



# Report and Recommendation of the President to the Board of Directors

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Project Number: 50145-001  
November 2016

## Proposed Loan and Technical Assistance Grant Republic of Azerbaijan: Countercyclical Support Facility Program

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Asian Development Bank

## CURRENCY EQUIVALENTS

(as of 15 November 2016)

Currency unit	–	Azerbaijan manat/s (AZN)
AZN1.00	=	\$0.5743
\$1.00	=	AZN1.7414

## ABBREVIATIONS

ADB	–	Asian Development Bank
CBA	–	Central Bank of Azerbaijan
CSF	–	countercyclical support facility
EITI	–	Extractive Industries Transparency Initiative
FMSA	–	Financial Markets Supervision Authority
GDP	–	gross domestic product
IMF	–	International Monetary Fund
LIBOR	–	London interbank offered rate
MOF	–	Ministry of Finance
SMEs	–	small and medium-sized enterprises
SOE	–	state-owned enterprise
SOFAZ	–	State Oil Fund of Azerbaijan
TA	–	technical assistance
TASF	–	Technical Assistance Special Fund

## NOTE

In this report, “\$” refers to US dollars.

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## PROJECT AT A GLANCE

<b>1. Basic Data</b>		<b>Project Number: 50145-001</b>	
<b>Project Name</b>	Countercyclical Support Facility Program	<b>Department /Division</b>	CWRD/CWPF
<b>Country Borrower</b>	Azerbaijan Republic of Azerbaijan	<b>Executing Agency</b>	Ministry of Finance
<b>2. Sector</b>	<b>Subsector(s)</b>	<b>ADB Financing (\$ million)</b>	
✓ <b>Public sector management</b>	Public expenditure and fiscal management		50.90
	Social protection initiatives		400.00
<b>Finance</b>	Finance sector development		50.30
		<b>Total</b>	<b>501.20</b>
<b>3. Strategic Agenda</b>	<b>Subcomponents</b>	<b>Climate Change Information</b>	
Inclusive economic growth (IEG)	Pillar 3: Extreme deprivation prevented and effects of shocks reduced (Social Protection)	Climate Change impact on the Project	Low
<b>4. Drivers of Change</b>	<b>Components</b>	<b>Gender Equity and Mainstreaming</b>	
Governance and capacity development (GCD)	Public financial governance	No gender elements (NGE)	✓
Knowledge solutions (KNS)	Knowledge sharing activities		
Private sector development (PSD)	Conducive policy and institutional environment		
<b>5. Poverty and SDG Targeting</b>		<b>Location Impact</b>	
Geographic Targeting	No	Nation-wide	High
Household Targeting	No		
SDG Targeting	Yes		
SDG Goals	SDG8		
<b>6. Risk Categorization:</b>	Complex		
<b>7. Safeguard Categorization</b>	<b>Environment: C Involuntary Resettlement: C Indigenous Peoples: C</b>		
<b>8. Financing</b>			
<b>Modality and Sources</b>		<b>Amount (\$ million)</b>	
<b>ADB</b>		<b>501.20</b>	
Sovereign Countercyclical Support Facility Lending (Loan): Ordinary capital resources		500.00	
Sovereign Project preparatory technical assistance: Technical Assistance Special Fund		1.20	
<b>Cofinancing</b>		<b>0.00</b>	
None		0.00	
<b>Counterpart</b>		<b>0.00</b>	
None		0.00	
<b>Total</b>		<b>501.20</b>	
<b>9. Effective Development Cooperation</b>			
Use of country procurement systems		Yes	
Use of country public financial management systems		Yes	



## I. THE PROPOSAL

1. I submit for your approval the following report and recommendation on a proposed loan to the Republic of Azerbaijan for the Countercyclical Support Facility Program. The report also describes the proposed technical assistance (TA) for Improving Public Sector Efficiency, and if the Board approves the proposed loan, I, acting under the authority delegated to me by the Board, approve the TA.

2. The proposed countercyclical support facility (CSF) program will, in the short term, help the government mitigate the significant negative economic impact caused by the crash in oil prices and the recession in the country's trading partners, which has triggered recession in Azerbaijan. The government's ongoing and planned fiscal stimulus expenditure includes social assistance programs, and promotion of inclusive private sector development and employment. The country's compliance status with the access criteria for a CSF is in Appendix 4.<sup>1</sup> The proposed TA will facilitate design of structural reforms covering macro fiscal management, state-owned enterprise (SOE) reform, and finance sector development as well as augment capacity of relevant government departments for implementation of the reforms. The medium-term structural reforms could be supported further under a planned policy-based loan in 2017.

## II. THE PROGRAM

### A. Rationale

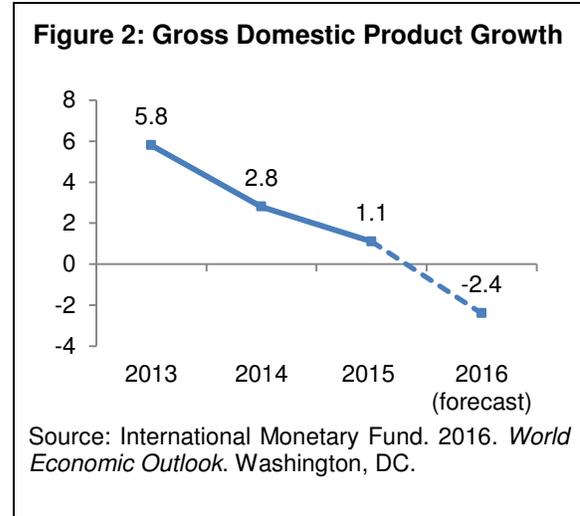
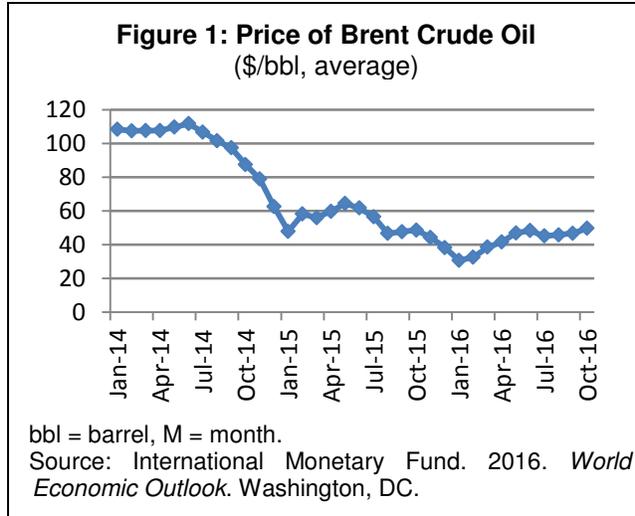
3. **Sharp economic downturn caused by drop in oil prices.** Azerbaijan has been experiencing distresses, which has led to lower growth rate, fiscal uncertainty, and finance sector instability. Oil prices have fallen sharply, by almost 55% from June 2014 to October 2016 (Figure 1). Given that oil and gas revenues account for about 30% of gross domestic product (GDP), 60% of budget revenues, and over 90% of export revenues, the crash in oil prices had a significant negative effect on the economic growth. All components of GDP experienced a sudden drop including government expenditures, investments, consumption and net exports. GDP growth fell from 2.8% in 2014 to 1.1% in 2015. Azerbaijan entered into recession, with negative GDP growth of 3.9% in the first three quarters of 2016 and a negative 2.4% forecast for 2016 as projected by the International Monetary Fund (IMF; Figure 2). Asian Development Outlook 2016 also projects negative 2.5% growth in 2016.<sup>2</sup>

4. The recession stems from lower hydrocarbon revenues, contraction in public investments (especially construction affecting private sector activity), and a tightened domestic demand. The current account evaporated from a surplus of 14% of GDP at end-2014 to a deficit of 4.5% in the first half of 2016, and is expected to be negative 0.6% in 2016. Lower commodity prices resulted in a 47% decrease in export revenues in 2015, while the inflow of remittances (mainly from the Russian Federation) suddenly dropped by 31% to \$1.2 billion hitting, in particular, the rural population. Exports further declined by 4.1% in the first half of 2016. The currency devaluation of major trading partners put substantial pressure on the national currency manat with a sharp decline in foreign exchange supply. Assets of the State Oil Fund of Azerbaijan (SOFAZ) declined by \$3.5 billion to \$33.6 billion (9.5%) in 2015, limiting the fiscal space for budget transfers and leading to a reduction in economic activities financed by SOFAZ.

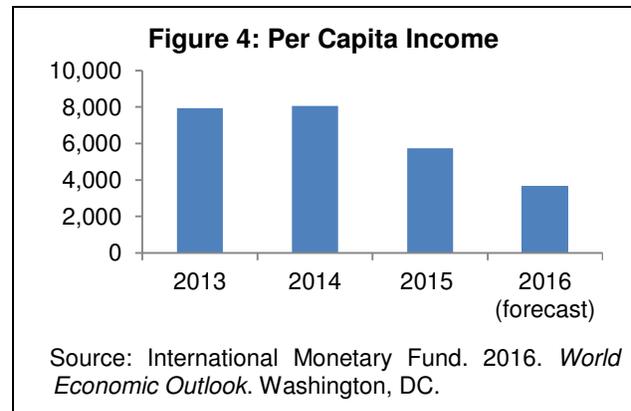
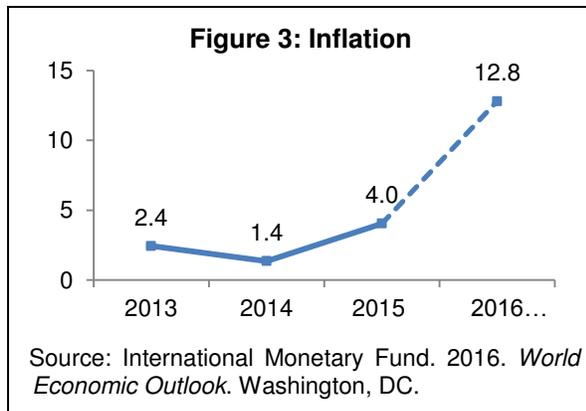
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<sup>1</sup> The design and monitoring framework is in Appendix 1.

