CURRENCY EQUIVALENTS	GOVERNMENT FISCAL YEAR
(Exchange Rate Effective June 15, 2010)	January 1 to December 31
Currency Unit = New Manat	WEIGHTS AND MEASURES
US$1 = .80 New Manat	Metric System

ABBREVATIONS AND ACRONYMS

AAA	Analytical & Advisory Services
ADB	Asian Development Bank
APUIS	Azeri Public Utility Services
AZN	New Azerbaijanian Manat
BEEPS	Business Env. Enterprise Performance Survey
BTC	Baku-Tbilisi-Ceyhan
CAREC	Central Asia Regional Economic Cooperation
CBA	Central Bank of Azerbaijan
CEM	Country Economic Memorandum
CG	Consultative Group
CGA	Country Gender Assessment
CIS	Commonwealth of Independent States
CPA	Country Procurement Assessment
CPAR	Country Procurement Assessment Report
CPI	Consumer Price Index
CPIA	Country Policy and Institutional Assessment
CPPR	Country Portfolio Performance Review
CPS	Country Partnership Strategy
CPSPR	Country Partnership Strategy Completion Report
CSC	Country Sector Coordinator
DPO	Development Policy Operation
EBRD	European Bank for Reconstr. and Development
ECA	Europe and Central Asia
EDSP	Education Development Strategy Paper
EIB	European Investment Bank
EITI	Extractive Industry Transparency Initiative
ESP	Environmental State Program
ESW	Economic and Sector Work
EU	European Union
FDI	Foreign Direct Investment
FIAS	Foreign Investment Advisory Service
FSA	Financial Sector Assessment
GDP	Gross Domestic Product
GNI	Gross National Income
IBA	International Bank of Azerbaijan
IBRD	Interntl Bank for Reconstruction and Dev.
ICA	Investment Climate Assessment
IDA	International Development Agency
IDF	Institutional Development Fund
IDP	Internally Displaced Persons
IEG	Independent Evaluation Group
IFC	International Finance Corporation
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
IPSAS	International Public Sector Accounting Standards
ISSA	International Social Security Association
JBIC	Japan Bank for International Cooperation
JERP	Joint Economic Research Program
KfW	Kreditanstalt für Wiederaufbau
LSMS	Living Standards Measurement Study
MDG	Millennium Development Goals
MED	Ministry of Economic Development
MIGA	Multilateral Investment Guarantee Agency
MLSPP	Ministry of Labor and Social Protection of Population
MOH	Ministry of Health
MTEF	Medium-Term Expenditure Network
NGO	Non-Governmental Organization
NPL	Non-Performing Loans
OCSE	Org for Security and Co-operation in Europe
OOP	Out-of-Pocket
PEFA	Public Expenditure & Financial Accountability
PER	Public Expenditure Review
PETS	Public Expenditure Tracking Surveys
PIFC	Public Internal Financial Control
PIRLS	Progress in International Reading Literacy Study
PISA	Program For International Student Assessment
PPER	Programmatic Public Expenditure Review
PRSC	Poverty Reduction Support Credit
PRSP	Poverty Reduction Support Strategy
ROSC	Reports on Observance of Standards and Codes
SECO	State Secretariat for Economic Affairs of Switzerland
SME	Small-and Medium-size Enterprises
SOCAR	State Oil Company of Azerbaijan
SOE	State Owned Enterprise
SOFAZ	State Oil Fund of Azerbaijan
SPPRED	State Program on Poverty Reduction and Economic Dev.
SPPRSD	State Program on Poverty Reduction and Sustainable Dev.
SSPF	State Social Protection Fund
TA	Technical Assistance
TI	Transparency International
TIMS	Treasury Information Management System
TIMSS	Trends in International Mathematics and Science
TRACECA	Transport Corridor Europe-Caucasus-Asia
TSA	Targeted Social Assistance
UNDP	United Nations Development Program
UNHCR	United Nations High Commissioner for Refugees
USAID	US Agency for International Development
WBI	World Bank Institute
WEF	World Economic Forum
WHO	World Health Organization
WTO	World Trade Organization

The World Bank Group Team

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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.

I. 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 that 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 steal). 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

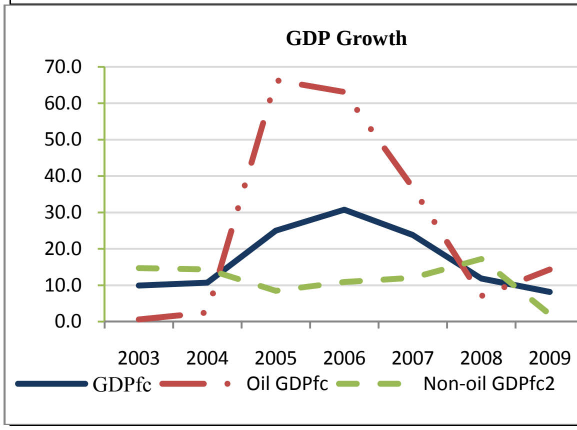
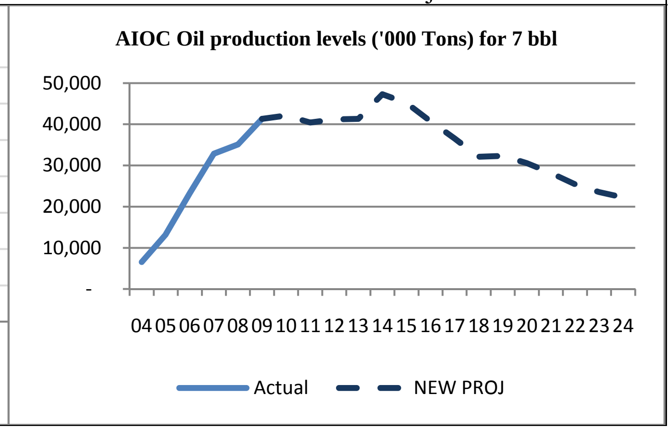
	2005	2006	2007	2008	2009	2010p	2011p	2012p
GNI per capita (US$, Atlas)	1,270	1,890	2,710	3,830	4,820	5,150	5,220	5,590
Growth rates								
GDP	26.4	34.5	25.0	10.8	9.3	3.7	3.9	3.9
Oil GDP	66.3	63.2	36.8	6.8	14.3	3.6	2.8	2.7
Non-Oil GDP	8.3	11.9	11.4	15.7	3.2	4.5	4.8	5.0
Agriculture	7.5	0.9	4.0	6.1	3.5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

Chart 1: GDP Growth	Chart 2: Oil Production Projections
	

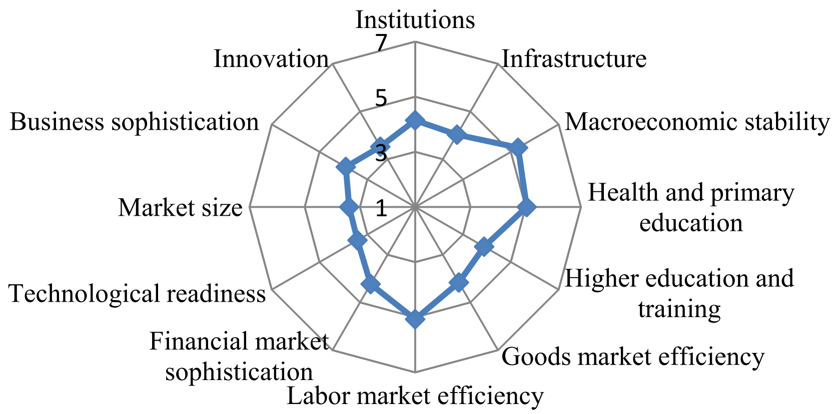
Source: State Statistical Committee, 2009 *Source:* Azerbaijan authorities, 2009

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

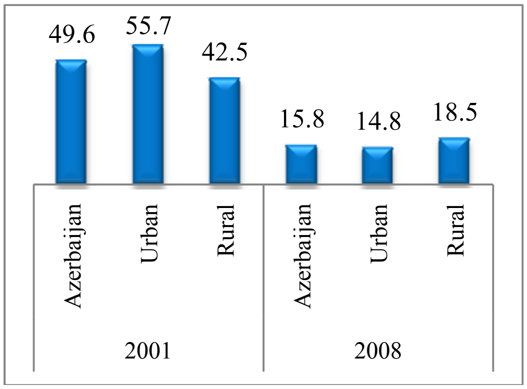


D. Poverty and MDGs

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.

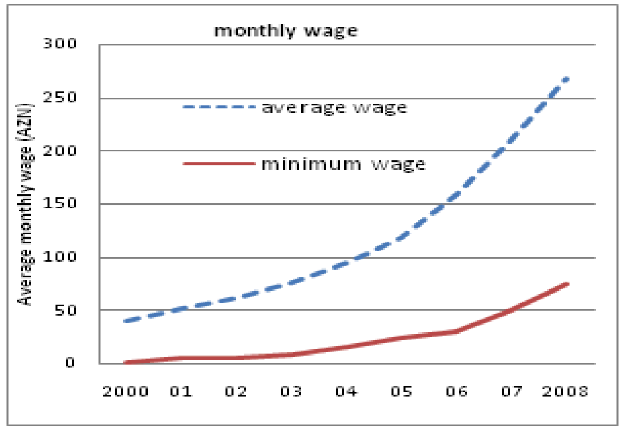
16. **This reduction in poverty can be traced to the growing economy, a strong rise in wages, and a well targeted and easy to access social assistance program**. Between 2000 and 2008, the minimum wage increased by more than 6,700 percent from an extremely low level of AZN 1.1 to 75 per month (Figure 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



Source: 2001 HBS and 2008 LSMS

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



Source: State Statistical Committee, 2009

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 sharply[3]. 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 IDPs[4]. 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.

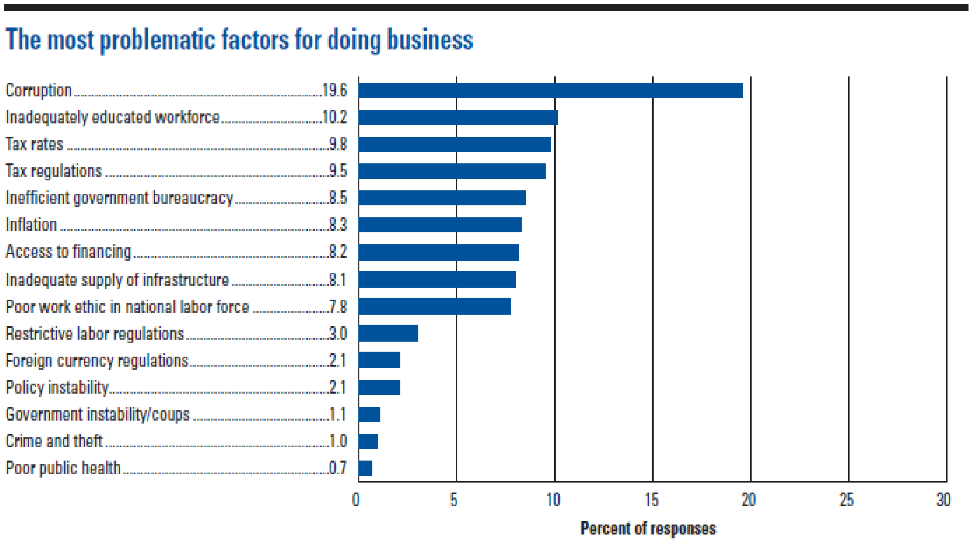
Action Plan on Family and Women's issues has been prepared by the Government and is pending approval (See Annex 3 for a fuller discussion of gender issues).

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 is 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.

II. Country Development Agenda and Priorities

A. The Country Development Program

24. **The Government's development program can be derived from a mix of sources:** The foundation is laid out in the "*State Program on Poverty Reduction and Economic Development 2003-2005*" (SPPRED) and the subsequent "*State Program on Poverty Reduction and Sustainable Development 2006-15*" (SPPRSD) which together represent the country's Poverty Reduction Support Program (PRSP). Broad development goals include maintaining macroeconomic stability, creating enabling conditions to improve income generating opportunities, improving the quality and access to basic health and education services, improving infrastructure, and strengthening the social protection system to better protect vulnerable groups including IDPs. Since then, these broad goals have been complemented by a number of more specific strategies. These include the Government's "*Regional Development Program*" covering 2009-2012 and supplemented by action programs in a number of specific sectors.

25. **More recently, the 2009 financial crisis appears to have heightened the Government's resolve to transform itself into a diversified, globally-integrated competitive economy**. Recent Presidential speeches address critical issues such as food security, the business environment, and counter-cyclical spending. The *High Level Policy Forum* organized jointly by the Government and the Bank also

provided an opportunity for the Government to set strategic directions in a post-crisis world. Taken together, these sources set out a vision where oil and gas would continue to play a critical role but would be complemented with new engines of growth. The government sees the geographical position as ideal to further develop transit-related services. Developing Azerbaijan as an expanded transportation hub, as a center for high value-added food processing industries and other light manufacturing, and even as a regional tourist destination, are all part of this vision. Significantly improved performance of the agricultural sector is expected to support the food processing sector. The government's vision thus expects to broaden the country's non-oil export markets, now mainly limited to Russia and Turkey, to the rest of Europe and Asia.

26. **In order to meet this vision, the Government envisages an active role for itself in both public infrastructure investments as well as policy and regulatory reforms.** Expanding infrastructure in roads, agriculture, water, power supply and gasification is seen as a critical input. The need to enhance the business environment is equally seen as an important goal. This includes both commercializing SOEs even if kept state-owned (for example, the recent decree in converting the railway administration to a joint stock company) and building a more market friendly business environment (for example, the April 2010 Presidential decree on unifying regulations of inspections and registry). Specific directions include:

- <u>Infrastructure.</u> The Government sees the continuation of priority infrastructure projects as critical for development of businesses. The need to ensure uninterrupted power supply and gasification is a priority. Roads are being built which are crucial for development of Azerbaijan as an E-W and N-S transport corridor, internal connectivity and development of regions. Irrigation investments are necessary for supporting farmers and using water efficiently. Improvement of social infrastructure will continue. The level of tariffs is mixed – for water they have been raised to 87 percent of cost-recovery but in solid waste tariffs and collection rates remain quite low. A Tariff Council has been created to guide rates and promote further moves towards commercialization.

- <u>Support to Business.</u> The Government recognizes the need to help local businesses, and not to interfere with their activities. The President has made a strong statement for Government agencies to stop unnecessary inspections. At the same time, the Government would welcome more involvement of businesses to support social and regional initiatives more actively.

- <u>Agriculture.</u> Agriculture is seen as a priority, particularly in the context of food security but also to help increase employment and trade. The State Program for Agriculture (2008-2015) recognizes the importance of rehabilitation of irrigation networks; development of food processing enterprises; private sector involvement in meat and milk processing; expansion of lending resources; and creation of a research center. The Government is also preparing or reviewing laws on extension and veterinary services.

- <u>Industry and Exports.</u> The Government is determined to facilitate modernization of its industrial base. It expects to help support new industrial facilities in the next 2-3 years that will help create jobs. This will be further strengthened with the help of a new non-oil export development strategy.

- <u>Environment.</u> The Government's Environment State Program 2006-2010 (ESP) committed to improve the environment, including investing in a large number of environmental cleanup operations given the huge legacy of environmental degradation, land rehabilitation activities and protection of environment resources – though implementation has lagged.

- Regional Development. Regional development is focused on strengthening the productive potential of the regions in non-oil sectors (such as agriculture and tourism) and improving the living conditions to ease the pressure on migration to Baku.

27. **Government strategies also point to Azerbaijan's vision for building its human capacity and social services.** The Government views the state as having a central role in providing social services to its citizens. The Government is proud of its social programs aimed at reducing poverty by targeted social assistance, and by improving infrastructure in education and health. Nevertheless, the Government has tended to focus more on building physical infrastructure (schools, hospitals) rather than building institutions and improving the quality of professional staff. On IDPs, the Government has provided significant direct financial and housing support, but has also sought to keep them together as a group with the expectation of their eventual return.

