

## Implementing the Strategy

### A. Bank Group Instruments

1. **For the full CPS period the Government has requested a total IDA/IBRD lending envelope of about \$1 billion.** Actual funding would be backloaded based on the principle of starting out modestly and deciding lending volumes based on performance. Over FY11-12, lending is anticipated to amount to about \$300 million in IBRD, plus about \$80 million in IDA in FY11.<sup>1</sup> FY11 is the last year of IDA, after which Azerbaijan will become IBRD-only. Funding levels in FY13-14 could be of similar amounts (or larger), depending on Government demand and performance, and IBRD's lending capacity. The lending level and program for the last two years of the CPS will be confirmed at the time of the CPS Progress Report. It is also anticipated that these funds will be leveraged with Government co-financing in the 20 to 40 percent range. In addition to new lending, the CPS period is expected to see accelerated disbursements under existing projects.

2. **The focus of IDA/IBRD during the CPS will be on faster implementation of ongoing projects.** While the ongoing portfolio is an important part of most country strategies, in Azerbaijan this is of heightened importance given the large IDA/IBRD portfolio of outstanding disbursements (\$1.8 billion) compared to new lending and the slow rate of disbursements (10 percent in FY10). The Bank will also more aggressively restructure or cancel slow or poorly performing projects. New overall lending will be carefully calibrated to the disbursement and implementation status of ongoing lending. The Bank's management and senior Government officials agreed to focus on speeding up implementation of ongoing projects. Because of this, new lending only for the first two years of the CPS – FY11-12 - has been identified (see Table 2 below), and the results matrix relies primarily on ongoing loans. The CPS Progress Report will provide more clarity on lending in the outer years and will update the results matrix accordingly.

**Table 1: Proposed IDA/IBRD Lending For FY11-12**

	<b>New Lending</b>	<b>Amount</b>	<b>Plus Ongoing Program</b>
Building a Competitive Non-Oil Economy	Capital Markets Judicial AF Irrigation II ADCP III	IBRD: 100 – 150 million IDA: 80 million	ADCP-II Highway II and III Rail CAPSAP Irrigation Judicial Modernization Power Transmission Public Investment Capacity Real Estate Registration
Providing Improved Social and Municipal Services	Higher Education IDP II AZRIP II Hovsan Outfall	IBRD: 150 – 250 million	Water Supply I and II Solid Waste IDP Support AZRIP Pension and Social Asst Social Protection Health Sector Reform Education Sector II
	<b>TOTAL</b>	<b>\$ 380 million</b>	<b>About \$1.8 billion undisbursed</b>

3. **New IDA/IBRD loans will be primarily investment loans, but some potential for other instruments will be explored.** All loans during the last CPS were investment loans and it is anticipated

<sup>1</sup> The FY11 actual IDA amount will depend on the exchange rate at the time of lending and includes a final IDA-15 allocation of about \$71-73 million plus \$8-9 million in funds cancelled and reserved for re-lending in IDA-15.

that this will remain largely the case during this CPS period with two possible exceptions. First, the Bank will explore the potential for new “Outcome Based” instruments in selected areas where adequate fiduciary controls can be assured. Second, the Bank and the Government will consider whether the possibility of a development policy instrument would be helpful to support the implementation of an economic diversification and export promotion strategy. If the Bank and the Government decide to pursue this option, it would need to be well grounded in an appropriate macro-economic framework.

4. **The Bank will increase its focus on analytic work.** One of the lessons of the last CPS was that projects were not sufficiently grounded in strategies that had widespread buy-in within the Government, and consequently were subject to change which slowed implementation. The current CPS will re-balance the activities of the Bank towards more analytic work as a consequence, particularly in areas where the Bank is actively lending (ongoing and new). Greater attention to analytic work should also help ground our policy dialogue more. Building links with projects should also help to strengthen the impact of analytic work, as will innovative approaches (see below).