<sup>2</sup> Government of Azerbaijan, State Statistical Committee. Monthly macroeconomic indicators, July 2016. <http://www.stat.gov.az/macroeconomy/indexen.php>; and International Monetary Fund (IMF) forecast (IMF Assessment Letter accessible from the list of linked documents in Appendix 2).



5. **Recession adversely affecting real incomes.** Given the economy's hydrocarbon export structure and public investment framework, the oil price shock had a strong impact on the real economy. Real consumption growth decreased from 12% in 2014 to 8% in 2015 as the purchasing power of the population fell following depreciation of the manat. The Central Bank of Azerbaijan (CBA) devalued the manat by 49.4% in 2015 from 0.78 manat to a dollar in February 2015 to 1.55 in December 2015, moving to a managed floating exchange rate regime. The manat depreciated another 10.9% in 2016 to its current rate of 1.74. Consumer price inflation is expected to rise to almost 12% in 2016 from 1.4% in 2014 (Figure 3). The high inflation is primarily the result of the massive currency devaluation increasing the price of the consumption basket. The devaluations also contributed to a significant drop in per capita income (current prices) from \$8,055 in 2014 to \$3,702 forecasted for 2016 (Figure 4). This fall in per capita income will have significant adverse impact on imports of key consumer goods. The sharply rising debt service burden of individual borrowers, especially for enterprises and housing loans denominated in foreign currency also negatively affected the purchasing power.<sup>3</sup>



6. **Elevated finance sector risks.** The CBA's foreign exchange reserves plummeted by 71% from \$13.7 billion in December 2014 to \$4.1 billion in October 2016. The currency devaluation caused a loss of public confidence in the manat. This led to large-scale dollarization

<sup>3</sup> The proportion of foreign currency denominated credit in total credit was 27% in January 2015 which increased to 48% by August 2016.

of deposits—from 38.5% in 2014 to 85% in 2016—resulting in significant drop in bank deposits in local currency. Moreover, the devaluation severely affected the asset quality of bank loans to customers prompting sharply increasing loan loss provision requirements, and as a consequence severely affecting profitability and eroding banks' capitalization. A number of banks were unable to mobilize additional equity injections by their shareholders and lost their licenses. Twelve of the country's 36 banks were closed in the first three quarters of 2016. The credit growth in local currency turned negative due to non-availability of loanable funds contributing to credit crunch.<sup>4</sup> For example, the number of rural borrowers serviced by the leading lenders has almost halved in 2016 since the first devaluation in February 2015. The cost of sovereign and nonsovereign borrowing from international capital markets increased significantly following the country's credit rating downgrade by major rating agencies raising the risk premium for borrowing.<sup>5</sup>

7. **Rising fiscal deficit and declining fiscal space.** The impact of the oil shock can be illustrated as follows. Oil-related state budget revenues averaged \$4.1 billion per quarter in the first three quarters of 2014. With the collapsing hydrocarbon price, oil revenue dropped to \$2.4 billion per quarter in 2015 and \$0.9 billion per quarter in the first three quarters of 2016.<sup>6</sup> Compared with the pre-shock period, the budget is receiving \$3.2 billion or 79% less per quarter in 2016, which is large given the size of Azerbaijan's budget. Consequently, the consolidated budget position changed from a surplus of 3.2% of GDP in 2014 to a deficit of 6.8% of GDP in 2015, and the deficit is expected to rise to 9.9% of GDP in 2016. Falling oil revenues led to cuts in capital expenditures, slowing the economic growth.<sup>7</sup>

8. **Countercyclical development expenditures.** In February 2016, the government initiated a countercyclical stimulus package. To ensure the effectiveness and quality of such expenditures, the government adopted a three-pronged strategy covering social assistance programs, economic diversification toward strengthening the non-oil sector, and employment generation and additional SOFAZ expenditures. The government has budgeted \$1.4 billion for countercyclical measures in 2016 (Table 1).<sup>8</sup> The accommodative budget in 2016 is appropriate for this purpose; however the government is planning to revert to fiscal consolidation measures building on preliminary steps taken in 2016.<sup>9</sup>

**Table 1: Fiscal Stimulus Summary (\$ million)**

<b>Groups</b>	<b>2016</b>
A. Social Assistance Programs (increase in wages, retirement benefits, social benefits including health benefits, social housing; tax benefits)	588
B. Economic Diversification	146
C. Employment Generation	668
<b>Total</b>	<b>1,402</b>

Source: Government of Azerbaijan budget documents.

(i) **Immediate increase in social assistance.** To enhance social protection of the vulnerable population, the government took the following one-off measures in

<sup>4</sup> The proportion of manat credit in total credit fell from 73% in January 2015 to 52% in August 2016.

<sup>5</sup> On 24 March 2016, Azerbaijan's Southern Gas Corridor Company sold \$1 billion in a 10-year Eurobond, which was 80 basis points above Azerbaijan's sovereign bonds, with a coupon of 6.875%.

<sup>6</sup> Government of Azerbaijan, Ministry of Finance. Information (operative) on the execution of the state budget for 2015. <http://www.maliyye.gov.az/node/1871>

<sup>7</sup> The consolidated budget includes the state budget, SOFAZ budget, social protection fund budget, external borrowings, and the budget for the autonomous region of Nakhchivan.

<sup>8</sup> This figure does not include 1 year's salary of 31,500 minimum wage workers.

<sup>9</sup> Going forward, the government has agreed not to repeat the 2016 pensions, wages, and social spending increases, to resume capital spending reductions and to lower pension deficits with the new pension legislation.

March 2016 targeting an estimated 3.7 million people representing more than one third of the population: (a) the wages of public employees were increased by 10% in the social security, education, science, culture, and agriculture sectors; (b) the floor for retirement benefits was raised by 10% to AZN110 monthly; (c) the amount of social benefits, health benefits, and food allowance for both public and private workers and refugees increased by 10%; and (d) an additional AZN20 million was allocated from the Reserve Fund of the President to support low-income families. The government has also made additional budgetary provision for social housing and tax benefits targeting low-income population. The State Housing Agency has been established, with an approved organizational structure, regulations, and staff, to provide social housing to low-income and vulnerable groups. The government has allotted to build affordable apartments benefiting around 9,000 people.<sup>10</sup> It has also established a student credit fund to cover tuition fees for students from low-income families during the economic downturn. The fund provides grants and concessional loans via credit organizations.

- (ii) **Stronger focus on economic diversification.** The crisis, which was triggered by the plummeting hydrocarbon prices, reminded the government of the need to transform the hydrocarbon-driven economy into a private sector-driven economy with well-diversified activities in non-oil sectors. The government has provided additional incentives to private investors, such as tax preferences and promotion of non-oil exports. Amendments to the Tax Code and the decree of the President of Azerbaijan “On additional measures to promote export of non-oil products” provide investors who invest in priority sectors with a certificate of incentives, as well as exemption from land and property taxes, and customs duties on imported equipment, for 7 years. Moreover, 50% of investor earnings are tax-exempt for 7 years, and exporters will receive a special export promotion compensation of 3% of the value of exported non-oil products.
- (iii) **Stimulating employment generation and efficiency in labor-intensive sectors.** The recession has increased unemployment, which rose to 5% in 2015. Azerbaijan’s growth has been less inclusive because of the capital intensive nature of the economy, the dominance of the oil sector and limited private sector activity. Consequently, the government is introducing reforms in labor market institutions and policies by modernizing vocational education, initiating life-long learning and prioritizing employment of youth, women, and disabled and internally displaced persons. Such countercyclical measures are addressing the following labor market challenges: (a) low-value agriculture due to small-sized crops production and limited access to finance; (b) lack of business skills and innovation from small and medium-sized enterprises (SMEs); (c) preference for public sector employment as compared to the private sector; and (d) the supply demand labor skills mismatch, which does not meet market needs. Additional steps taken include measures for supporting entrepreneurial activities and stimulating SMEs for creating jobs. Additional investment by SOFAZ for restructuring state-owned enterprises and revenue generating infrastructure projects is also expected to revive growth and generate employment.<sup>11</sup>

<sup>10</sup> The State Housing Agency is administering the project, with an administrative budget of AZN10 million and 60 staff.

<sup>11</sup> SOFAZ. SOFAZ 2016 budget amended. [http://www.oilfund.az/en\\_US/hesabatlar-ve-statistika/buedce-melumatlari/azerbaycan-respublikasi-doevlet-neft-fondunun-2016-ci-il-buedcesi-tesdiq-edildi.asp](http://www.oilfund.az/en_US/hesabatlar-ve-statistika/buedce-melumatlari/azerbaycan-respublikasi-doevlet-neft-fondunun-2016-ci-il-buedcesi-tesdiq-edildi.asp)

9. **Sound pre-shock record of macroeconomic management.** Until the oil shock, macroeconomic management was largely effective in achieving economic growth and stability. The CBA's monetary policy and exchange rate measures were effective in addressing price stability, with inflation averaging 1.6% during 2012–2014, and in managing the exchange rate. Public finances and budgetary frameworks were sound, with debt–GDP at 11.2% in 2014. The state budget was in surplus until 2014. SOFAZ capital increased from \$22.8 billion in 2010 to \$37.1 billion in 2014, providing a large buffer to shocks and transforming hydrocarbon revenues into long-term investment returns for the country. Consequently, Azerbaijan had international credit rating of investment grade before the shock.