- Education. The Government seeks both to decentralize budgetary spending and decision-making to the community level, while ensuring an objective availability of central budgetary resources. The Government strategy also includes basic education teacher training and curricula reform. While there is an Education State Program 2009-2013, the country lacks a longer term strategy, particularly for higher education and innovation

- Health. The Government has begun a process to rationalize its health care delivery system. It includes developing treatment protocols, training of personnel, and a licensing system for physicians. A state program on maternal and child health established a priority on vaccinations and better pre-natal care. A "Health Electronic Card" program is being implemented to better coordinate the flow of health information. A strategy for health financing and insurance is being developed but has not yet been adopted.

- Social Protection. The Government has implemented a well targeted social protection policy. Azerbaijan has also put the creation of increased work opportunities at the core of its labor policy.

- IDPs. Until now, assistance to IDPs has been mostly focused on improving elementary living conditions (moving the last IDPs from temporary tents was accomplished only last year) and securing daily needs by financial and in-kind subsidies. The next step is to provide training and opportunity to IDPs for more active participation in the labor market and self-reliance.

B. Key Economic and Social Priorities

(i) Economic Competitiveness

28. **Macroeconomic stability must be the foundation for sustainable growth**. At the moment, the overall macro-economic situation is stable, with high growth rates, low debt levels, and an accumulating oil fund which should reach about $20 billion by the end of 2010. However, as noted earlier, Azerbaijan is reaching the limit of its oil based GDP growth, though growth from the gas sector may postpone the decline for a few years. Macroeconomic policies that seek to enhance the competitiveness of the economy will be necessary. Maintaining a well run Oil Fund that withstands pressures to transfer excessive funding to the budget will also be necessary.

29. **An important challenge in macro-stability is to contain Dutch Disease.** Large inflows of foreign exchange from natural resource revenues have driven up the real exchange rate which together with structural impediments have rendering non-commodity exports less competitive. To contain this

will require a multi-faceted approach. The first prong of a containment strategy would be to manage entering of revenues to the domestic economy. Azerbaijan's Oil Fund is playing a central role in this, and has accumulated about half of Azerbaijan's fiscal revenues from oil to date. The second prong of the strategy would be to maintain fiscal prudence through clear rules on spending oil revenues and a strengthened MTEF.[5] The third prong is to maintain a flexible exchange rate and an open trade regime. Unfortunately, Azerbaijan's cross-border policies have pushed it to a low rank in the *Doing Business* Trade Facilitation Index. The fourth prong would be to accelerate structural reforms and infrastructure to improve productivity and allow the private sector to respond easily to market forces.

30. **Fiscal prudence is particularly important given Azerbaijan's oil and gas revenue profile**. Azerbaijan is likely to see fiscal surpluses in the near term while oil production is on a plateau (i.e. 2010-2015, chart 2) and maybe a few years subsequently as fiscal revenues from gas materialize. However, in the medium term, fiscal revenues from oil and gas are expected to decline significantly in nominal terms and as a percent of non-oil GDP, suggesting that the country may experience a severe fiscal adjustment at the end of its oil and gas boom, which could then be mitigated with resources saved in the Oil Fund during boom times. The Bank estimates that Azerbaijan is overspending relative to a "permanent income" approach (reflected in the country's Long Term Oil Revenue Management Strategy). Azerbaijan will continue to have the capacity to support priority infrastructure and social needs; and indeed these investments will be important to enhance competitiveness. But this will need to be accomplished in the context of careful investment review and prioritization so as not to exceed prudent overall spending limits.

31. **There is also room for greater efficiency in the use of public funds**. The 2008 Public Expenditure and Financial Accountability (PEFA) report rated Azerbaijan's system quite high in the implementation of budgetary expenditures, but found it wanting in the practices surrounding prioritization and medium-term investment budgeting. In particular, the expenditure management system needs strengthening. The budgetary planning process with a budgeting framework that sets the medium-term resources envelopes (ceilings) at the sector and agency levels is still not fully operational. Azerbaijan's Treasury Information Management System (TIMS) is still in its roll-out phase and its investment appraisal system is still under design. The PEFA also identified weakness in accounting and auditing capacity, particularly in the light of the Governments objective to introduce international financial accounting standards. The 2008 Country Procurement Assessment Report (CPAR) found the public procurement system leaves too much room for discretion regarding the use of restrictive procurement practices and limitation of bidders. The CPAR also pointed to the need to improve organizational and decision-making processes, strengthen oversight and develop standard documentation. Improved financial control and audit systems throughout the government would give greater assurance of efficiency. Making basic budgetary data available to the public would strengthen transparency and accountability.

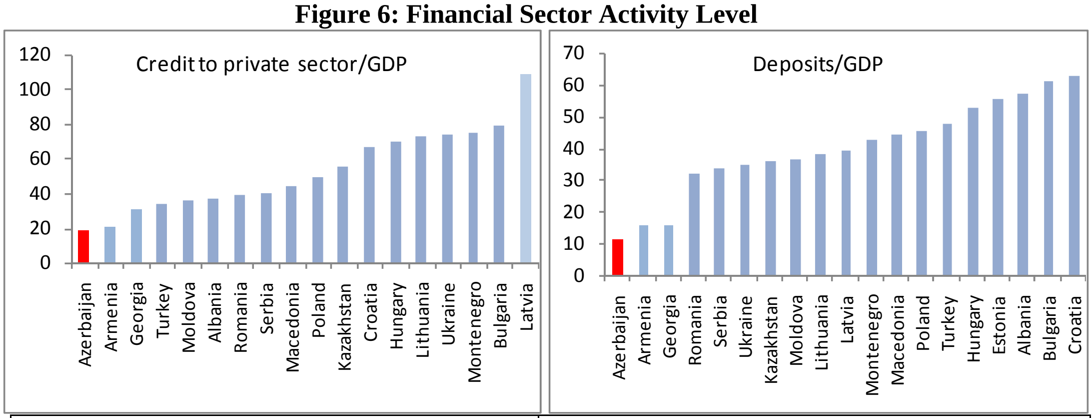
32. **Greater transparency and efficiency in State Owned Enterprises (SOEs) are also needed to avoid budgetary drain**. Azerbaijan is making some progress in converting SOEs to joint stock companies and commercializing them (for example, AzerRail), while raising utility tariffs to near market rates to ensure these companies can run with a minimum of budgetary support. New legislation provides that all new State debt and guarantees, including those through SOEs, must be approved by Parliament and disclosed in the budget. Progress is also underway in shifting SOEs towards the use of international accounting principles—and these should also be matched by introducing international auditing practices.

[5] In preparation for the oil boom, the government adopted the principle of "constant real spending" out of oil revenues in its Long-term Oil Revenue Management Strategy (LTORMS), but this was not fully implemented. From 2005-2008, Azerbaijan increased its budget by about 40 percent per year. While this increase in budgetary spending fueled growth in construction and non-tradeable sectors, it also contributed to reducing the competitiveness of tradable goods. Exchange rate appreciation has also had an impact on competitiveness.

There also remain considerable inter-SOE debt and non-commercial practices in many SOEs. In 2009, the Government needed to provide emergency liquidity support for SOCAR and other SOEs. Greater efficiency in public spending will also therefore require a focus on SOEs, including the potential to move towards privatization if consensus can be reached that this is an appropriate mechanism to enhance efficiency.

33. **The Azerbaijan financial sector has weathered the global financial crisis to date but remains underdeveloped**. Non-performing loans (NPLs) rose modestly to 6.1 percent in 2009 from 4.5 percent in 2008. The Central Bank of Azerbaijan (CBA) has reacted to the crisis by strengthening financial reporting and bank supervision, raising the deposit insurance coverage, and implementing a three year tax abatement to support capitalization of banks. Nevertheless, the banking system is significantly constrained in its ability to mobilize local deposits and support growth of the non-oil sector. Azerbaijan's credit to private sector/GDP ratio and deposit to GDP ratio are among the lowest in the region (see charts below).

Figure 6: Financial Sector Activity Level



Source: IMF, International Financial Statistics.	*Source: IMF, International Financial Statistics.*

34. **A key constraint in balancing of the banking sector is** a single public-owned bank (International Bank of Azerbaijan) which controls 44 percent of banking assets, while at the same time fragmentation of other banks (of the 45 other banks, none have a share above 5%). The overwhelming market dominance of IBA coupled with its governance, credit and liquidity pressures pose crucial concerns for financial stability as well as competition. Access to credit, particularly by SMEs, is constrained. High interest rates (in the 20-30% range) and collateral requirements also do not favor SMEs. More strategically, Azerbaijan should rebalance the banking sector to lower the level of concentration and encourage stronger commercial banks. Capacity constraints within the CBA also reduce the effectiveness of its supervisory and enforcement abilities. There is also the need to ensure a well working collateral system.

35. **Given constraints on banking, developing the non-banking financial markets and capital markets increases in importance.** Consistent with most small emerging markets, Azerbaijan's financial intermediation is virtually all provided through the banking sector; however, it is not well placed to support the medium term growth of the non-oil economy. The leasing and insurance markets are still relatively small and there is a need to deepen domestic capital markets as well. Recognizing this, development of the securities market is a priority area through, *inter alia*, strengthening the legal and regulatory framework, and improving the capacity of the regulatory body and underlying trading architecture. This will help to stimulate enterprises to tap sources of finance directly from the capital markets, and provide investors new opportunities and improve the resiliency of the financial system

(banking, insurance, securities and micro-finance). Development of the public and private pension funds is another area of possible focus.

36. **The business environment requires a mix of "basic and second generation" reforms.** The government recently stepped up its efforts to improve the regulatory environment for business, including relaxing the rules for starting small and medium businesses and creating a "one-stop window" for registrations. Azerbaijan's ranking improved from 97th to 38th among 158 countries, between the *Doing Business 2008* and *2010* surveys. A presidential decree on April 13, 2010 instructed the Cabinet of Ministers to prepare recommendations for unified regulations of inspections and inspections registry (at the Ministry of Justice). Azerbaijan's progress in three areas—approval of construction licenses, trading across borders and, to a lesser degree, payment of taxes—significantly lags other countries. This finding confirms views from firms about high transaction costs resulting from informal barriers to business operations in respect of licenses, customs clearances and tax inspections. Also, in some cases de facto arrangements have lagged legal reforms. Greater access by SMEs to credit (as noted above) is also needed.

37. **Trade facilitation.** If Azerbaijan is to be a transit hub, its trade and custom facilitation processes have to be comparable with the best. Currently it ranks at the very bottom in trading across borders in the *Doing Business 2010* report. The weaknesses are many: in addition to generally high costs in terms of both time and money for imports and exports, there is differential treatment of enterprises in customs processing as well as in formal and informal charges. The scope for collusion between some importers and customs officials is considerable. This is evident from the fact that similar import consignments obtain different duty rates and different regulatory treatment, which distort competition in domestic markets for the same imports. Also, the processes for clearing consignments are out-dated. There is no use of more modern risk-based inspections, where only a share of consignments would be inspected depending upon their risk profile. Azerbaijan undertakes measures to adress obstacles to trade. A "one-stop shop" principle for crossing the border has been introduced from January 1, 2009. Veterinary, phitosanitary and sanitary control measures, as well as the posts established for issuance of permission forms to international cargo vehicles were cancelled. Also, the number of documents and procedures necessary during offiialization of foreign trade operations were reduced. Azerbaijan remains one of the few countries in the world that has not yet acceded to the WTO. Accession would help to resist protectionist pressures and convey policy reliability to both domestic and external investors.

38. **Rural Development** The agro-food industries and primary agricultural production are key components of Azerbaijan's non-oil economy. Although its share of the country's total export revenues has declined to below 6 percent, the sector is the second-largest exporter after oil and gas with a contribution to total value-added in the non-oil sectors around 40%. Further, it is a key employer of the economy, employing close to 40 percent of the total workforce in full-time or seasonal employment. The growth potential for the sector is considerable on both the domestic and external markets, in particular in fruits, vegetables, and nuts. There have been improvements including establishment of a system of water user associations and improvement in animal health services. However, to meet its potential and improve productivity, the sector faces a number of structural and financial challenges, including:

- Weaknesses in the legal and regulatory system (quality standards, pest management, etc)
- Continuing difficulty in buying, selling and consolidating land
- Poor agricultural and pasture land management practices (landscape degradation)
- Poor state and maintenance of infrastructure (irrigation and drainage and rural roads)
- Weak agricultural research and education system
- Low level of agricultural services (advisory, veterinary, etc.)
- Poorly developed supply chains (storage, grading, cold chain, distribution, etc.)

- Limited access of credit for farmers, and SME modernization and development
- Poor quality or lack of inputs (including seeds, machinery, information)
- Greater risk of variability in the weather and of floods and droughts (due to climate change).

39. **Azerbaijan has developed a power and gas supply system capable of delivering electricity and gas of acceptable quality to almost the entire population.** Recent extensive government investments in the energy generation, transmission and distribution capacities (supported by the World Bank) have resulted in notable improvements in the quality of utility services. Electricity supply has improved along the entire grid, supporting economic activity in the process. Notwithstanding these positive developments, institutional reforms lag behind the improvements in infrastructure. In addition, the energy/gas transmission and distribution networks are still in need of upgrading. Another issue is that Azerbaijan has developed significant power generation capacity which exceeds domestic demand; however, it has experienced difficulties in selling its energy surplus to regional markets. To address these challenges the country needs to modernize utility services further, encourage investments in the transmission and distribution networks and help build regional energy markets.

40. **Continuing improvement of other infrastructure is a priority, including through a strong degree of commercialization.** Azerbaijan's poor quality of public infrastructure, exacerbated by a weak public expenditure framework, has been one of the factors impeding development since the mid-1990s.

- About 45 percent of the main roads are in poor condition. About 45 percent of regional roads are also in poor shape and about 15 percent are in need of immediate repairs. This hampers links between territorial units in a number of regions.
- Similar problems plague the rail sector. Due to deteriorating infrastructure, Azerbaijan Railway (an important export route for oil) is unable to operate at full capacity.
- The reliability of public water supply, although it has improved in recent years in the capital area and the construction of Oguz-Gabala-Baku water supply pipeline for providing Baku with uninterrupted and reliable potable water supply is about to complete, it remains low at 13 hours per day on average, and in many parts of the country outside Baku, people receive as little as three hours of water supply per day.

41. To expedite improvements in network utilities (power, gas, water, fixed-line telecoms), Azerbaijan has sought to fund critical investments from the budget while simultaneously pursuing financial viability through increases in tariffs (in some but not all cases to close to cost recovery levels) and the introduction of metering and billing systems. To strengthen institutions, the government is gradually moving to corporatization and consideration of private participation. It will be critical to continue and deepen these efforts. As investments go forward, it will be important to match these with improvements in information systems and maintenance practices to ensure the sustainability of investment returns.

42. **Environment.** The troubled state of the environment in Azerbaijan has been well recognized in Government and donor development strategies and priorities, and is largely a legacy issue. The broad concerns range from impacts of oil production on the Caspian Sea and coastal lands; discharge of untreated contaminated water; solid waste and radioactive waste; and pressures from urban sprawl and deterioration of natural resources. Particularly, the Absheron peninsula is a serious concern due to pollution accumulated in the course of nearly 150 years of oil production. Policy, institutional, and political economy issues remain key barriers to making progress. Despite the Government program and the declaration of 2010 as the year of the environment, much needs to be done.

(ii) Building Human Capital

43. **Reforms in primary and secondary education reforms need to be continued.** Primary enrollment rates are over 90 percent but the quality of basic education needs improvement. The PISA 2006 results rank Azerbaijan among the lowest of all 57 participant countries. Azerbaijan did poorly in Reading and Science, though interestingly the Mathematics scores are relatively high. The country took part in PISA 2009, and the results will be released later this year. National assessments in grades 4 and 9 are set to be introduced in 2010 and progress tracked every two years. A pilot new curriculum is under development which should help improve learning outcomes and should be rolled out over the next few years. Azerbaijan has been focused on a number of efficiency initiatives, such as increasing the very low student-teacher ratio, introducing an external rigorous assessment to measure the educational quality for judging the contribution of spending to quality improvement, and raising remuneration levels of teachers based on their performance.

