

Managing Risks

1. **The key risk facing Azerbaijan over the next few years is the political economy challenge involved in building a competitive economy.** Decision making within Azerbaijan is fragmented, and while there is a general support of reform at the highest levels of the government, there are also many vested interests. The forward movement has been rather cautious and not always linear. To mitigate the risk of reforms being deterred and/or delayed, the Bank will seek stronger positioning in its policy dialogue, through innovative approaches such as the High Level Forum, a Joint Economic Research Program, and possibly a DPO. The Bank will also invest greater effort into preparing the ground for reforms through more country and sector analytic work, disseminated broadly within society, before providing investments in particular areas. Where feasible, the Bank will also seek to take into consideration the political economy in its analytical and investment activities. This risk has important implications for IFC, as investment opportunities are currently constrained by poor transparency and financial disclosure, and the success of the investment climate advisory services depends on the political will to undertake changes to the regulatory and policy regime.

2. **The second key risk factor is continued weakness in governance and institutional capacity.** Weakness of institutions was the major obstacle to implementation of the previous CPS. Broader governance and corruption challenges erode the efficiency of public expenditures as well as portfolio implementation. And despite improvements in the private sector environment, there continue to be vested interests and a lack of transparency in the private sector that can hold the non-oil economy back and IFC from providing support. The Bank Group recognizes the complex environment and has elevated governance and institution building to a cross-cutting theme that needs to be taken into consideration in every activity the Bank undertakes. Each task (analytic and lending) will include efforts to intensify training in skills needed for professional management and improved transparency and financial soundness within supported institutions. The Bank will also use the recently completed Country Procurement Assessment Review (CPAR) as a guide to strengthening procurement practices.

3. **A third risk is portfolio implementation.** Some Bank investments within the previous CPS have been seriously delayed or are underperforming. The Bank will seek to mitigate this risk with the following actions: (i) The focus of the CPS will be first on implementing current projects, which will undergo regular review and a high level joint working group has been set up by the Government to review poorly performing projects – without corrective action or restructuring in a reasonable time frame, poorly performing operations will be cancelled; (ii) In considering new projects, the Bank will put special emphasis on implementation performance of ongoing projects within the sector and re-emphasize the need for projects to have fully developed technical and procurement plans, and safeguards – they must be ready to allow implementation immediately after the Board approval; (iii) Senior management within the Bank and the Government will continue recently renewed efforts to pay close attention to these issues in a more systematic way.

4. **Fourth, global economic impact will also need to be carefully monitored.** After many years of double digit growth led by increasing oil and gas exports, future growth in Azerbaijan is expected to fall to more modest levels and be increasingly dependent on progress on making the non-oil economy more competitive. Economic strains may develop if oil and gas prices further decline due to the prolonged global economic weakness. Azerbaijan has successfully built an impressive Oil Fund, which will have accumulated over \$20 billion by the end of 2010. This provides an important cushion of resources, although only as a last resort, for unexpected fiscal pressures. Other exogenous risks such as climate change and natural disasters will also need to be carefully analyzed and monitored.

5. **Finally, there is a regional security risk.** The conflict over Nagorno-Karabakh continues to fester, notwithstanding numerous high level meetings between the Governments of Armenia and Azerbaijan, and the international community through the Minsk Group being also engaged in mediation efforts. Should this currently frozen conflict enter into a period of greater armed conflict, this would affect development outcomes. On the other hand, should there be at least a partial resolution, the Bank would stand ready to re-orient and augment its support towards the major levels of reconstruction, resettlement and reintegration that would be needed. As noted, the Bank will also look for opportunities to strengthen regional knowledge sharing and integration where there is interest.