10. **Adequate macroeconomic policy response during crisis.** The recession triggered monetary and financial stability measures during 2015 and 2016, which aimed at maintaining price stability and restructuring the banking system, while preventing a post-devaluation economic slump. In December 2015, the CBA moved to a managed floating exchange rate regime and instituted the exchange rate band to allow more market-based price discovery and aiming for inflation targeting in the medium term. The CBA tightened the monetary policy stance to limit inflationary pressure and to restore trust in the local currency. The CBA raised the refinancing rate five times in 2016 from 3% to 15% cumulatively, and initiated deposit auctions by holding 10 auctions in 2016, increasing the interest rate on deposits from 6.5% to 9.5%. The extension of the deposit insurance guarantee to cover all deposits, subject to interest rate restrictions, was another policy response to address the large-scale dollarization in the banking system.<sup>12</sup> To prevent further deposit withdrawals from banks, the interest income on deposits earned by individuals was made tax-exempt for 3 years starting February 2016.

11. **Managing banking sector crisis and restoring confidence.** The regulatory and supervisory functions of the banking, insurance, and capital markets are consolidated under the Financial Markets Supervision Authority (FMSA), the new single regulator and supervisor. To accommodate banks' management of the increased exchange rate volatility, the FMSA widened the regulatory limit for open currency positions to regulatory capital. In mid-2015, the government created a bad bank special purpose vehicle to manage nonperforming assets transferred from International Bank of Azerbaijan, a state-owned bank and the largest bank in the country. To restore confidence in the banking system, the FMSA is currently pursuing consolidation of banks and has so far closed 12 insolvent banks. The FMSA is assessing all banks and agreed on specific restructuring plans with banks that have solvency issues with a clear road map and timeline to address such issues. In July 2016, a Financial Stability Board, chaired by the Prime Minister, was established with representation of CBA, MOF, FMSA, and SOFAZ to monitor the financial sector performance and recommend remedial actions based on international experience. Under the attached TA, the Asian Development Bank (ADB) will support the FMSA in developing capital markets to support diversification of the economy and expansion of the private sector.

12. **The shocks highlighted the urgent need for structural reforms.** The recession has exposed the limitations of the country's economic development model and the need to move away from growth driven mostly by public capital investments towards the one focused on private sector activity as professed in the development strategy "Azerbaijan 2020: Look into the Future."<sup>13</sup> In February 2016, the President of Azerbaijan appointed a presidential focal point on

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<sup>12</sup> Limited to deposits denominated (i) in manat priced at interest rates up to 12%, and (ii) in foreign currency priced at up to 3%.

<sup>13</sup> Office of the President of Azerbaijan. 2012. *Azerbaijan 2020: Look Into the Future Concept of Development*. [http://www.president.az/files/future\\_en.pdf](http://www.president.az/files/future_en.pdf)

economic reforms, and established an interagency working group to develop and coordinate the execution of a strategy for economic diversification comprising governance reforms, development of non-oil export sector and improvement of the business climate.

13. **Governance reforms.** Strengthening macroeconomic and fiscal management and managing state-owned enterprises (SOE) is a government priority. Overall, public financial management systems are effective but the recession pointed to important gaps that the government is planning to address.<sup>14</sup> These include (i) rule-based fiscal management that would require building capability for medium-term expenditure and macroeconomic forecasting, (ii) aligning sector strategies with long-term national development strategy, (iii) integration of financial management systems and better analysis of planned and actual budget data through introduction of program budgeting, (iv) strengthening public investments by improving feasibility and project management capacities, and (v) developing a medium-term public debt management strategy. Many of the country's 10,540 SOEs are incurring losses and receiving budget subsidies.<sup>15</sup> As part of the planned SOE reforms, the president of Azerbaijan issued a decree in September 2016 to facilitate entrepreneurship and competition in SOEs by encouraging participation of private investors. The decree sets a time bound plan to (i) formulate rules for evaluating the performance of SOEs, (ii) develop corporate governance principles and apply international management practices, and (iii) introduce international financial reporting systems and necessary structural reforms to increase financial transparency and efficiency of large SOEs. The government has started listing SOEs for privatization beginning in 2016. The attached TA will support these reforms.

14. **Development of non-oil sector.** In the wake of oil shock, transformation to an export-oriented economy characterized by non-oil sector growth and expanding non-oil export potential is a major priority of the government. A presidential decree issued in March 2016 implemented measures to stimulate the export of non-oil products. These include opening new e-government service centers; improving public construction tenders; simplifying customs clearance; increasing electronic payments; creating regional industrial zones; extending agriculture, tourism, and environmental reforms; and promoting regional economic integration. The government intends to enact a new pension legislation in 2017 that would increase the retirement age and contribution periods; this is expected to cut pension fund deficits. To stimulate the development of SMEs, the entrepreneurship law was amended in March 2016. Attached TA will assist the government in developing an SME institutional and financing strategy for inclusive finance. The government is also pursuing efforts to diversify the economy by improving the business climate and by expanding the financial sector. Azerbaijan's financial system is underdeveloped with vulnerabilities to external systemic risks. The binding constraints being addressed include underdeveloped financial markets, nascent government securities market, and limited financial inclusion due to the lack of local currency lending, especially for microenterprises, farmers, and small businesses.

15. **ADB's proposed program.** In the short-term, ADB will provide CSF program to mitigate the adverse impact of the economic recession. ADB and the government also agreed that transforming Azerbaijan into a dynamic and diversified economy will require comprehensive improvements in governance, ease of doing business, and fostering competition in the economy. As highlighted in the development policy letter, the government has, therefore, sought ADB's assistance to support structural reforms in the medium-term related to the three broad directions.

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<sup>14</sup> World Bank. 2014. *Azerbaijan: Public Expenditure and Financial Accountability Performance Report (Repeat Assessment)*. Washington, DC.

<sup>15</sup> Government of Azerbaijan, Ministry of Finance (MOF). 2015. *Budget Package-2015*. Baku.

These directions will be incorporated in a planned policy-based loan, which will cover (i) strengthening macroeconomic and fiscal management by establishing medium-term fiscal and debt management frameworks; (ii) improving public sector efficiency and accountability by developing a public investment framework, as well as restructuring and preparing the privatization of SOEs; and (iii) deepening the finance sector and expanding the role of the private sector by developing securities and capital markets and promoting SME development.

16. **Public debt remains sustainable.** A realistic oil price scenario in line with the *Asian Development Outlook 2016* and the International Monetary Fund (IMF) *April 2016 World Economic Outlook* would see Azerbaijan's public debt–GDP ratio rise from 28.3% in 2015 to 38.2% (37.5% is the IMF estimate) in 2016 and stabilize thereafter.<sup>16</sup> Thus, the public debt ratio will remain manageable.<sup>17</sup> This scenario reflects improved primary deficits, higher economic growth, as well as a projected rise in asset revenues. Traditionally, Azerbaijan has not borrowed to fund budget deficits. Instead, deficits have been financed mainly by transfers from SOFAZ, which contributed about 40% to total government revenues over 2010–2014. The projected public indebtedness, including the potential impact of the prospective CSF borrowing, is sustainable as the ADB loan comprises a small portion of the country's overall financing needs. The medium-term outlook is acceptable in terms of creditworthiness.<sup>18</sup>

17. **Coordination with the International Monetary Fund.** The ADB team has consulted and coordinated closely with the IMF on Azerbaijan's macroeconomic situation and future prospects. It overlapped with the IMF Article IV mission that concluded in June 2016. The IMF mission confirmed that shocks adversely affected Azerbaijan's economy, especially the fall in oil prices, slowdown in economic growth, and currency depreciations in Azerbaijan and its main trading partner economies. As a result, the IMF projects economic growth to turn negative (–2.4%) in 2016. The IMF supports the government's response to the weak external environment, including moving to a floating exchange rate regime, raising interest rates in 2016 to address rising inflation, and implementing a countercyclical fiscal stimulus in 2016 that focuses on raising wages, pensions, targeted social assistance, employment generation, and completing existing investment projects. The government has agreed with IMF on the appropriateness of countercyclical spending but to embark on consolidation from 2017.

18. The IMF also strongly endorses the government's planned move to a new economic model focused on private sector-led growth driven by the non-oil economy as the main challenge is to align macro policies with the new external environment while modernizing monetary and fiscal frameworks. The structural reform agenda needs to be implemented, with governance strengthened, the cost of doing business reduced and competition enhanced. The government has agreed with the IMF on instituting a rule-based fiscal framework and strong institutional arrangements to preserve fiscal sustainability in the medium term. The IMF underscored that a rule-based framework supplemented by a strong public financial management system, detailed multiyear budgets and a public debt strategy will strengthen fiscal discipline. In addition, expanding debt securities market will help in deepening the country's financial sector.

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<sup>16</sup> The realistic scenario is based on an oil price of \$38 in 2016 and increasing to \$50 per barrel in 2020. ADB. 2016. *Asian Development Outlook 2016: Asia's Potential Growth*. Manila; IMF. 2016. *World Economic Outlook*. Washington, DC.

<sup>17</sup> The size and composition of SOFAZ assets have a strong bearing on the country's debt sustainability. IMF analysis also suggests that the debt–GDP ratio will remain manageable (IMF Assessment Letter accessible from the list of linked documents in Appendix 2).

<sup>18</sup> More details are in Debt Sustainability Assessment (accessible from the list of linked documents in Appendix 2).

19. **ADB's value addition.** ADB has agreed on a medium-term development engagement framework with the government. In the short term, ADB is supporting the government's implementation of countercyclical expenditure program by helping to reduce the risks of fiscal and debt sustainability. In the medium to long term, ADB is engaging with the government on design and implementation of structural reforms by providing TA and planned policy based program (paras 15 and 26). ADB's support for infrastructure investment especially in energy, transport, and urban infrastructure will complement the CSF. ADB has coordinated closely with the IMF and the World Bank in identifying policy and program areas. The World Bank is supporting the government on finance sector modernization including the business environment, competition policies, pension reforms, and banking sector restructuring. The IMF is providing TA on banking and finance sector oversight and planning a TA to help address fiscal issues. ADB will coordinate with IMF on implementation of the TA.

