

Country Context

A. Introduction

1. This Country Partnership Strategy (CPS) for Azerbaijan covers the four year period from FY11 to FY14. It is a joint IDA/IBRD/IFC strategy, which builds on the complementarities of IFC and the Bank. The last Country Partnership Strategy for Azerbaijan was discussed by the Board in November 2006 (Report No. 37812-AZ) and the CPS Progress Report in April 2008 (Report No. 42935-AZ).

2. **In recent years, Azerbaijan's GDP has risen sharply and poverty has fallen dramatically, led by increasing oil revenues.** Oil sector growth was enabled by large off-shore investments that took place since 1995, and the construction of the Baku-Tbilisi-Ceyhan pipeline and Trans Caucasus Gas Pipeline which both came on stream in 2006, supported by growing oil prices. Driven by the natural resource boom, Azerbaijan's GDP growth has averaged over 20 percent per year and GNI per capita (according to the World Bank's Atlas method) rose dramatically, from \$1,270 in 2005 to \$4,820 in 2009. Poverty dropped from about 49 percent in 2001 to 16 percent in 2008 (latest LSMS survey year). Public investments and increased wealth of households has also led to double digit growth in the non-oil sectors. With a very low level of external debt to GDP (11 percent) and growing international reserves, it has achieved a remarkable level of creditworthiness in a short period of time. Azerbaijan will fully graduate from IDA in FY11.

3. **Azerbaijan's challenge is now to maintain its development momentum and to transform itself into a sustainable upper middle income economy.** This will require two things. First, Azerbaijan will need to adopt a more outward orientation to strengthen the non-oil economy and improve competitiveness. Second, Azerbaijan will need to improve its capacity to make full and effective use of this increase in income – by improving skills and strengthening its institutions. And there is urgency in strengthening competitiveness and capacity because projections indicate a leveling off of oil and gas production, and then decline, as currently identified oil and gas reserves will be drawn down over the coming 10-15 years. It is in this context that the CPS for FY11-14 has been prepared – to build on lessons learned over the past four years and help Azerbaijan build capacity and a competitive non-oil economy so that it can successfully make this transformation.

B. Political Context

4. **The political situation within Azerbaijan is stable.** President Aliyev easily won re-election last year, and a Constitutional Referendum removed the two term limit for the Presidency. Though polls show genuine support for President Aliyev, limitations on media and the civil society, and weak opposition parties, do not leave much space to work out and present alternatives, and the necessary socio-political reforms have to come from the top, with all the risks attached to it. The long-term framework may come under stress not so much from the political opposition *per se* but from whether the “social contract” of continued improvement of life conditions for the broad social strata is able to be sustained. As incomes rise and spread within Azerbaijan, expectations for greater participation are likely to grow. In this context, developing mechanisms for greater accountability and social inclusion are taking on greater importance.

5. **The conflict over Nagorno-Karabakh and surrounding regions remains frozen.** Armed conflict between Armenia and Azerbaijan over the Nagorno-Karabakh region in the early 1990s claimed some 30,000 lives and displaced up to a million Azerbaijanis. A ceasefire accord was signed in 1994, but peace talks have been fruitless so far and over 20 percent of Azerbaijan's territory remains under

occupation. Sporadic clashes on the frontline have continued. The Presidents of Armenia and Azerbaijan have met many times over the past year on the outskirts of various international meetings but without apparent progress.

6. **At a global level, Azerbaijan has carefully balanced relations between the US, EU, Russia, and Turkey.** Azerbaijan is a strategically important country, both geographically as a key link in the E-W and N-S trade corridors and in light of its oil and gas resources. It is a CIS country as well as an EU “Eastern Partnership” country. The EU has been keen to promote a new gas corridor - Nabucco - through which Azeri and Central Asian gas could be transited to Europe through Turkey. Azerbaijan has been neither an initiator nor organizer of the Nabucco Project, but has indicated it could be a potential source of gas and a transit country. At the same time, in June 2009, Azerbaijan entered into a deal to start selling gas to Russia in 2010, although the committed amounts are low.