44. **Radical change is needed in tertiary level education, both on enrollment and quality.** The Government faces two critical constraints to further social and economic development: (i) Azerbaijan has among the lowest participation in tertiary education among CIS countries at about 15 percent and (ii) the quality of its tertiary education is not producing the skills needed to support a competitive 21st century economy. The number of university applicants has been rising in the past decade; however the number of admitted students has been stable at 25,000-30,000 each year. The Government controls the size of enrollments, including the number of private university students. This tight control prevents institutional agility, quick development of new institutions and stifles innovation. Many courses are excessively theoretical, outdated, and not responsive to changing labor market needs. Reform will require increased merit based access to universities, greater independence of the education institutions, support for the private provision of education services, more accountability in education institutions and of professors, and stronger relationships with businesses, ensuring that curricula respond directly to market needs. A stronger quality assurance system and improved testing information can provide rigor.

45. **Healthcare is being rationalized and rehabilitated.** Health service delivery is characterized by extensive infrastructure with an emphasis on hospital facilities. New facilities have been built in several regions, but the quality of provided services and the level of the health personnel skills need to be improved. Access to health facilities and health personnel is almost universal, although most are skewed towards urban areas, creating difficult access for rural and remote communities. New quality standards for health facilities and clinical standards and protocols have been recently adopted and the MOH is developing mechanisms to introduce testing and certification of health personnel. Public expenditures on health have increased considerably during the last five years (though it remains low as a percent of GDP compared with other CIS countries). At the same time, access to essential medicines remains low (though improving), and this has contributed to keeping the level of out-of-pocket health expenditures high (see Box 2). Increased opportunities for public/private partnerships in health care provision should be considered.

46. **Progress has been good on social assistance.** Currently, the targeted social assistance program (TSA) supported by the Bank reaches about 50 percent of the very poor which is good compared to other CIS countries. At the same time, there is room for improvement of targeting mechanisms, updating the TSA law and additional training to further increase the coverage of the very poor to over 70 percent. Social care services to vulnerable groups (elderly, disabled, single mothers etc) need to be broadened and improved despite some 1500 social workers already providing the services. Moreover, more effective programs for providing people with opportunities to enter the labor market are needed. Professional and vocational education centers that offer opportunities to upgrade skills need to be improved through strengthened infrastructure and standards in order to better meet labor market requirements. These objectives should be pursued within a client centered framework that links employment services with the targeted social assistance mechanism.

Box 2: Out-of-pocket expenditures in Azerbaijan

The Government of Azerbaijan deserves credit for increasing public expenditures for health seven fold from 2002 to 2008. As a result, Out-Of-Pocket (OOP) health expenses have fallen from 79% to 52%. Nevertheless, at 52% OOP payments are still too high. Recent studies that look at the impact of OOP on households indicate that the impoverishing effect of OOP payments in Azerbaijan is very high (World Bank, 2007 and 2009). Evidence indicates that a large share of OOP is spent on pharmaceuticals, which often price out the poor. Further, large OOP expenditures may cause households to delay or forego care that would otherwise improve health and welfare, or lead to impoverishment in the event of ill health. As a result, a large share of households in Azerbaijan which fall below the poverty line do so because of high OOP health expenditures. It is estimated that the poverty headcount increases by about 7 percentage points after taking OOP expenses into account.

These findings suggest that notwithstanding the large increases in health expenditures, there is an important policy agenda to reduce OOP expenditures. OOP expenditures can be improved by either *prepayment or insurance*, as well as by scaling payments more *progressively* to patients' ability to pay. This has implications for the design of a basic benefits package, investments in health facilities, ways of providing financial protection against high OOP health payments, and the level and targeting of government health expenditures.

47. **IDPs remain displaced twenty years after the conflict, and their living conditions are far below those of the local population**. Infrastructure remains poor in IDP settlements. Most IDPs are dependent on the state for support and have limited opportunities for jobs, particularly those in rural communities. Further, governance and social accountability in IDP settlements is weak, with limited involvement of community members in their own development. The challenge will be to resettle IDPs into more permanent accommodations, provide improved infrastructure services, and involve IDPs in developing sustainable livelihoods beyond state support. The 2010 budget allocated substantial 182 million manats for settlement of refugees and IDPs.

III. The World Bank Group's Strategy

A. Implementation of the Last CPS

48. **The FY07-10 CPS was prepared at the start of the oil boom**. Growth in the years immediately preceding the CPS was robust, and even higher growth rates were anticipated with the coming on stream of several new oil and gas fields and the BTC pipeline in 2006. The Government saw this as an

opportunity to accelerate development and achieve the Millennium Development Goals as soon as possible, particularly given the temporary nature of this income. These ambitious goals were laid out in its PRSP. It viewed the Bank as a reliable partner that could help prioritize increased investments as well as ensure that they were carried out with adequate fiduciary oversight.

49. **The level of Bank support was ramped up dramatically in tandem with the Government's desire to accelerate development and its increased creditworthiness**. Up to FY05, Azerbaijan was an IDA-only country, receiving about $50-75 million per year. In FY05, Azerbaijan was declared creditworthy for IBRD lending, but IBRD lending was limited to two loans in FY05-06. The total amount of lending envisaged in the FY07-10 CPS was increased significantly to about $1.2 billion over four years (IDA plus IBRD). Further, the Government indicated its intention to provide 20-50 percent in cofinancing on Bank lending. Just a year into the FY07-10 CPS, many loans were larger than anticipated and the Bank had lent the full amount authorized. As a result, the Government requested a further increase in the lending envelope to support its ambitious development plans, and the amount was ramped up to $2.4 billion under the CPS Progress Report. However, this proved too ambitious and in the end, the Bank extended only $1.6 billion during the CPS period.

50. **The instruments envisaged were investment and technical assistance operations, as well as IFC investment and advisory services**. While there were relatively good results from the Bank's Development Policy Operations, given the lack of budgetary need, no further policy operation was envisaged during the CPS period. Rather, regular policy dialogue on key reforms was envisaged based on analytic work as well as monitoring under the CPIA. The danger of overheating the economy was recognized but it was felt that our public expenditure dialogue plus the well functioning Oil Fund (established with the help of the Bank) would help to prioritize expenditures and channel excess funds for future generations. Portfolio risk was also recognized but at the time, there were not significant portfolio issues and the disbursement ratio was reasonably strong at 20 percent.

51. **The focus of the CPS was quite broad, covering four pillars**: (i) *improving public sector governance* (including public expenditures, accounting, the business environment and the judiciary), (ii) *supporting growth of the non-oil economy* (including access to financial services, SME support, rural infrastructure , transport, energy and water infrastructure), (iii) *increasing the quality of and access to social services* (including health care, education, social assistance, and improving the living conditions of IDPs) and (iv) *improving environmental management* (including cleaning up legacy pollution, supporting biodiversity and natural resource management, and disaster management). Governance was a cross-cutting theme.

Results

52. **Overall country-level results during the CPS period were mixed.** As noted, growth rates were in the 20-30 percent range and poverty levels fell dramatically, from close to 50 percent to about 16 percent in 2008. Non-oil growth was also very high, though much of this is indirectly linked to oil production. Progress has also continued to be made towards most of the Millennium Development Goals (MDGs – See Annex 5). However, progress on overall policy reform and institutional deepening was more mixed. The CPS set out to monitor this through the CPIA ratings, but only about half of the targets on these were met. The greatest progress was against the overall macro-economic framework, meeting social needs, and improving rural and community infrastructure services. Health care and basic education services have improved and the social assistance program is increasingly well targeted. Reform progress was weakest in the areas of public expenditures, transparency and governance, and the environment. Overall, the perception of corruption in Azerbaijan continues to remain high. Though it should be noted that Azerbaijan has made the important achievement of becoming the first EITI compliant country.

53. **The design of the CPS as regards the specific activities and goals it supported proved to be overly ambitious.** The CPS as originally designed was consistent with the Government's strategy and built on the substantial results achieved in the previous CAS period, including a reasonably well performing portfolio and steady progress by the Government on structural reforms. However, it proved overly ambitious in two key ways: First, the Bank knew from experience elsewhere that reform progress often slows in situations of rapid income growth. Without a development policy operation or a clear replacement to anchor policy reforms, the policy dialogue was unable to make significant progress during the CPS period in several key areas such as public expenditures and certain elements of the business environment. Second, the ramp up of lending overwhelmed implementation capacity. Some projects were brought to the Board without meeting readiness conditions and implementation was protracted. The Bank took corrective action on both accounts during the second half of the CPS, including by (i) holding a High Level Policy Forum to help galvanize decision makers on key reforms needed, (ii) conducting a Joint Portfolio Review which brought high level attention to problem projects and established a Working Group representing key Ministries to maintain and elevate such attention, and (iii) slowing new lending and placing greater attention to readiness at entry.

54. **As a result, achievements as measured against CPS results targets were measured as moderately unsatisfactory according to the CPS Completion Report.** The best results came from smaller operations in community development, where lending to rural and IDP communities have continued to help improve people's lives. Good results were also achieved in the social protection areas, and to a lesser extent in health and education where reforms and improved infrastructure have been slow but steady. Progress has also been achieved in rural development, including irrigation, avian influenza control and agriculture credit. More mixed results were seen in the larger infrastructure projects – Highways, Water, and Rail – where implementation has been delayed but are on track to deliver results largely during the coming CPS period. The poorest results were seen in the public expenditure, governance and environmental areas where little progress has been made. The area of environment is particularly disappointing given the importance of making progress in cleaning up legacy issues in the Absheron Peninsula. In light of the difficulty in getting agreement with the Government on the way forward, two of the three loans in this regard were withdrawn in FY10 before becoming effective.

55. **IFC was relatively more successful than the Bank, committing $133 million in 20 projects from FY07 to date.** IFC saw steady growth in its investment portfolio reflecting strong economic growth, and increased human resources dedicated to Azerbaijan through its special initiative for Central Asia and Azerbaijan. Notably, all of this investment was outside of the oil and gas sectors supporting the non-oil economy, mainly through financial intermediaries, primarily banks. This represented a significant shift for IFC. In the prior five years (FY02-06) approved investments outside the oil and gas sector were $5 million or less per year. IFC's outstanding portfolio currently totals $102 million with 59% of this in financial institutions, 22% in the oil and gas sector, and 19% in the real sectors (primarily retail). This growing portfolio is generally performing well even through the crisis, although the level of risk in some of its bank exposures has increased, and one of its investments has started experiencing problems in 2010. IFC also increased advisory activities in investment climate, access to finance, and corporate governance, with some successful legislative and regulatory interventions, improvements made to individual FIs and real sector clients, and public awareness initiatives.

Key Lessons and Recommendations

56. Based on the CPSCR, the following key lessons can be learned from the implementation of the FY07-10 CPS:

- **Increase the focus on implementation**. The Bank should increase its attention to implementation of existing operations, and focus primarily on achieving results under existing operations. Where implementation is substantially stalled, the Bank and the Government should consider cancelling operations in order to better focus on those operations where success can be achieved more quickly.

- **Be more selective in new operations**. The Bank should try to narrow the focus of its activities, based on Government commitment and Bank experience. This will mean deepening project engagement in those areas where success has been achieved, and focusing on those areas of development priority, strong Government demand, and clear Bank comparative advantage. At the same time, the Bank should not shy away from playing an advocacy role in other areas where there is a high development need and Bank comparative advantage, but limited Government ownership.

- **Apply a stronger readiness filter for new operations**. In the previous CPS, a number of projects were brought to the Board where procurement and institutional arrangements were not fully developed. As a consequence, these operations were unable to disburse for 18 months and two had to be withdrawn. This wastes precious time, budget and focus. For the new CPS, project implementation arrangements should be more fully advanced before taking loans to the Board.

- **Rebalance Bank activities towards more concrete mechanisms for knowledge sharing and policy dialogue**. It may be useful to consider more concrete mechanisms for carrying the policy dialogue forward, including increased use of analytic work to underpin new lending and potentially some policy-based lending. The high level policy forum in 2009 yielded promising results and may also provide a mechanism to enhance dialogue.

57. **In addition, a FY10 Bank internal review echoed some of these lessons on implementation for the Bank's program in Azerbaijan**: (i) *Do not underestimate risks*--The sharp increase in lending did not adequately recognize the risks in low absorptive capacity and non-transparent decision-making, (ii) *Ensure readiness for disbursement*--While cutting preparation times, many projects did not have fully developed procurement and policy agreements. Inadequate preparation and lack of ownership have led to slow disbursements, (iii) *Strengthen portfolio monitoring*-- The Bank should provide increased support to country efforts at portfolio monitoring and coordination, and (iv) *Focus management attention early on project issues* –Bank management should be persistent in including implementation issues in its dialogue: in the absence of results on specific projects, restructuring and cancellation should be pursued.

B. The New Country Partnership Strategy for FY11-14

58. **The design of the CPS reflects the key challenges facing Azerbaijan in the medium term.** It is tightly focused on achieving results in two key pillars: (i) building a competitive non-oil sector and (ii) strengthening human and social services. These two pillars constitute independent developmental objectives but, at the same time, they are mutually re-enforcing. Further, a key lesson from the last CPS is that public investments grew faster than institutional capacity could improve thus resulting in opportunities for rent seeking and slowing implementation. Therefore, a cross-cutting filter for all activities will be improving governance and institution-building, without which it will be difficult to achieve sustainable results.

59. **How the strategy will be implemented is just as important as the focus areas**. The previous CPS also focused on priority areas for Azerbaijan, but did not achieve adequate traction. In light of this experience, the new CPS will focus in the first instance on implementation of the large existing Bank portfolio, including faster disbursements but also restructuring and closing projects when needed. New operations will be calibrated against existing operational progress. Because of this, most of the Bank's results objectives will be based on existing operations. Second, more attention will be paid to building

analytic knowledge and strategies in particular sectors in order to ensure that there is an agreed approach before launching operations. Third, a more structured approach towards policy dialogue will be sought through several vehicles – a regular high level forum focusing key policy makers on developing a shared reform agenda, a potential joint economic research program between the Government and the World Bank, continued close cooperation between the Bank and IFC on policy advice to the Government related to the private and financial sectors, and exploring a possible development policy operation to help support reform implementation.

60. **IFC and the Bank will play complementary roles** whereby IFC's advisory and financial services for private sector's benefit will reinforce the Bank's lending and AAA in the public sector. IFC will support the private sector to address CPS objectives, namely (1) building a competitive economy through greater access to finance and an improved business climate, (2) strengthening human and social capital through possible support to private sector participation in addressing issues such as provision of health care services, infrastructure, and possibly energy efficiency, and (3) improved governance and institution-building through the promotion of transparent business practices and capacity building for financial institutions and agencies key to private sector development.

Strategic Objective 1: Building a Competitive Non-Oil Economy

Results area 1: Enhancing macro-economic stability and growth policies

- Outcome 1: Prudent macroeconomic and fiscal management
- Outcome 2: Improved trade policy and institutions
- Outcome 3: Sustained improvements in business environment
- Outcome 4: More transparency and efficiency in public institutions

61. **Prudent macroeconomic and fiscal management.** In light of the leveling off of oil and gas revenues, the key element of macroeconomic management will be to help Azerbaijan keep its expenditure levels in line with sustainable income expectations. This will also provide an incentive to prioritize public investments, contain inflation, and avoid crowding out the private sector. The key indicator will therefore be the reduction in non-oil deficit as a percent of non-oil GDP. The goal by the end of the CPS period will be to reduce that.[6] The primary instrument will be the *programmatic public expenditure review*, which will focus on improving the use of medium term planning (MTEF) and sustainable recurrent cost financing. This would be combined with other instruments to make our overall policy dialogue more concrete (regular high level *policy forums*, exploring the potential for a *DPO* series as well as a *Joint Economic Research Program – JERP –* and possibly *IFC advisory services* to increase the ease of paying taxes. These efforts would help, inter alia, by building more effective inter-agency coordination on macro-policy. The Bank's Treasury Department will continue to provide support to the Oil Fund on *asset management*. Close coordination with the IMF will be essential.

