



COMMISSION OF THE EUROPEAN COMMUNITIES

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98/ 0129 (CNS)

Proposal for a

COUNCIL DECISION

**providing exceptional financial assistance
to Azerbaijan**

(presented by the Commission)

EXPLANATORY MEMORANDUM

General economic situation of Azerbaijan

Azerbaijan suffered a severe economic decline from the outbreak of the Nagorno-Karabakh conflict in 1988. This still unresolved conflict has destroyed infrastructure, and led to the occupation of twenty percent of Azerbaijan's territory by Nagorno-Karabakh-Armenian forces. As a result, around one million people, about one seventh of the total population of the country, were obliged to leave their homes and seek refuge in other regions of Azerbaijan. This situation was compounded by the disruption of trade and financial links with the other former Soviet republics in 1991-1992, by soaring prices for imports, and by the partial closure of the Azeri borders, not only with Armenia, but also with Russia because of the Chechen conflict. The effect was catastrophic for Azerbaijan's economy which contracted by some 60 % from 1992 to 1995 and reached hyper-inflation levels.

Under such critical circumstances, living standards of 60 % of the population fell below poverty levels. Moreover, the strict budgetary policies implemented from 1995 prevented the Azeri Government from providing as much funding as necessary for social purposes and prevented any significant improvement in the very difficult situation of the population. Currently, the monthly average salary is not higher than 40 US\$ and the monthly average pension is less than 15 US\$, while the income of 20 % of the population represents only 40 % of the minimum consumption basket.

Political instability prevented Azerbaijan from embarking early on economic and structural reforms in the years after independence. However, in 1995, supported by IMF Arrangements, the Government initiated a largely successful macroeconomic reform programme and, at present, economic recovery has started: a GDP growth of about 1.5 % was recorded in 1996, while a growth of 5 % was reached in 1997; annual average inflation declined from 1700 % in 1994 to 4 % in 1997 and the budget deficit from 12 % of GDP in 1994 to 2 % of GDP in 1997. However, tight fiscal policies have led to substantial sequestration of budgetary expenditure, in particular, in the social sectors.

Largely reflecting oil investments, the current account deficit soared to around 22 % of GDP in 1996 and 1997, and is expected to grow further up to some 34 % of GDP in 2000. As a result of investment into the oil sector, external financing gaps will appear in 1998 and 1999, while the gross reserves of the Azeri National Bank are not expected to exceed 16 weeks of imports in the coming years. Concerning structural reform, after a slow start which left Azerbaijan lagging well behind most other NIS, important steps were taken in 1996 and the reform process, although slower than expected in 1997, is now considered as being under way. The public external debt is expected to remain stable at around 15-20 % of GDP in the years to come. Despite the difficult circumstances, Azerbaijan has remained current on most of its external debt obligations, in particular towards the Community whose MECU 51 loan granted in 1994, was fully repaid on time (29 September 1997).

In order to cover its basic needs over the last five years Azerbaijan has had recourse to international humanitarian assistance, out of which the Community has provided the biggest share (under ECHO and exceptional food aid programmes). However, so far, the level of international assistance to Azerbaijan has been proportionally lower than to other

countries in the Caucasus, as a result, in particular, of the United States being precluded under its domestic legislation from providing assistance to this country.

Status of IMF programmes on Azerbaijan

Supported by a first Structural Transformation Facility (STF) (US\$ 46 million) in April 1995, the comprehensive stabilization and reform program that Azerbaijan launched at the start of 1995 has been very successful in achieving macroeconomic stabilization.

In December 1996, the IMF approved the new economic programme of the Government for the 1996-99 period, and supported it by three-year combined facilities: a US\$ 135 million Enhanced Structural Adjustment Facility (ESAF) and a US\$ 84 million Extended Fund Facility (EFF). This economic programme is addressing the key structural reform issues. The IMF Board approved the completion of the first review under these combined facilities in July 1997.

The proposed exceptional assistance

The Commission considers the Azeri macro-economic programme as being comprehensive and ambitious. This programme, if fully implemented, should reinforce the current macro-economic stabilisation and, by the means of structural reforms, establish the core frame of a market economy.

The Commission considers however that, without additional budgetary support, Azerbaijan will not be able to pursue the very tight macroeconomic policies implemented so far in the context of its reform programme. Indeed, a very restrictive budgetary stance has already put a strain on the very difficult social situation and has led to budgetary sequestration, in particular of much needed social expenditures, which can not be delayed any longer. The improvement in the social situation which would result from additional assistance targeted to the social safety net would be an essential element for political and social stability in this strategic but politically unstable region and would contribute to the sustainability of continuing economic and structural reforms.