C. The Economic Environment

7. **Azerbaijan’s GDP grew by an average of over 20 percent per annum during 2005-09, primarily owing to the coming on stream of its new oil production.** The Government used a significant portion of the oil-related revenue to fund an ambitious public investment program, in order to strengthen its infrastructure and social services. Azerbaijan’s approach was to both address its large infrastructure needs in order to provide a foundation for the non-oil economy, and to provide increased wages and social assistance in order to make a dent in poverty and raise incomes. Public investment increased from AZN 0.5 billion in 2005 to AZN 4.6 billion in 2009. During the same time period, the wage bill increased by an average annual rate of 44 percent per year. Not surprisingly, soaring expenditures and wages contributed to an appreciation of the real exchange rate by about 60 percent between 2005 and 2009; inflation reach 20 percent in 2008, but receding below 2 percent in 2009 as prices collapsed during the crisis.

8. **The oil sector growth helped to support growth of an emerging non-oil economy; the non-oil economy grew at an average rate of 10 percent in 2005-2009.** Agriculture grew on average at about 4 percent a year, relying on fruits and vegetables, nuts, and wheat –the country benefits from having nine different climate zones, which creates ample opportunity for diversity in agricultural production. Some non-oil industrial sectors, mostly light manufacturing, chemicals, and metals processing, grew in double digits as well through 2008 on the back of rising commodity prices--though in 2009 the majority of these industries suffered a contraction as commodities prices fell; the subsector grew at about 4 percent in 2005-2009. As might be expected, Azerbaijan also underwent a construction boom, which marked double-digit growth despite the contraction in 2009. Azerbaijan’s service sectors have been booming as well, growing in double digits. Transportation also grew in part owing to the growth in trade, as Azerbaijan is a regional trading center. Azerbaijan’s communication sector grew at more than 25 percent a year, as new cellular operators entered the local market. Wholesale and retail trade grew at about 14 percent a year, and hotels and restaurants grew at about 25 percent a year. Services overall grew on average at 13 percent a year in 2005-2009.

9. **Azerbaijan’s high growth rates came alongside increasing oil reliance and early phases of Dutch Disease were emerging before the global crisis hit Azerbaijan.** Azerbaijan’s oil reliance increased gradually as oil prices rose through 2005, and thereafter more abruptly as production of new oil came on stream in 2006. The share of oil in GDP and the share of oil revenues in fiscal revenues reached 51 percent and 66 percent in 2009, despite the fall of both ratios since their peak in 2008. The high oil revenues enabled public spending to increase relative to GDP, from 23 percent in 2005 to 35 percent in 2009. At the same time, the non-oil deficit increased in magnitude from about a third of total public spending to about two-thirds of total public spending between 2005 and 2009. As a share of non-oil GDP, the non-oil deficit increased from 13 percent in 2005 to about 39 percent in 2009; it was financed

with oil revenues earned in US Dollars. The large foreign exchange inflows led to an appreciation of the real exchange rate by nearly 60 percent from 2005 to 2009, which together with structural impediments to trade and businesses has impacted competitiveness.

10. **Azerbaijan’s mechanisms for managing Dutch Disease were partially successful.** The most important element, establishing a well run Oil Fund capable of retaining excess resources has received international recognition. To date the government has saved about half of its fiscal revenues from oil and gas in the Oil Fund (see Box 1). However, institutional and regulatory efforts to discipline public spending did not mature as planned. Annual spending decisions on the draw-down from the Oil Fund to finance the consolidated budget are largely discretionary. They are not governed by a fiscal rule or a Medium Term Expenditure framework to help manage inevitable spending pressures generated by oil revenues. The high level of public spending helped push up domestic prices and discourage non-oil investment. While non-oil exports have been increasing on nominal terms, as a share of non-oil GDP they have fallen from 10 in 2005 to about 5 percent in 2009.

Box 1: The State Oil Fund of Azerbaijan (SOFAZ)

The State Oil Fund of Azerbaijan (SOFAZ) is the cornerstone of the country’s natural resource revenue management strategy. It was established in 1999 with support from the IMF and the World Bank to accumulate excess oil and gas revenues. SOFAZ governance, news and accounts are published on its web site www.oilfund.az. Oil Fund expenditures are part of the consolidated budget approved by Parliament and executed through the single Treasury account. Financial reports are disclosed and audited annually. At end 2009, SOFAZ held \$15 billion. SOFAZ is recognized internationally for the high quality of its management. It received the 2007 UN Public Service Award, and in 2009 Azerbaijan was the first country to receive validation as compliant under the Extractive Industries Transparency Initiative (EITI). SOFAZ also received the highest rating for transparency by the Sovereign Wealth Fund Institute in 2009. In 2010 it announced that together with investment funds from the Netherlands, Korea and Saudi Arabia it would invest in the newly created African, Latin American and Caribbean Fund under the auspices of the IFC.