62. **Improved trade policy and institutions.** All studies and practice point to currently restrictive and non-transparent trade policies and institutions as a primary road block to achieving private sector led non-oil growth. Key indicators of success will be growth in the volume of non-oil exports and reduction in time and cost to export and import. An overall measure of progress would be an improvement in the

[6] Fiscal sustainability analysis presented in the Country Economic Memorandum for Azerbaijan (2009) indicates that if Azerbaijan wants to maintain fiscal sustainability, the non-oil deficit should be reduced to about 30 percent of non-oil GDP by the end of the CPS period (2014). At present, the absence of a fiscal rule and of an effective Medium Term Expenditure Framework makes the achievement of this result uncertain.

ease of Border Crossing in Doing Business (2009 Doing Business ranked Azerbaijan 177 out of 183 countries on ease of trading across borders). At the heart of making this happen is a non-oil export strategy by the Government now under preparation. The Bank will provide *analytic support on the export strategy* to ensure it focuses on central policy and institutional issues, and is endorsed with a time bound action plan and success markers. The Bank will also provide longer term *analytic assistance on WTO* to help the Government move forward on WTO accession which will spur increased and open trade. Several of the possible new instruments for policy dialogue (*Policy Forum*, *JERP*, and possibly a *DPO*) may also be utilized to support this outcome. If requested by the Government, IFC could provide complementary *advisory services to improve the ease of trading across borders*. Close coordination with the EU on reforms to enhance trade integration will be pursued.

63. **Sustained improvements in the business environment.** While Azerbaijan has made progress, there are quite a few areas where further significant improvement is possible to increase the ease of doing business and access to finance. The overall benefit of these improvements will be measured through various surveys (BEEPS, Doing Business, IFC SME survey etc). More specifically, in addition to improvements in tax and customs (see above), the following targets will be supported and monitored: (i) a significant reduction in land registration processing time, (ii) increase in the use of mortgages to finance investments, (iii) development of the domestic capital markets, and (iv) the number of micro and SME loans made through IFC-supported banks, and (iv) further progress in streamlining permits and inspections. The Bank will support these efforts through the ongoing *Real Estate Registration Project*, and the proposed new *Capital Markets Modernization Project*. The latter will be particularly important in promoting corporate transparency and providing new avenues for financing enterprises and supporting non-oil growth, given the weaknesses in the banking sector. The Bank will also maintain a *regular technical assessment and policy dialogue* with the CBA and other financial sector institutions, funded in part through the FIRST initiative. Several of the possible new instruments for policy dialogue (*Policy Forum*, *JERP*, and possibly a *DPO*) may also be utilized to support this outcome. The *CAPSAP project* will address weak financial reporting practices and underdeveloped audit profession to strengthen the business environment for SMEs. IFC will continue to provide *financing to SMEs*, in particular through financial institutions. It will also continue to provide *investment climate advisory work* to reduce regulatory burden on businesses, *corporate governance advisory services*, and *financial infrastructure advisory services* (credit information sharing and secured lending). SECO will remain a key IFC and Bank partner in this area.

64. **More transparency and efficiency in public institutions.** Greater transparency and efficiency in public institutions will reduce the opportunities for rent seeking, enable the Government to operate effectively within a tighter fiscal budget, and strengthen market based approaches. Key goals during the CPS period will be (i) greater utilization of the MTEF in budget formulation and the provision of a budget summary to the public, (ii) an increase in the number of public investment projects prepared on the basis of rate of return criteria, (iii) an increase in the number of SOEs and agencies using international financial standards, (iv) and an increase in user satisfaction of the courts, (v) more effective use of public procurement, and (vi) strengthen the capacity of the Chamber of Accounts to conduct ISA based audits. The Bank will support these goals directly through the ongoing *Public Investment Capacity Building Project*, *Judicial Project*, and *Corporate and Public Sector Accountability Project* and indirectly through other projects working through SOEs. Analytic work on budget transparency will be supported through the annual *Public Expenditure Review*, follow-up to the *Country Procurement Assessment Report*, and analytic work on helping the Government develop a market based *SOE strategy*. IFC, through its *Investment Climate Advisory* activities will help to improve the private sector awareness of regulatory processes and increase transparency through an *updated SME survey* and capacity building with the Government on surveys related to government services, for example a tax client survey currently being launched. A new *ROSC* may be considered in the outer years to measure progress in the area of Accounting and Audit development.

Results area 2: Upgrading Key Growth Supporting Infrastructure

- Outcome 1: Transport time and vehicle operating costs reduced
- Outcome 2: Improved agriculture and irrigation services

65. **Transport time and vehicle operating costs reduced.** Improved transportation is a central part of Azerbaijan's effort for non-oil growth since it will help to (i) strengthen inter-country linkages, (ii) provide greater export market access to local producers and (iii) build Azerbaijan's role as a regional East-West and North-South transit corridor. The overall goal is to upgrade highway and so reduce road user cost on the sections supported by Bank operations. For Railways, the goal is to purchase new locomotives and rehabilitate rail track so as to reduce the East-West transit time. With Bank support, the Government would seek to increase the volume of rail transit traffic (from 11 million tons to 23 million tons) and improve locomotive reliability. Bank supported activities include the ongoing *Highways 2 and 3* and *Railway Projects*, combined with a regional *Transport Sustainability Review*, a *Transport Sector Review*, and an *IDF grant for transport quality enhancement*. Dependent on implementation progress under Highways 2 and 3, an additional new *Highways 4 project* and a *regional life-line roads project* could be considered. IFC is looking into possible *investments in private logistics companies* and/or investment support to *private participation in transport infrastructure*. A key partner will be the ADB which is also providing significant transport investment to Azerbaijan.

66. **Improved agriculture and irrigation services.** Agriculture in Azerbaijan, with its myriad of micro-climates and close access to both Europe and Asia, holds great economic potential. Rural areas are also where most of the poor live and providing greater incomes in rural areas would help stem migration towards already crowded urban areas. The goal would be to continue to increase productivity and income levels of participating farmers under Bank projects. Irrigation services would also be strengthened (the volume of irrigation water would be increased from two irrigations to four irrigations per season). Water User Associations would continue to be expanded and strengthened. The Bank would support these efforts through its ongoing *Agriculture Development and Credit Project (ADCP) 2*, a follow up *ADCP3*, and a new Irrigation Project (*Irrigation II*). The Bank would support these projects with increase analytic work – an *Agriculture and Irrigation Sector Update,* and continuing analytic work on related trade issues – quality standards and WTO access. IFC would consider direct financing of agribusiness or related sectors (e.g. retail, packaging, logistics), as well as indirect support through financial institutions, and may also consider launching advisory services that contribute to improved competitiveness of the sector, for example in areas such as food safety standards and/or agrifinance.

Strategic Objective 2: Strengthening Social and Municipal Services

Results Area 3: Improving Social Services

- Outcome 1: Strengthened social protection and employment services
- Outcome 2: Wider access to health services
- Outcome 3: Improved quality of basic and higher education
- Outcome 4: Improved living conditions for IDPs
- Outcome 5: Improved road safety

67. **Strengthened social protection and employment services.** The Government has already made major progress in establishing a user-friendly targeted social protection system. At the same time, further improvements are needed in the social protection system, particularly to ensure that the coverage of social assistance for the very poor. In addition, the matching process between those seeking employment and businesses in need of staff is not functioning well. It would be helpful to ensure that the employment services be able to reach and serve a larger number of job seekers. If more job seekers can be helped, this will both help to focus social assistance on those that need it most, and facilitate business growth. The main mechanism the Bank has for pursuing this is the ongoing *Social Protection Project*. This will also be complemented by analytic support through the *Programmatic Poverty Assessment.*

68. **Wider access to health services**. Key health indicators have improved but more progress is needed if the MDG targets are to be met, particularly to address the growth of drug resistant TB. In order to do so, the Government is currently expanding and upgrading health facilities and improving health care organization and delivery of services with Bank support. The Bank is also supporting the Government in building an effective health strategy which would among other things help to make the sector more efficient and effective. However, the Government needs to continue to increase public health spending to reduce out of pocket expenses for the population, particularly to ensure a sustainable supply of essential medicines. Key goals would be the further improvement in health indicators in supported regions and the adaptation of an effective health strategy that would start to reduce out of pocket expenses. The main mechanism the Bank has to support these activities is the ongoing *Health Sector Reform Project*. Depending on market developments, IFC will also consider *possible investments in private health care services*.

69. **Improved quality of basic and higher education.** Popular access to basic education is not the issue. Rather there is a need to improve the quality and cost effectiveness of basic education. The Government has launched with Bank support reform in the basic education system, including curricula reform and streamlining the number of schools. In turn the success of these efforts would be measured against improvements in basic educational outcomes. As regards higher education, there is significant room for improvement both in the percent of population who go on to tertiary education and the quality of tertiary education. Ultimately, Azerbaijan needs a highly skilled workforce if it is to be competitive internationally. These reforms are therefore important not just for social reasons but to improve Azerbaijan’s overall competitiveness. The Bank will support efforts in basic education through its ongoing *Education APL2*. The Bank will complement this with an *Education Strategy*, covering both basic and higher education. If agreement can be reached on an effective higher education strategy, the Bank will provide financing for a *Higher Education Project* in support of this.

70. **Improved living conditions for IDPs.** Up to 900,000 or so IDPs (10 percent of the population) remain relatively poorly integrated into society and rely heavily on Government assistance. This is a large source of human capital that is not being effectively utilized. The need is to both improve the living conditions of the IDPs while strengthening their ability to generate their own livelihoods. Success in this area would be measured through the number of micro-projects that meet IDP community needs and if the number of IDPs generating self-reliant income can be increased. The main mechanisms for this are the *ongoing IDP project* and a proposed follow-on *IDP II Project*. The Bank would also support *analytic work on IDPs* during the CPS period to further determine how best to provide services and integrate them into society. Issues would also be tracked and analyzed in the *programmatic poverty assessment*.

71. **Improved road safety**. Azerbaijan has a high level of road traffic injuries and fatalities even by ECA standards. As Azerbaijan improves its road network, added efforts are needed to strengthen road safety systems, enforce existing laws and regulations and educate the population to prevent risky road behavior and protect pedestrians. The goal is to help Azerbaijan effectively implement a Traffic Safety Strategy and reduce road injuries. To this end, the Bank is providing support under the *Highway 2*

project to implement this strategy on the entire road network and to decrease the fatalities rate on the portion of the network being rehabilitated.

Results area 4: Improved municipal and rural services

- Outcome 1: More reliable water supply and sanitation
- Outcome 2: Improved reliability of solid waste management services
- Outcome 3: Improved access to rural infrastructure

72. **More reliable water supply and sanitation.** The Government has established the provision of reliable water and sanitation as a priority for the country. The World Bank, the ADB, KfW, JBIC and the Government itself are all supporting this priority. For the World Bank supported operations, the goal is to increase the number of people with improved water supply and sanitation. A second target would be improving reliability in water supply in the serviced population. The primary vehicle for achieving these results will be the ongoing *National Water Supply Projects 1 and 2.* Depending on implementation performance of these projects, the Bank could consider a follow up project. If there is potential and government support for private sector participation, IFC would consider extending advisory services or investment support, though at the moment no agreement on this exists.

73. **Improved reliability of waste management services.** Azerbaijan faces the need for a major upgrading of its disposal management for both waste water and solid waste. For solid waste, the goal would be to extend waste collection services for the currently un-served population of Greater Baku. This would include the rehabilitation of the largest informal waste dump in Baku. For waste water, the Government is upgrading several water treatment plants and has requested Bank assistance to put into place a mechanism to dispose of this water (after treatment) in an environmentally sound manner. On solid waste management, the primary vehicle for Bank support would be the ongoing *Solid Waste Management Project*. On waste water, a new project is under preparation - *the Hovsan Wastewater Outfall Project*. Follow-on projects could be considered for both activities, dependent on implementation performance. The Bank will invest in analytic work to ensure policy coherence in *solid waste and waste water management*.

74. **Improved access to rural infrastructure.** Comprehensive efforts to support rural communities by identifying and supporting the highest priorities are proven cost-effective methods of supporting local infrastructure. While there are many improvements to be made, one key area is rural roads and it is anticipated that the number of people with improved access to rural roads would increase significantly Rehabilitation of small scale irrigation works is estimated to increase production. Schools' rehabilitation to increase school enrollment in affected remote mountainous communities. Rural infrastructure projects also have a high impact in employment generation. The primary vehicle for achieving these outcomes will be the ongoing *Azerbaijan Rural Investment Project* (AzRIP) and follow-on *additional financing* for this.

75. **Improved environmental and energy planning.** Environmental needs loom large in Azerbaijan. While the importance of addressing these issues is widely recognized, there is not yet an agreed approach and methodological base for decision making. This CPS addresses this gap through investment in analytic work on *prioritizing environmental investments*. Analytic work on climate change would also be carried out built on the initial environmental cooperation with SOCAR currently underway,

and would help inform Bank projects such as irrigation. The Bank would also support the environmental agenda through its water and waste management projects as well as environmental impact assessments under several infrastructure projects. Closely linked to the environmental agenda is the energy agenda. The Bank has just completed support for a power transmission project which is improving efficiency in energy use, and we are also working with SOCAR on gas flaring and utilization options. The Government also took steps towards improving the financial viability and governance in the sector, through increased tariffs and in the case of Azerenerji moving to IFRS for its financial statements. Energy trade and energy efficiency continue to be important areas and the Bank will remain open to exploring ways to advance this agenda during the CPS period. IFC could consider possible advisory and/or investment in financing for energy efficiency improvements building on its experience in other ECA markets and the energy efficiency survey it completed in Azerbaijan in 2009.

Cross-Cutting Filter: Strengthening Governance and Institutions

76. **Within each of the proposed interventions the Bank will aim to help the Government strengthen key policies and institutions.** Azerbaijan cannot achieve sustainable growth or cost-effective service delivery without investing more in improving governance and institutions. Success would be measured against progress in four dimensions, where there are related activities and results targets in each of the main areas of focus.

- **Project Implementation Capacity:** The simplest dimension is the use of internationally accepted practices for accounting, procurement, and environmental assessments. The Government looks to the Bank to ensure that public funds are used in an efficient and effective manner. The Bank will continue to strengthen procurement practices throughout the Government through follow up on the recently prepared Country Procurement Assessment Review (CPAR). Beyond this, the Bank has a wealth of experience in helping the Government to ensure projects have strong Monitoring and Evaluation systems and are adequately staffed to design and review quality standards. Project implementation will also be supported by closer supervision, greater attention to capacity building, increased analytic work, and feedback channels from stakeholders. Decentralized procurement staff will help with risky projects and capacity building in the PIUs from the Country Office, and on-site technical supervision of the projects implementation will be further strengthened. The Bank will provide more procurement and financial management training for the PIUs and the government.

- **Institutional Capacity Building:** Building capacity beyond project activities within individual agencies will be an essential element in achieving results. Helping to strengthen the newly established Waste Management Company, the newly commercialized Azerbaijan Rail Company, the Roads Department, and various Ministries (health, education, labor, justice) rests at the heart of Bank supported projects. This can be accomplished through building the legal and regulatory framework, budgeting and accounting systems, information systems, adequate staffing, training, and study tours. The *Public Sector Capacity Building Project* and *the CAPSAP project* provide cross-cutting support for institutional capacity. Capacity building will also be embedded in the Bank's sector analyt*ic work that will underpin new investme*nts. *IFC would provide* capacity support for financial institutions and key Government ministries through its advisory work in the areas of access to finance and investment climate.

- **Policy reforms to reduce corruption**: Within each of the Bank's activities, we will be looking to identify and support policies or processes that reduce opportunities for corruption. This includes technical solutions such as providing ATM cards for recipients to withdraw social assistance directly without going through a middle man (see Box 3) or introducing methodology of the community based decision making and supervision of small public investments under the AZRIP project.. The Judicial Modernization Project and the Social Protection Project provide solutions for merit based hiring of judges and appropriate remuneration for public employees. Analytical work within individual sectors to provide a framework for new operations would be particularly important. Bank and IFC analytical work will help the Government identify ways to reduce corruption in cross-border activity and the high level policy forum provides a mechanism to focus on critical policy reforms needed. Much of IFC's work in investment climate is designed to increase the transparency of administrative procedures and requirements, which decreases opportunities for rent-seeking; with Doing Business Report having an important role in securing high level political support for change.

