent of these employments are not part of the consolidated government accounts.

<sup>2</sup> Foreign currency expenditures (e.g., service on external debt, certain defense, and embassy spending) of about 1½ percent of GDP also rose automatically following the devaluations.

2016, with a desire to move to an inflation targeting regime in the long run. With the move to a managed float and periodic FX auctions, exchange rate volatility has increased. Credit growth has been negative given weak economic activity, mismatches in banks' currency positions, and expectations of additional devaluations.

5. **The authorities have taken steps to address financial vulnerabilities.** The devaluations coupled with weak banking practices have led to a high rate of high nonperforming loans (NPLs), undercapitalization, and dollarization. In mid-2015, the government created a bad bank-special purpose vehicle (SPV) to manage and collect NPLs from the largest state bank, International Bank of Azerbaijan (IBA), while the CBA closed or merged a number of smaller banks, particularly in early 2016. In March 2016, the banking and insurance supervision role was transferred from the CBA and MoF, respectively, to a new supervisory and regulatory authority, the Financial Market Services Agency (FMSA). To support confidence, bank deposits were afforded a blanket guarantee backstopped through the CBA. To address dollarization, new macro-prudential limits were placed on dollar lending. The FMSA has put together a plan to rapidly address ailing institutions. A Financial Stability Board was created in mid-July 2016.

## **Outlook and Macroeconomic Policies**

6. **Near-term economic prospects remain weak—with a recession projected in 2016.** Under current policies, real GDP is expected to contract by -2.4 percent in 2016, with growth recovering to around 1 to 2 percent in the next few years, while inflation is expected to fall to under 8 percent. Large fiscal surpluses during the oil boom years are projected to turn into deficits in 2015-18. The current account balance should improve as the devaluations work to limit imports and support non-traditional exports. During 2016, the authorities plan to utilize a small amount SOFAZ assets to help finance balance of payments gaps. To ensure sustainable growth, the authorities are looking at ways to diversify the economy while consolidating budgetary expenditure and boosting non-oil revenues. Risks to the outlook are tilted to the downside as economy growth is still highly linked to oil shocks and government spending. The problems and ongoing restructuring in the banking system are an important risk to growth.

7. **The main challenge is to align macro policies with the new external environment, while modernizing monetary and fiscal frameworks, and accelerating structural reforms.**

- The devaluations in 2015 were necessary and helped to protect competitiveness and reserves. Since the shift to a managed float, the authorities have conducted periodic auctions to supply FX to the market. A majority of banks have participated in these auctions and the exchange rate has exhibited greater flexibility. As noted above, FX reserve levels remain comfortable. The CBA correctly increased interest rates and reduced excess liquidity in 2016 to address inflationary pressures.
- A small fiscal stimulus is helping to support growth in 2016, but consolidation needs to resume next year to safeguard medium-term fiscal sustainability. Fiscal space is contracting and public investment remains high. Although debt-to-GDP ratios have increased (mainly due to devaluation effects), they are projected to remain manageable in the medium term. The authorities plan to request technical assistance on fiscal rules.
- Azerbaijan would benefit from a modernization of their monetary and exchange rate policy frameworks. In particular, the CBA should emphasize the primacy of

their inflation objective, improve liquidity forecasting and management, and enhance its instrument and analytical toolkit. Greater exchange rate flexibility would help to preserve buffers, while more clarity on exchange rate policy objectives and intervention strategy would improve the functioning of the FX market and anchor expectations.

- The efforts to restructure the banking system are welcomed but more is needed. In particular, IBA continues to face incentives to undertake large corporate loans. As noted in the 2015 FSAP, there is a need to strengthen banking supervision, financial safety nets, and the macro-prudential framework.
- The priority structural reforms contained in the government's "2020 development strategy" are generally appropriate. To expand the economy's potential, efforts are needed to improve governance, reduce corruption and the costs of doing business, and remove barriers to competition.

### **Fund Relations**

8. **Article IV consultations are conducted annually.** The next Article IV Board date is set for September 9, 2016. The country continues to benefit from the Fund's technical assistance, particularly in areas related to financial sector restructuring, regulation and supervision, monetary and exchange rate policies and operations, public financial management, revenue mobilization, and national accounts.

