

Executive Summary

(i) The Country Partnership Strategy (CPS) for Azerbaijan for FY11-14 has been prepared under the circumstances of a rapid increase in income and decrease in poverty, but also the global economic crisis from which the country has emerged relatively well. But the drivers of growth and poverty reduction that served the country well in the recent past may not be available in the future, and the post-crisis world offers new challenges. This CPS therefore focuses on those areas where development needs are likely to be the strongest, Government demand and commitment is visible, and the Bank's advantage is clear. In this context, the CPS proposes a two pillar strategy of (i) building a competitive non-oil economy and (ii) strengthening social and municipal services; with a strong cross-cutting theme of governance and anti-corruption.

(ii) Azerbaijan faces a unique opportunity to propel itself into the ranks of a sustainable higher middle income country. Its remarkable success in reducing poverty from 49 percent in 2001 to 16 percent in 2008 was largely driven by very high growth rates which averaged more than 20 percent for the period. This was complemented by a strong rise in wages and transfers, and a well-targeted social benefit system. However, much of the rapid growth stemmed from a large increase in oil and gas revenues which are now likely to plateau over the coming decade and decline thereafter. A key driver of economic growth may therefore not be available. At the same time, while Azerbaijan weathered the global economic crisis relatively well, the crisis has underlined the need for a diversified economy, market-based policies, and strengthened social services and support. As the Government prepares to meet these emerging needs and challenges, this World Bank Group strategy seeks to support the country in this endeavor.

(iii) Over the course of the last CPS (FY07-10), the World Bank Group operations have had mixed results. The best results came from helping the Government maintain a strong macro-framework, support health, education and social assistance modernization, and improve rural infrastructure, especially in irrigation. Smaller operations in community development helped improve people's lives through lending to rural and IDP communities. Strong results were also seen in expanding access to credit, in particular through IFC's support to banks and advisory services to promote the growth of the leasing sector and improved financial infrastructure. Progress was made in improving the business environment, particularly on business registration. But significant work remains to be done in other areas of the business environment, especially with respect to permits and inspections, which deter private economic activity. Results have also been delayed in the larger infrastructure projects, especially roads, rail, and water supply and sanitation, where implementation has been slower, and in environment where limited progress has been made. Where performance was weak, there were several contributing factors including lack of project readiness, the rapid increase in lending ahead of implementation capacity, wavering Government ownership of projects, and an imbalance between lending and analytical work.

(iv) As a result of learning from this experience, the CPS will seek to modify the Bank's approach in a number of ways. The Bank will increase its focus on implementation of existing operations, and only consider new operations in selected areas with a strong record of sufficient institutional capacity. The Bank will re-emphasize its focus on those areas where there is clear country demand and ownership. Special attention will be placed on ensuring that any new operation will be brought to the Board only when it is ready for immediate implementation. The Bank will rebalance activities towards more analytical work and policy dialogue. And finally, the Bank will further strengthen its support for capacity building.

(v) The specific areas of focus for the CPS build on the Governments own development strategies as evidenced in a variety of sector specific frameworks. The first pillar of the CPS focuses on strengthening the non-oil economy, primarily through an improved business environment, better infrastructure and

agriculture improvements. The second pillar focuses on improving the effectiveness of social and community services, including health, education, social protection and water supply. All of these efforts will need to be accompanied by capacity building and improved governance in order to improve results. This will be a cross-cutting filter within the CPS.

(vi) 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 adjusting lending volumes to performance. Over FY11-12, lending is anticipated to amount to about \$300 million in IBRD, plus about \$80 million in IDA in FY11. 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 even larger), depending on Government demand and performance, IBRD's lending capacity and demand by other borrowers. The lending level and program for the last two years of the CPS will be confirmed at the time of the CPS Progress Report. IFC will seek to increase its investment program significantly to about \$200 million during the CPS period. In addition to new lending, the CPS period is expected to see accelerated disbursements under existing projects.

(vii) Bank lending will be complemented by a strong and enriched program of knowledge services. This would serve the dual purposes of informing country growth strategy and policy choices as well as the design of investment operations. The Bank will increase its analytic work in the areas of job creation and growth, poverty and inequality, the financial sector, agriculture and irrigation, wastewater, and public expenditures. The Government has agreed in principle to partner with the Bank with additional funding through a Joint Economic Research Program (JERP). The Bank and the Government have also established a strong vehicle for policy dialogue in the high level policy forum held for the first time in 2009, and expected to continue during the CPS period. IFC will continue to complement this with advisory services in the financial sector as well as improving the private sector business environment. The Bank and the IFC will deepen their cooperation in these endeavors.

(viii) The strategy described above is designed to channel funds in the most effective and prudent manner but is not without risks. The largest risks are associated with (i) social and political economy challenges as Azerbaijan moves to a new, more advanced stage of a competitive and diversified upper middle-income economy, (ii) progress in improving institutional capacity being slower than needed for increasingly more sophisticated governance requirements, (iii) implementation of existing portfolio, (iv) global economic uncertainties, and finally (v) regional security issues. Key elements of the CPS that will help to manage and moderate these risks are: better calibration to client demands and capacity, stronger emphasis on analytical services, faster implementation of the existing portfolio, and cross-cutting filter of governance.