- **Promoting transparency and public debate:** The Bank's efforts to build transparency through the Real Estate Registration Project, the Judicial Modernization Project, the CAPSAP project, and the proposed Capital Markets Project, along with the PER in strengthening the use of the MTEF and the policy forum would all promote this objective. However, the progress on improving governance will require strengthened demand for governance and not just the supply, and will require more systematic cooperation with other donors, the civil society, and business organizations. Within most Bank projects, the Bank will seek to promote public awareness, strengthen transparency, and build in mechanisms for consultations with stakeholders. Government publications on activities, policies and achievements would be supported. Success would be measured through improvement of user satisfaction through periodic surveys. Some examples of this would be an annual survey of railway users, a survey of irrigation water users in supported areas, a survey of the satisfaction of farmers with locally available seeds, and surveys of IDPs and rural communities on their satisfaction with supported micro-projects. IFC would complement these efforts through surveys of the private sector, including an update to the SME survey and survey work together with the Government related to tax services and other topics to be selected in the future. Public dissemination and discussion of these surveys would be built into the Bank Group's efforts.

Box 3: Improving Governance in Social Assistance

Targeted Social Assistance was introduced in Azerbaijan in 2006. Since then, Bank projects have assisted the Government in fully automating pension and social assistance systems. The new MIS gathers all information in one place to facilitate accurate planning and transparency. In the past, Pension Fund employees went door to door, collecting money which may or may not have been transferred. Now there is a formula based system that automatically collects funds. Second, the distribution of pensions and social assistance is also automatic through bank transfers. Now, 97% of pensioners have a visa card which they use to withdraw their pensions from ATMs – providing flexibility in terms of time and location, and reducing the opportunity for corruption. Third, the penetration of the economy has also increased. More and more people are opening accounts to receive social assistance as well.

A next step towards increased transparency and reduction in fraud is to consolidate the process. Once people are registered as employees, self-employed or business owners, they are to be registered both for social contribution and tax purposes. Trust in the system has been built by both internal controls and a successful PR campaign which included Public Service Announcements on TV, leaflets and posters in every region.

By the end of 2010, online services will be introduced to further improve transparency. A calculator will be available on an official website where people can work out their pension allowance without the aid of consultants. As time progresses, accounts will be accessible online so that pensioners can monitor their account activity themselves. As a result of these efforts, the State Social Protection Fund (SSPF) was awarded the winner of the European Competition of the International Social Security Association (ISSA) for Efficient Governance in 2010.

77. **Progress on these fronts will takes time and is a medium term challenge.** Nevertheless, over time the proposed governance filter is expected to lead to improvements at all three levels- - project, sectoral, and national.

IV. Implementing the Strategy

A. Bank Group Instruments

78. **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.[7] 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.

79. **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 2: Proposed IDA/IBRD Lending For FY11-12

	New Lending	**Amount**	**Plus Ongoing Program**
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
	TOTAL	**$ 380 million**	**About $1.8 billion undisbursed**

[7] 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.

80. **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 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.

81. **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).

82. **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.

83. **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.

84. **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.

Box 4: 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.

85. **Throughout the Bank and IFC's program, the regional dimension will be considered 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[8]. 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.

[8] The eight member states of CAREC are Azerbaijan, Afghanistan, China, Kazakhstan, Kyrgyz Republic, Tajikistan, Uzbekistan, and Mongolia

Box 5: 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

86. **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.

87. **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.

88. **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.

89. **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.

90. **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.

91. **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

92. **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.

93. **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

94. **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.

95. **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

96. **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

97. **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.

98. **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.

99. **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.

100. **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.

V. Managing Risks

101. **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.

102. **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.

103. **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.

104. **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.

105. **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.

Annex 1: Azerbaijan CPS Results Matrix – FY11 to FY14

Strategic Objective 1: Building a Competitive Non-Oil Economy

Results area 1: Enhancing macro-economic stability and growth policies
Outcome 1: Prudent macroeconomic and fiscal management
Outcome 2: Improved trade policy and institutions
Outcome 3: Sustained improvements in business environment
Outcome 4: More transparency and efficiency in public institutions

Results area 2: Upgrading Key Growth Supporting Infrastructure
Outcome 1: Transport time and vehicle operating costs reduced
Outcome 2: Improved agriculture and irrigation services

Strategic Objective 2: Strengthening Social and Municipal Services

Results Area 3: Improving Social Services
Outcome 1: Strengthened social protection and employment services
Outcome 2: Wider access to health services
Outcome 3: Improved quality of basic and higher education
Outcome 4: Improved living conditions for IDPs
Outcome 5: Improved road safety

Results area 4: Improved municipal and rural services
Outcome 1: more reliable water supply and sanitation
Outcome 2: Improved reliability of solid waste management services
Outcome 3: improved access to rural infrastructure

Cross-Cutting Filter: Governance and Institution-Building to be promoted in all activities

Azerbaijan: FY11-14 CPS Results Matrix

<table>
<tr><th colspan="3">CPS OBJECTIVE 1: BUILDING A COMPETITIVE NON-OIL ECONOMY</th></tr>
<tr><td colspan="3">Key Government Goals:
• Prudent macro-economic management and improved trade policies and institutions
• Strengthen Azerbaijan's role as a regional transport corridor and improve connectivity within Azerbaijan (to be measured by increased transit traffic)
• Improve the business environment for higher non-oil growth (to be measured by the level of growth of SMEs, non-oil exports).
• Build a more efficient and productive rural sector. (to be measured by increase in agriculture exports, farm income)
Key Issues and Obstacles:
• Macro-economic management will require careful balancing of expenditure, exchange rate, and inflation in light oil revenues.
• Trade policies and institutions need to relax the current "control oriented" approach.
• Transport: Roads need improvement and widening. Port and Rail need modernization, intermodal / interoperability.
• Business environment needs strengthening in several areas (tax, customs, licensing etc)
• The financial system remains shallow. The largest bank is state-owned and SMEs have limited credit access
• Agriculture – need to improve agriculture productivity, food certification and processing, irrigation framework, crop and livestock disease risk</td></tr>
<tr><th>CPS RESULT AREAS, OUTCOMES AND TARGETS</th><th>MILESTONES</th><th>WORLD BANK GROUP PROGRAM AND PARTNERS</th></tr>
<tr><td colspan="3">Results Area 1: Enhancing macro-economic stability and growth policies</td></tr>
<tr><td>Outcome 1: Prudent macroeconomic and fiscal management
Primary indicator: reduction in non-oil primary deficit to non-oil GDP (2009 baseline = -38.7%).

Outcome 2: Improved Trade Policy and Institutions

Primary indicator: Growth in the volume of non-oil exports (2009 baseline = $1.2 b).</td><td>- 2011-12 Budgets approved with declining non-oil deficit

- Non-oil export Program endorsed by Government

Progress in tabling proposals for key technical areas of WTO accession</td><td>Ongoing loans: None

New loans: None envisaged (DPL if requested)

AAA and TFs: PPER, Support to Non-oil sector strategy, TA on WTO accession and Trade Policy Support , Possible TA on tax and customs modernization, High Level Forum
IFC: Possible IFC Advisory services on ease of paying taxes and trading across borders</td></tr>
</table>

Results Area 1: Enhancing macro-economic stability and growth policies		
Primary indicator: *Doing Business 2010* baseline = 46/50 days to export/import; *Doing Business 2010* baseline = $2980/$3480 cost to export/import a container). **Outcome 3: Sustained improvement in business environment** -- *Primary Indicator*: Average time of land registration	20% reduction in time (days) and cost (US$) to export/import Average time of land registration drops from 90 to 30 days. Increase in online access to the land register by 100 Notaries Maps covering 4 million ha created Operating Reference System for land registration established and operational	**Ongoing loans**: Real Estate Registration Project
-- *Primary Indicator*: Number of mortgages for access to capital	Increase of the use of mortgages for access to capital and resultant investment from 14,000 in 2009 to 40,000 in 2013	**New loans**: Cap. Market Modernization Project **AAA and TFs:** High Level Forum on Competitiveness
--*Primary Indicator:* Improvements in the business climate, as measured by the Doing Business report and IFC SME survey(s). -- *Primary Indicator:* Number of loans provided to MSMEs.	-- implementation of one-stop shops for business registration and construction permits Number of loans provided to MSMEs increases through IFC client banks from 57,000 in 2009 to at least 85,000 in 2014.	**IFC:** IFC financing to SMEs, in particular through FIs; Advisory to strengthen FIs and financial infrastructure work (credit information sharing and secured lending); Investment climate advisory to reduce regulatory burden to businesses – currently on business registration, permits, and inspections; Advisory to improve corporate governance practices.
-- *Primary Indicator:* Reduction in number and scope of permits and/or licenses (outside construction) and reduction in cost and time required to receive these licenses/permits	-- reduction in number and scope of on-site business inspections and reduction in associated costs by 20 percent	**Key international partners:** SECO is a key Bank and IFC partner, as are the IMF, Netherlands, Austria, and BP.

Results Area 2: Upgrading Key Growth Supporting Infrastructure		
Outcome 4: More Transparency and Efficiency in Public Institutions -- *Primary Indicator*: Use of MTEF enhanced in budget formulation -- *Primary Indicator:* percentage of projects that are government financed which are prepared based on rate of return criteria **--** *Primary Indicator:* number of SOEs using International financial standards -- *Primary Indicator*: 20% increase in user satisfaction of judiciary system	- Summary of budget published At least 50 percent **--** number of ISA based audits conducted by Chamber of Accounts increases from 0 to 5. --number of SOEs using International financial standards increases from 2 to 20 -- 4 or more court houses built, 150 new judges trained	**Ongoing loans:** : Judicial Project, Corp and Public Accounting Project, Real Estate Registration Project, Rail Trade and Transport Facilitation Project, Public Investment Capacity Building Project **IFC:** IFC Investment Climate Advisory activities related to improving private sector awareness of regulatory processes **Key international partners:** EC, USAID
Results Area 2: Upgrading Key Growth Supporting Infrastructure		
Outcome 1: Transport Time and vehicle operating costs reduced -- *Primary Indicator: R*oad user costs ; Baku - Shamakhi road between km 15 - km116 (baseline is $0.40/vehicle km) Improve security for road transport -- *Primary Indicator*: train E-W transit time (2009 baseline = 22hrs, Target = 15 hrs) --*Primary indicator*: locomotive reliability -- *Primary indicator*: volume of rail transit traffic --*Primary Indicator:* ease of crossing border improves (2010 Doing Business: Azerbaijan is ranked 177 out of 183 on ease of trading across borders)	--reduction in road user costs by 20% on the -- upgrade 200Km of highways -- adopt new motor code --Purchase of 50 new electriclocomotives (25 kV) --Renewal of 240 km of rail track on East – West Corridor -- locomotive reliability (measured in distance between failures) increased from 17,000km to 100,000km --New 25 kV electrification installed on E-W rail corridor --Increased from 11 million tons to 23 million tons *E*ase of crossing border improves in DB ranking by 50 positions	**Ongoing loans:** Highways 2 and 3, Rail Trade and Transport Project **AAA and TFs:** Transport Sustainability Review, IDF on transport capacity building **IFC:** Possible Advisory on trade across borders, possible investments in private logistics companies and/or advisory or investment support to private participation in transport infrastructure **Key international partners:** ADB

Results Area 2: Upgrading Key Growth Supporting Infrastructure		
Outcome 2: Improved agriculture and irrigation services **--** *Primary Indicator:* Production marketed for cash -- *Primary Indicator:* Incomes of participating farmers and rural entrepreneurs -- *Primary indicator:* Volume of irrigation water to increase from two irrigations to four irrigations per season	- Increase by 10% (baseline: 60%) -To increase by 20% (baseline: annual income of AZN 11,000) - Collection percentage of Irrigation Fees in supported area to increase substantially (baseline: 10-20%) WUAs that have benefited from rehabilitation carry out most of O&M, (baseline 0, target 45WUAs)	**Ongoing loans:** ADCP2, IDSMIP **New loans**: Irrigation II, ADCP3 **AAA and TFs:** Agriculture & Irrigation Sector Update **IFC:** IFC financing of agribusiness or related sectors (e.g. retail, packaging, logistics), also through FIs. Possible advisory to be determined **Key international partners: USAID**

CPS Objective 2: Strengthening Social and Municipal Services

Key Government Goals

- Continued progress in poverty reduction (both urban and rural)
- Progress in health indicators
- Strengthening of quality of basic education
- Improvement in higher education coverage (15%) and quality
- Improved IDP conditions and livelihoods
- Full coverage of the population to reliable and high quality water supply
- Improved water and solid waste removal services
- Improve rural services
- Address environment legacy issues and prioritize environmental investments

Key Issues and Obstacles:

- Further improvements in social assistance and employment services coverage and quality
- Health facilities need to be upgraded and run in a more effective manner
- Basic education continues to need curriculum reform and streamline the number of schools
- Higher education needs reduced restrictions on entry, merit based entrance, and improved quality
- IDPs not well integrated into society. Need more permanent approach
- The state of the water pipes has significantly deteriorated and need major overhaul
- Waste removal services both limited and informal. Need to formalize approach and bring technology to support.
- Inter-govt budget and administrative processes for strengthening rural investment still weak
- Real commitment to the environmental agenda unclear. Calls for greater consensus building before working forward on pressing issues.

<table>
<tr><th colspan="3">CPS Objective 2: Strengthening Social and Municipal Services</th></tr>
<tr><th>CPS RESULT AREAS
OUTCOMES AND TARGETS</th><th>MILESTONES</th><th>WORLD BANK GROUP
PROGRAM AND PARTNERS</th></tr>
<tr><td colspan="3">Result Area 3: Improving Social Services</td></tr>
<tr><td>Outcome 1: Increased coverage and efficiency of social protection and employment services
Primary Indicator: Coverage of very poor by social assistance

Primary Indicator: # of job seekers served by employment services</td><td>-- Increases from 50% to 70%.

--To increase from 25% to 40%</td><td>Ongoing loans: Social Protection Project. Pensions and Social Assistance Project
AAA: Household survey to assess TSA program coverage of the very poor
AAA: Improved targeted program design and training; TSA linked to social services and employment assistance</td></tr>
<tr><td colspan="3">Result Area 3: Improving Social Services</td></tr>
<tr><td>Outcome 2: Wider access to health services

Primary Indicator: health indicators improve in supported regions (baseline maternal mortality target)

Primary Indicator: Out of pocket expenses decrease (baseline for private out of pocket expenditures as a share of total health expenditures 51.6% in 2008 – target is 30%)</td><td>-- Health facilities upgraded including 2 new hospitals, 3 village hospitals, 9 PHCs

-- Master plan for restructuring health services network developed

-- Share of total health expenditures reaches 30%

--New Human Resources and financing policies adopted

--Health MIS Prototype developed and tested</td><td>Ongoing loans: Health Sector Reform Project

IFC: Possible IFC investment in health care services

Key international partners: WHO, USAID</td></tr>
<tr><td colspan="3">Result Area 3: Improving Social Services</td></tr>
<tr><td>Outcome 3: Improved quality of basic and higher education
Primary Indicator: Improved test scores in basic education (baseline to be determined after first round of national assessments in 2010)</td><td>-- Sample based national assessment in grades 4 and 9 introduced in 2010

-- new curriculum adopted for grades 1-6 by 2014
-- number of schools streamlined/merged
-- # of innovation grants supported.</td><td>Ongoing loans: Education APL2

New loans: Higher Education Project

AAA and TFs: Education Strategy</td></tr>
</table>

CPS Objective 2: Strengthening Social and Municipal Services		
CPS RESULT AREAS OUTCOMES AND TARGETS	**MILESTONES**	**WORLD BANK GROUP PROGRAM AND PARTNERS**
Result Area 3: Improving Social Services		
Outcome 4: Improved living conditions for IDP *Primary Indicator*: Micro-projects achieve their expected results for improvement in living conditions, as rated by community members	-- Over 90% of Micro-projects achieve their expected results for improvement in living conditions, as rated by community members --Number and type of micro-projects -- Improved living conditions of IDPs -- # of IDPs generating self reliant income	**Ongoing loans**: IDP project **New loans**: IDP II Project **AAA and TFs:** Three year program of analytical work on IDPs in the Caucasus **Key international partners:** UNHCR
Outcome 5: Improved Road Safety -- *Primary Indicator:* Road traffic deaths per 10,000 vehicles (baseline = 10 road traffic deaths per 10,000 vehicles in 2009)	--20% reduction in road traffic deaths per 10,000 vehicles --Traffic Safety Strategy implemented	**Ongoing loan**: Highway 2 Project
Result Area 4: Improved Municipal and Rural Services		
Outcome 1: More reliable water supply and sanitation -- *Primary Indicator* Number of people with improved water supply and sanitation (2009 baseline = 100,000) -- *Primary Indicator*: Number of hours of available water service per day (2009 baseline = 3)	-- Target =1,000,000 --Number of hours of available water service per day surpasses over 15.	**Ongoing loans:** National Water Supply Projects 1 & 2 , Solid Waste Project **New loans**: Hovsan Wastewater Outfall Project, possible additional projects in water and sold waste **AAA and TFs:** Water sector note, strategy on municipal solid waste management

CPS Objective 2: Strengthening Social and Municipal Services		
CPS RESULT AREAS OUTCOMES AND TARGETS	**MILESTONES**	**WORLD BANK GROUP PROGRAM AND PARTNERS**
Result Area 4: Improved Municipal and Rural Services		
Outcome 2: Improved reliability of solid waste management services -- *Primary Indicator*: Extend waste collection services to 60% of currently un-served population of Greater Baku	--Target amounts to about 400,000 people. -- Rehabilitate Balakhani landfill (the largest informal waste dump in Baku)	**IFC:** If opportunities for private participation increase, possible role for IFC on advisory or investment, though no agreement on this at present
-- *Primary Indicator:* Improved solid waste disposal management	--Target: closure of 60% of informal dump sites. --9 km of pipe for Hovsan Outfall built	**Key international partners:** ADB, JBIC, KfW, IDB
-- *Primary Indicator*: Environmentally sound disposal of Hovsan wastewater	Implemented.	
Result Area 4: Improved Municipal and Rural Services		
Outcome 3: Improved access to rural infrastructure - *Primary indicator*: number of people with improved access to rural roads (2009 baseline=390,000) -- *Primary indicator:* other improvements in rural infrastructure and sustainable management	--About 800,000 people --number of micro-projects from 2010-2014	**Ongoing loans:** AzRIP, **New loans**: AzRIP

Annex 2: Consultations on the CPS

In July and early August 2010, separate CPS consultations were held in Baku with international donors, civil society representatives, and the business community.