## **B. Impact and Outcome**

20. The impact will be sustained broad-based inclusive growth. The outcome will be expenditures for fiscal stimulus introduced.

## **C. Outputs**

21. The CSF will have four outputs: (i) measures to provide a social safety net to citizens implemented, (ii) measures to facilitate social housing implemented, (iii) measures to create additional jobs implemented, and (iv) measures to identify and initiate specific structural reforms for economic diversification implemented.

## **D. Development Financing Needs**

22. SOFAZ transfers to the state budget form the basis of the government's fiscal policy, and have provided a large buffer to enable an expansionary fiscal policy. The activities carried out by SOFAZ contribute to (i) maintaining macroeconomic stability, (ii) financing national projects crucial to socioeconomic development, and (iii) ensuring intergenerational transfer of oil revenues. Procedures governing SOFAZ financing and spending are determined by a statutory policy that postulates reserving 25% of revenues for savings and intergenerational purposes. Expenditures incurred by SOFAZ are part of a consolidated budget that is approved by Parliament annually. SOFAZ has an independent investment strategy, and 82.1% (as of 2015) of its assets are invested in securities. Since 2013, the government has been downwardly adjusting transfers from SOFAZ to maintain critical assets to satisfy its long-term investment objective and stimulate an increase in non-oil fiscal revenues.

23. However, to meet budget expenditures in 2016, the government transferred an additional \$1 billion from SOFAZ to the state budget. Despite this transfer, the estimated consolidated budget deficit of 9.9% of GDP (\$3.4 billion) will remain in 2016. The government believes that additional transfers from SOFAZ are not in line with the government policy of ensuring intergenerational equity and sustainability of oil revenues. Further transfers would also not be prudent since oil production is expected to further decline in 2016–2019, with oil prices below historical averages, and any increase in SOFAZ transfers would increase the scale of the fiscal deficit. Some 90% of Azerbaijan's currency reserves comprise SOFAZ assets. It is critical to preserve these assets to maintain the country's international credit rating.<sup>19</sup>

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<sup>19</sup> Azerbaijan was rated BB+ (Negative) by Fitch, BB+ (Negative) by Standard and Poor's, and Ba1 (negative) by Moody's in 2016, a notch below the investment grade.

24. To fill the budget deficit, the government will need to tap capital markets or access international financial institutions. The cost of borrowing from the market has increased because of the higher perceived country risk, as shown by market indicators like credit default swap spreads and the international credit rating downgrade resulting from the economic recession and fall in oil prices. To mitigate this risk, the government has requested ADB to provide a loan of \$500 million from ADB's ordinary capital resources. The remaining portion of the consolidated deficit will be financed through the issuance of international bonds and from internal sources. The interest rate for the CSF loan will be determined in accordance with ADB's London interbank offered rate (LIBOR)-based lending facility plus 200 basis points; a 5-year term, including a grace period of 3 years; a commitment charge of 75 basis points on undisbursed loan balances; and such other terms and conditions as are in accordance with those set forth in the draft loan agreement.

### **E. Implementation Arrangements**

25. The Ministry of Finance (MOF) will be the executing agency for the CSF. The government, through MOF, will monitor budget execution and flow of funds for countercyclical measures. The government, through MOF, will submit to ADB reports on expenditures made from the state budget to support the countercyclical measures. The program implementation period is January 2016 to February 2017.

## **III. TECHNICAL ASSISTANCE**

26. To support the preparation of a planned policy-based loan in 2017 that builds on structural reforms initiated in 2016, policy and advisory TA for Improving Public Sector Efficiency is proposed, with total cost of \$1.3 million, of which \$1.2 million will be financed by ADB's Technical Assistance Special Fund (TASF-other sources). The government will provide counterpart support in the form of staff, office, administrative and logistics support, interpretation, and other in-kind contributions. The TA outputs and activities are (i) public debt management, including a review of the legal framework, and designing a medium-term debt management strategy and system; (ii) macro-fiscal management, including the development of medium-term fiscal and expenditure frameworks, program-based budgeting, training and capacity building, and mitigating fiscal risks and contingent liabilities related to SOEs; (iii) SME development, including a review of the legal and regulatory framework, designing an SME development strategy, and capacity building; and (iv) SOE management and capital market development, including a review of the legal and institutional framework, diagnosis of the securities market, and improving the financial management and governance of select SOEs.<sup>20</sup>

27. The TA will also assess and report on the effectiveness of the countercyclical measures. It will be implemented from January 2017 to January 2019. MOF will be the executing agency, and Ministry of Economy and the FMSA will be the implementing agencies. All consultants will be recruited in line with ADB's Guidelines on the Use of Consultants (2013, as amended from time to time). All disbursements under the TA will be made in line with ADB's *Technical Assistance Disbursement Handbook* (2010, as amended from time to time).

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<sup>20</sup> Rail transport is one of the subsectors being considered for in-depth SOE work.

## IV. DUE DILIGENCE

### A. Governance

28. Budget comprehensiveness and transparency, as well as predictability and control in budget execution, have improved significantly since 2014. Weaknesses remain in external and internal audit, especially in the line ministries, which have been taken up in the Public Financial Management Action Plan adopted by MOF. Azerbaijan currently uses an adhoc fiscal policy framework with drawdown from SOFAZ not following any formal fiscal rules.<sup>21</sup> A rule-based fiscal framework is needed to promote fiscal discipline. Improvement of fiscal management is a key reform being addressed under the attached TA. Corporate governance in SOEs is not adequately developed. The Ministry of Economy has made several awareness-building efforts to promote corporate governance principles in SOEs by organizing seminars and training. However, the use of the Organisation for Economic Co-operation and Development Principles of Corporate Governance is limited, which makes it difficult to assess the performance of SOEs by international standards. The policy and advisory TA will help address corporate governance issues. The government has placed combating corruption high on its agenda, announcing a “no tolerance” policy toward corruption in 2011. Efforts on combating corruption since 2005 indicate important improvements that are acknowledged by regional anticorruption bodies. ADB’s Anticorruption Policy (1998, as amended to date) was explained to and discussed with the government.

### B. Poverty and Social

29. The poverty ratio has declined sharply, from 49% in 2001 to 11% in 2009 and 5% in 2014. This has mainly been driven by strong economic growth, a rise in wages, and successful social protection measures. Sustaining high growth and maintaining social protection initiatives have come under severe stress after the oil price shocks and the ensuing economic recession. The CSF program plays a critical role in this context. Government initiatives supported under the loan will help mitigate price and income shocks, especially to the vulnerable population. The proposed facility is expected to be followed by a policy-based loan to help the government transform the economy into a diversified and dynamic economy that supports inclusive growth. Reforms proposed under the policy-based loan will improve the allocative efficiency of public resources, particularly in health, education, and other social services. There is also a gender pay gap attributed to high levels of vertical segregation in the labor market. Women are concentrated in lower-paid public sector activities such as education, health, and social services. Government measures to increase salary in these sectors under the countercyclical fiscal package will contribute in protecting the purchasing power of women.

### C. Safeguards

30. Following an assessment of the outputs, the CSF program will not have any likely social or environmental safeguard issues, and will not trigger ADB’s safeguard policies. It is assigned *category C* for environment, involuntary resettlement, and indigenous peoples.

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<sup>21</sup> Azerbaijan is an early member of the Extractive Industries Transparency Initiative (EITI) and was given *compliant* status in 2009. The EITI redefined its standards in 2013 and now includes more comprehensive requirements for civil society engagement. Against these new standards, Azerbaijan was downgraded to *candidate* status in 2015. During its October 2016 meetings, EITI’s board concluded that Azerbaijan has made meaningful progress with considerable improvements, maintaining the country’s *candidate* status. The government is expected to continue implementing corrective actions to regain compliant status in 2017.

## D. Risks and Mitigating Measures

31. Major risks and mitigating measures are summarized in Table 2 and described in detail in the risk assessment and risk management plan.<sup>22</sup>

**Table 2: Summary of Risks and Mitigating Measures**

<b>Risks</b>	<b>Mitigating Measures</b>
Strategic budgeting based on the multiyear rolling MTEF and MTFF has not been implemented, causing suboptimal allocation of public resources.	TA support to help improve the capacity to integrate MTFF and MTEF in budget making
Insufficient internal controls in line ministries on expenditure management and lack of effective internal audit units lead to diversion of funds.	TA to help improve the capacity of the line ministries; quarterly Ministry of Finance reports on countercyclical expenditures

MTEF = medium-term expenditure framework, MTFF = medium-term fiscal framework, TA = technical assistance.  
Source: Asian Development Bank.

## V. ASSURANCES

32. The government has assured ADB that implementation of the CSF shall conform to all applicable ADB policies including those concerning anticorruption measures, safeguards, gender, procurement, consulting services, and disbursement as described in detail in the loan documents.

## VI. RECOMMENDATION

33. I am satisfied that the proposed loan would comply with the Articles of Agreement of the Asian Development Bank (ADB) and recommend that the Board approve the loan of \$500,000,000 to the Republic of Azerbaijan for the Countercyclical Support Facility Program, from ADB's ordinary capital resources, with interest to be determined in accordance with ADB's London interbank offered rate (LIBOR)-based lending facility plus 200 basis points; a term of 5 years, including a grace period of 3 years; and such other terms and conditions as are substantially in accordance with those set forth in the draft loan agreement presented to the Board.

Takehiko Nakao  
President

15 November 2016

<sup>22</sup> Risk Assessment and Risk Management Plan (accessible from the list of linked documents in Appendix 2).