Azerbaijan, as a low income country, is eligible for World Bank lending at highly concessional IDA (International Development Association) conditions, as well as for IMF ESAF lending, the concessional facility of the Fund. In the circumstances, the country should, in the Commission's view, be supported with highly concessional assistance.

Throughout the 1993 - 1997 period, the bulk of the Community assistance to Azerbaijan was provided in the form of grants under humanitarian programmes, in particular in the context of the two important food aid operations of the Winter periods 1994-1995 and 1995-1996.

In January 1997, the Parliament urged the European Union to develop an active presence in Transcaucasia, a region of strategic importance, both politically (proximity of the Black Sea) and economically (trade corridor from Europe to Central Asia, energy resources - TRACECA and INOGATE initiatives). Recommending to encourage the economic development of this region, it underlined also the necessity of equitable treatment of

Armenia, Georgia and Azerbaijan and advocated consideration of exceptional financial aid to these three countries in the context of IMF agreements. In November 1997, the Council adopted the Commission's proposal for exceptional financial assistance to Armenia and Georgia, which is now in the process of implementation.

Owing to the exceptionally harsh political, economic and social conditions presently faced by Azerbaijan, the Commission considers that exceptional assistance in the form of grants targeted to social safety net budgetary expenditures is required to alleviate the social hardship resulting from the austerity measures accompanying the implementation of IMF supported stabilization programmes, notably by securing implementation of adequate levels of budgetary expenditures, in particular in the social sectors, and to help Azerbaijan to cope with its refugees problem.

Against this background, the Commission is now proposing that consistent with the present ceiling of Category 4 of the financial perspective, the Community makes available to Azerbaijan exceptional financial assistance in the form of grants of up to ECU 30 million to be financed from the general budget.

The Commission considers that this exceptional assistance to be financed through redeployment within the existing limits of Category 4 of the financial perspective should have to be implemented in three successive annual instalments from 1998 to 2000.

The Commission accordingly requests the Council to adopt the attached proposal.

Proposal for a
COUNCIL DECISION
providing exceptional financial assistance
to Azerbaijan

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community, and in particular Article 235 thereof,

Having regard to the proposal from the Commission¹,

Having regard to the opinion of the European Parliament²,

Whereas Azerbaijan is undertaking fundamental political and economic reforms and is making substantial efforts to implement a market economy model;

Whereas trade, commercial and economic links will develop between the Community and Azerbaijan within the framework of the Partnership and Cooperation Agreements signed on 22 April 1996; and whereas an Interim Agreement was signed on 8 October 1997;

Whereas Azerbaijan agreed with the International Monetary Fund (IMF) in April 1995 on a first set of stabilisation and policy reform measures which was supported by the IMF's Systemic Transformation Facility (STF), and whereas the IMF Board approved in November 1995 a Stand-by Arrangement and a second drawing under the STF Facility in support of further ambitious stabilisation and structural adjustment reforms, for the period November 1995 - November 1996; whereas the IMF board approved in December 1996 a combined three-year Enhanced Structural Adjustment Facility (ESAF) / Extended Fund Facility (EFF) at concessional terms in favour of Azerbaijan;

Whereas, so far, the level of international assistance to Azerbaijan has been proportionally lower than to the other countries in the Caucasus and whereas the Council adopted in November 1997 a Decision providing exceptional financial assistance to Armenia and Georgia (O.J. L 322 of 25.11.1997, p. 37);

Whereas Azerbaijan is a low income country and is facing particularly critical political, economic and social circumstances; and whereas the country is eligible to highly concessional loans from the World Bank and the IMF;

¹ OJ n° ...

² OJ n° ...

Whereas this assistance is exceptional and only justified on account of the particularly harsh political, economic and social conditions presently faced by Azerbaijan, and, in particular, on account of the large number of refugees living on its territory;

Whereas the authorities of Azerbaijan have formally requested exceptional financial support from the Community;

Whereas concessional financial assistance from the Community in the form of a grant is an appropriate measure to help the beneficiary country at this critical juncture by supporting the policy objectives attached to the governments' reform efforts and alleviating the social cost of adjustment measures;

Whereas the maximum amount of this assistance is without prejudice to the competences of the budgetary authority;

Whereas this assistance should be managed by the Commission;

Whereas the Treaty does not provide, for the adoption of this decision, powers other than those of Article 235,

HAS DECIDED AS FOLLOWS :

Article 1

1. The Community shall grant to Azerbaijan exceptional financial assistance of a maximum amount of ECU 30 million in the form of straight grants, with a view to alleviating the social hardship of the austerity measures accompanying the implementation of IMF supported adjustment programmes, notably by securing implementation of adequate levels of budgetary expenditures, in particular in the social sectors, and to helping the country to cope with its refugees problem.
2. The Community exceptional assistance shall be managed by the Commission in close consultation with the Monetary Committee and taking into account the provisions of any agreement reached between the IMF and Azerbaijan.