All stakeholders endorsed the main challenges facing Azerbaijan identified within the CPS, as well as, the proposed strategic objectives of the new CPS: (1) Building a Competitive Non-Oil Economy, and (2) Strengthening Social and Municipal Services. It was agreed that while the strategy separates these two strategic objectives for presentational and accountability reasons, in fact they are strongly interlinked and success of the CPS will require simultaneous and comprehensive progress in both directions.

Representatives of civil society and the business community particularly agreed with the emphasis the CPS puts on the cross-cutting "governance filter". They presented specific examples where – particularly in remote regions and for smaller entrepreneurs – lack of transparency and accountability on the part of authorities remains a significant obstacle to achieving economic and social results. At the same time, participants recognized that monitoring and measuring progress in improving governance – and taking practical follow-up measures - would be a challenge. From this perspective, the continuation of institutional capacity building initiated in a number of projects during the current CPS, and increasing the level and scope of analytical work proposed under the new CPS, are steps in the right direction. These measures must, however, be matched by a clear commitment on the part of government counterparts to address issues of governance and corruption as priority factors hindering the growth of the non-oil economy. The government should accept in practice that further development of Azerbaijan will require more bottom-up initiatives by local communities and individual entrepreneurs.

Discussants gave particular attention to the fact that limitations in economic competition and existing regulatory and bureaucratic obstacles weigh heavily on private businesses. These regulatory obstacles are amplified by shortages of professional advisory services and skills (legal, financial, marketing) and properly targeted state support, particularly to businesses organized by women and/or in remote regions.

Participants fully endorsed the diagnosis in the CPS that the current low level of tertiary education (college and vocational) is a major structural deficiency in Azerbaijan, and will require decisive measures on the government side, and deep changes in social attitudes to the benefits of such education.

Discussants agreed that new lending activities should be focused on sectors and institutions with stronger track records of successful implementation of World Bank projects. Simultaneously, it was understood that IFC could invest only in businesses with transparent ownership and financial reporting according to international standards.

In conclusion, many discussants stated that the proposed CPS for FY11-14 is more strategic and realistic that the current one and that the proposed CPS made proper use of the lessons learned. Participants also expressed their desire and commitment to work closely with the WBG on implementation of the CPS. A more efficient formula of such cooperation has to be elaborated.

Annex 3: Gender Issues in Azerbaijan

Overview. Azerbaijan is a middle income country with uneven social and economic gender indicators. The main gender-related issues that negatively affect women are higher unemployment rates, the concentration of female employment in low paid sectors, and low representation in politics. Men are negatively affected by a lower life expectancy by 5 years. In addition, there are social and human rights problems such as gender based violence and human trafficking.

Human development. Life expectancy at birth for women and men was 75 years and 70 years respectively in 2009. Primary school gross enrolment rates are 95% and 98%, secondary school gross enrolment rates are 81% and 85%, and tertiary school gross enrolment rates are 14% and 15% for girls and boys, respectively. Thus, for both males and females the issue in education is not a gender imbalance but the steep drop-off from secondary to tertiary enrolment. Health indicators for women are mixed. The estimated maternal mortality rate is 24 per 100,000 live births for 2009. Among the factors that contribute to the high rates of maternal mortality are high rates of anemia among women, high level of abortions, the poor health care infrastructure, especially in the rural areas, and the inadequate skills of service providers. Within the last five years, the number of live births among boys has risen considerably higher than that of girls (54 percent of boys vs. 46 percent of girls in 2009), likely attributable to sex-selective abortions.

Labor market outcomes. The labor force participation rates for females and males are 67% and 78% respectively. The majority of employed women are employed in services (54%) and agriculture (37%) while employment in industry is negligible for women. Unemployment rates are 10% and 8% for women and men, respectively. An estimated 84% of all females employed are wage and salaried workers while an estimated 14% of all females employed are self-employed. The share of all employed women working in the public sector is estimated at 92% for 2006 compared to 55% of males. While no gender differences in pay for the same work are observed, female employment tends to be concentrated in lower paid sectors. Female employment dominates in education, health and social services. The total wage gap across all sectors is 56.8 percent (percentage of the average monthly salaries of women to average monthly salaries of men).

Entrepreneurship. According to the Enterprise Survey in 2005, an average of 14% women participated in firm ownership. The share was highest in the case of medium firms (16%) and lowest in large firms with 4%.

Political participation. The representation of women in Azerbaijan is low. Only 14 of the 125 members of the National Assembly are now women. There is only one woman out of total 45 MPs in the Parliament of the Nakhichevan Autonomous Republic. At the municipal level, the representation of women is even weaker. The same pattern is found in the executive branch of government. In the Cabinet of Ministers, out of a total of 39 Ministers and Chairpersons of State Committees and Agencies, there is only one female member - the Chairperson of the State Committee on Family, Women, and Children‘s Affairs. At the level of Deputy Minister, only 6 percent are women.

Legal issues. Azerbaijan ratified CEDAW without reservations and the Optional Protocol. The national legislation does not discriminate against women. The Law on Equal Rights and Opportunities was approved by Parliament in late 2006 in a process that spurred intense public discussion with broad participation of various stakeholders including a number of non-government and civil society organizations. In Azerbaijan, like in many other countries, there is a discrepancy between legislative acts and their realization.

Violence and Trafficking. Although violence against women is considered a crime, enforcement is not particularly strong due to the lack of appropriate mechanisms. According to the 2008 US State

Department Report on Trafficking in Persons, Azerbaijan is a source and transit country for men, women, and children trafficked for the purposes of commercial sexual exploitation and forced labor. Azerbaijan is placed on a Tier Two Watch List because it does not fully comply with the minimum standards for the elimination of trafficking, though it is making significant efforts to do so. Azerbaijan prepared and enforced the National Action Plan to Fight Human Trafficking in 2004 and the Law on Human Trafficking in August 2005.

Annex 4: Climate Change in Azerbaijan

According to the 2009 Europe and Central Asia World Bank flagship report "*Managing Uncertainty: Adapting to Climate Change in Europe and Central Asia*" – Azerbaijan is **ranked 7th** overall among ECA countries in terms of the impact-vulnerability index which measures the relative strength of future anticipated climate change relative to today's natural variability.[9]

The main drivers of the vulnerability or impact index are:

- First, its relative *sensitivity* to climate change (ranked 8th highest among the 28 ECA countries) owing to the age of energy sector infrastructure (the power sector is hard pressed to respond to the peaks in electricity demand linked to rising summer temperatures, and is badly in need of upgrade and expansion. Warmer summers, with periods of intense heat, have strained the transmission networks. In addition, extreme weather threatens the ability of networks to function as intended—especially aging and poorly maintained facilities);

- Second, its relative *exposure* to climate change (Azerbaijan ranks 11th out of the 28 ECA countries) owing to the potential impact of catastrophic events (events that threaten an economic loss);

- Thirdly, Azerbaijan has one of the most limited adaptive capacity to the effects of climate change of the ECA countries.

Energy efficiency

Reduced venting and flaring of gas in the oil and gas sector in Azerbaijan represents a major opportunity for more efficient use of energy resources. In 2006, according to estimates by the World Bank Global Gas Flaring Reduction public-private partnership, Azerbaijan, Turkmenistan, and Uzbekistan together flared and vented 7 billion cubic meters of associated gas. Technical and commercial gas transmission and distribution losses are also relatively high in Azerbaijan, presenting further opportunities for improving efficiency.

On the electricity supply side, thermal power plant rehabilitation offers good potential for energy efficiency improvements. Technical and commercial losses of electricity have also been high. Azerbaijan has taken positive measures in this regard through tariff reform and re-metering and payment enforcement.

Government Actions

In 2000-2001 during the II Phase of "First National Communication to the Conference of Parties" the following activities were done:

- Estimation of Green Technologies requirements;
- Increasing of potential for participation in systematic global observation networks;
- Leading of additional scientific researches on vulnerability and adaptation of fish resources and on the processes of desertification as result of climate change.

[9] The vulnerability index combines three sub□indices capturing a country's exposure, sensitivity, and adaptive capacity. The index combines the number of additional hot, dry and wet years; hot, dry and wet summers; and hot, dry and wet winters projected over the 2070–2100 period relative to the 1961–1990 period.

More recently, Azerbaijan adopted additional programs including:

- Governmental program on using alternative and renewable sources of energy;
- National program on regeneration and forestry development;
- Sustainable Development program from ecological point of view;
- Governmental program on hydrometeorology development.

In terms of carbon finance, Azerbaijan has been involved in only a very limited way to date in the global carbon market There are at the moment five CDM projects under development in Azerbaijan (one fugitive emissions project, two supply side energy efficiency projects, one fuel switch project, and one hydro power project), and none of them have yet been registered by the UNFCCC as a CDM project. There are a number of opportunities to explore including thermal plant rehabilitation, heat supply, and to a more limited extent renewable energy. Small scale projects could be found in the rural/agriculture sector e.g. in the form of biogas installations and improved water supply and pumping.

Annex 5: Progress toward the Millennium Development Goals

Millennium Development Goal	*Current status*	*Prospects for achieving Goal by 2015*
Half income poverty	Poverty levels have fallen from about 50 percent in 2001 to about 16 percent in 2008.	**Achieved.** The oil sector boom, combined with broadening of employment-generating economic activities and targeted safety nets policies, has allowed Azerbaijan to achieve this target.
Achieve universal primary education	Enrollment rates in basic education (grades 1-9) are well above 90 percent, although drop-out rates are higher for the poor than for nonpoor. Sector concerns relate more to quality, including the need to build the skills necessary in an increasingly global economy.	**Likely.** The country inherited an education system that provides nearly universal basic education. Sector issues relate more to quality, than to access.
Achieve gender equality in primary education	Surveys show no significant gender differences in enrollment rates for basic education (grades 1-9). Concerns relate more to girls' access to upper secondary and higher education, particularly in rural areas.	**Likely.** Although girls drop out of secondary school earlier than boys and fewer attend post-secondary education, especially in rural areas, there is no evidence of gender inequality at the primary level. Access to higher education is an issue for both genders.
Reduce under-five mortality by two-thirds	According to MOH data, under-five mortality rate declined from 23.1 per 1,000 live births in 2001 to 16.1 in 2007. WHO estimates also show a decline, from 46 in 2005 to 39 per 1,000 live births in 2007. Despite these differences, the degree of decrease is similar, and continues a trend since 1990, when the level was over 100.	**Likely.** Azerbaijan can meet this MDG by 2015, considering the positive trend to date. The Government focuses on strengthening of primary healthcare services including access and quality of care as well as improving reproductive health services in the frame of National Reproductive Health Strategy (2008-20015)
Reduce maternal mortality by three quarters	According to the State Statistical Committee (2009) and WHO, HFA DB 2009, the MMR in 2008 was 26.3 deaths per 100,000 births compared with 37.6 in 2000.	**Possible.** There is a trend that shows decrease on MMR in the country, but it is still three times higher than the target MDG of 9.4 maternal deaths for 2015. The Government is strengthening primary health care with Bank support as part of the new National Reproductive Health Strategy (2008-20015).
Reverse the spread of HIV/AIDS	According to MoH, clinically diagnosed AIDS incidence per 100,000 population has increased over the period from 0.1 in 2001 to 0.7 in 2008. Part of the increase in the HIV prevalence is associated with improved case detection. Both, AIDS incidence and HIV prevalence rates in Azerbaijan favorably compare with corresponding average rates in CIS (2.2. per 100,000 population)	**Possible.** Given the nascent starting point, some rise was inevitable as more information and testing was available, and as Azerbaijan increased its trade links. The MOH has an ongoing HIV/AIDS program supported by the Global Fund and is strengthening its institutional capacity for HIV/AIDS/STI control; and scaling up preventive interventions, particularly in vulnerable groups.

Millennium Development Goal	***Current status***	***Prospects for achieving Goal by 2015***
Reverse the spread of tuberculosis	The prevalence of tuberculosis dropped over the period from 2001 to 2005 (from 180.4 to 63.4 per 100,000 population), but since then has slowly increased, reaching 100.8 per 100,000 population in 2008. In 2004, the National Tuberculosis Program (NTP) adopted full DOTS coverage to improve disease registration and control.	**Possible.** Notwithstanding the recent rise in tuberculosis (which may stem in part to improved registration) tuberculosis treatment and success rate are improving. At the same time, a troubling trend is the rise of drug resistant TB among new cases. TB control program efforts should be intensified and carefully monitored in order to achieve the Global TB Control Targets by year 2015.
Ensure environmental sustainability (including halving the proportion of people without access to safe water)	According to available estimates, around 76 percent of all households have access to improved drinking water source – 93 percent in urban areas and 58 percent in rural areas. On other areas, the Government has recognized the importance of cleaning up environmental hazards of the FSU period, but has yet to take concrete steps in this regard.	**Possible to unlikely.** The Government, particularly with World Bank and ADB support, has launched a major effort to improve the access and quality of drinking water throughout Azerbaijan. However, this program has been slow to be implemented. On cleaning up environmental legacy issues, increased Government commitment and focus will be needed.