## DESIGN AND MONITORING FRAMEWORK

<b>Impact the Facility is Aligned With</b>			
Broad-based inclusive growth sustained ( <i>Azerbaijan 2020: Look into the Future</i> ) <sup>a</sup>			
<b>Results Chain</b>	<b>Performance Indicators with Targets and Baselines</b>	<b>Data Sources and Reporting Mechanisms</b>	<b>Risks</b>
<b>Outcome</b> Expenditures for fiscal stimulus introduced	By February 2017, the government spends \$1.4 billion on fiscal stimulus (2015 baseline: None)	MOF annual budget reports	Continued commitment of the government to reform measures is not sustained.
<b>Outputs</b> 1. Measures to provide social safety net to citizens implemented	1a. By February 2017, the government covered 3.7 million people under the new social safety net program (2015 baseline: None)  1b. By February 2017, the government spent an additional \$588 million for government workers' benefits and social assistance (2015 baseline: Total salary and pensions of government workers \$6.1 billion)	1a.–b. MOF annual budget reports	Line ministries and sector agencies have limited planning; and financial and project management skills, causing delays in the timely execution of the projects and reforms.  Strategic budgeting based on the multiyear rolling MTEF and MTFF has not been implemented, causing suboptimal allocation of public resources.
2. Measures to facilitate social housing implemented	2a. By February 2017, the government established a State Housing Agency to facilitate the provision of social housing (2015 baseline: None)  2b. By February 2017, the government fully staffed and operationalized the agency with a regulatory framework to facilitate provision of affordable housing (2015 baseline: none)	2a.–b. MOF annual budget reports; website of the Social Housing Agency	Insufficient internal controls in line ministries on expenditure management and lack of effective internal audit units lead to diversion of funds.
3. Measures to create additional jobs implemented	3a. By February 2017, the government created an additional 21,000 jobs in the public sector (2015 baseline: 1.2 million government employees)  3b. By February 2017, the	3a.–b. Ministry of Economy reports; Office of the President, Azerbaijan	

Results Chain	Performance Indicators with Targets and Baselines	Data Sources and Reporting Mechanisms	Risks
	government facilitated the creation of new 63,000 jobs in the private sector (2015 baseline: 87,500 private sector employment)		
4. Measures to identify and initiate specific structural reforms for economic diversification implemented	<p>4a. By February 2017, a comprehensive technical assistance program is in place to identify critical structural reforms (2015 baseline: None)</p> <p>4b. By February 2017, budget expenditures to support entrepreneurial activities doubled (2015 Baseline; \$ 43 million)</p> <p>4c. By February 2017, sector- and region-specific new tax and customs incentives (covering exemptions, lower rates, tax holidays for certain years, and procedural simplifications) are implemented to promote private investment (2015 baseline: None)</p>	4a.–c. MOF annual budget reports	

**Key Activities with Milestones**

Not applicable.

**Inputs**

ADB: \$500,000,000 (OCR loan)

TA: \$1,200,000 (TASF-other sources)

**Assumptions for Partner Financing**

Not applicable.

ADB = Asian Development Bank, MOF = Ministry of Finance, OCR = ordinary capital resources, TA = technical assistance, TASF = Technical Assistance Special Fund.

<sup>a</sup> Government of Azerbaijan. 2012. *Azerbaijan 2020: Look into the Future*. Baku.

Source: Asian Development Bank.

### **LIST OF LINKED DOCUMENTS**

<http://www.adb.org/Documents/RRPs/?id=50145-001-3>

1. Loan Agreement
2. Sector Assessment (Summary): Public Sector Management and Finance
3. Contribution to the ADB Results Framework
4. Development Coordination
5. Attached Technical Assistance
6. Country Economic Indicators
7. International Monetary Fund Assessment Letter
8. Summary Poverty Reduction and Social Strategy
9. Risk Assessment and Risk Management Plan
10. List of Ineligible Items

### **Supplementary Documents**

11. Debt Sustainability Assessment
12. Indicative Terms of Reference for Consultants



**MINISTRY of FINANCE  
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*November 8 2016*

*No DA-02106-1162-6811*

**To: Mr. Takehiko Nakao  
President  
The Asian Development Bank**

**DEVELOPMENT POLICY LETTER**

**Dear President Nakao,**

Let me begin by thanking the Asian Development Bank for its strong and continued support to the Republic of Azerbaijan's development efforts in the recent past. Let me reiterate that the Government of Azerbaijan is making concerted efforts to revive economic growth that is broad-based and inclusive.

The economy of Azerbaijan experienced rapid growth since the early 2000s averaging over 12% between 2000 and 2013. As a result, the per capita income reached almost \$8000 taking Azerbaijan to upper middle income country status. Inflation, based on consumer price index, was low at 2.4% in 2013 and 1.4% in 2014. The current account was in surplus and the overall budgetary position was comfortable with a very low public debt to GDP ratio.

However, the sharp drop in oil prices in 2014 and the spillover from the sluggish economies of the main trading partners had a profound impact on various macroeconomic indicators of the economy. Oil prices have fallen by almost 57% since their peak in 2014 despite a recent upward trend. As oil and gas revenues account for more than 30% of GDP, 60% of budget revenues, and more than 90% of country's exports, fall in the oil price had a significant negative effect on growth and current account. GDP growth fell from 2.8% in 2014 to 1.1% in

2015, with non-oil GDP growth falling from 6.9% in 2014 to 1.1% in 2015. In the first half of 2016, the GDP and non-oil GDP growth were negative, at 3.4% and 6.1%. This decline stems from a lower hydrocarbon output, contraction of public investments and a tightened domestic demand. GDP growth for 2016 is expected to be in negative zone due to a higher than expected adverse impact of the fall in global oil prices that started in mid-2014. The current account turned into a deficit of 0.4% of GDP in 2015 from a surplus of 14% of GDP in 2014 and is expected to decline further in 2016 because of lower export earnings and reduced inflow of remittances.

The negative trend in energy prices and significant drop in export earnings forced the Central Bank to devalue the manat twice during 2015 - by 34% in February and by 47.6% in December and move to a managed float regime. Central Bank's defense of the currency peg resulted in a loss of more than two-third of its foreign currency reserves, which dropped from \$13.7 billion in January 2015 to \$4.1 billion in July 2016. The devaluations had an adverse impact on inflation in 2015 because half of consumption is based on imported products. Consumer price inflation reached 10.5% in June 2016 (food prices surged by 11.9%, non-food by 15.4%, and services by 4.4%). It is mainly cost-push driven by the exchange rate pass-through following the significant currency devaluations that occurred in 2015. The adverse impact will persist, and inflation is expected to remain high in 2016.

The decline in oil revenue put tremendous pressure on the state budget in 2015. Budget deficit rose from 0.5% of GDP in 2014 to 1.0% in 2015. Transfers from the State Oil Fund of Azerbaijan (SOFAZ) to the budget fell from 50.7% of total revenue in 2014 to 46.5% in 2015. The budget deficit is expected to remain high at around 3% of GDP in 2016 largely due to additional counter-cyclical expenditures budgeted by the government.

Government of Azerbaijan immediately responded to these adverse developments that are unprecedented in the recent history. The government is providing counter-cyclical stimulus of \$1.4 billion to arrest decline in growth covering 3.7 million people under the social safety net programs. This is shielding the lower income groups from the adverse impact of high inflation. To implement this program, government revised the budget for 2016 substantially. Countercyclical budget expenditures increased by 13.7% from 16,264 million manats (\$10.5 billion, 28% of GDP) to 18,495 million manats (\$11.9 billion, 32% of GDP). To enhance social protection of the population the following measures were introduced: (i) wages of workers have been increased by 10% as of 1 March, 2016 in a number of state budget sectors (social security, education, science, culture, agriculture); ii) the basic amount of retirement benefits was raised by 10% as of 1 February 2016; iii) the amount of social benefits, benefits for workers who lost their health, food allowance for refugees have been increased by 10% as of 1 February, 2016; iv) additional 20 million manats will be allocated from the reserve fund of the President to support social security of low-income families.

In order to stimulate businesses, help create jobs and provide funding for loans to manufacturing and agriculture businesses, entrepreneurship support expenditures increased twice (from 66 million manats to 136 million manats). To support investment programs, expenditures increased by 42.1% (excluding projects financed through foreign borrowings). Another important measure planned under this social safety net program is to develop low cost houses starting toward the end of 2016. A dedicated agency – Azerbaijan State Housing Agency – has been established for this purpose with an initial administrative budget set aside. 11.6 hectares of land has been allotted to the State Housing Agency in the Yasamal district of Baku to build 2000 affordable apartments in 2016 in the first phase. This initiative will serve twin purposes of providing social safety net and stimulating infrastructure investment. We are trying our best to provide the fiscal stimulus while maintaining a prudent fiscal stance. However, the short term

fiscal stimulus is currently straining our fiscal resources in a time of downward trend of revenues from oil.

Our main challenge is to diversify the economy and to build a strong export-oriented non-oil sector. This has necessitated immediate initiation of substantial reforms to develop the private entrepreneurship in a sustained manner. Our economic assessments show that there are three main constraints that are preventing sustainable development of the non-oil economy. These are limited ease of doing business, market access, and access to credit at competitive rates. We are fully committed to introduce structural reforms in all these areas. The process has already begun with some simplifications in customs and tax procedures that impact private businesses.