11. **Azerbaijan managed the 2009 global financial crisis well, though the weak places in the economy have begun to show.** Overall GDP growth for 2009 was 9.3 percent but mostly due to a recovery of oil prices and production following technical problems in 2008. However, the non-oil sector grew at 3.2 percent only, suffering a large contraction in construction and in the non-oil industry (especially chemicals and steel). Agriculture maintained a positive 3.5 percent growth in 2009, in part due to Government support following the food crisis. In the light of uncertainty around the price of oil, the government’s first reaction was to freeze the implementation of most new investment projects in the budget, and to reprioritize the recurrent budget towards supporting the social sectors, agriculture and utilities. The government also employed a strategy of: (i) containing contagion in the financial sector, by ensuring foreign obligations were met and strengthening bank supervision, (ii) enhancing access to credit by lowering key interest rates and supporting SMEs, (iii) continuing to fully fund the existing Targeted Social Assistance Scheme for the poor, and (iv) reducing the corporate tax rate by 2 percentage points, to 20 percent.

Table 1: Azerbaijan—Selected Economic Indicators 2005-2012

	2005	2006	2007	2008	2009	2010p	2011p	2012p
GNI per capita (US\$, Atlas)	1,270	1,890	2,710	3,830	4,820	5,150	5,220	5,590
<i>Growth rates</i>								
GDP	26.4	34.5	25.0	10.8	9.3	3.7	3.9	3.9
Oil GDP	66.3	63.2	36.8	6.8	14.3	3.6	2.8	2.7
Non-Oil GDP	8.3	11.9	11.4	15.7	3.2	4.5	4.8	5.0
Agriculture	7.5	0.9	4.0	6.1	3.5	1.5	4.5	5.5
Industry	14.8	4.1	7.9	6.4	-13.8	5.0	4.4	4.6
Services	9.6	18.2	12.5	13.7	9.1	5.0	5.0	5.0
CPI (e.o.p)	9.7	8.4	16.6	20.8	1.4	4.7	4.5	4.5
<i>In percent of GDP, except where noted</i>								
Total Revenues & Grants	25.1	28.0	28.2	51.1	41.6	48.1	48.7	47.1
Non-oil revenue	9.8	14.2	15.2	38.4	27.4	34.4	34.8	33.8
Total Expenditures	22.7	27.4	25.9	31.1	34.8	32.8	32.7	31.8
Overall Fiscal Balance	2.6	-0.2	2.6	20.8	6.8	15.3	15.9	15.4
Non-oil Prim Balance	-12.9	-31.3	-28.6	-38.4	-38.7	-38.7	-37.2	-35.4
(as % non-oil GDP)								
External Current Account Balance	1.3	17.6	27.3	35.5	23.6	27.0	24.1	22.7
Exports of Goods and Services	57.7	61.9	64.3	62.6	48.9	52.2	51.2	49.3
Imports of Goods and Services	32.8	25.1	18.3	16.3	15.1	14.1	14.7	15.1
FDI (net)	3.5	-6.1	-15.2	-1.2	0.3	2.5	3.1	3.2
Non-oil FDI (% Non-oil GDP)	3.0	4.1	3.3	2.7	3.0	2.5	2.4	2.3
Intl Reserves (Mo. of Imp. of G&S)	2.0	3.7	5.4	6.8	6.6	7.0	7.7	8.8
Intl Reserves (US\$ Bill.)	1.2	2.5	4.3	6.5	5.5	8.9	11.4	14.1
Oil Fund Assets (US\$ Bill.)	1.4	1.9	3.1	11.4	15.0	20.3	30.2	40.4
External Debt (% GDP)	15.4	12.3	10.9	9.3	11.3	11.8	12.1	11.9
Real Effective Exch. Rate (% ch)	6.8	9.2	9.0	14.3	10.8