Table 1. Azerbaijan: Selected Economic and Financial Indicators, 2013–20

	2013	2014	Prel. 2015	Projections				
				2016	2017	2018	2019	2020
(Annual percentage change, unless otherwise specified)								
<b>National income</b>								
GDP at constant prices	5.8	2.8	1.1	-2.4	1.4	2.3	2.9	2.5
<i>Of which:</i> Oil sector 1/	0.5	-2.4	0.3	-0.4	-0.1	3.0	4.3	1.0
Non-oil sector	9.9	6.9	1.1	-3.6	2.4	1.8	2.0	3.4
Consumer price index (period average)	2.5	1.5	4.1	10.2	8.5	4.2	4.1	4.0
<b>Money and credit</b>								
Domestic credit	4.3	20.4	10.1	4.8	3.1	7.8	10.9	10.8
<i>Of which:</i> Credit to private sector	27.6	26.7	14.0	-2.1	6.6	7.2	8.9	9.6
Manat base money	10.7	-0.9	-40.2	17.0	21.7	16.2	12.3	12.5
Manat broad money	19.0	6.1	-50.6	2.8	13.2	16.8	19.1	24.3
Total broad money	15.4	11.4	-1.1	1.3	7.9	6.9	5.6	4.6
<b>External sector</b>								
Exports f.o.b.	-1.9	-11.1	-44.8	-13.2	13.6	8.7	8.5	4.6
<i>Of which:</i> Oil sector	-2.1	-11.3	-47.1	-13.6	14.0	8.4	8.0	3.4
Imports f.o.b.	-0.8	-16.3	4.7	-13.7	10.9	10.7	2.3	6.3
<i>Of which:</i> Oil sector	9.3	23.3	67.1	-16.6	8.9	22.2	-1.5	5.7
Real effective exchange rate	0.3	4.4	-7.3	--	--	--	--	--
(In percent of GDP, unless otherwise specified)								
<b>Gross investment</b>	25.7	23.1	26.5	29.8	25.6	24.4	22.3	21.4
Consolidated government	20.3	15.3	16.3	18.4	14.9	14.0	11.6	10.7
Private sector	5.4	7.8	10.1	11.4	10.7	10.4	10.7	10.7
<i>Of which:</i> Oil sector	2.9	3.6	4.7	6.6	5.5	4.6	3.8	4.0
<b>Gross national savings</b>	42.1	36.7	26.1	30.5	28.7	33.4	32.0	31.8
Consolidated government	21.3	18.5	9.6	8.5	11.0	13.6	18.0	18.7
Private sector 2/	20.8	18.2	16.5	22.0	17.8	19.8	14.0	13.1
<b>Consolidated central government finances</b>								
Total revenue and grants	39.5	38.9	33.8	35.0	37.6	40.3	44.4	45.3
Total expenditure	38.5	35.7	40.5	44.9	41.5	40.7	38.1	37.3
Overall fiscal balance	1.0	3.2	-6.8	-9.9	-3.9	-0.4	6.3	8.0
Non-oil primary balance, in percent of non-oil GDP	-46.8	-36.0	-34.9	-38.6	-33.5	-32.6	-29.0	-28.0
General government gross debt	12.7	11.2	28.3	37.5	37.4	36.0	32.6	30.0
<b>External sector</b>								
Current account (- deficit)	16.4	13.9	-0.4	0.7	3.1	9.0	9.7	10.4
Foreign direct investment (net)	1.5	2.9	1.6	2.4	1.8	1.6	1.4	2.1
<b>Memorandum items:</b>								
Gross official international reserves (in millions of U.S. dollars)	14,152	13,758	5,017	4,117	4,617	5,117	5,617	6,117
Nominal GDP (in millions of manat)	57,708	58,978	54,352	55,314	59,739	62,128	65,235	67,844
Nominal non-oil GDP (in millions of manat)	34,051	37,701	39,542	39,906	43,099	44,823	47,064	48,946
Nominal GDP (in millions of U.S. dollars)	73,537	75,254	54,048	35,686	38,541	40,083	42,087	43,770
Oil Fund Assets (in millions of U.S. dollars)	35,878	37,104	33,574	33,120	34,407	37,254	41,289	46,066
Exchange rate (manat/dollar, end of period)	0.785	0.784	1.550	--	--	--	--	--

Sources: Azerbaijani authorities; and IMF staff estimates and projections.

1/ Includes the production and processing of oil and gas.

2/ Historical data includes statistical discrepancy.