The process of private business promotion will remain incomplete unless we have a vibrant and efficient financial sector to provide cost-effective and speedy financial intermediation. We are taking important measures in this direction. Full deposit insurance coverage for bank deposits has been introduced. This is expected to increase confidence in the financial sector, prevent deposit run and facilitate lending. Several steps have been taken to strengthen banking supervision. The licenses of 12 insolvent banks have been revoked. The Central Bank of Azerbaijan has also taken important steps to improve provisioning and accurately classifying the non-performing loans. In order to improve financial intermediation and provide local currency financing, we are also considering measures to streamline the country's capital markets. As part of institutional reforms, establishment of Financial Market Supervisory Authority was a major step. The new regulator was entrusted with regulation of the financial sector in the country, including oversight over the banks, securities and insurance market. As a result, some functions of the Central Bank and Ministry of Finance were transferred to the new regulator.

We are taking significant measures to strengthen ease of doing business through the one-stop window and the easy service centers—the ASAN Service. ASAN Service is part of the comprehensive reforms in modernizing the public administration and service delivery that brings together representatives of various government entities and private companies limiting direct interaction of the applicant with public servants. Services in the centers are rendered based on the "single window" approach. ASAN Service widely applies modern technologies and social innovations to increase efficiency and quality of the public service. With its 9 centers and mobile teams ASAN has served 10.9 million applicants by June 2016 since its establishment in 2012.

ASAN Service has increasingly taken more and more services that were once provided by various government agencies. The most recently introduced services include the electronic signature for the conduction of many tax-related operations, the opportunity to produce a number of Customs-related documents and to produce the documents related to the use and ownership of vehicles. That is to say, certain services of the Customs Committee have been delegated to ASAN Service, as a result of which those engaged in export or import of goods now face significantly less bureaucratic obstacles than before. For instance, it is now possible to fill in customs declaration forms in a branch of ASAN Service. Other reforms involving ASAN Service include the simplification of the license issuing procedures. A number of licenses covering the areas such as transport and the business set-up are now issued by ASAN Service without any bureaucratic obstacles observed hitherto. Generally, the number of licenses required for entrepreneurial activity has dropped significantly from 300 to 80. Alongside the reduction in the number of licenses required, those granted are now unlimited in terms of their validity, thus, eliminating the need of renewal. Moreover, the official fees for licenses have been reduced by two times and the processing period for them has been reduced from 15 to 10 days.

We are in the process of simplifying tax and customs procedures and providing tax incentives for new businesses. For example, the amount of taxable transactions on simplified tax increased from 120,000 manats to 200,000 manats in order to support small and medium-sized businesses. In customs, the brokerage system has been shut down and the import and export fees go to government treasury. Customs administration has been improved considerably. There has also been the introduction of electronic services in the customs, such as the production of electronic declarations and the payment of fees electronically, which are important in increasing transparency and reducing bureaucratic hurdles. To reduce corruption, we are working on a legislative initiative to establish and develop a national mechanism for asset recovery.

We recognize that there are other important areas that will need to be reformed. One such priority area is improving public financial management that will help in boosting growth, especially in the non-oil sector and reduce resource leakages. We are developing Medium-term Fiscal Framework and Medium-term Expenditure Frameworks for the line ministries. We are also planning to introduce a rule-based fiscal management framework in 2017-2018. These two initiatives will help us to improve fiscal responsibility and budget management. Moreover, public debt management and internal audit systems require improvements for better cash and liquidity management and for reducing any fiduciary risks. These reforms will go a long way to improve allocative efficiency of scarce public resources. A sound public financial management system is an important prerequisite to create fiscal space and enhance investments on social and economic infrastructure. This will lead to broad-based and inclusive growth in the country.

We are also in the process of instituting reforms to promote skills development and reorient our higher education system to better serve the needs of the private sector. We have developed academic standards for particular specialties. We have also set up retraining schools under Ministry of Labor and Social Protection to retrain professionals and upgrade their skills. Again these reforms are essential to support a dynamic and competitive private sector.

Student Credit Fund was established to provide funding opportunities for students from low-income families who face significant difficulties in the payment of tuition fees. The Fund is founded by 10 state universities and acts as an intermediary in the provision of concessional loans by credit organizations and grants by various agencies and individuals. Moreover, the Decree of the President of the Republic of Azerbaijan in April, 2016 on the establishment of State Agency for Vocational Training under the Ministry of Education is a further stride in increasing the efficiency of vocational training and ensuring the expansion of competitive skilled workforce. Based on the Statute, the Agency is responsible for deciding the directions of vocational training/skills development. This Agency organizes trainings for vocational education centers in order to ensure adaptation to dynamic labor market and contribute to their technical base. One of the major directions of the State Strategy on the Development of Education is to create an economically sustainable model of financing of education that is comparable to those in leading education systems worldwide.

Government is also finalizing a national road map listing Azerbaijan's structural reform priorities focusing on increased employment, non-oil sector diversification, improved competitiveness and healthy current account balance. The government also prioritized the development of strategic plan for the following sectors: i) agriculture, ii) small and medium sized enterprises development, iii) machinery and heavy industry, iv) tourism, v) logistics and trade, vi) social housing, vii) vocational education. The government will consider export competitiveness, import substitution, social welfare and inclusiveness while developing the road map.

We believe that we have taken concrete measures to respond effectively to mitigate the short-term impact of the external shock. In addition, important steps are being taken to transform the economy in a vibrant and diversified economy that supports broad-based and inclusive growth in the medium to long-term. We reiterate our request to ADB for a \$500 million loan under the Counter Cyclical Facility to enable the government to effectively implement the ongoing and planned countercyclical development programs.

The outcome of the proposed Program will be monitored by ensuring that additional expenditures have been incurred on countercyclical measures. The government is fully committed to launch a comprehensive structural reform program as early as possible. We have already requested ADB to provide technical and program support to continue implementing structural reforms to strengthen macroeconomic and fiscal management, improve public sector efficiency and accountability, deepen the financial sector and expand the private sector participation.

While we are strongly committed to the reforms described herein we appreciate ADB's support in helping shaping such reforms through the attached Technical Assistance and would value further ADB support of structural reforms through policy based loans over the medium to long-run to realize our growth objectives.

We would like to thank ADB for working closely with the Government of Azerbaijan in developing this program. We also appreciate ADB's continued support to the development of country's water supply and sanitation, road and energy infrastructure.

Sincerely,



**Samir Sharifov**  
**Minister of Finance and ADB Governor**

## ASSESSMENT OF COMPLIANCE WITH THE COUNTERCYCLICAL SUPPORT FACILITY ACCESS CRITERIA

Countercyclical Support Facility Criteria and Indicators	Asian Development Bank Assessment
1. Adverse impact of the crisis	<p>In 2014, Azerbaijan encountered economic slowdown due to slump in global oil prices. Oil prices fell sharply by 57% from their peak in 2014 to August 2016. Given the fact that oil and gas revenues account for more than 30% of GDP, 60% of budget revenues, and more than 90% of Azerbaijan's exports, the drop in the oil price has had a significant negative effect on the economy and growth. Overall, all components of GDP experienced a sudden drop including government expenditures, investments, consumption and net exports. The shock was felt through various channels: (i) fall in budget revenues and contraction in public investments (especially construction) and hence private sector activity, (ii) evaporated current account surplus, (iii) pressure on local currency in light of devaluations in neighboring and trading countries, and (iv) sudden drop in remittances (mainly from the Russian Federation) hitting, in particular, the rural population. Eventually, CBA devalued manat and switched to the floating exchange rate regime and national currency lost its cumulative value by 57% in 2015.</p>
i. Azerbaijan experienced a significant reduction in growth, exports and remittances; increase in dollarization; and a contraction in bank lending	<p>GDP growth fell from 2.8% in 2014 to 1.1% in 2015, with non-oil GDP growth falling from 6.9% in 2014 to 1.1 in 2015. In the first nine months of 2016, GDP growth was negative 3.9% and non-oil GDP growth was negative 6.1% This decline stems from a lower hydrocarbon output, contraction of public investments and a tightened domestic demand. It is expected that GDP may decline by 2.4% in 2016.</p> <p>Lower commodity prices together with reduced growth and devaluation of local currencies in trading partners in 2014-2015 resulted in a 47% decrease in export revenues in 2015, while remittances decreased by 31% to \$1.2 billion. Given the economy's hydrocarbon export structure and public investment framework, oil price shock had a strong impact on the real economy. Real consumption growth – another key economic growth driver, fell from 12% in 2014 to 8% in 2015, due to the devaluation of the manat and decline in consumer lending.</p> <p>The current account turned into a deficit of 0.4% of GDP by 2015 from a surplus of 14% of GDP in 2014. The current account is expected to remain in deficit in 2016. These developments put substantial pressure on the foreign exchange market with a sharp decline in foreign exchange supply and a rise in foreign exchange demand. The official international reserves of the CBA plummeted by about \$2.3 billion during December 2014 and January 2015 alone. In an attempt to respond to these external shocks, CBA devalued manat, the national currency, by 57% in 2015. At the same time the CBA announced a shift from pegged exchange-rate system to a managed float. The currency devaluations resulted in a loss of credibility of monetary policy and confidence in the manat. This led to a large-scale dollarization worsening bank balance sheets and aggravating liquidity risks in the banking sector, in particular.</p> <p>Devaluation of the local currency had an adverse impact on</p>