Notes: p=projections; 1/public and publicly guaranteed

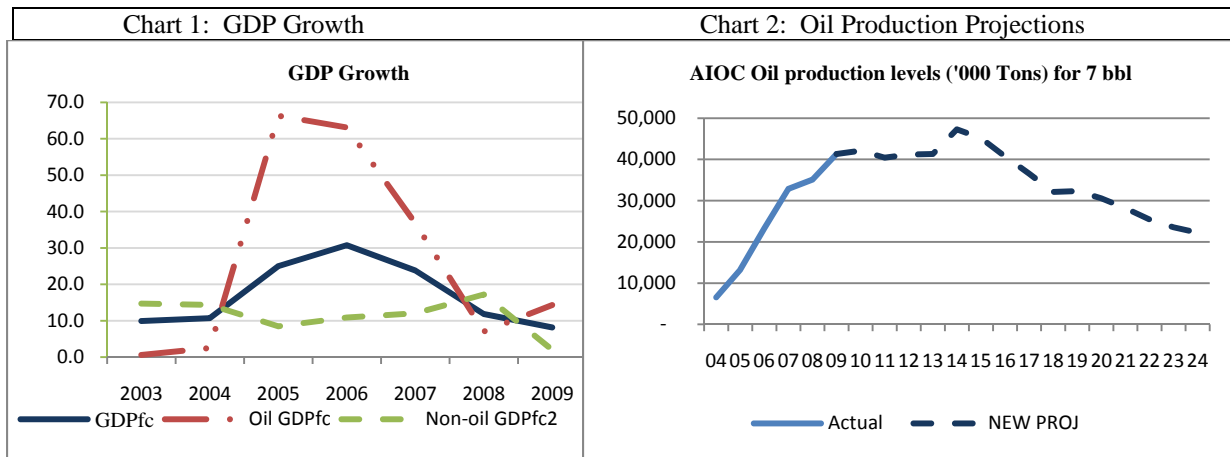
Source: Azerbaijan authorities, IMF and World Bank staff estimates as of June 2010

12. **The experience during the global economic crisis has highlighted the importance of strengthening the non-oil economy, particularly in light of the projected stabilization and subsequent decline in oil and gas revenues**¹ Chart 1 shows that non-oil economic growth, which had been buoyed indirectly by oil revenues, has declined from double digit growth for most of the decade (except 2005) to under 4 percent for the medium term. Azerbaijan's two largest sources of GDP growth and fiscal revenues are from the Azeri-Chirag-Guneshli (ACG) oil field and the Shah Deniz (SD) gas field. Chart 2 shows ACG oil production; it is likely to level off through 2016, and decline thereafter. With Turkey and Azerbaijan reaching agreement on the transmission price for SD Phase II gas in late May 2010, gas production may increase between 2014-2016 but flatten thereafter.² Proven reserves are approximately 9 billion barrels of oil (mainly in the ACG field) and 1.34 trillion cubic meters of natural gas. Without an increase in oil and gas reserves, the country can no longer afford to rely on the oil sector to carry total GDP growth. The need to establish new sources of growth beyond oil and gas revenues is therefore critical. This transformation cannot prudently be put off much longer.

¹ Out of convention, oil GDP refers to the extraction of oil and gas throughout the document.

² FDI in the gas sector in the order of \$2 billion is expected in 2011-2012; delays in operationalizing the agreement between Azerbaijan and Turkey could push gas revenues further into the future.