Annex 6: One Bank – IFC and IDA/IBRD Integrated Programs

The IFC and IDA/IBRD have continued to strengthen their integration in Azerbaijan, including through decentralization of staff to the field. Particular areas of integration and coordination expected to have a high pay-off during the CPS period include:

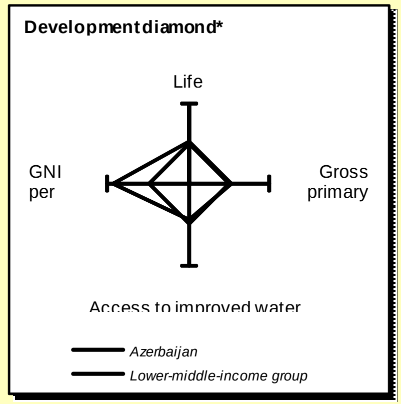
- The Financial Sector: IFC will continue to support the growth and consolidation of the banking sector and the provision of finance for SMEs and microenterprises through financial intermediaries. IDA/IBRD will complement this through supporting the development of the capital markets through the proposed Capital Markets Modernization Project. IFC and the Bank will support these efforts through coordinated analytic work including IDA/IBRD regular financial sector assessments and policy dialogues with the Central Bank and IFC advisory work on key issues for banks, such as credit information sharing, real estate appraisal, and the management of non-performing loans. IFC will work to identify potential areas for advisory on capital markets development, as per the Government's request.
- The Business Environment: IFC will continue to promote the implementation of improvements in processes for permits and inspections, with the possible addition of additional areas such as the ease of paying taxes and trading across borders. The Bank will complement these efforts with analytic work on trade and supporting a regular High Level Policy Forum to help the Government develop ways of further strengthening exports and competitiveness. Improvements will be measured through various surveys including BEEPs, Doing Business and a possible follow-up IFC SME Survey.
- Corporate Governance: The Bank and IFC will continue to cooperate closely particularly through the Bank's ongoing Corporate and Public Accounting Project, and a possible new ROSC on accounting and auditing, and the IFC completing a comprehensive advisory project on corporate governance in the private sector.
- Agriculture: IDA/IBRD will support the further development of the agriculture sector through a new agriculture development and credit project, as well as an agriculture review and analytic work on trade issues related to agriculture such as quality standards. IFC will complement this by considering financing agribusiness both directly and through financial institutions. It may also consider launching advisory services to improve competitiveness, including on issues such as food safety and agrifinance.

Annex 7: Standard CPS Annexes

Azerbaijan at a glance

9/2/10

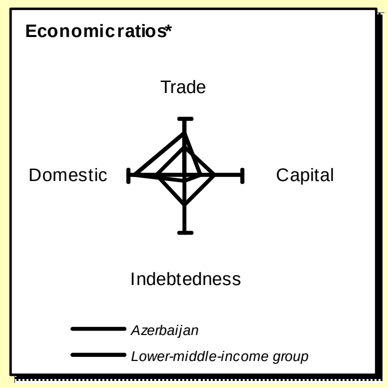
POVERTY and SOCIAL	Azerbaijan	Europe & Central Asia (ECA)	Lower middle-income (LIC)
2009			
Population, mid-year *(millions)*	8.8	441	3,702
GNI per capita *(Atlas method, US$)*	4,820	7,418	2,078
GNI *(Atlas method, US$ billions)*	42.6	3,274	7,692
Average annual growth, 2002-09			
Population *(%)*	1.1	0.1	1.2
Labor force *(%)*	2.2	1.0	1.6
Most recent estimate (latest year available, 2002-08)			
Poverty *(% of population below national poverty line)*	15.8	..	..
Urban population *(% of total population)*	52	64	41
Life expectancy at birth *(years)*	70	70	68
Infant mortality *(per 1,000 live births)*	32	21	46
Child malnutrition *(% of children under 5)*	8	..	26
Access to an improved water source *(% of population)*	78	95	86
Literacy *(% of population age 15+)*	100	98	83
Gross primary enrollment *(% of school-age population)*	116	98	109
Male	117	99	112
Female	115	97	106



KEY ECONOMIC RATIOS and LONG-TERM TRENDS

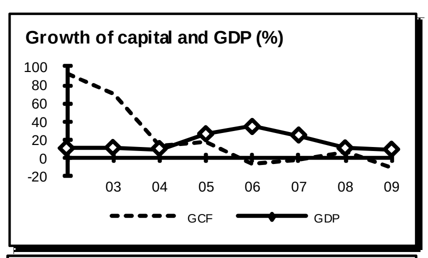
	1988	1998	2008	2009
GDP *(US$ billions)*	..	4.4	46.4	43.1
Gross capital formation/GDP	..	33.4	19.8	18.9
Exports of goods and services/GDP	..	22.7	69.3	53.1
Gross domestic savings/GDP	..	1.5	61.0	48.4
Gross national savings/GDP	..	2.7	55.3	42.5
Current account balance/GDP	..	-30.7	35.5	23.6
Interest payments/GDP	..	0.5	0.7	0.7
Total debt/GDP	..	15.9	8.8	11.3
Total debt service/exports	..	2.1	0.9	1.6
Present value of debt/GDP	..	..	7.5	8.6
Present value of debt/exports	..	..	9.1	15.5

	1988-98	1998-08	2008	2009	2010-13
(average annual growth)					
GDP	-10.6	15.9	10.8	9.3	3.8
GDP per capita	-11.7	14.9	9.6	8.4	3.0
Exports of goods and services	..	19.9	6.8	7.2	2.4

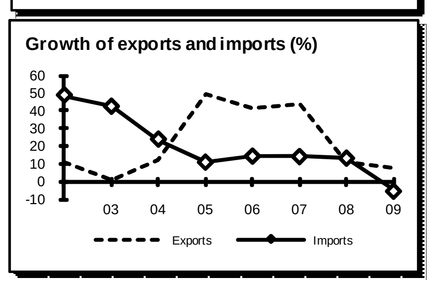


STRUCTURE of the ECONOMY

	1988	1998	2008	2009
(% of GDP mp)				
Agriculture	..	18.9	5.6	6.7
Industry	..	36.5	65.5	57.4
Manufacturing	..	8.7	4.7	4.0
Services	..	44.6	28.9	35.9
Household final consumption expenditure	..	83.3	27.5	37.3
General gov't final consumption expenditure	..	15.2	11.5	14.3
Imports of goods and services	..	54.5	18.7	18.3



	1988-98	1998-08	2008	2009
(average annual growth)				
Agriculture	-5.7	7.0	6.1	3.5
Industry	-5.5	17.8	9.9	10.6
Manufacturing	-15.4	3.7	7.1	-12.6
Services	-7.7	9.8	13.7	9.1
Household final consumption expenditure	-3.8	11.4	15.4	4.0
General gov't final consumption expenditure	-2.7	14.7	29.5	5.6
Gross capital formation	57.0	23.4	7.7	-10**
Imports of goods and services	..	18.1	10.6	-5.3



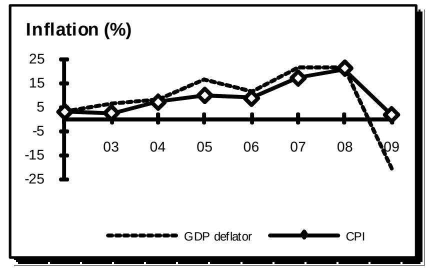
Note: 2009 data are estimates.

This table was produced from the ECSPE and the DEC databases; ECA and LIC data are for 2008.

* The diamonds show four key indicators in the country (in bold) compared with its income-group average. If data are missing, the diamond will be incomplete. (**) Estimate.

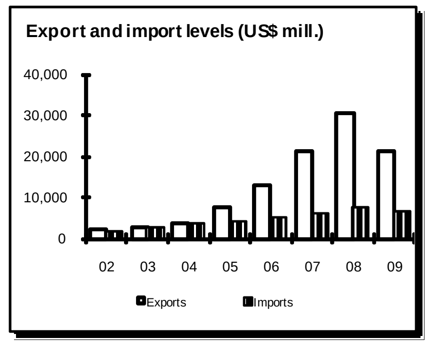
PRICES and GOVERNMENT FINANCE

	1988	1998	2008	2009
Domestic prices				
(% change)				
Consumer prices	..	-0.8	20.8	1.5
Implicit GDP deflator	..	-1.0	20.9	-21.2
Government finance				
(% of GDP, includes current grants)				
Current revenue	..	19.8	51.1	41.6
Current budget balance	..	-2.1	33.2	19.5
Overall surplus/deficit	..	-3.9	20.8	6.8



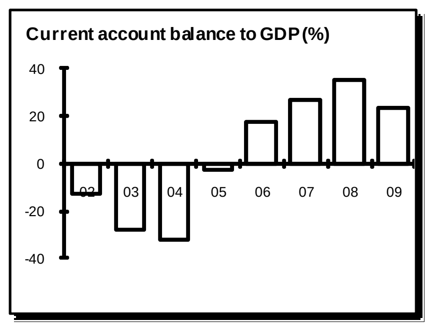
TRADE

	1988	1998	2008	2009
(US$ millions)				
Total exports (fob)	..	678	30,586	21,097
Crude oil	..	207	26,978	18,348
Petroleum products	..	243	2,165	1,622
Manufactures	..	125	1,065	984
Total imports (cif)	..	1,724	7,575	6,514
Food	..	175	922	737
Fuel and energy	..	356	1,064	700
Capital goods	..	435	3,424	2,910
Export price index *(2000=100)*	..	57	321	210
Import price index *(2000=100)*	..	102	125	120
Terms of trade *(2000=100)*	..	55	257	175



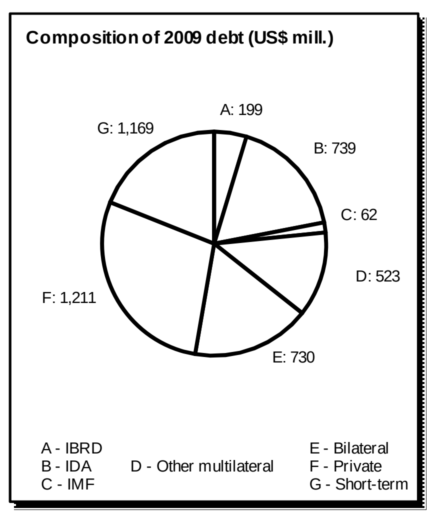
BALANCE of PAYMENTS

	1988	1998	2008	2009
(US$ millions)				
Exports of goods and services	..	1,009	32,133	22,873
Imports of goods and services	..	2,425	11,464	10,403
Resource balance	..	-1,415	20,669	12,470
Net income	..	-13	-5,266	-3,519
Net current transfers	..	64	1,050	776
Current account balance	..	-1,364	16,454	10,173
Financing items (net)	..	1,303	-4,404	-1,533
Changes in net reserves	..	61	-12,050	-8,640
Memo:				
Reserves including gold *(US$ millions)*	..	449	6,467	5,364
Conversion rate *(DEC, local/US$)*	..	0.8	0.8	0.8



EXTERNAL DEBT and RESOURCE FLOWS

	1988	1998	2008	2009
(US$ millions)				
Total debt outstanding and disbursed	..	709	4,315	4,865
IBRD	..	0	78	199
IDA	..	141	698	739
Total debt service	..	24	292	397
IBRD	..	0	3	5
IDA	..	1	13	14
Composition of net resource flows				
Official grants	..	36	108	80
Official creditors	..	73	213	296
Private creditors	..	67	350	335
Foreign direct investment (net inflows)	..	1,023	-542	142
Portfolio equity (net inflows)	..	0	0	0
World Bank program				
Commitments	..	40	638	684
Disbursements	..	21	106	166
Principal repayments	..	0	8	9
Net flows	..	21	98	158
Interest payments	..	1	8	10
Net transfers	..	20	90	147



Note: This table was produced from the ECSPE and DEC databases. 12/9/09

CAS Annex B2 - Azerbaijan
Selected Indicators* of Bank Portfolio Performance and Management
As Of Date 8/19/2010

Indicator	2008	2009	2010	2011
Portfolio Assessment				
Number of Projects Under Implementation [a]	24	24	19	19
Average Implementation Period (years) [b]	2.5	3.2	3.5	3.6
Percent of Problem Projects by Number [a, c]	16.7	12.5	15.8	15.8
Percent of Problem Projects by Amount [a, c]	4.7	5.4	22.4	22.4
Percent of Projects at Risk by Number [a, d]	16.7	16.7	15.8	15.8
Percent of Projects at Risk by Amount [a, d]	4.7	7.6	22.4	22.4
Disbursement Ratio (%) [e]	12.2	6.5	9.8	0.4
Portfolio Management				
CPPR during the year (yes/no)				
Supervision Resources (total US$)				
Average Supervision (US$/project)				

Memorandum Item	Since FY 80	Last Five FYs
Proj Eval by OED by Number	18	5
Proj Eval by OED by Amt (US$ millions)	538.9	113.3
% of OED Projects Rated U or HU by Number	27.8	0.0
% of OED Projects Rated U or HU by Amt	23.6	0.0

a. As shown in the Annual Report on Portfolio Performance (except for current FY).
b. Average age of projects in the Bank's country portfolio.
c. Percent of projects rated U or HU on development objectives (DO) and/or implementation progress (IP).
d. As defined under the Portfolio Improvement Program.
e. Ratio of disbursements during the year to the undisbursed balance of the Bank's portfolio at the beginning of the year: Investment projects only.
* All indicators are for projects active in the Portfolio, with the exception of Disbursement Ratio, which includes all active projects as well as projects which exited during the fiscal year.

CAS Annex B3 - IBRD/IDA
Program Summary

Proposed IBRD/IDA Base-Case Lending Program [a]

Fiscal year	*Proj ID*	*US$(M)*	*Strategic Rewards b (H/M/L)*	*Implementation b Risks (H/M/L)*
2011 -12	Capital Markets Modernization Project		M	L
	AZRIP II		H	L
	Hovsan Wastewater Outfall Project		H	M
	Judicial AF		H	M
	IRRIGATION & DRAINAGE III		H	L
	HIGHER EDUCATION		H	M
	ADCP III		M	L
	IDP II		H	L
	Result	**About $300 m IBRD**		
		Plus about $80 m IDA		
2013 – 14	TBD			

Azerbaijan - Key Economic Indicators

	Actual			Estimate			Projected		
Indicator	2005	2006	2007	2008	2009	2010	2011	2012	2013
National accounts (as % of GDP)									
Gross domestic product[a]	100	100	100	100	100	100	100	100	100
Agriculture	10	8	7	6	7	6	7	7	7
Industry	64	69	71	70	62	65	63	63	62
Services	27	24	22	24	31	28	30	30	31
Total Consumption	48	42	39	35	51	47	51	53	56
Gross domestic fixed investment	41	30	21	20	19	18	18	17	16
Government investment	4	8	10	15	12	10	10	9	8
Private investment	37	22	12	5	6	8	8	8	8
Exports (GNFS)[b]	63	67	68	69	53	58	56	54	53
Imports (GNFS)	53	39	29	25	23	22	24	25	25
Gross domestic savings	52	58	61	65	49	53	49	47	44
Gross national savings[c]	43	48	49	56	42	45	40	39	35
Memorandum items									
Gross domestic product (US$ million at current prices)	13245	20982	33049	46258	43116	50010	51549	55225	58516
GNI per capita (US$, Atlas method)	1270	1890	2710	3830	4820	5040	4950	5340	5530
Real annual growth rates (%, calculated from 03 prices)									
Gross domestic product at market prices	26.4	34.5	25.0	10.8	9.3	2.3	0.9	3.9	3.0
Gross Domestic Income	50.0	50.4	40.4	27.5	-24.5	3.5	7.8	8.0	8.9
Real annual per capita growth rates (%, calculated from 03 prices)									
Gross domestic product at market prices	25.1	33.0	23.6	9.6	8.5	1.5	0.1	3.1	2.2
Total consumption	20.2	37.8	15.8	13.7	0.8	4.5	8.0	6.9	4.8
Private consumption	18.8	36.8	14.3	14.1	-0.7	5.6	10.3	8.6	5.7
Balance of Payments (US$ millions)									
Exports (GNFS)[b]	8332	13955	22517	32133	22873	29016	28715	30004	31210
Merchandise FOB	7649	13015	21269	30586	21097	27024	26411	27358	28193
Imports (GNFS)[b]	7003	8133	9424	11464	9903	11173	12333	13590	14689
Merchandise FOB	4350	5269	6045	7575	6514	7402	8194	9032	9858
Resource balance	1329	5822	13093	20669	12970	17843	16383	16415	16521
Net current transfers	484	566	1005	1050	-62	310	710	910	110
Current account balance	167	3708	9019	16454	10137	13731	11448	11965	11337
Net private foreign direct investment	459	-1289	-5035	-542	152	1245	1667	1842	1879
Long-term loans (net)	142	69	66	2262	568	1099	376	397	476
Official	34	220	185	131	393	1040	461	368	517
Private	108	-151	-119	2131	175	60	-84	29	-40
Other capital (net, incl. E&O)[e]	-608	-1145	-2269	-15715	-11830	-13529	-12430	-12353	-13600
Change in reserves[d]	-161	-1342	-1781	-2460	972	-2547	-1062	-1851	-92
Memorandum items									
Resource balance (% of GDP)	10.0	27.7	39.6	44.7	30.1	35.7	31.8	29.7	28.2
Real annual growth rates (YR03 prices)									
Merchandise exports (FOB)	52.7	39.3	21.0	25.1	46.6	4.0	-3.8	1.9	2.4
Primary	47.5	46.3	54.7	4.3	9.5	3.3	-4.9	1.1	1.5
Manufactures	72.1	-7.0	21.5	29.7	35.0	17.3	13.6	13.6	13.7
Merchandise imports (CIF)	21.4	19.2	13.9	32.1	63.4	19.5	9.1	9.4	9.1