Countercyclical Support Facility Criteria and Indicators	Asian Development Bank Assessment
	<p>inflation in 2015 because half of consumption is imported. The negative impact will persist, and inflation is expected to remain high in 2016 at around 12%.</p> <p>The banking sector was hit hard by currency depreciation, as credit repayment ability of households and businesses deteriorated, leading to higher non-performing loans and lending problems. Additionally, the value of credits went down by \$6.2 billion, equivalent to 26% in 2015, and lack of credit availability negatively affected the capital formation in the country. Credit growth turned negative due to weak economic activity, mismatches in banks' currency positions and expectations of further devaluations. The drop in credit to the economy affected the rural economy significantly. Since the first devaluation in February 2015 when the two leading lenders serviced loans to 280,000 rural borrowers, the clientele dropped by nearly 50% to about 150,000.</p> <p>The banking system faced increasing non-performing loan ratios due to currency mismatches as bank credits were mainly in dollar terms, while wage and salaries of people in national currency. In addition, decelerating economic activity in the country and the closure of workplaces (40,000 workplaces closed in 2015) made it harder to repay loans in manat.</p> <p>Since 2000, income per capita (current prices) steadily increased to \$8,055 in 2014, but declined to \$5,739 in 2015, and is expected to decline further to \$3,702 in 2016. Additionally, the share of income devoted to final consumption increased to 75.7% in 2015, from 68.8% in 2014, which means the savings rate of population declined and larger portions of personal income were allocated to repayment of credits.</p>
<p>ii. Azerbaijan is facing significant fiscal constraints due to oil crisis.</p>	<p>The government budget came under pressure to meet expenditures. The consolidated budget changed from surplus in 2014 to deficit in 2016. The consolidated budget deficit is expected to be almost 10% of GDP in 2016 despite additional transfer from SOFAZ. Reduced oil revenues resulted in budget expenditure cuts, especially public investment with far reaching adverse impacts on growth.</p>
<p>iii. Available market indicators indicate a higher perceived credit risk, which is likely to increase the future cost of borrowing.</p>	<p>The share of dollar-denominated deposits increased from 38.5% in 2014 to 85% in 2016. In the context of significant balance sheet and liquidity risks with deposits declining by 19%, banks were forced to contract the lending to economy by 13% in 2015. The cost of sovereign borrowing from international capital markets have increased following Azerbaijan's credit rating downgrade by major global rating agencies. As a result, perceived credit risks have increased, limiting Azerbaijan's ability to raise funds in international markets at a low cost. On March 24th, 2016, Azerbaijan's Southern Gas Corridor company issued \$1 billion in a 10-year Eurobond, which was sold 80 basis points above Azerbaijan's sovereign bonds, with a coupon of 6.875%. MOF also issued manat denominated bonds with 11-12% interest rate.</p>
<p>2. Planned countercyclical development expenditures for poverty reduction</p>	<p>A countercyclical stimulus to promote growth and protect vulnerable sections of the population is being implemented. The revenues of the revised 2016 consolidated budget are 5.9% lower and the expenditures have increased by 23.1%.</p>

<b>Countercyclical Support Facility Criteria and Indicators</b>	<b>Asian Development Bank Assessment</b>
<p>i. The government has a specific countercyclical development expenditure/policy program to be supported by the CSF, and is committed to its implementation.</p>	<p>Total countercyclical expenditure is expected to be \$1.4 billion-divided into three broad groups. Social assistance program (\$588 million); economic diversification (\$146 million); and employment generation and additional SOFAZ expenditure (\$668 million).</p> <p>As one of the strategies to diversify economy and reduce oil dependency, the support for SMEs, agribusiness industry and tourism has been increased. Entrepreneurship support expenditures doubled from 66 million manat to 136 million manat, whilst investment support program expenditures went up by 42.1%. This has been accompanied by investor incentives like tax preferences and customs duty exemptions.</p> <p>There has also been significant investment in the development of the tourism sector. The introduction of electronic visa that is granted in 3 working days at the cost of \$20 and tax-free system have already been found to be effective in attracting nearly 1 million tourists in the first half of 2016. Increased tourist inflow is expected to play an important role in generating revenue for budget and jobs for the economy.</p>
<p>ii. The countercyclical development expenditure/policy program includes investment in public infrastructure.</p>	<p>Approximately additional \$110 million is allocated to the development of necessary infrastructure for supporting entrepreneurial activities and stimulating small and medium enterprises for creating new jobs. Additional investment by SOFAZ on restructuring of the state-owned enterprises and on revenue generating infrastructure projects is also expected to revive growth and generate employment. Overall Azerbaijan's infrastructure spending in 2016 is around \$2 billion, which includes financing of South Gas Corridor, counterpart share of externally financed projects and other critical investment projects.</p> <p>Government also established and enhanced a student credit fund to fund the payment of tuition fees for students from low-income families during the economic downturn. The fund acts as an intermediary in the provision of concessional loans by credit organizations and grants by various agencies and individuals. The government has established a State Housing Agency approving its organizational structure, regulations and staffing. The agency is tasked to provide affordable social housing to low income and vulnerable groups. The government has allotted 11.6 hectares of land in the Yasamal district of Baku to build affordable apartments. The number of beneficiaries is expected to be around 9,000. The project is being administered by the State Housing Agency with an administrative budget of 10 million manat and a staff of 60. The state budget has allocated funds for development of accessible infrastructure and inclusive education targeting the disabled people.</p>
<p>iii. The countercyclical development expenditure/policy program has a social safety net scheme and employment generation targeting the poor and vulnerable groups.</p>	<p>Despite the increasing pressure on budget revenues, social protection areas have been increased in the revised budget. To enhance social protection of the population and counteract inflation the following one-off measures were introduced: (i) wages of workers have been increased by 10% as of 1 March, 2016 in a number of state budget sectors (social security, education, science, culture, agriculture); ii) the basic amount of retirement benefits was raised by 10% as of 1 February 2016 and now equals 110 manats. It is estimated that about 140 million manats will be allocated for</p>

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	<p>this purpose; iii) the amount of social benefits, benefits for workers who lost their health, food allowance for refugees have been increased by 10% as of 1 February, 2016; iv) targeted social assistance of \$129 million has been provided with additional 20 million manats will be allocated from the reserve fund of the President to support social security of low-income families.</p> <p>Approximately 40,000 layoffs since the onset of economic recession created serious social problem in the short term. The government responded immediately by creating 35,000 short-term contractual jobs mostly in state owned enterprises and in local governments. Free trade zones and economic districts across the regions are being established. The government is introducing reforms in labor market institutions and policies by modernizing vocational education, initiating life-long learning and prioritizing employment of youth, women, disabled and internally displaced persons. It is expected that through these initiatives, and due to additional public and private investment, additional jobs will be created.</p>
3. Sound macroeconomic management	<p>Macroeconomic management until the oil shock largely proved effective in achieving growth and stability of the economy. Monetary policy and exchange rate measures by the CBA proved effective in managing single-digit inflation and managing the fixed exchange rate regime. Moreover, there has been a state budget surplus till 2014 with the country enjoying investment grade status.</p>
i. Monetary policy addresses price stability as one of its core objectives. Inflation is controlled.	<p>CBA has demonstrated high credibility in terms of addressing price stability in the country. A number of actions were taken to prevent further loss of confidence in the local currency, while keeping in view the scarcity of long-term funding and take control of a large-scale dollarization process in the banking system. Since the December 2015 devaluation, the CBA moved to a managed floating exchange rate regime and instituted the exchange rate bands limiting market interventions to preserve reserves. CBA also plans to move gradually to inflation targeting in the medium term. To reduce dollarization in the economy, the government raised the coverage of local currency deposit insurance scheme to 100% with interest rate of up to 12. Moreover, the annual interest income paid on deposits of individuals was made tax-exempt for a period of 3 years starting from February, 2016 to prevent outflow of deposits from the savings banks.</p> <p>Since the onset of the crisis, it was clear that financial sector will require structural reforms to make financial intermediation efficient. The most significant reform has been the establishment of Financial Markets Supervision Authority (FMSA) in 2016. FMSA was set up to improve the licensing, regulation and supervision of securities market and oversee the operations of other financial companies, as well as to prevent money laundering activities. Since its inception, FMSA has already taken a number of steps in regulating the activities in the financial sector through measures such as closure of insolvent banks and warning those engaged in risky practices.</p> <p>FMSA is assessing all the banks and has agreed on a specific restructuring plan with each bank with a clear roadmap and timeline to address capital adequacy and management issues. In July 2016,</p>

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	<p>a Financial Stability Board was established chaired by the Prime Minister with representation of CBA, MOF and FMSA. The Board is to monitor the current situation in the financial-credit sector and recommend actions based on international experience to address the existing challenges.</p>
<p>ii. In Azerbaijan, public finances are sound, and several fiscal adjustments and reforms have been planned.</p>	<p>The government's fiscal policy is to stabilize the budget and manage drawdowns from the SOFAZ by (i) developing a consistent medium-term macro-fiscal framework; (ii) increasing the sustainability of the non-oil deficit over the medium-term; and (iii) reducing the non-oil deficit, which is currently 40-45% of GDP—still above the 30-35% sustainability level recommended by the permanent income rule under a conservative scenario of oil and gas production. Major improvements have been made over the past years on comprehensiveness and transparency of the budget, predictability and control in budget execution as reported by the latest assessment of Public Expenditure and Financial Accountability (PEFA) by the World Bank. Major weaknesses remain in the area of external and internal audit, which have been taken up in the PFM Action Plan subsequently developed and approved by MOF in 2015.</p> <p>The state budget has been in surplus till 2014. Based on government's current macroeconomic and fiscal projections, the public debt to the GDP ratio is expected to be 21% in 2016. With proposed structural reforms in the areas of fiscal management, the fiscal position of the Government is expected to remain sustainable in the medium to long-run.</p>
<p>4. Structural Reforms</p>	<p>Implementing critical structural reforms for the development of non-oil export sector, improvement of the business climate and fiscal and financial governance are government's top priority. Government has also taken strong initiatives to mobilize additional non-tax revenue by revising the wholesale and retail power tariffs in July 2016. The power tariffs have not been revised since 2007. Water supply tariffs have increased by 38% and power tariffs have been increased by 16% in 2016.</p>
<p>i. Azerbaijan is taking credible steps to address the underlying structural issues to counteract future economic crisis</p>	<p>To identify and implement critical structural reforms in the above areas over next 2-3 years, a Presidential Advisor on Economic Reforms was appointed and a special interagency Working Group established to develop long-term strategic development plans for the national economy and its different sectors for achieving sustainability of economic growth. The recession exposed the limitations of country's economic development model that is based on hydrocarbon exports of over 90%.</p> <p>Strengthening macroeconomic and fiscal management is a government priority both at the central level and in managing state-owned enterprises (SOE). Overall, public financial management (PFM) systems are effective but the recession pointed to important gaps that need to be addressed. These include: (i) building capability for medium term expenditure and macroeconomic forecasting, (ii) aligning sector strategies with long-term national development strategy, (iii) integration of financial management systems and better analysis of planned and actual budget data through introduction of program budgeting, (iv) strengthening public investments by improving feasibility and project management</p>