Figure 1: Azerbaijan GDP Growth and Oil Production Projections



Source: State Statistical Committee, 2009

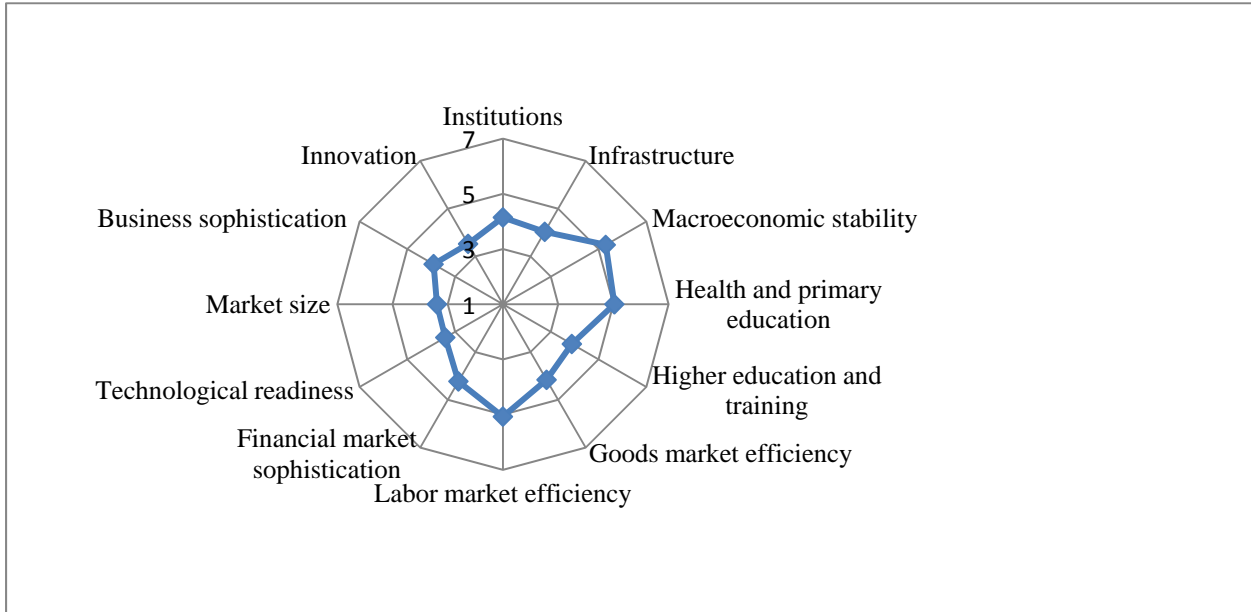
Source: Azerbaijan authorities, 2009

13. **Azerbaijan has made progress, notwithstanding the need to further strengthen its policy and institutional reforms.** Since 2001, the country has made significant progress and key achievements include:

- The establishment and management of the Oil Fund, to preserve wealth for future generations and transparency in revenue flows.
- Introduction of some business facilitating mechanisms, such as a one stop shop for registration
- Improvement in health and basic education funding
- Establishment of a well targeted social assistance program
- Improvements in Government institution and staff remuneration
- Investments in core infrastructure – power, roads, water, energy

14. **Creating a competitive non-oil economy will require deeper economic changes in a wide range of areas – in regulations and governance, infrastructure, skills, public institutions and in trade/FDI and macroeconomic policies.** The Competitiveness Index (see Figure 2 below) provided by the World Economic Forum provides an indication of the many facets of efforts needed. Important efforts are underway on macro-economic stability, health, and primary education but there is a continuing agenda there. Other areas such as infrastructure, institutions, financial markets, technology, goods markets and higher education require more profound reforms. And just as importantly, there is a need to maintain fiscal prudence and quality in public spending in line with the capacity of Azerbaijan to utilize funds efficiently and the capacity of the economy to absorb foreign exchange. The 2010 Doing Business ranking shows significant progress in some areas such as registering and starting a business and enforcing contracts, but continues to rate Azerbaijan low in three key areas: dealing with construction permits, paying taxes, and trading across borders.

Figure 2: Progress in Key Areas Affecting Competitiveness



D. Poverty and MDGs

15. **Azerbaijan’s high economic growth has translated into a sharp reduction in poverty.** The 2008 Living Standards Measurement Study (LSMS) survey was undertaken by the Bank in collaboration with the Ministry of Labor and Social Protection of the Population (MLSPP) and other Government agencies. It shows that Azerbaijan’s poverty rate has dropped from 49.6 percent in 2001 to an impressive 15.8 percent in 2008. Further, poverty rates have dropped significantly for both rural and urban populations (see Figure 3). According to the same survey, by 2008, Azerbaijan’s unemployment rate had fallen to 9 percent and the booming economy helped usher a significant number of women in the labor force, though unemployment among people aged 15-24 remains high at 16 percent.

16. **This reduction in poverty can be traced to the growing economy, a strong rise in wages, and a well targeted and easy to access social assistance program.** Between 2000 and 2008, the minimum wage increased by more than 6,700 percent from an extremely low level of AZN 1.1 to 75 per month (Figure 4). The average wage also grew in double digits per year and reached AZN 274.4 in 2008, compared with only AZN 44.3 in 2000, a cumulative increase of more than 650 percent. Azerbaijan’s per capita income (in real domestic prices) rose by over 30 percent in 2001-04 and further by more than 90 percent during 2005-09. Measured by the Atlas method, per capita income reached \$4,820 in 2009. Inequality is moderate when compared to other Former Soviet Union (FSU) countries; economic growth has generally been broad-based and pro-poor, lifting all income groups.