5. **The Bank will also explore innovative approaches to analytic work.** Greater attention will be put on building training and technical assistance into analytic work, particularly through the programmatic public expenditure and poverty assessment activities. Greater attention will also be put on wider dissemination and discussion of findings to the broader public and civil society as a mechanism to build societal consensus and momentum. Further, the Bank launched an innovative approach to analytic work in 2009 – through a High Level Policy Forum in which key policy makers were brought together along with Bank senior management and outside experts to focus on developing agreed policies and strategies. The Government expressed appreciation for this approach and asked the Bank to continue it over the CPS period. Finally, the Bank and the Government agreed in principal and are in the process of designing a Joint Economic Research Program (JERP) which would pair Bank and Azerbaijani resources to conduct economic analysis and prepare sectoral strategies, with additional emphasis on building lasting local research capacity. The Bank will also look for opportunities to strengthen dialogue with the Government and key stakeholders on ways to improve capacity building, including greater participation in WBI regional and global programs particularly in areas such as procurement, urban development, health and public/private partnerships.

6. **Trust Funds are limited and used to support Bank operations.** There are 12 active Trust Funds in Azerbaijan with a total undisbursed amount of \$9 million. Most of this (\$5 million) comprise PHRD grants for ongoing or proposed project preparation and implementation. The remainder are grants focused on complementing specific ongoing projects for IDPs (\$1 million), community development (\$2 million), roads (\$0.5 million), and water resources and one supporting our analytic work in environmental prioritization. The Bank is also slated to finalize a trust fund agreement with SECO as part of the FIRST initiative to support the proposed Capital Markets project and financial sector literacy.

7. **IFC expects to increase significantly its investment program in Azerbaijan during the CPS period.** Based on its track record in implementing projects in Azerbaijan and the slowly improving business environment, IFC will seek to increase its investment program from \$132 million during the last CPS period to around \$200 million over the new CPS period. Financing during the last CPS was heavily concentrated in the banking sector. During this CPS period, IFC will continue to support the financial sector but also look more actively for investment opportunities in the real sector and in infrastructure. This will be complemented by continued advisory services through its advisory services to improve the investment climate, increase access to finance and strengthen financial infrastructure, and to support improved corporate governance practices. Additional opportunities to address CPS objectives through IFC Advisory Services may be explored if there is demand, including possibly agribusiness related, energy efficiency finance, and private participation in infrastructure. Close coordination between the Bank and IFC on both lending and analytic work will support effective implementation (See Annex 6 for

a fuller description of Bank/IFC Collaboration). MIGA also remains open for cooperation though at the moment there is no expressed need for sovereign and/or private borrowing guarantees.

## 8. Throughout the Bank and IFC's program, the regional dimension will be considered

### Box 1: High Level Policy Forum – October 2009

In 2009, the Government and the Bank decided to jointly fund and create a mechanism to create greater consensus around the key issue facing Azerbaijan – the need to build competitiveness.

**Organization.** The Forum gathered together a small group of key economic policymakers in Azerbaijan together with a select group of international policymakers and academics. The High Level Forum was chaired by the Bank's Managing Director and the Azerbaijan Prime Minister.

**Analytical Input.** The Forum used as a background paper a Country Economic Memorandum (CEM) prepared by the Bank on the challenges of competitiveness. It reviewed the building blocks on improving infrastructure and the business environment that the Government had put into place, and the next steps needed particularly on establishing an effective export strategy, ensuring sustainability in public spending, improving trade facilitation, and improving skills in the labor force. This was complemented by the successful experiences of Ireland and Slovakia both of which overcame similar economic challenges.

**Conclusions.** Is export-led and FDI-led diversification the right message for a small economy like Azerbaijan? The answer at the forum was a resounding "yes". Participants concluded that, like all small economies, Azerbaijan needs foreign trade to draw knowledge, spur innovation, and expand markets. Crucial work is now under way on both an export development strategy and a non-oil economic strategy.