(Continued)

Azerbaijan - Key Economic Indicators
(Continued)

Indicator	Actual			Estimate			Projected		
	2005	2006	2007	2008	2009	2010	2011	2012	2013
Public finance (as % of GDP at market prices)[e]									
Current revenues	25.2	27.2	28.2	57.5	41.6	48.1	48.7	47.1	46.8
Current expenditures	18.2	18.4	16.2	15.6	22.0	21.2	21.3	21.0	20.8
Current account surplus (+) or deficit (-)	7.0	8.8	12.0	41.9	19.5	26.9	27.4	26.1	26.0
Capital expenditure	4.5	9.0	9.7	15.0	12.7	11.6	11.4	10.8	9.3
Foreign financing	0.3	1.4	1.4	0.7	0.9	2.1	0.9	0.7	0.9
Monetary indicators									
M2/GDP	14.7	18.4	20.8	27.8	24.5	25.0	24.9	25.0	25.0
Growth of M2 (%)	22.5	86.8	71.4	79.4	-0.3	21.1	6.4	7.8	7.2
Private sector credit growth / total credit growth (%)	108.4	90.0	97.3	-105.9	148.7	118.5	112.9	97.2	87.4
Price indices(YR03 =100)									
Merchandise export price index	172.5	210.7	212.6	213.6	262.9	329.0	417.9	536.6	699.2
Merchandise import price index	110.1	111.9	113.7	104.7	99.6	96.0	93.3	90.7	88.6
Merchandise terms of trade index	156.6	188.3	187.1	204.0	264.1	342.5	447.7	591.5	789.2
Real exchange rate (US$/LCU)[f]	102.3	111.2	121.2	139.2	152.4	..	..	..	..
Consumer price index (p.a., % change)	5.5	11.4	19.5	15.4	0.7	5.0	4.5	4.5	4.5
GDP deflator (% change)	16.1	11.3	21.0	20.9	-6.7	14.4	2.6	3.5	3.3

a. GDP at factor cost
b. "GNFS" denotes "goods and nonfactor services."
c. Includes net unrequited transfers excluding official capital grants.
d. Includes use of IMF resources.
e. Consolidated central government.
f. "LCU" denotes "local currency units." An increase in US$/LCU denotes appreciation.

Azerbaijan - Key Exposure Indicators

Indicator	Actual 2005	2006	2007	Estimated 2008	2009	2010	Projected 2011	2012	2013
Total debt outstanding and disbursed (TDO) (US$m)[a]	2043	2586	3593	4309	4859	6027	6527	6906	7371
Net disbursements (US$m)[a]	300	587	899	2241	549	1184	516	393	474
Total debt service (TDS) (US$m)[a]	234	271	202	263	379	467	569	690	641
Debt and debt service indicators (%)									
TDO/XGS[b]	22.6	17.4	15.1	12.8	20.4	20.7	21.3	21.5	21.8
TDO/GDP	15.4	12.3	10.9	9.3	11.3	11.8	12.1	11.9	12.0
TDS/XGS	2.6	1.8	0.8	0.8	1.6	1.6	1.9	2.1	1.9
Concessional/TDO	52.8	44.8	35.7	34.1	33.3	29.9	29.4	28.8	27.2
IBRD exposure indicators (%)									
IBRD DS/public DS	0.0	0.9	0.8	1.3	0.9	1.5	1.8	8.7	13.7
Preferred creditor DS/public DS (%)c	62.6	50.4	51.2	31.2	29.1	25.6	21.4	27.0	35.1
IBRD DS/XGS	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.2	0.2
IBRD TDO (US$m)[d]	0	5	21	78	146	314	570	835	1179
Of which present value of guarantees (US$m)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Share of IBRD portfolio (%)	0	0	0	0	0	0	1	1	1
IDA TDO (US$m)[d]	501	583	660	698	712	744	774	800	817
IFC (US$m)									
Loans	30.8	8.6	29.6	42.6	54.1	68.4	..	..	..
Equity and quasi-equity /c	3.0	1.6	4.1	7.4	7.4	7.4	..	..	..
MIGA									
MIGA guarantees (US$m)	0	0	0	0	0	0	..	..	..

a. Includes public and publicly guaranteed debt, private nonguaranteed, use of IMF credits and net short-term capital.

b. "XGS" denotes exports of goods and services, including workers' remittances.

c. Preferred creditors are defined as IBRD, IDA, the regional multilateral development banks, the IMF, and the Bank for International Settlements.

d. Includes present value of guarantees.

e. Includes equity and quasi-equity types of both loan and equity instruments.

Azerbaijan Social Indicators

	Latest single year			Same region/income group	
	1980-85	1990-95	2002-08	Europe & Central Asia	Lower-middle-income
POPULATION					
Total population, mid-year (millions)	6.7	7.7	8.7	443.3	3,703.0
Growth rate (% annual average for period)	1.6	1.4	1.0	0.1	1.2
Urban population (% of population)	53.5	52.2	51.9	63.7	41.3
Total fertility rate (births per woman)	2.9	2.3	2.3	1.8	2.5
POVERTY					
(% of population)					
National headcount index*	..	68.1	15.8	..	..
Urban headcount index	..	..	..	..	..
Rural headcount index	..	..	..	..	..
INCOME					
GNI per capita (US$)**	..	400	4,280	7,350	2,073
Consumer price index (2000=100)	..	69	194	133	126
Food price index (2000=100)	..	95	110	..	..
INCOME/CONSUMPTION DISTRIBUTION					
Gini index	..	35.0	16.8	..	..
Lowest quintile (% of income or consumption)	..	6.9	13.3	..	..
Highest quintile (% of income or consumption)	..	42.0	30.2	..	..
SOCIAL INDICATORS					
Public expenditure					
Health (% of GDP)	..	..	1.0	3.7	1.8
Education (% of GDP)	..	3.5	1.9	4.5	4.0
Net primary school enrollment rate					
(% of age group)					
Total	..	89	96	92	87
Male	..	89	97	93	89
Female	..	89	95	92	86
Access to an improved water source					
(% of population)					
Total	..	70	78	95	86
Urban	..	85	95	99	94
Rural	..	53	59	88	81
Immunization rate					
(% of children ages 12-23 months)					
Measles	..	64	66	96	81
DPT	..	74	70	96	79
Child malnutrition (% under 5 years)	..	..	8	..	25
Life expectancy at birth					
(years)					
Total	65	65	70	70	68
Male	62	61	68	66	66
Female	69	70	73	75	70
Mortality					
Infant (per 1,000 live births)	81	75	32	19	45
Under 5 (per 1,000)	102	93	36	22	64
Adult (15-59)					
Male (per 1,000 population)	262	216	181	305	204
Female (per 1,000 population)	127	96	110	126	138
Maternal (modeled, per 100,000 live births)	..	..	82	45	370
Births attended by skilled health staff (%)	..	..	88	97	65

Note: 0 or 0.0 means zero or less than half the unit shown. Net enrollment rate: break in series between 1997 and 1998 due to change from ISCED76 to ISCED97. Immunization: refers to children ages 12-23 months who received vaccinations before one year of age or at any time before the survey. (*) Living Standards measurement Survey 2008/9. (**) GNI per capita for 2009.

World Development Indicators database, World Bank - 23 April 2010.

Annex B3

Azerbaijan: IFC Investment Operations Program

	2006	2007	2008	2009	2010
Commitments (US$m)					
Gross	13.00	31.00	28.00	46.00	30.00
Net*	13.00	31.00	28.00	46.00	30.00
Net Commitments by Sector (%)					
Financial Markets	100%	42%	90%	100%	100%
General Manufacturing		58%	10%		
Total	100%	100%	100%	100%	100%
Net Commitments by Investment Instrument (%)					
Equity	17%	2%	10%		
Loan	83%	68%	60%	60%	67%
Guarantee		11%	12%	19%	33%
Quasi-Equity**		19%	18%	21%	
Total	100%	100%	100%	100%	100%

** IFC's Own Account only

** includes quasi-equity loan type

CAS Annex B4 - Summary of Nonlending Services - Azerbaijan
As Of Date
August 2010

Product	*Completion FY*	*Cost (US$000)**	*Audience[a]*	*Objective[b]*
Recent completions				
Accounting Development TA	FY07	286	G, B	K, PS
Structural Reform Support	FY07-09	200pa	G, B	K, PS
Educational Review	FY08	356	G, B	K
Corporate Bond TA (FIRST)	FY08	183	G	K, PS
Advice on Insurance Law TA (FIRST)	FY08	58	G	K, PS
Country Procurement Assessment Review	FY09	128	G, B	K, PD, PS
Corporate Governance Assessment (ROSC)	FY09	64	G, D, B, PD	K, PD, PS
Financial Sector Advisory TA	FY09	133	G, B	K, PS
SOE Governance Assessment	FY10	67	G, D, B, PD	K, PD, PS
SOCAR Gas Flaring Reduction TA	FY10	205	G, B	K, PS
Country Economic Memorandum	FY10	555	G, D, B, PD	K, PD, PS
Poverty Assessment (programmatic)	Annual	120pa	G, D, B, PD	K, PD, PS
Public Expenditure Review (programmatic)	Annual	100pa	G, D, B, PD	K, PD, PS
Presidential Forum	FY10	147	G, D, B, PD	K, PD, PS
Underway/Panned				
Public Expenditure Reviews (programmatic)	Annual	100pa	G, D, B, PD	K, PD, PS
Poverty Assessment (programmatic)	Annual	120pa	G, D, B, PD	K, PD, PS
Economic and Development Policy Dialogue	Annual	150pa	G, B	K, PS
Financial Sector Monitoring	Annual	75pa		
Environmental Investment Priorities	FY11	162	G, D, B, PD	K, PD, PS
Crisis Impact on IDPs	FY11	55	G, D, B, PD	K, PD, PS
Capital Market Development TA (FIRST)	FY11	123	G	K, PS
Education Review	FY11			
Agriculture and Irrigation Strategy	FY11-12			
Solid Waste Management Strategy	FY11-12			
Transport Sector Strategy	FY12-13			
Health Trends and Strategy	FY13-14			
Fiduciary Follow-up (CPAR, ROSC etc)	FY12-14			
Jobs and Growth Report	FY12-13			
Climate Change Adaptation	FY12-14			

a. Government, donor, Bank, public dissemination.
b. Knowledge generation, public debate, problem-solving.
* Costs for outer years are estimated.

International Finance Corporation

Statement of IFC's Committed and Outstanding Portfolio

Amounts in US Dollar Millions

Accounting Date as of : 08/31/2010

Region(s):Southern Europe and Central Asia

Country(s) : Azerbaijan

Commitment Fiscal Year	Institution Short Name	LN Cmtd - IFC	ET Cmtd - IFC	QL + QE Cmtd - IFC	GT Cmtd - IFC	ALL Cmtd - IFC	ALL Cmtd - Part	LN Out - IFC	ET Out - IFC	QL + QE Out - IFC	GT Out - IFC	ALL Out - IFC	ALL Out - Part
	A&DA Holding	0	0.03	0	0	0.03	0	0	0.02	0	0	0.02	0.00
2007	ADA-Ticaret	10.91	0	5.97	0	16.88	0	10.91	0	5.97	0	16.88	0.00
2003/ 2006/ 2007/ 2008/ 2009	AccessBank	18.86	4.41	0	0	23.27	0	15.10	4.36	0	0	19.46	0.00
2004	BTC Pipeline	20.45	0	0	0	20.45	17.03	20.45	0	0	0	20.45	17.03
1998/ 2003/ 2006/ 2007/ 2008/ 2009/ 2010/ 2011	Azerigazbank	1.00	3.06	10.00	3.31	17.37	0	1.00	3.06	5.00	3.31	12.37	0.00
2008	Azel	1.24	0	1.00	0	2.24	0	1.24	0	1.00	0	2.24	0.00
2008/ 2009	Credagro	4.23	0	4.00	0	8.23	0	2.93	0	4.00	0	6.93	0.00
2009/ 2010	DemirBank AZE	5.00	0	0	3.23	8.23	0	5.00	0	0	3.23	8.23	0.00
1998/ 2003/ 2007	Rabitabank	0	0	0.75	0	0.75	0	0	0	0.75	0	0.75	0.00
2007/ 2008/ 2009/ 2010/ 2011	Respublika	23.13	0	0	1.03	24.15	0	3.13	0	0	1.03	4.15	0.00
2006/ 2007/ 2008/ 2009/ 2010	UniBank	3.63	0	0	1.52	5.15	0	3.63	0	0	1.52	5.15	0.00
Total Portfolio		**88.43**	**7.50**	**21.72**	**9.10**	**126.75**	**17.03**	**63.37**	**7.44**	**16.72**	**9.10**	**96.63**	**17.03**

CAS Annex B8 - Azerbaijan

Operations Portfolio (IBRD/IDA and Grants)

As Of Date 8/19/2010

Closed Projects **24**

IBRD/IDA *	
Total Disbursed (Active)	405.32
of w hich has been repaid	0.00
Total Disbursed (Closed)	280.93
of w hich has been repaid	32.59
Total Disbursed (Active + Closed)	686.25
of w hich has been repaid	32.59
Total Undisbursed (Active)	1,838.10
Total Undisbursed (Closed)	0.00
Total Undisbursed (Active + Closed)	1,838.10

Active Projects

		Last PSR Supervision Rating			Original Amount in US$ Millions					Difference Expected a Disburse
Project ID	**Project Name**	**Development Objectives**	**Implementation Progress**	**Fiscal Year**	**IBRD**	**IDA**	**GRANT**	**Cancel.**	**Undisb.**	**Orig.**
P090887	ADCP-II	S	S	2006		29.2			3.334745	0.0829783
P110679	ARP/ II-INTEGRAT. SOLID	S	MS	2008	29.5				28.50848	10.448475
P118023	Azerbaijan Highway III	#	#	2010	171.6	70			241.9751	3.3333333
P099924	CORP & PUB SEC ACCT -	MU	MU	2008		11			10.27054	5.9333333
P094220	Health Sector Reform Proje	S	S	2006		50			39.75633	17.782137
P094488	Highway 2	S	MS	2006	613	62			471.4496	-10.51552
P089751	IDP ECON DEVT SUPPOF	S	S	2005		26.5		0.013391	10.10927	-4.470251
P008286	IRRIG DIST SYS & MGMT	S	S	2003		35			0.136843	-4.542592
P099201	JUDICIAL MOD	MS	MS	2006		21.6			15.17096	13.942673
P096213	NATIONAL WATER SUPPI	U	U	2007	230				221.0603	154.39368
P049892	PENSION & SOC ASST	S	S	2004		10			2.480456	-6.838806
P083341	POWER TRANSMISSION	S	S	2005	48				10.24291	10.242908
P115396	Public Investment Capacity	S	S	2009		8			7.765912	2.0333333
P083108	RAIL TRADE AND TRANSI	S	S	2008	450				447.375	116.04167
P100582	REAL ESTATE REG.	S	MS	2007	30				23.44189	7.4752281
P076234	RURAL INVSMT (AZRIP)	S	S	2004		30		0.000006	5.769026	-9.629457
P105116	SOCIAL PROTECTION DE'	MS	MS	2008		26.7			22.58709	17.753569
P102117	Second Education Sector [	MS	MS	2008		25			22.1051	5.9079508
P109961	Second National Water Su|	MU	MU	2008	230	30			254.5644	80.926734
Overall Result					1802.1	435		0.013397	1838.104	410.30137