Figure 3: Azerbaijan Achieved an Impressive Reduction in Poverty

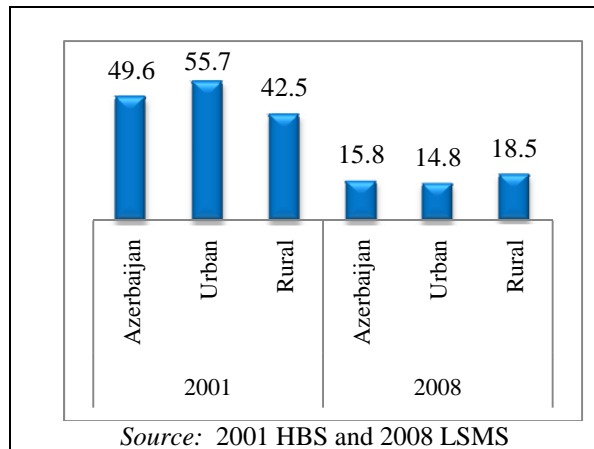


Figure 4: Minimum and Average Nominal Wages over Time (AZN)



17. **There does not appear to be much geographic disparity in poverty, though poverty is higher in rural areas and secondary towns.** Poverty in all of the regions surveyed fell sharply³. While Baku enjoys lower poverty than elsewhere, the gap between the capital and the rest of the country has shrunk. Poverty is somewhat more concentrated in rural areas. About 51 percent of Azerbaijan’s poor now live in rural areas, which account for about 45 percent of the total population. The poverty incidence in non-Baku urban areas is also more than twice that of Baku. A large number of people are concentrated around the poverty line, so small changes in income can have a large effect on poverty.

18. **The incidence of poverty for IDPs is about the same as that in the general population, though IDPs have greater poverty vulnerability and risk.** About 10 percent of the population, up to 900,000 people, report themselves as IDPs⁴. Although some IDPs have integrated into mainstream society, most still live in IDP settlements and about 86 percent live in urban or surrounding areas. Although they have been IDPs for more than a decade, most lack self-reliant economic opportunities and are heavily dependent on state transfers. They report very limited access to water, sanitation, electricity and heating. Interestingly, those IDPs who have their own accommodation outside of government provision and/or are living with relatives exhibit an even greater risk of poverty. The overall picture then is of more entrenched poverty, with more “hidden” vulnerability than the general population.

19. **Azerbaijan has uneven record on social and economic gender issues.** The level of inequality between men and women is very small, with virtually the same at Gini coefficient of 31 percent and 30.8 percent, respectively. This may be partly due to the traditional model of households. While more women than men live in widowed or divorced households, such households do not have a larger incidence of poverty than the average household. Laws and regulations do not discriminate on the basis of gender and there are no significant gender differences in primary or secondary school enrollment. At the same time, there are other gender-related issues that affect women including low maternal health care, higher unemployment rates, the concentration of female employment in low paid sectors, and low representation in the government. Trafficking also remains an issue though smaller than in other CIS countries. One area that needs more analysis and concerted efforts is the high boy-girl ratio at birth. A new National

³ The Nahichivan region which is physically separated from the rest of Azerbaijan has not been surveyed.

⁴ As in many conflict areas the exact size of the population of IDPs is contested. This figure is based on self reporting from the World Bank 2008 LSMS, however official figures put the figure closer to 560,000.

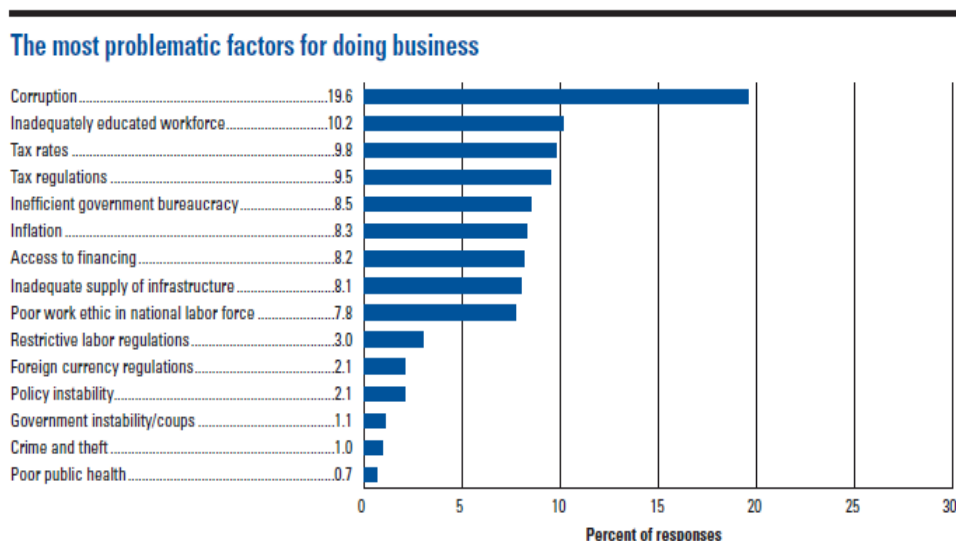
Action Plan on Family and Women’s issues has been prepared by the Government and is pending approval (See Annex 3 for a fuller discussion of gender issues).