**prominently.** Azerbaijan's ability to grow its non-oil economy depends significantly on strengthening its role as a transit economy, which in turn rests on ensuring that the trade and energy routes supported within Azerbaijan link with those supported within neighboring countries and in particular, Georgia, Russia, Turkey, Iran and Kazakhstan. To this end, the Bank sponsors an annual transport donor coordination meeting for the South Caucasus, covering all key modes of transport: railways, roads, maritime and aviation. Donors have confirmed the value they see in this cross-country effort and have expressed hope that the Bank will continue leading this effort. Looking eastward, the Bank, along with other multilateral institutions, is supporting trade, transport and energy coordination through the Central Asia Regional Economic Cooperation (CAREC) program<sup>2</sup>. The Bank Group will also seek to build synergy and learning within the South Caucasus across a wide range of other areas such as poverty and inequality, health policies, and trade. At the same time, frozen conflicts and other regional barriers mean that such approaches are often best pursued through coordinated national activities rather than purely regional programs.

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<sup>2</sup> The eight member states of CAREC are Azerbaijan, Afghanistan, China, Kazakhstan, Kyrgyz Republic, Tajikistan, Uzbekistan, and Mongolia

## Box 2: Expected Analytic Services For FY11-14

### Building a Competitive Non-oil Economy

- Programmatic Public Expenditure Reviews (each year)
- Programmatic Poverty Assessment (each year)
- Jobs and Growth Report
- Financial Sector Monitoring and Regulatory Support
- Agriculture and Irrigation Sector Review
- Fiduciary follow-up (CPAR, ROSC, PEFA etc)
- IFC support for business climate and corporate governance
- IFC advisory services to support the financial sector
- IFC may explore advisory areas in other areas (for example, energy efficiency, food safety, agrifinance, infrastructure)

### Providing Effective Social and Municipal Services

- Education Review
- National Solid Waste Strategy
- Climate Change Adaptation
- IDP Review
- Environmental Priorities and Strategies

Note: These are expected to be implemented with Joint Economic Research Program (JERP) support. These studies may change as the country situation or priorities shift.

## B. Portfolio management and performance

9. **Total Bank lending to Azerbaijan since independence (IDA and IBRD, disbursed and undisbursed) amounts to the equivalent of about \$2.4 billion**, of which about \$650 million has been disbursed and about \$1.8 billion is undisbursed. The active portfolio consists of 12 IDA credits, and seven IBRD loans for a total commitment of about \$2 billion.

10. **The quality of the portfolio has deteriorated over the last two years** mainly as a result of the substantial increase of the lending program in FY08, which swamped implementation capacity. The disbursement ratio of the portfolio -- a key indicator of overall portfolio performance -- was 6.5 percent in FY09, well below the Bank benchmark of 20 percent. The disbursement rate has improved a bit during this fiscal year and at end-FY10 stood at 10 percent. The major reasons for the low disbursement were change in the structure of the portfolio by significant increase of the lending volume toward new projects, combined with delayed effectiveness of the largest projects approved in FY08, and inadequate capacity of implementing agencies. There are currently three projects in unsatisfactory condition – First and Second Water Supply Projects, and CAPSAP.

11. **Remedial action is underway and disbursements are rising.** The Joint Portfolio Performance Review (JPPR) conducted in September 2009 identified major challenges and obstacles faced during portfolio implementation and outlined a set of actions directed to portfolio quality improvement. A 19 member joint working group has been established representing all key ministries for the purpose of addressing issues and accelerating implementation. As a follow-up on the JPPR Action Plan approved by the Government, the Second National Water Supply and Sanitation project was restructured with a change of implementation agency. The Railway project was also restructured and has now been signed and declared effective. Two long delayed environment projects were withdrawn after the Government

could not reach the consensus needed to authorize project signing and an unsatisfactory project was closed. Action is moving forward on other projects as well. The Judicial Project is now performing satisfactorily and is expected to be restructured within the next few months. The Real Estate Project is also making progress after some delay. CAPSAP and Water Supply I and II have suffered delays and institutional issues and concerted attention is being provided by the Bank and the Government to bring them up to satisfactory status.