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	<p>capacities, and (v) developing a medium term public debt management strategy.</p> <p>There are currently 10,540 SOEs, many of which are incurring losses and receiving budget subsidies. As part of the planned SOE reforms, the president of Azerbaijan issued a decree in September 2016 to facilitate entrepreneurship and competition in SOEs by encouraging participation of foreign and local investors. The decree sets a time bound plan to (i) formulate rules for evaluation of performance efficiency of SOEs, (ii) develop corporate governance principles and apply international practices in the management of enterprises; and (iii) introduce international financial reporting systems and necessary structural reforms to increase financial transparency and efficiency of large SOEs. The government has started listing non-strategic SOEs for privatization in 2016; this process will continue over the coming years.</p> <p>In the wake of oil shock, transformation to an export-oriented economy characterized by robust non-oil sector growth and expanding its export potential is a major priority of the government. A presidential decree signed in March 2016 implemented measures to stimulate the export of non-oil products. These include opening new e-government service centers, improving public construction tenders; simplifying customs clearance; increasing electronic payments; creating regional industrial zones; extending agriculture, tourism and environmental reforms and promoting regional economic integration. The government intends to enact a new pension legislation in 2017 that would increase the retirement age and contribution periods; this is expected to cut pension fund deficits. To stimulate the development of SMEs in the country, entrepreneurship law was amended in March 2016. The government is also pursuing efforts to diversify the economy by improving the business climate and by expanding the financial sector. Azerbaijan's financial system is small and a costly source of finance remaining vulnerable to external systemic risks. The binding constraints being addressed by the government include underdeveloped financial markets, nascent government securities market, limited access to finance especially for small businesses and lack of financial inclusion.</p>
<p>ii. Azerbaijan is engaging with ADB to prepare a policy based program to enhance the effectiveness of these reforms.</p>	<p>ADB and the government agreed that transforming Azerbaijan into a dynamic and diversified economy will require improving governance in a comprehensive manner, strengthening ease of doing business, and enhancing competition in the economy. As highlighted in the development policy letter, the government has, therefore, sought ADB's assistance to support structural reforms in areas related to the three broad directions. Government is in initial discussions with ADB to develop a policy based program. The objective of the proposed Public Sector Efficiency and Management program is to strengthen fiscal and financial management, improve public sector performance and facilitate development of the private sector. For this purpose a technical assistance grant is being provided to help prepare the program and to build capacities in the relevant government agencies. The program will have three policy areas as described below.</p>

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	<p>Policy Area 1 will help strengthen macroeconomic and fiscal management. The policy actions may include: (i) design and integration of rolling multi-year medium term fiscal framework and medium-term expenditure framework in budget making, (ii) amend the Law on State Debt and secondary regulations to consolidate legal framework on government debt management, (iii) design and adopt a medium term debt management strategy covering loan portfolio, goals and principles of incurring new debt, issues of debt sustainability and development of domestic government securities market, (iv) improve the analytical function of the public debt management office with an upgraded debt management and risk analysis system integrated with budget and treasury systems, (v) strengthen internal audit in the Line Ministries and in MOF through adoption of risk-based internal audit, and (vi) design and enact comprehensive amendments to Budget System Law and secondary legislation related to medium term fiscal framework, fiscal rules and program based budgeting.</p> <p>Policy Area 2 will improve public sector efficiency and accountability. The policy actions may include: (i) design and develop Public Investment framework to introduce formal and objective appraisal of the state investment programs based on project management cycle, (ii) ascertain the fiscal position, audited financial position and extent of contingent liabilities of SOEs, (iii) on the basis of the fiscal position of select SOEs, put in place a financial restructuring and debt restructuring plan for financial viability in select SOEs, (iv) develop corporate governance rules for better management of the SOEs, and (v) introduce commercialization and private partnership in delivery of services in select SOEs.</p> <p>Policy Area 3 will deepen the financial sector and expand private sector participation. The policy actions may include: (i) adopt the Law on Full Deposit Insurance to generate more confidence in the banking system, (ii) implement the new Law on Capital Markets and relevant bye laws to increase access to finance for businesses, (iii) develop and expand the liquid interbank money market, (iv) develop and expand the liquid government securities market, (v) increase employment opportunities in the regions thru financial inclusion and SME financing and skills building, (vi) establishment of a single financial industry mega regulatory authority in order to strengthen financial sector regulation, stability and coordination mechanism, (vii) implement steps to strengthen “Ease of Doing Business” including Single-Window Clearance for SMEs, and (viii) adopt the Law on Funded Part of Labor Pensions and Law on Private Pension Funds required for the establishment of the funded component of the pension system and for the development of non-state pension institutions.</p>
5. Debt Sustainability	The projected public debt to GDP ratio indicates that debt level is sustainable including the potential impact of the prospective CSF borrowing, as the ADB loan comprises a small portion of Azerbaijan’s overall financing needs.
i. Relevant indicators are based on the DSA done by Economics Research	An oil price scenario in line with the <i>Asian Development Outlook 2016</i> and the IMF’s <i>April 2016 World Economic Outlook</i> would see Azerbaijan’s public debt-to-GDP ratio rise from 28.3% in 2015 to

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<p>Department of ADB in line with the International Monetary Fund methods and MOF data.</p>	<p>38.2% in 2016 and stabilize thereafter. According to IMF, the public debt is manageable as the public debt ratio will not breach the 50% threshold that requires “higher scrutiny”, in line with IMF DSA practice. It should be noted that the 50% threshold for market-access countries in the IMF DSA framework serves as an indicative mark against which a country is deemed requiring closer scrutiny, in order to more broadly assess the specific factors bearing on that country’s sustainability. For example, one such factor would be the size and composition of Azerbaijan’s state oil fund.</p> <p>This scenario reflects improved primary deficits, higher economic growth, as well as a projected rise in asset management revenues. As a result, the public debt ratio would increase, yet remain well within the 50% threshold throughout the projection horizon. Under the conservative scenario oil prices to drop by nearly half from last year’s level, to then increase gradually but not beyond US\$40 by 2021. Combined with macroeconomic and fiscal assumptions of the government, and assuming debt financing, such an oil price scenario could potentially translate into increases in both the public debt ratio and the external debt ratio. For example, public debt to GDP ratio is expected to be at 67% in 2020 as against 43% under more realistic oil price assumptions. In this scenario, authorities make no additional SOFAZ transfers on top of the “normal” transfers to the budget—assumed 40% of total government revenues—and meet any fiscal shortfalls instead by new debt/borrowing in the local or international markets. The 40% share is based on the average historical share of SOFAZ transfers to total government revenues between 2010 and 2015. However, ADB analysis suggests that additional SOFAZ transfers could be used judiciously to stabilize the debt below 50% of GDP under the conservative oil price scenario.</p>
<p>ii. International reserves are determined to be adequate, taking into account the imports coverage ratio and the short-term external debt financing requirement.</p>	<p>The foreign currency reserves of CBA are \$4.1 billion. The assets of the SOFAZ are \$35.8 billion. In terms of the import coverage ratio, the strategic currency reserves of Azerbaijan are sufficient to cover the 25-month imports of goods and services.</p>
<p>6. Coordination with IMF</p>	<p>ADB has been coordinating with IMF and other development partners including World Bank for (1) designing the countercyclical facility; and (2) identifying critical reforms that will help the country to diversify economic activities.</p>
<p>i. Azerbaijan had constructive consultations with IMF on Article IV mission concluded in June 2016.</p>	<p>Article IV mission concluded in June 2016 underscored a series of negative shocks to the Azerbaijan’s economy especially the fall in oil prices, and slowdown and currency depreciations in trading partners’ economies. As a result, economic growth fell to 1.1% in 2015 and is projected to turn negative (-2.4%) in 2016. IMF is supportive of government’s response to the weak external environment. These include moving to a managed float exchange rate regime, raising interest rates in 2016 to address rising inflation, and implementing a countercyclical fiscal stimulus which focuses on raising wages, old-age pensions and targeted social assistance, as well as completing existing investment projects. Government has agreed with IMF on the appropriateness of countercyclical spending but to embark on consolidation from 2017.</p>

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	<p>IMF also strongly endorses government's planned move to a new economic model focused on private sector led growth driven by the non-oil economy. The structural reform agenda needs to be implemented, with governance strengthened, the cost of doing business reduced and competition enhanced. Government has agreed with the IMF on instituting a rule-based fiscal framework and strong institutional arrangements to preserve fiscal sustainability in the medium term. IMF underscored that a rule-based framework supplemented by a strong public financial management system, detailed multi-annual budgets and a public debt strategy will strengthen fiscal discipline. In addition, expanding debt securities market will help in deepening the country's financial sector.</p> <p>IMF is providing technical and advisory assistance to the government in improving public expenditure and financial accountability, enforcing fiscal rules, and strengthening banking supervision.</p>

ADB = Asian Development Bank, CBA = Central Bank of Azerbaijan, DSA = debt sustainability analysis, GDP = gross domestic product, IMF= International Monetary Fund, MOF= Ministry of Finance, PFM= public financial management, SME = small and medium-sized enterprises, SOE = state-owned enterprise, SOFAZ = State Oil Fund of Azerbaijan.