20. **Progress towards the Millennium Development Goals has been quite good.** As noted, overall poverty levels have fallen sharply in light of rising incomes and a more targeted safety net. Access to basic education is also good, though the issues of education quality and of access to higher education continue to be important challenges. Health statistics are more mixed and while Government policies and data trends are generally moving in the right direction continued attention will be needed if momentum is to be maintained. An area of particular concern is the high level of out-of-pocket payments in health. The most vulnerable MDG is on environment/water which the Government recognizes as an issue but more concerted commitment and faster implementation is needed. (See Annex 5 for Progress on MDGs)

E. Governance and Anti-Corruption

21. **There is wide-spread recognition that Azerbaijan faces an important challenge on improving governance and fighting corruption.** Various surveys provide evidence of the seriousness of this challenge, while also highlighting those areas of improvement. WBI governance indicators show improvements in regulatory quality and Government effectiveness. At the same time, Azerbaijan continues to rank in the bottom quartile as regards control of corruption and voice. In the 2008 Business Enterprise Survey, corruption was identified as the number one issue, with 85 percent of those surveyed indicating it as a problem. The World Economic Forum (WEF)’s competitiveness index also underlines the degree to which corruption stands out as an issue inhibiting business functions.

Figure 5: WEF Survey - Key Problematic Factors for Doing Business



22. **Nevertheless, while corruption remains entrenched, there are some areas that indicate progress can be made.** The *State Oil Fund (SOFAZ)* is a primary example, taking the lead in enabling Azerbaijan to become the first validated EITI compliant country in the world in 2009. The *Social Protection Fund* is another example, with its transition from paper based to fully electronic registration system sharply reducing the potential for rent seeking on social payments in a record short time period. The efforts to streamline *business registration and inspections* is another positive development, along with the creation of five Advocacy and Legal Advice Centers (ALAC) – offices that help citizens to claim their rights in cases of corruption – which opened across the country. The government has entered into an open dialogue with civil society through a network of local anti-corruption NGOs and TI Azerbaijan.

23. **Governance issues will likely play a significant role in whether Azerbaijan can make the transformation to a sustainable upper middle income country.** Some areas for improving governance in government agencies, State-Owned Enterprises, and the private sector, include the following:

- Stronger Institutional Capacity. Azerbaijan increased its public investments at a faster rate than it expanded institutional capacity. This has created increased room for state capture and suboptimal use of public resources. Improving institutional capacity in tandem with public investments will be critical in improving governance.
- More Transparent Decision Making. Greater attention is needed to budget transparency and modern fiduciary practices in auditing and procurement, and decision making practices in state owned enterprises. Blurred boundaries between public decision making and private business reduce the cost-effectiveness of adopted solutions.
- Improved Investment climate. Despite significant improvement in some areas – as documented in the Doing Business ranking - businesses, particularly SMEs, continue to face many non-competitive practices, particularly in imports and exports. Attracting new businesses and investments in the non-oil sectors is likely to be hampered by formal and informal restrictions documented by IFC and others.
- Skills Enhancement. As documented in World Bank and WEF surveys, improvement of governance in public institutions and private and state owned enterprises is also limited by low skill levels. Azerbaijan has a lower level of university educated people than other countries in the region, and this has resulted in a pervasive shortage of administrative and managerial skills necessary for the modern market economy. In addition, employment opportunities too often depend on nepotism and patronage, which then in turn often results in sub-optimum decision making.