12. **Decentralization will also support the new focus on implementation.** Improvement in project implementation is also expected to be supported by the decentralization of the Country Director, increased fiduciary staff, and three Country Sector Coordinators (CSCs) to the field during FY10-11. The Bank has also started a program of providing technical assistance to the Government to help it enhance its own implementation monitoring capacity.

13. **Fiduciary controls in the portfolio require close monitoring.** Financial management and procurement arrangements in most implementing agencies are adequate but continue to require attention, training and strengthening. Efforts will be taken to involve project financial management and procurement staff in improving processes, which should help increase disbursements. Currently, projects funded by the Bank make limited use of country systems given weakness in country fiduciary approaches. Under the CAPSAP project the Bank intends to strengthen accounting and financial management capacity of line ministries. In addition, the Public Investment Capacity Building Project will provide public institutions with a wide range of trainings, including FM and disbursement related courses to strengthen their institutional capacity. These efforts, while modest, should help build the foundation for considering phasing in some use of country systems in the future.

14. **IFC has a committed portfolio of \$127 million**, of which \$97 million is outstanding. The portfolio includes 10 clients, mostly in the banking sector. Portfolio performance has been mostly satisfactory, but the global financial crisis and weakening consumer demand has had a significant negative impact on one client. Staff continues to manage the portfolio closely.

### C. Results Based Monitoring and Evaluation

15. **The Bank will strengthen its results based monitoring and evaluation (M&E) to better assess how Bank activities are contributing to results on the ground.** The CPS Completion Report indicates that not all projects have been regularly monitoring results based indicators, which in turn has led to difficulties in assessment and in making mid-course corrections. During the CPS, the Bank would work with the Government to strengthen country monitoring and assessment systems through various mechanisms (Capacity Building Project, CAPSAP, CPAR follow up etc), recognizing however that this is a long term agenda, likely beyond the horizon of this CPS. This CPS is results-based with outcomes and monitorable indicators, and lending levels will depend on continuing to meet disbursement and results targets. The Bank will support this through:

- (i) Greater analytic work prior to investments so that results indicators are well integrated into strategy
- (ii) Increased attention to results in project design
- (iii) Strengthening project supervision, including providing more resources and management attention for risky or problem projects
- (iv) More attention to better physical verification of works

- (v) Improvements in the Governments and Ministries own ability to monitor and verify quality of works. This means greater investment in client M&E systems both at the project level and at the overall country level.
- (vi) Annual JPPRs based on results monitoring linked to key results indicated in this CPS. And ensure that the results matrix is maintained as a “live” data base
- (vii) Use of evidence-based surveys and indexes, including benchmarking from international surveys (BEEPS, Doing Business, WEF), and performance ratings (CPAR, PEFA)
- (viii) Improved multimedia efforts to raise awareness about results through stories of successful impact.

16. **The Bank will also explore the potential for results based lending during the CPS.** The potential for such a new instrument would depend on the Bank’s ability to ensure that the Bank’s fiduciary responsibilities could be assured in the sector, as well as the sector’s ability to generate objective and professional results indicators. Progress on country systems, country-wide or within certain sectors, would be an important element in determining how and where to explore this. The Bank will also hold annual high level discussions with Azeri policy makers on the pace of reforms necessary to advance the goals of the CPS. The progress on the policy dialogue will be used to recalibrate the analytical and policy work in the coming year.

#### **D. Communications Strategy**

17. **Enhanced participation and transparency have been used effectively within some operations to gain support and improve effectiveness.** The Azerbaijan Rural Investment Project encourages community development and, through that, greater public participation in decision making. Other operations such as the Judicial Modernization Project, Real Estate Registration Project, and Social Assistance Project, have made effective use of information technology to empower people. And the Government has recognized the power of greater communications in a number of areas including rolling out the Targeted Social Assistance System and using the communications component of the Avian Influenza Project to reach out to the rural areas and disseminate information critical for preventing the virus from spreading. Public education is a key component in IFC’s advisory work on the investment climate, corporate governance and access to finance.