Article 2

1. Subject to the provisions of Article 1, the Commission is empowered to agree with the Azeri authorities, after consultation with the Monetary Committee, the conditions attached to this assistance. These conditions shall be consistent with any agreement as referred to in Article 1 (2).
2. The Commission shall verify at regular intervals, in consultation with the Monetary Committee, that the policies in Azerbaijan are in accordance with the objectives of this assistance and that its conditions are being fulfilled.

Article 3

1. The assistance will be made available in three successive annual instalments from 1998 to 2000, subject to the provisions of Article 2.
2. The funds shall be paid to the National Bank of Azerbaijan.

Article 4

All related costs incurred by the Community in concluding and carrying out the operation under this Decision shall be borne by Azerbaijan.

Article 5

At least once a year, the Commission shall address to the European Parliament and to the Council a report, which will include an evaluation, on the implementation of this Decision.

Done at Brussels,

For the Council

The President

FINANCIAL MEMORANDUM

1. Title of Operation

Exceptional financial assistance to Azerbaijan.

2. Budget heading involved

Article (B7-53...) Exceptional financial assistance to Azerbaijan (to be created through an amending and/or supplementary Budget).

3. Legal basis

Article 235 of the Treaty

Proposal for a Council Decision providing exceptional financial assistance to Azerbaijan.

4. Description and Justification for the action

a) *Description of the action*

Provision of a Community grant of up to ECU 30 million (to be financed from the General Budget) to Azerbaijan with a view to alleviating the social hardship of austerity measures associated with the implementation of IMF supported adjustment programmes, notably by securing implementation of adequate levels of budgetary expenditures, in particular in the social sectors, and to helping the country to cope with its refugees problem.

b) *Justification for the action*

The sustainability of Azerbaijan' economic reforms heavily depends on complementary budgetary assistance, from official sources, at concessional terms.

5. Classification of the Expenditure

Non compulsory, differentiated.

6. Nature of the expenditure

- a grant (100% subsidy), which would be released in three successive annual instalments.

7. Financial impact

a) *Method of calculation*

- The evaluation of the amounts of the assistance deemed necessary is based on the present estimates of Azerbaijan's budgetary financing needs, in particular in the social sectors

b) *Effect of the action on intervention credits*

- The budget entry corresponding to the grant will be activated subject to compliance with a number of conditions to be agreed with Azerbaijan's authorities

c) *Financing of intervention expenditure*

The financing of the expenditure will be secured in three successive annual instalments from 1998 to 2000 through redeployment within the limits of Category 4 of the present Financial Perspective.

The following schedule of appropriations is proposed (in million of current ECU):

	1998	1999	2000
Commitment appropriations	10	10	10
Payment appropriations	10	10	10

8. Fraud prevention measures

The grant will be paid directly to the National Bank of Azerbaijan only after verification by the Commission Services, in consultation of the Monetary Committee and in liaison with the IMF and World Bank Services, that the macro-economic policies implemented in the country are satisfactory and that the specific conditions attached to this assistance are fulfilled.

9. Elements of cost-effectiveness analysis

a) *Grounds for the operation and specific objectives*

The improvement in the social situation which would result from assistance targeted to the social safety net and complementing financing by the International Community provided to the country in the context of an IMF agreed programme would be an essential element for political and social stability in this strategic but politically unstable region and would contribute to the sustainability of continuing economic and structural reforms.

The specific objectives are to alleviate the social hardship of austerity measures associated with the IMF supported adjustment programmes, notably by securing implementation of adequate levels of budgetary expenditures, in particular in the social sectors, and to help the country to cope with its refugees problem.

b) *Monitoring and evaluation*

This exceptional assistance is of macro-economic nature and its monitoring and evaluation are based on a satisfactory track record of the IMF supported adjustment and reform programme that Azerbaijan is implementing.

The monitoring of the action by the Commission services will take place on the basis of a genuine system of macro-economic and structural policy indicators to be agreed with the authorities of Azerbaijan. The Commission services will also remain in close contact with the IMF and World Bank services to benefit from their assessment of Azerbaijan's stabilization and reform achievements.

An annual report to the European Parliament and to the Council is foreseen in the proposed Council decision, which will include an evaluation of the implementation of this operation

10. Administrative expenditure

This action is exceptional in nature and will not involve an increase in the number of Commission staff.

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