18. **Nevertheless, the difficulties with the previous CPS underline the importance of building broad support for reforms more systematically across Bank projects.** Building on the good practices and lessons of previous years, the new CPS will require that operations support broader outreach, public participation and feedback. This is particularly true for new operations in the social sector, where public understanding of reforms needs strengthening as part of a readiness filter. The Bank will strengthen its communications strategy and country office staffing to also assist the Government in communicating policy reforms as well.

#### **E. Gender**

19. **The CPS considers gender issues as integral part of the whole program. Gender-related issues include maternal health levels, higher unemployment rates for women, the concentration of female employment in low paid sectors, and low representation in politics. Trafficking and high boy-girl ratios are also issues.** Many of the operations supported by the Bank - particularly in health, education and social protection – will have an important impact on women’s lives. Further, the community and rural level activities will also provide important support. The CPS will continue to monitor activities supported by the Bank to ensure adequate attention to gender issues, including through

its programmatic Poverty Assessments and support to IDPs. Bank supported activities will build on the gender analysis by the UN and its agencies, and work closely with them and the State Committee for Family, Women and Children in furthering progress on gender issues. The Bank will also remain engaged with the civil society organizations dealing with women issues, including through its small grant facilities (see Annex 3 for a fuller discussion of gender issues).

## **F. Partnerships**

20. **Donor aid for Azerbaijan has substantially declined because of its increased revenues.** In 2007-08, the Bank was the major aid donor to Azerbaijan, followed on the bilateral side by U.S., Turkey, Germany and France, and on the multilateral side by the ADB and EC. As a major development partner, the Bank has consistently aligned its strategy and individual operations with other donors by way of broad or individual consultations, and participation in coordination meetings. In a number of areas – particularly highways, water supply and wastewater management – the Bank is actively engaged with other donors to ensure consistency in approach. The new CPS will build on the existing partnerships and intensify relations to further achieve the country’s development goals.

21. **The Government plays a leading role in donor coordination.** Donor activity has been coordinated through the Department for Coordination of State Guaranteed Credits, Technical Assistance and Grants at the Cabinet of Ministers. In addition, since 2007 alignment of programs is also carried out at the Ministry of Economic Development through regular donor coordination meeting usually convened once a year. Finally, donors have been coordinating between themselves based on sector interests and through EU hosted coordination meetings on particular topics, to which Government participation is normally invited. Since 2007, coordination of donor activities is carried out by the Department for Foreign Investments and Assistance Coordination of the Ministry of Economic Development.

22. **Beyond partner resources, the relationship of Azerbaijan to the EU continues to be important in the context of aligning its approaches with Europe through the Eastern Partnership program.** The CPS process overlaps with the formulation of the EC’s new Indicative Programme for 2011-2013 which will focus on development of democratic structures and good governance, socio-economic reform and sustainable development, trade and investment and regulatory approximation, energy security and justice.

23. **Cooperation between the Bank and the EU covers a wide range of modalities including policy coordination, and joint or complementary activities in investment operations.** In the transport sector, Bank funded operations developing the country’s highway and railroad network are part of the EU supported TRACECA framework. The Logistical Center in Alyat funded by the EC complements the Rail, Trade and Transport Facilitation Project. The Bank is an implementing agency for the EU funded Forest Law Enforcement and Governance program which covers six countries (Azerbaijan, Armenia, Ukraine, Moldova, Belarus and Georgia) plus Russia. In the social sector, the EU Twining Project on Enhancing Effectiveness and Efficiency of Social Protection Policy contributes to the Bank’s work within the Social Protection Development Project. The EU and the Bank are also actively coordinating activities on modernization of the justice system in Azerbaijan, including strengthening the rule of law and human rights protection. While much of the coordination occurs at the country level, a “South Caucasus Day” was organized in Brussels in May 2010 to discuss Bank-EU coordination in the regional context.